Allen Matkins

Real Estate Tip

Investment Opportunities and Strategies for Acquiring Defaulted Community Facilities District (CFD) Bonds

An opportunity that investors have recently been exploring is the acquisition of defaulted CFD bonds which **may present special advantages to the investor**.

Opportunities include:

- foreclosing out lenders and fee owners, or
- holding the bonds and enjoying the higher yield resulting from the purchase of the bonds at less than their par value.

Community Facilities Districts ("CFDs") are often formed to finance the infrastructure for master planned communities. The lien securing the repayment of the special taxes which are pledged to pay debt service on the bonds issued by the CFD is senior to all liens securing private loans encumbering the property within the CFD.

Investors Seeking to Own the Property

From the perspective of an investor with the objective of owning the underlying asset, the foreclosure of property located within the CFD results in the extinguishment of liens securing all private financing, mechanics liens, and all other junior encumbrances. To the extent (i) the entitlements are still current and (ii) the improvements are complete and/or the CFD still has funds to finance the completion of the improvements, the investor may gain a valuable asset at a significant discount.

Investors seeking to own the underlying asset should be aware of the following risks:

- There is often a diversity of ownership of CFD bonds and it can be difficult to achieve a consolidation of the ownership at a low enough price to justify the risk.
- As non-judicial foreclosure is not an option, CFD bonds must be foreclosed judicially, a slow and expensive process, with the additional risk of a bankruptcy.
- The liens on the individual parcels securing the payment of special taxes pledged to pay debt service on CFD bonds are not cross-defaulted, allowing the owners and/or their lenders to bring current one or more parcels to frustrate the consolidation objectives of the investor.
- The lenders/owners of the property may elect to bring all special taxes current, forcing an investor to either hold the bonds as a long-term investment or attempt to sell the bonds in a potentially illiquid environment.
- The CFD may not have sufficient funds to finance the completion of the improvements and/or the applicable funding agreement may be in default.
- The parcels remain subject to the payment of *ad valorem* property

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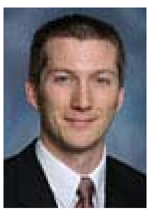

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taxes.

- The entitlements may have expired or be subject to termination due to breaches by the fee owner.

Investors Seeking to Hold the Bonds

From the perspective of an investor that desires to hold bonds as a pure investment, the bond acquisition can provide a significant tax-free return. The spread between municipal bonds and Treasury bonds is at its largest point in 50 years. This is noteworthy because the interest on municipal bonds is generally free of federal, state, and local income tax.

The lien seniority of CFD bonds to junior lien holders also provides an incentive for such junior lien holders to keep the debt service on the bonds current through the payment of timely special taxes. On the risk side, investors with a "buy-to-hold" strategy may end up in an unwanted ownership position with lapsed entitlements and unfinished infrastructure.