Tax-Exempt Compound Interest Borrowings: A Case Study

Heather G. White

Abstract

School district debt in the form of bonds payable from real property taxes is a major source of financing for school facilities in the United States. Interest on these bonds is typically exempt from both federal and state income taxation and results in significant tax expenditures at both levels. Some school districts have turned to compound interest bonds known as capital appreciation bonds, or CABs, instead of or together with traditional current interest bonds, to finance facilities. CABs have become increasingly controversial in recent years, particularly in California, where legislation to limit their use recently was passed. This paper discusses the problems created by the use of CABs, then draws on the experiences of California school districts over the last several years as a case study to explore the political and practical reasons they are used. It then proposes means to better control their use.
Table of Contents

Introduction ................................................................................................................................... 1
Background ................................................................................................................................... 3
   An Introduction to Municipal Bonds .......................................................................................... 3
   Zero Coupon Bonds, Capital Appreciation Bonds and Convertible Capital Appreciation
   Bonds. ......................................................................................................................................... 4
   Use of CABs by California School Districts ............................................................................... 6
   Treatment of CABs in Financial Statements and Budgets .......................................................... 7
Problems Created by the Use of Capital Appreciation Bonds...................................................... 10
   CABs Cost More ....................................................................................................................... 10
   CABs Burden Future Generations ............................................................................................ 11
   Voters Don’t Understand What They Are Approving ............................................................... 14
   School Boards and Other Officials May Not Understand What They Are Approving ............. 16
   Disproportionate Federal and State Subsidies ......................................................................... 18
Reasons for the Use of CABs by California School Districts ....................................................... 19
   As A Component of An Overall Structure ................................................................................. 19
   Use to Avoid Violating Statutory Debt Limitations .................................................................. 21
   To Address Needs In Rapidly Growing Areas .......................................................................... 24
   To Address Needs in Areas Where Assessed Valuations Have Declined ................................. 26
   To Provide New or Modernized Facilities Without Increasing Taxes ...................................... 27
Potential Ways to Address Misuse of Capital Appreciation Bonds ................................................. 29
   Ban the Use of CABs Entirely .................................................................................................... 29
   Restrict the use of CABs .......................................................................................................... 32
   Increase Information Available to Public and School Boards .................................................... 34
   Count Accreting Interest Against Authorization ....................................................................... 37
   Requiring Collection of Property Taxes Throughout Life of CABs ......................................... 37
   Re-Evaluate Debt Limitations ................................................................................................... 39
Conclusion ................................................................................................................................... 41
Introduction

In 2012, a particular type of school district financing referred to as “capital appreciation bonds” or “CABs” began receiving a lot of attention in California, virtually all negative. The California State Treasurer and State Superintendent of Public Instruction issued a letter to all local educational agencies in California urging them not to issue any capital appreciation bonds until the State Legislature and the Governor completed their consideration of reform proposals.1 Grand juries in three California counties investigated the use of capital appreciation bonds in their counties and issued scathing reports.2 Newspapers ran articles with headlines like “Risky Bonds Tie Schools to Huge Debt”3 and “California Schools Finance Upgrades by Making the Next Generation Pay.”4 A measure (“AB 182”) was introduced in the California State Legislature and ultimately enacted into law that restricts the use of these bonds beginning in 2014.5

Unlike traditional current interest bonds issued by school districts, on which interest is paid periodically, interest on capital appreciation bonds (sometimes referred to as compound interest bonds) is added to principal (“accreted”) periodically. Such accreted interest itself bears interest until it is paid in a lump sum, together with principal, at maturity. Between 2007-2012, government entities in well over half the U.S. states, as well as the District of

---

5 AB 182 is discussed in greater detail under “Potential Ways to Address Misuse of Capital Appreciation Bonds – Restrict the Use of CABs,” infra.
Columbia and Puerto Rico, issued CABs. 6 Some estimate that at least 1,350 government agencies across the United States have issued them.7

After a brief introduction to the U.S. municipal bond market and to CABs in particular, this paper discusses some of the problems created by the use of capital appreciation bonds, particularly in the context of bonds payable from property taxes.8

This paper then draws on the experiences of California school districts over the last several years as a case study to explore how districts have used CABs and the political and practical reasons that they have used them. Because California is one of the states where capital appreciation bonds are issued most frequently9 and because California school districts are responsible for nearly all of the capital appreciation bonds issued in California,10 their experiences likely are representative of issuers of CABs generally.

Finally, this paper evaluates potential means to control the misuse of capital appreciation bonds. It concludes that some limitations on their use are appropriate and that the best solution is a combination of restrictions on the ability of school districts to issue capital appreciation bonds outside certain parameters (at least without additional external checks), increased education of school board members, availability of more information to the public and to school board members, and changes in the way that CABs are counted against bond authorization. The paper also suggests that requiring taxes to be collected to

---

6 Based on a review of the listing of bond issuances available on emma.msrb.org for the years 2007-2012.
8 Some municipalities issue CABs that are payable from sources other than property taxes, such as from their general funds or a specific revenue stream. While this paper focuses on CABs that are payable from property taxes, some of the same or similar issues apply to CABs payable from other sources as well.
9 Based on a review of the listing of bond issuances available on emma.msrb.org for the years 2007-2012 (Texas and Ohio also have numerous issuances of CABs). See also Lovett, supra note 4 (“Capital appreciation bonds have become especially popular in California and Texas, according to Fitch Ratings, which evaluates risks for bond investors.”).
pay accreting interest, at least up to specified amounts, may be desirable in addition to, or in lieu of, other limitations on the ability to issue CABs. In addition, because debt limitations cause issuers to use more costly instruments, like CABs, this paper suggests that these limitations be re-evaluated periodically.

Background

An Introduction to Municipal Bonds

State and local governments (also referred to herein as “municipalities” or “municipal issuers”) are responsible for constructing much of the public infrastructure in the United States. In 2007, total state and local government spending on infrastructure totaled $215 billion (as compared to $68 billion for the federal government).11 A great deal of the public infrastructure in the United States is financed through the issuance of state and local government debt, generally in the form of bonds.12 Between 1991 and 2007, approximately $1.3 trillion of tax-preferred debt proceeds were used by state and local governments to finance capital projects, over half of the total $2.3 trillion in capital spending on infrastructure by state and local governments during that period.13 In 2011, there was $3.7 trillion of state and local government debt outstanding, issued by close to 44,000 issuers.14 Approximately $355 billion of municipal securities were issued in 2011 alone.15 Municipalities issue both “new money bonds,” which generally finance capital projects, and “refunding bonds,” which refinance already outstanding bonds.

---

11 CONG. BUDGET OFFICE & JOINT COMM. ON TAXATION, SUBSIDIZING INFRASTRUCTURE INVESTMENT WITH TAX PREFERRED BONDS 5 (Oct. 2009).
12 The term “bonds” generally refers to debt securities with a maturity of greater than three years, though they can have a shorter term. MUN. SEC. RESERVE BD., GLOSSARY OF MUNICIPAL SECURITIES TERMS definitions of “Bond” and “Short Term or Short Term Range,” http://www.msrb.org/Glossary/Definition/BOND.aspx and http://www.msrb.org/glossary/definition/short-term-or-short-term-range.aspx (accessed Nov. 28, 2013).
13 CONG. BUDGET OFFICE & JOINT COMM. ON TAXATION, supra note 11, at 9. Tax preferred bonds include both tax exempt bonds and tax credit bonds.
15 Id. at 6 (Jul. 31, 2012).
The federal government reduces the cost to state and local governments of issuing debt by making interest earnings on such debt exempt from federal income tax under Section 103 of the Internal Revenue Code. In 2011, 90.6% of state and local government securities were issued on a tax-exempt basis.\textsuperscript{16} Tax-exempt bonds typically bear interest at a lower rate than taxable bonds of identical credit quality because the taxpayer receives the benefit of tax exemption. Interest on state and local government debt generally is also exempt from home state taxation.\textsuperscript{17}

State and local governments usually issue debt in the form of current interest bonds – that is, bonds on which interest is paid periodically (usually every 6 months). Most of the time, local government bonds are issued as a group (or “series”) of bonds with different maturities. Principal payments often vary from year to year but are usually paid over the life of a series of bonds. It is common for a series of bonds to include bonds that mature in consecutive years (“serial bonds”) and/or bonds that mature in a single year (“term bonds”) and to provide for mandatory deposits to a sinking fund over a period of years for mandatory redemption of the term bonds before maturity or, less frequently, to be used to make the full payment on the term bonds at maturity.

\textit{Zero Coupon Bonds, Capital Appreciation Bonds and Convertible Capital Appreciation Bonds}

Zero coupon bonds and capital appreciation bonds (sometimes referred to as compound interest bonds) were introduced in the municipal market as an alternative to current interest bonds in the early 1980s.\textsuperscript{18} Zero coupon bonds do not bear interest, and as a result sell at a substantial discount. At maturity, they pay at their face value and can offer

\begin{footnotes}
\item[16] Id. at 11. This was a return to historical levels after much higher levels of taxable municipal securities issuances in 2009 and 2010 due to the availability during those years of tax credit bonds such as Build America Bonds under the American Recovery and Reinvestment Act of 2009. \textit{Id.}
\end{footnotes}
substantial returns. Since earnings are, in effect, automatically reinvested, zero coupon bonds appeal to investors who believe that interest rates are likely to decline or who want the convenience of not having to reinvest their returns. Issuers of zero coupon bonds do not pay any debt service on the bonds until maturity, when the full amount is due, so may prefer to use them in circumstances where they anticipate having more funds available at the maturity date than they presently have.

However, zero coupon bonds are problematic for municipal issuers because in many instances there are limits on the amount of debt they can issue (for example, California school districts can only issue general obligation bonds up to a principal amount that has been authorized by voters and are also subject to other limitations, as discussed below under “Reasons for the Use of CABs by California School Districts – Use to Avoid Violating Statutory Debt Limitations”). While the issuer receives only a small percentage of the face amount of zero coupon bonds as proceeds (because they are sold at a deep discount), the full face amount counts against the issuer’s bond authorization.

Capital appreciation bonds are the functional equivalent of zero coupon bonds, but the earnings on them are characterized as compounded or accreted interest rather than as original issue discount. As a result, only the initial principal amount of these bonds is counted against the issuer’s bond authorization. This is far more advantageous to issuers. And unlike traditional current interest bonds, interest on capital appreciation bonds is not paid periodically, but instead accretes until maturity, at which time the issuer pays a single lump

---

20 Id. at 29.
21 Id. at 29.
sum to the investor. That is, interest is added to principal periodically (usually every six months), and then bears interest itself until it is paid at maturity.

Municipal issuers also utilize a hybrid of capital appreciation bonds and current interest bonds called “convertible capital appreciation bonds” or “convertible CABs.” Convertible CABs are issued at an initial principal amount and interest is added to principal until a specified date. Thereafter current interest is paid periodically (usually every six months) on the sum of the original principal amount plus the accreted interest, and the original principal amount and accreted interest are paid at maturity. The issues in this paper with respect to CABs also affect convertible CABs, though to a lesser degree.

A single transaction by an issuer may include only current interest bonds, only capital appreciation bonds or convertible capital appreciation bonds or a combination of types of bonds.

Use of CABs by California School Districts

The approximately 950 school districts in California finance many capital projects including new schools and renovations of existing ones by issuing bonds. In 2011, approximately $6.5 billion of bonds and notes were issued to finance or refinance K-12 school facilities in California.\(^{23}\) Approximately $5.4 billion of these were “general obligation bonds” issued by or for school districts.\(^{24}\) In 2011, school districts were responsible for approximately 73% of the $7.4 billion of general obligation bonds issued by local governments in California.\(^{25}\) These general obligation bonds are payable primarily from property taxes.\(^{26}\) School districts are also the most frequent issuers of capital appreciation

\(^{23}\) Based on analysis of data obtained from the California Debt & Investment Advisory Commission (on file with author).
\(^{24}\) Id.
\(^{25}\) Id.
\(^{26}\) A small portion of debt service on school district general obligation bonds is also payable from other sources such as federal tax credits. The State of California also issues “general obligation bonds” but these are payable from the state general fund, not property taxes assessed for the purpose of paying the debt.
bonds in California and were responsible for approximately 75% of the $1.7 billion of capital appreciation bonds issued in California in 2011.\textsuperscript{27}

California school districts must obtain voter approval in order to issue general obligation bonds. The regimes under which they can do this are discussed below under “Reasons for the Use of CABs by California School Districts – Use to Avoid Violating Statutory Debt Restrictions.”

\textit{Treatment of CABs in Financial Statements and Budgets}

California school districts are required to follow the standards of the Governmental Accounting Standards Board (“GASB”) in their audited financial statements.\textsuperscript{28} GASB requires that governments provide both fund financial statements and government-wide statements.\textsuperscript{29} Funds financial statements for governmental funds are prepared on a modified accruals basis and are more focused on the short-term and are prepared using a current financial resources measurement focus.\textsuperscript{30} Fund financial statements are intended to demonstrate whether resources were obtained and used in accordance with the entity’s budget and to demonstrate compliance with legal and contractual requirements.\textsuperscript{31} GASB also requires that governments provide government-wide statements consisting of a statement of net assets and a statement of activities that are prepared on an accruals basis and an economic resources measurement focus.\textsuperscript{32} Government-wide statements are intended to allow users to assess the condition of the entity as a whole and the extent to which interperiod equity is

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{27}] Based on analysis of data obtained from the California Debt and Investment Advisory Commission and from the State of California Treasurer’s Office (on file with author).
\item[\textsuperscript{28}] \textsc{Cal. Educ. Code §41010} (Deering 2013); School Fiscal Services Division, California Department of Education, California School Accounting Manual, 101-1 (2011).
\item[\textsuperscript{29}] \textit{Governmental Accounting Standards Bd., Statement No. 34, Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments ¶¶ 6, 7 (1999)} [hereinafter \textit{GASB Statement 34}].
\item[\textsuperscript{30}] Id. at ¶¶ 79 (1999). \textit{Governmental Accounting Standards Board, Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements, Interpretation No 6 ¶ 1 (Gov. Accounting Standards Bd. 2000)} [hereinafter \textit{GASB Interpretation No. 6}].
\item[\textsuperscript{31}] \textit{GASB Statement 34, supra} note 29, at ¶¶ 235-238. GASB also requires comparisons to budget for the general fund and each major special revenue fund that has a legally adopted annual budget. \textit{Id.} at ¶130.
\item[\textsuperscript{32}] \textit{Id.} at ¶¶ 6, 7, 12-16.
\end{itemize}
\end{footnotesize}
being achieved, among other things.\textsuperscript{33} GASB also requires a reconciliation to show the differences between the government wide statements and the fund statements.\textsuperscript{34} In addition, GASB requires notes to financial statements that include information about long-term liabilities.\textsuperscript{35}

Accreted interest on capital appreciation bonds is not treated as an expense under the modified accrual method and therefore does not appear on the fund statements until it is due; under this method, debt service expenditures on long-term general obligations are recognized when they mature, not when they accrue.\textsuperscript{36} In a 2010 article about the modified accrual basis, Robert Freeman and Craig Shoulders indicate that this is because “property taxes are typically levied for debt service in the year [debt] matures (‘when due’) and there is no appropriation in the current year for debt service coming due in the following fiscal year.”\textsuperscript{37} GASB notes in Statement 34 that “if a government issues fifteen-year debt to build a school, it does not collect taxes in the first year sufficient to repay the entire debt; it levies and collects what is needed to make that year’s required payments.”\textsuperscript{38}

However, accreted interest is reflected in the government-wide statements, which are prepared on an accruals basis. In fact, GASB uses accretions of deep-discount debt (such as zero coupon bonds, which are functionally the same thing as CABs) as an example of the limitations of the fund financial statements and the need for government-wide statements.\textsuperscript{39} The differences between the fund financial statements and the government-wide financial statements – such as the treatment of capital appreciation bonds – are explained in a required reconciliation. In addition, the notes to the financial statements are required to include detail

\textsuperscript{33} Id. at ¶¶ 232-34.
\textsuperscript{34} Id. at ¶ 77.
\textsuperscript{35} Id. at ¶¶ 116-119.
\textsuperscript{36} GASB INTERPRETATION NO. 6, supra note 30, at ¶ 13.
\textsuperscript{37} Robert J. Freeman and Craig D. Shoulders, Modified Accrual Decision-Useful and Accountability Centered, GOV’T FIN. REV. 18, 26 (August 2010).
\textsuperscript{38} GASB STATEMENT 34, supra note 29, at Preface – Retaining the Familiar.
\textsuperscript{39} Id. at ¶ 225.
about long term liabilities (such as bonds) including balances, increases or decreases, and what portion of each item is due within one year. Thus, information about the accretion of interest on capital appreciation bonds is available in the financial statements, but is not immediately apparent to a reader who focuses only on the fund financial statements.

The full impact of capital appreciation bonds likely is not taken into account in school district budgets. Most school districts operate on a year to year basis. In California, school districts are required to prepare and adopt a budget for the following fiscal year in the form provided by the State Superintendent of Public Instruction. In addition, school districts file two interim budget reports every year; each interim report must include a certification regarding the district’s ability to meet its financial obligations for the current and subsequent two fiscal years. Further, state-developed criteria for reviewing school district budgets and interim reports only focus on payments due in the current and two following fiscal years. While each county superintendent of schools is required to determine whether the budget for each school district in the county will allow the district to meet its obligations during the fiscal year and is consistent with a plan that will enable to the district to satisfy its multiyear commitments, it is unlikely that CABs that are not payable for many years would be an impediment to this determination even if the superintendent looked out more than two years, particularly since under California law property taxes are required to be collected sufficient to pay those amounts when due.

---

40 Id. at ¶ 119.
42 CAL. EDUC. CODE §§ 42126, 42127 (Deering 2013).
45 CAL. EDUC. CODE § 42127 (Deering 2013).
46 CAL. EDUC. CODE § 15250 (Deering 2013).
Problems Created by the Use of Capital Appreciation Bonds

The use of capital appreciation bonds gives rise to a number of problems, including increased costs and the transfer of the debt burden to future generations. In addition, capital appreciation bonds may be issued without voters or school board members fully understanding their implications, or even being aware that CABs are being issued. These problems give cause for concern that school districts issuing CABs are receiving disproportionate federal and state subsidies relative to those that are issuing traditional current interest bonds.

CABs Cost More

Interest rates are usually higher on CABs than on current interest bonds because investors demand a higher spread on these bonds due to their perceived increased risk.47 CABs may be perceived as riskier both because payments aren’t received until at or near maturity and because in today’s low interest rate environment investors expect that they will be able to invest interest earnings at higher rates.48 One municipal financial advisor noted in a May 2012 presentation that the interest rate differential between current interest bonds and capital appreciation bonds was near historic highs at that time.49 At a California Senate Committee on Education hearing held on June 26, 2013, the Assistant Treasurer of Kern County noted that a long-term capital appreciation bond carries a premium of between 0.75% and 2.00% over a current interest bond with a similar maturity.50

48 When CABs were initially introduced, interest rates were so extraordinarily high that CABs actually bore interest at lower rates than current interest bonds. See, e.g., Quint, supra note 18, at D7; Metz, supra note 18, at D8.
In addition, the interest on CABs compounds over many years, which also increases the overall cost, though not – absent the higher interest rates described in the preceding paragraph – the present value of the stream of debt service payments. While commentators have slightly different estimates, they generally indicate that issuers pay back $2 to $3 on every $1 borrowed using current interest bonds. The amount paid for every dollar borrowed can be much higher for capital appreciation bonds. According to a bill analysis of AB 182 prepared for the Senate Governance and Finance Committee in July 2013, CABs have debt service to principal ratios ranging from 3.5 to 1 all the way to 23 to 1. A bill analysis of AB 182 prepared for the Assembly Committee on Education noted that one school district had a ratio of total debt service to principal of 23.4 to 1 and would have to pay $6.6 million in debt service for the $238,600 of proceeds that it had received.

**CABs Burden Future Generations**

Payments on CABs are not made until at or (in the case of capital appreciation bonds subject to mandatory sinking fund redemption) near maturity. California school districts typically do not make regular deposits into a debt service fund to pay debt service coming due far in the future. Prior to the effectiveness of AB 182, California school districts could issue capital appreciation bonds that would not be paid for up to 40 years. Following the passage of AB 182, capital appreciation bonds must mature within 25 years.

---


54 Cal. Gov’t Code § 53508(f) (Deering 2013).

55 A.B. 182, §6, 2013-14 Reg. Sess. (Ca. 2013). Note that a one time waiver may be granted for districts that are refinancing bond anticipation notes issued before Dec. 31, 2013 if certain conditions are met. Id. at §4.
For capital appreciation bonds that do not mature for many years, it is likely that the
voters and school board members who are authorizing the bond issuances today, and whose
children will benefit from the new or renovated facilities, will not actually pay the debt
service on the bonds. As California Treasurer Bill Lockyer is quoted as saying, “The average
tenure of a school superintendent is about three and a half years, so they aren’t going to be
around in most instances to worry about paying that off. Nor will the voters, probably, that
enacted it in the first place.”\(^{56}\) Furthermore, by the time the debt service is due, the facilities
that had been financed will be old and possibly in need of replacement or renovation. This
raises interperiod or intergenerational equity issues. In addition to the risk of substantially
higher property taxes to pay off the debt, future generations bear the risk that future debt
capacity will be constrained.\(^{57}\)

One of the arguments in favor of financing capital projects with bond proceeds is that
doing so is equitable. It spreads the cost of the project over the facility’s useful life, so all of
its users, not just the present taxpayers, pay for the facility.\(^{58}\) Long term capital appreciation
bonds, however, take this to the opposite extreme, burdening only future taxpayers but not
present ones. Richard Briffault suggests that one of the reasons that constitutional debt
restrictions have been put into place is as a means of “reconciling the conflict between the
short-term and long-term interests that debt generates,” noting that elected officials may incur
too much debt when the benefits of the project will be received immediately but the debt will
not have to be paid until sometime in the future.\(^{59}\) James Guthrie and his co-authors noted
that the intent of debt limitations is to “prevent present voters from saddling future residents

---


\(^{59}\) Briffault, *supra* note 58, at 917.
with unmanageable debt." The Governmental Accounting Standards Board similarly noted in Concepts Statement No. 1 that balanced budget requirements and debt limitation statutes are intended to achieve interperiod or intergenerational equity, but that they don’t always work and that one of the roles of financial reporting is to help users to assess whether future taxpayers will be burdened for today’s benefits.

If the future cost of capital appreciation bonds were fully capitalized into real estate values, future homeowners would not bear a disproportionate burden as a result of the issuance of CABs. Current home values would be reduced by the anticipated cost of paying the debt service, as well as being increased by the current benefits of the facilities being financed. In a 2004 article, Clayton Gillette notes that the more that debt is capitalized into home values, the more the interests of current homeowners are aligned with the interests of future homeowners. He goes on to note that many scholars have looked at whether property taxes are capitalized into home values and have reached varying conclusions, though it appears that some capitalization occurs.

Even if property taxes are fully capitalized in some circumstances, it seems unlikely that the possibility of higher future property taxes as a result of the debt structure utilized by a school district would be fully capitalized into the value of the home. Darien Shanske concluded in a 2007 article that despite some findings of others to the contrary, it is unlikely that Mello Roos taxes are fully capitalized. It is even less likely that the debt structure of the school district would be fully capitalized. Notices of Mello Roos assessments are recorded as a special lien and would be found in a title search, while a school district’s debt

60 GUTHRIE ET AL, supra note 41, at 254.
61 GOVERNMENTAL ACCOUNTING STANDARDS BOARD CONCEPT STATEMENT NO 1, ¶ 59-61, 82-87. Accounting treatment of capital appreciation bonds is discussed in greater detail under “Background – Treatment of CABs in Financial Statements and Budgeting,” supra.
63 Id. at 392.
65 CAL. GOV’T CODE § 53328.3 (Deering 2013), CAL. STS. & HIGH. CODE §§ 3114.5, 3115.5 (Deering 2013).
would not be reflected in title search results and therefore would be less likely to be known by a buyer. Furthermore, even if the debt structure and projected tax rates were known to the buyer, he or she would have to access school district board meeting materials and/or ballot materials to know the assumptions on which the projected tax rates were based and he or she would have to independently evaluate the assumptions to determine likelihood that the actual tax rate would be higher or lower. In addition, even if a buyer were aware of the outstanding capital appreciation bonds and the possibility of higher tax rates in the future, it is by no means certain how that buyer would factor that information into the price they were willing to pay for the home, particularly if the buyer did not anticipate owning the home at the time that taxes would be collected to pay the debt service on the bonds.

Voters Don’t Understand What They Are Approving

General obligation bonds issued by school districts in California must be authorized by the voters of the district.66 The San Diego County Grand Jury found that “often voters are not provided useful information regarding financial costs and payback terms essential to making informed decisions when asked to pass a school bond measure.”67 Voters approving a bond issue generally have little information about the proposed bonds immediately available to them as they vote. The summary of the measure on the ballot itself is limited to 75 words.68 It typically includes the principal amount of the bonds to be authorized, a statement that the interest rate will be within legal limits and general information about the types of facilities to be financed. Voters are also sent, along with a sample ballot, a pamphlet containing the full text of the bond measure, an impartial analysis of the measure not in excess of 500 words,69 and, if submitted, one argument in favor of and one against the

66 For further discussion, see “Reasons for the Use of CABs by California School Districts – Use to Avoid Violating Statutory Debt Restrictions.”
67 SAN DIEGO COUNTY GRAND JURY, supra note 2, at 1.
68 CAL. ELEC. CODE §§ 13247, 9051(b) (Deering 2013).
69 CAL. ELEC. CODE § 9500 (Deering 2013).
measure (not to exceed 300 words)\textsuperscript{70} and one rebuttal to each of those arguments (not to exceed 250 words).\textsuperscript{71} In addition, a statement is mailed to all voters that includes the estimated tax rate for the bonds in the first year after bonds are issued, the last year that bonds are issued and the in the year where the rate is estimated to be highest.\textsuperscript{72}

None of the over 200 school district bond measure summaries on ballots in California in 2010, 2011 or 2012 included any mention of capital appreciation bonds or any specific information about the anticipated structure of the debt.\textsuperscript{73} Based on a review of the materials for the 14 school district bond measures that were on the November 6, 2012 ballot in Los Angeles County,\textsuperscript{74} none of the impartial analyses, the arguments for or against measures or the rebuttals addressed the proposed structure of the transactions with any specificity or mention whether capital appreciation bonds were or were not included in the proposed transactions. The tax rate analyses for these bond measures did not describe in any detail the assumptions about transaction structure and assessed valuation growth on which they were based, other than indicating the last year in which bonds were expected to be issued (which ranged from fiscal year 2012-13 through fiscal year 2027-28).\textsuperscript{75} This is not surprising given that bonds typically are issued over a period of several years and that the structure and timing of the transaction(s), including the decision of whether or not to issue CABs, will be affected by capital needs, market conditions and assessed valuations at the times the bonds are issued.

\textsuperscript{70} CAL. ELEC. CODE §§ 9501, 9503 (Deering 2013).
\textsuperscript{71} CAL. ELEC. CODE § 9504 (Deering 2013).
\textsuperscript{72} CAL. ELEC. CODE § 9401 (Deering 2013).
\textsuperscript{73} Based on data from Institute for Social Research, Center for California Studies, California State University, Sacramento, California County, City and School District Election Outcomes, 2010 Elections, School District Offices and Ballot Measures [hereinafter 2010 Election Outcomes]; Institute for Social Research, Center for California Studies, California State University, Sacramento, California County, City and School District Election Outcomes, 2011 Elections, School District Offices and Ballot Measures [hereinafter 2011 Election Outcomes]; and Institute for Social Research, Center for California Studies, California State University, Sacramento, California County, City and School District Election Outcomes, 2012 Elections, School District Offices and Ballot Measures [hereinafter 2012 Election Outcomes], all available at http://www.sos.ca.gov/elections/county-city-school-district-election-results/.
\textsuperscript{74} Review of data available at http://www.smartvoter.org/2012/11/06/ca/la/meas/.
\textsuperscript{75} Id.
Thus, voters authorize a specified amount of bonds to be issued for specified projects and these bonds are generally issued in multiple issuances over a period of several years. Capital appreciation bonds are counted against the authorized amount based on their initial principal amount, not including interest that accretes over the life of the bonds. This is consistent with the Municipal Securities Rulemaking Board’s definition of “Capital Appreciation Bond,” which states that “… only the initial principal amount of a CAB would be counted against a municipal issuer’s statutory debt limit, rather than the total par value ….” However, since accreted interest bears interest just like the initial principal amount does, and since interest on CABs is treated as a liability in government wide financial statements (though not fund financial statements) just like accreted original issue discount on zero coupon bonds (the full face amount of which is counted against bond authorization), it is likely that voters would expect that it counts against the bond authorization.

_School Boards and Other Officials May Not Understand What They Are Approving_

It is also likely that at least in some instances, school boards do not understand what capital appreciation bonds are, what their impact is or even that capital appreciation bonds are being issued. Most school board members likely do not have the experience and background to understand the impact of capital appreciation bonds, at least not without explanation and guidance from district officials and outside financial advisors. While school district board members frequently are committed, intelligent, educated individuals who work hard for their school districts, under California law anyone who is at least 18 years old, a citizen of California, a resident of the school district and a registered voter, and who is not disqualified

---

under the California Constitution or state law from holding civil office, is eligible to be elected or appointed as a member of a school board.\textsuperscript{77}

Further, in at least some cases, school boards are presented with bond resolutions that authorize the issuance of current interest bonds, capital appreciation bonds and/or convertible capital appreciation bonds, and they delegate to their authorized officers the decision of precisely which type of bonds will be issued, the term of the bonds (within specified parameters) and the interest rates on the bonds (within specified parameters). In some instances, final decisions are not made about the structure of the bond issue until the bonds are priced, which occurs after the board has approved the transaction.

In a letter to the Chair of the Senate Education Committee supporting AB 182, California State Treasurer Bill Lockyer noted that school board members and the public are not always fully informed about the total costs and risks associated with CABs.\textsuperscript{78} This is consistent with statements by some school board members that they could not recall approving CABs or were not aware of the impacts of issuing CABs.\textsuperscript{79}

Similarly, school district officials may not have the experience to understand the full impact of CABs, at least without guidance from outside financial advisors. Monique Moyer, public finance director for the City and County of San Francisco, noted in a 2003 article that most cities and counties have few resources dedicated to debt management and that their external financial advisors frequently know more about bonds, and even about the issuer’s own debt portfolio, than the issuers do.\textsuperscript{80} Bill Simeon, Mark Robbins and Lee Helgerson noted in a 2001 article that smaller communities tend to have smaller financial staffs, often

\textsuperscript{77} CAL. EDUC. CODE § 35105(a) (Deering 2013).
\textsuperscript{78} Letter from Bill Lockyer, Treasurer, State of California, to Carol Liu, Chair, Senate Education Committee (May 28, 2013) (on file with author).
\textsuperscript{80} Monique Moyer, Current Issues Facing Bond Issuers and Their Financial Advisors, MUN. FIN. J. 17, 18 (2003).
generalists with less technical training than larger communities, and that the differences in capacity are likely to be more pronounced in debt administration. They found in an empirical study of municipal bond sales in Oregon that small communities pay higher interest rates on their general obligation bonds than larger communities, all else being equal, and that this is particularly true for communities under 10,000 and under 5,000 people. The same likely holds true of school districts, especially small ones, and particularly when evaluating a more complex and unusual financing structure such as CABs. Of the approximately 950 school districts in California, approximately 375 have fewer than 1,000 students and approximately 655 had fewer than 5,000, while only approximately 160 have more than 10,000 students.

Disproportionate Federal and State Subsidies

As noted above, interest on most local government obligations is exempt from federal taxation. Interest on local government obligations is also generally exempt from home state taxation. The federal and state governments are foregoing revenues they otherwise would have taken in. Thus, the tax-exempt nature of local government bonds is, in effect, a federal and state subsidy of local government debt. Because the total amount of interest on CABs is so much higher than on current interest bonds as a result of both the higher rate of interest on CABs and the compounding of that interest, the subsidy is higher for school districts that issue CABs than those that do not. This creates equity issues between districts and may even mean the federal and state governments are encouraging use of CABs (or at least not discouraging their use). Given the issues discussed above, this is problematic.

82 Id. at 713-14.
Reasons for the Use of CABs by California School Districts

This section discusses some of the reasons that California school districts use capital appreciation bonds. Many of these reasons are inter-related. For example, much of the reason that capital appreciation bonds are used in areas where assessed valuations have declined is that those areas face challenges completing their capital development programs while complying with statutory debt limitations.

As A Component of An Overall Structure

Some school districts issue capital appreciation bonds in order to meet particular structuring needs, such as trying to achieve a relatively level tax burden over time, trying to take advantage of types of debt that are only available for a limited time and even trying to achieve lower overall debt service.

According to an EdSource Today article, school districts issuing bonds typically endeavor to impose a relatively level tax burden over time.84 This can be complicated, particularly when newly issued bonds are structured around existing bonds to maintain relatively level debt service and “…. often requires both CABs and [current interest bonds] to make the math work ….,”85 Similarly, the Manual of Accounting and Financial Reporting for Pennsylvania Public Schools indicates that “CABs are used in wrap-around financing when the traditional current interest bond structure cannot accommodate a wrap-around debt structure.”86 (Wrap around financing refers to structuring around debt service on the district’s current debt so that overall debt service remains level.)

85 Id.
In a presentation sponsored by the California State Debt and Investment Advisory Commission and given by two prominent municipal financial advisors, the advisors noted that usually CABs are included in a structure with current interest bonds and that in some instances using some capital appreciation bonds allows issuers to achieve lower overall debt service because issuing CABs would allow the rest of the bonds to be issued as shorter-term current interest bonds and to take advantage of an upward sloping yield environment.87

More than 80% of the issuances of CABs and/or convertible CABs by California school districts in 2011 were part of a transaction that also included current interest bonds.88

School districts may also issue capital appreciation bonds in circumstances where they feel there are long term benefits to issuing bonds quickly. For example, California school districts had six months after allocation to issue Qualified School Construction Bonds (which are issued by districts on a taxable basis and for which the district receives a payment from the federal government covering a portion of the interest cost).89 Similarly, districts that wanted to issue Build America Bonds (which are also issued on a taxable basis and for which the district receives a payment covering a portion of the interest cost) had to do so before the end of 2010 when the program expired.90 Districts also may issue CABs to take advantage of market conditions such as low interest rates generally or low construction costs. When school districts (correctly or incorrectly) see a compelling need to issue bonds quickly, they are particularly likely to issue CABs if they would otherwise be prevented from issuing bonds by debt limitations.

88 Based on analysis of data obtained from the California Debt & Investment Advisory Commission (on file with author) and official statements available at emma.msrb.org.
Use to Avoid Violating Statutory Debt Limitations

Fitch Ratings, one of the three entities providing credit ratings on municipal bonds, noted in an August 2012 article that “by delaying repayment, CABs provide a financing vehicle when tax rate or debt level restrictions would prevent the issuance of current interest bonds” and indicated that tax rate limits, combined with growing enrollments and stagnant or declining assessed valuations, are one of the primary reasons for increased CABs issuances in California. 91 State Constitutional and statutory limitations on the ability of local governments to issue debt are common. Generally, these include limits on the amount of debt that can be outstanding and procedural restrictions such as requiring supermajority approval by voters and/or legislative bodies. 92 For example, according to Clayton Gillette, approximately 27 states have constitutional restrictions alone requiring a vote of the electorate prior to the issuance of local government debt. 93

In California, school districts can obtain two types of voter authorization to issue general obligation bonds. One process requires that 2/3 of the voters in a school district authorize the issuance of bonds by the district (the “Traditional Authorization”). 94 The second process requires that the district obtain the approval of 55% of the voters (the “Proposition 39 Authorization”). 95 Obtaining the approval of 55% of the voters is much easier than obtaining approval of 2/3 of the voters. David Gamage and Darien Shanske note in a 2013 article that in the first eight years after the implementation of the 55% regime, the number of school bond measures on ballots in the state more than doubled and almost half of the principal amount of bonds approved would not have been approved but for the lower

91 Fitch Ratings, supra note 57.
92 Briffault, supra note 58, at 916.
93 Gillette, supra note 62, at 370.
94 See CAL. CONST. art. XIII A, § 1(b)(2), art. XVI, § 18(a) (Deering 2013), CAL. EDUC. CODE § 15100 et seq. (Deering 2013).
95 See CAL. CONST. art. XIII A, § 1(b)(3), art. XVI, § 18(b) (Deering 2013), CAL. EDUC. CODE § 15264 et seq. (Deering 2013).
As a result, virtually all recent voter authorizations for bonds have been obtained as Proposition 39 Authorizations.97

School districts are subject to debt limitations under both of these processes. Regardless of which authorization method is used, elementary and high school districts are subject to a cap on the total principal amount of outstanding general obligation bonds equal to 1.25% of assessed valuation of property in the district and unified school districts are subject to a cap of 2.50% of assessed valuation of property in the district.98 In addition, school districts are limited to the principal amount of bonds that voters have approved. Bonds approved under a Proposition 39 Authorization are subject to the additional limitation that they may be issued only if debt service on bonds approved at a single election is not expected to exceed $30 per $100,000 of assessed valuation in any year for elementary and high school districts and $60 per $100,000 for unified school districts.99 The 1.25%/2.50% caps can be – and in fact are – waived by the California State Board of Education.100 However, the California Department of Education will only recommend approval if the $30/$60 projected tax rate limits are not violated because they assume that the average voter is unaware that these limits could be waived and because of concerns about the likelihood that a waiver of these limitations could adversely affect the success of future school district bond measures.101 Since the projected tax rate limit applies to each election, school districts can, of course, go back to voters if they wish to exceed this limit (and in fact at least 10 school districts successfully had voters reauthorize previously authorized bonds, thus achieving this, this in

97 Based on data from 2010 ELECTION OUTCOMES, 2011 ELECTION OUTCOMES and 2012 ELECTION OUTCOMES, supra note 73, only 5 of the 232 school district general obligation bond measures on the ballot in 2010, 2011 and 2012 were seeking Traditional Authorization.
98 CAL. EDUC. CODE §§ 15102, 15106, 15268, 15270 (Deering 2013).
99 CAL. EDUC. CODE §§ 15268, 15270 (Deering 2013).
100 At the May 8-9, 2013 California State Board of Education meeting, seven school districts requested and were granted waivers of the 1.25%/2.50% limitations. See Calif. State Bd. of Educ., Final Minutes, May 8-9, 2013, available at http://www.cde.ca.gov/be/nt/ms/.
but districts may be reluctant to seek voter approval, especially in hard economic
times.

School districts use capital appreciation bonds in order to be able to issue debt while
staying within these limitations, primarily the $30/$60 projected tax rate limits. Interest
accretes on CABs and is not actually paid until at or near maturity. Since taxes are not
collected to pay the accreted interest until near the time it is payable, accreted interest is not
reflected in the calculation of projected tax rates until at or near maturity of the CABs. As a
result, districts are able to take expected growth in assessed valuations into account in making
the projections. In addition, districts that are concurrently issuing or already have issued
current interest bonds that are projected to result in tax rates at or near the limits in the near-
term would not be able to issue additional current interest bonds without violating the
projected tax rate limits, but can structure CABs or convertible CABs so payments are not
made until after debt service on the current interest bonds ends or declines. In addition,
unlike zero coupon bonds, only the initial principal amount of the CABs (not the maturity
value) is counted against the 1.25%/2.50% overall general obligation debt limit caps and the
voter authorization.

James Guthrie and his co-authors noted in School Finance and Education Policy:
Enhancing Educational Efficiency, Equality and Choice that both rapidly growing districts
and property-poor districts in particular may be impeded by debt limitations. Eric Brunner
and Kim Rueben indicated in a 2001 article that the 1.25% and 2.5% debt limitations
specifically were likely to constrain districts with lower property values.

---

102 Based on data from 2012 ELECTION OUTCOMES, supra note 73.
103 GUTHRIE ET AL., supra note 41, at 254.
104 Eric J. Brunner & Kim Rueben, Financing New School Construction and Modernization: Evidence from
have focused on the additional restrictions under Proposition 39 Authorizations since this form of authorization
was not available until November 2000.
Districts with declining assessed valuations and even districts where assessed valuations have not continued to increase as previously projected may be similar to lower property value districts in being constrained by debt limitations and likely are utilizing CABs to continue to issue debt and build the facilities that their voters expect without violating debt limitations. The County of Los Angeles Treasurer alluded to debt limitations as a reason that school districts issue capital appreciation bonds in a May 16, 2011 white paper when he recommended (referring to the $30/$60 projected tax rate limitations) that “Unless a district is certain to exceed its Proposition 39 tax rate limits, it should not consider the issuance of CABs.”105 Similarly, the Assembly Floor Analysis of AB 182 noted that CABs became more popular after the housing downturn and indicated that declining assessed valuations coupled with the projected tax rate limitations are the reason for this.106 Texas school districts also have indicated that they need to issue capital appreciation bonds because the state limits debt service to $0.50/$100 of assessed valuation.107

To Address Needs In Rapidly Growing Areas

Another reason that school districts may issue capital appreciation bonds is that they are growing. This growth could take either of two forms, which may be but are not necessarily related – growing enrollments and growing assessed valuations.

Rapidly growing districts need to construct additional school facilities to accommodate increasing enrollments. Fitch Ratings, one of the three entities providing credit ratings on municipal bonds, noted in an August 2012 article that the issuance of capital

---

appreciation bonds is particularly common in rapidly growing areas, explaining that “For rapidly growing areas, the primary appeal is that needed capital improvements can be funded immediately, but the repayment burden is shared with the larger future population.” An analyst for Moody’s, another of the entities rating municipal bonds, similarly noted in 2007 that “districts that use capital appreciation bonds are usually experiencing high growth.” Similarly, both the House Committee Bill Analysis and the Senate Committee Bill Analysis of Texas Senate Bill 449, which would have imposed limits on the ability of governmental entities in Texas to use CABs, noted that CABs are typically used by school districts where there is an immediate need for development due to an expanding population. While in a 2001 article, Eric Brunner and Kim Rueben noted that the correlation between general bond revenues and enrollment growth was weak (in fact, general obligation bond revenues were lowest in the fastest growing 20% of districts), this may be because these districts were receiving greater amounts of state aid. For districts that issue general obligation bonds at all, it is likely that rapidly growing districts are more likely to issue capital appreciation bonds because they expect a growing population to support these bonds in the future.

Capital appreciation bonds may also be more likely to be used in districts that are experiencing growth in assessed valuations. This may be in part because such districts have growing populations and/or expect to have growing populations. But it may for other reasons as well. There is a link between higher assessed valuations and general obligation bond issuances generally. Eric Brunner and Kim Rueben found in a study of California school districts that there is a strong relationship between general obligation bond revenue and assessed valuation per pupil, with districts having higher assessed valuations also having

---

108 Fitch Ratings, supra note 57.
111 Brunner & Rueben, supra note 104, at 535.
112 See id. at 535.
higher general obligation bond revenues.\textsuperscript{113} This does not appear to be as a result of disparities in state aid, which vary depending on assessed valuations, but not in a way that appears to correlate state aid with lower assessed valuations (for example, the 20% of districts with the highest assessed valuation per pupil actually receive more state aid than those in the second highest 20%).\textsuperscript{114} It is possible that this link extends to districts that expect assessed valuation to grow, and in those cases capital appreciation bonds may be a more attractive option for the district. Even a flyer for a November 28, 2012 webinar presented by the California Debt and Investment Advisory Commission noted that “CABs make sense when revenues are expected to increase” (while also noting that problems may arise if they do not),\textsuperscript{115} presumably because the expectation is that there will be a larger tax base supporting the bonds when debt service is due and as a result the debt service will comprise a lower percentage of assessed valuations.

The interplay between capital needs caused by growing enrollments, current assessed valuations and the debt limitations discussed above almost certainly also plays a role in the decision of rapidly growing districts to issue CABs.

\textit{To Address Needs in Areas Where Assessed Valuations Have Declined}

In the recent economic downturn, many California school districts experienced declines in assessed valuations. After growth in every year since at least fiscal year 1989-1990 and particularly high rates of growth in fiscal years 2005-06 and 2006-07, statewide net assessed valuations (gross assessed valuations net of exemptions) declined 2.35\% in fiscal year 2009-10 and 1.77\% in fiscal year 2010-11 before stabilizing in fiscal year 2011-12.\textsuperscript{116}

\begin{thebibliography}{11}
\bibitem{113} See Id. at 536-37.
\bibitem{114} Id. at 537 (2001).
\end{thebibliography}
The impacts varied dramatically between regions. For example, in fiscal year 2010-11, 48 out of 58 counties experienced reductions in net assessed valuation from the prior fiscal year and changes ranged from an increase of 4.67% in Kern County to a decrease of 12.14% in Calaveras County.117

The California Senate Governance and Finance Committee analysis of AB 182 noted that “Over the last five years, school districts have increasingly resorted to the use of capital appreciation bonds (CABs) due to the housing downturn and low assessed valuations. CABs allow higher levels of borrowing by deferring payment of principal and interest for up to 40 years, with the anticipation that property values will increase substantially by the time the bonds are due.”118 In part, this may be because, like districts with rapidly growing assessed valuations, districts that have experienced recent, often unprecedented, declines in real estate values reasonably expect that assessed valuations will increase and that the property tax rate will not have to be increased, or at least will not have to be increased substantially, in the future to pay the debt service on the bonds. However, the more significant reason that districts that have experienced recent declines in assessed valuations utilize CABs is the impact of such reduced assessed valuation on the ability of issuers to otherwise stay within the debt limitations discussed above.

To Provide New or Modernized Facilities Without Increasing Taxes

Even where debt limitations aren’t an issue, school districts sometimes use capital appreciation bonds to provide new or modernized facilities now while avoiding political fallout of increasing taxes. Some of the incentives for this are discussed above under “Problems Created by the Use of Capital Appreciation Bonds – CABs Burden Future Generations.” As Jackson Flanigan and his co-authors note in a 1995 book on school

---

bonding, “Officials of a community, because of the negative attitude of its citizens, sometimes hesitate to present new tax requests to the electorate. In order to keep taxes low, they postpone maturity dates for the principal for long periods of time.” Capital appreciation bonds take this to a greater extreme, postponing interest payments as well as principal payments for long periods of time. Moody’s is reported to have indicated in 2007 that school districts issue capital appreciation bonds not only because they are trying to stay within statutory debt limitations, but also because they are often asked by taxpayers to build new schools and maintain low student-to-teacher ratios without significantly increasing taxes.120

California has a history of voter resistance to tax increases, and to property tax increases in particular.121 Most notably, Proposition 13, a ballot initiative that reduced property taxes in California and imposed strict limitations on the ability to increase property taxes, was passed by the electorate in 1978. Following the passage of Proposition 13, local governments in California, including school districts, were not able to issue general obligation bonds until the Traditional Authorization option was implemented in 1986. One quarter of the school district bond measures on local ballots in California in 2010 included language promising no increase in taxes.122 Napa Valley Unified School District reportedly issued capital appreciation bonds in order to keep tax rates below the $36/$100,000 (well below the $60/$100,000 projected tax rate limit for unified school districts) promised to the

119 JACKSON L. FLANIGAN, MICHAEL D. RICHARDSON & DEWEY H. STOLLAR, MANAGING SCHOOL INDEBTEDNESS: A COMPLETE GUIDE TO SCHOOL BONDING 83-84 (2d ed. 1995)
120 Shields supra note 109.
121 Resistance to tax increases is not unique to California. See, e.g., Kirk J. Stark, The Right to Vote on Taxes, 96 NW. U. L. REV. 191, 203-206 (2001). James Guthrie and his co-authors suggest that taxpayers are particularly resistant to higher property taxes even though they are more supportive of state and federal funding for schools (which are, of course, paid from other types of taxes). They suggest that this may be because of the “fiscal illusion” that they are getting something for nothing. GUTHRIE ET AL, supra note 41, at 86.
122 Based on data from 2010 ELECTION OUTCOMES, supra note 73. Notably there were significantly fewer measures containing such language in 2012 based on 2012 data available at the same website. This type of language in a ballot measure does not mean that property tax rates cannot be increased if required to pay debt service on bonds.
voters. Similarly, a San Diego Unified School District school board member indicated that the reason he had voted in favor of a capital appreciation bond issuance was because the only way to keep a prior board’s promise of no tax increases was to refinance outstanding debt with capital appreciation bonds. 

It also appears that concern about keeping tax rates low was one of the reasons amendments to California Government Code bond issuance provisions were passed in 2009, in the wake of the financial crisis, making it easier for school districts to issue longer term capital appreciation bonds. While capital appreciation bonds were not specifically mentioned in the analysis of the relevant bill, the Governor’s Office of Planning and Research enrolled bill report indicated that the requirement for substantially level debt service (which was eliminated by the bill) “means issuers cannot use increasing property values to keep property taxes at their lowest possible rate through final maturity of the bonds.”

Potential Ways to Address Misuse of Capital Appreciation Bonds

This paper now turns to how to best address the problems created by CABs and considers several alternatives.

Ban the Use of CABs Entirely

One means of eliminating the misuse of CABs is to ban their use entirely. For example, school districts in Michigan were banned from issuing capital appreciation bonds in 1994 by Public Act 278 (Senate Bill 164), which prohibited school districts from issuing

---

123 Bundy & Shifflett, supra note 7.
125 Among other things, these amendments eliminated the requirement that bonds issued under the relevant Government Code provisions have substantially level debt service. A.B. 1388, 2008-09 Reg. Sess. Leg. Counsel’s Digest (1) and §1 (Ca. 2009). The result was that school districts could issue capital appreciation bonds with maturities going out 40 years rather than only 25.
bonds that appreciate in principal amount or are sold at a discount of more than 10%. In February 2013, California State Senator Anderson introduced Senate Bill 685, which provided that “It is the intent of the Legislature to enact legislation that prohibits a school district from issuing capital appreciation bonds.” The bill was referred to the Rules Committee but did not progress beyond that point.

Banning capital appreciation bonds entirely would likely require some kind of alternative financing arrangements for some districts, particularly those with rapidly growing enrollments and those with low assessed valuations and aging infrastructure. These districts are more likely than others to be unable to issue bonds to pay for needed facilities without violating debt limitations.

In new developments, developer fees are one alternative, and property taxes imposed within the new development with the approval of the developer are another. California school districts are authorized to levy fees on developers for construction within their district for the purpose of funding construction of reconstruction of school facilities. In addition, the Mello-Roos Community Facilities Act of 1982 allows local governments in California, including school districts, to form “community facilities districts” within their boundaries and to impose additional taxes on real property in those districts with the approval of the voters or, in the case of a district where there are fewer than 12 registered voters, with the approval of the landowners voting on the basis of acres owned. It is common for California developers to encumber their land with Mello-Roos taxes. However, these financing methods are only effective in areas with new developments.

127 MICH. COMP. LAWS. SERV. § 380.1351b (LexisNexis 2013).
129 CAL. EDUC. CODE § 17620 (Deering 2013).
131 CAL. GOV’T CODE § 53326(b) (Deering 2013).
132 Shanske, supra note 64, at 721.
For other areas, a grant or loan program may be necessary. Over the years, California has had several grant or loan programs to assist school districts in financing facilities. The state had a loan program prior to the passage of Proposition 13 that provided loans to districts that were bonded to their debt capacity yet were facing high enrollment growth. In addition, the state has issued general obligation bonds (with statewide voter approval) and has lent or granted the proceeds to school districts; grants and loans often have been aimed at specific types of projects such as those needed to ease overcrowding and those needed to modernize older school buildings. California currently provides some state matching funds and in some cases full funding, to address overcrowding, to modernize school facilities and to retrofit buildings to make them safe. These programs could be expanded to address additional needs resulting from the inability to issue capital appreciation bonds.

One concern with a grant or loan program is that resources from throughout the state are being allocated to specific school districts, either temporarily or permanently. Even a loan program may result in permanent reallocations of resources, either because loans are forgiven after a specified time, as was the case with a prior California state loan program, or because the interest rates on the debt do not allow the state to recoup its cost of funds and transactional and administrative costs. Depending on one’s perspective and the specifics of the program, this reallocation of resources may or may not be desirable. In addition, a loan program may also raise some of the same issues as capital appreciation bonds in terms of deferring interest and passing along the costs of current facilities to future generations.

---

133 Brunner & Rueben, supra note 104, at 529.
134 See Id. at 529.
136 See Brunner & Rueben supra note 104, at 529.
Restrict the Use of CABs

The misuse of capital appreciation bonds might be limited by restrictions on the ability to issue this type of debt. This is the approach that was utilized in California with the enactment of AB 182, which will take effect January 1, 2014. This legislation limits the maximum term of capital appreciation bonds to 25 years,\(^{138}\) limits the maximum interest rate on CABs to 8%,\(^ {139}\) limits the ratio of debt service to proceeds of a series of CABs to a maximum of 4:1,\(^ {140}\) and requires that CABs include provisions allowing for redemption at the option of the school district after 10 years.\(^ {141}\) AB 182 also includes public notice and information requirements as discussed below under “– Increase Information Available to Public and School Boards.”

While one can – and many have\(^ {142}\) – debated whether the restrictions in A.B. 182 strike the appropriate balance, legislation of this kind, at least if it is carefully tailored, may prevent the most problematic CABs issuances. However, there may be circumstances where a transaction that falls within the limitations still is not desirable and conversely there may be circumstances where a transaction that does not fall within the limitations may be desirable.

In a 2013 article, David Gamage and Darien Shanske advocated more state regulation of local government bond issuances generally, noting that one community’s failure to pay its debt can adversely affect other communities and that many small, local governments lack experience

\(^ {141}\) A.B. 182, Section 3, 2013-2014 Sess. (Ca. 2013). AB 182 allows school districts that have outstanding bond anticipation notes that were issued before AB 182 became effective to seek a one time waiver of the new restrictions on CABs from the State Board of Education for the purpose of refinancing the bond anticipation notes.
\(^ {142}\) See, for example, Rosenblatt, supra note 84 (criticizing the 4:1 ratio as too restrictive); letter from James Cervantes, Chair, California Public Securities Association, to Carol Liu, Chair, Senate Committee on Education (June 7, 2013) (criticizing the 25 year limit, the 8% interest rate cap and the 4:1 ratio as too restrictive); letter from David Wolfe, Legislative Director, Howard Jarvis Taxpayers Association, to Joan Buchanan (Jun. 4, 2013) (supporting AB 182 but suggesting that it doesn’t go far enough); letter from Karen Lange, Legislative Advocate, California Association of California Treasurers and Tax Collectors, to Joan Buchanan, California State Assembly and Ben Hueso, California State Senate (May 24, 2013) (supporting A.B. 182 as “common sense reforms”).
and tend to pay higher borrowing costs. Allowing for a regional expert or an expert state entity to authorize bond financings that do not fall within established parameters would provide additional flexibility while allowing for the input of experts.

One possibility would be for school districts to require County Offices of Education, which are already required to approve non-voter approved debt such as lease-leaseback financings, or County Treasurers, who are already involved in many general obligation bond issuances to varying degrees, to approve capital appreciation bonds outside particular limitations. While this approach has the benefit of the approval being given by an authority that is in the same region and therefore is more familiar with the needs of the region, it may also lead to inconsistent policies being applied throughout the state and, particularly in smaller counties, the person or people responsible for determining whether to allow the financing to proceed may not have more expertise than the individuals at the school district.

Another option is a state entity. In their 2013 article, David Gamage and Darien Shanske point to the North Carolina Government Commission, which approves all local government debt issuances in North Carolina, as an example, and suggest that the California Debt and Investment Advisory Commission (“CDIAC”) could play a similar role in California, at least with respect to certain types of debt issuances. CDIAC has nine members: the State Treasurer (or his or her designee), the State Governor or Director of

\[143\] Gamage & Shanske, supra note 96, at 189-90. See also Simonsen, et al, supra note 81, at 715 (suggesting that higher levels of government handle bond sales for smaller governments).

\[144\] CAL. EDUC. CODE 17150.1 (Deering 2013).

\[145\] A study by CDIAC found that “While some County Treasurers view their role as merely administrative, others feel strongly that they have a responsibility to make sure no one takes advantage of school districts in bond transactions. In their view, this role extends to safeguarding taxpayers by making sure that the bonds are issued at the lowest cost and with a structure that maximizes project and financial outcomes. Some County Treasurers believe when a county issues on behalf of the school district they should take an active role to ensure a fair bond transaction, including overseeing the bond sale.” CAL. DEBT AND INVESTMENT ADVISORY COMMISSION, A SURVEY OF THE COUNTY TREASURER’S ROLE IN SCHOOL DISTRICT GENERAL OBLIGATION BOND FINANCING, CDIAC No. 12-02 3 (2012) http://www.treasurer.ca.gov/cdiac/publications/survey.pdf.

\[146\] Gamage & Shanske, supra note 96, at 192-93. Gamage and Shanske also suggest reducing voter approval thresholds at the same time.
Finance; the State Controller (or his or her designee); two local government finance officers appointed by the State Treasurer; two members of the State Assembly; and two members of the State Senate.\textsuperscript{147} CDIAC would have the general financial expertise and, particularly if they were responsible for granting waivers of the limitations on school district CABs statewide, the expertise with CABs specifically, to determine whether a waiver was appropriate in a particular case. The State Board of Education, which currently waives the 1.25%/2.50% debt limits for school districts and will be able to waive the new restrictions on CABs imposed by AB 182 for districts to refinance outstanding bond anticipation notes that were issued before AB 182 became effective,\textsuperscript{148} would be another possibility.

While requiring a county or state authority to approve issuances of capital appreciation bonds outside of certain parameters could subject school districts to regional or state political considerations and could result in delays in the ability of districts to sell their bonds, particularly if the volume of waiver requests is high, in the limited context of capital appreciation bonds that fall outside specified parameters, the benefit of access to additional expertise and judgment outweighs the cost.

\textit{Increase Information Available to Public and School Boards}

It appears that in at least some instances, voters and school board members may not understand the full implications of the capital appreciation bonds they are approving, or may not even know that they are approving capital appreciation bonds. While it isn’t likely that significantly more information could be made available to voters at the time that they authorize an issuance of bonds, additional information certainly could be provided to school district boards and, with California’s open meeting laws, this additional information would be available to the public as well, giving members of the public the opportunity to express

\textsuperscript{147} \textsc{Cal. Gov’t Code} § 8855(a) (Deering 2013).
support or opposition for a particular financing structure and to take the actions of school board members into consideration at the next school board election.

AB 182 includes provisions that are intended to provide additional information to school board members and the general public. Specifically, AB 182 requires that if capital appreciation bonds are being considered, the resolution must be publicly noticed on at least two consecutive meeting agendas, first as an information item and second as an action item,¹⁴⁹ that the agenda item specify that CABs are proposed¹⁵⁰ and that specific information be provided to the school board. This information includes an analysis of the total overall cost of the proposed CABs, a comparison to the total overall cost for current interest bonds and the reasons that CABs are being recommended and a copy of underwriter disclosures made under Rule G-17 of the Municipal Securities Rulemaking Board,¹⁵¹ which generally relate to the underwriter’s role and duties in the transaction, its compensation, conflicts of interest and the characteristics and risks of complex transactions as appropriate for the issuer’s knowledge and experience.¹⁵² While the precise nature of the information that will actually be provided and the impact of its provision remain to be seen, it is likely that additional information and additional opportunities for members of the public to participate in public meetings discussing capital appreciation bonds will be beneficial to the school boards and to the community as a whole.

The San Diego Grand Jury took the idea of informing the public that CABs are being considered even further, recommending that school districts send notices of meetings where

---

¹⁴⁹ A.B. 182, § 5, 2013-2014 Sess. (Ca. 2013). California law requires that with limited exceptions, school district board meetings be open and public and that agendas be posted in a publicly accessible location and on the agency’s website (if the agency has one) and be mailed to anyone requesting a copy. CAL. GOV’T CODE §§ 54953, 54954.1, 54954.2, 54956 (Deering 2013).
¹⁵¹ Rule G-17 of the Municipal Securities Rulemaking Board (“MSRB”) requires municipal underwriters to deal fairly with all persons and not engage in deceptive, dishonest or unfair practices. The Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities issued by the MSRB in 2012 (available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2) generally provides that in negotiated underwritings (as opposed to competitively bid transactions), underwriters must disclose the specified information to the issuer.
bond proposals are to be discussed to all residents.\textsuperscript{153} School districts in the county objected to this proposal on the basis that doing this would be prohibitively expensive and that notice of meetings and agendas are already widely distributed.\textsuperscript{154}

In addition to information about specific financings, additional education of school boards and school district staff members would be valuable in assisting board and staff members in understanding the implications of capital appreciation bonds, and of debt financings generally. Bill Simonsen and his co-authors recommended additional training as a means to assist small local governments issuing debt, though they also noted that such training alone might not be sufficient.\textsuperscript{155} Similarly, Monique Moyer, Public Finance Director of the City and County of San Francisco pointed out that financial advisors know “10,000 times more” about municipal bonds than their clients do.\textsuperscript{156} Others have noted that new school board members do not understand their responsibilities and that training is crucial,\textsuperscript{157} and in fact according to the National School Board Association, 23 states (not including California) require school board members to receive training, and several mandate training on financial matters specifically.\textsuperscript{158} While training alone may not be sufficient and even with training, financial advisors likely will know more about the municipal bond market than their clients do, additional training, through existing CDIAC programs including webinars and the CDIAC Debt Issuance Primer, through trainings presented by the California School Boards Association, through programs and materials prepared by the district’s financial advisors,

\begin{footnotesize}
\begin{enumerate}
\item[153] \textit{SAN DIEGO COUNTY GRAND JURY, supra note 2, at 7.}
\item[155] Simonsen, et al, \textit{supra} note 81, at 715.
\item[156] Moyer, \textit{supra}, note 80, at 18.
\item[158] National School Boards Association, Mandated Training for School Board Members - Last Updated 10-2012, \url{http://www.nsba.org/Board-Leadership/Surveys/MandatedTraining.pdf}.
\end{enumerate}
\end{footnotesize}
bond counsel and others, or other forms of training would be valuable for school board and school district staff members.

**Count Accreting Interest Against Authorization**

As was noted above, capital appreciation bonds are counted against the voter-authorized amount based on their initial principal amount, not including interest that accretes over the life of the bonds. Similarly, only the initial principal amount is counted against the debt statutory provisions limiting debt to 1.25% for elementary and high school districts and 2.5% for unified school districts. While there is a logic to this – districts only count the amounts they actually receive and can spend against their voter authorization and debt limit – this would also be true for zero coupon bonds, yet their full principal amount (not only the deeply discounted initial purchase price) would be counted. Further, because accreted interest is like principal in that it bears interest and is paid at maturity and because it is treated as a liability in the government-wide financial statements (though not the governmental fund financial statements) as described above under “Background – Treatment of CABs in Financial Statements and Budgets,” it would be more appropriate to amend state law to provide that at the time bonds are issued, the anticipated accretion of interest should be taken into account in determining compliance with voter authorization and statutory debt limits. If a series of capital appreciation bonds were to be redeemed or defeased prior to maturity, any interest that did not ultimately accrete could be available again for a concurrent or future bond issuance.

**Requiring Collection of Property Taxes Throughout Life of CABs**

As is noted in the Pennsylvania Manual of Accounting and Financial Reporting for Pennsylvania public schools, “Good financial management requires a rational, systematic accumulation of resources in a debt service fund to enable the LEA to repay the debt. If resources are not accumulated throughout the period the bonds are outstanding, the burden of
debt repayment will be more difficult for taxpayers and could place severe strain on the
school’s resources.”159 If state law required California school districts to take accreting
interest into account as an expense in its budgets (and perhaps on its fund financial statements
as well) and to collect property taxes to pay interest as it accretes, districts likely would issue
far fewer capital appreciation bonds. Further, to the extent they did issue CABs, current
taxpayers would be paying for them rather than future taxpayers, addressing one of the major
problems with CABs. School districts could be allowed to use taxes collected either to pay
mandatory sinking fund payments on CABs (thus retiring them over a period of several
years) or to deposit the taxes in a sinking fund and invested (subject to provisions of Section
148 of the Internal Revenue Code and related regulations that would restrict the yield on such
investments in the case of tax exempt bonds) until the time payment is due on the bonds,
depending on the premium that investors would charge to have their bonds subject to early
redemption. While mandatory sinking funds without a corresponding required redemption
are uncommon in the tax-exempt marketplace (though term bonds subject to mandatory
sinking fund redemption are common), some taxable bond transactions, including Qualified
School Construction Bonds issued for California school districts, have included such
provisions.160

Since many districts use capital appreciation bonds to avoid violating the Proposition
39 projected tax rate limitations, requiring taxes to be collected throughout the life of the
CABs would prevent many CABs from being issued. Further, such a requirement would not
allow rapidly growing areas to take anticipated growth into account when issuing bonds. It
would, however, continue to permit the issuance of CABs should they be the most cost
effective method of financing for a particular district at a particular point in time.

159 PA. DEP’T OF EDUC., supra note 86, at 12.29.
160 Based on review of official statements for California school district general obligation bonds issued in 2011.
See, e.g., Official Statement, West Contra Costa Unified School District General Obligation Bonds 7 (Nov. 8,
If this prevented the issuance of bonds by too many school districts – particularly districts in need of new or rehabilitated facilities without access to an alternate funding source – another option would be to require districts to collect a minimum of $30/$100,000 ($60/$100,000 for unified school districts) for all bonds issued under a particular Proposition 39 Authorization, even if the tax rate required to service debt coming due in a particular year were lower and to either apply collected amounts to redeem bonds or deposit them into a sinking fund to be used to pay the bonds at maturity. One possible problem with this approach is that it would prohibit school districts from issuing any additional bonds under the same Proposition 39 Authorization until their CABs were repaid. This might make it more difficult for districts that need to or find it economically beneficial to phase their issuances over a period of years. If it is the case, however, that CABs are mostly used when districts otherwise could not stay within their projected tax rate limitations, it is likely that they are mostly issued towards the end of the issuances under a given authorization, reducing the impact of this problem. A second problem is that different districts might be impacted very differently by such a provision (with some having to collect far more than the amount they would have had to collect to pay debt service and others that already have high debt service levels under their Proposition 39 Authorization not having to collect any extra). Still, the benefits of this could well outweigh the costs, particularly given that districts could return to the voters for an additional authorization if circumstances changed such that they needed to issue bonds again before the CABs were paid. This might be a preferable alternative to statutory (or other) limitations on the ability of districts to issue CABs.

Re-Evaluate Debt Limitations

It appears that one of the primary reasons that capital appreciation bonds have been used in California in the last few years is to continue to issue debt without violating debt
limitations, particularly the projected annual tax rate limitations for bonds with Proposition 39 Authorization.

A tremendous amount of effort and expense goes into issuing debt (or debt-like instruments) without violating debt restrictions. In a 2003 article, Richard Briffault indicates that “debt limits have affected the form of state and local debt, but they do not appear to have significantly affected the total amount of debt” and notes that nearly three quarters of all state debt and two thirds of city and county debt are not treated as “debt” for purposes of complying with state constitutional limitations.\(^{161}\) Briffault goes on to point out that avoiding debt limitations results in additional administrative and legal costs and frequently higher interest rates.\(^{162}\) Similarly, Jeffrey Chapman notes in a paper for the Public Policy Institute of California that “Perhaps the most important insight that can be gained from the passage of Proposition 13 is that blunt initiatives lead to the development of other ways of getting things done. These other ways are usually more complex, more expensive, and typically are not discussed in public forums in ways that are intelligible to the public and elected officials.”\(^{163}\)

The State Legislature should evaluate the debt limitations that give rise to capital appreciation bonds, particularly the projected annual tax rate limitations, to determine whether they remain appropriate and, if so, whether the use of capital appreciation bonds is inconsistent with the intention of the limitations. Given that Proposition 13 severely limited increases in assessed valuations, assessed valuations may have increased at a slower rate than inflation,\(^{164}\) and a tax rate of $30 (or $60) per $100,000 may be less burdensome on taxpayers


\(^{162}\) Briffault, \textit{supra} note 58, at 926. As was discussed above under “Problems Created by the Use of Capital Appreciation Bonds – CABs Cost More,” capital appreciation bonds typically bear interest at higher rates than comparable current interest bonds.

\(^{163}\) \textsc{Jeffrey I. Chapman, Public Policy Institute of California, Proposition 13: Some Unintended Consequences}, 15 (1998) \url{http://www.ppic.org/content/pubs/op/op_998jcop.pdf}.

\(^{164}\) According to the California Legislative Analyst’s Office, inflation has averaged 4.1% per year since 1978 while assessed valuation increases are capped at the lesser of inflation or 2% absent a change in ownership or new construction. Cal. Legislative Analyst’s Office, California’s Property Tax (presented to San Francisco
today than was contemplated when the restriction was put into place in 2000. If the legislature were to modify the projected annual debt service debt limitations (or to expressly permit waivers of them to be obtained), that alone would likely reduce the use of capital appreciation bonds by school districts. On the other hand, if the legislature determines that the limitations are appropriate, it may want to at the very least evaluate the quality of assumptions about future growth that are being used in issuing long term capital appreciation bonds and perhaps restrict the use of capital appreciation bonds as a means to avoid the restrictions (though this could raise some of the same issues discussed above under “– Ban the Use of CABs Entirely”). The legislature could well determine that the existing safety valves – the ability to request a State Board of Education waiver of the limitations on the aggregate amount of general obligation debt as a percentage of assessed valuation and the ability to return to the voters for authorization to exceed the projected annual debt service limitations – are adequate.

Conclusion

School districts use capital appreciation bonds for a variety of reasons, one of the most significant of which is to avoid violating debt limitations. This is particularly true for districts that are growing rapidly or that have experienced declining assessed valuations. It also appears that even where debt limitations are not a constraint, some districts utilize CABs to keep property taxes at a lower level while incurring debt to build or modernize facilities. Districts often use CABs as part of a structure that also includes current interest bonds.

The use of CABs gives rise to a number of issues, including higher costs and hence disproportionate federal and state subsidies to districts that use CABs. Most significantly, long term CABs allow today’s homeowners to benefit from facilities that will be paid for by Planning and Urban Research Association)(2012). http://www.lao.ca.gov/handouts/state_admin/2012/CA_Property_Tax_4_11_12.pdf. The Assembly Committee on Education bill analysis of AB 182 suggested that since it has been more than 12 years since the enactment of the tax rate caps, the authors may wish to consider a review of the need to adjust the limits. Assemb. Comm. on Educ. Analysis AB 182, supra note 53 at 4.
future homeowners. In addition, it appears that often neither voters nor school board members understand the full implications of CABs that are issued by school districts, and sometimes do not even know that CABs are being issued. Although CABs raise numerous problems, in some circumstances (such as when new development is occurring in a district, when districts do not have an alternate funding source to finance necessary facilities or when CABs are used as part of an overall economically efficient structure) CABs may be an appropriate financing tool. However, much of the time they are not.

While this paper does not advocate wholesale prohibition of CABs, it does recommend that (a) CAB issuances outside of specified parameters be approved by a state authority, (b) school board members and school district staff receive training on financing alternatives and their implications, (c) additional information be provided to school boards – and hence to the general public – when CABs are being considered so that board members can make an informed decision and (d) accreted interest on CABs be counted against the amount of bonds authorized by the voters and against statutory limits on the amount of general obligation debt school districts can have outstanding. This paper also suggests that requiring taxes to be collected to pay accreting interest, at least up to specified amounts, may be desirable in addition to, or in lieu of, other limitations on the ability to issue CABs. In addition, because debt limitations cause issuers to issue more expensive debt or debt-like instruments, including CABs, this paper recommends that debt limits be re-evaluated periodically to determine whether they remain appropriate.