Financing Options for School Districts

Alabama Association of School Business Officials (AASBO)
Financial Management Strategies
Birmingham, Alabama

Thursday, September 21, 2023

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Kane Burnette's primary practice involves serving as bond counsel to municipalities, counties, boards of education and public corporations throughout Alabama on both publicly underwritten and privately placed tax-exempt financings.

Kane is particularly active in the public education sector, where he has represented both public universities and boards of education on tax and finance matters, and he currently serves on the faculty of the University of Alabama's academy for finance training for new school superintendents and chief school financial officers.

In addition to bond counsel engagements, he has served as company counsel and bank counsel in letter-of-credit backed transactions, as lender's counsel in direct placement transactions and as trustee's counsel. He also advises municipal clients on economic development and incentive matters. Kane has experience in representing governmental bodies in compliance matters before the Internal Revenue Service and the U.S. Securities and Exchange Commission.

As an Alabama-licensed Certified Public Accountant (currently inactive), Kane worked in the Birmingham office of Ernst & Young LLP before attending law school.

Practices

- Public Finance
- Distressed Municipal Finance
- Corporate & Securities

Education

- University of Alabama School of Law, J.D., 2009, *magna cum laude*
- University of Alabama, Master of Accountancy, 2003
- University of Alabama, B.S., 2002, Accounting *summa cum laude*

Licensed In

- Alabama

Accolades

- Listed in *Chambers USA*, Banking & Finance: Public Finance, 2020-2022
- Listed in *Mid-South Super Lawyers*, "Rising Stars," Government Finance, 2016-2019
- Listed in *B-Metro*, "Top Lawyers," 2019-2020

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Agenda

- Discuss the two primary options for capital financing
  - Issuance of Warrants (Article 14)
  - Alternative Financing Contracts (Leases or Installment Sales)
- Discuss short-term (operations) borrowings
- Hypothetical Situations

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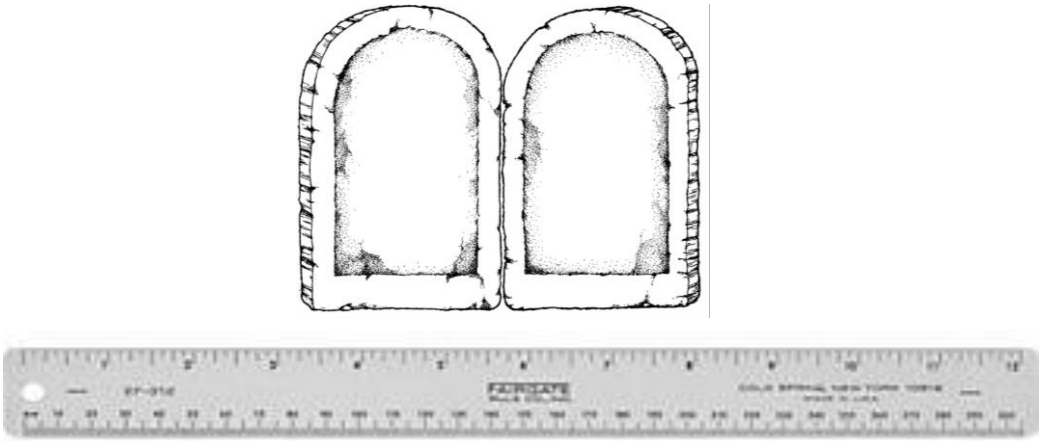
The Legal Framework – Dillon's Rule

- "a municipal corporation possesses and can exercise the following powers and no others: (1) **<u>those granted in express words</u>**; (2) those necessarily or fairly implied in or incident to the powers expressly granted; and (3) those essential to the declared objects and purposes of the corporation – not simply convenient, but indispensable."



Borrowing Powers Expressly Given to Boards of Education Under Alabama Law

- The Legislature of Alabama has expressly granted Boards of Education the power to borrow, primarily under the following two code sections:
  - Article 14 of the School Finance portion of the Code (§ 16-13-300 *et seq*.) (issuance of Warrants)
  - Alabama Governmental Leasing Act (§ 41-16A-1 *et seq*.) (alternative financing contracts)

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Article 14 – Warrants for Educational Purposes

- Article 14 grants Boards of Education the power to issue and sell warrants for a wide array of capital projects:
  - Real Property
    - Land
    - School buildings
    - Classrooms
  - Personal Property
    - Equipment (computers/IT, copiers, HVAC)
    - Furniture
    - School buses

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Article 14 – Warrants for Educational Purposes

- Article 14 also authorizes the issuance of warrants for the following:
  - Refunding (usually for interest rate savings) prior warrant issues ("refinancing")
  - Funding operating expenses
  - Funding extraordinary expenses (casualty losses, legal judgments, etc.)

Article 14 – Warrants for Educational Purposes

- May be sold at either public or private sale
  - Public sale: Board engages a financial advisor to issue an invitation for bids and awards sale to lowest bidder
  - Private sale: Board selects a bank or an underwriting firm to work with
- Board must identify a source of repayment; Warrants may NOT be general obligations of the Board

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Article 14 – Warrants for Educational Purposes

- What are permissible sources of repayment?
  - Ad valorem tax or taxes
  - Sales and use taxes
  - Other revenues allocated or apportioned to the Board (such as, sales and use taxes levied by a city and allocated to the Board through an irrevocable funding agreement)

Important Consideration: ideally a Board should set the maturity of the Warrant(s) to be issued so that the debt does not exceed the duration of levy of the tax or taxes pledged for repayment.

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Article 14 – Warrants for Educational Purposes

- Board may NOT pledge Foundation Program funds or any other state revenues (including fleet renewal funds).
- Warrants issued under Article 14 must have prior written approval by the State Superintendent of Education.
  - Failure to obtain this approval means the Warrant is void and unenforceable.
  - The State Superintendent of Education must also give prior, specific approval for issuance of any variable rate warrants.

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Article 14 – Warrants for Educational Purposes

- Other requirements
  - Maximum Term: 30 years
  - Must be signed by Board President, sealed and attested by the Board Secretary (Superintendent)

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Article 14 – Warrants for Educational Purposes

- Summary
  - A Board MAY issue its warrants to finance virtually any permissible capital project.
  - A Board MUST identify one or more available local revenue sources for repayment of its warrants.
  - A Board MAY NOT issue warrants payable out of "all available funds."
  - A Board MUST obtain the written approval of the State Superintendent of Education prior to issuance of any warrants.

Alternative Financing Contracts

- Boards of Education are also authorized to enter into "alternative financing contracts" to finance certain equipment.
- Examples include
  - Leases
  - Lease-Purchases
  - Installment Sales

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Alternative Financing Contracts

- Focus for Warrants under Article 14
  - Revenue source pledged for repayment
    - Investor/lender will want to know all about that particular revenue stream
- Focus for Alternative Financing Contracts
  - General creditworthiness of borrower
  - Asset that can be protected and re-leased/sold in the event the borrower terminates the contract

Alternative Financing Contracts

- Alternative financing contracts are available only for **tangible personal property**.
  - Examples of tangible personal property include: office equipment (copiers, telecommunication equipment, computers, etc.), HVAC equipment (maybe) and school buses.
  - Does NOT include: classrooms, land, field turf or other items constituting real property.

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Alternative Financing Contracts

- Security
  - Boards of Education may pledge for payment under an alternative financing either (1) its general faith and credit (general obligation) or (2) one or more specified revenue sources (taxes)
  - Assets themselves are also security

Alternative Financing Contracts

- Perceived Advantages over Warrant issuance
  - Streamlined documents
  - Expedited timeframe
  - Lower costs/fees
  - Board does not have to "tie down" one of its revenue sources, thus preserving more room for traditional financings

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Alternative Financing Contracts

- However….
  - There is no one perfect set of "lease documents." Every Board is well-advised to have Board counsel and/or Bond counsel review the documents.
  - Alternative financing contracts still require Board approval, so they are not inherently faster or more efficient than warrant financings.
  - The most important cost for any financing is usually the interest cost. An installment sale/lease does not inherently have a lower interest rate than a warrant financing. ALWAYS check the APR.
  - Even if a Board does not have to pledge a particular revenue source for payment of an alternative financing contract, it does have to budget for the payments.

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Comparison – Warrant Financing vs. Alternative Financing Contract

	Warrant Financing	Alternative Financing Contract
Permissible assets	Any lawful	Tangible personal property ONLY
Security	Specified source(s)	General obligation or specified source(s)
Term	30 years maximum	No specified maximum (but not beyond useful life)
Conditions	ALSDE approval; Board approval	Board approval

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Operating Loans/Lines of Credit

- Alabama is a "Dillon's Rule" state – governmental bodies only have those powers granted to them by the Legislature of Alabama.

- Two statutes authorizing short-term or operating borrowing:
  - § 16-13-145 (older method)
  - § 16-13-300 (newer method)

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Older Method - § 16-13-145

- Authorizes a board to borrow in anticipation of current revenues, if funds on hand are not sufficient to pay salaries and other current expenses
- "Unsecured" borrowing – not backed by a pledge of specified local revenues
- Requires the Board to determine, on an ongoing basis, that the loan balance does not exceed a formula prescribed by law (Total SDE-approved revenues LESS current revenues received LESS expected debt service)
- Still "good law" and is used by some lenders in their form loan documents.

Newer Method - § 16-13-300

- Issuance of Warrant and pledge of a local revenue source
  - Authorized "for the purpose of providing any money or moneys deemed necessary by the board to provide for the administration and operation of the board to the expiration of the then current fiscal year."

- Eliminates the cumbersome rolling available amount calculation required under § 16-13-145.

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Newer Method - § 16-13-300 (cont'd)

- A warrant issued by a Board under § 16-13-300 may not be a general obligation; rather, the Board must identify and pledge a revenue or revenues available for that purpose.
  - Ad valorem tax
  - Sales tax
  - Other revenue source

- Unlike the older method, warrants must be approved by the State Superintendent of Education.

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Practical Considerations

- Usually these lines of credit do not qualify for federal tax-exempt treatment (still exempt from Alabama income taxation).

- Very often short-term borrowings bear interest at a variable rate (for example, SOFR + ___%), which requires "specific approval" of the State Superintendent of Education.

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Practical Considerations

- Maturity of Loan
  - While technically not a requirement of state law, it is good budget procedure to have the short-term borrowing mature at the end of the current fiscal year.

- No requirement that a Board utilize a request for proposals (RFP) process, but…
  - Compare interest rates and fees (e.g., "unused facility" fee, commitment fee, etc.)

- Remember "Dillon's Rule" – standard bank forms and notes are discouraged.

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Hypothetical Situations

- Hypothetical #1 – New School Construction
  - BOE votes to proceed with construction of a new high school, as outlined in its five-year capital plan. The Board estimates the school will cost $60 million and wants to finance the building (and the related equipment and furnishings) over 30 years. How should the Board proceed?

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Hypothetical Situations – Hypothetical #1 (cont'd)

- Warrant issuance or alternative financing contract?
  - Warrant issuance – not tangible personal property.
- Publicly underwritten or private placement?
  - Either is permissible under Article 14, but > 10 (or 15 in some instances) years usually calls for a publicly underwritten transaction.
- Remember
  - Must have prior written approval of State Superintendent.
  - Must identify a source of repayment; taxes in place for 30 years?
- Consider future borrowings
  - May be a good time to "throw in" funds for anticipated future borrowings (new buses, equipment needs, etc.).

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Hypothetical Situations

- Hypothetical #2 – Refunding (Refinancing)
  - BOE receives proposals from multiple bond underwriters to refinance existing debt of the Board. How do I know if this is a good idea?

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Hypothetical Situations – Hypothetical #2 (cont'd)

- Apples-to-apples comparison is critical
  - Is debt being extended?
- What is the purpose of the refunding
  - Debt service savings?
  - "Unlocking" revenue source?
- Remember that sometimes it is better to refund only some of the outstanding warrants, but not all.
- ALSDE has engaged a financial advisory firm to "run the numbers" on BOE refundings – very good thing.

Hypothetical Situations

- Hypothetical #3 – New Revenue Source / Funding Agreements
  - City recently passed an ordinance to increase its sales tax rate by 1%, all for public school purposes.
  - BOE needs $20MM for new school capital improvements and plans to use the new sales tax proceeds to service the additional debt.

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Hypothetical Situations – Hypothetical #3 (cont'd)

- Big question – who is the issuer of the debt? City or the BOE directly?
  - Advantages of City issuance
    - Proceeds to be used to service debt will already be at City Hall (new sales tax).
    - City COULD have a higher credit rating, leading to a lower total borrowing cost.
  - Advantages of BOE issuance
    - BOE has control over the debt issuance process.
    - BOE has control over disbursement of funds.

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Hypothetical Situations – Hypothetical #3 (cont'd)

- Disadvantages of City issuance
  - City takes control of the debt issuance process and can insert its own preferences/considerations into the capital project.
  - From City's perspective, the additional debt may have negative impact on its credit rating.
- Disadvantages of BOE issuance
  - BOE MIGHT have a lower credit rating than host City.
  - BOE and City will need to enter into a funding agreement in order to "tie down" the new 1% revenue sources, so City political involvement will be required in any event.

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Hypothetical Situations – Hypothetical #3 (cont'd)

- Either approach can work successfully.
  - An open dialogue between City Hall and the BOE is critical.
- How does this change if the new revenue source is an ad valorem tax?
  - Depending on the constitutional authority for the tax, the City may not be authorized to use proceeds of the tax for any purpose OTHER than education?
  - Does ballot require proceeds be paid over to the BOE?
- Same considerations for County and County BOE?

Key Takeaways

- Two primary options for long-term financings
- The lease/installment sale might make sense in certain situations (school buses, IT equipment, non-affixed equipment)
- No one-size-fits-all approach – always look at the APR
- Short-term financings are also authorized under AL law
- Refinancing/refunding transactions may require extra attention – compare apples-to-apples and ask ALSDE to review carefully
- Funding Agreements between primary local government and BOE can make sense but not always

Questions and Answers

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