

# Public Charter Schools Borrowing With Tax-Exempt Bonds

THIRD EDITION

Eugene Clark-Herrera,  
Marc Bauer, Todd Brewer,  
Steffi Chan, Darrin Glymph,  
Kathryn Garner, Alison Radecki



DISCLAIMER: NOTHING CONTAINED IN THIS BOOKLET SHOULD BE CONSTRUED OR RELIED UPON AS LEGAL ADVICE. INSTEAD, THIS BOOKLET IS INTENDED TO SERVE AS AN INTRODUCTION TO THE GENERAL SUBJECT OF THE USE OF TAX-EXEMPT BONDS BY CHARTER SCHOOLS, FROM WHICH BETTER INFORMED REQUESTS FOR ADVICE, LEGAL AND FINANCIAL, CAN BE FORMULATED.

Published by: Orrick, Herrington & Sutcliffe LLP

All rights reserved.

Copyright © 2019 by Orrick, Herrington & Sutcliffe LLP

No part of this book may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording or any information storage and retrieval system, without permission in writing from the publisher.

# Contents

<b>Chapter 1: Introduction</b>	<b>1</b>
<b>Chapter 2: Why Use Tax-Exempt Bonds?</b>	<b>3</b>
<b>Chapter 3: Timing of Project Acquisition</b>	<b>10</b>
<b>Chapter 4: Eligible Uses of Bond Funds</b>	<b>14</b>
<b>Chapter 5: Interplay between Bonds and Fund-Raising</b>	<b>19</b>
<b>Chapter 6: Credit Considerations</b>	<b>22</b>
<b>Chapter 7: Investor Perspectives</b>	<b>28</b>
<b>Chapter 8: Credit Enhancement</b>	<b>31</b>
<b>Chapter 9: Financing for CMOs</b>	<b>36</b>
<b>Chapter 10: Market Disclosure</b>	<b>40</b>
<b>Chapter 11: Transaction Structure and Documentation</b>	<b>46</b>
<b>Chapter 12: Steps to Issuing Bonds and the Finance Team</b>	<b>49</b>
<b>Chapter 13: Federal Tax Rules</b>	<b>55</b>
<b>Chapter 14: Post-Issuance Compliance</b>	<b>68</b>
<b>Chapter 15: SEC Enforcement</b>	<b>74</b>
<b>Afterword: Bank Loans and Direct Placements</b>	<b>76</b>
About the Authors	78
Orrick Contacts	80



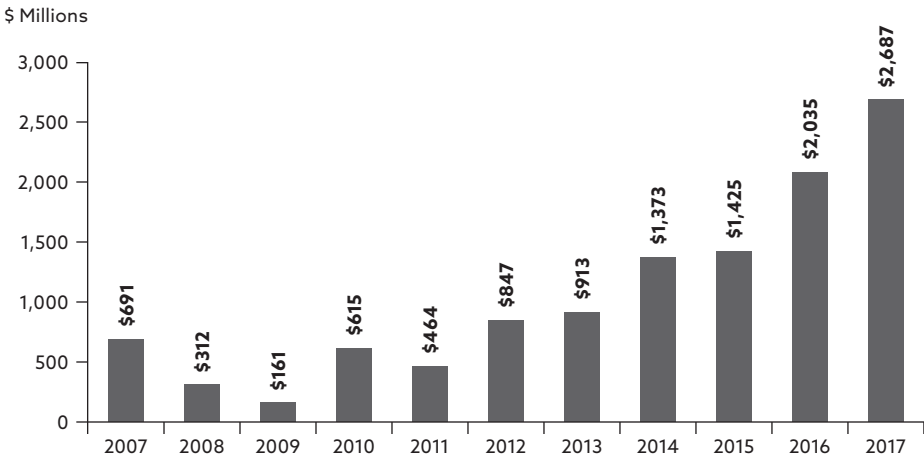
# CHAPTER 1

# Introduction

The public charter school movement has existed for three decades, and still the fundamental need to secure affordable educational facilities continues to challenge charter schools nationwide. Myriad enterprises have evolved as solutions catering to a wide range of charter schools, including government-sponsored, private sector, and collaborative programs that provide facilities, financing or both. Among these, the issuance of tax-exempt bonds remains an effective and increasingly acceptable option to obtain relatively low-cost facilities financing.

Nonprofit corporations and governmental entities have borrowed money using tax-exempt bonds for decades. While major hospitals and universities once dominated the marketplace of nonprofit borrowing, individual public charter schools and groups of commonly managed public charter schools are now regularly borrowing on a tax-exempt basis. Since 1998, public charter schools have borrowed over \$10 billion using tax-exempt bonds, representing over 800 transactions.<sup>1</sup>

For illustrative purposes, the par amount of tax-exempt debt issued each year between 2007 and 2017 is shown below:



Source: Siebert Cisneros Shank & Co., L.L.C.

Bond market access has been spurred by increasing demand for facilities, better understanding of the benefits of tax-exempt financing, and greater market acceptance of public charter school credits. Not only large, established public charter school management organizations (CMOs) with substantial financial resources need apply, but also relatively small, even start-up, public charter schools with limited credit history may be financeable under certain circumstances.

The main purpose of this booklet is to provide public charter schools and their stakeholders relevant information about the benefits of tax-exempt financing, including:

- Who qualifies for tax-exempt financing
- What types of projects qualify for tax-exempt financing
- How to decide if tax-exempt financing might be right for your school
- Some insights, based on years of experience about best practices and what to expect from financing participants and the overall process

The booklet starts by asking the basic question, “Why use tax-exempt bonds?” From there, attorneys from the leading bond counsel firm in the country<sup>2</sup> will explore the nuts and bolts of uses of proceeds, structuring considerations, including considerations of ownership versus leasing of facilities, financing for networks, market disclosure, financing milestones, and what to expect after the bonds are issued and the project is underway.

---

<sup>1</sup> See “Charter School Bond Issuance: A Complete History” published in July 2015 by the Charter School Advisors and the Local Initiatives Support Corporation, available at <http://www.lisc.org/our-resources/resource/2015-charter-school-bond-issuance-a-complete-history-volume-3>.

<sup>2</sup> Rankings for securities transactions of various types are performed annually by Securities Data Company, which has ranked Orrick number one in the country as bond counsel for tax-exempt bonds nearly every year for over 20 years. On average, Orrick handles more than 300 bond issues as bond counsel, aggregating more than \$16 billion, each year.

## CHAPTER 2

# Why Use Tax-Exempt Bonds?

To fund their capital project needs, public charter schools generally have the following choices:

- Conventional taxable financing from a bank or similar private loan
- Charitable contributions or other accumulated funds
- Governmental financing (grant or loan) programs
- Federal tax-credit financing
- Tax-exempt financing by private placement or publicly-offered bonds

Of these, tax-exempt bond financing is often the best option because it offers the lowest cost-of-borrowing, greater flexibility and usually the best terms. While each public charter school's specific circumstances are unique, and may make other options more advantageous, tax exempt bonds should always be included in the analysis of facilities financing options. This chapter compares tax-exempt bonds with the four other major alternative methods of funding capital projects.

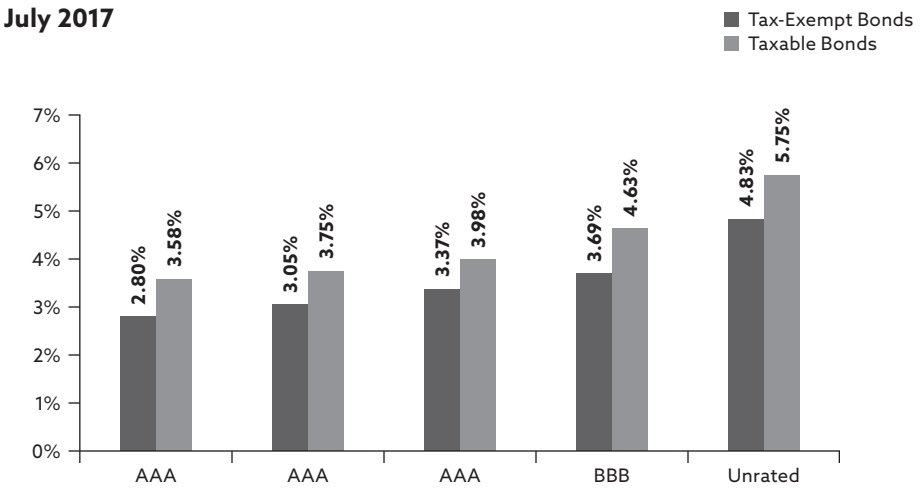
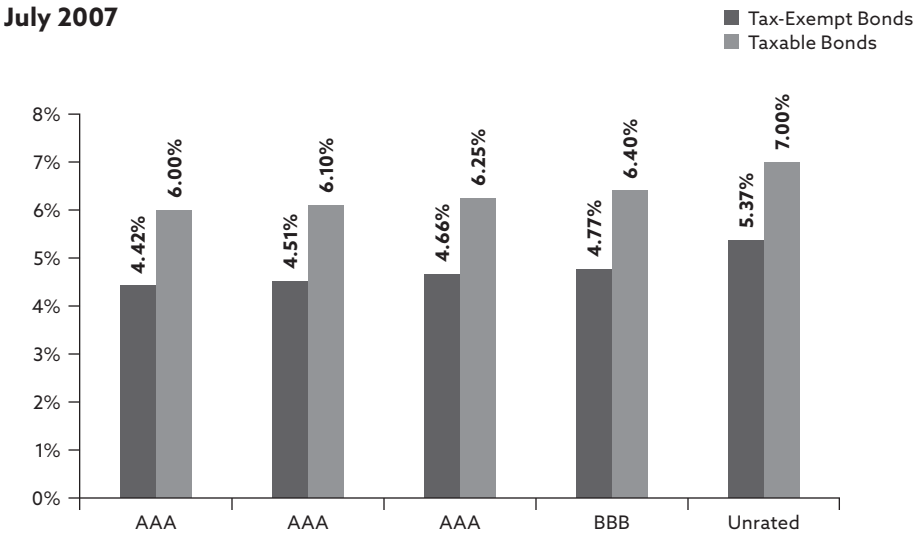
### A. COMPARISON TO TAXABLE DEBT

**Interest Rates.** The public capital markets where tax-exempt bonds are traded typically offer lower interest rates than private loans or bank financing for the simple reason—more competition usually produces lower rates.<sup>3</sup>

Tax-exempt financing normally offers lower interest rates than taxable debt in either public capital markets or private lending transactions because interest paid on tax-exempt debt is exempt from current federal income tax, and often exempt from the income tax of the state in which the bonds are issued as well. The investor/lender requires a lower interest rate to produce an equivalent after-tax return on comparable taxable debt.

This difference in comparative interest rates varies from time to time based on market factors, but as demonstrated in the following graph, tax-exempt rates are usually two or more full percentage points less than comparable taxable debt.

For example, interest rates on 30-year bonds with various credit ratings<sup>4</sup> sold around July 1, 2007, and around July 1, 2017, were roughly as follows:



Source: Siebert Cisneros Shank & Co., L.L.C.

While the difference—referred to as the “spread”—between taxable and tax-exempt rates fluctuates over time, the fundamental lower cost of tax-exempt debt remains constant.<sup>5</sup>



**Tenure.** Tax-exempt debt is often issued on a long-term basis of 20 to 35 years, and at fixed interest rates. On the other hand most taxable debt, is often issued with a shorter term and on the basis of variable interest rates indexed to the prime lending rate, U.S. Treasury notes or bonds, or LIBOR.<sup>6</sup>

Short- or medium-term taxable debt generally matures earlier than the useful life of the financed facility and has to be extended or refinanced, exposing the school to refinancing risk and causing the school to expend new resources both in money and in time when it comes time to refinance shorter term financings. Market conditions, interest rates, and bank lending policies have historically fluctuated, and in some cases dictate higher interest costs to refinance or worse, the inability to refinance. Tax-exempt debt, on the other hand, generally aligns the term of the financing with the usefulness of the project, which adds predictability to school budgeting and planning over the life of the financed facility, and can extend the time horizon for refinancing options.

**Size of Borrowing.** The tax-exempt bond market usually accepts financing of 100% of a project's cost, in contrast to a typical bank or traditional loan financing, which may be limited to 70–75% of the value of the asset financed.

**Covenants.** The financial covenants required in connection with tax exempt and taxable financing are typically similar. Both types of financing limit the ability of the borrower to incur additional debt or encumber property, specify levels of liquid assets or asset to liability ratios, put conditions on the acquisition or disposition of property and on mergers or consolidations, and require quarterly or other regular reporting. In cases of failure to meet these covenants, conventional lenders usually reserve the right to intervene directly in the school's operations or to liquidate collateral assets. Tax-exempt financing remedies typically allow for a cure period during which time the school works with an independent consultant to restore debt performance or other covenant compliance. While foreclosure on a tax-exempt bond financed facility is a remedy under the terms of most financings, it is a remedy of last resort. As discussed further in Chapter 14 "Post Issuance Compliance", tax-exempt financing also requires the school to covenant to comply with certain restrictions designed to ensure that interest on the related bonds remains tax-exempt for the life of the financing.

In summary, tax-exempt financing typically offers better interest rates, longer-term financing and more flexible terms and conditions compared to conventional taxable financing.

## **B. COMPARISON TO AVAILABLE FUNDS AND CONTRIBUTIONS**

The availability of tax-exempt financing presents one of those rare circumstances in which it may be better to borrow than to pay with accumulated or donated funds, even if there are ample available funds. While public charter schools do not generally maintain substantial cash reserves or endowment funds, an increasing number of schools and CMOs have been able to grow substantial cash reserves to guard against financial uncertainties or in supporting long-term capital programs.

Accumulated funds of nonprofit corporations can normally be invested in taxable obligations earning taxable rates of return on which the nonprofit corporation does not, however, pay any tax. On the other hand, because rates applicable to tax-exempt borrowing are based on market rates for tax-exempt obligations, the interest is not subject to income tax in the hand of the investor/lender. This can provide investors with the same after-tax returns as taxable obligations, but at lower interest rates. As a result, by spending proceeds of tax-exempt debt on facilities instead of accumulated funds, a public charter school may have the opportunity to invest those accumulated funds in taxable obligations yielding more than it must pay in interest on the tax-exempt debt. This earnings advantage on the accumulated funds can serve as additional operating cash or as a capital reserve for the school and help to demonstrate financial strength to potential investors.

For example, imagine a CMO wishes to finance a \$20 million project and has \$20 million of available funds. If the \$20 million is invested at 7%, and the CMO can also borrow with tax-exempt bonds at 5.5%, the CMO will earn \$350,000 a year more on its investments than it is paying on the bonds. Of course, there will be some costs associated with issuance of the bonds, which will depend on the size and difficulty of the financing, but except for relatively small financings of \$5 million or less, such costs are usually less than one year's worth of this earnings advantage.

While reinvestment yields after the Great Recession rendered this type of earnings advantage significantly more difficult to achieve, nonprofit corporations have realized this type of earnings advantage and may do so once again when interest rates trend upward. This earnings advantage, based on the spread between taxable and tax-exempt interest rates, is referred to as "arbitrage." As discussed further in Chapter 5 "Interplay between Bonds and Fund Raising", federal tax requirements for the tax exemption of interest on bonds govern when such arbitrage is permitted.

Thus, although it is somewhat counterintuitive, available funds may be better held and invested while using tax-exempt borrowing to finance facilities.

### **C. COMPARISON TO GOVERNMENTAL FINANCING PROGRAMS**

Several states and local government agencies have developed public charter school facilities financing programs to address the dire need in the marketplace.<sup>7</sup> Such programs offer facilities financing at no cost through grants or at very low interest rates through a variety of loan or guarantee programs. By necessity of public policy, these programs tend to involve a variety of eligibility requirements, competitive access, lengthy and sometimes costly procurement procedures, public bidding rules, and rigorous ongoing compliance provisions. Many programs also mandate governmental ownership of the financed facilities. By comparison, public charter schools that use tax-exempt bonds retain ownership of the financed facilities and thereby exercise control over the design and future use of such facilities. Ownership of the facility may also give the school the opportunity to leverage the asset for future renovations or other expansion plans. Further, tax-exempt bond financings generally impose fewer restrictions on things like site location and design as compared with governmental grant or loan programs.

Governmental grant and loan programs may also involve significantly greater periods of time to access funding. As described in more detail in Chapter 12 “Steps to Issuing the Bonds and the Finance Team”, a typical bond financing schedule ranges from 90–120 days absent unexpected complications. A governmental grant or loan program, however, may involve a year or more from application to receipt of funds. Moreover, governmental funding may be subject to budgetary constraints on apportionments or to other problems affecting the funding source, independent of the applicant’s eligibility.

The only limitation on the size of a public charter school’s borrowing with tax-exempt bonds is the school’s ability to pay. If a public charter school can meet the debt service obligation, a project generally can be fully funded (that is, 100% debt-financed) with tax-exempt bonds. By contrast, regardless of a public charter school’s ability to pay, few governmental charter facilities financing programs provide all of the funding needed to cover the cost of a project. Those that do may be in high demand and only accessible through a competitive process. Instead, many programs provide partial funding to spread resources among a greater number of public charter school projects), giving rise to a shortfall and the need for multiple sources of funding to complete a single project.

Thus, while a federal or state agency or local chartering authority may be able to offer comparable or even zero-cost funds relative to tax exempt financing, the need for capital has to be balanced with program requirements, limitations, timing and other restrictions.

#### **D. COMPARISON TO FEDERAL TAX-CREDIT FINANCING**

Federal tax law establishes the exemption from federal income tax on interest earned on municipal bonds, including those issued on behalf of nonprofit corporations such as public charter schools, thereby incentivizing the flow of private capital to public infrastructure financing. The tax code also encourages public infrastructure development by providing tax credits to lenders or investors who lend or purchase and hold bonds issued through qualifying programs to finance certain types of public capital improvements, such as affordable housing and in certain locations, such as qualified low-income communities. Tax-credit financing has been used successfully for public charter school facilities located in qualified areas or serving qualified populations of students, providing a relatively low cost-of-capital similar to tax-exempt bonds.<sup>8</sup>

The successful completion of both tax-exempt bond financings and tax-credit loan financings relies on assembly of a team of knowledgeable professionals who have experience in the marketplace. In either case, nuanced legal negotiations and structuring decisions must be coordinated with market conditions and investor or lender appetite to secure the most favorable financing. Key differences include the following:

- **Location of facilities.** While existing tax-credit financing programs require the school to be located in a qualified geographic area<sup>9</sup>, there are no restrictions on the geographic location of a school financed with tax-exempt bonds.
- **Availability of funding.** Generally, there is no statutory limit on the dollar amount of tax-exempt bonds that may be issued in a given year by a given municipal conduit issuer on behalf of any individual public charter school or all public charter schools. Tax-credit loans and related bonds are dependent on the availability of tax credits, as determined by Congress on a periodic basis for the nation as a whole. A public charter school must apply for and receive the right to use tax credits, if available. Once the allotment of tax credits in a given year has been allocated to various tax-credit loans or bonds in a given tax-credit financing program, no further financings may be completed through

such program unless and until Congress provides for a new allotment of tax credits.

- **Term of loan subsidy.** Tax-exempt bonds for public charter schools are typically structured as long-term financings (20-35 years), and the tax-exemption of interest is designed to remain in effect for the life of the bonds assuming the school adheres to the terms of the financing. However, existing tax-credit financing programs provide a maximum of seven years subsidy<sup>10</sup> to the school, regardless of whether loan amortization is longer. Generally, at the end of a tax credit subsidy period i.e., when investors have recognized or used all the tax credits, the public charter school bears an increase in the cost of its debt or must refinance the debt to maintain affordability. Tax-exempt bond financing may be available to refinance a tax credit financing at the end of the subsidy period, depending on market conditions.

(See Chapter 4 “Eligible Uses of Bond Funds”, regarding refinancing rules.)

---

<sup>3</sup> A brief explanation of this dynamic involves simple economic supply/demand rules. A bank loan typically involves one lender, who has great leverage over the borrower in negotiating the terms of the loan. A private placement of a bond issue or note issue similarly involves one or a very limited number of private investors, who again, enjoy leverage in negotiations because no one else is competing for the opportunity to buy the bond or note (i.e., to provide the loan). In a public offering, bonds are offered for sale to the entire marketplace of municipal bond investors. This creates competition (greater demand) for the right to purchase the bonds, and thus shifts some of the leverage in negotiating financing terms (depending on a variety of credit factors) back toward the borrower. For discussion of other factors affecting borrowing cost, see Chapter 6 “Credit Considerations”, and Chapter 7 “Investor Perspectives”.

<sup>4</sup> Ratings refer to independent appraisals of the credit quality of the bonds and the likelihood of their repayment performed by one or more of the credit rating agencies: Standard & Poor’s Financial Services LLC, Moody’s Investors Service or Fitch Ratings, Inc. The ratings are expressed as letter grades AAA, AA, A, BBB (expressed as Aaa, Aa, A and Baa by Moody’s) from highest to lowest investment grade ratings, with +/- or numerical subcategories. Ratings are considered very important by the underwriters in marketing the bonds and by investors in determining what interest rates will induce them to purchase the bonds. Charter school bonds are often sold without a rating, although usually at higher interest rates. See Chapter 6 “Credit Considerations”, and Chapter 7 “Investor Perspectives”, for more information.

<sup>5</sup> The comparison between taxable and tax-exempt bond interest rates is for illustrative purposes only, and it should be noted that charter schools rarely, if ever, finance facilities entirely using taxable municipal bonds.

<sup>6</sup> “LIBOR” refers to the London Interbank Offered Rate, the average interest rate that leading banks in London charge when lending to other banks. LIBOR is set to be phased out by 2021.

<sup>7</sup> See “Making Charter School Facilities More Affordable: State-Driven Policy Approaches” published in December 2008 by the Office of Innovation and Improvement of the U.S. Department of Education, available at [www.ed.gov/admins/comm/choice/charterfacilities/charterfacilities.pdf](http://www.ed.gov/admins/comm/choice/charterfacilities/charterfacilities.pdf).

<sup>8</sup> For a discussion of examples of tax-credit financing for charter school facilities, see “Charter School Facilities Finance: How CDFIs Created the Market, and How to Stimulate Future Growth” by Annie Donovan, a working paper published in 2008 by the Center for Community Development Investments in the Community Affairs Department of the Federal Reserve Bank of San Francisco, available at <http://www.frbsf.org/publications/community/wpapers/2008/wp08-02.pdf>; see also, “2014 Charter School Facility Finance Landscape” published in September 2014 by The Educational Facilities Financing Center of the Local Initiatives Support Corporation, available at <http://www.lisc.org/our-initiatives/education/charter-school-financing/publications/charter-school-facility-finance-landscape/>.

<sup>9</sup> The New Markets Tax Credit (NMTC) program rules require charter schools to be located in qualified low income communities. Certain exceptions also apply, regarding low population density and high migration patterns. See the NMTC rules at <https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx>.

<sup>10</sup> The most frequently utilized tax-credit program is the New Markets Tax Credit program described above in footnote #8, which has a seven year tax-credit subsidy period. Longer tax-credit subsidy periods apply to both Qualified Zone Academy Bonds and Qualified School Construction Bonds, each with subsidy periods ranging from 14 -19 years (reset monthly by the U.S. Department of Treasury). The authority for the QZAB program was repealed by the Tax Cuts and Jobs Act after December 31, 2017, and the QSCB program was limited to tax credit volume cap allocated in 2009 and 2010 under the federal Recovery Act. As of publication, neither program has been renewed.

## CHAPTER 3

# Timing of Project Acquisition

The acquisition of public charter school facilities financed with tax exempt bonds may take one of three basic paths:

1. purchasing a site and undertaking a new construction project;
2. purchasing an existing facility and undertaking renovations to convert it to the school's intended use; or
3. purchasing a completed facility, that has been built or renovated to the school's specifications, and is ready for occupation and use.

The choice of whether to acquire the facility before or after the period of time during which the facility is still under construction or major rehabilitation (the "construction period") influences the structure of the tax-exempt bond financing. Depending upon the approach taken, there are at least two options for structuring the tax-exempt bond financing:

- (a) acquisition and construction financing undertaken separately from the tax-exempt financing of the permanent loan, or
- (b) tax-exempt financing that covers both the acquisition and construction and permanent loan.

In the former approach, tax-exempt bonds are only needed for the permanent financing.

### **A. SEPARATE CONSTRUCTION AND PERMANENT FINANCING**

The inherent economic problem associated with the construction period (which may last from one to three years) is how to pay the debt service for a loan associated with a new facility for which there are no operating revenues, while continuing to pay occupancy expenses for the existing facility in which the school operates. In essence, during the construction period, the school could be obligated to pay double for its facilities—once for the current space and again for the space under construction.

Generally, tax-exempt financing is not practical or cost effective for short-term construction period loans. Instead for this type of short-term need, schools may utilize lending institutions that specialize in providing construction loans to public charter schools. These institutions are in the business of undertaking construction risk—the risk of delayed or failed project completion—and bring to bear expertise in project finance, management, and construction in order to ensure timely and effective project completion. These short-term loans are predicated on the availability of some form of long-term (or “permanent”) financing to repay (or “take out”) the short-term loan, and are structured to mature in a lump sum (“bullet”) upon project completion with no payments (or only interest payments) due in the interim. When choosing this path, during construction, the school will follow the steps outlined in Chapter 12 “Steps to Issuing the Bonds and the Finance Team”, culminating in the issuance of bonds on or around the maturity date of the short-term loan, which will coincide with the completion of the project.

## **B. COMBINED CONSTRUCTION AND PERMANENT FINANCING**

A tax-exempt bond financing can be (and is often) structured to cover both construction financing and permanent financing. The economic problem of simultaneously paying for two facilities is typically solved by financing the debt service obligation of the public charter school during the construction period. In other words, the loan is structured such that principal does not begin to amortize until after scheduled construction completion, and interest payments are made from the proceeds of the loan itself (known as “capitalized interest”) during the same period (and often for a short additional contingency period).<sup>11</sup> However, timely and successful project completion remains of paramount concern.

Because completion of the project is a prerequisite to the public charter school’s occupancy and use, the construction financing risk in this case is shifted to the tax-exempt bond investors. Delays in or failure of completion could result in the school being obligated to repay the bond debt service while it continues to pay the occupancy expense for its existing facilities, and potentially the costs created by an extended construction period. Thus, extra precautions are taken in this approach to ensure timely and on-budget project completion. Since investors are taking both construction risk and permanent financing risk, they will expect that charter schools have detailed disclosure regarding the project plans, the construction or project manager, the general contractor, and the terms of a guaranteed maximum price construction

contract, in addition to the ordinary disclosure about the school's finances and operations.<sup>12</sup> This approach is more suitable for schools that have substantial internal expertise (either at the staff or board level) in project finance and management, or that have access to such expertise through a CMO, consultants, financial advisors, or attorneys.

### **C. ACQUIRING A COMPLETED FACILITY**

A growing industry within the public charter school movement includes a number of private, nonprofit and for-profit real estate development organizations specializing in the construction and renovation of facilities for public charter schools.<sup>13</sup> These developers arrange their own financing (or otherwise arrange access to capital) for site acquisition and construction or renovation of the project, while working closely with the school to design the facility and establish a timeline for completion. This arrangement may be particularly beneficial because, in addition to its own financing, the developer brings valuable expertise in local real estate markets, public charter school architectural design, general contracting and construction, procurement, and project management (little of which exists within a typical school's staff or board of directors). Certain developers may even be able to facilitate the school's arrangements for permanent financing through tax-exempt bonds.

Some contracts provide that the developer lease the new facility to the public charter school for a number of years at a negotiated rate. This arrangement can prove beneficial when lease costs are set at affordable rates, allowing the school to focus on programmatic success and enrollment stabilization before the process of obtaining permanent financing is required.

In this approach, the school follows the steps outlined in Chapter 12 "Steps to Issuing the Bonds and the Finance Team", either during the construction period or near the end of the lease term, culminating in the issuance of bonds on or around the completion of the project or lease termination. The proceeds of the bond issue are primarily used to finance the purchase of the completed project from the developer (at a price at least sufficient to cover the developer's original acquisition cost and construction costs). This option solves the inherent economic problem of paying for two facilities, as the school does not pay for the construction financing. Instead, the developer has borne this cost. The school easily transitions from paying for its existing facility to paying the debt service on its new facility upon the closing of the bond financing.



---

<sup>11</sup> Federal tax rules generally permit proceeds of tax-exempt bonds to be used for this purpose for up to three years after issuance of the bonds. See Chapter 4 “Eligible Uses of Bond Funds”, for more detail.

<sup>12</sup> See Chapter 10 “Market Disclosure”, for more explanation of the charter school’s information disclosure obligations in connection with a tax-exempt bond issue.

<sup>13</sup> Three prominent examples of nonprofit developers include, in California, Pacific Charter School Development (see [www.pacificcharter.org](http://www.pacificcharter.org)), in New York, Civic Builders (see [www.civicbuilders.org](http://www.civicbuilders.org)) and, in Washington, D.C., Building Hope (see [www.buildinghope.org](http://www.buildinghope.org)). One example of a for-profit developer that provides 100% project financing for the construction period (bridge until full enrollment) is Turner Impact Capital (see [www.turnerimpact.com](http://www.turnerimpact.com)).

## CHAPTER 4

# Eligible Uses of Bond Funds

There are five eligible categories of expenditures of the proceeds of tax-exempt debt:

(1) capital expenditures, (2) refinancing prior debt, (3) reimbursing prior capital expenditures, (4) working capital, and (5) financing costs, such as costs of issuing the bonds, capitalized interest and reserves. A single bond issue may combine more than one or even all of these purposes. In addition, proceeds of tax-exempt bonds may be invested during the period prior to their expenditure for the above mentioned purposes, creating an opportunity for permissible arbitrage earnings.

### **A. CAPITAL EXPENDITURE PROJECTS**

The most common use of any debt is the acquisition or construction of a project—land, buildings, equipment and/or related infrastructure. The primary limitation on the types of projects that can be financed with tax-exempt bonds is that they must be owned by the nonprofit corporation (public charter school or CMO) or by a governmental entity. Such projects may not be used (i) in a manner that constitutes an unrelated trade or business under Section 513(a) of the Internal Revenue Code (which generally means that it be used in a manner consistent with the nonprofit purpose of the corporation) or (ii) in the trade or business of another person or entity (other than another 501(c)(3) corporation or governmental entity) (a “non-exempt person”).

### **B. REFINANCING PRIOR DEBT**

Refinancing outstanding taxable debt, including construction financing, tax-credit financing, bank loans and mortgages, is a very common use of tax-exempt bonds, particularly (but by no means exclusively) by first-time users of tax-exempt debt. The primary limitation is that the proceeds of the prior debt were used for capital projects that would have qualified for original financing with tax-exempt bonds as described above in subsection A.

Tax-exempt bonds may also be used to refinance (or "refund") prior outstanding tax-exempt bonds, although so-called "advance refundings" of outstanding tax-exempt bonds are not permitted on a tax exempt basis as of January 1, 2018, as a result of the 2017 Tax Cuts and Jobs Act. An advance refunding occurs when the issuance of the refunding bonds is more than 90 days before repayment of the tax-exempt bonds to be refunded. In an advance refunding, proceeds of the new bonds are invested in a special trust (or "escrow") fund until the date of repayment of the prior bonds. Refundings of tax-exempt bonds within 90 days of repayment of the refunded bonds remains available, and the provisions of the 2017 Tax Cuts and Jobs Act do not prohibit refinancing of taxable debt, as described in the preceding paragraph.

### **C. REIMBURSING PRIOR CAPITAL EXPENDITURES**

Under certain circumstances, capital expenditures that could qualify for financing with tax-exempt bonds, but which are made prior to issuance of the bonds, can be reimbursed with proceeds of the bonds when issued.

The tax rules generally prohibit reimbursement of expenditures made prior to the issuance of bonds based on a concern about where to draw the line. However, there are some exceptions:

1. If the prior expenditures were made with the proceeds of a bank loan or other type of borrowing which is still outstanding, then that prior debt may be refinanced, as described in immediately preceding section (B).
2. Certain preliminary "soft costs" such as architectural, engineering, surveying, soil testing and similar costs paid prior to commencement of acquisition, construction or rehabilitation of a project may be reimbursed in an amount up to 20% of the aggregate issue price of the bonds issued to finance the project. Land acquisition, site preparation and similar costs are not included in such "soft costs."
3. Any other capital expenditures (including costs of issuance) paid before the bonds are issued may be reimbursed if they are paid after, or not more than 60 days before, the public charter school expresses "official intent" to reimburse such expenditures by resolution, declaration or other action that meets the requirements of applicable tax regulations. Certain limitations apply, namely that the reimbursement can only be made no later than 18 months after the later of (a) the date the cost is paid or (b) the date the project is placed in service (but in no event,

more than three years after the cost is paid). One of the first steps in any serious consideration of a tax exempt financing for a capital project should be the adoption of an official intent reimbursement resolution. Properly drafted, it can be simple and nonbinding. There is no cost or liability to not issuing the bonds or not using the proceeds for reimbursement. Bond counsel will normally provide such a resolution upon request without charge. (See Chapter 12 “Steps to Issuing the Bonds and the Finance Team”, below.)

Bond proceeds used to reimburse the public charter school as described in (1) or (2) above are considered “spent” and may generally be used for any purpose or invested at an arbitrage profit by the nonprofit corporation without regard to the restrictions otherwise attached to tax-exempt bond proceeds. (See section (F) below regarding investment of bond proceeds.)

#### **D. OPERATING FUNDS (OR “WORKING CAPITAL”)**

While use of tax-exempt bonds to finance operating expenses (or “working capital”) is not specifically prohibited, the tax rules governing the tax-exemption of interest on the bonds make such financings impractical. This holds true, except in some cases for an amount not exceeding 5% of the bond proceeds (net of reserves), if used as working capital in connection with the project being financed with the balance of the bond issue.<sup>14</sup>

#### **E. COSTS OF ISSUANCE, CAPITALIZED INTEREST, RESERVES**

**Costs of Issuance.** Costs incurred in connection with issuing the bonds, such as underwriter’s discount or fees, fees of bond counsel and other lawyers and consultants, rating agency fees, trustee’s fees and the like, may be included in the bond issue, subject to a cap of 2% of the tax-exempt bond issue—which cap does not include the cost of any bond insurance or credit enhancement. While this 2% cap may be sufficient to cover costs of issuance, as a bond issue size decreases, issuance costs tend to remain constant. Therefore, for a relatively small issue size (\$5 million or less) additional sources of financing may be required (in excess of the 2% cap). In this case, a taxable series of bonds can be added to the financing sized to cover exactly the amount beyond the 2% cap and structured to mature first (since the debt will bear a higher taxable rate of interest).

**Capitalized Interest.** Interest payable on the bonds during the longer of three years or the period in which the project is to be constructed and for up to one year after completion of construction, may be included (i.e., capitalized) in the bond issue. The capitalized interest is used to pay interest on the bonds, with the result that the public charter school does not have to pay any debt service on the bonds from its own funds during such period.

**Reserves.** A debt service reserve fund is used to pay debt service on the bonds, if for any reason the public charter school fails to pay. The debt service reserve fund is solely for the protection of investors and is expected to be used only as a last resort. It is common to have a debt service reserve fund held by a trustee bank on behalf of the bondholders, and funded with bond proceeds equal to the lesser of 10% of the bond issue, 125% of average annual debt service on the bonds, or (in the typical case) maximum annual debt service. Other reserves, such as operating reserves, may also be funded with bond proceeds but usually only within the limitations on working capital set forth in section (D) above.

## **F. INVESTMENT OF PROCEEDS**

The proceeds of tax-exempt bonds, regardless of how they will ultimately be applied, will be held by a trustee bank and should be invested from the date of issuance until such time as they are spent. The earnings on such investments are always taken into account in structuring the tax-exempt financing, and under certain conditions these investments give rise to permissible arbitrage opportunities. The scale of this earnings advantage is dependent on the characteristics of the financing plan and market conditions at the time of bond issuance.

The key controlling metric in structuring the investment of tax-exempt bond proceeds is the bond "yield." Yield can be thought of broadly, as the overall interest cost to the public charter school of its tax-exempt borrowing. More specifically, yield refers to the discount rate which, when used in computing the present value of all unconditionally payable payments representing principal, interest and certain other costs paid and to be paid with respect to the bonds, produces an amount equal to the issue price of the bonds.

The yield is determined at the time of issuance of the bonds and functions as a ceiling for certain investment earnings purposes. For instance, proceeds of tax-exempt bonds issued to fund acquisition or construction of capital

projects (as in section (A) above) may, so long as certain conditions are met, be invested without regard to the yield on the bonds, creating the opportunity to earn arbitrage and apply those earnings to pay project costs.

During the fifth year after issuance of tax-exempt bonds, the public charter school will be required to file a return with the IRS, declaring any arbitrage earnings associated with the bonds. Based on the applicable tax rules, if the school has earned too much arbitrage, then certain amounts may be required to be returned (or "rebated") to the IRS. The complex rebate rules generally follow the policy premise that the federal subsidy created by the income tax exemption on the school's bonds is limited, and any excess subsidy garnered through disallowed arbitrage earnings must be returned to tax payers. Thus, careful investment planning in consultation with qualified tax counsel is vital to a properly structured tax-exempt financing that maximizes arbitrage earnings and minimizes rebate liability. See Chapter 12 "Steps to Issuing the Bonds and the Finance Team", and Chapter 14 "Post-Issuance Compliance", for more information about rebate analysis and compliance.

---

<sup>14</sup> Programs have recently been developed to assist charter schools with cash management, by providing temporary funding of operating costs (for example, to bridge gaps in the receipt of state funding). Orrick attorneys involved with such cash flow management programs in certain states can provide more information. See the contact information on the inside back cover of this booklet to locate a member of Orrick's Charter School Finance Group for more information.

## CHAPTER 5

# Interplay Between Bonds and Fund-Raising

While most public charter schools operate exclusively on the funding provided through state per-pupil funding formulas, some larger, more established schools or large networks of commonly managed schools may have a choice of financial resources to apply to a facilities project, including:

1. proceeds of tax-exempt bonds,
2. donations and pledges,
3. quasi-endowment or other accumulated funds, or
4. third-party guarantees or other financial support, perhaps from a foundation with which the school has close ties.

As pointed out above in Chapter 2 “Why Use Tax-Exempt Bonds?”, to the extent that tax-exempt bond proceeds can be used instead of other funds that can be invested in taxable obligations, it is possible to earn more on the investments than the interest paid on the bonds. Again, this earnings advantage, based on the spread between tax-exempt and taxable interest rates, is referred to as arbitrage.

As described in Chapter 4 “Eligible Uses of Bond Funds”, the federal tax requirements governing the tax-exemption of interest on bonds prohibit certain types of arbitrage. One type of arbitrage that is prohibited is that which results from using the proceeds of tax-exempt bonds to “replace” moneys that have been raised or set aside, and restricted or earmarked, specifically to finance the same project to which the tax-exempt bond proceeds would be applied.<sup>15</sup> However, so long as the donations were not restricted to use on acquiring or constructing the project, or other funds that may have been accumulated were not specifically and formally earmarked for the project, then the use of tax-exempt bonds instead of such donations or accumulated funds generally would be permissible. For this reason, it is advisable to consult bond counsel as early as possible regarding these issues and any related fundraising program. It is usually easier to raise funds for a project than for endowment, and bond counsel can offer advice about how to

phrase fund raising campaign literature and pledge documentation (including in some cases, how to recast pledges already received) in a manner designed not to interfere with the fund raising objective yet concurrently preserving the maximum opportunity for tax-exempt financing and for permissible arbitrage.

In order to improve the security and possibly the ratings of the bonds (and thereby lower the interest rate), the public charter school may be asked to pledge a portion of any available reserve or other funds or to promise to maintain available fund balances at a particular level. If the pledge creates too great of an assurance that the pledged moneys will be available to pay debt service on the bonds (even if the school encounters financial difficulty), or if the fund balance required to be maintained exceeds the amount reasonable for the purpose for which it is maintained, or is tested more frequently than semi-annually, the nexus between such funds and the bonds may be considered so close that applicable tax regulations will require the yield on investments of such funds to be restricted to the yield on the bonds, thereby eliminating some of the benefit of tax-exempt bonds. It does not matter whether the pledge or covenant is to the bondholders or to a guarantor of the bonds. However, it is usually possible to structure a pledge or fund balance requirement in a manner that provides reasonable security without tripping over the yield restriction line.

Foundations, community development financial institutions, and other third parties may provide a variety of forms of financial support to a public charter school's project, such as cash contribution, collateral or guaranty. The best structural choice to optimize the benefits of the tax exempt financing will turn on similar issues to those discussed above, as well as on the particulars of any legal relationship between the third party and the school.

The proper allocation of the resources mentioned at the beginning of this chapter is an important part of the "art" of structuring a financing that maximizes the benefit of the tax-exemption of interest on the bonds and the potential arbitrage earnings advantage described above. In situations where these opportunities apply, this will be one of the most important steps in formulating the transaction.

Federal tax regulations relating to the measurement and tracking of private business use provide flexibility for public charter schools engaging in strategic planning. Charter schools can benefit from these rules primarily by using tax-exempt bonds to finance a portion of the total cost of facilities and using other sources of funding to finance the remaining costs. "Qualified equity" is



the term used for these other sources of funds and can include donations and pledges, accumulated revenues or taxable debt. While limits apply to these other funding sources, they often can be applied in a fluid manner throughout the bond-financed project.

Assume a charter school plans to issue tax-exempt bonds and also use qualified equity to finance the simultaneous construction of two buildings on the same or separate campuses. If the charter school elects to treat both buildings as a single project, the qualified equity can be treated as used to pay for any portion of the two buildings that, from time to time, has private business use. In fact, that allocation of qualified equity to private business use occurs automatically and shifts to the changing locations in the buildings where the private business use is occurring. It does not matter whether the qualified equity is spent first, last or ratably. This type of “floating equity” allocation can be made to one or more assets so long as the assets are part of the same project. A project that includes multiple facilities acquired or constructed in the same time frame and financed with multiple sources of funds, including the proceeds of an issue of tax-exempt bonds, qualifies for this treatment. This allocation provides flexibility to the charter school by permitting (i) use of its facilities by private entities when they are not being used by the charter school and (ii) use by the charter school for unrelated trade or business activities. However, the charter school is limited on such use and the revenues therefrom by federal tax law restricting the scope of unrelated trade or business activities that may be conducted by a 501(c)(3) organization.

While the circumstances are too varied and the applicable tax rules often too complex and subtle to cover more thoroughly here, advice of highly qualified bond counsel with substantial experience in this area is needed and should be accessed at the earliest possible stage. (See Chapter 12 “Steps to Issuing the Bonds and the Finance Team”, below.)

---

<sup>15</sup> The “replacement” issue occurs when the moneys raised or set aside for a project are freed up by the bond issue. No issue is presented to the extent that the project is financed with such moneys in combination with tax-exempt bond proceeds.

## CHAPTER 6

# Credit Considerations

Investors who will buy the public charter school's bonds must first analyze the transaction to determine if they are interested, and if so, how much interest earnings on the bonds is necessary to induce them to invest. This analysis focuses on a number of characteristics of the school, including its authorizing statutory scheme (length of charter and process for revocation), organizational structure, program and market position, management team and operating history. In addition, the terms of the contractual arrangement between the school and its bondholders form a key part of the analysis. Generally, a public charter school is viewed as more creditworthy the higher it ranks in light of these various characteristics, and a transaction is viewed as more secure the greater protections bondholders enjoy under the terms of the bond documents. Together, these transaction characteristics (or credit considerations) influence the cost of capital (or interest rates) associated with the tax exempt bonds.

Investors rely on a variety of sources of information in assessing the public charter school's creditworthiness or risk profile and in making their investment decisions. These may include, (a) the school's financial statements and operating information (including asset values and unusual positive or projected cashflows), (b) academic research and press coverage regarding the school, (c) information regarding the chartering authority, its legal framework and relationship with the school, (d) assessments and evaluations by the chartering authority, if any, (e) physical inspection of the school site and operations, (f) the school's primary market disclosure, and (g) the analysis of third-party credit rating agencies, if applicable. Most of this information is already in existence when a public charter school begins the process of a bond financing, with the exception of the primary market disclosure (or "official statement") and the credit rating. At the time a transaction is commenced, counsel will work closely with the school to prepare the official statement, which will ultimately be provided for investor review prior to the sale of the bonds. (See Chapter 10 "Market Disclosure", for details about the official statement.) Additionally, if the school so elects,

application will be made to one or more credit rating agencies for review of the transaction and rendering of a credit rating.

## **A. RATING AGENCY CRITERIA**

Credit rating agencies play an important role in tax-exempt bond financing, giving investors comfort that a standards-based third-party review of the risk profile of the public charter school and the proposed transaction has been undertaken. An “investment grade” credit rating is considered “BBB” or higher.<sup>16</sup> Three of the major municipal bond credit rating agencies, S&P, Moody’s and Fitch, maintain published methodologies for evaluating the characteristics of public charter schools that contribute to their ongoing success or failure.<sup>17</sup> Of those three, only S&P and Moody’s have assigned an investment grade rating to charter school bonds since 2009. Since the first public charter school bond rating in 1999, about half of the total number of public charter school tax-exempt financings have been rated, with the trend increasing each year as the sector matures.<sup>18</sup> While this area of credit analysis continues to evolve, some common analytical themes have emerged among the three agencies. Generally, to garner an investment grade credit rating, schools must satisfy the following criteria (although each specific school’s circumstances will ultimately be determinative):

- 1. Authorizing Statutory Scheme.** The public charter school authorizing statutory scheme is viewed as strongest if it provides for an impartial review and approval process for new and renewing charter applications. The length of charters (longer is better), the level of oversight and communication (more frequent is better), and the predictability of state funding (more predictable is better), all influence this analysis as well. Often, the specific relationship a school has with its chartering authority will be reviewed (good working relationship is better). An ideal charter law provides for early identification of problems that may lead to charter revocation, the opportunity for a school to take corrective action to avoid revocation and alternative charter authorizing bodies for appealing adverse decisions.
- 2. Program and Market Position.** Generally, the public charter school’s program is viewed as strongest if it serves a specific need in the enrollment area that competing public schools do not serve (either through a unique curriculum or delivery model or higher quality, or a combination of all three), and sufficient demand for the program is

evidenced by a well-documented and regularly updated waiting list. Other factors include the retention rate of students between grades (higher is better), the retention rate of teachers (higher is better), the growth trend of the school's enrollment area (growing is better), student performance relative to competing programs, the program's reputation (research-based validation and positive press coverage) and the school's relationship with parents and other community constituents (indicating support). Finally, the prospect of future competition is also analyzed (i.e., is the number of charters limited, do other barriers to entry exist, or could competing schools be established in the future?)

**3. Management Team and Organizational Structure.** The strongest public charter school management team represents a broad array of organizational expertise, including programmatic, financial, managerial, operational, and legal knowledge. Leadership is vital; however, over dependence on the skills of one founder can jeopardize a school's longevity. Thus, effective cross-training of key personnel, institutionalized management policies and practices, and effective financial, debt management, and operational controls are all viewed favorably in the credit rating process. In order to borrow using tax-exempt bonds, the school must be organized as a nonprofit corporation exempt under Section 501(c)(3) of the Internal Revenue Code or be characterized as an instrumentality of the government. Both individual schools and larger CMOs (or networks of commonly managed charter schools) may be eligible to borrow.<sup>19</sup>

In addition to the above factors, evaluation of the credit of CMOs involves a two-pronged analysis: first, assessment of the entire system of commonly managed schools; and second, assessment of that portion of the system that will be the source of repayment of the proposed issue of bonds. The credit rating on the bonds will generally be capped at the lower of the two prongs of the analysis. Thus, even if one school in a CMO network on its own is far stronger than the others, and could garner a higher credit rating than the others (or than the CMO system as a whole), in a bond offering the credit rating will be limited to the rating of the system. This limitation is justified by the expectation that CMOs will share resources across the system in order to assist a struggling school.

The credit analysis of a CMO's bond offering also takes into account the degree to which the school or schools that will be obligated to repay

the bonds impact the overall operating health of the system. The more “core” to the system the financed schools are deemed, the more likely the bond rating of the financed schools can rise to match the overall rating of the system.

**4. Financial Management and Operating History.** A minimum of three to five years of operating history, ideally having successfully completed at least one charter renewal process, is uniformly viewed as the strongest scenario for investment grade credit rating. Historically, this minimum operating history was required to access the bond market. Recently, however, even start-up schools have been able to use tax-exempt financing in certain circumstances. Sound financial management practices (as evidenced by prior financial reports and the existence of strong internal controls and procedures) are equally important, the former is not likely possible without the latter. Rating agencies have uniformly acknowledged that the most prominent cause of public charter school failure is financial mismanagement and thus focus heavily on these characteristics in the rating process.<sup>20</sup> Important factors in this analysis include maintenance of operating reserves, adherence to existing reserve policies over time, effective cashflow management, regular oversight and reporting, financial contingency planning for unexpected challenges, expenditure flexibility, and a strong history of budgeted to actual performance.

**5. Debt Management and Financial Planning.** Undertaking the construction of a new facility or the acquisition of an existing facility involves incurring significant debt, relative to a public charter school’s operating income. Review of a school’s debt management policies and practices and projections related to the incurrence of new debt also play an important role in credit review. Typically, a public charter school is viewed as strong if its debt burden consumes no more than 15-20% of its operating revenues (both historically and prospectively in light of the proposed financing) and, after payment of all operating expenses in a given year, the net revenues available for bond debt service are at least 1.25 times the amount needed to pay the bonds. Dependence on future enrollment growth to meet debt service obligations is viewed as risky, and thus, conservative, data-driven projections should be employed, if needed. Favorable factors in this analysis include the availability of per-pupil state funding for facilities, appropriate project scale (i.e., completion of the project with one financing is better than dependence on obtaining future financing for

a phased project where enrollment depends on project completion), and sound capital facilities maintenance practices (not dependent on future borrowing).

**6. Bond Transaction Legal Provisions.** Finally, rating agencies will analyze the protections bondholders will be afforded under the terms of the various transaction documents that form the contract between the public charter school and its bondholders. The strongest security features include a mortgage lien on the financed facility, the maintenance of a debt service reserve fund (pledged and solely available to cover debt service payments in case of a shortfall), restrictions on future incurrence of long-term debt (either by satisfaction of an affordability test or by outright prohibition), and covenants to maintain operating revenues at a specified level over expenditures (ensuring debt service coverage). An investment grade rating is likely dependent, in part, on the existence of all of these features in the legal documents. (See Chapter 11 "Transaction Structure and Documentation", for more information about legal documentation.) Each transaction is analyzed individually, and no one factor in the analysis is determinative. Because these factors are viewed together, strength in one or more categories may outweigh weakness in another. Once a rating is assigned by a rating agency, whether above or below investment grade, the rating must be disclosed to prospective purchasers of the bonds. Thus, bond counsel works closely with the underwriter and other professionals involved in the transaction to present the transaction in the best possible light to rating agencies.

## **B. UNRATED BONDS**

Generally, the review of a public charter school's bond transaction by an independent credit rating agency that results in the assignment of an investment-grade credit rating provides a higher level of confidence to investors and allows the bonds to be offered to a larger investor audience and thus sold at lower interest rates. However, about half of all public charter school tax-exempt bonds have been sold without ratings based on the creditworthiness of the school. The evolving investor community analyzing public charter school bonds is largely comprised of sophisticated institutions accustomed to conducting rigorous due diligence review of credit risk prior to making an investment decision (and may also be motivated, in part, to

advance the purposes of the public charter school movement through such capital investments). Thus, while a credit rating is helpful in obtaining more favorable borrowing rates, it is not a prerequisite.

Without a credit rating, the bond underwriter may face a narrower field of investors who are qualified to purchase the public charter school's bonds, based on the investors' own internal portfolio management requirements or restrictions. Generally, as demand for such bonds narrows, the cost of the borrowing (or interest rate) increases. Thus, to the extent a public charter school is able to satisfy the various credit rating agency rating criteria, the better off it will be in accessing the lowest borrowing rates available in the market.

The following chapter examines the perspectives of some of the public charter school bond sector's most active institutional investors.

---

<sup>16</sup> For explanation of the credit rating scale, see Chapter 2 "Why Use Tax-Exempt Bonds?", at footnote 4, above.

<sup>17</sup> The three major credit rating agencies and their most recent charter school credit ratings publications are as follows: Fitch Ratings, see "Charter School Rating Criteria", November 4, 2016, available at [www.fitchratings.com](http://www.fitchratings.com); Standard & Poor's, see "U.S. Public Finance Charter Schools: Methodology and Assumptions", January 3, 2017, available at [www.standardandpoors.com](http://www.standardandpoors.com); and Moody's Investors Service, see "Rating Methodology - US Charter Schools", September 7, 2016, available at [www.moody.com](http://www.moody.com). (Note these websites may require registration.)

<sup>18</sup> See "A Complete History", at footnote 1 above.

<sup>19</sup> See Chapter 11 "Transaction Structure and Documentation", for discussion of alternatives to the charter school being the borrower entity. Other affiliated nonprofits may also be eligible.

<sup>20</sup> See Chapter 7 "Investor Perspectives", for discussion of charter school tax-exempt bond payment defaults.

## CHAPTER 7

# Investor Perspectives

As described above in Chapter 6 “Credit Considerations”, investors who will buy a public charter school’s bonds do not rely solely on the assessment of a credit rating agency but instead review a breadth of available information about a school’s bonds. Many investors apply their own unique due diligence process to determine their own internal credit rating for a public charter school’s bonds, irrespective of the third-party rating agency’s assessment. In this review process, investors typically focus on similar categories of information as do credit rating agencies. However, some of the market’s most active institutional public charter school bond investors indicate that they place emphasis on particular characteristics of a transaction, as follows:<sup>21</sup>

- 1. Governance and Leadership.** The composition of the public charter school’s leadership team, including the board of directors, is key to investor assessment, and some investors expect to have personal interaction with members of the board before making an investment decision. Strong leadership includes a board of directors that is independent from the CEO, with clear separation of duties among qualified individuals across key areas of expertise necessary to guide the public charter school—including those with backgrounds in finance, accounting, management, legal, and instruction—as well as influential local community members who can assist the school in navigating local and regional political dynamics that may affect the program. Strong leadership also includes executive staff or administrators with requisite programmatic expertise as well as reasonable expectations about growth. Growth plans should be supported by an analytical framework and not simply the passion of a charismatic school leader.
- 2. Charter Management Organizations.** While most investors do not give preference to stand-alone public charter schools over public charter schools that are part of a network of schools commonly managed by a single entity (a CMO), or vice versa, an appropriate relationship should exist between a CMO and its schools in order to attract investors. Investors typically prefer nonprofit CMOs over for-profit CMOs because



the for-profit CMO's profit motive tends to weaken managed school balance sheets over time, to the detriment of bondholder security.<sup>22</sup> For nonprofit CMOs, a self-sustaining revenue model that permits managed public charter schools to retain reserves for unexpected circumstances presents the strongest credit profile.

- 3. Enrollment and Revenue Projections.** Where future payment of bond debt service depends on the growth of a public charter school's enrollment and net revenues, most investors apply a variety of stress scenarios to the projections provided by the school in marketing its bonds. The strongest projections are based on conservative assumptions about future per-pupil funding, demand for the program, and major expenditure trends (such as teacher salaries). Investors may assess whether enrollment projections are based on organic growth of the school population matriculating from one grade to the next, or they may make more aggressive assumptions. Demographic trends, including the impacts of gentrification dynamics, may be included in their analysis. The credibility and knowledge of the school's leadership in projecting growth and revenues are key considerations for investors.
- 4. Subjective Factors/Site Visit.** An investor in public charter school bonds will conduct a site visit before making an investment decision, especially if such investor is considering purchasing a major portion of the bonds offered for sale. Such visits provide an opportunity for investors to meet school leaders and board members in person as well as to gain a sense of the culture of the school. Parent involvement, engaged faculty and staff, and happy kids who are learning all support a conclusion that the school is in position for long-term success. In addition, the site visit can allow investors to understand the connection between the proposed construction project to be financed with the bonds and the school's program and population. Alignment of architectural design and project scale to the school's program and its financial capability is a credit strength.
- 5. Quality of Finance Team.** By virtue of their day-to-day involvement in the capital markets, the portfolio managers and analysts who assess public charter school bonds for institutional investors tend to be familiar with all of the most active underwriters and legal counsel involved in public charter school tax-exempt bond finance. Careful selection of a bond finance team is a credit strength to investors. Reputable, experienced professionals are known to many investors and lend a measure of

credibility to the school's bond transaction, which becomes valuable, in particular, for a school that has never issued bonds before and is unknown to the bond market. Conversely, investors are wary of financial market participants that mislead schools into transaction structures and terms that are not appropriate for long-term programmatic success.

**6. Other Considerations.** Certain investors look beyond the information that is considered standard in charter school bond assessment. Such analysis could include surveying the history of charter school revocations within the state and jurisdiction of the charter school offering the bonds in order to contextualize the legal framework and appeals process for charter authorization. Data-driven, objective revocation frameworks represent the strongest protection for bond investors. Some investors contact charter authorizers directly to assess the relationship between the charter and its authorizing agency. Others review parent surveys, third-party generated school "report cards", academic research or empirical verification of student performance, and ordinary searches through Google for publicly available information or publicity on the Internet.

The due diligence and credit review process is rigorous and time-consuming, but for good reason. With millions of dollars at stake for up to two or more decades, investors must gain comfort that a payment default is unlikely to occur. Historically, the public charter school sector has not experienced a materially higher rate of bond payment defaults as compared to the broader municipal bond marketplace<sup>23</sup> and has experienced a low rate of loan foreclosures and write-offs even beyond tax-exempt bonds.<sup>24</sup> However, unrated public charter school bonds historically defaulted many times more often than did rated public charter school bonds,<sup>25</sup> giving investors added incentive to carefully review such credits.

---

<sup>21</sup> The perspectives described in Chapter 7 "Investor Perspectives", represent a summary of several informal interviews conducted by the authors. They do not represent the views of any specific investor or financial institution.

<sup>22</sup> Special tax-related considerations come into play in the context of using tax-exempt financing for a nonprofit charter school that is managed by a for-profit CMO. The management agreement or contract between the CMO and the charter school is a key focus of this analysis.

<sup>23</sup> See "A Complete History" above at footnote 1, indicating an overall default rate on charter school bonds of 3.3% (in terms of par amount of bonds outstanding) and 5.0% (in terms of number of transactions) as of December 31, 2014, compared to an overall historical municipal bond default rate of less than 1% since the Great Depression. See "Municipal Defaults in a Post-Bankruptcy World" published by Kroll Bond Ratings, dated September 23, 2013.

<sup>24</sup> See "A Decade of Results: Charter School Loan and Operating Performance" (May 2011), by Ernst & Young LLP for the Low Income Investment Fund, the Reinvestment Fund, and Raza Development Fund, available at <http://www.liifund.org/wp-content/uploads/2011/05/Decade-of-Results-CS-Loan-Operating-Performance-05-11.pdf>, indicating that through December 31, 2010, only 1.2% of loans to charter schools had either been foreclosed or written off by lenders (excluding tax-exempt bond financings).

<sup>25</sup> See "A Complete History" above at footnote 1, counting 10 defaults on a rated tax-exempt bond issue through December 31, 2014, but 31 defaults on unrated tax-exempt bond issues during the same period.

---

## CHAPTER 8

# Credit Enhancement

For public charter schools that do not yet possess the characteristics of an investment-grade organization, credit enhancement of tax-exempt bonds may make a facilities project economically feasible by lowering the cost of the borrowing. Credit enhancement involves the guarantee by a more credit-worthy entity of the obligations of a less credit-worthy entity, such as private mortgage insurance. The guarantor takes on the risk of the obligor in exchange for a payment of money by the obligor. The greater the risk transferred, the higher the cost to the obligor. Ultimately, if the risk is too great, no price will be sufficient, and thus no credit enhancement will be available. Credit enhancement for public charter schools is an evolving industry, thus far seldom utilized in tax exempt bond financing.

Credit enhancement for any type of tax-exempt bonds (not only for public charter schools) traditionally took two basic forms—bank letters of credit and bond insurance. Since the Great Recession, the bond insurance industry has materially diminished. As of this publication, no remaining bond insurance company will insure public charter school bonds. For public charter schools, however, bank letters of credit may be an option. In addition, several government-sponsored credit enhancement programs have been established in recent years. Finally, innovative forms of credit enhancement are being developed by a variety of institutional supporters of the public charter school movement. Credit enhancement represents an area for innovation to expand the access of public charter schools to capital financing through tax exempt bonds.

### **A. BANK LETTER OF CREDIT**

Letters of credit are typically structured as short term commitments ranging from one to five years to support the debt service obligations of the borrower. Letters of credit are commonly utilized in combination with variable-rate tax-exempt bond transactions, which contain structural features more suitable to the short-term nature of a letter of credit. Using this form

of credit enhancement, the public charter school's bonds are sold with the higher credit rating of the letter of credit provider, and they garner a lower cost of borrowing. Because variable-rate bonds do not guarantee a certain rate of interest over time—but by definition periodically change interest rates—such bonds are usually more suitable for larger, more sophisticated tax exempt borrowers (such as large hospitals or health care networks). However, public charter schools have used letters of credit issued by local, regional, and national banking institutions to enhance their tax exempt bonds for transactions ranging from under \$10 million to over \$20 million. Typically, banks issuing a letter of credit will require collateral assets to secure the letter of credit, in some cases in an amount equal to the principal amount of the bonds secured by the letter of credit. A variety of financial instruments (beyond the scope of this booklet) can be used in combination with letter of credit backed variable-rate tax-exempt bonds to mitigate the risk over time of fluctuating interest rates.

The motivation to use variable-rate bonds stems from the traditionally significant lower overall borrowing costs associated with such financing arrangements, as compared with traditional fixed-rate bond structures. Because it is usually more expensive to borrow money for a longer period of time, long-term fixed rate bonds usually have an overall borrowing rate that is higher than a variable-rate financing. While variable-rate bonds can be structured to amortize principal over a long-term period (20–30 years), they reflect the interest rate for the short-term period between the time an initial rate is set and the time the initial rate is reset to a new rate. Variable-rate bond interest rates can be structured to reset daily, weekly, yearly, or less frequently and to bear interest rates reflective of the corresponding interest rate reset periods. For example, the school could be paying interest at a weekly borrowing rate for bonds that mature in 25 years.

In addition to variable-interest rate exposure, risks associated with letter of credit backed variable-rate tax-exempt bonds include: (a) letter of credit renewal risk and (b) letter of credit provider bankruptcy. Because letters of credit are typically short-term commitments, the school must plan for either renewal or replacement of the letter of credit prior to its expiration date. There is a risk that the existing provider will not renew, or that no replacement provider will be willing to step forward. In addition, prior to the expiration of a letter of credit, a letter of credit provider could become insolvent or become otherwise unable to honor its obligations under the letter of credit.

## **B. GOVERNMENT-SPONSORED CREDIT ENHANCEMENT PROGRAMS**

Four states have established programs that leverage public resources to lower the borrowing costs for charter school tax-exempt bonds. These include two programs that offer a complete guarantee of the charter school's bond payments and two programs that create the right—but not the formal obligation—of a state to cover the charter school's bond payments.

The Texas Permanent School Fund (PSF) guarantees timely payment of the principal and interest on a charter school's bonds. To be eligible for the program, a charter school must obtain at least an investment-grade credit rating on its own. Further, state law limits the amount of charter school bonds that can be guaranteed. For schools that participate in the program, the bonds receive the credit rating of the PSF ("AAA" as of publication), and they should therefore be able to be sold at the lowest interest rates available.

The Arizona Credit Enhancement Board (CEB) also guarantees the full principal and interest payments on a charter school's bonds. Eligibility for the CEB program is based on Arizona's own state academic performance rating rather than on a third-party credit rating. To be eligible, a school must have an "A" academic rating. For schools that participate, bonds carry the rating of the CEB program ("AA-" as of publication).

While Texas and Arizona formally dedicate designated public resources to guarantee charter school bonds, the states of Colorado and Utah make certain state reserves available to pay the principal and interest on bonds of charter schools in their programs. However, these payments are not guaranteed, and they instead remain subject to appropriation if and when such payments are needed. This type of obligation is referred to as a "moral obligation" (as opposed to an enforceable obligation). For charter schools that participate in these programs, bonds receive ratings upgrades but do not carry the same credit ratings as direct obligations of the respective states.

## **C. OTHER GUARANTORS AND CREDIT-ENHANCEMENT VEHICLES**

As the public charter school movement enters its third decade and access to facilities financing remains a challenge, the need for nontraditional forms of credit enhancement has gained prominence. As described above, credit-enhancement programs for public charter school tax-exempt bonds that have

been developed by federal<sup>26</sup> and state<sup>27</sup> agencies may serve as models for future program development.

In the Second Edition, we observed that several reform-oriented charitable foundations have invested substantially in the public charter school movement, impacting charter facilities policy development broadly, as well as supporting high-performing individual schools. Such foundations could leverage their financial resources in a variety of ways to enable public charter schools to access tax-exempt financing (that might not otherwise be eligible) and to lower the school's borrowing cost. Approaches could include: (a) guaranteeing a school's timely debt service payments (akin to a bond insurer), (b) purchasing a subordinate portion of a project's tax-exempt debt (thereby "deleveraging" the school's balance sheet from the tax-exempt bond investor's perspective), and (c) pledging a pool of funds to perform either of these functions for a regional or state-wide portfolio of facilities projects.

One example of this type of innovation has been deployed in a small number of tax-exempt financings, where a large charitable foundation extended a guarantee to bondholders in the form of a program-related investment (or "PRI") loan.<sup>28</sup> In line with example (a) above, the public charter school's payment obligations were supported by the contractual obligation of the foundation to issue a payment to bondholders in the event of a shortfall in funding of the school. The payment by the foundation is derived from a PRI loan, which is eventually repayable to the foundation, so that the foundation may continue to redeploy its capital for its charitable purposes. The alignment of PRI loan guarantees with the full principal amount and term of a tax-exempt bond financing represents the greatest benefit to bondholders and the greatest likelihood of lowering the overall borrowing cost for the school.

A second, perhaps significantly more impactful initiative, in line with example (c) above, established a credit-enhanced pool of charter school tax-exempt loans. The Charter Impact Fund (CIF)<sup>29</sup> is a new nonprofit organization that offers long-term facilities financing to public charter schools across the United States. CIF uses credit enhancement to lower borrowing costs for charter schools through a revolving loan fund model. Using philanthropic contributions, CIF began making loans to charter schools at rates designed to be lower than the charter schools would otherwise be able to obtain on an un-enhanced basis. Over time, as CIF makes multiple loans to schools using these philanthropic resources, it may pool the loan repayments from multiple charter school borrowers as security for its own tax-exempt bond financing.

The credit strength of CIF's tax exempt bonds should be greater than the credit strength of any individual charter school loan in its revolving loan fund, allowing CIF to borrow at lower rates, and continue making additional loans to charter schools on the same basis. This credit enhancement model can be expanded without limitation through additional philanthropic contributions, serving as a significant demonstration of the creative application of credit enhancement tools for charter school financing.

---

<sup>26</sup> For example, the U.S. Department of Education maintains the Credit Enhancement for Charter School Facilities Program, which can be utilized to provide credit enhancement for charter school tax-exempt bonds as well as other types of charter school facilities financing. The U.S. Department of Education grants federal credit enhancement funding resources to various programs across the country (through both governmental and private nonprofit organizations). For further information, see <https://innovation.ed.gov/what-we-do/charter-schools/credit-enhancement-for-charter-school-facilities-program/awards>.

<sup>27</sup> As described above, see the State of Colorado program information: <https://www.colorado.gov/pacific/treasury/charter-school-intercept-and-moral-obligation>; the State of Texas Permanent School Fund information: [http://www.tea.state.tx.us/index4.aspx?id=2147485578&menu\\_id=2147483695](http://www.tea.state.tx.us/index4.aspx?id=2147485578&menu_id=2147483695); the State of Utah program information: <https://ucsfa.utah.gov/credit-enhancement-program>; and the State of Arizona program information: <https://education.azgovernor.gov/edu/credit-enhancement-eligibility-board>.

<sup>28</sup> See the Official Statement related to California Statewide Communities Development Authority Educational Facilities Revenue Bonds (Aspire Public Schools), Series 2010, dated March 25, 2010, available at <https://emma.msrb.org/EA372751-EA293678-EA689270.pdf>, describing PRI loan guarantees supporting debt service obligations of the borrower.

<sup>29</sup> See [www.charterimpactfund.org](http://www.charterimpactfund.org).

## CHAPTER 9

# Financing for CMOs

This chapter explains how networks of commonly managed charter schools (CMOs) enhance the credit strength of their bond financings by leveraging their scale—applying the concept of “strength in numbers”—to obtain lower bond interest rates than otherwise available through “stand-alone” transactions. The approach is commonly referred to as an “obligated group” in the charter school bond market, and has emerged as the market standard credit structure for CMOs using tax-exempt bonds.

The credit strength of charter schools is generally riskier than that of traditional school districts. Thus, as discussed previously, charter school bond interest rates are generally higher. For stand-alone charter schools (operating one school at a single site), non-renewal or revocation of the charter contract would likely cause a default on the charter school’s bonds and losses for the bond investors. For CMOs, however, this risk is mitigated in certain respects. Each additional school in a network represents another example of successful charter approval and operation. As the first schools in a network obtain charter renewals, reach full enrollment, and establish track records of success, the institutional knowledge is transferred to newer schools in the network, and the risks of non-renewal or revocation for all schools in the network are reduced. In other words, successful CMOs are viewed as more credit-worthy organizations, in part, by virtue of their scale and repetitive successes.

As a borrower, one goal in structuring a loan is to balance the desire to make the fewest promises to a lender, with the need to make enough promises that motivate lenders to loan money at reasonable borrowing rates. In theory, the more restrictive loan terms are, the more security lenders obtain, and thus the lower rates they should be willing to lend money. Applied to CMOs, the highest level of security a CMO could provide to a lender would be a security interest in virtually all its revenues and fixed assets across the system. However, as a practical matter, it makes no sense for a CMO to leverage ten schools to finance the construction of an eleventh. Moreover, many state laws would prohibit such an arrangement.



Thus, the challenge faced by growing CMOs in the late 2000s was how to give bond investors security that reflected the strength of the network—the benefit of the institutional knowledge developed across so many successful schools—while balancing the state law limits and practicalities of resource allocation. How could CMOs get credit for their institutional success and scale, without “mortgaging the farm” or over promising to lenders?

In the 1980s, Orrick attorneys developed the obligated group structure to enable growing healthcare systems (networks of commonly managed hospitals) to pool the revenues derived from hospital campuses located around the U.S., as security for periodically issued tax-exempt bonds. The obligated group gave bond investors a parity claim on all pledged assets, which included hospital campuses in multiple states or jurisdictions, resulting in a stronger credit than individually financed projects. Certain hospitals could be included in the obligated group, while others could be excluded, allowing the healthcare system to balance competing objectives.

In 2010, Orrick attorneys adapted that financing structure to a growing mid-western charter school management organization, enabling the simultaneous financing of campuses in multiple states on a pooled basis, and achieving economies-of-scale to lower transaction costs and borrowing costs. The adaptation of the obligated group structure to growing CMOs created a mechanism for CMOs to effectively balance the issues outlined above—providing investors greater security while allocating resources in a manner consistent with internal policies and state law.

## **A. HOW DOES AN OBLIGATED GROUP WORK?**

In a typical obligated group financing structure, a nonprofit charter management organization creates a sister nonprofit organization, established solely to support the CMO, and intended exclusively to own facilities and undertake financing. This supporting organization (call it “Support Org”) becomes the central figure in the obligated group. For illustrative purposes, imagine a CMO has ten schools. Five are in permanent facilities (former district sites, grant-funded or donated facilities, ect.), and the other five are in temporary spaces (leased parochial school buildings, leased former retail spaces, etc) seeking permanent facilities. CMO identifies two sites, completes plans, obtains permits and seeks tax-exempt financing. The obligated group is used in this scenario to allow the CMO to leverage the experience and credit-

worthiness of its entire network, while only pooling the resources of the two schools that will move into the new sites.

Support Org will borrow tax-exempt bond proceeds, and use the proceeds to acquire the two sites and build the new facilities. Support Org will lease the two sites to the CMO, one site for each school, which provides Support Org with rental income and the ability to mortgage the land and buildings at the two sites. Support Org, as the borrower, can provide investors substantial security by pledging all of its revenues and fixed assets to secure payment of the bonds. Through this approach, bond investors obtain a traditional pledge of all the assets of the borrower, and comfort from the fact that the two schools in the financed facilities benefit from the institutional knowledge of the entire ten-school network.

Over time, Support Org may identify three additional sites for the three remaining schools in the CMO's network that need permanent facilities. The obligated group documentation allows Support Org to undertake additional tax-exempt bond financings over time, and add those additional sites and rental income to the security for all the previously issued bonds of Support Org. The principle of "strength in numbers" comes into play for the later issued bonds, as Support Org is able to obtain lower interest rates on bonds secured by a growing (from two to five) pool of collateral. This arrangement is characterized as a form of credit enhancement because the last school to obtain financing in an obligated group structure borrows at a rate that is lower than it would otherwise have been able to obtain on a "stand-alone" basis. The later transactions are thus "enhanced" by the pooling effect of combining the substantial revenues and collateral of the earlier transactions with the later transactions in the obligated group. And, the five schools that did not need financing for facilities remain outside the obligated group, their resources unencumbered by Support Org's bonds.

## **B. CURRENT APPLICATION**

The obligated group approach can be tailored to address specific organizational needs of successful CMOs beyond credit enhancement of bonds. For example, operation in multiple jurisdictions may give rise to the need for the use of multiple conduit governmental issuers for tax-exempt financing. Facilities costs can vary significantly from one geography to another, or even from neighborhood to neighborhood within the same city, presenting equity issues across networks. CMOs with significant operational

history may have accumulated substantial operating reserves, seeking a means to leverage the value of years of sound financial management to maximize the efficiency of bond financing. CMOs may have, as outlined above, the desire or need to finance only a few sites across a much larger network of facilities, leaving others unencumbered. Also, CMOs may seek to combine various types of debt financing across various facilities projects over time, using tax-exempt bonds, but also traditional commercial bank loans, New Markets Tax Credits, nonprofit CDFI loans and philanthropic subsidized loans. All of these dynamics can be addressed and objectives achieved through a carefully structured obligated group model.

## CHAPTER 10

# Market Disclosure

The capital markets obey the fundamental economic rule of supply/demand. Thus, one consideration in undertaking borrowing with tax-exempt bonds is the determination as to whether bonds will be offered for sale to the public capital markets (a “public offering”) or instead privately offered to one or a select few investors (a “private placement”). Invariably, the broader a market for a public charter school’s bonds, the lower the cost of funds (or interest rates) the school will be able to obtain. Thus, a public offering, if possible, is almost always expected to be more favorable than a private placement. In either case, the school must provide initial and ongoing information to investors about itself and its bonds. This chapter describes various aspects of public offering versus private placement of tax-exempt bonds.

### A. PUBLICLY OFFERED BONDS

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 Exchange Act of 1934 (the “Exchange Act”). Public charter school bonds 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, moreover, including those of most public charter schools, 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 public charter school bonds 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 public charter schools to make periodic disclosure of certain information relevant to the security of their bonds unless certain exemptions apply.

**1. Official Statement.** The offering document in a public offering of public charter school bonds is usually called an “official statement.” If the bonds 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’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 final 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 public charter school’s official statement, the school and its financing professionals must carefully consider the school’s situation and the terms of the bonds proposed to be issued. From these, they must form a judgment as to what information is required 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 decision. What information is material in any given case depends, of course, on the circumstances of the issuing school and the nature of the bond issue.

Coordination of the preparation of the official statement is generally undertaken by the school’s disclosure counsel. This party prepares a draft official statement on the basis of information provided by the school (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 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.

**2. Public Charter School 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 public charter school. The school is primarily liable for any material misstatements or omissions regarding its operations or finances made in the documents used to offer and sell the school's securities. The school may not transfer this primary liability to its underwriter, general counsel, bond or disclosure 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 of its primary liability. Consequently, the school and its staff must make every effort to ensure that the school's offering documents are accurate and complete, and that the bond counsel and disclosure counsel be of the highest quality and have significant resources.

**3. Underwriter Obligations and Rule 15c2-12.** Underwriters of municipal securities are also subject to the anti-fraud and other provisions of the securities laws. To protect themselves from liability, underwriters (usually with the assistance of their counsel) must conduct an investigation of the public charter school'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'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 the official statement which the issuer "deems final as of its date," exclusive of certain pricing and underwriting information. In order to comply with Rule 15c2-12, the underwriter generally requires the public charter school to certify that it deems the preliminary official statement final as of its date (the date it is electronically posted or printed). 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 is now typically included in the bond purchase agreement.

Rule 15c2-12 also requires the underwriter to obtain a commitment from the public charter school 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 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 public charter schools and certain bond issues are exempt from the continuing disclosure requirements discussed below.

**4. Continuing Disclosure.** SEC 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, issues maturing in 18 months or less are exempt from the annual disclosure requirement, and only limited annual disclosure is required of public charter schools with less than \$10 million in outstanding bonds at the time of the issuance. Nevertheless, these exemptions do not excuse qualifying schools from the disclosure of certain material events.

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"<sup>30</sup> has undertaken in a written agreement (typically referred to as a continuing disclosure 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 certain extraordinary events (as specified in the Rule) in a timely manner.
- Notice of any failure to file the required annual financial information. 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 bond purchase agreement, 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's bonds.

**5. 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 the school.

## **B. PRIVATE PLACEMENT OF BONDS**

The first tax-exempt financings undertaken by public charter schools were privately placed bonds; almost necessarily, given the uniqueness of public charter schools and the fact that no such bonds had theretofore been issued or sold in the capital markets. Over time, with greater market understanding of public charter school bonds, public offering has become the standard method of sale. As described above, the general rule is that a public offering will elicit the lowest cost of borrowing. However, certain conditions may make private placements at least worth considering:

1. In some cases, a school may have a private foundation or high net worth individual or institution that is interested in directly supporting the project financing, and would be interested in offering attractive pricing for the private purchase of the bonds.



2. A school may not be able to sell bonds on the public markets, due to credit issues (such as limited operating history, or other unique characteristics), but must complete a facilities project in order to continue operations, and therefore may seek a private placement to a specialized category of institutional high yield investor (where the cost of capital will likely be highest).
3. Certain governmental agency financing programs may require the school to issue a tax-exempt security for private purchase in order to effectuate the financing of the project.

The disclosure rules described above in (A) do not apply to privately placed bonds because they are not offered for sale to the public, with the exception of the anti-fraud rules which apply to any disclosure made in connection with the offer or sale of securities. No official statement or continuing disclosure is required. However, as a practical matter, investors in private placement financings will typically require similar disclosure to that required under SEC rules, and in some cases require more detailed continuing disclosure than would otherwise be required in a public offering.

---

<sup>30</sup> 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. For charter school bonds, the charter school is ordinarily the only obligated person. A joint powers authority acting as the issuer on behalf of a charter school is not deemed an obligated person, because the source of debt service is the charter school.

## CHAPTER 11

# Transaction Structure and Documentation

There are a number of variations in the structure of tax-exempt financings for public charter schools. Nonetheless, the following is illustrative of the basic model:

1. The Bonds are issued by a state or local governmental entity (the "Issuer") which, under applicable state law, has the power to issue bonds for nonprofit corporations, including public charter schools (the "Borrower") for projects or purposes (the "Project") of the type proposed.<sup>31</sup> The Bonds are issued pursuant to an indenture or trust agreement (the "Indenture") between the Issuer and a trustee bank (the "Trustee"). The Trustee holds the bond proceeds until requisitioned for the Project, plus the debt service reserve fund and the bond repayment fund.
2. The Bonds are sold by the Issuer to an underwriter or underwriters (the "Underwriters") pursuant to a bond purchase agreement (the "Bond Purchase Agreement") between the Issuer and the Underwriters, which is approved by the Borrower. The Bonds are resold to investors in the tax-exempt market using an official statement (the "Official Statement") describing the Bonds and other information that investors would want to know in deciding whether to buy the Bonds, which includes financial and operating information about the public charter school that will use the financed facilities.
3. The proceeds of the Bonds are loaned to the Borrower<sup>32</sup> pursuant to a loan agreement (the "Loan Agreement") between the Borrower and the Issuer (which assigns most of its rights, including the right to receive repayments of the loan from the Borrower, to the Trustee as security for the Bonds pursuant to the Indenture). The Loan Agreement sets out the terms of repayment of and security for the loan. There may or may not be a deed of trust on the Project or other property to further secure the loan. If so, it is also assigned to the Trustee.
4. The proceeds of the Bonds are used by the Borrower to finance the Project, fund the debt service reserve fund and pay the costs of a

separate public entity is required to issue the Bonds, because only public entities are qualified under the Internal Revenue Code to issue bonds the interest on which is exempt from federal income tax. However, the nonprofit corporation public charter school is the true party-in-interest and the true obligor of the Bonds. The Issuer functions as a conduit, passing the Bond proceeds collected from Bond investors by the Underwriters (net of the Underwriters spread or fee) to the Borrower and the loan repayments received from the Borrower back to the holders of the Bonds, in each case through the Trustee. The Issuer is not liable on the Bonds except to apply amounts received from the Borrower pursuant to the Loan Agreement as provided in the Indenture. Having assigned its rights under the Loan Agreement (except the right to receive payment of any fee or indemnification) to the Trustee, the Issuer generally has no role or a very limited role after issuance of the Bonds. The Trustee takes over at that point to collect, maintain and disburse the moneys and enforce the rights assigned to it by the Issuer under the Loan Agreement.

The documents of primary interest to the charter school are the Loan Agreement and the portion of the Official Statement describing the public charter school's finances and operations. The Loan Agreement will typically contain a number of representations about the Borrower and a variety of covenants, usually including covenants pertaining to the following: the amount and times of amortization and repayment of the loan, including option to prepay; a pledge and security interest of general or project revenues of the charter school; maintenance of corporate existence and mergers; maintenance of its charter; limitations on encumbrances, indebtedness, acquisition and disposition of property; financial ratios (such as income to debt service and/or assets to liabilities); maintenance and operation of facilities; insurance; indemnification of the Issuer; events of default and remedies. These terms will vary considerably with the circumstances of the public charter school and, possibly, the nature of the Project, but are generally less onerous than those found in an equivalent bank or other conventional loan agreements.

As described above in Chapter 10 "Market Disclosure", the Official Statement is the disclosure document used in most tax exempt bond financings. It describes the Bonds and contains the information material to bond investors in deciding whether or not to purchase the Bonds. It may involve some effort on the part of the public charter school personnel to compile this information,

and the school will be responsible for certifying that the portion of the Official Statement pertaining to it, meets the federal securities law standard of not containing any misstatement of material fact or omitting to state any material fact necessary to make the statements contained therein—in light of the circumstances under which made—not misleading. If the Bonds receive a credit rating, then the rating will be included on the cover of the Official Statement.

In some cases, the Bonds will be credit enhanced by a letter of credit or some other mechanism. In that case, there will be an additional contract between the Borrower and the credit provider, containing additional covenants, and payment of the Bonds may then depend more on the credit provider than the Borrower, which may afford an opportunity, in effect, to replace information in the Official Statement about the public charter school with information about the credit provider.

---

<sup>31</sup> Each state has a different statutory environment for issuing tax-exempt bonds for public charter schools. Therefore, bond counsel should be consulted regarding the specific procedures and approvals that may be applicable to the issuance of tax-exempt bonds for public charter schools in your state.

<sup>32</sup> Under certain circumstances, a tax-exempt loan also may be made to a nonprofit corporation that is affiliated with or controlled by the public charter school, or to a special purpose entity such as a limited liability company (that is disregarded for tax purposes) created to own the financed facility.

## CHAPTER 12

# Steps to Issuing Bonds and the Finance Team

### A. STEPS

While there are variations depending on the type of Issuer, the type of Project, applicable state law, policies and procedures of the Issuer and other factors, the following is illustrative of the basic steps in a typical tax-exempt bond issue for a public charter school:

- 1. Engage the Underwriter.** The Underwriter is an investment banking firm, selected by the charter school, that is responsible for marketing the bonds—to help structure the financing, to organize the charter school’s financial information for inclusion in the Official Statement and for presentation to the rating agencies to obtain ratings on the bonds and/or to credit providers, and to purchase (i.e., underwriting) the bonds for resale to investors. The Underwriter’s counsel is primarily responsible for preparing the Bond Purchase Agreement and may prepare the Official Statement. Consulting an Underwriter with experience in structuring and marketing tax-exempt bonds for public charter schools early in the process is crucial in determining whether there is a market for the school’s bonds, what may be the expected rating and interest rates, and working out the basic structure of the financing with Bond Counsel.
- 2. Consult Bond Counsel.** Bond Counsel is the law firm primarily responsible for rendering an opinion on the validity and tax exemption of the bonds and for drafting the legal documents to be executed by the public charter school and the Issuer in connection with the bond issue and may prepare the Official Statement. While Bond Counsel typically represents the Issuer, and the school is represented by its own counsel, Bond Counsel’s fees (like all other expenses of the transaction) are paid by the charter school, and most Issuers permit the school to choose or at least recommend Bond Counsel. It is important to have a Bond Counsel experienced in public charter school bond financings and given the tax driven nature of most such financings,

particularly experienced in the complex tax laws that govern the tax-exemption of interest on the Bonds.

**To pause for a brief pitch:** *Orrick, Herrington & Sutcliffe LLP is the leading bond counsel firm in the country (ranked number one for more than a decade) with unparalleled expertise and experience in the tax laws applicable to tax-exempt bonds generally—and particularly their application to tax-exempt bonds for public charter schools.*

It is important to involve Bond Counsel early to determine whether the charter school and the project it wishes to finance are eligible for tax-exempt financing and to help design the basic legal and structural conditions for such a financing. Most bond counsel will provide preliminary advice on these matters without charge, in case the transaction proceeds no further.

- 3. Adopt Reimbursement Resolution.** (See discussion in Chapter 4 “Eligible Uses of Bond Funds—Reimbursing Prior Capital Expenditures”.) Bond counsel will normally provide this resolution on request without charge.
- 4. Determine with Bond Counsel and Underwriter what public entity will serve as the Issuer of the Bonds.** In some states or in some situations, there may be several possible issuers with different policies, procedures, politics, governing laws, applications and fees.
- 5. Bond Counsel prepares and circulates to the working group initial drafts of Indenture and Loan Agreement.**
- 6. If applicable (see Chapter 10 “Market Disclosure”), the charter school works with the Underwriter** and disclosure counsel (either bond counsel or underwriter’s counsel may serve in this role) to prepare a draft of the portion of the Official Statement that sets forth the relevant financial and operating information about the school and/or the Project.
- 7. Underwriter’s counsel prepares and circulates to the working group initial draft of Bond Purchase Agreement;** disclosure counsel prepares and circulates to the working group initial draft of the Preliminary Official Statement.
- 8. One or two rounds of meetings or conference calls to discuss the foregoing documents** followed each time by circulation of revised drafts.

9. **Draft documents are submitted to the rating agencies and/or credit enhancement providers, if applicable.**
10. **Another round of document review** to take into account any comments or requirements of the rating agencies, etc. followed by circulation of substantially final drafts.
11. **Meeting of the governing board of the public charter school to approve the Bond issue** and authorize execution of the legal documents to which it is a party or signatory.
12. **Hearing on and approval of the Bonds by the Issuer** (or government entity in which the Project is located, if not the Issuer) after at least 14 days of published notice (usually combined with step 13).
13. **Meeting of the governing board of the Issuer to adopt the bond resolution** authorizing issuance of the Bonds and execution and delivery of the legal documents and distribution of the Official Statement.
14. **The Underwriter mails the Preliminary Official Statement to potential purchasers of the Bonds** (or posts it on the Internet and emails notice of its availability).
15. **Pricing of the Bonds** (i.e., setting the interest rates to be borne by the Bonds) by the Underwriter (based on interest by investors) in consultation with the Issuer and the school.
16. **Sale of the Bonds** by execution of the Bond Purchase Agreement between the Issuer and the Underwriter, approved by the school.
17. **Preparation of a final Official Statement** containing the final sale information for delivery to purchasers of the Bonds at or before receipt of their purchase confirmations.
18. **Closing**—delivery of the Bonds to the Underwriter in exchange for the purchase price and funding of the charter school’s loan, simultaneously with delivery of final executed copies of the legal documents, and various certificates, receipts and opinions.

## **B. TIMETABLE**

A typical Bond issue for a nonprofit corporation takes approximately 90–120 days from start to finish. For example, assume at least 30–40 days for steps 1–7 (i.e., structuring the issue and circulating first drafts of the basic legal

documents), another 40–60 days for steps 8–13 (i.e., finalizing documentation and obtaining approvals, ratings and, if applicable, credit enhancement), 7–10 days for steps 14–16 (i.e., for the Underwriter to market the bonds), followed in about two weeks with step 18 (the closing).

These timeframes are fairly representative but may in each case take a lot longer if circumstances require.

## **C. OTHER ESSENTIAL MEMBERS OF THE FINANCE TEAM**

**Municipal Advisor or Financial Advisor.** The financial advisor assists the charter school with the structure, timing, marketing, fairness of pricing, and terms of a bond financing. Financial advisors can also help with the process of obtaining a bond rating. In addition, they can provide an analysis regarding whether to sell the bonds in a public or private transaction. Financial advisors may be one of the first participants to be hired in a bond financing, because their analysis and guidance can be instrumental in the charter school's decision-making process as to whether or not to proceed with a bond financing.

Over the last few years, charter schools and their management organizations have increasingly sought to utilize the services of financial advisors. This has been done (i) in part because some of the financings have become more complex, and (ii) as a response to the Dodd-Frank Act., Section 975 of the Dodd-Frank Act amended Section 15B of the Securities and Exchange Act of 1934 and made it unlawful for an "advisor" to provide advice to a municipal entity or obligated person (which includes charter school borrowers and affiliates) with respect to municipal securities (which includes charter school bonds) without registering with the SEC as a "municipal advisor". As a result, underwriters and other market participants are prohibited from providing advice with respect to municipal securities unless the entity can fit within certain exemptions. For example, an underwriter can provide advice on the structuring of the bond transaction as long as it was hired for that transaction, was in response to a request for underwriting services or if it relied on the fact that the issuer or borrower retained the services of an independent municipal advisor and documented that reliance. The reason behind this amendment is that the SEC believed that the responsibilities and duties of market participants was not well defined, which resulted in issuers and borrowers receiving advice from participants who just wanted to make a profit. Consequently, the SEC sought to limit the number of parties who



provide advice to the issuer or borrower in a municipal finance transaction and when those parties can provide such advice.

Importantly, the Dodd-Frank Act specifies that municipal advisors owe their issuer clients a "fiduciary duty" which encompasses the duty of loyalty and duty of care, and their charter school (obligated person) clients a duty of care. See definitions as follows:

*Duty of Loyalty:* requires the fiduciary to act in its client's best interests without regard to its own financial or other interests, and to disclose conflicts of interest that might impair its ability to fulfill this duty.

*Duty of Care:* a fiduciary must be qualified to undertake its engagement and consider alternatives that might better serve its client's interests.

**Borrower's Counsel.** The public charter school's general counsel (typically an outside law firm) will represent the school in the transaction and be responsible for reviewing and negotiating provisions of all documents to which the school is a party. In addition, in order to deliver its final opinion regarding the Bonds, Bond Counsel will rely on an opinion of Borrower's Counsel regarding the tax exempt status of the public charter school, the validity of the actions it has taken to approve the financing, and its good standing under state law, among other matters.

**Disclosure Counsel.** Disclosure Counsel takes primary responsibility for drafting the Official Statement and conducting the due diligence inquiry into the operations and finances of the school. To minimize issuance costs, it is not necessary to hire a separate law firm to serve as Disclosure Counsel, but instead, either Bond Counsel or the Underwriter's counsel can serve in this role.

**Trustee.** A national trustee bank typically serves as bond Trustee, acting to collect, maintain and disburse the moneys in connection with the bonds and enforce the rights of bondholders. The Issuer may select the Trustee based on its preexisting relationship in connection with previous bond issues. If not, the school may select a trustee bank. The Trustee often serves an additional key role, that of dissemination agent, responsible for receiving and transmitting the school's annual report (under its Continuing Disclosure Agreement) to the appropriate information repositories.

**Investment Advisor/Bidding Agent.** As described in Chapter 4 "Eligible Uses of Bond Funds", the charter school may seek to utilize a structured

investment to maximize interest earnings on funds held by the Trustee. An investment advisor or bidding agent assists the school in determining the optimal structure for such investments and assists in complying with the public bidding rules applicable to the procurement of such investments. Historically, the Underwriter could serve in this role; however, recent federal regulations require an independent investment advisory firm be retained for this limited purpose, if applicable.

**Rebate Analyst.** As described in Chapter 4 “Eligible Uses of Bond Funds”, a tax filing is required in the fifth year following issuance of the bonds to report any arbitrage earnings to the IRS and provide for payment of any rebate liability that may be associated with investment earnings on the bond proceeds. Rebate analysts often charge a nominal fee to undertake annual monitoring of the investment earnings and responsibility for the required rebate filing.

**Post-closing Compliance Monitor.** To assist the public charter school in meeting ongoing post-issuance compliance responsibilities, a compliance monitor should be engaged to undertake a variety of responsibilities, including periodic private use review and tabulation, private activity bond monitoring and analysis, internal audits, completion of new IRS Schedule K (annual reporting requirements for tax-exempt bonds applicable to nonprofit corporations), analysis of post-issuance tax compliance procedures (such as rebate filings), and review of tax documentation and recordkeeping procedures. A compliance monitor can typically be engaged to perform the rebate analyst’s role as well. (See Chapter 14 “Post-Issuance Compliance”, for more discussion of the responsibilities of the charter school after issuance of the bonds.)

## CHAPTER 13

# Federal Tax Rules

Public charter schools often finance their facilities using the proceeds of tax-exempt bonds, loans and other debt instruments (collectively, "bonds"). This chapter describes the basic federal tax rules applicable to tax-exempt bonds issued to benefit public charter schools. All references herein to a charter school are with respect to a public charter school. With respect to charter schools, the tax-exempt bonds are issued by or on behalf of a state and local government (a "conduit issuer") that loans the proceeds of the bonds to the charter school. Payments of principal and interest by the charter school on this loan are used by the conduit issuer to pay the principal and interest on its bonds. Sections 103, 141 through 150 of the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code") and the related Treasury Regulations (the "Regulations") set forth the federal tax law applicable to the tax-exempt bonds. Most public charter schools are created under state law as nonprofit organizations and are exempt from federal income taxation pursuant to Section 501(c)(3) of the Internal Revenue Code. Accordingly, most tax-exempt bonds issued to benefit public charter schools are issued as "qualified 501(c)(3) bonds" pursuant to Section 145 of the Internal Revenue Code.

### 1. GENERAL

The Internal Revenue Code provides for two categories of tax-exempt bonds that may be issued by or on behalf of state and local governments – "governmental bonds" that finance facilities owned by the governmental entity and used by the general public or by the government entity itself and "private activity bonds" that finance facilities or loans used for governmental purposes but provide significant benefit to private businesses. Notwithstanding the rule that interest on bonds issued by state and local governments is generally tax-exempt, the interest is taxable if the bonds constitute (a) arbitrage bonds (i.e., bonds issued for the main purpose of deriving arbitrage profits), (b) impermissible private activity bonds (i.e. bonds issued to finance facilities used by or for the benefit of a private business and are not specifically permitted by the Internal Revenue Code), or (c) hedge

bonds (i.e., bonds issued too far in advance of the time the bond proceeds are expected to be spent). The arbitrage bond prohibition has two important components: arbitrage yield restrictions and rebate requirements. Private activity bonds may only be issued as “qualified bonds” for the purposes listed in the Internal Revenue Code.<sup>33</sup> The hedge bond rules focus primarily on the timing of the issuance and the investment of the proceeds prior to expenditure.

### **A. Arbitrage Yield Restriction.**

With respect to arbitrage yield restrictions, the Internal Revenue Code generally prohibits the issuance of 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. 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 “arbitrage yield” on the charter school’s bonds. Generally, the arbitrage yield is the discount rate when used to calculate the present value of all principal and interest payments on the bonds that produces an amount equal to the issue price of the bonds with certain adjustments. However, exceptions to yield restriction apply to some bond proceeds during certain periods of time (referred to as “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 beginning on the date of issuance of the bonds. During this period, no yield restrictions apply to bond proceeds that are used to finance capital improvements or costs of issuing the bonds. This temporary period is applicable if the charter school has reasonable expectations that on the date the bonds are issued: (i) the charter school expects to spend at least 85% of the “net sale proceeds” (generally the proceeds from the sale of the bonds, less any proceeds used to fund a debt service reserve fund) within 3 years from the issuance of the bonds; (ii) the charter school has incurred, or within 6 months after the issuance date, will incur a binding obligation to one or more unrelated parties to spend at least 5% of such proceeds; and (iii) the charter school will spend such proceeds and investments thereon 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,” generally a fund 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.

*Reasonably Required Reserve Fund.* A debt service reserve fund is eligible to be invested without regard to yield if the fund is considered “reasonably required” under the Internal Revenue Code, and the size is limited to the least of (i) 10% of the proceeds of the bonds, (ii) the maximum annual debt service on the bonds, and (iii) 125% of average annual debt service on the bonds. The charter school’s financial advisor typically certifies that the reserve fund is reasonably required.

## **B. Rebate Requirement.**

Even if a charter school is permitted to invest its bond proceeds at a higher rate of return than the arbitrage yield, separate rules (the “rebate rules”) determine whether the charter school can keep the investment earnings in excess of the arbitrage yield. An issuer may not retain such excess arbitrage earnings unless it meets an exception provided in the Internal Revenue Code. Thus, while certain exceptions to yield restriction 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 arbitrage earnings ultimately be paid to the federal government.

*Rebate Exceptions.* Two categories of exceptions to the rebate requirement applicable to a charter school’s qualified 501(c)(3) bonds are: (i) the bona fide debt service fund exception and (ii) three spending exceptions, including the six-month spending exception, the eighteen-month spending exception, and the two-year construction expenditure exception. A “small issuer exception” exists but is not applicable to qualified 501(c)(3) bonds.

*Bona Fide Debt Service Fund Rebate Exception.* Amounts earned on a bona fide debt service fund are not taken into account if the gross earnings on such fund are less than \$100,000 for the bond year, and no dollar limitation applies to other bonds (except private activity bonds) if the average maturity of the bond issue is at least 5 years and the bonds are fixed rate bonds for the entire term they are outstanding.

*Spending Exceptions to Rebate.* One of three spending exceptions to rebate may apply if the charter school spends all of the proceeds of the bonds within prescribed time periods. These exceptions are based on actual expenditures of the bond proceeds and the expected investment earnings thereon. The spending exceptions do not apply to amounts held in a reasonably required reserve fund which remain subject to the normal rebate requirement.

*Yield Reduction Payments.* For bond proceeds that are not eligible, or are no longer eligible, for a temporary period, yield reduction payments may be available to reduce the yield on the investments. Only certain classes of bond proceeds qualify for yield reduction payments, including (i) those that initially qualified for one of the temporary periods described above that has expired, (ii) amounts held in a reasonably required reserve fund but exceed the prescribed limits described in this chapter and (iii) certain types of bond proceeds arising in refundings.

*Rebate Compliance Provider.* Because of the technical requirements and complexities involved in rebate calculations, a charter school should consider engaging an expert to provide rebate (and penalty) calculation services for its debt financings. BLX, a subsidiary of Orrick, Herrington and Sutcliffe LLP, offers full rebate compliance services on a cost effective basis. For further information regarding BLX, contact a member of Orrick Charter School Finance Group listed on the inside back cover of this booklet.

### **C. Hedge Bond Restrictions.**

The Internal Revenue Code generally prohibits tax-exempt bonds from being issued too far in advance of the time the proceeds are expected to be used to construct or acquire the assets to be financed. However, under certain circumstances, charter schools may be interested in issuing bonds at the earliest opportunity, particularly when interest rates are expected to rise. In general, interest on the bonds will not be tax-exempt unless the charter school reasonably expects to spend at least 85% of the net sale proceeds (generally the proceeds from the sale of the bonds, less any proceeds used to fund a debt service reserve fund) within 3 years of the issue date of the bonds and does not invest more than 50% of the bond proceeds in investments with a guaranteed yield for 4 or more years.

#### **D. Overburdening Restrictions.**

Charter schools should be aware that the Internal Revenue Code prohibits bond issues that “overburden” the tax-exempt bond 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 purpose and whether the bonds would have been issued if interest on the bonds was not tax-exempt. Bonds with a weighted average maturity of more than 120% of the average reasonably expected economic life of the financed assets and bonds that do not qualify for any expenditure-related temporary periods may indicate overburdening. Facts and circumstances may outweigh these factors.

#### **E. Reimbursement Financings.**

The rebate requirement applies to limit the return on the investment of unexpended bond proceeds. The most common way to expend bond proceeds quickly is through a reimbursement financing where bond proceeds are used to reimburse the charter school for project costs previously paid from its other funds. Reimbursement financings are subject to additional requirements and are described in more detail in section C of Chapter 4 of this booklet.

## **2. QUALIFIED 501(C)(3) BOND REQUIREMENTS**

As previously stated, most tax-exempt bonds issued to benefit charter schools are issued as “qualified 501(c)(3) bonds,” a category of private activity bonds issued pursuant to Section 145 of the Internal Revenue Code that are available to organizations exempt from federal income taxation pursuant to Section 501(c)(3) of the Internal Revenue Code (“501(c)(3) organizations”). Generally, a bond qualifies as a qualified 501(c)(3) bond if the 501(c)(3) organization (in this case, the charter school) owns the financed facility and uses it to conduct its exempt activities. The private business tests are applied to 501(c)(3) bonds using a 5 percent limit rather than the 10 percent limit applied to governmental tax-exempt bonds. Several other requirements specific to private activity bonds apply to qualified 501(c)(3) bonds that do not apply to governmental bonds.

As explained below, the law related to governmental status of organizations, such as a public charter school, is evolving currently. Public charter schools

may be able to benefit from the issuance of governmental bonds in the future. But, for now, Orrick believes the best approach is that a public charter school file for federal tax exemption under Section 501(c)(3) of the Internal Revenue Code and issue tax-exempt bonds as qualified 501(c)(3) bonds.

### **A. Government Instrumentality vs. 501(c)(3) Organization.**

As previously mentioned, the discussion in this booklet generally assumes that tax-exempt bonds issued to finance public charter school facilities will be issued as qualified 501(c)(3) bonds. Almost every nonprofit charter school is organized as a 501(c)(3) organization, as are most charter management organizations (CMOs) and other related entities. Issuance of qualified 501(c)(3) bonds involves procedural requirements and limitations that are not applicable to governmental bonds, including for example, the requirement for a public hearing and the 2% limit on proceeds used to pay costs of issuance. For these reasons and because charter schools are public schools, it is fair to consider whether a charter school is a governmental entity for this purpose, and therefore, whether the tax-exempt bonds issued for charter school facilities can be governmental purpose bonds as opposed to the more restrictive qualified 501(c)(3) bonds.

The tax analysis for determining whether a charter school is a governmental entity (the term typically used is “instrumentality”) is complicated for two reasons. First, the IRS has established different tests for determining instrumentality status depending on whether the question is analyzed for tax-exempt financing purposes, public pension plan purposes, excise tax purposes, etc. Most of the discussion in recent years has focused on whether charter schools are instrumentalities for public pension plan purposes.<sup>34</sup> The IRS generally treats charter school as instrumentalities for that purpose. Second, the existing test for tax-exempt financing purposes focuses primarily on whether a government unit controls the charter school. Historically, control of a non-profit organization, such as a charter school, exists if the government unit has the ability to appoint and remove a majority of the governing board of the charter school. On the other hand, IRS private letter rulings, again mainly in the public pension plan space, conclude that the chartering process, together with state funding and regulatory oversight, for a charter school meets the control requirement. However, every state has different rules and regulations making it difficult to apply this guidance across the states. Helpful



guidance from the Internal Revenue Service for tax-exempt financing purposes has yet to be provided for charter schools. Generally, it is Orrick's current view that charter school transactions should be undertaken using qualified 501(c)(3) bonds. Importantly, even if the charter school qualifies as a government instrumentality, the bonds may be required to be issued as qualified 501(c)(3) bonds if the bond-financed project is managed by a CMO or if the proceeds are loaned to a related property owner and leased to the charter school.

## **B. Ownership of Financed Facilities.**

Federal tax law requires that all property financed with the proceeds of a charter school's qualified 501(c)(3) bonds must be owned by the charter school, another 501(c)(3) organization or a state or local governmental unit.<sup>35</sup> Alternate structures can provide some flexibility while meeting this ownership requirement.

Long-term ground leases may be an acceptable alternative to formal ownership. For example, a charter school could enter into a long-term ground lease of land owned by a non-exempt entity and use proceeds of tax-exempt bonds to construct its facility on this land. In this circumstance, the term of the ground lease must be long enough to cause the bond-financed facility to be owned by the charter school for federal tax purposes. Generally, this requires the term of the ground lease to be substantially longer than the reasonably expected economic life of the financed project. In practice, the terms of the ground lease are often longer and may include one or more options to renew the lease based on the circumstances.

Another common structure for charter school financings involves the lease of an existing structure and the use of tax-exempt bond proceeds solely to finance certain tenant improvements required for the charter school's educational activities. In these situations, in order to meet the ownership requirement, unless the tenant improvements are of a type that reasonably can be removed by the charter school and used elsewhere, (such as, moveable partitions, equipment or furniture), similar to the ground lease, the term of the lease cannot end prior to the end of the expected economic life of the financed improvements, is often longer and may include one or more renewal options.

## **C. Use of Financed Facilities.**

In addition to the requirement that all property financed with proceeds

of the bonds must be owned by the charter school, at least 95% of the net proceeds of the bonds must be used to finance qualified project costs. Use by the charter school for activities that constitutes an unrelated trade or business use is counted as part of the 5% non-qualified use (including use of proceeds to pay costs of issuance up to the 2% limit). Nevertheless, the project or portions of it may be used by non-exempt entities in their trade or business if (i) the portion of the project so used can be allocable to moneys spent on the project from sources other than proceeds of tax-exempt bonds (such as accumulated funds, donations or proceeds of taxable debt)<sup>36</sup>; (ii) as stated above, the portion of the project so used represents less than 5% of proceeds of the tax-exempt bonds (net of reserves), with any proceeds (up to the 2% cap) used to pay costs of issuance counted against this 5% amount; or (iii) the use by a non-exempt entity is pursuant to an operating or management contract that meets the requirements of a qualified management contract.<sup>37</sup>

#### **D. Financing Costs of Issuance.**

Costs of issuance may be financed with proceeds of qualified 501(c)(3) bonds subject to a cap of 2% of the sale proceeds of the bonds. This 2% counts against the 5% otherwise permitted for non-qualified costs. If this amount is insufficient to cover all issuance costs of the bonds, the charter school may use equity or proceeds of a taxable borrowing to cover the issuance costs in excess of the 2% limit.

#### **E. Public Hearing and Governmental Approval.**

Qualified 501(c)(3) bonds must be approved by the governmental issuer of the bonds and, if different from the governmental issuer, governmental entities with jurisdiction over the site(s) where the bond financed property will be located. This approval must occur after a public hearing held in the jurisdiction providing approval and prior to the issuance of the bonds. The public hearing is often referred to as the "TEFRA Hearing" based on the name of the tax legislation requiring such hearing.<sup>38</sup> Public notice of such hearing must be published at least 14 days prior to the date of the TEFRA Hearing using one of several permitted methods. Publication in a newspaper of general circulation in the approving jurisdiction is currently the most common method used. Once the public hearing has occurred, the governmental unit must approve the issuance of the bonds. Approval can take several forms,

but typically consists of approval by the applicable elected official of the governmental unit or its elected legislative body.

#### **F. \$150 Million Limitation.**

In some circumstances, a 501(c)(3) organization cannot benefit from more than \$150 million of outstanding qualified 501(c)(3) bonds that are not "qualified hospital bonds" (95% or more of the net proceeds used for a hospital). Because charter school bonds do not meet the requirements of qualified hospital bonds, this \$150 million limitation must be taken into account. This limitation was repealed for capital project bonds issued after August 5, 1997, as long as at least 95% of the net proceeds of such bonds are used to finance capital expenditures incurred after that date. In other words, the \$150 million limitation may apply to bonds issued to finance charter schools if the bonds also finance working capital expenditures, including otherwise permissible post-construction funded interest on the bonds, exceeding 5% of the net proceeds of the bonds. Organizations under common management and control are treated as one entity for purposes of this limitation; thus, large charter school networks and CMO's must monitor their working capital expenditures financed with qualified 501(c)(3) bond proceeds to ensure compliance with this exception to the \$150 million limitation.

#### **G. Contracts with Private Managers, Operators and Other Service Providers.**

A management or service contract can result in private business use of a tax-exempt bond financed facility. The IRS has provided a safe harbor, and satisfying the safe harbor requirements means these contracts will not cause private business use of the financed project.

*Qualified Management Contracts Rules – Safe Harbor Requirements.*

Key components of the safe harbor for qualified management contracts are set forth below.

*Reasonable Fee.* The fee paid to the service provider must be reasonable.

*No Net Profits or Net Losses.* Compensation to the service provider cannot be based, even in part, on the net profits or net losses of the financed project.

*Term Limitation.* The term of the services contract may not be longer

than 30 years or if shorter, 80% of the remaining useful life of the project.

*Control.* The project owner must exercise control over the project, including approval of the annual operating budget, capital expenditures, disposition of property, the rates charged for the use of the project, and the general nature and type of use of the project.

*Risk of Loss.* The service provider cannot be responsible for replacing the project if there is a catastrophic loss; however, it can obtain adequate insurance as long as this cost is reimbursed by the charter school.

*Service Provider Tax Position.* The contract must state that the service provider will not claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the financed project.<sup>39</sup>

*Limitation on Rights.* Finally, the service provider must not have a role or relationship with the borrower that as a practical matter would limit the borrower's rights to take action under the contract.

*Excluded Incidental Services.* Contracts for ancillary or incidental services (routine repair and maintenance contracts, for example) are not considered to be service contracts and therefore, do not cause the service provider to be a private business user even if the term of the contract is longer than 30 years.

*CMO's and Management Contracts.* CMO's are created to manage an association of charter schools and typically qualify as a 501(c)(3) organization. CMO's have significant control over the activities and funding of the individual charter schools; thus, management contracts between charter schools and CMO's often are not qualified management contracts because the contract cannot satisfy the "Limitation of Rights" requirement set forth above. In this circumstance, it is important that the CMO's status as a 501(c)(3) organization be confirmed before the charter school's bonds are issued and while they remain outstanding.

## **H. Change of Use or Disposition of Tax-Exempt Financed Facilities.**

If the charter school takes a deliberate action that changes the use of bond-financed property or disposes of it while the qualified 501(c)(3) bonds are outstanding, and the change in use or disposition causes

the bonds to fail to comply with applicable federal tax law, it must take one of the remedial actions permitted by the Regulations in order to preserve the tax-exempt status of interest on its bonds. If a change in use or disposition of bond-financed property occurs or is being considered, the charter school should contact bond counsel immediately to discuss the remedial actions available to it.

### **I. Qualified Tax-Exempt Obligations (“Bank Qualified”).**

Governmental bonds and bonds issued to provide financing for a 501(c)(3) organization may be eligible for “qualified tax-exempt obligation” status (also referred to as “bank qualified” status).<sup>40</sup> With respect to qualified 501(c)(3) bonds, this status is based on the eligibility of the conduit issuer of the bonds. The conduit issuer (i) must reasonably expect to issue no more than \$10 million of tax-exempt obligations (excluding private activity bonds, other than qualified 501(c)(3) bonds) during the current calendar year, and (ii) must specifically designate the bonds as qualified tax-exempt obligations. This status permits banks and other financial institutions to deduct that portion of their interest expense that is related to ownership of tax-exempt bonds. Bank qualified bonds are attractive to smaller charter schools and CMO’s because they are typically issued at lower interest rates. Many private placements of charter school debt are issued as bank qualified obligations.<sup>41</sup>

## **3. 501(C)(3) ORGANIZATION STATUS**

Most charter school bonds are issued as qualified 501(c)(3) bonds, and the tax exemption of these bonds is dependent on the initial and continuing tax-exempt status of the charter school pursuant to Section 501(c)(3) of the Internal Revenue Code. In the context of qualified 501(c)(3) bonds, typically, bond counsel and borrower’s counsel will require that the charter school complete a tax due diligence questionnaire. The information provided by the charter school in response to the questionnaire is critical to the determination that the charter school’s activities comply with the requirements for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. As part of the questionnaire, bond counsel will request copies of certain documents, IRS filings and other information important to the tax-exempt status of the charter school.

## **A. Key Corporate Documents.**

It is important for a tax-exempt organization to be able to provide copies of certain key documents, including its articles or certificate of incorporation, its bylaws, IRS Form 1023 (Application for Exemption)<sup>42</sup>, the IRS determination letter declaring the charter school's tax-exempt status and IRS Form 990 for each of the past 3 to 5 years, depending on the circumstances.

## **B. Board of Directors Composition (Founders, Friends and Family).**

Many charter schools are an outgrowth of a school created by a church, a community, or a like-minded group of individuals who wish to provide a particular educational environment for students. Upon conversion to a charter school, the board of directors may consist of interested parties related to the original school, including family members, friends, church members, and others. The charter school should review the composition of its board of directors, and if necessary, diversify the board to include individuals who represent the public served by the charter school and who are well-qualified for the responsibilities of managing its operations.

## **C. Conflicts of Interest with Contractors and Vendors.**

Often charter schools in their infancy have relationships with the contractors and other services providers which may present conflicts of interest because a member of the board of directors or a family member of a director has an ownership or financial interest in the service provider. While generally these relationships are not forbidden, the charter school must confirm that the compensation paid to these contractors and service providers reflects the fair market value of the services rendered and that the contracts do not constitute private business use.<sup>43</sup> The board of directors should consider and approve these contracts, and a director with a conflict should recuse herself or himself from the consideration and approval. Such action should be properly documented.

## **D. Board of Directors' Approval and Documentation of Key Matters.**

Important matters of the charter school must be reviewed, approved and documented by the board of directors. Examples of these matters include, but are not limited to (i) the amendment of its articles and bylaws, (ii) election of its officers and directors, (iii) termination and

replacement of directors, (iii) employment and compensation of executive personnel, (iv) adoption of an annual budget, (v) investment of its funds, (vi) adoption of corporate policies and long-term plans, (vii) compliance with state and federal reporting requirements (i.e., IRS Form 990), (viii) corporate borrowings, and (ix) sales, leases or other dispositions of its property.

## **E. IRS Form 990 and Schedule K.**

Organizations that are exempt under Section 501(c)(3) of the Internal Revenue Code annually must file IRS Form 990 (Return of Organization Exempt From Income Tax). Failure to timely file IRS Form 990 can result in significant penalties and possible revocation of the organization's tax-exempt status. Completion of IRS Form 990 – Schedule K (Supplemental Information on Tax-Exempt Bonds) is required for most tax-exempt organizations with outstanding tax-exempt obligations. Schedule K solicits information regarding the organization's tax-exempt bonds and the bond-financed property. Because the IRS may use information provided on Schedule K to select qualified tax-exempt bonds for audit, careful completion of Schedule K is critical. The charter school should contact qualified tax counsel if it has any questions or concerns about the information to be provided on Schedule K.

If you have additional questions or concerns regarding the federal tax rules applicable to a charter school's tax exempt financing or the tax-exempt status of your charter school, please contact one of the members of the Orrick Charter School Finance Group who are listed on the inside back cover page of this booklet.

---

<sup>33</sup> Section 141(e) of the Internal Revenue Code provides 7 categories of permissible private activity bonds.

<sup>34</sup> See IRS Notice 2015-7, 2015-6 I.R.B. 585.

<sup>35</sup> Section 145(a) of the Internal Revenue Code.

<sup>36</sup> See, Chapter 5 "Interplay Between Bonds and Fund-raising".

<sup>37</sup> See subsection G for a discussion of IRS Revenue Procedure 2017-13 regarding the requirements for a qualified management contract.

<sup>38</sup> Tax Equity and Fiscal Responsibility Act of 1982.

<sup>39</sup> IRS Revenue Procedure 2017-13, 2017-16 I.R.B. 787.

<sup>40</sup> Section 265(b) of the Internal Revenue Code.

<sup>41</sup> See the Afterword of this booklet "Bank Loans and Direct Placements" for information regarding private placements.

<sup>42</sup> A charter school may file IRS Form 4506-A to request a copy of its IRS Form 1023, IRS determination letter and IRS Form 990, if these documents cannot be located.

<sup>43</sup> See subsection 2.G. of this chapter - Contracts with Private Managers, Operators and Other Service Providers.

## CHAPTER 14

# Post-Issuance Compliance

## A Long Term Responsibility

Public charter schools are responsible for monitoring post-issuance compliance with respect to a range of matters relating to property and programs financed with tax-exempt bonds. As further described herein, these responsibilities apply over the entire life of the obligations, including any refunding bonds.

## What Kinds of Responsibilities Do Issuers and Conduit Borrowers Have After Bonds Are Issued?

In addition to the obvious, which is paying the debt service on the bonds, there are a variety of crucial post-issuance responsibilities that public charter schools must perform. Failure to perform these duties could lead to serious consequences. The adoption of written organizational procedures governing internal compliance with post issuance obligations helps public charter schools ensure long term success, despite changes in the public charter school including through normal staff turnover and attrition. Typical examples of post-issuance responsibilities include the following.

### A. TAX RESPONSIBILITIES

In general, when bonds have been issued on a tax-exempt basis, the school will have covenanted in the bond documents (that is, promised to bondholders) that it will not do anything that will cause interest on the bonds to become taxable and that it will take any and all actions necessary to preserve and defend tax-exemption. While the tax requirements are many and complex, and vary from bond issue to bond issue, they generally include the following:

#### 1. Expenditure and allocation of bond proceeds.

- a. Ensuring that bond proceeds are actually spent on qualified tax exempt bond purposes.



- b. Ensuring that bond proceeds are spent within the time allotted for “temporary period” investment of bond proceeds—usually three years from issuance. If moneys other than bond proceeds are also to be spent on the project (e.g., equity or funds from a taxable financing), making a proper and timely allocation of the bond proceeds to qualified tax-exempt bond purposes by the later of 18 months from when the money was spent or from the date the project was completed and in all events within five years and sixty days from the date the bonds were issued to ensure intentions to use a portion of the project for purposes that may not qualify for tax-exempt financing is respected by the IRS.

## **2. Investment of bond proceeds.**

- a. Ensuring that bond proceeds are invested in a manner that complies with the bond documents and with the arbitrage rules.
- b. Ensuring that any earnings resulting from investing bond proceeds or pledged funds at an investment yield in excess of bond yield are rebated to the U.S. Treasury in accordance with applicable tax requirements (except to the extent a specific rebate exception applies).

## **3. Use of the bond financed project.**

- a. Ensuring that impermissible private use does not occur as a result of arrangements to use the bond-financed project including through:
  - Sale of bond financed property
  - Management or service contracts such as cafeteria/food service contracts or contracts with non-employee specialists that do not meet IRS safe harbor requirements
  - Leases or subleases of bond financed property
  - Short term use arrangements, such as for summer camps, private events or weekend use of gym or classrooms, if such use is unrelated to the public charter schools purpose or if all uses pursuant to such arrangement exceed fifty days
  - Other arrangements providing comparable special legal entitlements with respect to bond financed property
- b. Making sure that any specific use or program requirements continue to be satisfied (like the operating the facility as a public charter school).

#### **4. Other Post-Issuance Tax Compliance Responsibilities.**

- a. Adopting written post-issuance tax compliance procedures outlining responsibility to monitor compliance with applicable tax rules.
- b. Designating specific staff positions as responsible for monitoring post-issuance tax compliance.
- c. Providing staff involved with post-issuance tax compliance appropriate educational opportunities and training (available through bond counsel, professional associations or IRS outreach programs).
- d. Keeping detailed records with respect to expenditure of proceeds, final allocations of bond proceeds to expenditures, arbitrage and rebate compliance and use of bond-financed property for as long as such bonds (or refunding bonds) are outstanding, plus three years.
- e. For public charter schools organized as 501(c)(3) organizations, timely filing Schedule K to IRS form 990.

#### **5. Inquiries from the IRS.**

During the last few years, the IRS has significantly stepped up enforcement of the tax rules pertaining to tax-exempt bonds, resulting in increased probability of receiving inquiries for information from the IRS and possibly an audit challenging the tax exemption of the bonds. It is necessary not only to have comprehensive and accurate records, as noted above, but also to get good advice in responding to even the simplest of IRS inquiries. Copies of a pamphlet prepared by the tax department of Orrick, Herrington & Sutcliffe LLP, "An Introduction to IRS Audits of Tax-Exempt Bonds" are available upon request. In recent years, IRS officials have repeatedly emphasized the importance of implementing post-issuance tax compliance programs. Public charter schools that have effective post-issuance compliance procedures are significantly more likely to respond to an IRS audit both successfully and cost-effectively.

## **B. DISCLOSURE RESPONSIBILITIES**

The school will have executed a Continuing Disclosure Certificate or Agreement obligating it to:<sup>44</sup>

1. Provide to the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system (EMMA) certain financial and operating information on a periodic basis (typically quarterly).
2. Provide immediate notice to EMMA of the occurrence of certain specific events listed in the Continuing Disclosure Certificate.
3. In certain transactions, conduct investor information conference calls on a periodic basis (e.g., semi-annually) to review financial and operating information.<sup>45</sup>
4. Like the IRS, the Securities and Exchange Commission ("SEC") has significantly increased its enforcement activity in the tax-exempt bond area. This has led to increased requests for information and some very serious enforcement actions. As with IRS inquiries, good legal advice is needed before responding to even an informal inquiry from the SEC.

### **C. BOND DOCUMENT RESPONSIBILITIES**

The bond documents themselves (not only the indenture and loan agreement, but any credit provider agreement, investment agreement or swap agreement) contain a number of responsibilities of the school in addition to timely payment of debt service. These will vary widely depending on the type of bonds, source of security and payment, credit enhancement and the like. Typical examples include:

1. Providing audited financial statements by a certain date.
2. Providing other specified information periodically or upon the occurrence of certain events to bond holders, rating agencies, credit enhancement or liquidity providers, and swap providers.
3. Compliance with a debt service coverage test.
4. Compliance with other financial tests (including a cash-on-hand test).
5. In case of general fund pledges by conduit borrowers of their non-trustee held general funds, making sure all general funds are deposited in the pledged account.
6. Periodically renewing of UCC or other filings.
7. Maintenance and periodic certification of casualty and other insurance.

## **What Are the Consequences of Failure to Perform Post-Issuance Responsibilities?**

### **A. TAX RESPONSIBILITIES**

Failure to perform these responsibilities could lead to the bonds being declared taxable or to substantial payment to the IRS to close its audit without declaring the bonds taxable, following a painful, time consuming and expensive audit process. Either result mentioned could lead to a SEC investigation and enforcement actions based on the premise that the official statement for the bonds had failed to properly disclose the tax risk. A declaration of taxability would also likely lead to lawsuits from bondholders.

### **B. DISCLOSURE RESPONSIBILITIES**

Failure to provide the Annual Report or Special Events Notices in accordance with and by the time agreed in the Continuing Disclosure Certificate would result in the school having to disclose such failure in its official statements for the next five years. Disclosing information that is either inaccurate or incomplete in a way that would be material to investors, in light of the circumstances under which these disclosures are made, could lead to investor lawsuits or SEC action for securities fraud under Rule 10b-5.

### **C. BOND DOCUMENT RESPONSIBILITIES**

Failure to comply with covenants in the bond documents normally would constitute a default under the documents and could lead to a declaration of an Event of Default and consequent remedies, including the involvement of a special third-party consultant guiding a review and reform of the school's operations or, in some cases, a declaration that the entire principal amount of bonds become immediately due and payable. Even without a declaration of Event of Default, bond document defaults may be required to be disclosed in audited financial statements or to rating agencies or credit providers. It may also affect the ability to issue additional bonds under the terms of the bond covenants.

As described above in Chapter 12 "Steps to Issuing the Bonds and the Finance Team", professional assistance in complying with the several post-issuance responsibilities is available through rebate analysts and other compliance

monitoring consultants. Public charter schools that issue tax-exempt bonds should retain such services in order to ensure compliance over the relevant period of time, as it is likely the tenure of the staff and board of the charter school who were involved in the issuance of the bonds will not outlast the tenure of the bonds themselves. Even large sophisticated CMOs should review the need to retain such services.

---

<sup>44</sup> If the bonds are issued in authorized denominations of \$100,000 or more, and are sold to qualified purchasers by private placement (or may be tendered at par at least as frequently as every nine months), they are exempt from SEC Rule 15c2-12, which requires the charter school to undertake the obligations described in this paragraph. However, even when the exemption applies, charter schools will typically take on such responsibilities anyway in order to satisfy the requirements of bond investors.

<sup>45</sup> Direct communications with investors should be undertaken carefully, in order to comply with the basic concept that no material nonpublic information be provided to any one or small group of investors without also making such information available to the entire marketplace (e.g., through posting on EMMA).

## CHAPTER 15

# SEC Enforcement

As previously discussed in Chapters 10 and 13, charter school bonds are “securities” for purposes of the Securities Act and the Exchange Act and consequently are subject to certain securities laws concerning disclosure of material information to potential investors. As such, charter schools and their bonds, as well as financing participants, are subject to oversight by the SEC, the MSRB and the IRS, the regulatory agencies in the municipal bond arena. All market participants, including charter schools, are held accountable under the securities and tax laws.

While enforcement activity by the SEC has occurred for many years, there has been a marked increase in the SEC’s focus on the municipal market since 2010 due to the formation of the Public Finance Abuse Unit (formerly called the Municipal Securities and Public Pensions Unit) in the Enforcement Division. This Unit has approximately 25 professionals located in SEC Regional Offices around the country, including attorneys, accountants and investigators, many of whom are former prosecutors. These professionals have taken their role seriously, and all participants in the municipal market—borrowers (including a charter school operator), issuers, underwriters, municipal advisers, attorneys, consultants—have been the targets of enforcement actions.

Most of these enforcement actions claim that the anti-fraud provisions of the federal securities laws (Sections 17(a)(2) and (3) of the Securities Act of 1933, and Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934), have been violated. These anti fraud provisions 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. In particular, these claims have included the following:

- Failure to disclose prior violations of continuing disclosure obligations,
- Misleading or incomplete disclosures about financial condition,
- Failure to disclose the use of unusual accounting practices,

- Failure to disclose shortcomings in risky economic development projects, and
- Failure to disclose other material financial or legal risks.

An example of a recent charter school case with the SEC is UNO Charter School Network, Inc., IL (2014). In this case, a charter school operator failed to disclose in an official statement that family members of senior management had engaged in certain transactions with the operator, which violated prohibitions against conflicts of interest in grant agreements with the State of Illinois. These conflicts could have led to the withdrawal of the grants, which were critical to sustaining the operation of the charter school and the operator's ability to repay the bonds. Charges were also brought against the President and CEO of the charter school operator. The operator and its President and CEO settled with the SEC. The operator agreed to improve its internal procedures and training, including appointment of an independent monitor. The President and CEO agreed to pay a \$10,000 penalty and were barred from participating in any future municipal bond offerings.

It is important to point out that the SEC (as distinct from a private plaintiff) does not have to prove that an alleged disclosure violation or failure resulted in any bond default, loss of value or financial harm to any investors. Rather, it just has to prove that the violation or failure occurred. The SEC can even base its claim on statements made by an issuer or obligor and its representatives either orally or in other reports or documents other than an official statement. In addition, as demonstrated in the case above, the SEC can fine individuals and bar them from participating in the industry.

Even if the SEC does not end up bringing charges, the consequences of an SEC investigation can be very expensive and harmful to defend. Moreover, SEC investigations and charges result in bad publicity, political damage, and possible reductions in ratings or other financial market consequences.

Charter schools participating in a bond transaction must be aware of these securities laws and hire competent counsel—whether it be their own borrower's counsel or special disclosure counsel. Such counsel can assist the school in telling its story in an accurate and fulsome manner in the official statement. In addition, counsel can also help the school with creating policies and procedures aimed at ensuring compliance with the school's ongoing continuing disclosure requirements.

## AFTERWORD

# Bank Loans and Direct Placements

When used appropriately, bank loans and the direct placement of bonds with banks and other financial institutions are valuable structuring alternatives to long-term public or limited offering of bonds for charter schools.

Bank loans are often structured as commercial real estate secured transactions, and are commonly used by charter schools for the acquisition and/renovation of school facilities, or the purchase of equipment. This type of financing may be a preferred choice by a charter school (i) as a financing early in a charter school's life cycle when it may not have sufficient operating history to access the bond market, (ii) as a means of bridge financing prior to the issuance of bonds, or in anticipation of receipt of capital campaign moneys or anticipated philanthropic donations, or (iii) as a permanent financing structure with a shorter maturity than the bond market affords<sup>1</sup>. Bank loans are also regularly used as a means of financing working capital. Without satisfying the additional requirements described below, bank loans are structured as taxable financings for federal income tax purposes.<sup>2</sup>

In some states, Issuers (as described in Chapter 11 "Transaction Structure and Documentation") have the legal authority to enter into loan-structured financings as well as issue bonds on behalf of qualified 501(c)(3) organizations.<sup>3</sup> Under such authority, bank loans to charter schools may be facilitated through an Issuer, and to the extent the requirements of the federal tax laws are satisfied, done on a tax-exempt basis. Bank loans documented using this method are not treated as securities and not subject to the disclosure requirements discussed under Chapter 10 "Market Disclosure", and generally have less upfront costs than a publicly offered bond issue.<sup>4</sup>

In addition to a public offering, bonds may also be directly placed with and purchased privately by a bank or other financial institution.<sup>5</sup> Transactions structured in this way are often internally treated for regulatory and accounting purposes by banks or financial institutions as evidence of a loan. Certain modifications to bonds are consistently required in order to allow for such treatment, but none of such changes are legally or economically



detrimental to the charter school.<sup>6</sup> As with a bank loan structure, bonds structured as a direct purchase or limited offering are typically also exempt from the market disclosure requirements, and all financial and other information is usually required to be delivered directly to the bank or financial institution.

Both bank loans and direct purchase or privately placed bonds may be effective financing tools for charter schools; however, careful consideration should be given when structuring so as to not unduly restrict future borrowings or conflict with any existing debt. As it is often said, when considering any financing, one should always think about the next borrowing. In that regard, a charter school would be well advised to look to its advisors and consultants to ensure that bank loans and direct purchase or privately placed bonds are structured to allow or maximize (1) the ability to borrow in the future utilizing long-term bonds, (ii) reasonable prepayment rights, (ii) acceptable and workable additional debt provisions (regardless of structure), (iv) consistency in collateral or security that is pledged to secure any or all debt, and (v) consistency with all covenants (financial and otherwise) and events of default. Conversely, when a charter school is borrowing using a long-term bond issue, careful consideration should equally be given to preserving and maximizing the charter school's rights to access future borrowings using a bank loan and direct purchase or privately placed bond issue.

---

<sup>1</sup> Three years of audited operations is a common criteria used by rating agencies and bond underwriters and investors to evaluate credit worthiness; Bank loans tend to have maturities of 15 years or less (with some exceptions), while public or limited offering bonds may often mature as long as 30 years.

<sup>2</sup> Most working capital loans are required to be done on a taxable basis.

<sup>3</sup> Texas is an example (see Texas Education Code, Chapter 53A, as amended).

<sup>4</sup> Costs of issuance vary by transaction.

<sup>5</sup> In the instance described, there is a single bank or financial institution purchasing the bonds as distinguished for a limited offering of bonds to a small number of accredited investors or qualified institutional buyers (which is more similar to a public offering).

<sup>6</sup> Some examples: No initial or continuing disclosure requirements, no CUSIP numbers, no ratings, single term bond, denominations no smaller than \$100,000, physical bond certificate (no book-entry), and limited assignability.

## ABOUT THE AUTHORS

**Eugene H. Clark-Herrera**, a Partner in Orrick's San Francisco office and Chair of Orrick's Charter School Finance Group, has served as bond counsel for public charter schools across the country in debt financing transactions for over fifteen years. Eugene pioneered capital markets access for California public charter schools, structured several of largest multi-campus public charter school financings to date, and has advised governmental issuers, foundations, advocacy groups and policy makers in the development and expansion of public charter school access to tax-advantaged financing. He is a graduate of Stanford Law School and an alumnus of the Teach for America Corps. He also founded an arts-based youth development organization in the San Francisco Bay Area.

**Marc Bauer**, a Senior Associate in the Los Angeles office, is a member of the Public Finance Department. Marc has represented issuer and underwriter clients in charter school transactions involving both long- and short-term, fixed and variable rate obligations, lease structures, obligated group obligations, and new market tax credit refinancings.

**Todd Brewer**, a Partner in Orrick's Houston office, has over 30 years of public finance experience in all areas of tax exempt transactions, serving as bond counsel, bank counsel, underwriter's counsel, trustee's counsel, letter of credit providers counsel and borrowers counsel in transactions for traditional governmental entities, nonprofit organizations and private entities. The portion of his practice devoted to education includes tax exempt and taxable financings for public and private K-12 schools, charter schools, and public and private universities and colleges. He also devotes a significant portion of his practice to the representation of banks and other financial institutions in connection with direct purchases of tax-exempt bonds, tax-exempt loans, and the issuance of letters of credit and other liquidity facilities in connection with tax-exempt obligations. He also serves as Vice Chair of Orrick's Texas Public Finance practice.

**Steffi Chan** is a Managing Associate in the Public Finance Department in Orrick's San Francisco office. Steffi has participated as bond counsel, disclosure counsel and underwriter's counsel on a variety of transactions including general obligation bond financings, revenue bond financings and lease financings for school districts, community college districts, local government and state agency clients.

**Darrin L. Glymph**, Partner and Head of the Public Finance team in the Washington, D.C. office, is a member of the Public Finance Department. Darrin's practice is primarily transactional, focusing on public finance and legal issues facing state and local governments and instrumentalities.

**Kathryn Garner**, Of Counsel in Orrick's Austin and Houston offices, focuses her practice on federal tax law related to public finance and tax-exempt bond financings. She advises cities, counties, school districts, higher education authorities, nonprofit organizations (including charter schools), transit authorities and water utility districts. Kathryn regularly consults with governmental issuers on arbitrage and rebate compliance and responds to inquiries from governmental issuers, borrowers and investment bankers regarding tax issues. She has represented numerous issuers and borrowers in connection with IRS audits of tax-exempt bonds. Kathryn also advises non-profit organizations regarding the process for achieving tax-exempt status under the Internal Revenue Code and Texas sales and franchise taxes as well as providing guidance regarding ongoing compliance with federal tax laws and regulations. Kathryn is a member of the National Association of Bond Lawyers, the Houston Bar Association, the Houston Bar Foundation and is a past president of the Texas Chapter of Women in Public Finance.

**Alison J. Radecki**, a Partner in Orrick's New York office, is a member of the Public Finance Department. Ms. Radecki serves as underwriters' counsel or bond counsel for a wide variety of bond issuances in the not for profit arena, including in the areas of healthcare, education, social services and cultural institutions. She also has substantial borrower's counsel experience representing charter schools as well as K-12 private schools, and has expertise in securities law matters affecting all players in the municipal market.

Members of Orrick's Charter School Finance Group are shown on the contact list on the following page of this booklet.

## ORRICK CONTACTS

For further information about any of the topics discussed in this book, please contact one of the Orrick lawyers listed below.

### AUSTIN

Kathryn Garner  
+1 512 582 6941  
kgarner@orrick.com

### HOUSTON

Todd Brewer  
+1 713 658 6410  
tbrewer@orrick.com

Marcus Deitz  
+1 713 658 6420  
mdeitz@orrick.com

Hoang Vu  
+1 713 658 6430  
hvu@orrick.com

Kathryn Garner  
+1 713 658 6440  
kgarner@orrick.com

Amanda Stephens  
+1 713 658 6412  
astephens@orrick.com

### NEW YORK

Eileen Heitzler  
+1 212 506 5235  
eheitzler@orrick.com

Alison Radecki  
+1 212 506 5282  
aradecki@orrick.com

Helen Pennock  
+1 212 506 5321  
hpennock@orrick.com

Jennifer Grew  
+1 212 506 3782  
jgrew@orrick.com

### PORTLAND

Christine Reynolds  
+1 503 943 4821  
cereynolds@orrick.com

Michael Schrader  
+1 503 943 4840  
mschrader@orrick.com

### SAN FRANCISCO

Eugene Clark-Herrera  
+1 415 773 5911  
ech@orrick.com

Roger Davis  
+1 415 773 5758  
rogerdavis@orrick.com

Chas Cardall  
+1 415 773 5449  
ccardall@orrick.com

Christine Rankin  
+1 415 773 5907  
crankin@orrick.com

Steffi Chan  
+1 415 773 5441  
steffi.chan@orrick.com

### WASHINGTON, D.C.

Darrin L. Glymph  
+1 202 339 8401  
dglymph@orrick.com



**Orrick, Herrington & Sutcliffe LLP** [orrick.com/publicfinance](http://orrick.com/publicfinance)



AUSTIN HOUSTON LOS ANGELES NEW YORK ORANGE COUNTY PORTLAND SACRAMENTO  
SAN FRANCISCO SANTA MONICA SEATTLE SILICON VALLEY WASHINGTON DC

---

**National Alliance for Public Charter Schools** [publiccharters.org](http://publiccharters.org)

The National Alliance for Public Charter Schools is the leading national nonprofit organization committed to advancing the public charter school movement. The mission of NAPCS is to lead public education to unprecedented levels of academic achievement for all students by fostering a strong public charter school sector.

1101 15th Street, NW, Suite 1010  
Washington, DC 20005

T: +1 202 289 2700  
F: +1 202 289 4009

