Why the Joint Powers Authority Refunding Bond Model Works: A Critique of the Attorney General's Claim of Unconstitutionality

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Introduction

In 2007, amid concerns that cash-out refunding bonds were legally unsound and might violate state law,[1] State Senator Joseph Simitian (D-Palo Alto)—a former local school board member—submitted five questions to the California Attorney General addressing the legality of cash-out refunding bonds.[2] Of particular interest is Question 5, which asks whether a school district may sell refunding bonds to a joint powers authority ("JPA")[3] with an above-

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1. *See e.g.*, Bob Porterfield, *Schools use controversial practice for extra cash (cash-out refunding)*, FreeRepublic.com, Apr. 4, 2006, *available at* http://www.freerepublic.com/focus/f-news/1623869/posts; Neil Gonzalez, *Report: school-bond refinancing costing taxpayers more*, BNET, July 12, 2008, *available at* http://find articles.com/p/articles/mi_qn4176/is_20080712/ai_n28063389/?tag=content;col1; Citizens for School Bond Accountability Blog, http://citizensforschoolbondaccountability.blogspot.com/ (last visited Jan. 16, 2010).

2. Rich Saskal, *Cashing-Out in California*, The Bond Buyer, Apr. 26, 2007, *available at* http://www.bond buyer.com/news/-269320-1.html.

3. A joint powers authority is a separate legal entity that is created when "two or more public agencies by agreement . . . jointly exercise any power common to the contracting parties." CAL. GOV'T CODE § 6502. An example of a JPA would be the Oakland-Alameda County Coliseum Authority, which was formed by the City of Oakland and Alameda County in 1995 to finance renovations to the Oakland-Alameda County

market interest rate.[4] The Attorney General answered No, stating that because such an arrangement results in an issuance of refunding bonds in excess of the minimum amount required to refund the school district's outstanding indebtedness, it would violate the state's constitutional voter approval requirement for incurring new indebtedness and levying new taxes.[5]

This Comment is a critique of the Attorney General's answer to Question 5, and as such, it is assumed that the reader has already read the opinion.[6] Moreover, to avoid redundancy and to save the readers' time, this Comment relies largely on the foundation provided by the Attorney General's opinion that explains the basic mechanics of municipal bonds, and refunding bonds in particular.[7] Part I provides the relevant constitutional provisions, attempts to explain how refunding bonds work by giving several examples, and offers a brief synopsis of the Attorney General's opinion. Part II lays out a critique of the Attorney General's opinion that focuses on, *inter alia*, a problematic assumption, dicta cited as precedent, and a substance-over-form argument that does not conform with existing case law.

I. Background

A. Relevant Constitutional Provisions

In California, a school district's ability to issue refunding bonds is restricted by a pair of constitutional provisions.[8] Article XIIIA, section 1, prohibits a school district from levying *ad valorem* property taxes in excess of one percent to support new debt, unless that debt existed prior to July 1, 1978, or resulted from voter-approved bonds satisfying article XVI, section 18.[9] Article XVI, section 18, requires two-thirds or fifty-five percent (depending on the nature of the project) voter approval before issuing new bonded indebtedness.[10] These two provisions thus work in tandem, requiring a school district

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Coliseum and Oracle Arena and to manage both of these facilities. http://www.coliseum.com/info/images/ DVC_ ColiseumAuth_sm_062005.pdf (last visited Jan. 23, 2010).

4. 92 Ops. Cal. Att'y Gen. 1 (2009).
5. *Id.*
6. *See id.*
7. *Id.* at 3–9.
8. There is also an applicable statutory scheme. *See infra* Part II.
9. CAL. CONST. art. XIIIA, § 1(a), (b)(2), (b)(3).
10. CAL. CONST. art. XVI, § 18(a), (b).

to obtain voter approval "for both pieces of the refunding bond process—i.e., both to issue the bonds and to levy the taxes to repay them."[11] A JPA, by contrast, is not bound by either of these constitutional provisions and thus can incur new debt without two-thirds voter approval.[12]

B. Cash-Out Refunding

Cash-out refunding operates much like refinancing a home mortgage. A homeowner might refinance his existing mortgage (old debt) at a lower interest rate and take out additional cash (new debt) to pay for home improvements, education, travel, etc. In the cash-out refunding context, a school district issues refunding bonds in an amount sufficient to pay off its existing bonds (old debt) and to also create excess proceeds (new debt) in the process. The excess proceeds are analogous to the additional cash in the home mortgage-refinancing scenario and are used to shore up over-budget capital projects and pay for other school-related expenditures.

The cash-out refunding bonds at issue here—that is, those bonds issued in conjunction with a JPA—are slightly more complex. Accordingly, a basic example of such an arrangement might go as follows. First, a school district and one or more additional government units (e.g., a county) form a JPA. The school district then sells the JPA $10 million in refunding bonds. These bonds are sold with an interest rate that is pegged below the original interest rate and above the current market rate. The JPA then sells $11 million in revenue bonds at the current market interest rate to investors. Because the school district's refunding bonds were issued with an above-market interest rate, the debt service on those bonds is designed to cover the debt service on the JPA's revenue bonds. As a result of these two transactions—the JPA purchasing $10 million in refunding bonds and then selling $11 million in revenue bonds—the JPA is left with $1 million to spend on local capital improvements, including new school facilities.

In even more simple terms, imagine that the school district has a loan with an original interest rate of six percent. It then has the opportunity to refinance that loan at the current market rate of four percent. Instead, however, it refinances at five percent. The one

11. 92 Ops. Cal. Att'y Gen. at 2.

12. *See* Rider v. City of San Diego, 18 Cal. 4th 1035 (1998).

percent difference between the market rate and the refinanced rate goes to the JPA, which then spends it on school-related projects.

C. The Opinion: A Synopsis

School districts recently began to use refunding bonds as a means to create excess proceeds for unfinished or over-budget capital projects. This controversial practice, dubbed "cash-out" refunding, was criticized as violating state law because it generated a premium without voter approval.[13] The controversy eventually escalated, provoking voter backlash and, in some cases, sparking litigation.[14] In 2007, State Senator Simitian posed several questions to the State Attorney General to bring clarity to the situation. One of these questions hypothesized a refunding bond issued in conjunction with a JPA. Specifically, the senator asked:

> May a school district, acting without voter approval, sell refunding general obligation bonds to a joint powers authority at par value but with an above-market interest rate in exchange for the joint powers authority's agreement to issue its own revenue bonds and to use the resulting proceeds both to purchase the school district's refunding bonds and to fund the construction of additional school facilities?[15]

The Attorney General answered in the negative, stating:

> Because the proposed arrangement between a school district and a joint powers authority would result in a refunding bond issuance in excess of that needed to merely refund the district's designated outstanding bonded indebtedness, both the refunding bond issuance and the higher tax required to support it are constitutionally impermissible without specific voter approval.[16]

The Attorney General continues by making a substance-over-form argument by analogizing the JPA refunding bond model to a non-JPA-based cash-out scheme in which the premium would be

13. *See supra* note 1.

14. *See e.g.*, Jack Van Zandt, *The San Jose Unified School District Bond Refinancing Scheme*, *available at* http://www.sanjoseinside.com/sji/blog/entries/the_san_jose_unified_school_district_bond_refinancing_scheme/.

15. 92 Ops. Cal. Att'y Gen. at 2.

16. *Id.* at 20.

spent directly by the school district.[17] The opinion next acknowledges that the refunding bonds would be sold without premium and assumes that JPAs promise to finance capital projects for the school district in exchange for above-market interest rates on the refunding bonds.[18] The Attorney General concludes his analysis on this point by stating that the constitution's debt limit only allows refunding bonds that are limited to refunding existing debt and refers the reader to Question 1 for further analysis.[19]

In his response to Question 1, the Attorney General argues that cash-out scenarios in which the principal amount owed by the district is not increased are unconstitutional because "the excess proceeds beyond those needed to merely refinance existing debt would result from an artificial increase in the refunding bonds' interest rate."[20] This "artificial increase" is a reference to an above-market interest rate. The Attorney General considers the proceeds from such an interest rate to be new bonded indebtedness, therefore triggering the two-thirds voter approval requirement.

The Attorney General also argues that the JPA model would be unconstitutional because the above-market interest rates would result in an increase in, or perpetuation of, *ad valorem* property taxes higher than what is necessary to retire the original bonds.[21] The reader is then referred to the analysis found in the answer to Question 3 to

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17. *Id.*

18. *Id.* at 20–21.

19. *Id.* at 21. Here is the relevant excerpt from the answer to Question 1 referenced in the answer to Question 5:

> Accordingly, to the extent that a district's proposed refunding bonds would generate proceeds beyond the amount needed to refund its outstanding bonds, we believe that the refunding bonds would constitute a new bonded indebtedness within the meaning of article XVI, section 18, and would therefore require specific voter approval. Likewise, article XIII A, section 1, would prohibit the levying of taxes to support such new debt without voter approval.
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> We acknowledge that some cash-out scenarios may not necessarily increase the principal amount owed by the district beyond that of the existing debt. However, this is a distinction without a constitutional difference. In such cash-out scenarios, the excess proceeds beyond those needed to merely refinance existing debt would result from an artificial increase in the refunding bonds' interest rate. And the constitution's prohibitions apply to "bonded indebtedness"—a term that includes both the principal and the interest associated with a bond sale. Hence, the district's debt would nonetheless exceed what is necessary to retire the original obligation, thereby triggering the voter-approval requirement.

Id. at 12–13.

20. *Id.*

21. *Id.* at 22.

support this position.[22] Question 3's response interprets article XIIIA, section 1's one-percent property tax cap as a prohibition against increases or continuations of taxes at a rate higher than necessary to refund existing debt.[23] [24]

II. A Critique of the Attorney General's Opinion

A. Market Rate Is Not Mandatory

The Attorney General makes several claims in support of his categorical rejection of cash-out refunding schemes, none more important than the implicit argument that refunding bonds must be sold at market rate. This assumption lies at the heart of the opinion and provides the foundation for the Attorney General's principal argument: "To the extent that a district's proposed refunding bonds would generate proceeds beyond the amount needed to refund its outstanding bonds, we believe that the refunding bonds would constitute a new bonded indebtedness within the meaning of article

22. Here is the relevant excerpt from the answer to Question 3 referenced in the answer to Question 5:

> Article XIII A, section 1, imposes a one-percent property tax cap on local agencies, with the exception that ad valorem taxes may be levied to pay principal and interest on voter-approved bonds permitted under article XVI, section 18. Thus, the constitution prohibits increases or continuations of taxes, without voter approval, at a rate higher than necessary to refund the original voter-approved bonds, and therefore would forbid the imposition or maintaining of an ad valorem tax to support cash-out refunding bonds as proposed.

Id. at 18.

23. *Id.* The Attorney General does not cite any authority or provide any rationale for his interpretation. Instead, the Attorney General makes a logical leap from the constitutional tax cap to a ban on higher-than-necessary tax rates, leaving us to connect the dots. Such underdeveloped reasoning is not persuasive, much less grounds for finding the JPA refunding bond model unconstitutional. To the extent that the JPA model might be viewed as an exception to the restrictive "spirit" of the constitutional tax limitation imposed by article XIIIA and, therefore, should be interpreted narrowly, the Attorney General's stance is not unreasonable. However, neither the answer to Question 3 nor the answer to Question 5 advances this argument.

24. It should be noted that the referenced answers to Questions 1 and 3 address non-JPA-based cash-out refunding bond schemes rather than those refunding bond issuances structured around a JPA that are at issue in Question 5. This apples-to-oranges approach is all the more curious considering the distinct powers granted to, and limitations placed upon, school districts and JPAs by the constitution and state law. *See generally* CAL. CONST. art. XIIIA, art. XVI § 18; CAL. GOV'T CODE § 6500 et seq.; CAL. EDUC. CODE § 15000-15425. Yet the opinion does not explore in depth the powers of the JPA or the JPA-school district relationship. And while the Attorney General notes that he was not asked to examine the powers of the JPA, it seems that such an analysis is required to fully answer the question presented.

XVI, section 18, and would therefore require specific voter approval." This statement is predicated upon the assumption that a refunding bond must be sold at market rate because if a bond is sold *above* market rate (and everything else being equal), the bond proceeds will be more than what is necessary to retire the original bonds, which would (according to the Attorney General) create new indebtedness and therefore trigger the two-thirds voter approval requirement. There are, however, several flaws in the Attorney General's line of reasoning.

1. *Dicta, Dicta, Dicta*

The Attorney General supports this market rate mandate with *Golden Gate Bridge and Highway District v. Filmer*,[25] which he cites for the proposition that a school district must sell its bonds on the "best terms available."[26] The Attorney General's interpretation of the *Golden Gate* court's decision is unique, however, as no other California court has ever cited *Golden Gate* for this particular proposition.[27] And with good reason—this language is dicta. The single question presented in *Golden Gate* was whether the term "rate of interest" referred to the coupon rate or the interest yielded to investors.[28] The court held that it was the former.[29] In coming to its conclusion, however, the court discussed several decisions from other states including *Rowland v. Deck*.[30] In that case, the Kansas Supreme Court held that bonds may be issued at a discount if they bear the maximum interest named and are sold on the "best terms available."[31] The Attorney General seizes upon this language and references it several times in the opinion to support his market rate argument.[32] Yet, this language is merely the summarized holding of an out-of-state court that does not address the question presented in the case in

25. Golden Gate Bridge and Highway Dist. V. Filmer, 217 Cal. 754 (1933).

26. 92 Ops. Cal. Att'y Gen. at 7.

27. Only six California cases that have cited *Golden Gate* in the 77 years since it was decided. Connerly v. State Personnel Bd., 92 Cal. App. 4th 16, 49 (2001); Allis-Chalmers Corp. v. City of Oxnard, 126 Cal. App. 3d 814, 819 (1981); Assoc. Students of N. Peralta Cmty. Coll. v. Bd. of Tr., 92 Cal. App. 3d 672, 677 (1979); Veterans of Foreign Wars v. California, 36 Cal. App. 3d 688, 692 (1974); Eastern Mun. Water Dist. v. Scott, 1 Cal.App.3d 129, 135 (1969); Metro. Water Dist. of S. Cal. v. Toll, 1 Cal.2d 421, 430 (1934).

28. *Golden Gate*, 217 Cal. at 756-57.

29. *Id.* at 762.

30. *Id.* at 760.

31. Rowland v. Deck, 195 P. 868, 871 (Kan. 1921).

32. *See, e.g.*, 92 Ops. Cal. Att'y Gen. at 7, 18 n.66.

which it is cited. As such, it is highly doubtful that any court would find such dicta to be persuasive, let alone controlling precedent.[33]

Moreover, *Rowland* was cited by the *Golden Gate* court for the general rule that, in the absence of express statutory language to the contrary, municipal bonds may be sold for less than par. The court in *Golden Gate*, quoting the Kansas Supreme Court, stated that when confronted with statutory silence on the issue of the amount for which a bond may be sold, a "'strong presumption [is created] that the legislature was content to rely upon the good faith and business judgment of the local officials to see that the bonds brought *substantially the market price*.'"[34] By analogy, where, as here, there is no statute on point regarding the interest rate at which a bond must be sold, it is reasonable to assume that the state legislature most likely intended to defer to the good faith and business judgment of the school district board members to secure an interest rate.[35] Even then, *Golden Gate* would only require that the refunding bonds bring "substantially the market [rate]."[36]

Even if the Attorney General's interpretation were accepted, the phrase "best terms available" is ambiguous at best. And due to ever-changing market conditions, defining the "best terms" would have to be done on a case-by-case basis—a process that conflicts with the Attorney General's categorical rejection of all refunding bonds issued with above-market interest rates.

33. If anything, the *Golden Gate* court relied on legislative intent when it concluded that "it was the intent of the lawmaking power to grant to the [directors] the entire discretion to sell at the best advantage possible under the circumstances." *Golden Gate*, 217 Cal. at 760. And while citing legislative intent could be a legitimate rebuttal against the JPA bond refunding model, the Attorney General only mentions legislative intent and legislative history in passing. 92 Ops. Cal. Att'y Gen. at 16 n.58.

34. *Golden Gate*, 217 Cal. at 760 (quoting *Rowland v. Deck*, 195 P. at 871) (emphasis added).

35. In fact, the state legislature has already granted school districts discretion when issuing bonds. *See* GOV'T CODE § 53555 ("Refunding bonds issued pursuant to this article may be exchanged for the bonds to be refunded on such basis as the legislative body determines is for the benefit of the local agency . . ."). There is, of course, an existing political check on the school district's discretion: If voters believe that their interests are not being faithfully represented, they can always vote the school district board members out of office. This point dovetails somewhat with the school district's fiduciary duty as managers of public funds. *See* CAL. GOV'T CODE §§ 53600 et seq. The Attorney General only hints at this duty, *see* 92 Ops. Cal. Att'y Gen. at 18 n.66, even though it presents another potentially legitimate attack on JPA-financed refunding bonds.

36. *Golden Gate*, 217 Cal. at 760 (quoting *Rowland v. Deck*, 195 P. at 871).

2. *Three More Problems*

The market-rate premise presents three additional problems as well. First, there is no provision in the state constitution and no statute on the books that requires refunding bonds to be sold at the current market rate. Education Code section 15140 sets the maximum interest rate at eight percent.[37] Government Code section 15146(e) sets the ceiling for the interest rate at the legal maximum (currently twelve percent).[38] But nowhere is the interest rate on a refunding bond mandated to be the market rate. In other words, a school district is not legally compelled to sell their refunding bonds at the current market interest rate. Thus, rather than interpret existing statutes or constitutional provisions, the Attorney General purports to create new law.

Second, statutes authorizing negotiated bond sales would be problematic. Government Code section 6589 explicitly allows for negotiated sales between local agencies and JPAs.[39] Education Code section 15146 specifically provides for negotiated sales or competitive bidding.[40] Neither code section requires refunding bonds to be sold at market rate, but rather they expressly permit more tailored transactions, allowing a school district the flexibility to land the best overall deal. Under the Attorney General's opinion, however, these sections would be more difficult to apply.

Third, such an approach is too inflexible to account for the volatility of the marketplace. The Attorney General assumes that that the school district will know what the market rate will be when the bonds are sold. But like any free trading marketplace, the bond market's daily fluctuations are unpredictable. And to be able to react to these changing market conditions and obtain the best overall deal, the parties to the transaction must have the ability to adjust the interest rate as well as other bond terms.

B. Substance Over Form Fails

The Attorney General also makes a substance-over-form argument, asserting that "[q]ualitatively, the JPA scheme is the same as a cash-out with premium in which the excess cash received at closing (acquired in exchange for above-market interest rates) would

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37. CAL. EDUC. CODE § 15140.

38. CAL. GOV'T CODE § 15146(e); CAL. CIV. CODE § 1916-1.

39. CAL. GOV'T CODE § 6589.

40. CAL. EDUC. CODE § 15146.

be expended by the district on capital projects."[41] The California Supreme Court addressed a similar qualitative argument in *Rider v. City of San Diego*. In that case, a JPA had been formed as part of a lease financing arrangement for the specific purpose of financing the expansion of a convention center.[42] Per the agreement, the JPA first issued revenue bonds to generate money for the expansion.[43] The JPA then subleased the convention center to the City of San Diego in exchange for rent payments equal to the debt service on the bonds.[44] The plaintiffs contended that "through the legal equivalent of smoke and mirrors, the City has arranged to do what the Constitution . . . [does] not permit it to do: issue bonds without the approval of two-thirds of the electorate."[45] The court expressly rejected this substance-over-form argument, instead finding that due to the contingent nature of the lease agreement and independent legal status of the JPA, the financing arrangement satisfied the constitutional requirements.[46] In other words, the court found that the state constitution and the city's charter allowed the city to circumvent the two-thirds vote requirement by creating a JPA to finance public works projects.[47]

Following the *Rider* court's reasoning, the Attorney General's substance-over-form argument should be rejected here as well. In the JPA-financed refunding bond context, the JPA—and not the school district—receives the excess proceeds. This means that the JPA—and not the school district—incurs any new debt. And because JPAs are exempt from the constitutional debt limitation, the two-thirds voter approval requirement is not triggered. Admittedly, such an arrangement is a legal fiction that effectively circumvents the constitutional debt limitation. However, this is nothing new. Lease financing arrangements, such as the one upheld in *Rider*, are clearly an end run around the constitutional debt limit, and yet they have been accepted by California courts because they comply with all of the formal legal requirements. Consequently, there seems to be little reason why a JPA-financed refunding bond issuance that is structured

41. 92 Ops. Cal. Att'y Gen. at 22.

42. Rider v. City of San Diego, 18 Cal. 4th 1035, 1040 (1998).

43. *Id.*

44. *Id.*

45. *Id.* at 1042.

46. *Id.* at 1055.

47. *Id.* at 1042.

to satisfy all of the formal JPA and school district refunding laws should not be accepted by California courts as well.

Conclusion

The Attorney General's answer to Question 5 suffers from several infirmities and generally fails to adequately vet the JPA refunding bond model. The Attorney General makes logical leaps without connecting the dots, relies on inapt comparisons, cites dicta as precedent, and refuses to indulge in the same legal fiction expressly endorsed by the California Supreme Court. Because there are no statutes and no case law compelling the school board to sell refunding bonds at market rate, such a decision is left up to the good faith and business judgment of the school board members. And if form truly does trump substance—and based on the court's decision in *Rider*, there is very good reason to think so—the JPA refunding bond model should pose no new-debt problems under the state constitution.

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