THE XYZs OF

CALIFORNIA SCHOOL DISTRICT DEBT FINANCING

Third Edition

Greg Harrington
John Hartenstein
Donald Field

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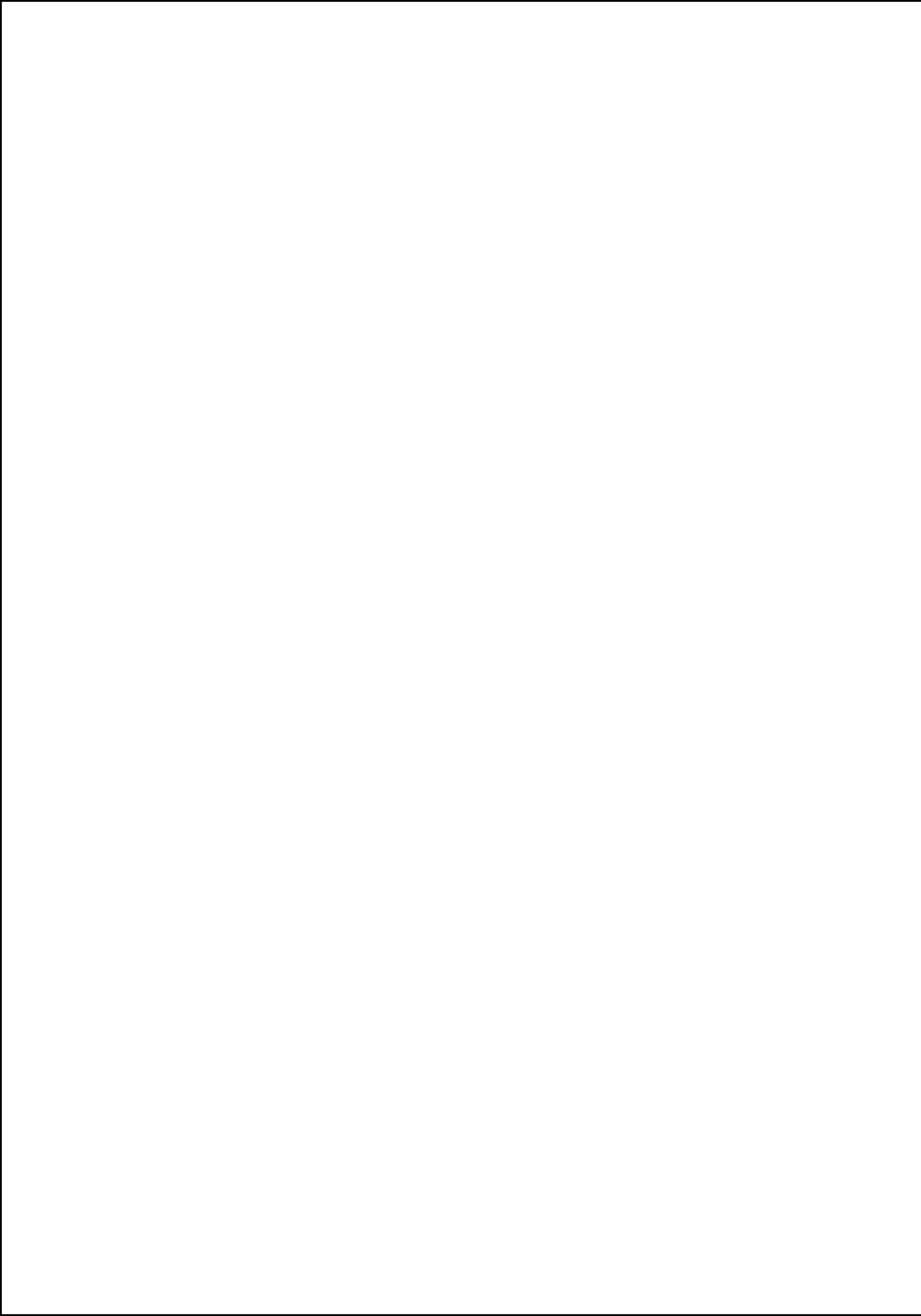

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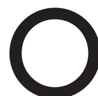

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DISCLAIMER: Nothing contained in this guidebook should be construed or relied upon as legal advice. Instead, this guidebook is intended to serve as an overview of the public finance techniques most often used by school districts in California, from which better informed requests for advice, legal and financial, can be formulated.

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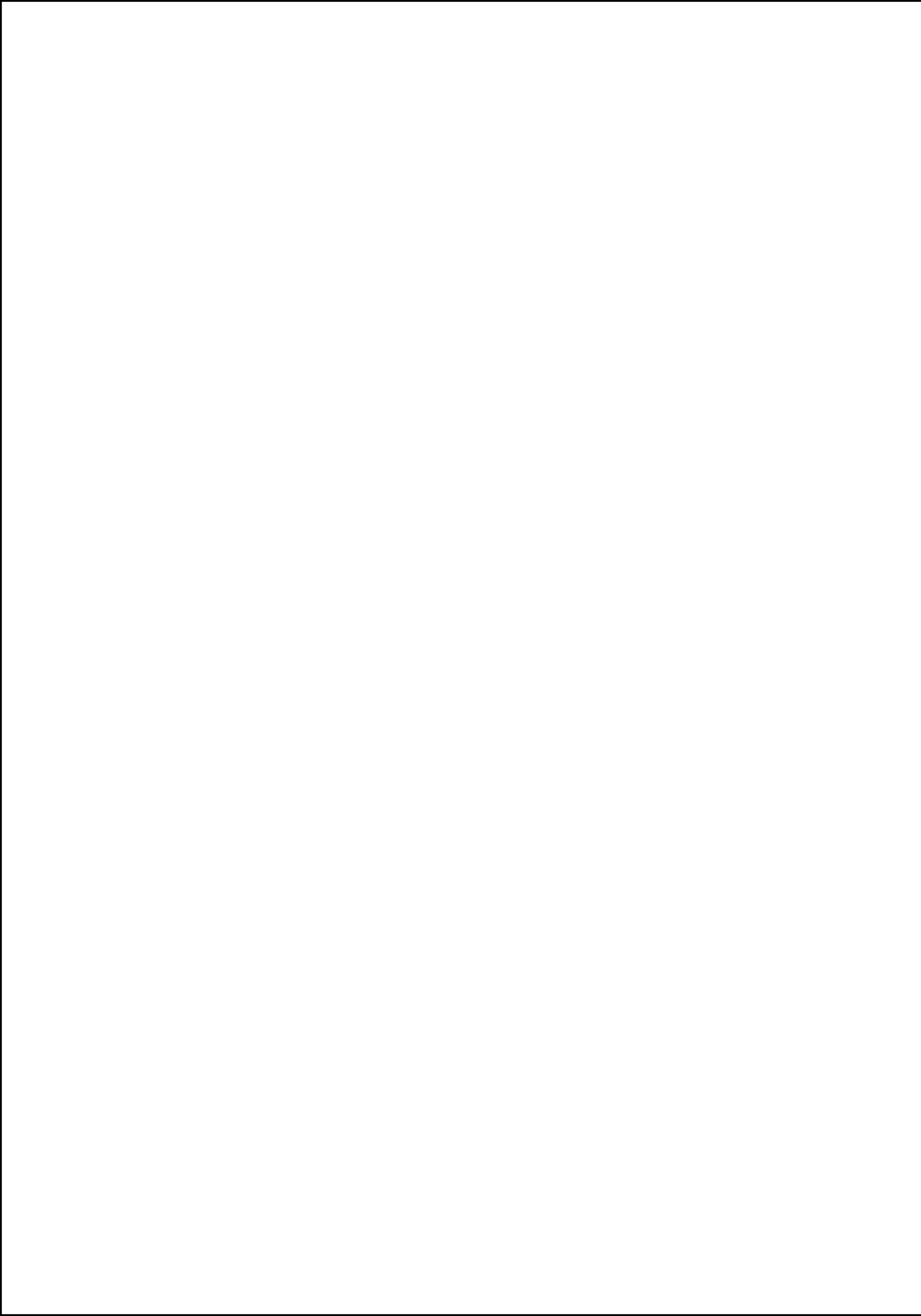
Members of Orrick's **School Finance Practice Group** are shown on the contact list on the inside of the back cover of this guidebook.



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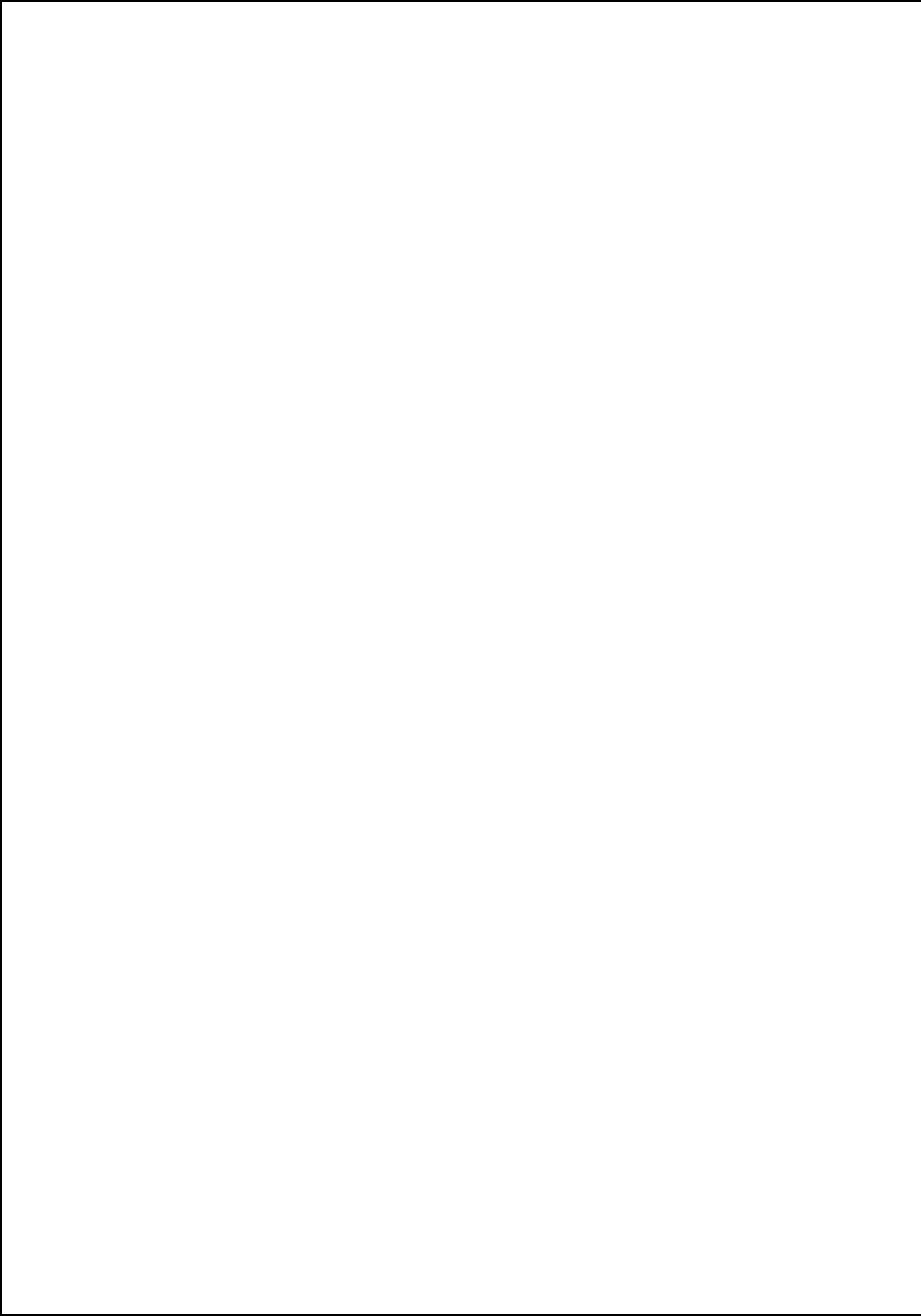

CHAPTER 1

OVERVIEW OF SCHOOL DISTRICT DEBT FINANCING

Introduction

School district administrators in California function in a complex financial universe that increasingly requires familiarity with and use of sophisticated tax-exempt public finance techniques to finance school facilities, equipment and operating expenses. This guidebook is an overview of the public finance techniques most often used by school districts in California. It is written primarily for school district administrators as an aid to understanding the financing process and as a guide in determining which financing techniques might suit a school district's particular needs.

Although this guidebook is designed to be thorough, it cannot anticipate every need or circumstance of any particular school district. Furthermore, new market and legal developments will continue to occur. **Therefore, this guidebook should not be considered to constitute legal advice nor should it be relied upon as a substitute for consultation with qualified bond counsel as early in a financing as possible.**

General Concepts

Debt Financing Defined. "Debt financing" is any arrangement by which a school district obtains money today and agrees to repay the money over time, with interest. Debt financing is a technique for converting an expected future stream of income (whether from tax receipts, general fund revenues, state or federal grants or any other source) into a currently available dollar amount. School districts use debt financing to obtain the money needed to acquire land, to construct new buildings or improve existing ones, to install improvements and facilities, and to acquire equipment, among other purposes. Additionally, in some circumstances, debt financing is undertaken to provide school districts with working capital.

Basic Financing Techniques Available To School Districts. Debt financing may be accomplished by a number of techniques and variations thereon. The four basic, commonly used debt financing techniques available to school districts are general obligation bonds, lease financing (certificates of participation or "COPs"), Mello-Roos bonds, and tax and revenue anticipation notes ("TRANs"). Chapters 2 through 5 of this guidebook describe the four basic financing techniques, addressing each of the following questions with respect to each type of debt financing:

- What is the debt instrument involved?
- What is the legal authority for issuance?
- What can be financed?
- Are additional revenues generated?
- What are the procedures for issuance?
- How long does the financing take?
- What are the significant restrictions?
- What are the important advantages and disadvantages?

A chart comparing the four basic financing techniques in summary form is included on pages 4 and 5 of this chapter. Some important variations on the basic techniques as well as common features of school district debt financings are described in Chapter 6 of this guidebook.

For purposes of this guidebook, "debt financing" encompasses the various techniques by which a financing may be accomplished, including the issuance of bonds or notes and the execution and delivery of COPs in a financing lease. For the sake of simplicity, each type of financing instrument—whether a bond, a note or a financing lease—will, at times, be referred to in this guidebook simply as a "bond."

Advantage of Tax-Exempt Interest; Federal Tax Law Considerations. When investors buy a school district's bonds, they are making a loan to the school district. Because, in most cases, the interest on the loan paid by the school district constitutes tax-exempt income to the owners of the bonds, those bond owners are willing to lend their money to the school district at a significantly lower rate of interest than they would demand if such interest constituted taxable income.

While the issuance of school district bonds is a matter of state law, the exclusion of interest on such bonds from income for purposes of federal income taxation is governed by federal tax law. The Internal Revenue Code of 1986 (the "Internal Revenue Code"), and the regulations thereunder, contain an intricate set of requirements that must be complied with in order for a school district to issue bonds that are tax-exempt. Additionally, in order for the bonds to retain their tax-exemption, the school district must continue to comply with certain requirements after the bonds are issued. A summary of federal tax law as it pertains to school district debt financing is provided in Chapter 7 of this guidebook.

Securities Law Requirements. Although the issuance of bonds is, essentially, the borrowing of money, a bond financing is typically implemented in a far different manner than a loan from a bank or other institution. Whereas a bank loan is funded with the bank's own money, a bond "loan" is usually funded by selling the bonds to investors. Because the bonds constitute securities, their offering and sale is subject to various provisions of federal and state securities laws. Most significantly, the anti-fraud provisions of such laws impose liability on a school district for material misstatements or omissions made in connection with the offering and sale of the school district's bonds. In addition, federal securities laws indirectly require school districts to disclose and annually update certain financial and operating information relevant to the security and repayment of its bonds. A summary of such securities laws as they pertain to school district debt financing is provided in Chapter 8 of this guidebook.

SUMMARY COMPARISON OF THE FOUR BASIC FINANCING TECHNIQUES

	GENERAL OBLIGATION BONDS	LEASE FINANCING
Statutory Authority	Education Code Section 15000 and following; Governing Code Section 53506 and following	Education Code 17400 and following
What Can Be Financed?	Real property acquisition and improvement only (traditional authority); school facilities, including furnishing and equipping of school facilities (Proposition 39)	Generally any real or personal property (must constitute a capital expenditure)
Are Additional Revenues Generated?	Yes	No
Is Voter Approval Required?	Yes	No
How Long Does the Financing Take?	6 to 9 months or more	3 weeks to 3 months or more
What Is the Maximum Maturity?	25 years (Education Code); 40 years (Government Code)	Useful life of property leased
What Is the Maximum Interest Rate?	12%	Generally, none
May Negotiated Sale Be Used?	Yes	Yes
What Are the Most Important Advantages?	Low cost; simplicity; self-supporting	Flexibility; no vote required
What Are The Most Important Disadvantages?	Vote required; debt limit restrictions	More expensive than general obligation bonds; reserve fund, insurance and capitalized interest required

SUMMARY COMPARISON OF THE FOUR BASIC FINANCING TECHNIQUES

	MELLO-ROOS BONDS	TRANS
Statutory Authority	Government Code Section 53311 and following	Government Code Section 53850 and following
What Can Be Financed?	Tangible property with useful life of 5 years or more	Cash flow deficits
Are Additional Revenues Generated?	Yes	No
Is Voter Approval Required?	Yes, but (in some circumstances) may be vote of landowners instead of registered voters	No
How Long Does the Financing Take?	3 to 6 months (landowner election); 6 to 9 months (registered voter election)	3 to 6 weeks
What Is the Maximum Maturity?	40 years	15 months (13 months if tax-exempt)
What Is the Maximum Interest Rate?	12%	12%
May Negotiated Sale Be Used?	Yes	Yes
What Are the Most Important Advantages?	Ability to finance facilities required as a result of new development; self-supporting; tax formula flexibility	Ability to finance working capital
What Are The Most Important Disadvantages?	Vote required; more expensive than general obligation bonds and, usually, lease financing; complex procedures	Federal tax code restrictions

Principal Participants

The successful implementation of a school district debt financing requires the involvement of a number of participants, each serving a particular function. In addition to the school district, the financing team might include bond counsel, an underwriter, a financial advisor, a bond trustee, a credit enhancement provider, one or more rating agencies and others. Furthermore, the school district, the underwriter, the bond trustee and the credit enhancement provider often each have legal counsel who are participants in the financing. Because the school district is ultimately responsible for its debt issue and because there are a variety of ways that a school district is exposed to risk of liability after its debt is issued, the school district should exercise special care in selecting the members of its financing team.

School District. The school district, as the issuer of the bonds, plays the central role in the financing. The school district and the members of its staff involved in the financing are responsible for selecting the financing participants, ensuring that the bond issue is integrated with the school district's overall financial management plan, approving the structure of the bond issue, reviewing and approving all documentation relating to the bond issue, and, after the bonds are issued, administering the investment and expenditure of bond proceeds and causing debt service payments to be made in a timely manner.

District Counsel. District counsel usually participates in a school district debt financing by rendering day-to-day and ongoing general counsel legal advice to the school district, reviewing the financing documentation, and negotiating certain aspects thereof on behalf of the school district. Generally, district counsel is also asked to provide certain opinions that are within the scope of its representation of the school district, including opinions that the school district has been legally established and is validly operating as such, that there is no litigation that would adversely affect the financing, that all approvals necessary to consummate the financing have been obtained, that all procedural requirements necessary to consummate the financing have been met, and that the financing will not cause the school district to breach any of its existing contracts.

Bond Counsel. Next to the school district itself, bond counsel is probably the most involved member of the financing team. Bond counsel should generally be selected and consulted as early as possible so that bond counsel can review the proposed financing and determine whether it can be structured so as to comply with applicable state law and federal tax law. Additionally, this will allow bond counsel to compare the relative advantages and risks to the school district of alternative ways of structuring the financing. Once the decision to proceed with a financing is made, bond counsel drafts the bond documents and orchestrates the financing to ensure that all legal requirements critical to the validity of the bonds are satisfied.

It is essential that bond counsel be thoroughly familiar with the constitutional and statutory authorities, the procedural requirements and all legal restrictions applicable to the school district, and the particular financing technique to be employed. It is also essential that bond counsel be an authority on the complex and restrictive federal tax law requirements pertaining to the financing. At the time of issuance of the bonds, bond counsel renders an opinion that the bonds and the bond documents are valid and binding obligations of the school district and, if applicable, that interest on the bonds is tax-exempt.

Disclosure Counsel. The Securities and Exchange Commission (the "SEC") has stressed that, regardless of who prepares the school district's disclosure document, the school district bears the ultimate responsibility for the disclosure contained therein. Accordingly, school districts may wish to engage disclosure counsel (who may be bond counsel or a separate special counsel) to assist in the preparation of the school district's disclosure and other offering documents rather than having underwriter's counsel undertake such responsibilities. If it will not be prepared by bond counsel, disclosure counsel may also draft a continuing disclosure agreement to ensure that the school district will provide any required continuing disclosure over the life of the bonds.

Underwriter. Beyond the school district and bond counsel, the makeup of the financing team is dependent upon a number of factors, including how and to whom the bonds are to be sold. If the bonds are to be offered to the public, an underwriter will be a participant in the financing. An underwriter purchases the bonds from the school district in order to resell them to the public. If the bonds are to be sold to a limited number of investors, the financing team may include a placement agent instead of an underwriter. Finally, if the bonds are to be sold to a single investor (as is the case in many vendor and lease-purchase financings) there may be no intermediary between the school district and the investor.

Financial Advisor. The makeup of the financing team may also depend upon whether the bonds are sold at competitive or negotiated sale. If the school district bonds are to be sold by competitive sale, the financing team will almost certainly include a financial advisor. The financial advisor is a professional consultant employed by the school district to assist it in implementing the financing. The financial advisor might help develop the school district's financing goals, analyze and make recommendations about the alternative financing techniques, and assist in structuring the financing to meet the identified goals.

If the school district bonds are to be sold by negotiated sale, the underwriter often undertakes the duties performed by the financial advisor in a competitive sale. Consequently, the financing team may not include a financial advisor. However, even in a negotiated sale, the school district may retain a financial advisor to coordinate the financing or to assist in negotiating the terms of the sale of the bonds to the underwriter.

Underwriter's Counsel. In a negotiated sale, the underwriter will usually employ its own counsel to review the financing documentation and to provide advice to the underwriter with respect to securities law disclosure requirements. If the school district has not retained its own disclosure counsel, underwriter's counsel will often oversee the preparation of the disclosure and other offering documents to be used in connection with the sale of the bonds. Additionally, underwriter's counsel usually prepares the purchase contract, pursuant to which the bonds are sold by the school district to the underwriter.

Trustee/Fiscal Agent. The bond trustee in a school district debt financing is responsible for carrying out the administrative functions under the documents pursuant to which the bonds are issued. Such functions include establishing and holding the funds and accounts relating to the bond issue, authenticating the bonds, maintaining a list of owners of the bonds, registering the transfer and exchange of the bonds, paying principal of and interest on the bonds to the owners, and protecting the interests of the owners in the event of a default by the school district. In relatively straightforward financings, the administrative entity often performs some, but not all, of such functions, in which case it may be called a "fiscal agent" or "paying agent" (depending on which responsibilities are undertaken). For ease of discussion, the administrative entity will be referred to in this guidebook simply as a "trustee."

Credit Enhancement Provider. The financing team for a school district financing may or may not include a credit enhancement provider. A credit enhancer is an insurance company, bank or other financial institution with a high credit rating that insures or guarantees the payment of the bonds. The purpose of the credit enhancement is to add security to the bonds, thereby raising the credit quality of, and lowering the interest rate on, the bonds. In a school district financing, credit enhancement usually takes the form of bond insurance or a letter of credit.

Bond insurance insures the payment of scheduled debt service on the bonds in a timely manner, usually over the full term of the bonds to maturity. The cost of a bond insurance policy usually consists of a one-time premium paid at the time of issuance of the bonds. Bond insurance is most often utilized in connection with fixed rate bonds.

A letter of credit is generally used in variable rate bond issues. The letter of credit is issued by a domestic or foreign bank. The trustee is permitted to draw on the letter of credit when needed to make debt service payments on the bonds or to purchase bonds from bond owners when required under the financing documentation. The school district becomes obligated under a "reimbursement agreement" to reimburse the bank for any draw on the letter of credit and to pay an annual fee to the bank for providing the letter of credit.

Rating Agency. Rating agencies are special participants that are often involved in school district debt financings. The rating agency's role is to provide, for a fee, an independent judg-

ment of the credit quality of a bond issue. In order to obtain a rating, the school district must supply the rating agency with all requested information about the school district and the proposed bond issue. Additionally, representatives of the rating agency may visit the school district, or the school district may make a presentation to the rating agency at the offices of the rating agency. The bond rating issued by the rating agency is relied upon by the purchasers of the school district's bonds and it significantly affects the rate of interest that the school district is required to pay (the better the rating, the lower the interest rate). Ratings are often sought from more than one rating agency. The principal rating agencies are Moody's Investors Service, Standard & Poor's Ratings Services and Fitch Ratings.

County. For general obligation bonds and TRANs, the county board of supervisors may issue the bonds on behalf of the school district and, therefore, the county may also be involved with reviewing and approving the structure and documentation relating to such financings. The county tax collector, auditor and controller also administer the levy and collection of property taxes for the repayment of general obligation bonds. Lease financing and the issuance of Mello-Roos bonds (other than collection of property taxes) usually do not require the county's involvement.

Rebate Compliance Provider. An additional participant is the rebate compliance provider. The rebate compliance provider is an expert, usually a bond counsel or accounting firm, that provides the arbitrage rebate calculation services that are necessary to ensure compliance with federal tax law. The rebate compliance provider should be engaged by the school district at or prior to the time of the bond issuance.

Other Participants. Depending on the financing technique involved, there may be additional members of the financing team. An election consultant is often retained to assist with the election campaign for general obligation bonds. A Mello-Roos bond financing team typically includes a special tax consultant to advise with respect to the structuring of the rate and method of apportionment of the special tax, the owner or developer of the property on which the special taxes are to be levied, consultants to the developer (including counsel), and an appraiser to provide an opinion as to the value of the property to be taxed. For larger development projects, a Mello-Roos bond financing team often includes a market absorption consultant to evaluate the likelihood and timing of the absorption into the market of the product to be developed on the property. Other members of the financing team might be a real property title insurer (lease financings) and a certified public accountant to verify the sufficiency of the escrow account (refundings).

Financing Process

The following is a general description of the financing process for school district debt. Certain types of financings require additional procedures and, even in transactions of the same type, differing emphases on the various facets of the financing process are common. Variations on any of the following are also, of course, possible. A detailed issuance timetable and outline for each of the four basic financing techniques is included in the respective chapters of this guidebook describing such techniques.

Threshold Matters. Once a school district has determined that a project or program is necessary or desirable and has made the decision to finance such project or program, the financing process may commence. However, since the financing technique utilized and the manner of sale of the school district's bonds significantly affect the makeup of the financing team, the school district, as a threshold matter, should determine which financing technique will be implemented and how and to whom the school district's bonds will be sold. It is usually desirable to identify and retain bond counsel to assist the school district at this stage.

Which financing technique will be implemented? Often, the nature of the item to be financed determines which financing technique will be employed. For example, working capital may generally only be financed through TRANs. However, in many circumstances, more than one technique is available to accomplish a particular financing. In such circumstances, the alternatives must be analyzed in order to determine which best accomplishes the school district's financing goals. Chapters 2 through 5 of this guidebook describe the four basic financing techniques and the advantages and disadvantages of each. A chart comparing the four basic financing techniques in summary form is included in this chapter on pages 4 and 5.

How and to whom will the school district's bonds be sold? The two basic methods of sale for school district debt (whether bonds, notes or COPs) are negotiated sale and competitive sale. Some statutes require that there must first be an attempt to sell bonds at competitive sale but, as a practical matter, some debt (e.g., variable rate debt and debt of undeveloped community facilities districts) can only be sold by negotiated sale. The securities issued in connection with each of the four basic financing techniques may be sold either by negotiated or competitive sale. The two types of sales involve different processes, players and roles, and present different sets of advantages and disadvantages. The best choice for a given debt offering depends upon the facts and circumstances of the financing and the importance placed by the school district on the different inherent attributes of the choices.

In a negotiated sale, the school district selects an underwriter to underwrite the bonds (by purchasing the bonds from the school district for resale to investors) on terms to be negotiated between the school district and the underwriter. The school district works with the underwriter, bond counsel and, if it uses one, its financial advisor to structure the

transaction. The school district enters into a purchase contract with the underwriter providing for the purchase of the bonds by the underwriter from the school district on agreed terms and conditions. Having the underwriter as an integral part of the structuring process in a negotiated sale may allow the bond structure to be better tailored to what the underwriter perceives as the demands of the marketplace. Negotiated sales allow the underwriter to work with potential investors before the actual offering date of the bonds to provide information and otherwise generate interest in the issue. A negotiated sale also allows flexibility to make last minute adjustments to debt structure or sale timing, allowing the school district to respond to investor needs and market fluctuations. Flexibility is of particular value for unusual borrowings, volatile markets or financings involving a number of independent variables.

In a competitive sale, the school district works with its financial advisor and bond counsel to structure the transaction. A notice of sale is published inviting bids for the bonds specifying the terms of the offering and detailing the basis for the award of the bonds (generally the lowest "true interest cost"). The bonds are sold to the winning bidder. The underwriter underwrites the bonds by purchasing the bonds from the school district and reselling them to investors, but does not play an active role in structuring the transaction. A competitive sale results in a competitive pricing of the bonds—the best bid (in terms of lowest debt service cost to the school district) wins the bonds.

One variation on the foregoing is a "private placement," in which the bonds are sold by the school district directly to an investor or investors. A private placement can be, in essence, a private loan (e.g., a direct equipment lease financing with a bank). Alternatively, a private placement can be an offering of limited scope, in which case the school district will generally employ a "placement agent" to locate a purchaser. Privately placed bonds are a less liquid investment and may bear a higher interest rate than bonds sold through a public offering, but issuance and marketing costs may be less.

Steps To Issuing Debt. Although the specific steps to issuing debt are determined by the type of financing technique that is implemented, the following is illustrative of the basic steps generally applicable to all school district financings.

Assemble Financing Team. The first step in a financing is usually the assembling of the financing team. The school district selects the firms that will act as bond counsel, disclosure counsel (if any), financial advisor (if any) and, in a negotiated sale, underwriter for the upcoming bond issue. Selections can be made on a deal-by-deal basis, but often a school district maintains a financing team on an ongoing basis for multiple financings. This latter approach provides the benefit of financing professionals familiar with the school district's needs and overall financing context and can provide a source of advice between financings. Trustees, credit

enhancement providers and rating agencies are generally selected later with the assistance of the financial advisor or the underwriter.

Refine Terms and Structure of Financing. The next step is to discuss and refine the terms and structure of the financing. Presumably, the type of financing technique to be employed will have been decided. However, the financing team as a whole will need to identify and analyze relevant legal and financial issues and constraints to further refine the terms and structure of the financing. From this, the school district can make the basic strategic decisions relating to the financing. These decisions can include, among others, the amount to be borrowed, the scheduling of debt service, whether to issue variable or fixed rate debt, security features (including the relationship of security for the debt to existing and future school district debt), and covenants. The school district also needs to decide whether seeking liquidity support or other credit enhancement is necessary or desirable and, if necessary or desirable, to schedule a time to solicit proposals from the credit enhancement providers.

Draft Financing Documents. Based upon these decisions, bond counsel then prepares drafts of the bond documents and necessary governing board resolutions; disclosure counsel (who may also be bond counsel) or underwriter's counsel prepares a draft of the official statement; and the financial advisor or underwriter prepares a preliminary financial analysis of the transaction. Documents are then reviewed and commented upon by members of the financing team. This can be done in one or more document meetings or conference calls or through separate conversations or communications among the parties. Comments are made to better conform the documents to the agreed upon terms of the transaction, to improve the documents for the school district's benefit, or to further define or clarify the rights and responsibilities of the various parties. The underwriter and its counsel also perform such investigation of the school district and its affairs as they deem necessary to satisfy their "due diligence" obligation under the securities laws.

Governing Board Approval; Rating Agency Review. When the documents are in substantially final form (generally after a second or third draft), they are submitted to the school district's governing board and, for most TRANs and general obligation bond issues, the county board of supervisors, for approval through adoption of a resolution authorizing the debt. The documents and relevant financial information and projections are also generally submitted to one or more rating agencies for their review.

Sale. Following governing board approval and the receipt of ratings and/or credit enhancement commitments, the debt is marketed and sold. In a negotiated sale, a preliminary official statement is distributed to potential investors, the bonds are "priced" (i.e., the underwriter and the school district agree to interest rates and other financing terms) and the bonds are sold through the execution of a purchase contract between the school district and the underwriter.

In a competitive sale, a preliminary official statement and a notice of sale are distributed and, at a specified time, bids are received and the bonds awarded. Following sale (negotiated or competitive), a final official statement reflecting the terms of the sale is prepared and distributed to investors.

Closing. The final stage in the financing process is the closing. At the closing, the bond documents and all necessary certificates and opinions are executed and delivered and the bonds are issued, delivered and paid for. Generally, all executed documents are deposited with bond counsel and are released simultaneously on the closing date when all conditions for issuance and delivery of the debt have been satisfied. Signed documents, certificates and opinions are generally collected at a pre-closing conference the afternoon before the closing so that on the date of closing all that needs to be done is to receive payment for the bonds and to release the documents, certificates and opinions held by bond counsel. It is usually important for the closing to take place early on the closing date to enable the underwriter to "redeliver" the bonds to investors on the same day.

Financing Documentation

As is the case with the composition of the financing team, the complexity of the documents is determined, to a large degree, by the type of financing technique that is being implemented. General obligation bonds and TRANs are issued using a small number of relatively simple documents, in part because many terms are governed by statute. Because it involves transfers of interests in real or personal property, a lease financing generally requires documentation that is more complex. In order to implement a Mello-Roos bond financing, proceedings for the establishment of the community facilities district must be undertaken and, therefore, such a financing usually involves an even larger number of individual documents.

The following is a discussion of resolutions, opinions and documents typically needed to successfully complete a school district financing. These include authorizing resolutions of the school district's governing board, basic financing documents, legal opinions and closing documents. The documentation for any particular school district debt financing will undoubtedly vary, at least slightly, from that described below. There may be a larger or smaller number of documents which include some of the items discussed below and omit others.

Ballot Measure and Resolution Calling Election. In the case of general obligation bonds and Mello-Roos bonds, the school district adopts a resolution calling an election and approving the language of the bond measure.

Authorizing Resolution. Each school district debt financing includes one or more resolutions that authorize the issuance of the bonds and establish parameters for the terms thereof, approve the forms of and authorize the execution and delivery of the financing documents

(including the indenture, the lease agreement, if applicable, the purchase contract and the continuing disclosure agreement) and approve the form of and authorize the distribution of the official statement and, if applicable, the notice of sale. In general obligation bond and TRAN financings, a single resolution often authorizes the sale of the bonds and, like an indenture, contains the specific terms of issuance of the bonds.

Indenture/Trust Agreement. The central document in a school district financing is the instrument under which the bonds are issued. The document is usually identified as a "resolution" in a general obligation bond or TRAN financing, as a "trust agreement" in a lease financing involving COPs, and as an "indenture" or "fiscal agent agreement" in a Mello-Roos bond financing. Regardless of its name, in each case its purpose is essentially the same: to set forth the principal terms of the agreement between the school district and the owners of the bonds. For ease of discussion, the central financing document—whether a resolution, a trust agreement, an indenture or fiscal agent agreement—will, at times, be referred to in this guidebook simply as an "indenture." The indenture is usually divided into sections, or articles, each dealing with a different aspect of the bonds or the school district's agreement with the bond owners, described in turn below.

Defined Terms; Terms of Bonds. Often the first article sets forth the definitions of various terms that are used throughout the remainder of the indenture. The following article usually specifies the name of the bonds, the denominations in which the bonds may be issued, the principal amounts of and interest rates on the bonds of each maturity, the principal and interest payment dates for the bonds, and the method and place of payment for the bonds. Additionally, this article typically provides for the registration, transfer and exchange of bonds by their owners.

If the bonds are issued in "book-entry-only" form, which is now the rule rather than the exception, this article of the indenture usually also contains the provisions relating to the depository system of The Depository Trust Company ("DTC"). In the DTC book-entry-only system, the bond certificates (usually a single certificate for each bond maturity date) are deposited with DTC as securities depository for the bonds and bond owners do not hold physical certificates. Any transfer, exchange, clearance or settlement of or with respect to the bonds is accomplished through electronic book-entry changes in accounts.

Application of Proceeds of Bonds. The following article often contains provisions relating to the application of the proceeds of the bonds to the various funds and accounts created by the indenture. Amounts deposited in a construction fund, or in accounts within such fund, are used to pay the costs of the acquisition, construction and installation of the project financed with the bonds. If the construction fund is held by a trustee, rather than the school district, the indenture will set forth the mechanism through which the school district may requisition

money from such fund. Amounts may also be deposited in an interest account if debt service will be paid from proceeds of the bonds for any period of time, deposited in a reserve account if one has been established, transferred to an escrow fund in the case of a refunding bond issue, or otherwise deposited or paid as may be required in a given financing.

Terms of Redemption of Bonds. If the bonds are subject to redemption (i.e., payment) prior to maturity, a separate article of the indenture will usually specify the terms of such redemption. The indenture may provide for optional redemption, mandatory redemption from sinking fund payments and mandatory redemption as a result of a calamity. An optional redemption provision allows the school district to elect to pay the bonds before their due date and usually includes the payment of a premium (or penalty) if the bonds are optionally redeemed before a specified date.

Mandatory sinking fund redemptions are usually included in those situations where the bond issue includes "term bonds" rather than being solely made up of "serial bonds." Serial bonds are bonds that mature in successive years without interruption. Term bonds are bonds comprising a large part or all of a bond issue which mature on a single date, usually a number of years after the last serial maturity. When a term bond is included in the structure, a portion of the term bond is redeemed in each of the years preceding its maturity from annual payments called "sinking fund payments." The result is that the school district's debt service payments on the bonds are approximately level, even though the bond maturity dates are skewed toward the later years.

A mandatory redemption for calamity would usually only be included in a lease financing. Such a redemption provision requires that if a portion of the property leased by the school district has a title defect or is damaged, destroyed or taken through eminent domain, the insurance proceeds or eminent domain payments received as a result of such defect, damage, destruction or taking must be used either to replace or repair such property or to redeem a corresponding portion of the bonds.

Depending on the circumstances of the particular financing, the indenture may permit or require early redemption of bonds for reasons other than those described above. In addition to specifying the applicable terms of redemption, the article of the indenture relating to redemption normally sets forth the method of selecting bonds to be redeemed and specifies the notices that must be given to bond owners and others in order to redeem bonds.

Funds and Accounts; Pledge of Revenues. Usually there is a separate article of the indenture governing the flow and application of revenues and funds. If certain revenues are to be pledged to the payment of the bonds (such as special tax revenues in a Mello-Roos bond financing or general revenues in a TRAN financing) this article contains the pledge of, and creates the lien on, such revenues. Additionally, the article creates the debt service funds and establishes the flow of moneys through such funds. The debt service funds typically include an interest fund,

a principal fund and, if applicable, a redemption fund, into which payments by the school district are deposited and out of which payments to the bond owners are made. Additionally, the indenture for a lease financing or a Mello-Roos bond financing usually creates a reserve fund. The reserve fund is normally funded out of the proceeds of the bonds and is drawn upon in case the amounts in the debt service funds are not sufficient to make required payments to bond owners. Often included in the same article are provisions regulating the investment of moneys held in the funds subject to the indenture.

Other Covenants of the School District. A separate article of the indenture contains particular covenants, or promises, of the school district (or, in a Mello-Roos bond financing, the community facilities district). Certain covenants are unique to each of the financing techniques; however, most indentures include a covenant to pay the bonds as and when due, a covenant to protect the rights of the bond owners, a covenant to provide continuing disclosure to designated information repositories and, if applicable, tax covenants to ensure that the interest on the bonds remains tax-exempt.

Provision for Event of Default. Another article of the indenture specifies what events constitute events of default under the indenture and describes the consequences of a default. Such events normally include, at a minimum, the failure of the school district to make debt service payments as and when due and the continuing failure by the school district, for a specified period of time, to perform any of its other obligations under the indenture. The article sets forth the remedies that may be pursued by the bond owners, or the trustee on behalf of the owners, upon the occurrence of an event of default.

Trustee Provisions. The provisions relating to the trustee are usually contained in a separate article of the indenture. The article provides for the appointment of a bank or trust company to act as trustee, specifies the qualifications for the trustee and sets forth mechanisms for the removal and resignation of the trustee and for the appointment of a successor. Additionally, the article usually includes provisions relating to the compensation of the trustee, specifies the rights of the trustee and sets forth the limitations on the liability of the trustee.

Amendment Provisions. A separate article usually governs the amendment of the indenture. The article specifies which provisions of the indenture may be amended without the consent of the bond owners, which provisions may be amended with the consent of a majority (or super-majority) of the bond owners and which provisions may be amended only with the consent of each affected bond owner. The article often also sets forth the method by which the required consent of bond owners is to be obtained.

Defeasance. One of the final articles in the indenture may provide for "defeasance" of the bonds and the discharge of the indenture. Such an article usually provides that when all of the bonds are paid in accordance with the terms of the indenture, the school district will be discharged of its obligations under the indenture and that any pledged revenues will be released

from the lien created by the indenture. Additionally, the article normally specifies that bonds will be "defeased," or deemed to have been paid, if the school district places in escrow specified high quality securities (usually United States Treasury obligations) which are sufficient to pay the bonds through maturity or earlier redemption.

Provision for Credit Enhancement. If the financing includes credit enhancement, a separate article of the indenture may set forth the rights of the letter of credit provider or bond insurer. Typically, the credit enhancement provider is granted the right to consent (or withhold consent) to any amendment of the indenture and the right to control proceedings against the school district if an event of default occurs under the indenture.

Miscellaneous Provisions. The final article of the indenture contains miscellaneous provisions, including those relating to governing law and addresses for notices. The form of the bond is often attached as an exhibit to the indenture.

Lease Agreement. In a lease financing, another primary document is, of course, the lease agreement. The lease agreement contains many provisions similar to those that would be included in a standard, non-financing lease, including provisions relating to the lease of the property, the term of the lease, the payment of rent, the maintenance of the leased property, insurance, defaults and remedies. Additionally, the school district financing lease includes provisions relating to the prepayment of lease payments (which correspond to indenture provisions for early redemption of the bonds) and the school district's tax covenants. Finally, in order to avoid the constitutional limitations on the incurring of debt by a school district, the financing lease includes, usually, "abatement" provisions or, sometimes, "annual appropriation" provisions. The legal significance of the abatement provisions and the annual appropriation provisions is explained in Chapter 3 of this guidebook.

Official Statement. Except in the case of direct lease financings with a vendor, leasing company or bank and financings where the bonds are sold to a very limited number of sophisticated investors, the documentation in a school district debt financing includes a disclosure document, which is usually called an "official statement." The official statement is used to provide information to investors and prospective investors about the school district and the bonds. The bonds constitute securities for purposes of state and federal securities laws and, therefore, the offering and sale of the bonds through the official statement is subject to certain provisions of such laws, including, importantly, the anti-fraud laws. The official statement sets forth information about the terms of the bonds, the security for the bonds, the sources and uses of the proceeds of the bonds, the project being financed with the proceeds of the bonds, the school district or, in the case of Mello-Roos bonds, the property on which the special taxes securing the bonds are levied, any material risk factors inherent in an investment in the bonds, the documents under which the bonds are issued and the tax-exemption of interest on the bonds.

Further information about the content and use of official statements and the impact of securities laws on official statements is contained in Chapter 8 of this guidebook.

Purchase Contract. In a negotiated sale, the agreement for the purchase and sale of the bonds is formalized in a purchase contract between the underwriter and the school district. The purchase contract (which is sometimes called a "contract of purchase" or "bond purchase agreement") specifies the purchase price of the bonds to be paid by the underwriter, the interest rates, maturity dates and principal amounts of each maturity of the bonds, the date, time and place of the closing of the bond issue, the allocation between the underwriter and the school district of the expenses incurred in connection with the bond issue, the parties' representations to and agreements with each other, any rights the underwriter and the school district have to indemnification from each other and the conditions which the school district must satisfy before the underwriter becomes obligated to purchase the bonds, including, typically, the delivery at closing of certain documents, certificates and opinions. In addition, the underwriter is usually excused from performing under the purchase contract if certain events should occur between the time of the signing of the purchase contract and the closing of the bond issue, which would be likely to undermine the marketability of the bonds. Such events might include, for example, the enactment of laws affecting the tax exemption of interest on the bonds or similar securities, the closing of the major stock exchanges, or the discovery of a fact that makes the official statement misleading or incomplete.

Notice of Sale. In a competitive sale, the bonds are sold through a notice of sale. A summary notice is published in a financial newspaper and the complete notice of sale is usually distributed to likely bidders. The notice of sale describes the details of the bond sale, including the method of delivering bids and the date, time and place of the bid opening, the terms of the bonds and the security therefor and any limitations on the interest rates or purchase price which may be bid for the bonds. The notice of sale, together with the winning bid and the school district's acceptance of such bid, form the agreement for the purchase and sale of the bonds between the school district and the underwriter submitting the winning bid.

Continuing Disclosure Agreement. Federal securities laws indirectly require school districts (and other obligated persons) to disclose and annually update certain financial and operating information relevant to the security and repayment of bonds. The continuing disclosure agreement contains the undertakings of the school district to provide the ongoing disclosure in the form of annual reports and event notices. These undertakings must be made for the benefit of and be enforceable by the holders of the school district's bonds and generally must remain in place for the life of the bonds. A summary of these securities laws as they pertain to school district debt financing is provided in Chapter 8 of this guidebook.

Closing Documents. Each school district financing also includes a number of documents and certificates that, together, are referred to as "closing documents." These include evidence of the authority of the financing participants to perform their respective obligations, certifications that the conditions precedent to the issuance of the bonds have been satisfied, the school district's tax certifications upon which bond counsel relies in rendering its tax opinions, the opinions of bond counsel and other counsel representing financing participants, and documents evidencing receipt of the bonds by the purchaser and of the purchase price of the bonds by the bond trustee on behalf of the school district.

Other Documents. If the financing includes credit enhancement, the financing documentation will include either an insurance policy issued by a municipal bond insurance company or a letter of credit and a reimbursement agreement with the letter of credit bank. Depending on the financing technique involved, the financing documentation may include additional documents. A title insurance policy is usually required in a real property lease financing. General obligation bond and Mello-Roos bond financings involve a number of documents relating to the election proceedings, including ballots, notices, affidavits and, in the case of general obligation bond financings, a tax rate statement. A Mello-Roos bond financing usually includes a property appraisal and often includes a market absorption study. Additionally, the initiation and implementation of a Mello-Roos bond financing requires the adoption of a number of resolutions at various stages of the financing process.

CHAPTER 2

GENERAL OBLIGATION BONDS

What Is the Debt Instrument Involved?

General obligation bonds are voter-approved long-term debt instruments which are secured by the legal obligation to levy and collect ad valorem property taxes sufficient to pay annual debt service on the bonds. Because general obligation bonds are secured by the taxing power of the school district, they are considered to pose the lowest risk to the investor and, therefore, provide the lowest borrowing cost to the school district of any of the financing techniques available.

Although the documentation for issuing general obligation bonds is relatively simple, in part because nearly all aspects of the issuance and repayment, as well as the use of proceeds, are regulated by specific statutes, a number of important structuring decisions must be made by the school district early in the bond authorization process. Accordingly, it is critical that a school district review its various options prior to placing a bond measure on the ballot. Changes in the law governing general obligation bonds, including the enactment of Proposition 39, have only added to the significance of these early decisions.

What Is the Legal Authority for Issuance?

General. Article XIII A, Section 1 and Article XVI, Section 18 of the California Constitution provide the constitutional basis for the issuance of voter-approved general obligation bonds. Section 15000 and following of the Education Code provide the statutory authority for the issuance of general obligation bonds by a school district.

In November 2000, voters in California approved Proposition 39, which amended the California Constitution to permit the passage of general obligation bonds of school districts upon the approval of 55% of the votes cast on the measure if certain conditions are satisfied. Proposition 39 also changed the types of projects that are authorized to be financed by general obligation bonds. Proposition 39 did not, however, eliminate the traditional basis (requiring a two-thirds voter approval) for seeking voter-approved general obligation bonds. Thus, school districts seeking voter approval of general obligation bonds now must decide whether to seek such approval under Proposition 39 or the traditional rules governing the approval and issuance of general obligation bonds. As summarized in the table on the following page, there are many differences between the two procedures in addition to the differences in voter approval and use of proceeds. These all need to be considered before selecting which procedure to employ.

Citizens' Oversight Committees. If a school district is authorized to issue general obligation bonds under Proposition 39, the school board will be required to establish a citizens' oversight committee. The committee is charged with ensuring that bond proceeds are only spent for the specific projects listed in the bond measure and that no funds are used for teacher or administrator salaries or other school operating expenses. The committee is also charged with advising the public if this is not done. The committee is not granted any powers to determine how bond funds may be spent.

The committee must consist of at least seven specified members, though the school board may appoint additional members as it sees fit and there is no upper limit on the size of the committee. Willful failure to appoint the committee can subject the school board to taxpayer lawsuits and an injunction against spending any bond proceeds. No district employee, official, vendor, contractor or consultant may serve on the committee; however the law does not specify how long a person must wait to join the committee after leaving the district's employ. Nor does the law state that members must reside in the school district. Members serve a term of two years, without compensation, and may serve no more than two consecutive terms.

The school board is required to provide administrative and any necessary technical assistance to the committee, including sufficient resources to publicize the committee's conclusions, without spending bond funds. The committee may review the annual, independent financial

REQUIREMENTS UNDER TRADITIONAL AUTHORITY COMPARED TO PROPOSITION 39

	TRADITIONAL AUTHORITY	PROPOSITION 39
Board Approval	Simple majority approval of the school board to place a measure on ballot.	Two-thirds approval of the school board to place a measure on ballot.
Ballot Measure	May contain all of the purposes authorized by law, or may be more limited. A specific school facilities project list is not required.	Must list the specific school facilities projects to be funded and such list must be certified by the school board after an evaluation of safety, class size reduction and information technology needs.
Voter Approval	Two-thirds of the votes cast on the measure must be in favor.	55% of the votes cast on the measure must be in favor.
Election Dates	May generally be held on any Tuesday.	May only be held on the same day as a statewide primary, general or special election, or at a regularly scheduled local election. This generally means in June and November of even-numbered years. Any other date must coincide with a regular local election (e.g., a school board or city council election) which will vary from district to district.
Debt Limitations	The total amount of outstanding and new general obligation bond debt to be issued may not exceed 2.5% of the assessed value of taxable property within a unified school district; the limit for other school districts is 1.25%.	Subject to same limitations.
Tax Rate Limitations	No limitation.	Tax rate as the result of any single election must be projected to be no more than $60 for a unified school district, $30 for other school districts, per year per $100,000 of taxable property value.
Use of Proceeds	May be used only for the acquisition or improvement of real property.	May be used only for the construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities and may not be used for teacher or administrator salaries or other school operating expenses.
Accountability Measures	Measure must specify its purposes, require bond proceeds to be applied only to such purposes, create an account into which the bond proceeds must be deposited and require preparation of an annual report regarding the amount of funds collected and expended and the status of any required or authorized project.	Subject to same requirement. In addition, must conduct annual, independent performance and financial audits and establish a citizens' oversight committee, with the authority to audit and review the bond program and advise the public.

and performance audits required by Proposition 39, make physical inspections of the school buildings and grounds, and review deferred maintenance plans and other cost-saving efforts in building design and use.

Issuance of General Obligation Bonds Directly by School District. Historically, school district general obligation bonds have been issued by the county board of supervisors on behalf of the school district. School districts, however, also have the authority to issue their own general obligation bonds under both the Government Code and the Education Code. Under the Education Code, the board of supervisors of any county may provide by resolution that the school board of any school district within the jurisdiction of such county and which has not received a qualified or negative certification in its most recent interim report, may issue and sell bonds on its own behalf. The board of supervisors of a county may adopt such a resolution with respect to a particular issuance by a school district or adopt a blanket resolution for all issuances of general obligation bonds by school districts within its jurisdiction.

Under the Government Code, school districts are authorized to issue their own general obligation bonds without the consent of the county, except that negotiated sales require the consent of the county. This authority permits school district general obligation bonds to mature up to 40 years after the date of issuance (provided the extended maturity was approved by the voters), while the Education Code permits only 25 years. However, this authority places tight restrictions on how debt service must be structured over the life of the bond issue.

School districts are also authorized to issue their own general obligation refunding bonds. When general obligation bonds are refunded, the refunding bonds (see Chapter 6) are issued under statutory authority in the Government Code which applies to bonds of all local agencies. There is no explicit requirement in these statutes that the county board of supervisors, rather than the school district, issue the refunding bonds. Nevertheless, coordination with county officials is required and essential to ensure that the county tax collector continues to levy ad valorem taxes to pay the refunding bonds issued by the school district.

School Facilities Improvement Districts. Some school districts may wish to limit the area within which voters will be entitled to vote on a bond measure or to limit the area within the school district to be taxed. For instance, a school district containing an existing community facilities district which levies a special tax to pay Mello-Roos bonds may expect voters within the community facilities district to oppose an additional tax for general obligation bonds which are used to finance facilities that may be located elsewhere or serve areas outside the community facilities district. Under the Education Code, if the board of supervisors of the county determines to make the law applicable in that county, a school district may form a school facilities improvement district consisting of any portion of the school district territory which is not located in an existing community facilities district and conduct a bond election

within the improvement district. If approved, general obligation bonds may be issued on behalf of the improvement district pursuant to provisions of law which are nearly identical to the statutes governing school district general obligation bonds. These statutory provisions are found at Education Code Section 15300 and following.

Political Conduct Rules. School board members and staff often have questions about the role that school district officers and employees and interested constituents may play in promoting the successful passage of a bond measure. Without explicit statutory authority, a school district may not spend public funds to promote a partisan position in an election campaign. To highlight some important legal issues with respect to campaign activities, Orrick has published a School Finance Bulletin entitled "Campaign Finance and Political Conduct Rules For School District Bond Elections" available on the internet at www.orrick.com. For further guidance, it is recommended that school districts and other interested parties seek advice from their own counsel.

What Can Be Financed?

Use of General Obligation Bond Proceeds.

Proposition 39 vs. Traditional Authority. The enactment of Proposition 39 has created two distinct authorities for seeking voter approval of general obligation bonds and, as a result, two sets of rules relating to the permitted uses of bond proceeds. Under the traditional authority (requiring a two-thirds voter approval), bond proceeds may only be used to finance "the acquisition or improvement of real property." Thus, under this authority, general obligation bonds may be used to finance the acquisition of land, the construction or acquisition of school buildings and facilities, the expansion, restoration, remodeling or improvement of school facilities and the permanent improvement of school grounds.

Even though the statutory provisions governing the issuance of general obligation bonds contained in the Education Code appear to grant school districts the authority to finance certain additional items, including furniture, equipment and school buses, the traditional constitutional basis for authorizing voter approved general obligation bonds prohibits the use of bond proceeds to acquire vehicles, furnishings or equipment (unless the equipment is affixed to real property and treated as real property for legal purposes). The statutory provisions contained in the Education Code were simply never amended after the enactment of Proposition 13 to conform to its limitations.

Under Proposition 39, bond proceeds may be spent on "the construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities." Consequently, general obligation bonds authorized under Proposition 39 may also be spent on furniture and

equipment. The Constitution still prohibits the use of general obligation bonds to purchase vehicles and also prohibits the use of general obligation bonds to finance ordinary operation or maintenance expenses regardless of which authority the bonds are approved under.

Operating vs. Capital Expenses. Although ordinary operating expenses may not be financed with general obligation bonds, labor costs, professional fees (such as for general contractors, architects and construction managers) and other costs directly connected to real property acquisition and improvement are probably appropriately financed from general obligation bonds. In this regard, although Proposition 39 prohibits the use of bond proceeds for teacher and administrator salaries and other school operating expenses, the Attorney General has opined that project administrative costs, such as monitoring contracts and project funding, overseeing construction progress and performing overall project management and accounting that facilitates timely completion of the construction project, are appropriately financed from proceeds of general obligation bonds issued under Proposition 39.

Maintenance Expenses vs. Deferred Maintenance. Similarly, while ordinary maintenance expenses may not be financed with general obligation bonds, what school districts normally refer to as "deferred maintenance" may be financed so long as such maintenance refers to projects which involve replacement of major building systems or components such that the project is classified as an improvement to real property or, under Proposition 39, reconstruction, rehabilitation or replacement of school facilities. For example, the replacement of a roof that cannot be patched should properly be classified as an improvement to real property. It should be noted, however, that there is an issue as to whether the use of general obligation bond proceeds will qualify as a school district's match for deferred maintenance funding from the State.

Interpretation of Bond Measure. Voter approval of a bond measure creates what has sometimes been called a "contract" between the school district and the voters. While this "contract" is not a separate document of the financing, it nevertheless limits the school district's authority with respect to the bonds. This agreement with the voters consists of the constitutional and statutory law authorizing the election and the issuance of the bonds, the resolution calling the election and the specific language contained in the ballot measure itself. The assenting vote of the electorate completes the agreement.

If a ballot measure is too specific with regard to the projects to be financed (e.g., "construction of an elementary school on Jefferson Street"), the school board may be bound to build what it has promised to the voters and may not be able to change its plans (e.g., "construction of an elementary school on Main Street") in the future despite changes in school district priorities or circumstances. Accordingly, when drafting a ballot measure and resolution calling an election, school districts must carefully balance the need for specificity and the desire for flexibility to ensure that the measure is specific enough to permit the bond proceeds to be used for

their intended purposes without eliminating all flexibility of the school district to handle changing priorities or circumstances.

Retaining flexibility is particularly difficult if voter approval is sought under Proposition 39. Under the traditional authority for issuing general obligation bonds, the ballot measure may be as broad or as narrow as the school board determines, allowing the school district to spend bond proceeds on a changing or expanding set of priorities over time. Under Proposition 39, however, the ballot measure is required to list the specific school facilities projects to be funded. Thus, it is very difficult to provide for changes without providing too much flexibility—such as reserving the right to substitute or add projects or even to spend leftover money on projects not on the list—that may make the bond measure unconstitutional from the start.

Are Additional Revenues Generated?

By voting to approve a general obligation bond measure, voters are also approving an increase in ad valorem property taxes sufficient to pay the debt service on the general obligation bonds. Thus, this financing technique incorporates the means for its own repayment, and general obligation bonds cause no reduction in other school district financial resources. This is the main reason that general obligation bonds enjoy such favor in the investment marketplace, and is why general obligation bonds have the lowest interest costs.

What Are the Procedures for Issuance?

While there are many intermediate steps, the following is illustrative of the basic steps for the authorization and issuance of general obligation bonds:

- The school board orders the election and adopts the ballot measure language.
- The county registrar of voters is required to distribute a sample ballot to each registered voter along with a voters' pamphlet containing the text of the bond measure, a projection of the tax rates required to repay the general obligation bonds, a legal analysis by the county counsel and arguments for and against issuance of the general obligation bonds, if any are submitted.
- At least two-thirds or, if approved under Proposition 39, 55% of the votes cast on the measure must be in favor of issuance.
- The school board adopts a resolution authorizing the issuance and sale, or requesting the county board of supervisors to issue and sell on behalf of the school district, all or a portion of the authorized amount of general obligation bonds.
- If issuing on behalf the school district, the board of supervisors adopts a resolution authorizing the issuance and sale of the school district bonds.
- General obligation bonds may be sold at competitive or negotiated sale.

How Long Does the Financing Take?

Because of the procedural time constraints for the election and the requirement for both the school board and, if necessary, the county board of supervisors to act, a general obligation bond financing often takes from six to nine months or more from the initiation of election proceedings to the receipt of bond proceeds by the school district. A complete election and general obligation bond issuance timetable and outline is included at the end of this chapter. Each year, Orrick prepares updated timetables reflecting the election dates in that year; these are available on the internet at **www.orrick.com**.

What Are the Significant Restrictions?

There are a number of restrictions and requirements applicable to general obligation bonds, the most significant of which are as follows:

- The voter approval requirement is the most significant limitation on the issuance of general obligation bonds.
- The total amount of general obligation bond debt (including previously issued outstanding bonds) may not exceed 2.5% of the assessed value of taxable property within a unified school district; the limit for other school districts is 1.25%. In addition, the tax rate levied as the result of any single Proposition 39 bond measure must be projected to be no more than $60 for a unified school district, $30 for other school districts, per year per $100,000 of the assessed value. For these purposes, assessed value is determined only at the time of issuance; subsequent changes in assessed value are not relevant.
- The maximum interest rate on general obligation bonds is 12% per year. In addition, the yield on general obligation bonds sold at a discount may not exceed 12% per year.
- General obligation bonds must mature no later than 40 years from the date of the bonds, although general obligation bonds issued under the Education Code may not mature beyond 25 years from the date of the bonds.

What Are the Important Advantages and Disadvantages?

There are a number of advantages and disadvantages applicable to general obligation bonds, the most significant of which are as follows:

ADVANTAGES AND DISADVANTAGES OF GENERAL OBLIGATION BONDS

ADVANTAGES

- Generate additional revenue to pay debt service.
- Lower interest rate and costs of issuance because of strength of security and simplicity of structure.
- Financing terms are dictated by statute, often allowing the legal documentation to be less complex, compared to other financing methods.
- Minimal school district staff time required, compared to other financing methods.
- No need for a reserve fund.
- Flexibility in structure of issue and type of sale.

DISADVANTAGES

- Voter approval required.
- Debt limit restrictions.
- Election requirements impose significant delay and costs to a financing.
- Use of proceeds limited.
- Tax must be levied based on a uniform percentage of the assessed value of each parcel within the school district; unlike the Mello-Roos bond financing technique, there is no flexibility in establishing the tax formula.
- Bonds issued under Proposition 39 require school districts to establish a citizens' oversight committee and to conduct annual, independent performance and financial audits.

See also the chart entitled "Summary Comparison of the Four Basic Financing Techniques" included in Chapter 1 of this guidebook.

Election and Bond Issuance Timetable and Outline

*The following is a timetable and outline for placing a general obligation bond issue on the ballot and for issuing bonds after a successful election. The timetable and outline are based on statutory provisions in effect as of January 1, 2005, which provisions may be subsequently amended. Each year, Orrick prepares updated timetables reflecting the election dates in that year; these are available on the internet at **www.orrick.com**.*

ELECTION TIMETABLE

Action Deadline	Election Action Item
	1. Conduct of Election and Duties of Registrar of Voters. School district bond elections will generally be governed by the Elections Code, except where contrary provisions are found in the Education Code or in the charter of any city or city and county in which the school district is located. The county clerk or the registrar of voters, if the county has one (the "Registrar"), is to perform all of the duties of preparing for and holding the election. If the school district is located in more than one county, the respective Registrars shall divide their duties by agreement. The costs of the election, including the Registrar's services, shall be borne by the school district upon approval of the county board of supervisors.
Not later than 88 days before the date of the election.	***2. Order of Election.**** The governing board of the school district (the "school board") must order the election to decide whether or not to issue bonds for one or more of the purposes authorized by the applicable provisions of the Education Code, as limited by Article XIII A of the California Constitution.
Not later than 88 days before the date of the election.	***3. Specifications of Election Order**** Concurrently with or after the order of election, the school board must deliver to the Registrar a resolution adopted by the school board known as the "specifications of the election order." The resolution must specify the date of the election, the purpose of the election, the exact wording of the measure as it is to appear on the ballot and the authority for both the order of election and the specification of the election order and must contain the signature of the clerk of the school board. Furthermore, under Proposition 39, the bond measure must, among other things, list the specific school facilities projects to be funded.

** Items 2, 3 and 4 should be combined in one resolution.*

Date of Election: The date on which a bond election must be held depends on the authority under which the election is being called. Under Proposition 39, bond elections may only be held on the same day as a statewide primary, general or special election, or at a regularly scheduled local election. Statewide primary elections are held on the first Tuesday after the first Monday in June of even numbered years. Statewide general elections are held on the first Tuesday after the first Monday in November of even numbered years. Any other date must coincide with a regularly scheduled local election (e.g., a school board or city council election) which will vary from district to district. Under the traditional authority for issuing general obligation bonds, the election may generally be held on any Tuesday, unless the school district is located within a charter city or charter county in which the charter provisions provide otherwise, or the election is consolidated with a scheduled charter city or county election held in a jurisdiction that includes 95% of the school district's population.

No election may be held on the day before, the day of, or the day after a state holiday, or within 45 days before or after a statewide election unless consolidated with the statewide election or conducted on an established election date, or within 90 days following another bond issue election in the same district. The established election dates in each year are as follows: (i) the first Tuesday after the first Monday in March (odd numbered years); (ii) the second Tuesday in April (even numbered years); (iii) the first Tuesday after the first Monday in June; and (iv) the first Tuesday after the first Monday in November.

Form of Ballot: The form of the ballots is governed generally by the Elections Code, except as otherwise provided in the Education Code. A brief statement of the bond proposition must be printed upon the ballot. The proposition must set forth the amount of the bonds to be voted upon, the maximum rate of interest and the purposes for which the proceeds of the bonds are to be used. The ballot statement of the proposition may not exceed 75 words. Special rules apply for counting the number of words in the measure. The words "Bonds-Yes" and "Bonds-No," or words of similar import, must appear on the ballots.

4. Consolidation of Election.* *

Not later than 88 days before the date of the election.

The election may be consolidated with any other election scheduled for the same day and generally must be consolidated with a statewide election held on the same day.

To consolidate the election with another election, the school board must adopt a resolution requesting consolidation. The resolution requesting consolidation must contain the exact form of the bond proposition, must be filed with the Registrar and with the governing body of the other jurisdiction which has called an election, and must be adopted and filed at the same time as the adoption of the resolution or order calling the election. In other cases, the governing body of each jurisdiction, or the officers otherwise authorized by law to call the election, may order the consolidation.

In counties of the first class, the county board of supervisors may deny any request for consolidation upon a finding that the county cannot handle the additional election or materials due to the ballot style or the county's voting equipment or computer capacity.

5. Tax Rate Statement.

Not later than 88 days before the date of the election.

The school board must deliver a tax rate statement to the Registrar. The tax rate statement must include the best estimate (from official sources, based on assessed valuations available at the time of the election or a projection based on experience within the school district or other demonstrable factors) of the following:

(i) the tax rate (per $100 of assessed valuation on all property to be taxed) which would be required to fund the bonds in the first fiscal year following the initial sale of bonds;

(ii) the tax rate which would be required to fund the bonds in the first fiscal year following the final sale of bonds, if the bonds are to be sold in series, and an estimate of the year in which that rate will apply; and

(iii) the highest tax rate which would be required to fund the bonds and an estimate of the year in which that rate will apply.

The statement may also describe any intent to use revenues other than ad valorem taxes to fund the bonds and the effect such a policy

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** Items 2, 3 and 4 should be combined in one resolution.*

would have on the tax rate(s) expected to be levied. The bonds issued under a single ballot measure seeking 55% voter approval under Proposition 39 must require a tax of no greater than $30 per $100,000 of assessed valuation in an elementary or high school district, or $60 per $100,000 of assessed valuation in a unified school district.

A copy of the tax rate statement must appear in the sample ballot and all official publications, including any ballot pamphlet prepared or sponsored by the school district.

6. Withdrawal of Order of Election.

The school board may not amend or withdraw the order of election, including the ballot measure, except by resolution delivered to the Registrar by the 83rd day prior to the election.

Not later than 83 days before the date of the election.

7. Deadline for Filing Ballot Arguments and Rebuttals.

The Registrar must set a reasonable time for submission of ballot arguments and publish notice of the deadline once in a newspaper of general circulation.

Reasonable time prior to election which will allow for compliance with rebuttal period, public examination period and deadline for mailing of sample ballots, below.

Direct and rebuttal arguments must be in the form prescribed in the Elections Code and must be verified in the same manner as a pleading in a civil action. Direct arguments are limited to 300 words; rebuttals to 250 words. A single argument for and a single argument against the proposition must be selected by the Registrar, with priority given to the arguments submitted by the school board or authorized board members and to bona fide citizen-group proponents of the measure.

The Registrar must mail a copy of each ballot argument to the authors of the contrary argument. The deadline for filing rebuttals is 10 days after the deadline for filing direct arguments.

8. County Counsel's Analysis of Ballot Measure.

Upon its qualification for the ballot, the Registrar must send a copy of the bond proposition to the County Counsel (or County District Attorney if there is no County Counsel), who must then prepare an impartial analysis of the measure in 500 words or less. The County Counsel's analysis is printed in the election pamphlet preceding the ballot arguments.

Reasonable time prior to public examination period.

Action Deadline	Election Action Item
	9. Period of Public Examination.
Reasonable time prior to deadline for mailing sample ballots.	At least 10 days before the Registrar submits the County Counsel's analysis, the ballot arguments and the rebuttals for printing, copies of such election materials must be made available for public inspection in the Registrar's office. During the ten-day period, any voter in the school district may seek a writ of mandate to have any or all of these election materials amended or deleted. The examination periods for the various materials may run consecutively.
	10. Mailing of Sample Ballot, Voter Pamphlet and Tax Rate Statement.
Not earlier than 40 days nor later than 21 days before the date of the election.	Not more than 40 nor less than 21 days before the election, the Registrar must mail to each registered voter: (i) a sample ballot and County Counsel's analysis; (ii) a tax rate statement (as described above); (iii) a notice card describing the polling place and time of the election; (iv) an application for an absentee ballot; and (v) a notice of the voter's right to an absentee ballot.
	11. Election Procedures.
Election date. Must be one of the election dates described in item 3.	The qualification of the voters, the establishment of election precincts, the designation of polling places, the appointment of officers of election, the conduct of the election and the manner of voting, are all handled by the Registrar on the school district's behalf pursuant to the Elections Code, except as otherwise provided in the Education Code.
	12. Canvass of Returns.
Not later than the first Thursday following the date of the election.	An official canvass shall be conducted by the Registrar commencing no later than the first Thursday following the election. The canvass shall be conducted by opening the returns and determining the vote for and against each measure and declaring the results thereof.

Election Action Item	Action Deadline
13. Statement of Election Results. The Registrar shall prepare a certified statement of the results of the election and submit it to the school board and the county board of supervisors within 28 days of the election, or for elections held in November of odd-numbered years, no later than the last Monday before the last Friday of such month. The statement of election results shall show: (i) the total number of ballots cast; (ii) the number of votes cast at each precinct for and against each measure; and (iii) the total number of votes cast for and against each measure.	**Not later than 28 days after the election, or, for elections held in November of an odd-numbered year, not later than the last Monday before the last Friday in November.**
14. Declaration of Results. If two-thirds, or 55% if approved under Proposition 39, of the votes cast are in favor of issuing the bonds, the school board shall enter that fact in its minutes and shall then certify all election proceedings to the county board of supervisors. The county superintendent of schools must send a copy of the statement of election results to the county board of supervisors.	**Following submission of the statement of election results.**
15. Citizens' Oversight Committee. After bonds are approved at a Proposition 39 election, the school board has 60 days in which to establish an independent citizens' oversight committee.	**Not later than 60 days after the school board declares the results of the election.**
16. Report to Superintendent. Within 30 days after the end of each fiscal year, the school board is to submit to the county superintendent of schools a report concerning each bond election containing: (i) the total amount of the bond issue; (ii) the percentage of registered voters of the school district who voted at the election; and (iii) the results of the election, with the percentage of votes cast for and against the proposition.	**Not later than 30 days after the end of each fiscal year in which a bond election is held.**

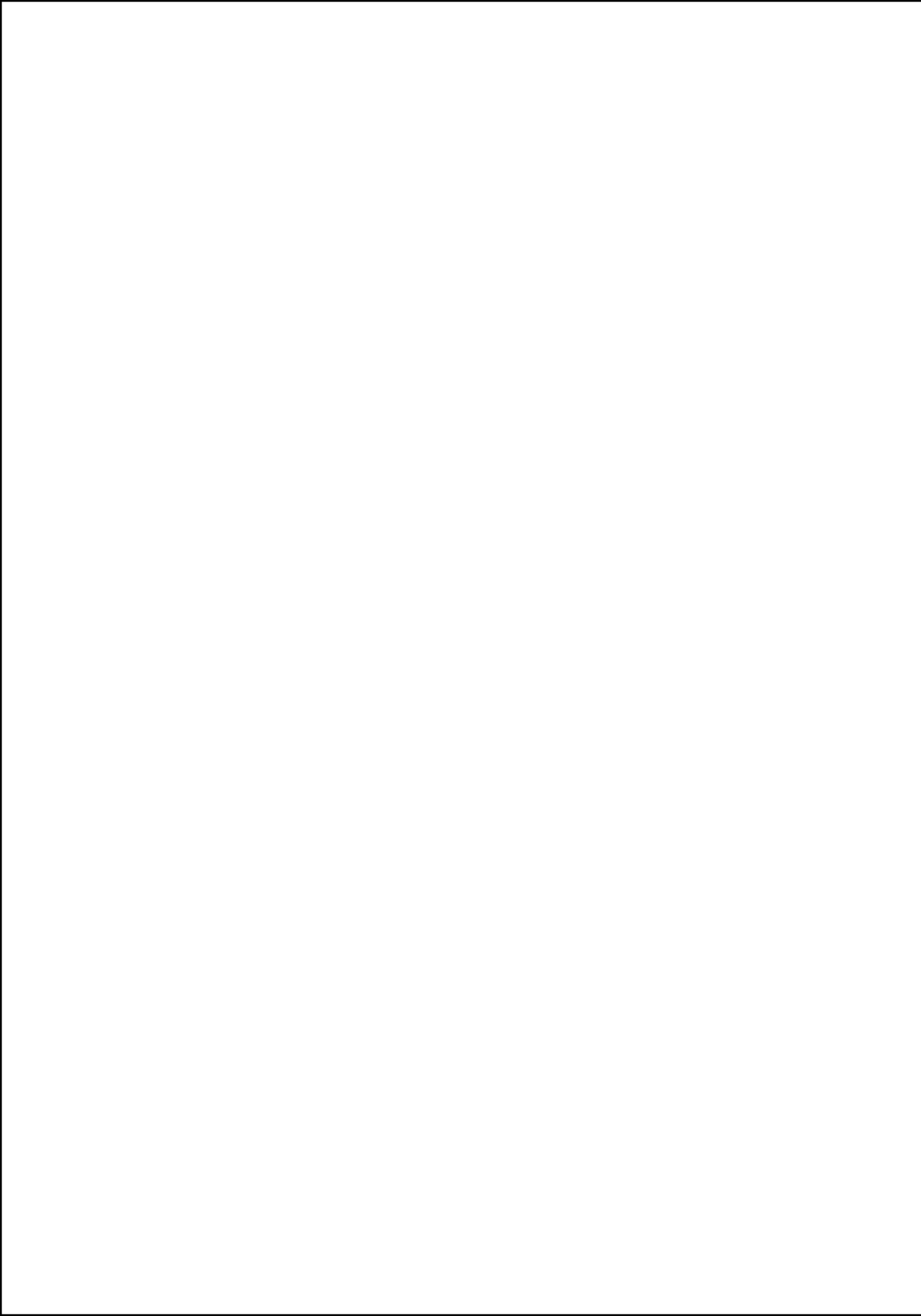
BOND ISSUANCE TIMETABLE

Action Deadline	Bond Issuance Action Item
	1. School Board Resolution.
Prior to bond sale.	The bonds may be issued by the county on behalf of the school district, or under certain circumstances, by the school district directly. In either case, the school board initiates the bond sale proceedings by adopting a resolution prescribing the total amount of bonds to be sold. The resolution may also state the maximum acceptable interest rate (not to exceed 12%), the call provisions of the bonds and the maturities and sinking fund payments. If the bonds are being issued by the county on behalf of the school district, such resolution shall be delivered to the county board of supervisors.
	Debt Limit: The total amount of bonds issued and outstanding at any time may not exceed 1.25% of the taxable property of the district as shown by the last equalized assessment of the county or counties in which the district is located, as modified pursuant to Education Code Sections 15103 and 15105. However, a unified school district may have bonds issued and outstanding up to 2.5% of such modified amount, as further modified by Education Code Section 15106. The computation for a reorganized district must be determined pursuant to Education Code Sections 15107 and 15108. In each case, 50% of remaining payments on certain lease-financing debt of the school district must be included. For these purposes, assessed value is determined only at the time of issuance; subsequent changes in assessed value are not relevant.
	Tax Rate Limit: When bonds have been approved in a 55% vote election called pursuant to Proposition 39, the issuance of any series of the bonds cannot require the tax rate to exceed in any year, based on the school district's projections, $60 per $100,000 of assessed valuation in a unified school district, or $30 per $100,000 of assessed valuation in an elementary or high school district.

Bond Issuance Action Item	Action Deadline
2. Board of Supervisors Order. If the bonds will be issued by the county on behalf of the school district, the county board of supervisors, following receipt of the school board resolution, by an order entered upon its minutes, shall fix the maturity dates, sinking fund payments and call provisions prescribed by the school board resolution. If no such provisions are set forth in the school board resolution, the county board of supervisors shall fix such provisions by order and shall also fix the form of the bonds, optional call provisions and the method of giving notices of redemption. The bonds shall be sold no later than the date designated by the school board in its resolution. The bonds must be in registered form.	**Prior to bond sale.**
3. Preliminary CDIAC Notice. Notice of the proposed bond sale must be filed with the California Debt and Investment Advisory Commission ("CDIAC").	**Not later than 30 calendar days prior to bond sale.**
4. Financial Publication Notice. If the amount of bonds to be sold exceeds $1,000,000 and the bonds are to be sold at public sale, the school board or the county board of supervisors must cause notice of the sale to be published in a financial publication generally circulated throughout California or reasonably expected to be disseminated among prospective bidders for the bonds.	**Not later than 15 calendar days prior to bond sale if bonds exceed $1 million but do not exceed $10 million; not later than 5 calendar days prior to bond sale if bonds exceed $10 million.**
5. Official Statement. The school district has an official statement prepared to provide information to investors and prospective investors about the school district and the bonds.	**Prior to bond sale.**

Action Deadline	Bond Issuance Action Item
	6. Sale of Bonds.
At time determined by the school district.	General obligation bonds may be sold at negotiated or competitive sale. Whenever a school district sells its own bonds, whether under the authority of the Education Code or the Government Code, the authorizing document and final debt service schedule must be provided to appropriate county officials to permit the levy of taxes and payment of bonds.
	7. Bond Delivery.
Following bond sale, as determined by the school district or the county and the purchaser.	The bonds are to be delivered to the purchaser thereof and the purchaser is to pay for the bonds, on the date determined by the school district or the county and the purchaser. Bond proceeds are to be deposited in the county treasury and credited to the school district's building fund. Any premium or accrued interest received by the school district from the sale of the bonds is to be deposited in the interest and sinking fund of the district.
	8. Tax for Payment of Bonds.
At the time of levying other county taxes.	The county board of supervisors must annually establish and levy a tax for the purpose of paying the principal (redemption price, if any) and interest on the bonds. If the school district is located in more than one county, the county tax shall be apportioned according to the ratio which the assessed value of the property in the district in each county bears to the total assessed value of the property in the district.
	9. Form 8038-G Filed.
Not later than the 15th day of the second calendar month following the close of the quarter in which the bonds were issued.	The reporting requirements of Section 149(e) of the Internal Revenue Code must be met.

Bond Issuance Action Item	Action Deadline
10. Final CDIAC Notice. Following the sale, the Report of Final Sale must be filed with CDIAC. The CDIAC fee is due from the underwriter.	**Not later than 45 days after bond sale.**
11. Annual Report. At least once a year, no later than January 1, the chief fiscal officer of the school district must file a report with the school board containing: (i) the amount of funds collected and expended and (ii) the status of any project required or authorized to be funded, as identified in the ballot proposition.	**Once a year following bond sale.**
12. Continuing Disclosure. Pursuant to a continuing disclosure agreement or certificate, the school district will be required to annually provide (by filing with certain specified information repositories) certain financial and operating information. See Chapter 8.	**Annually, as required by the continuing disclosure agreement.**
13. Oversight Committee Report. For general obligation bonds issued under Proposition 39, the citizens' oversight committee is required to issue regular reports on its activities with a minimum of one report to be issued per year.	**At least annually, as determined by the committee's bylaws or the committee.**



CHAPTER 3

LEASE FINANCING

What Is the Debt Instrument Involved?

Lease financing is a mechanism whereby a school district leases property and, in consideration of the use of the property, makes periodic lease payments during the term of the lease. Lease financing enables school districts to finance capital assets over a multi-year period without voter approval. In effect, a lease financing is a borrowing to be repaid over time from the school district's general fund.

A lease financing usually involves either a direct lease of property from a vendor, leasing company or bank or a financing lease, undivided interests in which are evidenced by certificates of participation.

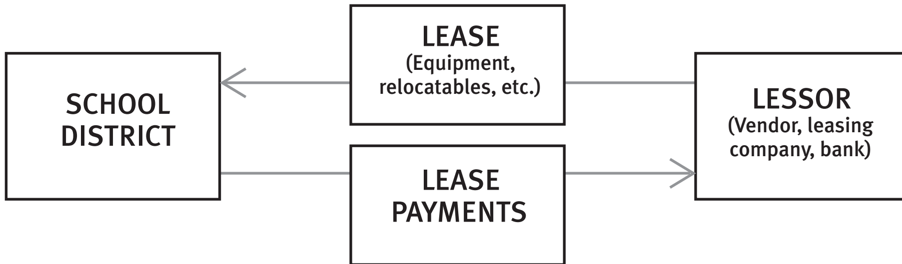
Direct Leases. The direct lease (or lease-purchase) method is most often used to finance the acquisition of equipment or relocatable classroom buildings. In the usual transaction, the school district leases the property from the lender, which may be the vendor of the property, a leasing company or a bank. Under this financing lease, title to the property is transferred to the school district upon expiration of the lease term. A portion of each lease payment made by the school district is designated as "interest," which may qualify as tax-exempt income to the vendor, leasing company or bank. The vendor, leasing company or bank may subsequently transfer its interest in the lease to another party.

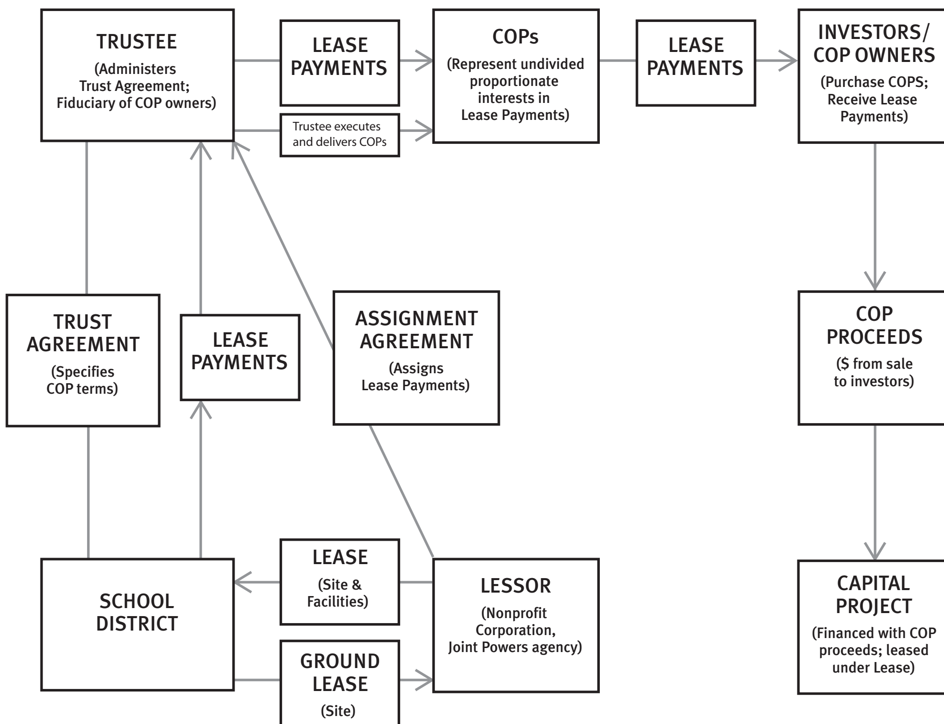
COPs. In the COP method, the school district, as lessee, leases the property from a third-party lessor, usually a nonprofit corporation created by or on behalf of the school district. The lease payments made by the school district to the third-party lessor are assigned to a commercial bank trustee. The trustee executes and delivers COPs, which are sold to investors. Each COP owner is entitled to a proportionate amount of the lease payments made by the school district under the lease; the COPs represent this entitlement. In the typical COP financing, a portion of each lease payment is designated as interest and, consequently, the owners of the COPs may receive tax-exempt interest payments. COPs are sold to investors much as bonds are; the proceeds of the sale of the COPs provide the money used to acquire and construct the school district project.

Unlike bonds, COPs have no independent legal existence or significance. They are simply receipts evidencing ownership of a share in the school district lease; the lease itself is the school district obligation the payment of which gives rise to tax-exempt interest. However, because COPs are not a creature of statute, they are not subject to certain statutory requirements that may affect bonds, such as interest rate limitations, election restrictions and other statutory limitations.

Financing Structure. In a typical lease financing for a school facilities construction project, the school district leases the site on which the facilities are to be constructed to a nonprofit corporation pursuant to a ground lease or a site lease. The school district, as agent of the lessor, undertakes the construction of the facilities to be located on the site. The improved site is subleased back to the school district, as lessee under the financing lease.

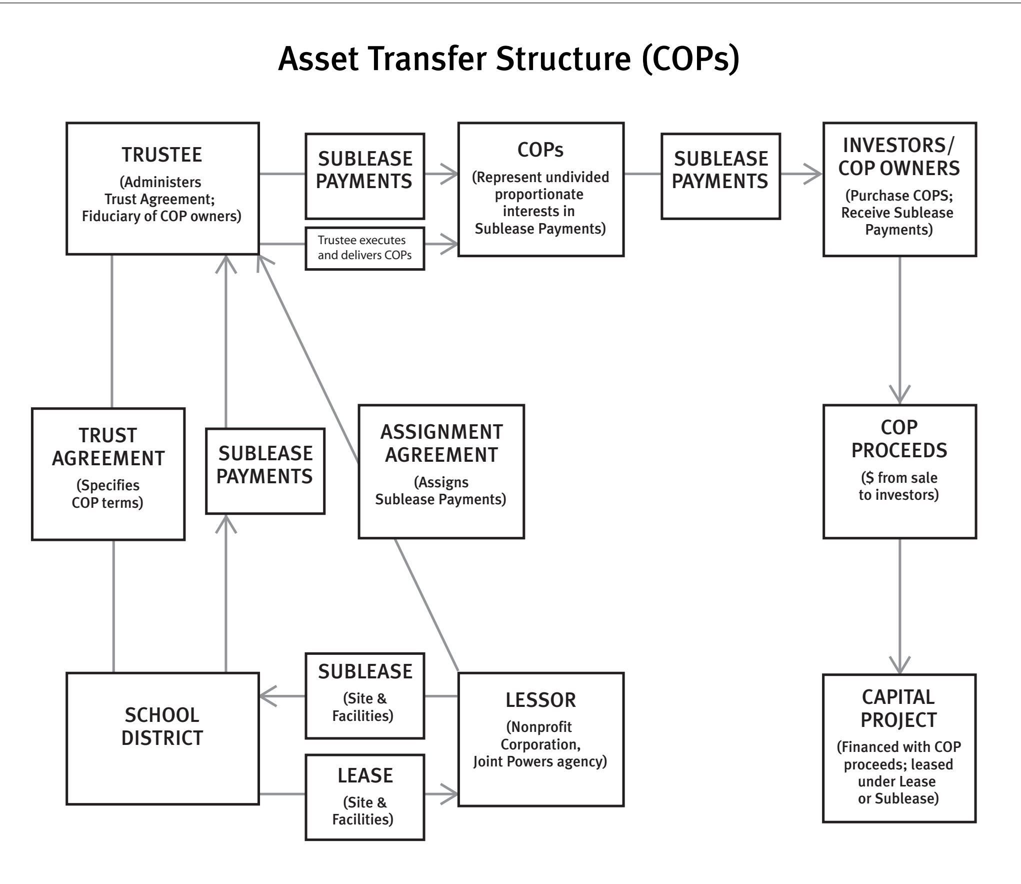
In a direct lease financing, the vendor, leasing company or bank receives the school district's lease payments as they are made over the term of the lease. In a COP financing, the lessor's right to receive payments under the lease are assigned to a trustee, who executes and delivers to investors COPs representing interests in the lease payments. Diagrams of a direct lease financing structure and a COP structure are provided below.


Direct Lease Structure
SCHOOL DISTRICT
LEASE
(Equipment, relocatables, etc.)
LEASE PAYMENTS
LESSOR
(Vendor, leasing company, bank)


COP Structure
TRUSTEE
(Administers Trust Agreement; Fiduciary of COP owners)
LEASE PAYMENTS
Trustee executes and delivers COPs
COPs
(Represent undivided proportionate interests in Lease Payments)
LEASE PAYMENTS
INVESTORS/ COP OWNERS
(Purchase COPS; Receive Lease Payments)
TRUST AGREEMENT
(Specifies COP terms)
LEASE PAYMENTS
ASSIGNMENT AGREEMENT
(Assigns Lease Payments)
COP PROCEEDS
($ from sale to investors)
SCHOOL DISTRICT
LEASE
(Site & Facilities)
GROUND LEASE
(Site)
LESSOR
(Nonprofit Corporation, Joint Powers agency)
CAPITAL PROJECT
(Financed with COP proceeds; leased under Lease)

Asset Transfer/Equity Strip Lease Financings. A variation on the basic lease financing technique is the "asset transfer" or "equity strip" financing. This method allows a school district to finance a project by leasing out and leasing back another, unencumbered asset of the school district. Asset transfer financings follow the basic lease structure described above; however, the property to be leased by the school district as lessee is property already owned by the school district, rather than property that is being purchased or improved in connection with the financing.

To accomplish a COP asset transfer financing, the school district, as lessor, leases existing school district property to a nonprofit corporation or other third party for a one-time payment of rent, and the third party sublets the property back to the school district. The third party's rights to receive periodic payments from the school district under the sublease are assigned to a trustee, who executes and delivers COPs to investors. The proceeds from the sale of the COPs are used to make the one-time site lease rental payment to the school district. The school district must use this payment for capital projects, although those projects need not have any relation to the leased property. A diagram of an asset transfer financing is provided below.



Under the most common method of lease financing in California, a school district's obligation to make lease payments must be contingent upon the school district having use and occupancy of the leased property during the period for which such lease payment is due. When the project to be financed is also the subject of the lease, the school district is not permitted to make lease payments until construction is completed and the school district has use and occupancy of the project. However, because a school district has immediate use and occupancy of the existing improvements under a COP asset transfer structure, lease payments may commence immediately. As a result, there are two significant advantages of the structure: First, there is no risk associated with non-completion of the construction project. Second, there is no need to capitalize interest to cover lease payments during the construction period for the financed project.

What Is the Legal Authority for Lease Financing?

Article XVI, Section 18 of the California Constitution provides that a school district may not incur any indebtedness (payable beyond the fiscal year in which it is incurred) without the approval of the requisite percentage of the voters voting on the matter at an election held for such purpose. In a lease financing, however, the school district's obligations under the lease are designed to avoid classification as indebtedness for purposes of this Constitutional restriction. This is usually accomplished in one of two ways.

Abatement or Offner-Dean Leases. The first, most common, method utilizes a long-term lease containing a rental abatement provision. Under such a lease, each lease payment is contingent upon the school district having use and occupancy of the leased property during the period for which such lease payment is due. The school district's obligation to make lease payments is abated, or reduced, during any period in which the school district does not have full beneficial use and occupancy of the leased property. These leases are often referred to as "Offner-Dean" leases, after two leading California court cases holding that such leases do not constitute debt for California Constitutional purposes. For security purposes, these type of leases usually include a covenant of the school district to include the lease payments in annual budgets submitted to the governing board of the school district and to appropriate the lease payments as long as the lease property is available for use and occupancy.

Annual Appropriation Leases. The second type of lease which avoids classification as debt is known as an "annual appropriation lease." Under such a lease the school district is obligated only for payments due in the then-current fiscal year. The school district has the right, at least once during each fiscal year, to unilaterally terminate the lease by not appropriating the lease payments for the following year. Upon any such termination, the leased property is returned to the lessor.

Either an Offner-Dean lease or an annual appropriation lease may be used as the basis of a direct lease financing or a COP financing. Annual appropriation leases are commonly used in states where courts have not approved Offner-Dean style leases. Because an Offner-Dean lease provides greater security, it is the type most often used in California. However, since many vendors are more familiar with annual appropriation leases, direct lease financings for school districts are frequently based on annual appropriation leases.

Leasing of property by a school district is authorized under various provisions of the Education Code, including Section 17400 and following (leasing property), Section 17430 and following (leasing facilities), Section 17450 and following (leasing of equipment) and Section 17455 and following (sale or lease of real property). Certain of the Education Code leasing provisions overlap, and portions of certain provisions have been repealed, leaving some gaps among the remaining provisions; the resulting interrelationship among the statutory provisions is sometimes complex. Consequently, care should be taken in ascertaining which sections of the Education Code will apply to a proposed lease financing.

What Can Be Financed?

Lease financing generally may be used to finance any real or personal property, the cost of which would constitute a capital expenditure, including land, buildings, relocatable structures, vehicles, computers and other equipment. State law prohibits school districts from using the proceeds of a lease financing for general operating purposes.

Are Additional Revenues Generated?

The lease payments payable under a financing lease are payable out of the school district's general fund or from other available revenues. Thus, the lease financing technique does not generate any new or additional revenue which the school district may use to repay the debt. Lease financing is simply a mechanism for capitalizing a portion of revenues expected over the future term of the lease to create a lump sum that may be used for projects today.

What Are the Procedures to Accomplish a Lease Financing?

Because there are no voter approval and few procedural requirements, the procedures for implementing a lease financing are relatively simple. The school board, by resolution, authorizes the execution and delivery by the school district of the financing documents to which the school district is a party. In a direct lease financing, this is often just a lease agreement. In a COP financing, the school district is party to the ground lease and, usually, the trust agreement as well.

Additionally, the governing body of the lessor—the nonprofit corporation or other third party—must authorize the execution and delivery of the financing documents to which the lessor is a party. These would include the lease agreement (all financings) and the ground lease, the trust agreement and the assignment agreement (COP financings).

COPs may be sold at a negotiated or competitive sale. However, a school district that has a qualified or negative certification in any fiscal year may not proceed with a COP financing in that fiscal year or the next succeeding fiscal year without a determination by the county superintendent that repayment of the obligations by the school district is probable.

How Long Does the Financing Take?

The time required to accomplish a lease financing can be anywhere from three weeks to three months or more, depending primarily on the time it takes to agree on documentation. A sample timetable and outline of a COP financing is included at the end of this chapter.

What Are the Significant Restrictions?

There are a number of restrictions and requirements applicable to lease financings that result either from the legal basis for the lease, from the need to increase the security of investors, or both. Some important restrictions and requirements are as follows:

SIGNIFICANT RESTRICTIONS AND REQUIREMENTS APPLICABLE TO LEASE FINANCINGS

- If the leased project is to be constructed, interest usually must be capitalized during construction because, under an abatement lease structure, the school district may not make lease payments while it does not have use and occupancy of the project. A significant advantage of the asset transfer financing structure is that lease payments may commence immediately.
- A reserve fund is usually required.
- The school district usually must insure the leased project against damage and destruction, provide rental interruption insurance and obtain real property title insurance.
- Lease payments may not be accelerated in the event of a default.
- The term of any equipment lease may not exceed the shorter of the estimated useful life of the equipment or 10 years.

What Are the Important Advantages and Disadvantages?

There are a number of advantages and disadvantages applicable to lease financings, the most significant of which are as follows:

ADVANTAGES AND DISADVANTAGES OF LEASE FINANCINGS

ADVANTAGES	DISADVANTAGES
• No voter approval required. • Significant flexibility because of lack of procedural and other restrictions. • Can be accomplished in a relatively short time. • Can finance virtually any real or personal property.	• Does not generate additional revenue to pay debt service. • Because lease financing is more complex and less secure than general obligation bond financing, interest rates and costs of issuance are higher. • Encumbers the property leased, complicating disposition of such property or future borrowing against it.

Financing Timetable and Outline

The following is a timetable and outline for the execution and delivery of COPs in connection with a lease financing. The timetable and outline are based on statutory provisions in effect as of January 1, 2005, which provisions may be subsequently amended.

FINANCING TIMETABLE AND OUTLINE

COP Financing Action Item	Action Deadline
1. Preliminary Matters.	
A school district that has a qualified or negative certification in any fiscal year may not proceed, in that fiscal year or in the next succeeding fiscal year, with a COP financing or any other debt financing that does not require the approval of the voters of the district, unless the county superintendent of schools determines, pursuant to criteria established by the Superintendent of Public Instruction, that the district's repayment is probable.	**Prior to school board authorizing financing.**
2. Site Selection.	
The title records for any real property involved in the lease financing should be reviewed to confirm that such property is not subject to any prohibited encumbrances. Since real property title insurance must generally be obtained in connection with a lease financing involving real property, this can be accomplished by obtaining a preliminary title report from a title insurance company.	**Prior to school board authorizing financing.**
3. Board Authorization.	
The school board, by resolution, authorizes the execution and delivery by the school district of the financing documents to which the school district is a party, which generally include the ground lease, the lease agreement and the trust agreement, as well as the sale documents involved in the financing (i.e., the certificate purchase contract, official statement, continuing disclosure agreement, etc.).	**Prior to sale of COPs.**
Additionally, the governing body of the lessor—the nonprofit corporation or other third party—must authorize the execution and delivery of the financing documents to which the lessor is a party (generally, the ground lease, the lease agreement, the assignment agreement and the trust agreement).	

Action Deadline	COP Financing Action Item
	4. Notice to County Superintendent of Schools and County Auditor.
Upon the approval of school board to proceed.	Upon the approval by the school board of the school district to proceed with a COP financing, the school district must notify the county superintendent of schools and the county auditor. The superintendent of the school district must provide to the county auditor, the county superintendent, the school board and the public the repayment schedules for the lease and evidence of the ability of the school district to repay the lease payments. Within 15 days of the receipt of the information, the county superintendent of schools and the county auditor may comment publicly to the school board regarding the capability of the school district to repay the lease payments.
	5. Preliminary CDIAC Notice.
Not later than 30 calendar days prior to sale of COPs.	Notice of the proposed COP sale must be filed with CDIAC.
	6. Confirm Availability of Necessary Insurance Coverage.
Prior to sale of COPs.	Since the school district usually must insure the leased property against damage and destruction, provide rental interruption insurance and obtain real property title insurance, the insurance provisions of the lease documents should be reviewed and it should be confirmed that the necessary insurance coverage can be obtained.
	7. Financial Publication Notice.
Not later than 15 calendar days prior to COP sale if COPs exceed $1 million but do not exceed $10 million; not later than 5 calendar days prior to COP sale if COPs exceed $10 million.	If the amount of COPs to be sold exceeds $1,000,000 and the COPs are to be sold at public sale, the school board must cause notice of the sale to be published in a financial publication generally circulated throughout California or reasonably expected to be disseminated among prospective bidders for the COPs.

COP Financing Action Item	Action Deadline
8. Official Statement. The school district has an official statement prepared to provide information to investors and prospective investors about the school district and the lease financing.	**Prior to sale of COPs.**
9. Sale of COPs. COPs may be sold at negotiated or competitive sale.	**At time determined by the school district.**
10. Record Lease Documents in County Recorder's Office. In order to preserve the security interest in the real property, evidence of the leasehold interest must be recorded in the County Recorder's Office.	**At closing.**
11. COP Delivery. The COPs are to be delivered to the underwriter and the underwriter is to pay for the COPs, on the date determined by the school district and the underwriter.	**Following COP sale, as determined by the school district and the underwriter.**
12. Form 8038-G Filed. The reporting requirements of Section 149(e) of the Internal Revenue Code must be met.	**Not later than the 15th day of the second calendar month following the close of the quarter in which the COPs are executed and delivered.**

Action Deadline	COP Financing Action Item
	13. Final CDIAC Notice.
Not later than 45 days after COP sale.	Following the sale, the Report of Final Sale must be filed with CDIAC. The CDIAC fee is due from the underwriter.
	14. Continuing Disclosure.
Annually, as required by the continuing disclosure agreement.	Pursuant to a continuing disclosure agreement or certificate, the school district will be required to annually provide (by filing with certain specified information repositories) certain financial and operating information. See Chapter 8.

CHAPTER 4

MELLO-ROOS SPECIAL TAX BONDS

What Is the Debt Instrument Involved?

Mello-Roos bonds are bonds payable from and secured by voter-approved special taxes levied within a specified geographic area (the "community facilities district") established under the Mello-Roos Community Facilities Act of 1982 (the "Mello-Roos Act"). The term "Mello-Roos" is derived from the names of Senator Henry Mello and Assemblyman Michael Roos, the authors of the Mello-Roos Act. The Mello-Roos Act authorizes the creation of a community facilities district, the levying of a special tax and the issuance of Mello-Roos bonds.

The special tax is secured by a lien on the land upon which the special tax is levied. The special tax is not a personal debt of the property owner. The special taxes are generally collected with and at the same time as general property taxes, although they can be collected at different times and in a different manner if circumstances require.

What Is the Legal Authority for Issuance?

The authority to establish a community facilities district, to levy a special tax and to issue Mello-Roos bonds is granted by the Mello-Roos Act. The Mello-Roos Act also authorizes a school district to act jointly with a city, county or other local agency to form a community facilities district to finance school facilities and other public improvements. The Mello-Roos Act is found at Sections 53311 and following of the Government Code.

What Can Be Financed?

Facilities. Mello-Roos bonds may be issued to finance the purchase, construction, expansion, improvement or rehabilitation of real or other tangible property with an estimated useful life of five or more years. Thus, a community facilities district may be used to finance land, buildings, improvements, relocatable structures, furniture, school buses and equipment with a useful life of at least five years. A Mello-Roos bond financing may also be used as a means of financing developer fees imposed pursuant to Section 53080 and following of the Government Code or to make payments in lieu of such fees.

The facilities financed need not be physically located within the community facilities district and may either be constructed by the school district or purchased from others. Where facilities are purchased, however, the construction must either be completed before a resolution establishing the community facilities district is adopted or be constructed as if they had been constructed under the direction and supervision or under the authority of the school district. Thus, for example, if and to the extent the school district would be required to provide for the payment of "prevailing wages," the construction of facilities to be purchased from the private entity would be subject to the same requirements.

When a community facilities district is formed pursuant to a landowner election, the need for the facilities must be caused by new development or rehabilitation occurring in the district. In fact, a local agency may only conduct a landowner vote if it determines "that any facilities financed by the district are necessary to meet increased demands placed on local agencies as the result of development or rehabilitation."

For purposes of financing specified public facilities, the bond provisions of the Mello-Roos Act enable the school board to form "improvement areas" within a community facilities district. Where an improvement area has been designated, all proceedings under the Mello-Roos Act, including proceedings for purposes of levying special taxes, incurring bonded indebtedness and any change proceedings, apply only to the improvement area and only the voters within the improvement area approve the related special taxes, bonds or changes.

Services. In addition to facilities, a community facilities district may finance certain services specified in the Mello-Roos Act. Of such services, those that might be pertinent to a school district include recreation program services, library services, maintenance services for elementary and secondary school sites and structures, the operation and maintenance of museums and cultural facilities and the maintenance of parks and open space. Recreation program services, library services, maintenance services for elementary and secondary school sites and structures and the operation and maintenance of museums and cultural facilities may only be authorized through an election by registered voters, unless the proposed special tax will not be apportioned in any tax year on any portion of property in residential use in that tax year. The maintenance

of parks may be authorized by a landowner election. Services are financed out of the proceeds of the annual special tax levy; bond proceeds may not be used to finance services. Any services authorized by a landowner election must be in addition to those already provided within the community facilities district and may not supplant services already available within that territory when the community facilities district was created. The limitation does not apply to registered-voter elections.

Payment of Other Obligations. A community facilities district may also be used to eliminate any fixed special assessment liens or to pay any indebtedness secured by any tax, fee, charge or assessment levied within the area of the community facilities district, or may pay debt service on that indebtedness. In addition, tax revenues of a community facilities district may be used to make lease or debt service payments on any lease, lease purchase contract or certificate of participation used to finance authorized community facilities district facilities.

Are Additional Revenues Generated?

General. Mello-Roos bonds are payable from a voter-approved special tax levied within the community facilities district; additional tax revenues are generated for payment of the bonds. Like general obligation bonds, Mello-Roos bonds are not payable from the school district's general fund; they are self-supporting and cause no reduction in school district financial resources.

Rate and Method. There is nearly unlimited flexibility in designing the rate and method of apportionment of the special tax (the "rate and method") such as a rate per acre, per parcel or on the basis of the size of buildings. The tax must, in every case, have a stated maximum; but it can reflect virtually any reasonable public policy consideration or development consideration in terms of how and when the taxes are to be levied. The only real legal constraints are that the rate and method must have a reasonable basis and the tax cannot be an ad valorem tax; that is, it cannot be based on the value of the property taxed.

The Mello-Roos Act does not confer any right on the taxpayers to prepay the special tax, but the Mello-Roos Act does permit a prepayment mechanism to be defined as part of the rate and method.

Limitations on Special Tax to Pay for Facilities. In the case of any special tax on property used for residential purposes to pay for facilities, a termination date for the levy of the tax must be established, the tax must not escalate by more than 2% per year and any increase in the tax levy from one year to the next to cover tax delinquencies within the community facilities district must not exceed 10%. A special tax for services is not so limited. No increase in a special tax, whether by automatic escalation or to cover delinquencies, may in any event exceed the maximum tax established as part of the formation of the community facilities district.

What Are the Procedures for Issuance?

While there are many intermediate steps, the following is illustrative of the basic steps for the formation of a community facilities district and the authorization and issuance of Mello-Roos bonds:

- *Goals and Policies.* Prior to initiating proceedings for creation of a community facilities district, a school board must adopt goals and policies concerning the use of the Mello-Roos Act.
- *Proceedings Initiated.* Proceedings to establish a community facilities district may be instituted by initiative of the school board, by written request signed by two members of the school board, by petition signed by not less than 10% of the registered voters within the proposed community facilities district or by petition signed by the owners of not less than 10% of the area of land within the proposed community facilities district.
- *Resolution of Intention.* A resolution of intention to establish a community facilities district must be adopted within 90 days after a written request or a petition to create the community facilities district is filed.
- *Resolution to Incur Bonded Indebtedness.* Generally, proceedings to issue bonds secured by the levy of a special tax are combined with the proceedings to establish a community facilities district. A resolution to incur bonded indebtedness is considered at the same time as the resolution of intention.
- *Public Hearings.* A public hearing on the establishment of the community facilities district must be held not less than 30 or more than 60 days after the adoption of the resolution of intention. If there is a majority protest against the formation of the community facilities district, no further proceedings may be undertaken for a period of a year; if the majority protest is only against the furnishing of a specified type of facility or service, that facility or service must be eliminated. If the protest is against levying a specified special tax, that special tax must be eliminated. If a resolution to incur bonded indebtedness has been adopted, a public hearing regarding the proposed debt issuance would be held at the same time as the public hearing on the establishment of the community facilities district.

- *Community Facilities District Report.* When the resolution of intention is adopted, the school board must direct each officer responsible for providing one or more of the proposed services or facilities to file a report that contains a brief description of the type of public services or facilities required to meet adequately the needs of the community facilities district and an estimate of the cost of providing the services or facilities.
- *Resolution of Formation.* Assuming there is no majority protest to the formation of the community facilities district or the issuance of bonds, the school board may proceed to establish the community facilities district by the adoption of a resolution of formation.
- *Resolution of Necessity.* If a resolution to incur bonded indebtedness has been adopted and the school board has proceeded to establish the community facilities district by adopting a resolution of formation, the school board may also adopt a resolution of necessity to incur bonded indebtedness.
- *Resolution Calling Election.* The school board must then submit the propositions to levy the special tax, to incur the bonded indebtedness and to establish an appropriations limit to the qualified electors of the proposed community facilities district, which may be combined into one ballot proposition.
- *Conduct Election.* The authorization of the Mello-Roos special tax requires a two-thirds vote of the "qualified electors." If 12 or more registered voters have been registered to vote within the community facilities district for each of the 90 days preceding the close of the public hearing, the qualified electors are the registered voters. If not, the qualified electors are the owners of property within the community facilities district. In a landowner election, each owner receives one vote for each acre or portion of an acre owned.
- *Resolution Declaring Results of Election.* If at least two-thirds of the votes cast upon the propositions are in favor of such propositions, the school board may levy the special tax and issue bonds. The school board must adopt a resolution declaring the results of the election. If the question of levying the special tax fails to receive approval by two-thirds of the votes cast, the school board must not take any further action with respect to levying the special tax for a period of one year from the date of the election.
- *Notice of Special Tax Lien.* Within 15 days after declaring that the requisite number of voters are in favor of the levy of a special tax, the clerk of the school board must execute and record a notice of special tax lien in the office of the county recorder of each county in which all or any part of the community facilities district is located.
- *Levy and Collection of the Special Tax.* The special tax must be levied initially by an ordinance enacted by the school board. The school board may thereafter provide, by resolution, for the levy of the special tax in the current tax year or future tax years at the same rate or at a lower rate than the rate provided by the ordinance.

- *Resolution Authorizing Issuance of Bonds.* The school board adopts a resolution authorizing the issuance and sale of all or a portion of the authorized amount of Mello-Roos bonds. Mello-Roos bonds may be sold at negotiated sale if the school board determines that a negotiated sale would result in a lower overall cost than a competitive sale; otherwise, the bonds must be sold at an advertised public sale. Unless certain special findings are made, the school board may sell Mello-Roos bonds only if it determines prior to the award of sale of such bonds that the value of the real property that would be subject to the special tax to pay debt service on the bonds will be at least three times the principal amount of the bonds to be sold and the principal amount of all other bonds outstanding that are secured by a special tax levied pursuant to the Mello-Roos Act on property within the community facilities district or a special assessment levied on property within the community facilities district.

A sample timetable and more complete outline of the procedures for creating a community facilities district and issuing Mello-Roos bonds is included at the end of this chapter.

Amendment of Financing Powers After Community Facilities District Formed. The Mello-Roos Act provides procedures by which changes to the types of public facilities or services financed by the district or to the rate and method may be made or by which an entirely new special tax may be levied. However, the Mello-Roos Act does not permit the school board to conduct change proceedings unless it makes a finding that the change will not jeopardize the repayment of any outstanding debt. Change proceedings require the adoption of a resolution of consideration (specifying the proposed changes) and, like the initial formation proceedings, a public hearing, notice of the public hearing and an election with respect to the proposed change. The number of registered voters or landowners within the community facilities district comprising a majority protest are the same as in the initial formation proceeding and the effect of a majority protest is also the same (i.e., no further proceedings with respect to such change may be undertaken for one year). The election procedures to make such a change are also generally the same as in the initial formation proceeding.

Annexation To An Existing Community Facilities District. A school district may establish a community facilities district to provide school facilities to a relatively small geographic area knowing that additional property will use and will be served by the facilities at a later time. The Mello-Roos Act provides procedures by which territory may be annexed to an existing community facilities district. The territory to be annexed need not be contiguous to territory included in the existing community facilities district. The proceeding for annexation of territory is similar to the initial formation proceeding. A resolution of intention to annex the territory must be adopted, a map of the territory to be annexed must be prepared and recorded, a public hearing must be held and notice of the public hearing must be given in the same time

and manner as the notice to establish a community facilities district. If a majority protest is filed by either the registered voters or landowners of the community facilities district or the territory to be annexed, as the case may be, no further proceedings may be undertaken for one year. The election procedures for an annexation are also generally the same as in the initial formation proceeding. However, only the registered voters within or landowners of the territory to be annexed vote with respect to the annexation.

How Long Does the Financing Take?

A distinction needs to be made between the time necessary to conduct the formal proceedings and the time necessary to negotiate all of the terms of the community facilities district with the landowners before the formal process can begin. The negotiation process can take a substantial amount of time. Once the formal process begins, and because of the time required to conduct all of the proceedings described above for forming the community facilities district and conducting the election, a Mello-Roos financing subject to a landowner election may take from three to six months to accomplish. A Mello-Roos financing subject to a registered voter election may require an additional three months or more for the formal proceedings, although it typically does not involve the negotiation process and hence may take less time overall. A sample timetable and outline of the procedures for creating a community facilities district and issuing Mello-Roos bonds is included at the end of to this chapter.

What Are the Significant Restrictions?

There are a number of restrictions and requirements applicable to Mello-Roos bonds, the most significant of which are as follows:

SIGNIFICANT RESTRICTIONS APPLICABLE TO MELLO-ROOS BONDS

- The levy of a special tax and the issuance of Mello-Roos bonds must be approved by two-thirds of the qualified electors of the community facilities district.
- The vote on the special tax must be by registered voters residing in the community facilities district if at least 12 persons have been registered to vote within the community facilities district for each of 90 days preceding the close of the public hearing.
- Interest rates on bonds, including those that bear a variable rate, may not exceed 12% per year.
- State law generally requires a 3-to-1 value-to-bond ratio.
- The special tax may only be levied pursuant to a rate and method of apportionment, which contains clear maximum rates, all of which must be specified at the time the community facilities district is formed.

What Are the Important Advantages and Disadvantages?

There are a number of advantages and disadvantages applicable to Mello-Roos bonds, the most significant of which are as follows:

ADVANTAGES AND DISADVANTAGES OF MELLO-ROOS BONDS

ADVANTAGES	DISADVANTAGES
• Generate additional revenue to pay debt service and expenses. • Flexibility in establishing rate and method. • Array of facilities and services that can be financed. • Because the rate and method is flexible, it can be designed to match financing needs to pace of growth due to new development in school district.	• Voter approval required. • Registered voter approval required if there are 12 or more registered voters in the community facilities district for each of 90 days preceding the close of the public hearing. • Compared to other school district financing methods, most community facilities district financings are complicated. • Lengthy financing time frame.

Mello-Roos Bonds Compared to General Obligation Bonds. The primary advantage of utilizing Mello-Roos bonds over general obligation bonds is the ability to narrowly mitigate the impacts of new development through the establishment of a community facilities district by a landowner vote that imposes special taxes only on property proposed to be developed. A school district may also want to consider Mello-Roos bonds as an alternative to general obligation bonds because they can be used to finance such things as furniture without the accountability requirements imposed by Proposition 39 and vehicles, for which general obligation bonds cannot be used. In addition, the special tax can avoid what some perceive as the unfairness of Proposition 13's artificial differentiations in the assessed valuations of comparable properties. See also the chart entitled "Summary Comparison of the Four Basic Financing Techniques" included in Chapter 1 of this guidebook.

Special Continuing Disclosure Considerations. The federal continuing disclosure requirements under SEC Rule 15c2-12 are discussed in Chapter 8 of this guidebook. In addition to those requirements, there are specific continuing disclosure requirements in State law concerning the Mello-Roos special tax. Annual reporting to CDIAC is required for Mello-Roos bonds of the principal amount of bonds outstanding, the balances in the reserve fund, capitalized interest fund and construction fund, the delinquency and foreclosure information on all delinquent parcels and the assessed value of all parcels subject to the tax. Immediate reporting (within 10 days) to CDIAC is required whenever the reserve fund is drawn down below the reserve requirement or bonds go into default.

Formation and Mello-Roos Bond Issuance Timetable and Outline

The following is a general timetable and outline for forming a community facilities district and issuing special tax bonds. The timetable and outline are based on statutory provisions in effect as of January 1, 2005, which provisions may be subsequently amended. The deadlines are stated in terms of number of days before or after other action items rather than as specific dates.

FINANCING TIMETABLE AND OUTLINE

Formation Action Item	Action Deadline
1. Goals and Policies. A school board must adopt goals and policies concerning the use of the Mello-Roos Act, including statements concerning: (i) the priority that various kinds of public facilities shall have for financing through the use of the Mello-Roos Act; (ii) the credit quality to be required of bond issues, including criteria to be used in evaluating the credit quality; (iii) the steps to be taken to ensure that prospective property purchasers are fully informed about their taxpaying obligations imposed under the Mello-Roos Act; (iv) the criteria for evaluating the equity of tax allocation formulas and concerning desirable and maximum amounts of special tax to be levied against any parcel; (v) the definitions, standards and assumptions to be used in appraisals required by the Mello-Roos Act; and (vi) priority attendance access to students residing in a community facilities district whose residents have paid special taxes which have financed the construction of school district facilities. In developing a priority access policy for residents of a community facilities district, a school district may incorporate the school district's attendance policy, including criteria for student assignment such as goals to achieve ethnic, racial, or socioeconomic diversity; federal, state, or court mandates; transportation needs, safe pedestrian routes; grade levels for which facilities were designed; and ensuring students continuity of schooling within any single school year.	**Prior to initiating proceedings for creation of a community facilities district.**

2. Proceedings Initiated.

Anytime after adopting local goals and policies.

Proceedings to establish a community facilities district may be instituted in any of the following ways: (i) by initiative of the school board; (ii) by written request signed by two members of the school board; (iii) by petition signed by not less than 10% of the registered voters within the proposed community facilities district; or (iv) by petition signed by the owners of not less than 10% of the area of land within the proposed community facilities district. A proceeding initiated by a written request or a petition must be accompanied by a fee determined by the school board to be sufficient to cover the costs of conducting the proceedings and such written request or petition must describe the boundaries of the territory which is proposed for inclusion in the community facilities district and state the type or types of facilities and services to be financed by the community facilities district.

3. Resolution of Intention.

Within 90 days after a written request or a petition to create the community facilities district is filed.

A resolution of intention to establish a community facilities district must be adopted within 90 days after a written request or a petition to create the community facilities district is filed. The resolution of intention must:

- State that a community facilities district is proposed to be established under the terms of the Mello-Roos Act and describe the proposed boundaries of the community facilities district. Only whole parcels of real property may be included within the boundary. The community facilities district may include areas of territory that are not contiguous.
- State the name proposed for the community facilities district.
- Generally describe the type or types of facilities or services to be financed (and identify any completed facilities to be acquired or incidental expenses to be incurred) by the community facilities district. Briefly describe any lease, lease-purchase or installment-purchase arrangements proposed.
- State that a special tax will be levied to pay for the facilities and services and specify the rate, method of apportionment and manner of collection of the special tax. The latter must be specified in

sufficient detail so each landowner or resident is able to estimate the probable annual amount and maximum amount that must be paid. Any conditions under which the obligation to prepay the special tax may be prepaid may be specified. In the case of any special tax to pay for public facilities and to be levied against any parcel used for private residential purposes, (i) the maximum special tax must be specified as a dollar amount which must be calculated and thereby established not later than the date on which the parcel is first subject to the tax because of its use for private residential purposes, which amount cannot be increased over time except that it may be increased by an amount not to exceed 2% per year, (ii) the resolution must specify a tax year after which no further special tax subject to this sentence shall be levied or collected, and (iii) the resolution must specify that under no circumstances will the special tax levied against any parcel subject to this sentence be increased as a consequence of delinquency or default by the owner of any other parcel or parcels within the community facilities district by more than 10%. For purposes of this paragraph, a parcel shall be considered "used for private residential purposes" not later than the date on which an occupancy permit for private residential use is issued.

- Describe any adjustment in property taxation to pay prior indebtedness.
- Fix a time and place for a public hearing on the establishment of the community facilities district which shall be not less than 30 or more than 60 days after the adoption of the resolution of intention.
- Describe the proposed voting procedure.
- State any proposal to repay a person who (or an entity that) advanced funds or work in kind to the school board to pay any cost incurred in creating the community facilities district.

When a community facilities district is proposed by a school board, a copy of the resolution of intention must be submitted to the city or county where the land to be taxed lies.

4. Resolution to Incur Bonded Indebtedness.

Generally, at the same time as the resolution of intention.

Generally, proceedings to issue bonds secured by the levy of a special tax are combined with the proceedings to establish a community facilities district and, therefore, a resolution to incur bonded indebtedness is considered at the same time as the resolution of intention. The resolution to incur bonded indebtedness must (i) declare the necessity for the bonds, (ii) state the purpose for which the bonds will be issued, (iii) state the amount of the proposed bonds, and (iv) fix the time and place for a public hearing on the issuance of the bonds.

The amount of the proposed bonded indebtedness may include all costs and estimated costs incidental to, or connected with, the accomplishment of the purpose for which the proposed debt is to be incurred, including, but not limited to, the estimated costs of construction or acquisition of buildings, or both; acquisition of land, rights-of-way, water, sewer, or other capacity or connection fees; lease payments for school facilities, satisfaction of contractual obligations relating to expenses or the advancement of funds for expenses existing at the time the bonds are issued pursuant to the Mello-Roos Act; architectural, engineering, inspection, legal, fiscal and financial consultant fees; bond and other reserve funds; discount fees; interest on any bonds of the district estimated to be due and payable within two years of issuance of the bonds; election costs; and all costs of issuance of the bonds, including, but not limited to, fees for bond counsel, costs of obtaining credit ratings, bond insurance premiums, fees for letters of credit and other credit enhancement costs and printing costs.

5. Recordation of Boundary Map.

Within 15 days after the adoption of the resolution of intention and in no event later than 15 days before the public hearing.

The map of the community facilities district must be recorded within 15 days after the adoption of the resolution of intention (which fixes the time and place of the public hearing on the establishment of the community facilities district) and in no event later than 15 days before the public hearing. The community facilities district may include areas of territory that are not contiguous, but only whole parcels of real property may be included within the boundary. Land devoted primarily to and being used for the commercial pro-

duction of agriculture, timber or livestock uses may only be included in a community facilities district if (i) the land is contiguous to other land that is included within the boundaries of the community facilities district and (ii) the school board finds that the land will be benefited by the proposed services or facilities. Where an owner of any such land requests its inclusion, it may be included. In addition, land that is dedicated or restricted to agricultural, open-space, or conservation uses may not be included within or annexed to a community facilities district that provides or would provide facilities or services related to sewers, nonagricultural water, or streets and roads, unless the landowner consents to the inclusion or annexation of that land to the community facilities district.

6. Notices of Public Hearings.

The clerk of the school board is required to publish notice of the public hearings once in a newspaper of general circulation in the proposed community facilities district. The publication must be completed at least seven days before the public hearings. Notice of the public hearings may also be given by first-class mail to each registered voter and to each landowner within the proposed community facilities district. Mailed notice must be sent at least 15 days before the public hearings. The published notice and the mailed notice must contain (i) the text or a summary of the resolution of intention, (ii) the time and place of the public hearing, (iii) a statement that the testimony of all interested persons will be heard at the hearing and a description of the effect of any protests, and (iv) a description of the proposed voting procedure.

Publication must be completed at least seven days before the public hearings. Mailed notice must be sent at least 15 days before the public hearings.

7. Community Facilities District Report.

When the resolution of intention is adopted, the school board must direct each officer responsible for providing one or more of the proposed services or facilities to file a report that contains a brief description of the type of public services or facilities required to meet adequately the needs of the community facilities district and an estimate of the cost of providing the services or facilities. If the community facilities district proposes to purchase completed public facilities or to pay incidental expenses, the officer must estimate the

Must be filed with the school board at or before the time of the public hearing on the formation of the community facilities district.

fair and reasonable cost of those facilities or expenses. If removal or remedial action for the cleanup of hazardous waste is proposed, the school board must direct its responsible officer to prepare a remedial action plan or determine that such a plan is not required. The report must be made a part of the record of the hearing on the formation of the community facilities district.

8. Public Hearings.

Not less than 30 or more than 60 days after the adoption of the resolution of intention.

A public hearing on the establishment of the community facilities district must be held not less than 30 or more than 60 days after the adoption of the resolution of intention. The public hearing may be continued, but must be completed within 30 days unless the school board finds that the community facilities district is so complex or that the need for public participation requires additional time, in which case the public hearing may be continued but only up to six months.

Protests may be made at the hearing by any interested persons or taxpayers in writing or may be oral and may be against the establishment of the community facilities district, the extent of the community facilities district or the type of facilities or services to be provided. Protests about the regularity or the sufficiency of the proceedings must be in writing and must clearly set forth the irregularities or defects. Written protests must be filed with the clerk of the school board on or before the time fixed for the hearing and may be withdrawn in writing at any time before the hearing is concluded.

If (i) the greater of 50% or more of the registered voters or six registered voters residing in the territory proposed to be included in the community facilities district, or (ii) the owners of one-half or more of the area of land in the territory proposed to be included in the community facilities district (excluding land exempt from the special tax), file (and do not withdraw) written protests against the establishment of the community facilities district and the protest is not reduced to less than a majority, the proceedings to create the community facilities district or to levy the special tax must be discontinued for a period of one year; if the majority protest is only against the furnishing of a specified type of facility or service, that

facility or service must be eliminated. If the protest is against levying a specified special tax, that special tax must be eliminated.

At the public hearing, the resolution of intention may be modified by (i) eliminating proposed facilities or services, (ii) changing the rate or method of apportioning the special tax but only to reduce the maximum special tax for all or a portion of the property owners within the community facilities district, or (iii) removing territory from the proposed community facilities district. If the school board proposes to modify the resolution of intention in a way that will increase the probable special tax to be paid by the owner of any lot or parcel, it must direct that a report be prepared that includes a brief analysis of the impact of the proposed modifications on the probable special tax to be paid by the owners of lots or parcels in the community facilities district and must receive and consider the report before approving the modifications or any resolution of formation which includes those modifications.

If a resolution to incur bonded indebtedness has been adopted, a public hearing regarding the proposed debt issuance would be held at the same time as the public hearing on the establishment of the community facilities district. At the hearing, any person interested, including persons owning property within the area, may appear and present any matters material to the questions set forth in the resolution declaring the necessity for incurring the bonded indebtedness.

9. Resolution of Formation.

Action Deadline: After the public hearing.

Assuming there is no majority protest to the formation of the community facilities district, the school board may proceed to establish the community facilities district. This is accomplished by the adoption of a "resolution of formation." The resolution of formation must contain all of the information contained in the resolution of intention and must also (i) state that the proposed special tax to be levied within the community facilities district has not been precluded by majority protest, (ii) identify any facilities or services proposed to be funded with the special tax, (iii) set forth the name, address and telephone number of the office, department, or bureau which will be responsible for preparing annually a current roll of special tax levy

obligations by assessor's parcel number and which will be responsible for estimating future special tax levies, (iv) state that upon recordation of a notice of special tax lien, a continuing lien to secure each levy of the special tax will attach to all nonexempt real property in the community facilities district and that the lien will continue in force and effect until the special tax obligation is prepaid and permanently satisfied and the lien canceled in accordance with law or until collection of the tax by the school board ceases, (v) set forth the county of recordation and the book and page in the Book of Maps of Assessments and Community Facilities Districts in the county recorder's office where the boundary map of the proposed community facilities district has been recorded, and (vi) determine by a specific finding, whether the proceedings were valid and in conformity to the Mello-Roos Act.

10. Resolution of Necessity.

After the public hearing.

If a resolution to incur bonded indebtedness has been adopted and the school board has proceeded to establish the community facilities district by adopting a resolution of formation, the school board may also adopt a resolution of necessity to incur bonded indebtedness. The resolution of necessity must state: (i) the necessity for the bonds, (ii) the purpose for which the bonds will be issued, (iii) either (a) that the whole of the community facilities district will pay for the bonded indebtedness or (b) that a portion of the community facilities district (designated as an improvement area pursuant to the Mello-Roos Act) will pay for the bonded indebtedness, (iv) the amount of the proposed bonds, (v) the maximum term of the bonds (not exceeding 40 years), (vi) the maximum annual interest rate to be paid, (vii) that the proposition will be submitted to the voters, (viii) the date of the election at which time the proposition will be submitted to the voters, (ix) if the election is not conducted by mail ballot, the hours between which the polls will be open, and (x) if the election is conducted by mail ballot, the hour when the mailed ballots are required to be received in the office of the election officer conducting the election and that if all qualified electors have voted, the election shall be closed.

11. Resolution Calling Election.

The school board must submit the levy of any special taxes to the qualified electors of the proposed community facilities district subject to the levy in the next general election or in a special election to be held, notwithstanding any other requirement, including any requirement that elections be held on specified dates, contained in the Elections Code, at least 90 days, but not more than 180 days, after the school board adopts the resolution establishing the community facilities district. These time limits may be waived with the unanimous consent of the qualified electors and the concurrence of the election official. The concurrence of the election official conducting the election must be obtained if the election is to be held less than 125 days following the adoption of the resolution of formation.

Immediately following the adoption of the resolution of formation and the resolution of necessity.

The provisions of law regulating elections of school districts govern all elections called by the school district under the Mello-Roos Act. An impartial analysis pursuant to specific sections of the Elections Code listed in the Mello-Roos Act must be prepared and included in the ballot material provided to each voter. If the vote is to be by the landowners of the proposed community facilities district, the analysis and ballot arguments may be waived by the unanimous consent of all the landowners. A ballot proposition may combine propositions relating to (i) the levy of a special tax, (ii) the incurring of bonded indebtedness, and (iii) the establishment of an appropriations limit.

12. Information Delivered to Election Official.

The school board must provide the resolution of formation, a certified map of sufficient scale and clarity to show the boundaries of the community facilities district and a sufficient description to allow the election official to determine the boundaries of the community facilities district to the official conducting the election within three business days after the adoption of the resolution of formation. Assessor's parcel numbers for the land within the community facilities district must be included if it is a landowner election or the district does not conform to an existing community facilities district's boundaries and if requested by the official conducting the election.

Within three business days after the adoption of the resolution of formation.

Action Deadline	Formation Action Item

13. Notice of Election.

Reasonable time prior to election which will allow for compliance with other election deadlines.

The resolution of necessity must be published in a newspaper of general circulation circulating within the area of the community facilities district and such resolution will constitute the notice of the special bond election. In addition, there are various other notices required by the California Election Code that must be published, including notice for submitting ballot arguments.

14. Election.

At least 90 days (except when waivers are obtained), but not more than 180 days, after the school board adopts the resolution establishing the community facilities district.

The authorization of the Mello-Roos special tax requires a two-thirds vote of the "qualified electors." If fewer than 12 registered voters reside in the community facilities district for each of 90 days preceding the close of the public hearing, the qualified electors are the owners of property within the community facilities district. Each owner receives one vote for each acre or portion of an acre owned. If the community facilities district is inhabited (12 or more registered voters reside within the community facilities district for each of 90 days preceding the close of the public hearing), the qualified electors are the registered voters; provided, however, that if the special tax will not be apportioned on any property in residential use at any time, the vote may be by the owners of land which would be subject to the special tax at the time of the election. In certain circumstances, a landowner election may be completed the same night as the public hearing. In a registered voter election, the election becomes very formal and is generally handled by the county and coordination with the county elections clerk or registrar of voters is essential. Any procedure to attack, set aside, void or annul the levy of a special tax must be begun within 30 days after the special tax is approved by the voters.

15. Resolution Declaring Results of Election.

After certification of the election results.

If at least two-thirds of the votes cast upon the propositions are in favor of such propositions, the school board may levy the special tax and issue bonds. The school board must adopt a resolution declaring the results of the election. If the question of levying the special tax fails to receive approval by two-thirds of the votes cast, the school board must not take any further action with respect to levying the special tax for a period of one year from the date of the election.

16. Notice of Special Tax Lien.

Within 15 days after declaring that the requisite number of voters are in favor of the levy of a special tax, the clerk of the school board must execute and record a notice of special tax lien in the office of the county recorder of each county in which all or any part of the community facilities district is located. The notice refers to the recording data for the boundary map, describes the authorized facilities and services, includes a copy of the rate and method and includes a listing of the names of the owners and the assessor's tax parcel numbers of the real property included within the community facilities district and not exempt from the special tax as shown on county assessor's roll.

Within 15 days after declaring the results of the election.

17. Levy and Collection of the Special Tax.

The special tax must be levied initially by an ordinance enacted by the school board. The school board may thereafter provide, by resolution, for the levy of the special tax in the current tax year or future tax years at the same rate or at a lower rate than the rate provided by the ordinance, if the resolution is adopted and a certified list of all parcels subject to the special tax levy including the amount of the tax to be levied on each parcel for the applicable tax year, is filed by the clerk or other official designated by the school board with the county auditor on or before the 10th day of August of that tax year.

After declaration of the election results and in accordance with the rate and method of apportionment.

The special tax installments are generally collected on the regular property tax bill and are subject to the same enforcement mechanism as ad valorem property taxes. There also is authority to judicially foreclose the lien of unpaid special taxes if Mello-Roos bonds are outstanding, and a covenant to do so under specified circumstances is usually a requirement of selling Mello-Roos bonds.

BOND ISSUANCE TIMETABLE

Action Deadline	Bond Issuance Action Item
	1. Appraisal.
Prior to school board authorizing bond sale.	Unless certain special findings are made, the school board may sell Mello-Roos bonds only if it determines prior to the award of sale of such bonds that the value of the real property that would be subject to the special tax to pay debt service on the bonds will be at least three times the principal amount of the bonds to be sold and the principal amount of all other bonds outstanding that are secured by a special tax levied pursuant to the Mello-Roos Act on property within the community facilities district or a special assessment levied on property within the community facilities district. Any determination of value must be based upon the full cash value as shown on the ad valorem assessment roll or upon an appraisal of the subject property made in a manner consistent with the school board's goals and policies concerning the use of the Mello-Roos Act. If the school board finds and determines that the proposed bonds do not present any unusual credit risk due to the availability of credit enhancements or certain escrow deposits of bond proceeds or for other reasons specified by the school board, the school board may sell Mello-Roos bonds without making the value-to-lien finding. Similarly, if the school board finds and determines by a vote of not less than four-fifths of all of its members that the proposed bond issue should proceed for specified public policy reasons, the school board may sell Mello-Roos bonds without making the value-to-lien finding.
	2. Resolution Authorizing Issuance of Bonds.
Prior to bond sale.	The school board adopts a resolution authorizing the issuance and sale of all or a portion of the authorized amount of Mello-Roos bonds.
	3. Preliminary CDIAC Notice.
Not later than 30 calendar days prior to bond sale.	Notice of the proposed bond sale must be filed with CDIAC.

Bond Issuance Action Item	Action Deadline
4. Financial Publication Notice. If the amount of bonds to be sold exceeds $1,000,000 and the bonds are to be sold at public sale, the school board must cause notice of the sale to be published in a financial publication generally circulated throughout California or reasonably expected to be disseminated among prospective bidders for the bonds.	**Not later than 15 calendar days prior to bond sale if bonds exceed $1 million but do not exceed $10 million; not later than 5 calendar days prior to bond sale if bonds exceed $10 million.**
5. Official Statement. The community facilities district has an official statement prepared to provide information to investors and prospective investors about the community facilities district and the Mello-Roos bonds.	**Prior to bond sale.**
6. Local Publication Notice. Before selling bonds, if the bonds are to be sold at public sale, the school board must publish notice of the sale once, in a newspaper of general circulation in the proposed community facilities district, not less than 10 days prior to the date of sale. If no bids are received or if the school board determines that the bids received are not satisfactory as to price or responsibility of the bidders, the school board may reject all bids received, if any, and either readvertise or sell the bonds at private sale.	**Not later than 10 days prior to bond sale.**
7. Sale of Bonds. Mello-Roos bonds may be sold at negotiated sale if the school board determines that a negotiated sale would result in a lower overall cost than a competitive sale; otherwise, the bonds must be sold at an advertised public sale.	**At time determined by the community facilities district.**

Action Deadline	Bond Issuance Action Item
	8. Bond Delivery.
Following bond sale, as determined by the community facilities district and the purchaser.	The bonds are to be delivered to the purchaser thereof and the purchaser is to pay for the bonds on the date determined by the community facilities district and the purchaser.
	9. Form 8038-G Filed.
Not later than the 15th day of the second calendar month following the close of the quarter in which the bonds were issued.	The reporting requirements of Section 149(e) of the Internal Revenue Code must be met.
	10. Final CDIAC Notice.
Not later than 45 days after bond sale.	Following the sale, a report of final sale must be filed with CDIAC. The CDIAC fee is due from the underwriter.
	11. Annual Report.
Not later than the earlier of 120 days after the last day of each fiscal year or January 1 of each year following bond sale, as applicable.	At least once a year, no later than January 1, the chief fiscal officer of the school district must file a report with the school board containing: (i) the amount of funds collected and expended, and (ii) the status of any project required or authorized to be funded as identified in the ballot proposition. In addition, if requested by a person who resides in or owns property in the community facilities district, the community facilities district must prepare, within 120 days after the last day of each fiscal year, an "annual report," which must include the following information for the fiscal year: (i) the amount of special taxes collected for the year; (ii) the amount of other moneys collected for the year and their source, including interest earned; (iii) the amount of moneys expended for the year; (iv) a summary of the amount of moneys expended for the following: (a) facilities, including property; (b) services; (c) the costs of bonded indebtedness; (d) the costs of collecting the special tax; and (e) other administrative and overhead costs;

(v) for moneys expended for facilities, including property, an identification of the categories of each type of facility funded with amounts expended in each category, including the total percentage of the cost of each type of facility that was funded with bond proceeds or special taxes; (vi) for moneys expended for services, an identification of the categories of each type of service funded with amounts expended in each category, including the total percentage of the cost of each type of service that was funded with bond proceeds or special taxes; (vii) for moneys expended for other administrative costs, an identification of each of these costs; and (viii) a certification and explanation by the community facilities district of how the moneys described in subdivisions (iv), (v), (vi), and (vii) comply with the Mello-Roos Act. The community facilities district may charge a fee for the report not exceeding the actual costs of preparing the report. The annual report must be made available to the public upon request.

12. Continuing Disclosure.

Pursuant to a continuing disclosure agreement or certificate for the benefit of the holders of the bonds, the community facilities district (and certain other obligated persons, i.e., developer landowners) will be required to provide (by filing with certain specified information repositories) certain financial and operating information. For a discussion of the federal continuing disclosure requirements under SEC Rule 15c2-12, see Chapter 8.

Annually, as required by the continuing disclosure agreement with respect to the bonds.

In addition to the federal continuing disclosure requirements, there are specific continuing disclosure requirements under State law concerning the Mello-Roos special tax. Annual reporting to CDIAC is required for Mello-Roos bonds of the principal amount of bonds outstanding, the balances in the reserve fund, capitalized interest fund and construction fund, the delinquency and foreclosure information on all delinquent parcels and the assessed value of all parcels subject to the tax. Immediate reporting (within 10 days) to CDIAC is required whenever the reserve fund is drawn down below the reserve requirement or bonds go into default.

CHAPTER 5

TAX AND REVENUE ANTICIPATION NOTES

What Is the Debt Instrument Involved?

Tax and revenue anticipation notes are short term debt instruments used to finance cash flow deficits in anticipation of receiving taxes and other revenues. Generally, TRANs are issued for 12 or 13 months and are repaid out of revenues of the fiscal year in which the borrowing occurs.

What Is the Legal Authority for Issuance?

Because a TRAN is payable only out of revenues of the fiscal year in which the borrowing occurs, it is not an indebtedness requiring voter approval under Article XVI, Section 18 of the California Constitution. Sections 53820 through 53859.09 of the Government Code authorize school districts to engage in temporary borrowing for various purposes. However, TRANs are usually issued under Section 53850 and following of the Government Code.

What Can Be Financed?

The proceeds of a TRAN may be used and expended by the school district for any purpose for which the school district is authorized to use and expend moneys, including, but not limited to, current expenses, capital expenditures and the discharge of any obligation or indebtedness of the school district. TRAN proceeds may not be invested for a term longer than the maturity of the notes.

Are Additional Revenues Generated?

In effect, money derived from the issuance of TRANs is a temporary advance against taxes and other revenues to be received by a school district. Thus, this type of financing vehicle does not generate additional revenue through an increase in taxes or otherwise. However, as described below, if certain restrictions are complied with, a school district may be able to retain the arbitrage earnings from investment of the TRAN proceeds, and such earnings would constitute additional revenue for the school district.

What Are the Procedures for Issuance?

In school districts which have been accorded fiscal accountability status under the Education Code, the school board adopts a resolution authorizing the issuance of the TRANs.

In school districts which have not been accorded fiscal accountability status, the school board adopts a resolution requesting the county board of supervisors to issue the TRANs and then the board of supervisors adopts a resolution authorizing the issuance of the TRANs in the name of the school district. In the case of TRANs issued by two or more school districts which are pooled and sold together (see below), each school district may issue its TRANs on its own behalf if (i) the board of supervisors fails to act within 45 days of receiving the school district's resolution or (ii) the county board of supervisors notifies the school district that it will not authorize that issuance within that 45-day period.

TRANs may be sold at competitive or negotiated sale. However, a school district that has a qualified or negative certification in any fiscal year may not issue TRANs in that fiscal year or the next succeeding fiscal year without a determination by the county superintendent that repayment of the TRANs by the school district is probable.

In order to achieve cost savings and efficiencies, it is becoming increasingly common for TRANs to be issued as part of a pooled TRAN financing, where a large number of school district TRANs are simultaneously issued and, through one of several mechanisms, pooled together for sale to investors. For a discussion of pooled financings, see Chapter 6 of this guidebook.

TRANs are repaid from revenues of the school district set aside by the county treasurer for that purpose in accordance with the authorizing resolution. Sometimes a better rating may be obtained from the rating agencies if the repayment fund is held by a third-party trustee, rather than by the county treasurer. This alternative structure requires more documentation and involves more parties and therefore, if TRANs are issued individually rather than combined in a pooled financing, would ordinarily entail greater issuance costs than TRANs issued without a trustee.

How Long Does the Financing Take?

Because a TRAN borrowing is structurally simple and the procedures for issuance are relatively easy, a TRAN financing typically only takes from three to eight weeks from start to finish. Traditionally, TRAN financings have been initiated in mid-to-late May and completed during the first week of July. The borrowing (i.e., the closing of the transaction) must take place on or after the first day of the fiscal year from which revenues will be used to repay the TRANs. A sample timetable and outline of a TRANS financing is included at the end of this chapter.

What Are the Significant Restrictions?

The important restrictions applicable to TRANs stem from two sources: California law and the provisions of the Internal Revenue Code and its accompanying regulations.

California Law. The statute under which most TRANs are issued provides that, generally, the amount of the TRANs, together with the interest payable thereon, may not exceed 85% of the school district's uncollected revenues available to pay the TRANs, estimated as of the time of issuance. The TRANs must be repaid no later than 15 months after their date of issuance (but see federal tax limitations below) from available revenues of the fiscal year in which they were issued. The maximum interest rate TRANs may bear is 12%.

Federal Tax Law. If the TRANs will mature more than 12 months after their date of issuance, under certain circumstances (in particular, where no interest is paid during the first 12 months) the payment made at maturity could give rise to a taxable gain to the note holder. To avoid this, when longer term TRANs are issued, they must be structured to provide for an interim interest payment, usually on the anniversary of the issuance date. The Internal Revenue Code effectively does not permit any TRANs to remain outstanding for longer than 13 months.

The Internal Revenue Code restricts the investment and expenditure of TRAN proceeds, the size of the borrowing and, importantly, the ability of a school district to retain its arbitrage earnings. Arbitrage earnings are, basically, the portion of the earnings that results from investing the TRAN proceeds at a yield higher than the interest rate paid on the TRANs. The Internal Revenue Code provides that arbitrage may be retained only if the TRAN borrowing is limited in size to the school district's cumulative cash flow deficit plus a "reasonable cash reserve." Among other measures, a school district's actual practice of maintaining a year-end cash balance in recent years indicates the size of that school district's reasonable cash reserve; provided, that, in any event, a cash reserve greater than 5% of the school district's prior year's expenditures will not be deemed reasonable. For school districts qualifying for the small issuer exception described below, a reserve of 5% of the prior year's expenditures is presumed to be reasonable.

To qualify for the small issuer exception, the issuer must reasonably expect to issue no more than $5,000,000 in tax-exempt debt during the calendar year in which the TRANs are issued, including the TRAN borrowing. For school districts, this amount is increased by the lesser of $10,000,000 or the amount of bonds attributable to the construction of school facilities. Additional borrowing not reasonably foreseeable at the time of the TRAN financing will not affect the availability of this exception. The small issuer exception is described in greater detail in Chapter 7 of this guidebook.

If the school district does not qualify for the small issuer exception, the TRAN proceeds must actually be "spent" within six months of the date the TRANs are issued in order for all arbitrage earnings to be retained. TRAN proceeds are considered spent on the day the cumulative cash flow deficit for an issuer exceeds the lesser of (i) 90% of the aggregate face amount of the issue, or (ii) the amount of the issue less the amount of the issuer's reasonable cash reserve. Unlike under the small issuer exception, good faith attempts to comply with the actual expenditure requirements are insufficient; for a school district to keep its arbitrage earnings, it must comply with these expenditure rules in fact.

Because the potential to earn arbitrage increases with the size of the TRAN borrowing, there could clearly be an advantage to artificially increasing the size of a school district's cumulative cash flow deficit, using measures such as placing otherwise available money aside in a restricted account through action of the school board. However, adopting such a strategy solely to increase arbitrage earnings from a tax-exempt TRAN borrowing is in direct violation of United States Treasury regulations; similar schemes have been the subject of investigation by the SEC. Unless the school board's action is taken for significant, non-arbitrage business reasons, a TRAN borrowing relying on such an action would not be tax-exempt. On the other hand, there may be legitimate ways to treat certain reserves as not available for federal tax law purposes. School districts should consult their bond counsel regarding how to determine the appropriate size of a TRAN borrowing.

What Are the Important Advantages and Disadvantages?

There are a number of advantages and disadvantages applicable to TRANs, the most significant of which are as follows:

ADVANTAGES AND DISADVANTAGES OF TAX AND REVENUE ANTICIPATION NOTES

ADVANTAGES	DISADVANTAGES
• Provides a source of funds for temporary cash deficits. • Only direct method of borrowing for working capital authorized by statute. • Simple and inexpensive. • No voter approval required. • Permits arbitrage earnings to be kept if either the small issuer exception or the actual expenditure rules are satisfied.	• Generates no additional revenue. • Size of borrowing is restricted. • Only revenues received or attributable to the fiscal year in which the TRANs are issued may be pledged for repayment.

Financing Timetable and Outline

The following is a timetable and outline for the issuance of TRANs. The timetable and outline are based on statutory provisions for issuance of TRANs under California Government Code Section 53850 and following in effect as of January 1, 2005, which provisions may be subsequently amended. The deadlines are stated in terms of number of days before or after other action items rather than as specific dates.

FINANCING TIMETABLE AND OUTLINE

Action Deadline	TRAN Issuance Action Item
	1. Preliminary Matters.
Prior to school board authorizing financing.	A school district that has a qualified or negative certification in any fiscal year may not issue, in that fiscal year or in the next succeeding fiscal year, COPs, TRANs, revenue bonds, or any other debt instruments that do not require the approval of the voters of the district, unless the county superintendent of schools determines, pursuant to criteria established by the Superintendent of Public Instruction, that the district's repayment of that indebtedness is probable.
	2. School Board (and Board of Supervisors) Authorization.
Prior to sale.	In school districts which have been accorded fiscal accountability status under the Education Code, the school board adopts a resolution authorizing the issuance of the TRANs. In school districts which have not been accorded fiscal accountability status, the school board adopts a resolution requesting the county board of supervisors to issue the TRANs and then the board of supervisors adopts a resolution authorizing the issuance of the TRANs in the name of the school district. In the case of TRANs issued by two or more school districts which are pooled and sold together, each school district may issue its TRANs on its own behalf if (i) the board of supervisors fails to act within 45 days of receiving the school district's resolution or (ii) the county board of supervisors notifies the school district that it will not authorize that issuance within that 45-day period. If the TRANs are issued as part of a pool and revenue bonds are issued secured by the TRANs, the issuer of the revenue bonds (e.g., a

TRAN Issuance Action Item	Action Deadline
joint powers authority) will need to approve issuance of the revenue bonds and the documents relating to the revenue bonds (e.g., the indenture, purchase contract, disclosure document, etc.).	
3. Submission of School District Resolution to County Superintendent and County Treasurer. The school district must provide a copy of the resolution of the district authorizing the issuance of the TRAN to the county superintendent of schools and the county treasurer.	**Simultaneously with submission of the resolution to the county board of supervisors.**
4. Preliminary CDIAC Notice. Notice of the proposed TRAN sale must be filed with CDIAC.	**Not later than 30 calendar days prior to TRAN sale.**
5. Financial Publication Notice. If the amount of TRANs to be sold exceeds $1,000,000 and the TRANs are to be sold at public sale, the school board or the county board of supervisors must cause notice of the sale to be published in a financial publication generally circulated throughout California or reasonably expected to be disseminated among prospective bidders for the TRANs.	**Not later than 15 calendar days prior to TRAN sale if TRANs exceed $1 million but do not exceed $10 million; not later than 5 calendar days prior to TRAN sale if TRANs exceed $10 million.**
6. Official Statement. The school district has an official statement prepared to provide information to investors and prospective investors about the school district and the TRANs to be sold.	**Prior to sale.**

7. Sale of TRANs.

At time determined above but no later than the date designated by the school board as the final date for the sale.

TRANs may be sold at public or negotiated sale.

8. TRAN Delivery.

Following TRANs sale, as determined by the purchaser and the school district or the county board of supervisors, but not prior to the first day of the fiscal year.

The TRANs are to be delivered to the purchaser thereof and the purchaser is to pay for the TRANs on the date determined by the purchaser and the school district or the county board of supervisors, but not prior to the first day of the fiscal year.

9. Form 8038-G Filed.

Not later than the 15th day of the second calendar month following the close of the quarter in which the TRAN is issued.

The reporting requirements of Section 149(e) of the Internal Revenue Code must be met.

10. Final CDIAC Notice.

Not later than 45 days after TRAN sale.

Following the sale, the Report of Final Sale must be filed with CDIAC. The CDIAC fee is due from the underwriter.

11. Continuing Disclosure.

TRANs and other issues maturing in 18 months or less are exempt from the annual disclosure requirement under SEC Rule 15c2-12. See Chapter 8.

CHAPTER 6

VARIATIONS ON AND COMMON FEATURES OF THE FOUR BASIC FINANCING TECHNIQUES

In addition to understanding the four basic financing techniques available to school districts (i.e., general obligation bonds, lease financing, Mello-Roos bonds and TRANs), it is important for school district officials to understand variations on, and other common features of, school district debt that may arise in connection with one or more of the basic financing techniques. Some of these variations and common features are set forth in this chapter.

Credit Enhancement

General. One common feature of school district bonds is the inclusion of credit enhancement. Credit enhancement involves the provision of additional security for a school district's bonds through a credit facility providing for the timely payment of debt service to bondholders, whether or not such amounts are paid by the school district. In a school district financing, credit enhancement usually takes the form of bond insurance or a letter of credit.

Bond Insurance. With bond insurance, an insurance company approved to insure municipal bonds issues a policy insuring timely payment of principal and interest on the bonds. The bond insurer pays scheduled principal and interest on the bonds in the event payments are not made by the school district. Following any such payment, the bond insurer is subrogated to (i.e., steps into the shoes of) the bondholder with respect to rights to receive payments from the school district.

To obtain a bond insurance policy insuring its bonds, a school district must pay a premium generally based upon total debt service on the bond issue and determined in large measure by the bond insurer's analysis of the credit of the school district and the security for the bonds.

Bond insurance premiums are paid when the bonds are issued and are not refundable, even if the bonds are refunded or otherwise prepaid. Because bond insurance can be obtained to cover the full term to maturity of the bonds, bond insurance is the usual form of credit enhancement for fixed rate issues.

Letters of Credit. Letters of credit are issued by highly rated banks. A letter of credit can be a standby letter of credit or a direct-pay letter of credit. With a standby letter of credit, the trustee for the bonds draws under the letter of credit only if the school district fails to make a payment or files for bankruptcy. With a direct-pay letter of credit, the trustee draws under the letter of credit to make all payments on the bonds, with amounts paid by the school district as debt service being used to reimburse the bank for such draw. Because they better address bankruptcy concerns, direct-pay letters of credit are more common than standby letters of credit.

A draw on a letter of credit to pay debt service is treated as an advance from the bank to the school district. If the advance by the bank is not immediately reimbursed, the school district must pay interest to the bank at an agreed rate (e.g., prime plus 2%) that is usually higher than the interest rate on the bonds. Unlike bond insurance, letter of credit fees are paid only partially up front, most fees being paid over the term of the letter of credit.

Letters of credit are usually available only for an initial term of three to seven years, so the school district faces renewal risk. Because letters of credit allow for draws in the full amount of the bonds at any time, however, a letter of credit can serve as a liquidity facility. Consequently, letters of credit are the most common form of credit enhancement for variable rate bonds.

Credit Enhancement Situations. School districts often use credit enhancement to achieve debt service savings. With credit enhancement, a school district's bonds can be rated based upon the credit rating of the credit enhancement provider (generally "AAA" or "Aaa" for bond insurers). Although the credit of the school district is still of interest to investors, the bonds are more secure and more highly rated than they would be without credit enhancement. Consequently, the bonds can be sold to investors with a lower interest rate. If, on a present value basis, the interest cost saved by reason of credit enhancement is greater than the cost of obtaining the credit enhancement, the school district enjoys debt service savings.

Working with Credit Enhancement Providers. Because a credit enhancement provider suffers a loss if the school district defaults on the insured or guaranteed bonds, credit enhancement providers have the same interest as investors in ensuring that a school district will be able to make timely payment on its bonds. While investors in publicly offered bonds are generally passive (they buy or do not buy the bonds as structured), credit enhancement providers can play an active role in the structuring of a financing. Credit enhancement providers review the borrowing documents and usually request specific terms relating to mat-

ters such as covenants, investment of trustee-held funds and the issuance of additional parity bonds. Credit enhancement providers generally also seek control over the declaration of defaults and the exercise of remedies and approval rights with respect to any amendments to bond documents, and may require the school district to provide various types of information relating to its financial condition on an ongoing basis. With credit enhancement, a school district may, therefore, lose some flexibility in managing its bonds.

Variable Rate Debt

Fixed rate bonds bear interest at rates determined when the bonds are issued. Variable rate bonds are bonds the interest rate on which is periodically changed. The interest rate on the variable rate bonds at any particular time depends upon prevailing market rates, the term of the bonds in the hands of the holder and credit and liquidity quality. The school district's interest cost, therefore, rises and falls with interest rates generally, but can also increase if the credit of a credit enhancement or liquidity provider declines.

Except for highly unusual markets, short-term interest rates are lower than long-term interest rates for bonds of comparable credit quality. Accordingly, if interest rates remain constant, the school district will generally have significantly lower interest cost on variable rate bonds than on fixed rate bonds. Also, if interest rates decline, the school district issuing variable rate bonds will benefit from lower interest costs without the necessity or cost of a refunding. On the other hand, significant interest rate increases may cause financial stress for the school district.

School districts issuing variable rate bonds generally issue them in the form of tender bonds. With tender bonds, the holder of the bonds has a periodic right to tender the bonds to the bond trustee for purchase at par (i.e., the nominal principal amount of the bond). Interest rate periods vary (the interest rate on tender bonds can be adjusted daily, weekly, monthly, quarterly, semiannually, annually or only every several years), and the school district is generally allowed to convert the bonds from one "interest rate mode" to another or to convert the bonds to a fixed rate through maturity. The interest rate on the bonds is the rate necessary to allow the tendered bonds to be remarketed to new purchasers at par.

Bonds tendered are sold at par to new purchasers and, if they cannot be remarketed, are purchased with the proceeds of a liquidity facility. A shorter tender period with more frequent interest rate adjustments generally results in a lower interest rate. The most common form of tender bond provides for the establishment of a new interest rate weekly, the payment of interest monthly and a tender at the option of the holder on any business day on seven days' notice.

For tender bonds, a school district needs to engage, in addition to a trustee, a remarketing agent (usually an investment banking firm) to remarket tendered bonds. To assure holders that tender bonds will be purchased even if not remarketed, the school district will need to

obtain a liquidity facility to support the tender. The liquidity facility is usually a bank letter of credit although a standby bond purchase agreement providing for the purchase of unremarketed bonds by the liquidity provider is also a possibility. Also, because tender bond purchasers generally demand a high level of credit quality, the school district may also need to obtain credit enhancement for the bonds, which is often obtained from the liquidity facility provider.

The terms of liquidity facilities vary, but it is generally not possible to obtain a liquidity facility covering the full term of the bonds (the available initial term is usually three to seven years). Accordingly, if the school district's credit declines or the liquidity facility market changes, the school district may not be able to obtain an extension or renewal of or replacement for an expiring liquidity facility or may need to pay significantly higher fees to the provider. If a liquidity facility expires without extension, renewal or replacement, the school district must convert the bonds to fixed rate (which may not be attractive) or have the bonds purchased by the liquidity facility provider and face a workout situation.

Debt Service Reserve Funds

Most school district financings (other than general obligation bonds and TRANs) are additionally secured by a debt service reserve fund, generally held by the bond trustee and invested in high quality debt securities (often United States Treasury securities, although investment agreements or other securities can also be used). The debt service reserve fund can be used solely to make debt service payments should available revenues prove insufficient (or for the final debt service payment on the bonds).

Debt service reserve funds are generally required to be maintained at a level equal to (i) maximum annual debt service, (ii) a percentage of outstanding principal (e.g., 10%) or (iii) the maximum amount that can be invested without yield limitations for tax purposes. Investments in debt service reserve funds must be periodically valued (generally annually on a lesser-of-cost-or-market basis) and, if the market values of investments held in the debt service reserve fund decline, the school district must deposit, from revenues available after the payment of debt service, amounts necessary to increase the debt service reserve fund to its required level of funding. The debt service reserve fund usually must also be replenished after a withdrawal to pay debt service.

In place of a reserve fund funded from bond proceeds and invested in securities, a school district may seek a debt service reserve fund surety bond or letter of credit. This instrument, generally issued by a bond insurance company or highly rated bank, provides funds to pay debt service under the circumstances under which the bond trustee would otherwise use amounts on deposit in a reserve fund. The total amount available under the surety bond or letter of

credit is equal to the amount that otherwise would be deposited in the reserve fund (e.g., maximum annual debt service) or any portion thereof. Any draws must be repaid with interest. Prior to obtaining a debt service reserve fund surety bond or letter of credit, a school district should discuss the advantages and disadvantages with its financial advisor or underwriter.

Capital Appreciation Bonds

"Capital appreciation bonds" are bonds the interest on which is compounded on each interest payment date rather than paid to investors. All interest is paid when the principal on the bond is paid at maturity or prepaid. Because capital appreciation bonds have an established reinvestment rate (compounded interest is in essence reinvested at the yield on the bond), capital appreciation bonds fluctuate in value more than conventional bonds of the same maturity. Moreover, since interest and principal on capital appreciation bonds are only paid at maturity, the amount of debt service due in any particular year is more easily manipulated. Accordingly, capital appreciation bonds are most often used to structure debt service to achieve a desired annual payment amount.

Pooled Financings

A pooled financing is one that combines debt issuance by multiple borrowers into a single financing in order to achieve economies of scale, cost savings and reduction in school district staff effort. The pooling is achieved either by having a single issuer loan the proceeds of its bonds to multiple borrowers or by issuing COPs evidencing interests in the several debt obligations of the multiple borrowers. The repayment of these pool bonds or COPs ("Pool Bonds") is dependent on the repayment by each of the multiple borrowers of its respective loan. Consequently, absent credit enhancement, the Pool Bonds can be rated only as a function of the credit of the weakest of the multiple borrowers. In order to overcome this problem, pooled financings usually include credit enhancement, either in the form of a letter of credit or bond insurance. The credit enhancement device can secure either the Pool Bonds or the individual obligations of each of the multiple borrowers.

Pooled financings involving Pool Bonds are often referred to as "Marks-Roos" financings because the Pool Bonds are issued by a joint powers agency under the Marks-Roos Local Bond Pooling Act of 1985. Pooled financings have been effectively implemented for lease financings, Mello-Roos bond financings and TRAN financings. Pooling the TRANs issued by a number of school districts offers each school district simple, cost-effective market access, even for relatively small note issues.

By far the largest TRAN pool program in California is the one sponsored by the California School Boards Association ("CSBA"). A nonprofit corporation established by CSBA issues Pool

Bonds at the beginning of July of each year and simultaneously uses the proceeds of the Pool Bonds to acquire the TRANs of participating school districts. The pool of TRANs is pledged to secure and repay the Pool Bonds which are also secured by a bond insurance policy or letter of credit. The TRAN proceeds received by the participating school districts as payment for their TRANs (until needed by the school district), and the school district funds set aside to repay the TRANs, may be invested in a guaranteed investment contract.

The CSBA program started in 1988 with six participating school districts, resulting in the issuance of $9,630,000 principal amount of Pool Bonds. By 2004, over 278 school districts, 13 county boards of education and six community college districts in 47 counties participated (with individual TRANs ranging from $20,000 to $14,840,000), resulting in the issuance of $754,300,000 principal amount of Pool Bonds. The 2004 Pool Bonds were sold at a yield of 1.60% per annum and the proceeds were invested in a guaranteed investment contract yielding 2.475%, producing 0.875% (87.5 basis points) in arbitrage earnings. The school districts were entitled to retain the arbitrage earnings under exceptions to the federal arbitrage rebate requirements.

The CSBA TRAN pool program was, in large measure, designed by members of Orrick's School Finance Practice Group.

Refundings

General. Refunding is a procedure through which a school district refinances an existing issue of bonds, notes or COPs (the "refunded bonds") with a new issue of bonds, notes or COPs (the "refunding bonds"). Through one of the mechanisms described below, the proceeds of the refunding bonds are used to pay the refunded bonds, either at the maturity of the refunded bonds or, if the refunded bonds are subject to optional redemption prior to maturity, usually at an earlier redemption date.

A refunding is usually undertaken either to reduce the school district's debt service costs (in situations where the refunding bonds can be issued at a lower interest rate than the refunded bonds) or to eliminate or modify one or more restrictive provisions imposed on the school district by the refunded bonds (e.g., a requirement to maintain a burdensome amount of insurance in a COP financing). The restrictive provision is eliminated when the refunding bonds are issued under new, less restrictive, documents.

Refundings are applicable to all of the four basic financing techniques; however, because of the short maturity involved, it would be unusual to refund TRANs. A refunding is a variation on the basic financing techniques because the proceeds of the refunding bonds are applied to the payment of the refunded bonds rather than being used to pay the costs of a school district capital project such as the acquisition of land or the acquisition, construction and installation of improvements, facilities or equipment. Thus, the "project" in a refunding is the

payment of the refunded bonds. Refunding bonds and capital project bonds are, however, frequently combined in a single issue.

Escrow Funds. If the refunded bonds are not to be paid in full immediately upon the issuance of the refunding bonds, the proceeds of the refunding bonds will usually be deposited in escrow and invested in certain types of securities ("escrow securities"). Typically, the earnings (including return of principal) on the escrow securities are used to pay debt service on the refunded bonds as and when due through the maturity thereof or the earlier date on which the refunded bonds are to be redeemed.

Escrow securities are usually United States Treasury obligations. These can be either open market securities, in the form of Treasury bills, notes or bonds, or State and Local Government Series Securities ("SLGS"). SLGS (pronounced "slugs") are special securities sold by the United States Treasury to local government agencies for the investment of bond proceeds which are subject to yield restriction or rebate under the Internal Revenue Code. SLGS can be ordered to earn interest at the exact rates (up to the maximum specified in the weekly schedule published by Treasury) and pay principal and interest on the exact dates necessary to pay debt service on the refunded bonds through maturity or earlier redemption, as required. Consequently, SLGS usually constitute the most efficient type of escrow securities.

On the date the refunded bonds are paid in full, either directly with refunding bond proceeds or with earnings from escrow securities, in accordance with the terms of the indenture under which the refunded bonds were issued, the school district is released from its obligations under that indenture. In some situations this release occurs on the date the final payment on the refunded bonds is actually made to bond owners. However, the refunded bonds indenture often contains "defeasance" provisions specifying that the refunded bonds will be deemed to have been paid upon the deposit in escrow of escrow securities verified by a certified public accountant as being sufficient to pay the refunded bonds through maturity or earlier redemption. If the refunded bonds' indenture provides for defeasance, then the school district will be released from its obligations under the refunded bonds' indenture on the date such escrow securities are deposited in escrow, which date will be prior (in some cases many years prior) to the date the final payment on the refunded bonds is actually made to bond owners.

Tax Laws. Under the Internal Revenue Code and its accompanying regulations, refundings are classified as either "current refundings" or "advance refundings." In a current refunding, the refunding bonds are issued no earlier than 90 days prior to the date on which the refunded bonds are to be paid in full. When the refunding bonds are issued more than 90 days prior to such date, the transaction is classified as an advance refunding.

Refundings, and particularly advance refundings, are subject to a complex set of arbitrage and rebate requirements and restrictions under the Internal Revenue Code. An explanation of such requirements and restrictions is beyond the scope of this guidebook. However, if one is to be involved in a refunding, it is helpful to have a general understanding of certain concepts which are central to the tax analysis.

One important threshold arbitrage restriction prohibits the advance refunding of any bonds which cannot be called for redemption prior to their maturity—unless there is some significant non-arbitrage business or other reason for defeasing those bonds. Nevertheless, since an advance refunding of such non-callable bonds cannot produce debt service savings (that is, since non-callable bonds will bear interest at their original rate to their original maturity date regardless of the interest rate on the refunding bonds), an advance refunding which excludes the non-callable portion of the outstanding issue necessarily produces more debt service savings as a proportion of the bonds which are refunded.

In connection with a refunding, the Internal Revenue Code requires special treatment of the unexpended proceeds of the refunded bonds. The "unexpended proceeds" of refunded bonds are, simply, the original proceeds of the refunded bonds and investment proceeds thereon which remain unspent at the time of the refunding. For example, as described in Chapter 7 of this guidebook, amounts in a construction fund are usually excepted from yield restriction during a three-year temporary period. However, in the case of a refunding, unexpended proceeds of the refunded bonds in a construction fund immediately become subject to yield restriction. As a result, such unexpended proceeds may no longer be invested at a yield materially higher than the yield on the refunded bonds.

In the case of both current and advance refundings, as debt service is paid on the refunded bonds, either directly with refunding bond proceeds or with earnings from escrow securities, a portion of the unexpended proceeds of the refunded bonds become "transferred proceeds" of the refunding bonds. Once transferred, such proceeds become subject to the rebate requirements and yield restrictions applicable to the refunding bonds and not the refunded bonds.

Because an understanding of the complex federal tax issues is critical to a successful refunding, it is especially important that a school district retain consultants, particularly bond counsel and a financial advisor or underwriter, who have expertise in the refunding area.

Qualified Zone Academy Bonds (QZABs)

General. Federal tax legislation enacted in 1997 (the "QZAB Law") authorized a debt instrument known as a "qualified zone academy bond" ("QZAB"). As described further below, this provision of the Internal Revenue Code provides a source of funding that may be used for renovating school buildings, purchasing equipment, developing curricula and/or training school personnel. The proceeds of the QZABs may not be used for new construction.

The QZAB program is a tax credit program. A QZAB provides an annual federal income tax credit to eligible taxpayers, which include certain banks, insurance companies and other organizations actively engaged in the business of lending. The credit is deemed paid once a year and an eligible taxpayer may use it to offset its income tax liability for the taxable year in which the credit is received. Thus, QZABs reduce the burden of interest payments by giving certain financial institutions holding the QZABs a tax credit in lieu of interest. The school district must pay back the principal amount it initially borrowed, but it does not have to pay any interest. The credit rate for QZABs sold on a given day is set by the United States Treasury Department.

Allocation. Prior to issuing a QZAB, a school district must receive allocation from the California Department of Education. The California Department of Education administers the QZAB program through its School Facilities Planning Division. Information regarding application requirements and process can be found on the website of the Department of Education, www.cde.ca.gov.

Qualifications. To be eligible to use a QZAB, at least 95% of the proceeds must be used for a "qualified purpose" with respect to a "qualified zone academy" established by a local education agency. The eligibility criteria are generally applied on a school-by-school basis, not district-wide.

Qualified Purpose. A "qualified purpose" with respect to any qualified zone academy means (i) rehabilitating or repairing the public school facility in which the academy is established, (ii) providing equipment for use at such academy, (iii) developing course materials for education to be provided at such academy, and (iv) training teachers and other such personnel in such academy. The school district must prepare a written spending plan specifying how the proceeds of the QZABs are to be used.

Even though permitted under the QZAB Law, if the QZAB is structured as part of a lease financing, expenditures on items (iii) and (iv) above will not be permitted under the Education Code. Accordingly, any school district applying for allocation to the California Department of Education under the QZAB Law should contact bond counsel during the application process to discuss possible finance structures to ensure that all items in the school district's application may be financed under California law.

Qualified Zone Academy. A "qualified zone academy" includes any public school or academic program within a public school (below the post-secondary level) if:

(i) such school or program is designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, or better prepare students for the rigors of college and the work force, and the school or program receives a private business contribution that is not less than 10% of the net present value of the proceeds of the QZAB;

(ii) the comprehensive education plan of such school or program is approved by the governing school district and the students in such school or program are subject to the same academic standards and assessments as other students; and

(iii) either the school is located in an empowerment zone or enterprise community or there is a reasonable expectation as of the date of issuance of the bonds that at least 35% of the students attending such school or participating in such program will be eligible for free or reduced cost lunches under the federal lunch program (National School Lunch Act).

The private business contribution requirement is met if the school district that established the qualified zone academy has written commitments from private entities to make "qualified contributions" having a present value as of the date of issue of the QZABs of not less than 10% of the proceeds of the QZAB issue. For this purpose, "qualified contributions" include (i) equipment for use in the qualified zone academy, (ii) technical assistance in developing curriculum or in training teachers in order to promote appropriate market driven technology in the classroom, (iii) services of employees as volunteer mentors, (iv) internships, field trips, or other educational opportunities outside the academy for students, or (v) any other property or service specified by the local education agency.

State Law Limitations. Article XVI, Section 18 of the California Constitution provides that a school district may not incur any indebtedness (payable beyond the fiscal year in which it is incurred) without the approval of the requisite percentage of the voters voting on the matter at an election held for such purpose. Accordingly, unless such approval is obtained, a school district's obligations under a QZAB must be designed to avoid classification as indebtedness for purposes of this Constitutional restriction. This can be accomplished by structuring the obligation as a lease financing. (See Chapter 3.) However, if the QZAB is structured as a lease financing, the school district will be prohibited from using the proceeds of the QZAB for developing course materials or training as permitted under the QZAB Law. Accordingly, if a school district desires to use QZAB proceeds for developing course materials or training, an alternative structure must be employed. In some circumstances, a school district may be able

to accomplish this through the use of the temporary borrowing statutes (see Chapter 5) in combination with other finance statutes. However, such circumstances are limited and bond counsel should be consulted prior to submission of any application to ensure that such uses may be financed.

CHAPTER 7

FEDERAL TAX LAW AND SCHOOL DISTRICT DEBT FINANCING

General Rule

Under the Internal Revenue Code, bonds of state and local governmental units, including school districts, generally bear interest that is excludable from gross income for federal income tax purposes. For purposes of the Internal Revenue Code, the term "bond" means any evidence of indebtedness, including COPs, notes or financing leases (which are treated as installment sale agreements under the Internal Revenue Code). Although exempt from federal income tax, interest on bonds may have other federal income tax consequences, such as on corporate minimum tax, interest expense deductions and taxation of social security benefits.

Notwithstanding the rule that interest on school district bonds is generally tax-exempt, this interest is taxable if the bonds are private activity bonds (i.e., the bonds are issued to finance facilities that have excessive private business use or benefit), arbitrage bonds (i.e., the bonds are issued for the main purpose of deriving arbitrage profits) or hedge bonds (i.e., the bonds are issued too far in advance of the time the bond proceeds are expected to be spent), or if the bonds are federally guaranteed or violate other prohibitions contained in the Internal Revenue Code. However, in the vast majority of school district financings, the only significant issues that arise are those relating to the Internal Revenue Code's prohibitions against arbitrage bonds and hedge bonds. Generally, this will be true whether the financing is accomplished through general obligation bonds, a lease financing, Mello-Roos bonds or TRANs.

The arbitrage bond prohibition has two important components: arbitrage yield restrictions and rebate requirements. The hedge bond rules focus primarily on the amount of time the school district expects to take to spend the proceeds of the bonds. Other tax topics are also briefly discussed at the end of this chapter.

Arbitrage Yield Restriction

With respect to arbitrage yield restrictions, the Internal Revenue Code generally prohibits municipalities from issuing tax-exempt bonds if the issuer reasonably expects to use the proceeds of such bonds, directly or indirectly, either (i) to acquire securities or obligations with a yield materially higher than the yield on such bonds or (ii) to replace funds used to acquire such higher yielding securities or obligations. The yield on the bonds is equal to the total interest to be paid on the bonds, according to the initial offering price to the public, plus the cost of any qualified credit enhancement fees, including bond insurance premiums and letter of credit fees. Thus, the Internal Revenue Code restricts the rate of return on investments made with bond proceeds to a yield that is not materially higher than the interest rate, adjusted as described above, to be paid by the school district on such bonds. However, the Internal Revenue Code provides exceptions to the yield restriction for some bond proceeds during certain temporary periods and for the portion of the bond proceeds held in a "reasonably required reserve or replacement fund" during the life of the bond issue.

Three-Year Temporary Period. The most important temporary period is the three-year temporary period, during which no yield restrictions apply to bond proceeds that are used to finance capital improvements or costs of issuing the bonds. The three-year period is measured from the date of issuance of the bonds. The temporary period is applicable to most financings of new school district facilities, provided that the school district's reasonable expectations are as follows on the date the bonds are issued: (i) at least 85% of the "net sale proceeds" (generally, for school district financings, the amount of proceeds received from the sale of the bonds) will be spent to pay costs of capital improvements and costs of issuing the bonds within three years from the issuance of the bonds; (ii) the school district has incurred or within six months after the issuance date will incur a binding obligation to one or more unrelated parties involving an expenditure of at least 5% of such proceeds; and (iii) allocations of such proceeds, and investment earnings thereon for such purposes, will proceed with due diligence.

Thirteen-Month Temporary Period. A second key temporary period is the thirteen-month temporary period for amounts deposited in a bona fide debt service fund. A bona fide debt service fund is one that is used primarily to achieve a proper matching of revenues and debt service each bond year by depositing revenues in the fund until they are needed to pay debt service. The fund must be depleted at least once each year, except for a carryover amount not exceeding one month's debt service on the bonds or one year's earnings on the fund.

Reasonably Required Reserve Fund. A debt service reserve fund is eligible to be invested at an unrestricted yield (i.e., invested without regard to yield) if the fund is considered "reasonably required" under the Internal Revenue Code. The amount of a reasonably required reserve fund is limited to the least of (i) maximum annual debt service on the bonds, (ii) 10% of the proceeds of the bonds, and (iii) 125% of average annual debt service on the bonds. For general obligation bonds, however, a reserve fund may not be able to qualify as a reasonably required debt service reserve fund. See "De Facto Reserve Funds for General Obligation Bonds" below.

De Facto Reserve Funds for General Obligation Bonds. A slightly different situation often results with general obligation bonds due to the fact that many, if not most, counties collect more property taxes in the first year after the issuance of general obligation bonds than is needed to pay debt service on the same bonds in that year pursuant to a State law permitting the county to establish an annual reserve for general obligation bonds. The amount of this over-collection varies from county to county and is typically held simply as a running balance in the debt service fund. Depending on the terms of repayment of the general obligation bonds, this balance may be larger than the carryover amount permitted by the thirteen-month temporary period for bona fide debt service funds. Thus, this over-collection may result in a reserve fund of sorts, which may not qualify as a reasonably required debt service reserve fund. There are various ways to resolve this situation. However, the issue should be addressed early in the financing with full participation of the school district's bond counsel, underwriter or financial advisor, and the county officials responsible for determining how the general obligation bond tax is levied and how those tax moneys are to be accounted for and held.

To the extent that bond proceeds, other than those held in a reasonably required reserve fund, remain unexpended after the end of a temporary period, these proceeds may not be invested at a yield in excess of 1/8% above the yield on the bonds. Alternatively, as discussed below, the school district may elect to make yield reduction payments. See "Rebate" below. As described in Chapter 5 of this guidebook, different temporary period rules apply to TRANs and other working capital financings. Additionally, as described in Chapter 6 of this guidebook, more restrictive temporary period rules apply to certain types of refundings, where the bond proceeds are to be used to retire previously issued bonds.

As a result of the three-year temporary period, the thirteen-month temporary period for bona fide debt service funds and the reserve fund exception, none of the proceeds of a typical school district debt financing should be subject to arbitrage yield restriction, except, in certain circumstances, where a general obligation bond issuance results in a de facto reserve fund. However, such proceeds may be subject to rebate as described below.

Rebate

General. Even if a school district is permitted to invest its bond proceeds at a higher rate of return than the arbitrage yield, separate rules determine whether the school district will be allowed to retain such investment earnings in excess of the arbitrage yield. The general rule under the Internal Revenue Code is that an issuer may not retain such excess arbitrage earnings unless it meets an exception provided for in the Internal Revenue Code. For example, if the proceeds of bonds yielding 7% are invested during the three-year temporary period in securities yielding 8%, the 1% excess, which constitutes the arbitrage earnings, must be paid to the United States Treasury, unless certain exceptions apply. Thus, even though, as described above, certain exceptions to the yield restriction requirement permit bond proceeds to be invested at an unrestricted yield during certain times or when held in certain funds, the rebate requirement generally requires that any arbitrage earnings ultimately be paid to the federal government.

Rebate Exceptions. For bond proceeds that are not deemed immediately spent at the time the bonds are issued, there are five important exceptions to the rebate requirement that may apply to a school district financing: (i) the bona fide debt service fund exception, (ii) the small issuer exception, (iii) the six-month expenditure exception, (iv) the eighteen-month expenditure exception, and (v) the two-year construction expenditure exception.

Except for the "small issuer exception," most exceptions reward the quick expenditure of bond proceeds. Realistically, however, the faster an issuer spends its bond proceeds, the less likely it will have any excess earnings (and therefore rebate liability) because, under normal market conditions, short-term investments have a lower rate of return than investments held for a longer term.

Bona Fide Debt Service Fund Rebate Exception. For amounts that qualify as part of a bona fide debt service fund, arbitrage earnings are exempt from any rebate payment for most issues of bonds that have a fixed rate of interest or for issues with an average annual debt service of $2,500,000 or less. For other fixed rate issues with an average maturity of less than five years, or issues of bonds that pay a variable rate of interest, the bona fide debt service fund is only exempt from rebate obligations for any year that gross earnings on amounts in such fund do not exceed $100,000.

Small Issuer Rebate Exception. The small issuer exception allows a qualifying "small issuer" school district to retain all arbitrage earnings realized from the investment of bond proceeds. The small issuer exception is available only to governmental units, including school districts, which possess general taxing powers. To qualify, a school district cannot issue or expect to issue tax-exempt obligations in a total amount in excess of $5,000,000 for the calendar year, provided that such amount of $5,000,000 is increased by the lesser of $10,000,000 or the aggregate face

amount of bonds attributable to the new construction of school facilities. For example, an issuer can issue $5,000,000 in TRANs and $10,000,000 in one or more issues of bonds to finance the construction of school facilities and still qualify as a small issuer. An additional requirement is that the school district must spend at least 95% of the proceeds of all such issues for the governmental purposes for which the bonds and other obligations are issued.

The small issuer exception is based on the school district's reasonable expectations at the time each issue of obligations is issued. For this exception, entities that issue bonds on behalf of the school district (such as counties in general obligation bond financings) and entities that are subordinate to the school district (such as community facilities districts) are treated as one issuer, and all tax-exempt debt issued by all such entities in the calendar year is aggregated in order to determine whether the applicable limit has been exceeded.

Six-Month Rebate Exception. Under the six-month expenditure exception, a bond issue is not subject to the rebate requirement if the school district actually spends all proceeds of the issue (including investment proceeds) within six months of the date the bonds are issued. Unlike the small issuer exception, the six-month exception is based on actual expenditures, not on the school district's reasonable expectations. Solely for purposes of determining compliance with the six-month exception, amounts held in a reserve fund are not treated as bond proceeds. Consequently, the six-month rule excepts from the rebate requirement all arbitrage earnings on amounts held in an acquisition or construction fund, but applies the normal rebate requirements to amounts held in a reserve fund. The six-month expenditure exception is most likely to apply to acquisition financings (where the project is being acquired rather than constructed), TRAN financings, reimbursement financings, and current refundings.

Eighteen-Month Rebate Exception. As with the six-month exception, an issue is not subject to the rebate requirement if all proceeds (including investment proceeds) are expended within 18 months from the issue date, provided that at least:

- 15% of the proceeds are spent within six months;
- 60% are spent within 12 months; and
- 100% are spent within 18 months.

Compliance with the 18-month exception is also based on actual expenditures and not on the school district's reasonable expectations, although the 15% and 60% expenditure requirements include a pro rata portion of the school district's expected investment earnings during the 18-month period. Additionally, as with the six-month exception, amounts held in a reserve fund are not treated as bond proceeds. The 18-month exception does not apply to refundings.

Two-Year Rebate Exception. For certain construction bonds, under the two-year rule, the issue is not subject to the rebate requirement if all proceeds (including investment proceeds) are expended within two years from the issue date, provided that at least:

- 10% of the proceeds are spent within six months;
- 45% are spent within 12 months;
- 75% are spent within 18 months; and
- 100% are spent within 24 months.

Compliance with the two-year exception, similar to the six-month and 18-month exceptions, is based on actual expenditures and not on the school district's reasonable expectations, although the 10%, 45%, and 75% expenditure requirements include a pro rata portion of the school district's expected investment earnings during the two-year period. Additionally, as with the other expenditure exceptions, amounts held in a reserve fund are not treated as bond proceeds. The two-year exception does not apply to refundings.

In order to qualify for the two-year exception, at least 75% of the proceeds of the bond issue must be expected to be expended for construction costs, as opposed to acquisition or refinancing costs. If the 75% construction cost requirement is not expected to be met by the bond issue as a whole, the Internal Revenue Code allows the issuer to treat the bond issue as two separate issues for purposes of this exception. If one of such issues (the construction portion) meets the 75% construction cost requirement, then the construction portion is eligible for the two-year exception. The six-month exception (but not the 18-month exception) or the normal rebate requirements would apply to the remaining portion. Special rules apply to pooled financings.

Penalty in Lieu of Rebate. If the proceeds of a construction issue (or construction portion) are not spent within the six-month, 18-month or two-year time periods, the school district generally will be required to rebate all arbitrage earnings under the normal arbitrage rebate requirements. However, the Internal Revenue Code allows the school district to pay a penalty in lieu of such rebate for issues that would otherwise qualify for the two-year exception, if the school district makes this election at the time its bonds are issued. The penalty is 1.5% of the amount of proceeds of the bond issue which, as of the close of each six-month period described above for the two-year exception, is not spent in accordance with the expenditure schedule. For example, if the school district was required to have spent $450,000 of a $1,000,000 issue within 12 months (45%), but has spent only $400,000, the school district would pay a penalty of 1.5% of $50,000, or $750.00. The penalty must be paid within 90 days of the end of the relevant six-month period.

The election to pay the penalty in lieu of rebate may be useful for school districts wishing to avoid the complications normally encountered in calculating rebate. Also, the penalty election permits school districts to retain arbitrage earnings during the temporary period, which may exceed the amount of the penalty even if the proceeds are not spent entirely within the expenditure schedule specified by the two-year rebate exception. However, the benefit to be gained by balancing penalty payments against potential arbitrage earnings depends entirely on the school district's ability to invest proceeds at interest rates above the bond yield. School districts should consult with their bond counsel and financial or investment advisor in deciding whether to elect the penalty in lieu of the normal rebate requirement.

Yield Reduction Payments. For bond proceeds that are not or are no longer eligible for temporary periods, yield reduction payments are sometimes available to a school district so the district will not have to actively monitor and restrict such proceeds. Yield reduction payments are similar to rebate payments but only certain classes of bond proceeds qualify. Those include proceeds that initially qualified for one of the temporary periods described above, but for which the temporary period has expired, amounts held in reserve funds in excess of the limitations described in this chapter and certain types of bond proceeds arising in current and advance refundings.

Rebate Compliance Provider. Because of the technical requirements and complexities involved, especially for bonds that bear a variable rate of interest, a school district generally should engage an expert to provide rebate (and penalty) calculation services for its debt financing. Bond Logistix LLC, formerly the Financial Services Group of Orrick, Herrington and Sutcliffe LLP, offers full rebate compliance services, on a cost effective basis. For further information regarding Bond Logistix, contact any member of Orrick's School Finance Practice Group shown on the contact list on the inside of the back cover of this guidebook.

Hedge Bond Restrictions

The Internal Revenue Code generally prohibits tax-exempt bonds from being issued too far in advance of the time proceeds are expected to be used to construct or acquire the assets to be financed. The temporary period rules and the rebate exceptions described in this chapter often provide good reason to issue bonds close to the time when the bond proceeds will be spent; similarly, economics dictate this result whenever the short-term interest rates at which bond proceeds may be invested are lower than the long term rates at which the bonds accrue interest. However, under certain circumstances, school districts may be interested in issuing bonds at the earliest opportunity, particularly in the case of general obligation bonds, where interest earned generates funds to finance additional projects, while interest is paid from tax receipts.

In general, interest on the bonds will not be tax-exempt unless the school district reasonably expects either (i) to spend at least 85% of the net sale proceeds within three years of the date the bonds are issued, as well as invest no more than 50% of the bond proceeds in investments of guaranteed yield of four or more years or (ii) to spend at least 10% of the net sale proceeds within one year, 30% within two years, 60% within three years, and 85% within five years, as of the date the bonds are issued. These expenditure requirements do not apply to refundings, or to new money bonds in which virtually all of the proceeds of the bonds are invested in other tax-exempt bonds until such proceeds are expended.

Overburdening Restrictions

School districts should also be aware that the Internal Revenue Code prohibits bond issues that are considered to "overburden" the market, such as issuing more bonds, issuing bonds earlier and allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds. This analysis mostly depends on whether the primary purpose of the transaction is a bona fide governmental purpose and whether the bonds would have been issued if interest on that issue was not tax-exempt. Other indicators of overburdening include bonds with a weighted average maturity of more than 120% of the average reasonably expected economic life of the financed asset, and bonds that do not qualify for any expenditure-related temporary periods, such as the three-year temporary period. Facts and circumstances, however, may outweigh these factors.

Reimbursement Financings

The rebate requirement applies to limit the return on the investment of unexpended bond proceeds. Under ordinary market conditions, short-term investments have a lower rate of return than investments held for a longer term. Accordingly, the faster bond proceeds are considered expended, the less likelihood the school district will incur any rebate liability. The most common way to expend bond proceeds quickly is through a reimbursement financing, where bond proceeds are used to reimburse the school district for project costs previously paid out of other school district funds. When the bond proceeds are received by the school district as reimbursement for such previous expenditures, they are deemed immediately spent for tax purposes and, consequently, are no longer subject to arbitrage or rebate rules.

Valid reimbursements from bond proceeds require that the school district take an official action to evidence its intent to reimburse project costs with bond proceeds in the future. Such official action can take the form of a resolution adopted by the school board or some comparable public action. The official action must include the maximum amount of bonds the school district expects to issue for the project and a brief description of the project. If the reimburse-

ment rules are not satisfied, bond proceeds reimbursed to the school district for the prior expenditures will not be deemed expended for tax purposes and will continue to be subject to the yield restriction and rebate requirements of the Internal Revenue Code.

The reimbursement rules provide that the expenditure must have been made no earlier than 60 days prior to the declaration of official intent, and the reimbursement must be made not later than eighteen months after the later of: (i) the date the original expenditure is paid, or (ii) the date the project is placed in service or abandoned, but in no event more than three years after the original expenditure is paid. These timing constraints are more relaxed for small issuers.

An exception to the reimbursement timing rules applies to "preliminary expenditures," the amount of which may not exceed 20% of the aggregate issue price of all the issues that are expected to finance the project. "Preliminary expenditures" include architectural, engineering, surveying, soil testing, reimbursement bond issuance costs and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation and similar costs incurred incident to commencement of construction.

Guaranteed Investment Contracts

Proceeds of bonds may be invested pursuant to investment agreements commonly known as "guaranteed investment contracts" ("GICs"), where the school district is assured a certain rate of return on the amount of bond proceeds being invested with an investment agreement provider. GICs usually involve the portion of bond proceeds used to finance capital improvements or held as a reasonably required reserve fund. The GIC should permit a school district enough flexibility to spend the money invested so that all tax requirements under the Internal Revenue Code are met, such as the timing requirements of the hedge bond rules. Fees paid to the GIC broker are permitted to be used to increase the yield on the bonds to the extent permitted by the U.S. Treasury regulations. However, certain bidding requirements and certifications are required in order to take such payments into consideration. For GICs that are expected to be entered into contemporaneously with the issuance of the bonds, bond counsel should be involved early in the bidding or negotiation process because the GICs may have collateral effects on the tax or bond analyses.

Bank Qualified Bonds

For certain tax advantages, financial institutions periodically seek to own bonds that are described under Section 265 of the Internal Revenue Code, or "Bank Qualified Bonds." To properly qualify as an issuer of such bonds, a school district cannot reasonably expect to issue more than $10,000,000 in tax-exempt bonds in any calendar year, excluding certain refunding bonds. Similar to the determination of a small issuer, bonds issued by any subordinate or related entity of the school district, and those issued by another agency on behalf of the school district, are included in calculating the amount. An issuer must also specifically designate such obligations as Bank Qualified Bonds, usually in the offering statement for these bonds.

CHAPTER 8

SECURITIES LAWS AND CONTINUING DISCLOSURE

Securities Laws

The offering and sale of securities is regulated by federal laws codified primarily in the Securities Act of 1933 (the "Securities Act") and the Securities and Exchange Act of 1934 (the "Exchange Act"). School district general obligation bonds, financing leases, Mello-Roos bonds and TRANs all constitute "securities" for purposes of the Securities Act and the Exchange Act. For most corporate securities, a public offering must be preceded by filing a registration statement with the SEC pursuant to the Securities Act, and the corporation is required to make periodic reports to the SEC pursuant to the Exchange Act. Municipal securities, on the other hand, including those of school districts, are exempt from the registration requirements of the Securities Act and from the reporting requirements of the Exchange Act. However, the offering and sale of school district securities is not exempt from the anti-fraud provisions of the Securities Act or the Exchange Act. In addition, the SEC's rules governing underwriters of municipal bonds effectively require school districts to make periodic disclosure of certain information relevant to the security of their bonds unless certain exemptions apply.

School District Responsibilities

The anti-fraud provisions of the Securities Act and the Exchange Act require that the information provided in connection with the offer or sale of securities must not contain any untrue statement of a material fact and must not omit to state a material fact necessary to make such information not misleading. This is of critical importance to the school district. The school district is primarily liable for any material misstatements or omissions regarding the

school district made in the documents used to offer and sell the school district's securities. The school district may not transfer this primary liability to its underwriter, its financial advisor, district counsel, bond counsel or any of the other parties involved in the financing. Such parties might be liable in their own right, but their liability will not absolve the school district of its primary liability. Consequently, the school district and its staff must make every effort to ensure that the school district's offering documents are accurate and complete. The SEC has stated that:

> Because they are ultimately responsible for the content of their disclosure, issuers [of municipal securities] should insist that any professionals retained to assist in the preparation of their disclosure documents have a professional understanding of the disclosure requirements under the federal securities laws.

In connection with its Orange County bankruptcy investigations, the SEC reiterated that issuers "bear the most significant responsibility to ensure" disclosure is adequate, and commented that:

> [A] public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading.

Underwriters' Obligations and Rule 15c2-12

Underwriters of municipal securities are also subject to the anti-fraud provisions of the securities laws. To protect themselves from liability, underwriters (usually with the assistance of their counsel) must conduct an investigation of the school district's affairs and generally will require, as a condition to their obligation to purchase the bonds, the delivery of certifications and opinions as to the completeness and accuracy of the school district's offering materials.

In addition, Rule 15c2-12, adopted by the SEC under the Exchange Act, places specific burdens upon the underwriters of municipal securities. First, unless an exemption is available, Rule 15c2-12 requires an underwriter, prior to any bid, purchase, offer or sale of a municipal security, to obtain and review an official statement which the issuer "deems final as of its date," exclusive of certain pricing and underwriting information. See "Official Statement" below. In order to comply with Rule 15c2-12, the underwriter generally requires the school district to certify that it deems the preliminary official statement final as of its date (which is generally the date it is mailed). Second, unless an exemption is available, Rule 15c2-12 also requires the underwriter to contract with the issuer to receive a sufficient number of copies of a final official statement within seven business days after the final agreement to purchase bonds. As a result, such an undertaking on the part of the school district is now typically included in the purchase contract or notice of sale. Rule 15c2-12 also requires the underwriter to obtain a com-

mitment from the issuer to provide continuing disclosure during the entire life of the bond issue, including a commitment to disclose certain material events whenever they occur. See "Continuing Disclosure" below. Generally, Rule 15c2-12 exempts from its requirements primary offerings of school district bonds in authorized denominations of $100,000 or more, if such bonds (i) are sold to no more than 35 sophisticated investors purchasing for their own accounts, (ii) have a maturity of nine months or less, or (iii) at the option of the bond owner, will be repurchased from the bond owner at no less than par at least as frequently as every nine months. In addition, certain school districts and certain school district bond issues are exempt from the continuing disclosure requirements discussed below.

Official Statement

The offering document in a public offering of school district securities is usually called an "official statement." If the securities are being offered on a more limited basis, the offering document might be called an "offering circular," a "private placement memorandum" or a "limited offering memorandum." In any case, the offering document contains the school district's official statements; that is, the statements about itself, its financial condition, the bonds, the project to be financed with the bonds and the sources of repayment of the bonds upon which it intends investors to rely. A preliminary official statement is distributed before the official statement and before the financing terms are final. It is used by the underwriter to solicit interest in the bonds. The official statement contains the final terms of the financing, including the principal amounts, interest rates and maturity dates of the bonds and the uses of the bond proceeds.

To determine what ought to be contained in a school district's official statement, the school district and its financing professionals must carefully consider the school district's situation and the terms of the bonds proposed to be issued, and from these form a judgment as to what information must or should be included to ensure that the official statement (i) contains the information needed for a potential investor to make an informed investment decision, and (ii) does not contain any material misstatements or omissions. The threshold for adequate disclosure is the concept of materiality: information is deemed "material" if there is a substantial likelihood that knowledge of that information would be important to a reasonable investor's investment decision. What information is material in any given case depends, of course, on the circumstances of the issuing school district and the nature of the bond issue.

Coordination of the preparation of the official statement is generally undertaken by the school district's bond counsel or disclosure counsel in a competitive sale and by bond counsel, disclosure counsel or underwriter's counsel in a negotiated sale. This party generally prepares a draft official statement on the basis of information provided by the school district (with respect

to itself, its operations and its financial condition) and the terms of the financing documents prepared by bond counsel (with respect to descriptions of financing documents and tax law matters). Different members of the financing team review and comment on different portions of the official statement drafts, often as part of scheduled drafting sessions. Parties also conduct a "due diligence" investigation with respect to the official statement involving inquiries of school district officials and review of supporting documentation. A preliminary official statement and an official statement are generally not printed and distributed until all concerned parties are comfortable that the information included is accurate and complete.

Continuing Disclosure

Rule 15c2-12 requires issuers of municipal bonds and certain other "obligated persons" to contract to provide continuing information during the life of their bond issues. The three exemptions from Rule 15c2-12 described above apply to these requirements. In addition, TRANs and other issues maturing in 18 months or less are exempt from the annual disclosure requirement, and only limited annual disclosure is required of school districts with less than $10 million in outstanding bonds at the time of the issuance. Nevertheless, these exemptions do not excuse qualifying school districts from the disclosure of certain material events. See "Material Events Disclosure" below.

The Disclosure Agreement. Rule 15c2-12 requires the underwriter of $1 million or more in municipal securities to "reasonably determine" that each issuer and any other "obligated person" has undertaken in a written agreement for the benefit of holders of the securities to provide (by filing with certain specified information repositories) four categories of information:

- Certain "annual financial information," of the type presented in the official statement, for each obligated person for whom financial information or operating data is presented in the final official statement, or for obligated persons meeting certain objective criteria.
- Audited financial statements of the obligated person(s), when and if available, if not provided with the annual financial information.
- Notice of the occurrence of any of 11 events, if material, in a timely manner (see "Material Events Disclosure" below).
- Notice of any failure to file the required annual financial information.

Just as the information initially disclosed in the official statement is a matter of judgment which depends on the type and terms of the debt, the type of financial or operating information that must be provided on an annual basis depends on the type of debt instrument that is issued. For example, school district general obligation bonds are secured by taxes levied against property located in the school district. Relevant financial information may therefore include

assessed valuation of taxable property in the school district, annual tax levies and outstanding debts of the school district. For general fund-supported lease obligations, more information about the school district's financial and operating data may be relevant, such as unfunded retirement obligations and average daily attendance. In any case, a judgment must be made as to which financial and operating data of the school district are both relevant and material to the security for the bonds.

Material Events Disclosure. In addition to providing financial and operating information annually, the school district will have to disclose in a timely manner the occurrence of any of the following events, if deemed "material" to investors under federal securities law principles:

- Principal and interest payment delinquencies.
- Non-payment related defaults.
- Unscheduled draws on debt service reserves reflecting financial difficulties.
- Unscheduled draws on credit enhancements reflecting financial difficulties.
- Substitution of credit or liquidity providers, or their failure to perform.
- Adverse tax opinions or events affecting the tax-exempt status of the security.
- Modifications to rights of security holders.
- Optional or unscheduled bond calls.
- Defeasances.
- Release, substitution, or sale of property securing repayment of the securities.
- Rating changes.

The promise to make the annual reports and the material event reports must be included in a document or agreement which is enforceable by bond owners, such as an indenture, must be reflected in the notice of sale for competitively bid issues or the purchase contract for negotiated sales, and must be described fully in the Official Statement. Non-compliance must be reported to the repositories and disclosed in future official statements for five years, with possible adverse market consequences for the school district's bonds.

Obligated Persons. An "obligated person" is defined to mean "any person who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold." It is generally accepted that a person's obligation must be for a material portion of the annual debt service in order for that person to be an obligated person. However, a passive taxpayer is not an obligated person, even if the taxpayer represents a significant portion of the school district's tax base. For general obligation bonds and lease revenue-supported debt, including COPs, the school district is ordinarily the only obligated person. A nonprofit corporation or joint powers authority

acting as the issuer on behalf of a school district's lease-revenue debt is not deemed an obligated person, because the source of debt service is the school district's lease payments. On the other hand, landowners/developers in Mello-Roos financings are often obligated persons.

Interplay of Rule 15c2-12 and the Anti-Fraud Provisions. The SEC's anti-fraud rules apply to disclosures intended to influence securities markets. Under accepted legal principles, annual reports and material event disclosures must therefore be accurate and not omit any material information needed to make the disclosures not misleading. Material misstatements or omissions in the annual or event reports may be the basis for claims of securities fraud under federal or state securities laws, actionable by the SEC or private plaintiffs (bond owners or other investors), with substantial potential liability for issuers or other obligated persons.

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