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California's Cash-Out Deals Stir Debate

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By Andrew Ward

SAN FRANCISCO - When California Attorney General Jerry Brown said "cash-out refunding bonds" violated the state's constitution, he gave bond lawyers and school officials a degree of clarity on a controversial aspect of the law.

He also gave them something new to debate: What should schools do about the dozens - perhaps even hundreds - of outstanding cash-out bond deals?

Brown earlier this week said that the bonds remain legal obligations of the school districts - which should be reassuring to investors - because none of the deals were challenged during the 60-day validation period designated under state law. But he added that the districts may face lawsuits from taxpayers demanding to be compensated by school districts that over-taxed them.

Bond lawyers and financial advisers are divided over what school districts need to do now, but at least one long-time opponent of cash-out refundings said she expects her local school district to refund taxpayer money or face a lawsuit.

"The district has to find a way to repay the taxpayers ... and to minimize any further illegal taxation," said Jill Escher, founder of Citizens for School Bond Accountability in San Jose. "Why should we have to file a lawsuit when it's absolutely, undeniably clear that their cash-out scheme is unconstitutional?"

The deals in question involve bond refinancings for California school districts. The schools sold bonds at a premium above par value by offering higher-than-market interest rates to refund general obligation debt that was originally issued when interest rates were higher.

By offering higher than market rates - which were lower than the rates on their outstanding debts - districts raised enough money to pay off the original debt and garnered extra proceeds without exceeding the par amount approved by voters.

The problem, according to Escher and muni market critics, is that the California Constitution requires voter approval for new GO bonds. The attorney general agreed with the critics that the premium raised amounted to new debt.

"Absent specific approval from the district's electors, a school district may not issue refunding general obligation bonds at a price or an interest rate that will generate proceeds in excess of the amount needed to retire the designated outstanding bonds," Brown said in an opinion prepared by supervising deputy attorney general Constance L. LeLouis and deputy attorney general Daniel G. Stone.

The state lawmaker who asked Brown to issue an opinion on the deals said the opinion lacks the force of law that a legal precedent carries but should essentially clear up the question for school board members considering the deals.

"My goal was to provide school districts some clarity about the law," said state Sen. Joseph Simitian, D-Palo Alto, who was formerly a local school board member. "School districts were getting conflicting advice on this issue."

Brown, the state's top lawyer, said that the deals are illegal even if they finance projects approved by voters under

the original bond issue or if the deals were funneled through a joint powers authority that issued the new, higher amount of debt.

California bond lawyers agreed that the opinion is likely to convince risk-averse lawyers and school districts to abandon the cash-out refundings unless a court explicitly rules that the deals are legal.

"It's very helpful to get some guidance," said Robyn Helmlinger, head of the school finance practice at Sidley Austin LLP in San Francisco. "Sidley has been unwilling to give an unqualified legal opinion on the cash-out legal structure."

She said she struggled with the issue because she was "very sympathetic" to school districts that wanted to raise extra money to build better facilities for students, but she just didn't think the deals fit "within the letter of the law."

While the opinion vindicates lawyers and other muni professionals who turned away business from districts that were eager to do the deals, it also forces them to figure out whether any remedial action is necessary for clients who went ahead and did the deals.

A spokesman for Brown's office said he couldn't comment beyond what was written in the published opinion.

"Apart from the invalidation of the bond sale, other remedies may be available pursuant to a taxpayer's suit ... or actions by the attorney general," the opinion said.

Lori Raineri, a school district financial adviser and president of Government Financial Strategies Inc. in Sacramento, advised her clients against the deals and urged the attorney general to issue an opinion against cash-out refunding.

The technique "addressed a real problem that school districts faced of having cost overruns on projects," she said. "But it also caused a problem in terms of the public trust," by circumventing the need for voter approval of new debt.

"I think you have to make a wrong right," Raineri said. She said she's not sure how a district would do that, though some districts, knowing the practice was controversial, saved the premium proceeds and may be able to use the money to pay down excess debt.

A spokeswoman for the San Jose Unified School District, where Escher lives, didn't return repeated calls seeking comment. In December 2005, the district sold $148.1 million of bonds to refund debt authorized by voters in 1997. The official statement on the deal shows that it generated an original issue premium of $20.4 million, which was deposited into a building fund for the prior bonds.

David Casnocha - head of the education group at Stradling, Yocca Carlson & Rauth, which was bond counsel on the San Jose deal and many of the cash-out refundings - did not return e-mail and telephone messages by press time yesterday.

Roger Davis, head of the public finance group at Orrick, Herrington & Sutcliffe LLP, said California's bond validation law, which gives plaintiffs just 60 days to question a bond issue, may mean that school districts don't have to do anything. The state also passes annual bond validation acts that validate bonds that haven't been challenged.

"The bonds certainly should be valid, as the attorney general's opinion concludes, as a result of the application of Section 860 in the Code of Civil Procedure," Davis said. "That means they [school districts] shouldn't have to do anything with regard to the bonds, and it may well be the case as a result of the scope of the validation that they may not have to do anything. But one will have to wait and see what actions might be taken, on what legal theories, by taxpayers or the attorney general."

Orrick, by far the state's biggest bond counsel, rejected the bulk of the cash-out refundings, but it did develop a structure through which a few school districts achieved similar results using a joint powers authority.

Under that structure, school districts sold bonds at above-market rates to a JPA. The authority then sold a higher amount of debt at a lower yield, securing additional proceeds, similar to the premium from the cash-out deals. The JPA used the extra money to build facilities for use by the school district. As such, the school district wasn't doing the cash-out refunding directly.

Brown's opinion said such a legal buffer wasn't enough to get around the constitutional requirement of voter approval, but Davis said he thinks the JPA structure is on much more solid legal ground than the direct deals.

Indeed, California courts have long allowed governments to issue certificates of participation through an analogous legal structure: With COPs, governments enter into a lease with a nonprofit that issues debt backed by the lease payments. The net effect is a government debt, but the legal structure allows the government to avoid getting voter approval every time it wants to use general fund dollars to support a long-term capital project.

"The joint-powers authority version should be less vulnerable to the challenge on the basis of the attorney general's analysis than the direct school district cash out," Davis said. "It seems to be saying that because the results of the two versions is similar, the constitutional infirmity is the same, but in fact, it's common to structure financings to accomplish indirectly what the constitution may prohibit directly."

For now, he'll wait for a higher power than Jerry Brown to prove him wrong.
