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"Cash Out" Refunding of General Obligation Bonds

We periodically publish guest articles when they address topics that are particularly relevant and timely for our clients. An article by Jeff Small and Cathleen Dominico of Capitol Public Finance Group, LCC, discusses a particular type of General Obligation Bond refunding, known as "cash out" refunding, and we believe the topic may be of interest to local educational agencies. The article is included below.

The article is provided for informational purposes only, and we would stress that bond transactions are complex legal agreements and should only be undertaken by a district after appropriate review and discussion with its financial advisors, legal counsel, and certified public accountants.

—The Editor

Exploring the Complexities of "Cash Out" General Obligation Bond Refundings

By Jeffrey Small and Cathleen Dominico of Capitol Public Finance Group, LLC

Many school districts have been approached by public finance professionals about pursuing "cash out" general obligation bond ("G.O. bond") refundings. These transactions involve refinancing outstanding G.O. bonds for the purpose of converting the savings into cash to be used for school facilities. Although such refinancings may be legal, they can be abused. The complexities associated with "cash out" G.O. bond refundings are discussed below.

Overview of G.O. Bond Refundings

A G.O. bond refunding is when a local agency replaces some or all of its existing debt with new debt. The old debt is referred to as the "refunded" bonds. The new debt is referred to as the "refunding" bonds. A refunding is undertaken to either save money or restructure outstanding bonds.

When a local agency issues refunding bonds to save money, the savings can be captured in one of two ways:

1. *Over-Time*—Reduces annual debt service, which lowers tax rates; or
2. *Up-Front*—Generates a premium to pay for additional authorized capital projects while also lowering

It is clear in the Government Code ("G.C.") that savings generated from refunding G.O. bonds can be used to pay debt service, thereby lowering tax rates. However, when school districts attempt to capture the savings up front to pay for additional school facilities, they should proceed with caution as this transaction is complex and controversial.

"Cash Out" G.O. Bond Refunding Structures

There is legal uncertainty about "cash out" refundings, whereby school districts issue refunding bonds, use the savings to prepay refunded bonds, and directly receive all of the savings. Although this transaction is straightforward, several nationally recognized bond counsels, that such a transaction is not legal given G.C. § 53555, v relevant part, "The proceeds of any sale of refunding bonds for cash shall be placed in the treasury of the the credit of a fund to be established for the purpose of refunding the bonds to be refunded..."

However, a few nationally recognized bond counsel firms believe it is legal for school districts to take so

by utilizing a joint powers authority ("JPA") through the Marks-Roos Local Bond Pooling Act of 1985. If a school district could issue \$10 million of G.O. refunding bonds to a JPA, which would simultaneously sell revenue bonds to the public. The JPA would use \$10 million of the \$11 million in proceeds from the revenue bonds to purchase the school district's \$10 million G.O. refunding bonds. The district could then use the proceeds from the lower interest rate G.O. refunding bonds to prepay the higher interest rate G.O. refunded bonds, thereby reducing the service obligation of the taxpayers. The remaining \$1 million would then be available for the JPA to pay the principal on the G.O. refunding bonds. This alternative structure is legally justified because the revenue bonds are not subject to the refunding premium of G.C. § 53555 discussed above. Although this method may sound complex and artificial, it has been successful in several school districts in California. In fact, some districts have filed validation actions with their county courts to establish the legality of this method, and it has withstood scrutiny.

In addition to legal concerns regarding "cash out" refundings, we have seen "cash out" refunding proposals whereby crafty techniques are used to elude provisions of the law. Under the G.C., the principal and interest on the refunding bonds must be less than the principal and interest on the refunded bonds. To meet this test, and still generate the "cash out" premium, total debt service savings can be achieved by shortening the bond term. Savings is generated because even if interest rates are not lower, the school district pays less total interest due to a shorter repayment period. The shorter bond term may result in an annual increase in tax rates (even if the average tax rate over the life of the bonds does not increase) because higher tax rates are needed to generate sufficient tax collections to pay the accelerated debt service associated with the shorter bond term. This financing technique is legal because the G.C. does not require refundings to reduce taxes, only to reduce total debt service. But, does it meet taxpayer expectations?

The California Association of County Treasurer and Tax Collector's legislative platform for 2006 opposes "cash out" refundings, and limits the fees paid for costs of issuance. The goal is to ensure that the savings from a bond refunding are dedicated to the benefit of the taxpayers in the district.

Evaluating G.O. Refunding Bonds

There are a few important considerations for a school district when evaluating whether to refund G.O. bonds. First, foremost, it is essential to be in line with the tax rates and expenditures promised to the voters. Second, the district should identify the expectations of the taxpayers regarding whether savings should be taken up-front or distributed in the form of lower tax rates. Districts who use the JPA structure to generate a premium for school facilities do so under the premise that their voting public wanted the district to get as much value from the promised tax rate as is possible. Third, especially if using the JPA structure, it is important to obtain a legal opinion and/or court action that will ensure that the district is acting legally in structuring the refunding and using the proceeds. Finally, it is essential to find a willing and trustworthy JPA or public agency partner to enable the transaction.

Given the controversy and complexities associated with "cash out" refundings, we recommend that school districts interested in using them, proceed with caution, and undertake thorough due diligence and extensive public consultation to ensure a responsible transaction.

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