

BOWIE, ARNESON, WILES & GIANNONE

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
ATTORNEYS AT LAW

ALEXANDER BOWIE*
JOAN C. ARNESON
WENDY H. WILES*
PATRICIA B. GIANNONE
ROBERT E. ANSLOW
BRIAN W. SMITH
JEFFREY A. HOSKINSON
MEGAN V. WATT
DANIELE D. SHERIDAN
PAUL W. LEE
JEFFERY A. FRAYER

4920 Campus Drive
NEWPORT BEACH, CALIFORNIA 92660
(949) 851-1300

(800) 649-0997
FAX (949) 851-2014

*A PROFESSIONAL CORPORATION

Coalition for Adequate School Housing 31st Annual Conference on School Facilities

February 23, 2010

***Community Facilities District
Delinquent Special Tax Collection
& Foreclosure***

By

Wendy H. Wiles

&

Megan V. Watt

BOWIE, ARNESON, WILES & GIANNONE

I. CFD BONDS TODAY AND TOMORROW

The Mello-Roos Community Facilities Act of 1982, as amended (“The Act”) provides a method for financing certain public capital facilities and services for local governmental agencies. They are most commonly used in developing areas and areas undergoing rehabilitation. The Act has also been useful as a mechanism whereby school districts can negotiate a mutually acceptable “Mitigation Agreement” with developers and form community facilities districts (“CFDs”) to issue CFD Bonds in order to fund amounts greater than statutorily authorized developer fees. The fees negotiated are commonly referred to as “Mitigation Payments.” The Mitigation Payment may be funded up front by the issuance of CFD Bonds, thereby providing school districts with funds in advance of development to fund a school district’s local match requirement. The overall CFD tax rate, that includes special taxes, was ordinarily assumed to be 1.8% to 2% of a home’s sale price. However, due to the decline in the housing industry, the CFD special taxes are, in some instances, well above 2% of the value of the home. This issue is discussed in more detail below.

II. 2% TAX THRESHOLD

In the early 2000’s, California experienced substantial development of higher-priced homes. During this growth, CFDs were established, and the CFD special tax rates were based on the price of the home at the time the special tax rates were set and bonds were sold. Many of those homes have subsequently been sold, or foreclosed and resold at significantly lower prices. Due to the substantial reduction in home sales prices, the estimated total tax rates have exceeded the maximum not to exceed rates that were originally anticipated. Some CFDs allow the applicable special taxes to be prepaid in full pursuant to the provisions of the Rate & Method of Apportionment (“RMA”) established when the CFD was formed. In addition, some RMAs may permit a partial prepay to reduce the special taxes in order to achieve an overall total tax rate to be less than 2% of the reduced resale price.

As to undeveloped property, where CFD Bonds have been sold and issued, the remaining lots may have changed hands at a substantial reduction from the original assumed price or value. If and when developed, such lots may be re-subdivided into a greater number of smaller lots, for smaller sized homes, to be sold at a lesser price than the homes previously developed and sold. There may not be a direct proportional reduction in applicable special taxes upon a smaller home of a substantially lesser sales price. Where CFD Bonds have been sold and issued and homes developed and sold, any reduction in special taxes is usually precluded by the covenant of the CFD Bonds previously sold and issued although some more recent issues allow a reduction of the CFD tax where the Bond size is reduced to increase coverage levels. Any reduction in special taxes needs to be proportional throughout the CFD, as opposed to applying only to the future homes to be developed and sold at a lesser price necessitating any such reduction to be consistent with applicable Bond covenants and the Goals & Policy requirements for all taxes, including special taxes not to exceed 2% of the sale prices of homes in a CFD.

In the predominant situation where the RMA does not allow for a reduction or reallocation of special taxes, Bondholder or property owner consent could be necessary. Bondholder consent has always been problematic but in today’s environment where Bonds are more diversely held it is even more difficult. One possible alternative is to create an

BOWIE, ARNESON, WILES & GIANNONE

Improvement Area (“I/A”) in the CFD to allow the I/A to buy up the lien and with proceeds of its CFD Bonds when sold pay off the special taxes or Bonds, if feasible, or with partial cash from the Developer. A new RMA for the I/A, when funded, will in essence defease the CFD Bonds of the initial CFD, and the resulting lien for the applicable special taxes of the initial CFD. If there is not a sufficient number of remaining homes to be constructed, two or more residual portions of projects may need to be combined in a new CFD. Higher interest rates, the lack of Bond Insurance and more stringent Bond Issuance criteria will all tend to create a challenge for the financing team.

As the housing industry revives, the need to address existing Mitigation Agreements and existing CFDs and their established and authorized special taxes, will be brought to school districts. Requests will be made to renegotiate the existing Mitigation Agreements and to reduce special taxes. When such occurs, the school district will need legal counsel experienced in such matters, and if CFD Bonds have been sold and issued, the school district financing team will need to interface as well. It is unlikely that a cookie cutter method of dealing with such issues will come about thus requiring each unique issue to be properly analyzed and addressed by the school district financing team.

In addition, when developer requests are received to restructure CFDs, or when a request for issuance of authorized CFD Bonds to be sold and issued are received, the school district should request an adequate deposit to cover the school district’s costs in addressing any such request, including costs to cover legal counsel and other consultants.

III. SPECIAL TAX COLLECTION, ADMINISTRATION AND FORECLOSURE

A. CFD Bond Foreclosure Covenants

CFD Bonds are purchased with the understanding that the special taxes of the applicable CFD will be timely levied, collected, and used to make the necessary debt service payments on the CFD Bonds. The CFD Bond holders have an expectation that the CFD Bond will retain its par value, and that payments of interest and principal will be made. Neither the general fund nor other revenues (unless specifically pledged) are available to the CFD Bond holders if the special tax revenue collected by the CFD is insufficient to pay the interest and principal payments due. Generally, the CFD special taxes are collected by the county and appear as a line item on a property owner’s county tax bill.

If the property owner fails to pay their property taxes in a timely manner, counties may pursue foreclosure approximately five (5) years after nonpayment. In addition, the property owners’ nonpayment of property taxes may be a default under the deed of trust pursuant to the mortgage documents recorded to purchase the home. However, lenders generally defer foreclosure for nonpayment of the mortgage and property taxes as a measure of last resort. Neither of the foregoing foreclosure remedies is immediate enough to be consistent with the expectations of the CFD Bond holders. Therefore, CFDs have accelerated foreclosure rights pursuant to Government Code Section 53356.1, *et seq.*, which allows the legislative body of the CFD to file an action in superior court when special taxes are delinquent in order to foreclose the lien of special tax.

BOWIE, ARNESON, WILES & GIANNONE

Hence, when CFD Bonds are sold and issued, pursuant to Government Code Section 53311, *et seq.*, a foreclosure covenant is included and generally reads as follows:

Covenant. Commence Foreclosure Proceedings.

On or about March 1 and July 1 of each Fiscal Year, the District will compare the amount of Special Taxes theretofore levied in the District to the amount of Special Taxes theretofore received by the District, and:

(A) Individual Delinquencies. If the District determines that (i) any single parcel is subject to a Special Tax delinquency in the aggregate amount of \$5,000 or more or (ii) any owner owns one or more parcels subject to a Special Tax delinquency in an aggregate amount of \$5,000 or more, then the District shall send or cause to be sent a notice of delinquency (and a demand for immediate payment thereof) to the property owner within forty-five (45) days of such determination, and (if the delinquency remains uncured) foreclosure proceedings shall be commenced by the District within ninety (90) days of such determination to the extent permissible under applicable law.

(B) Aggregate Delinquencies. If the District determines that (i) the total amount of delinquent Special Taxes for the prior Fiscal Year for the District (including the total of delinquencies under paragraph (A) above) exceeds five percent (5%) of the total Special Taxes due and payable for the prior Fiscal Year, the District shall notify or cause to be notified property owners who are then delinquent in the payment of Special Taxes (and demand immediate payment of the delinquency) within forty-five (45) days of such determination, and shall commence foreclosure proceedings within ninety (90) days of such determination against each parcel of land within the District with a Special Tax delinquency.

School districts that have issued CFD Bonds may often contract with their Special Tax Administrator to send written reminders when the first and second installments are delinquent and due to the county on December 10th and April 10th, respectively. In some instances, property owners have paid the tax installments but the county records are not accurately reflecting the payment. In other instances, the tax bill has gone to a former property owner or the developer. After the end of the fiscal year, if either installment remains delinquent, the Special Tax Administrator sends a default notice requesting payment, advising the property owner of possible foreclosure and informing them that their lender will be notified. During such period, the Special Tax Administrator provides the school district and Foreclosure Counsel with a Delinquency Report. The events that are subsequently taken by Foreclosure Counsel are hereinafter described.

BOWIE, ARNESON, WILES & GIANNONE

B. Economic Consideration Of Foreclosure Covenants

There are several considerations as to why these actions on behalf of a CFD are necessary and in the best interest of the CFD and the governing board of the school district acting as the legislative body of the applicable CFD. These include the following:

1. Cash flow requirements for timely payment of interest and principal on the CFD Bonds are more likely to be satisfied when the herein described follow-up actions are taken by the Special Tax Administrator and Foreclosure Counsel.
2. Timely performance by the Special Tax Administrator and Foreclosure Counsel working as a coordinated team ensures cost effective, timely satisfaction of the contractual obligations created by the foreclosure covenants. This avoids the time and cost of responding to various inquiries from the CFD Bond holders. It may also assist in avoiding adversarial political unrest in the local community.
3. Timely accomplishment of follow-up notices, as well as timely commencement and accomplishment of foreclosure proceedings, will be viewed positively by the investment banking community when future financing opportunities are being pursued.
4. Such actions consistent with the foreclosure covenants facilitates positive timely responses as part of accomplishing required Continuing Disclosure reports and should avoid the need for a negative response to the California Debt and Investment Advisory Commission (“CDIAC”).
5. Implementation of the foreclosure covenants is also necessary to avoid a draw on the Reserve Fund of the CFD. Draws on a Reserve Fund to make interest and principal payments on CFD Bonds needs to be disclosed with a filing to CDIAC and such notices are viewed negatively by the investors in CFD Bonds.
6. The steep decline in home prices in California has erased the equity in many homes. Timely follow up by Foreclosure Counsel with the applicable lender can produce the defaulted special taxes needed to meet the interest and principal payments on CFD Bonds issued. It can also evidence a good faith effort to comply with the provisions of applicable foreclosure covenants, and provide funds to avoid a draw on the applicable Reserve Fund.

C. Collection/Foreclosure With No Covenant To Commence But Debt Has Been Issued

In some instances, CFDs have not sold bonds or entered into bond covenants, but have issued other debt which is backed by the school district’s general fund. In that instance, a school district may still want to proceed with collection and foreclosure proceedings to pay debt service and for cash flow reasons. As long as the special taxes in a CFD are collected and pledged for the repayment of debt, a school district may proceed with collection and foreclosure on delinquent parcels. Government Code Section 53356.1 provides “as a cumulative remedy, if debt is outstanding, the legislative body may, not later than four years after the due date of the last installment of principal thereof, order that any delinquent special taxes levied in whole or in

BOWIE, ARNESON, WILES & GIANNONE

part for payment of the debt, together with any penalties, interest, and costs, be collected by an action brought in the superior court to foreclose the lien of special tax.” Thus, any debt issued by a CFD where the special taxes are collected for the repayment of the debt may proceed with collection and foreclosure of delinquent taxes; bonds and bond covenants are not required.

D. Determining Delinquencies, And Collection And Foreclosure Procedures

1. Special Tax Administration Process: The Special Tax Administrator each year determines the special taxes to be levied and collected by the CFD. The operative document is the RMA which is approved at the election conducted as part of the proceedings to establish the CFD. The RMA specifies the amount of money that is permissible to levy by means of the special taxes. In many instances, this will be on the basis of an “Assigned Special Tax” designated in a specific amount for various types of dwelling units. The Assigned Special Tax is generally ten percent (10%) greater than what is assumed will be needed for debt service of the CFD Bonds and administration costs. The extra ten percent (10%) is often referred to as a “Special Tax Remainder.” The Special Tax Remainder inures to the benefit of the CFD and school district in addition to the proceeds of the CFD Bonds. For CFDs that levy at the maximum Assigned Special Tax, in the event of a substantial delinquency in the payment of special taxes, a CFD can pursue use of the Special Tax Remainder on an interim basis to meet its cash flow requirements for interest and principal payments on the CFD Bonds after the end of the applicable fiscal year. This may require an amendment to the applicable Bond indenture; the Special Tax Remainder is not usually pledged for the benefit of the CFD Bond holders. This 10% levied each year is a cash flow buffer which together with actual special taxes received, may meet interest and principal requirements so long as delinquent property taxes are less than 10% or can be reduced to less than 10% by reason of follow-up and timely action by Foreclosure Counsel. Also, there may be a Backup Special Tax that can be used in subsequent years to meet requirements of CFD Bonds and avoid a draw on the Reserve Fund of the CFD. Where an Undeveloped Property Special Tax is provided for in the RMA, it can also be levied in subsequent years to the extent provided for in the applicable RMA. Depending on the wording of the RMA, the Special Tax Administrator may be able to consider the extent of past or future delinquencies of the CFD when establishing the special tax rate for a CFD in a fiscal year. The Special Tax Administrator submits the proposed levy of special taxes to the governing board of the school district for approval as the legislative body of the CFD. Once the proposed levy is approved by the governing board of the school district acting as the legislative body of the CFD, the Special Tax Administrator submits the tax levy to the counties around the second week of August.

The recent increase in delinquent special taxes and information as to such delinquencies not being available from a few of the applicable counties until some time in July has presented challenges to the Special Tax Administrator when the applicable RMA provides such delinquencies be taken into account when determining the amount of special taxes of a CFD for the future fiscal year.

In current times of economic distress for land developers and home builders, the applicable Mitigation Agreement should require that, if and when CFD Bonds are issued, a Letter of Credit for one year’s Undeveloped Property special taxes should be provided by the

BOWIE, ARNESON, WILES & GIANNONE

developer until substantial development and sale of the homes have occurred. This Letter of Credit should be required because if developer owned property is delinquent in the payment of its special taxes, the school district can draw on the Letter of Credit to pay the delinquent special taxes. In the past, substantial development has been when fifty-five percent (55%) of the homes in a project have been sold to individual property owners. Recently, substantial development is when closer to seventy-five percent (75%) of the homes within a project have been built and sold.

After the delinquency date for the first installment of property taxes which is December 10th, the county will provide information to the Special Tax Administrator as to the nonpayment of special taxes. In many cases, the county information may not be received until February. While not required by all foreclosure covenants, a payment reminder, in most instances, is sent by the Special Tax Administrator. This process is similar after the April 10th delinquent date for the second installment of property taxes. After the end of the fiscal year, the county provides to the Special Tax Administrator the information as to nonpayment of the special taxes of the CFD for the prior fiscal year. The Special Tax Administrator then sends the above-described demand notice requesting payment and advising that if payment does not occur, then foreclosure proceedings will be commenced. The demand notice often allows direct payment of the delinquent special taxes to the Special Tax Administrator. In most instances, the property owner is advised that the lender will also be notified of such nonpayment. Additionally, a delinquency report is prepared, sent to the CFD and furnished to Foreclosure Counsel. The demand notice usually has a *not later than* payment date. After this date and reconfirmation of the outstanding delinquent parcels, Foreclosure Counsel will initiate and pursue foreclosure as provided for and required by the applicable foreclosure covenant.

2. Foreclosure Counsel Process: After receiving the Delinquency Report from the Special Tax Administrator and expiration of the *not later than* payment date in the demand notice to the property owner, Foreclosure Counsel initiates actions sufficient to satisfy the requirements of the applicable foreclosure covenant. In many instances, the governing board of the school district acting as the legislative body of the CFD will have adopted a resolution delegating authority to the assistant superintendent of business services or similar designated position to pursue collection and cause to be initiated, as applicable, foreclosure proceedings.¹ Pursuant to such delegated authority, a “Certificate of Commencement” is executed under penalty of perjury pursuant to the delegated authority. The Certificate of Commencement identifies the specific property as to which foreclosure proceedings are authorized to be commenced.

The following actions of Foreclosure Counsel can be accomplished concurrently. These include the following:

- Verify with Special Tax Administrator that the APN and property information are current.

¹ As a CFD is a separate legal entity, requirements of the Brown Act should be satisfied as to any such meetings. This might include adoption at a meeting of a CFD of a resolution that all meetings of the governing board of the school district shall be deemed to be a meeting thereof as to each CFD of the school district. We suggest the heading of each agenda be so described and that applicable requirements of the Brown Act be satisfied.

BOWIE, ARNESON, WILES & GIANNONE

- Prepare and file with the county the “Notice of Intent to Remove Special Taxes.”
- Record Notice of Intent to Remove Special Taxes.
- Ascertain the lender on the delinquent property.

If we are unable to obtain payment from the lender or property owner, we then begin formal foreclosure proceedings and file a lawsuit in Superior Court. A separate lawsuit is filed for each delinquent parcel. Often, once the lawsuit is filed, any remaining delinquencies are paid. If it is not, it typically takes 9-12 months to obtain a judgment, proceed to a foreclosure sale and recover the total amount due. However, our Firm, as Foreclosure Counsel for our school district and other public agency clients, has established a productive, direct contact relationship with many of the major banks and lenders that hold the notes and trust deeds. By reason of our working relationships with such parties, where other means of collection have been exhausted, we have been able to accomplish payment of the delinquent special taxes. Also, as sales, foreclosures, and resales occur, it is important for Foreclosure Counsel to timely and promptly interface with escrow officers and title officers to facilitate payment and avoid the staff of the school district having to address these requests and issues.

IV. TEETER PLANS – PUBLIC AND PRIVATE

Desmond Teeter was the County Auditor for Contra Costa County in the 1940’s. His concept, for a county to finance cash flow to public agencies within a county was enacted by the legislature in 1949. The Teeter Plan legislation has subsequently been judicially affirmed. A Teeter Plan, if implemented by a county, allows cities and counties, for which the county officers assess property and collect taxes or assessments, to receive the funds anticipated from individual property taxes in the event such taxes are not paid. The incentive for the county is that all interest and penalties go to the county, instead of the local agency, together with the unpaid property taxes or assessments when not paid. It is discretionary for counties to include CFDs in an existing Teeter Plan. It is understood that most counties have Teeter Plans, however, only two counties, including the County of Orange, allow CFDs in their Teeter Plans. As noted, the principal benefit is cash flow to the public entity for making interest and principal payments, and avoiding a draw on a Reserve Fund.

By reason of Teeter Plans not being made applicable to CFDs in other counties and based on the revenues generated from collecting the interest and penalties of special taxes of a CFD, private parties have approached school districts with proposals for “Private Teeter Plans.” They propose to advance the funds, at their election, to cover unpaid property taxes, and take an assignment of property taxes, interest, and penalties in the estimated amount discussed above. The school district, on behalf of the CFD, contractually agrees to the Private Teeter Plan however, the CFD may not be relieved of the foreclosure covenant simply by its contractual obligation to the Private Teeter Plan.

Generally, Private Teeter Plans propose to commit their right (and not obligation) to purchase the delinquent debt in March of the current fiscal year. However, the special tax rolls and coverage of delinquencies are submitted by August of the current fiscal year for payment by December 10th and April 10th. If the school district does not receive a commitment until March, the school district would still need to plan for anticipated delinquencies back in August and

BOWIE, ARNESON, WILES & GIANNONE

therefore, this time factor will not assist school districts in cash flow management. Our review of foreclosure covenants in Orange County where CFDs presently are included in the applicable Teeter Plan, reflect no change in the usual 45 day requirement for commencement of foreclosure proceedings.

If the penalties and interest earned are substantially greater than what a CFD of a school district can earn on its inactive funds, neither a Private Teeter Plan nor a Public Teeter Plan is a beneficial business decision. The key is to have collection and foreclosure outsourced to a competent Special Tax Administrator and Foreclosure Counsel who handle all such matters without adding to the duties of the staff of the school district that has established the applicable CFD. If such is not occurring, the school districts need to look for alternatives as to the services being provided to its CFDs by its Special Tax Administrator and Foreclosure Counsel. The costs of this service are paid when the lender, or in some instances the homeowner, pays the delinquent special taxes of the CFD, which have been stripped from the tax roll and can only be paid directly to the CFD, together with penalties, interest, and costs of collection. Hence, the CFD receives the penalties and interest net of collection costs, which is a return substantially greater than what can be earned on the inactive funds of the CFD.

Our experience has been that collection by the CFD with interest funding from timely collection by Foreclosure Counsel is a preferable alternative. After a fiscal year is concluded, special taxes not needed for interest and principal are available for additional school facilities, and are not pledged to the holders of the CFD Bonds. Hence, such funds can be used as interim funding should some nominal amount be needed to avoid a permissible, but undesirable draw on the Reserve Fund of a CFD. In instances reviewed, we have found school districts prefer to achieve the greater return from unpaid special taxes of a CFD as opposed to pursuing the alternative of recently proposed Private Teeter Plans.

Should you have any questions or comments in regard to any of the matters contained herein or would like any assistance in regard to complying with the applicable legal requirements pertaining to Community Facilities Districts, and collection and foreclosure of delinquent special taxes, please do not hesitate to contact Wendy Wiles (wwiles@bawg.com) or Megan Watt (mwatt@bawg.com) at (949) 851-1300 or (800) 649-0997.

The applicability of the legal matters discussed may differ substantially in individual situations. The foregoing information has been prepared by Bowie, Arneson, Wiles & Giannone as an overview of the subjects discussed and should not be construed as individual legal advice.