
ARTICLE

GETTING LOCAL GOVERNMENTS WHERE THEY NEED TO GO WITHOUT TAKING TAXPAYERS FOR A RIDE: “CABS,” WHY THEY ARE USED, AND WHAT CAN BE DONE TO PREVENT THEIR MISUSE

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The United States has tremendous infrastructure needs, and if those needs are to be met, local governments are likely to play a significant role in fulfilling them. Local governments spend hundreds of billions of dollars annually building infrastructure, and much of this is financed with debt in the form of bonds payable from real property taxes. Ideally, the cost of a capital project would be spread evenly over its life so all taxpayers who benefit from the project contribute to its cost. However, local political leaders have incentives to defer payment, requiring future taxpayers to pay more than their fair share. This article discusses an extreme example of this—the use of long-term compound interest bonds, on which neither principal nor interest is paid until at or near maturity. The article describes the problems with the extensive use of this form of financing and explores the reasons California and Texas school districts issue hundreds of millions of dollars of these bonds annually, then considers alternative means of addressing those problems, including recent California and Texas legislation. It is critical that problems with the framework within which local governments issue debt, such as those that lead to the misuse of long-term compound interest bonds, be addressed.

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I. INTRODUCTION

Every four years, the American Society of Civil Engineers releases its Infrastructure Report Card, which, like a school report card, assigns a letter grade to the condition of American infrastructure.¹ The 2017 grade is a D+, and the Society indicates that nearly \$4.6 trillion of infrastructure investment is needed over the next ten years.² If pressing infrastructure needs are to be met, it is likely that local governments will play a major role in fulfilling them. Local governments construct much of the public infrastructure in the United States, and President Trump's infrastructure plan is expected to require substantial spending by local governments.³

Local governments frequently borrow to build facilities, many of which are intended to last for decades.⁴ Ideally, the cost of this infrastructure—and hence the payments on the debt issued to finance it—would be spread evenly over its life so that neither today's nor tomorrow's taxpayers (or users) pay more than their fair share. Yet, in recent years, in California, Texas, and elsewhere, there has been considerable—perhaps even excessive—reliance on long-term compound interest bonds (referred to as “capital appreciation bonds” or “CABs”), on which neither principal nor interest is paid until at or near maturity.⁵ This article explores this phenomenon, considers some of the factors that may cause local governments to resort to a financing structure that on its face seems unfair, and presents alternative means of addressing misuse of this financing tool, including recent California and Texas legislation.

This article focuses on the use, by California and Texas school districts, of debt that is payable from property taxes (referred to as “general obligation bonds”)⁶ and the reasons districts sometimes issue this debt in

1. AM. SOC'Y OF CIVIL ENG'RS, 2017 INFRASTRUCTURE REPORT CARD 1 (2017).

2. *Id.* at 5, 8.

3. See Jim Watts, *Trump's \$1 Trillion Infrastructure Plan Requires State, Local Funding Match*, THE BOND BUYER (June 7, 2017), <https://www.bondbuyer.com/news/trumps-1-trillion-infrastructure-plan-requires-state-local-funding-match> [<https://perma.cc/KN2N-AND9>] (noting the plan would require states and localities to provide matching funds to obtain federal funding for infrastructure).

4. See GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016) (“[W]hen a municipal government issues bonds, the principal (or proceeds) is typically used to finance the construction of capital facilities”).

5. See *infra* note 9 and Part III for a discussion of the problems associated with CABs.

6. The term “general obligation bonds” refers to bonds supported by the issuer's full faith and credit, power to levy *ad valorem* property taxes, or both. NAT'L ASS'N OF BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS i-ii, 1-4

the form of CABs. California and Texas school districts administer public schools within their geographic areas and are controlled by locally elected governing boards.⁷ There are approximately 1,000 school districts in each of these states, each serving anywhere from a few students to hundreds of thousands of students.⁸

In recent years, California and Texas have been among the states where CABs are used most, and in both states, school districts are the most frequent issuers of this type of debt, issuing hundreds of millions of dollars of these bonds.⁹ California legislation limiting the use of CABs (AB 182) took effect in January 2014.¹⁰ Texas legislation with the same purpose (HB 114) took effect in September 2015.¹¹ The controversy surrounding

(2014). This article uses the term to refer to bonds that are supported by an unlimited pledge of *ad valorem* property taxes, but not by other revenues or assets. Sometimes general obligation bonds are referred to as “unlimited tax bonds.” See *Glossary of Municipal Securities Terms: Unlimited Tax Bond*, MUN. SEC. RULEMAKING BD., <http://www.msrb.org/glossary/definition/unlimited-tax-bond.aspx> [<https://perma.cc/73LJ-DDV4>] (defining unlimited tax bonds as “bond[s] payable from ad valorem taxes that are not limited by law in rate or amount”). The analysis in this article draws on technical issues discussed in *The Bond Lawyer*, a publication of the National Association of Bond Lawyers. Heather G. White, *Catching Too Many “CABs”?*, BOND LAW., Winter 2017, at 4.

7. CAL. EDUC. CODE §§ 35100–35125 (Deering 2013); TEX. EDUC. CODE ANN. §§ 11.002–11.0511 (West 2012).

8. *Fingertip Facts on Education in California – CalEdFacts*, CAL. DEP’T OF EDUC., <https://www.cde.ca.gov/ds/sd/cb/ceffingertipfacts.asp> [<https://perma.cc/8V6V-HWNT>]; *Largest & Smallest Public School Districts – CalEdFacts*, CAL. DEP’T OF EDUC., <http://www.cde.ca.gov/ds/sd/cb/ceflargesmalldist.asp> [<http://perma.cc/HN6C-UW2D>]; *Snapshots 2016: District Size*, TEX. EDUC. AGENCY, <https://rptsvr1.tea.texas.gov/perfreport/snapshot/2016/distsize.html> [<https://perma.cc/AAC2-WAL3>] (click each column heading to view school districts that fall within the size indicated at the top of each column).

9. See Press Release, Fitch Ratings, Fitch: Capital Appreciation Bonds May Pressure School Districts, (Aug. 29, 2012) [hereinafter Fitch Ratings Press Release], available at <https://www.fitchratings.com/site/fitch-home/pressrelease?id=759075> [<https://perma.cc/7GJG-CAAY>] (noting school districts in rapidly growing states including California and Texas use CABs often). School districts were responsible for 83.6% of the CABs issuances and 64.1% of the principal amount issued in California in 2015, and for 87.8% of the issuances and 99.2% of the principal amount issued in Texas in the fiscal year that ended on August 31, 2015 (Texas fiscal year 2015), based on data from the California Debt and Investment Advisory Commission (CDIAC) and the Texas Bond Review Board (TBRB), respectively. California Issuances 2015 (2016) (unpublished data) (on file with author) [hereinafter California Issuances 2015]; Texas Bond Review Board Issuances Texas Fiscal Years 2007–2015 (2015) (unpublished data) (on file with author) [hereinafter TBRB Issuances FY 2007–2015]. California school districts issued over \$700 million original principal amount of CABs in 2015, and Texas school districts issued over \$200 million in Texas fiscal year 2015, based on data from CDIAC and the TBRB. *Id.*

10. Assemb. B. 182, 2013–2014 Leg., Reg. Sess. (Cal. 2013).

11. Act of May 26, 2015, 84th Leg., R.S., ch. 991, §§ 1–3, sec. 1201.0245, 2015 Tex. Gen. Laws 3517–3519 (codified at TEX. GOV’T CODE § 1201.0245).

CABs that led to AB 182 and HB 114 focused on school districts.¹² One of the transactions that received considerable attention was the 2011 issuance of \$105 million CABs by the Poway Unified School District in California (Poway Transaction).¹³ No payments are required on these bonds until 2033, but nearly \$1 billion will be due between 2033 and 2051.¹⁴ While this is an extreme example, it demonstrates the issue that exists to varying degrees with all CABs.

Problems with the framework within which local government debt is issued, including those that lead to the misuse of capital appreciation bonds, must be addressed because of the important role that local government debt plays in public construction in the United States and the nation's looming infrastructure needs. Adding to the significance of these problems is the fact the United States federal government and state governments subsidize most local government borrowing.¹⁵ The federal

12. See Ian Lovett, *California Schools Finance Upgrades by Making the Next Generation Pay*, N.Y. TIMES (Feb. 9, 2013), http://www.nytimes.com/2013/02/10/us/10schools.html?_r=0 [<https://perma.cc/ENS6-9DEC>] (quoting California Treasurer Bill Lockyer as analogizing the use of CABs as “the school district’s version of printing money”); Mark Lisher, *Texas Schools Pass Debt on to the Next Generation*, WATCHDOG.ORG (Nov. 6, 2013), <http://watchdog.org/114596/texas-schools-pass-debt-next-generation/> [<https://perma.cc/5CPP-SAHL>] (reporting the filing of bills by Texas representatives to modify the use of CABs due to their propensity to be abused); Dan Weikel, *Risky Bonds Tie Schools to Huge Debt*, L.A. TIMES (Nov. 29, 2012), <http://articles.latimes.com/2012/nov/29/local/la-me-school-bond-20121129> [<https://perma.cc/7HU5-3MJQ>] (describing the dangers and concerns surrounding CABs).

13. Will Carless, *Where Borrowing \$105 Million Will Cost \$1 Billion: Poway Schools*, VOICE OF SAN DIEGO (Aug. 6, 2012), <http://www.voiceofsandiego.org/topics/education/where-borrowing-105-million-will-cost-1-billion-poway-schools/> [<https://perma.cc/3DAX-MU7J>]; see also Randall Jensen, *Calif. Capital Appreciation Bonds Have Unintended Consequences*, THE BOND BUYER (Sept. 20, 2012) [hereinafter Jensen, *Calif. Capital Appreciation Bonds Have Unintended Consequences*], http://www.bondbuyer.com/issues/121_183/california-school-districts-capital-appreciation-bonds-consequences-1044196-1.html [<https://perma.cc/QSE8-C4KD>] (stating the Poway Schools’ \$105 million bond will “require nearly \$1 billion in debt service at their 40-year maturity”); Lovett, *supra* note 12 (“And in the most expensive case yet, the Poway Unified School District borrowed \$105 million to finish modernizing older school buildings, which local property owners will be paying off until four decades from now at an eventual cost of nearly \$1 billion.”); Weikel, *supra* note 12 (“By the maturity date of 2051, however, the \$105 million in Poway notes will cost district taxpayers almost \$1 billion in principal and interest[—]more than \$9 for every \$1 borrowed.”).

14. POWAY UNIFIED SCH. DIST., \$105,000,149.70 GENERAL OBLIGATION BONDS OF SCHOOL FACILITIES IMPROVEMENT DISTRICT NO. 2007-1 OF THE POWAY UNIFIED SCHOOL DISTRICT, 2008 ELECTION, SERIES B (SAN DIEGO COUNTY, CALIFORNIA) 13 (2011) [hereinafter POWAY UNIFIED SCH. DIST., 2011 OFFICIAL STATEMENT], <http://64.79.135.236/docs/SFID%20No.%202007-1,%20GOB%202008%20Series%20B.pdf> [<https://perma.cc/U98Y-GTFE>].

15. GRANT A. DRIESSEN, *Summary to CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT* (2016) (“The federal

government reduces the cost to state and local governments of issuing debt by making interest earnings on most of such debt exempt from federal income tax.¹⁶ Tax-exempt debt typically bears interest at a lower rate than taxable debt of identical credit quality because lenders receive the benefit of tax exemption.¹⁷ Interest on most state and local government debt is also exempt from home state taxation.¹⁸

Part II of this article provides general background information, including a brief introduction to local government bonds (also referred to as “municipal bonds”), the key legal limits that apply to these bonds (particularly to California and Texas school district general obligation bonds), and the differences between capital appreciation bonds and other local government bonds. Part III discusses the most significant problems associated with the use of long-term CABs, including concerns about interperiod equity, costs, and transparency. Some of the factors that appear to contribute to the use of CABs despite these problems are canvassed in Part IV. Part V outlines recent legislation adopted in California and Texas to limit the use of CABs and highlights similarities and differences in the approaches taken in these two states. Finally, Part VI sets out the potential means to prevent misuse of CABs. The lessons this article draws from the California and Texas school district experience with CABs can be applied to local governments generally.

government subsidizes the cost of most state and local debt by excluding the interest income from federal income taxation.”).

16. Traditionally, the vast majority of state and local government securities are issued on a tax-exempt basis. U.S. SEC. & EXCH. COMM’N, REPORT ON THE MUNICIPAL SECURITIES MARKET 11 (2012). In 2015, the loss of federal tax revenue (also referred to as a “tax expenditure”)—resulting from the exemption from income of interest on public purpose tax-exempt bonds—was \$29.4 billion. GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 3 (2016).

17. See GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016) (detailing the benefits of tax-exempt bonds).

18. *State Tax Treatment of Municipal Bonds: 2012*, THE BOND BUYER (Aug. 5, 2013) (on file with author).

II. INTRODUCTION TO MUNICIPAL BONDS

A. Overview

There are more than 90,000 local governments in the United States, including more than 12,500 school districts.¹⁹ State and local governments (including school districts) put in place \$258.5 billion of new non-residential construction and improvements in 2016, including \$41.3 billion for primary and secondary school facilities.²⁰ Much of this construction is financed with state and local government debt.²¹ In 2015, state and local governments issued \$403.6 billion of debt with maturities of at least thirteen months, and a total of approximately \$3.7 trillion of state and local government debt was outstanding (including debt issued in prior years).²² Most of this is in the form of “bonds.”²³ This term generally is used to refer to local government debt securities with a maturity of more than three years;²⁴ most bonds have a significantly longer term, frequently up to thirty years and, sometimes, even longer.²⁵

Local governments, including California and Texas school districts, issue bonds primarily to finance capital projects (“new money bonds”) and

19. CARMA HOGUE, U.S. CENSUS BUREAU, NO. G12-CG-ORG, GOVERNMENT ORGANIZATION SUMMARY REPORT: 2012, at 1 (2013), http://www2.census.gov/govs/cog/g12_org.pdf [https://perma.cc/L3CH-LSSY].

20. *Annual Value of State and Local Construction Put in Place 2008–2016*, U.S. CENSUS BUREAU, https://www.census.gov/construction/c30/historical_data.html [https://perma.cc/BN8W-LS7G]. The federal government only put in place \$21.9 billion of similar projects in 2016. *Id.*

21. GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016).

22. SEC. INDUS. & FIN. MKTS. ASS'N, 2016 FACT BOOK 29, 33 (2016), <http://www2.sifma.org/WorkArea/DownloadAsset.aspx?id=8589963035> [https://perma.cc/5VPH-R686]. Local government borrowing to finance capital improvements had become customary by the early 1900s. A.M. HILLHOUSE, MUNICIPAL BONDS: A CENTURY OF EXPERIENCE 32 (photo reprint 1975) (1936).

23. GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 4 (2016).

24. *Glossary of Municipal Securities Terms: Bond*, MUN. SEC. RULEMAKING BD., <http://www.msrb.org/glossary.aspx> [https://perma.cc/Z887-56QB]. In some cases, “bonds” may have a term shorter than three years. *Glossary of Municipal Securities Terms: Short Term or Short Term Range*, MUN. SEC. RULEMAKING BD., <http://www.msrb.org/Glossary/Definition/SHORT-TERM-OR-SHORT-TERM-RANGE.aspx> [https://perma.cc/7Z7R-WQUM]. Local governments also issue “notes,” which generally have a shorter term. *Glossary of Municipal Securities Terms: Note*, MUN. SEC. RULEMAKING BD., <http://www.msrb.org/Glossary/Definition/NOTE.aspx> [https://perma.cc/J3A6-UWNH].

25. *Bond*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/bond.asp> [https://perma.cc/L2H3-FHAT] (“Bond maturities can range from a day or less to more than 30 years.”).

to refinance previously issued bonds (“refunding bonds”).²⁶ Principal and interest (“debt service”)²⁷ on municipal bonds may be paid from a single source or a combination of sources, including property taxes, sales taxes or other taxes; the local government issuer’s general fund; or revenues from a particular project.

Most debt issued by school districts in California and Texas is in the form of general obligation bonds, several billion dollars of which are issued annually in each state.²⁸ These bonds are the focus of this article. Principal and interest on California and Texas school district general obligation bonds are payable from *ad valorem* real property tax assessments that are levied solely for this purpose.²⁹ *Ad valorem* property taxes are calculated as a percentage of property value.³⁰ These taxes generally are collected shortly before debt service is due.³¹ Most, but not all, Texas school district general obligation bonds are also guaranteed under the Texas Permanent School Fund Bond Guarantee Program.³²

26. STEVE MAGUIRE, CONG. RESEARCH SERV., R41735, STATE AND LOCAL GOVERNMENT DEBT: AN ANALYSIS 2 (2011). Local governments also borrow to finance operating expenses. *Id.* This is less common and is generally accomplished with shorter-term notes rather than with bonds. *Id.*; see *Policy Basics: State and Local Borrowing*, CENTER ON BUDGET & POLICY PRIORITIES (Jan. 15, 2015), <https://www.cbpp.org/research/policy-basics-state-and-local-borrowing> [<https://perma.cc/7KAC-5M7P>] (“Almost all state and local bond debt is long-term debt incurred to pay for capital expenditures . . . not to cover operating expenses.”). Proceeds of California and Texas school district general obligation bonds cannot be used to pay operating expenses. See *infra* Section II. B., “Permitted Uses of Proceeds.”

27. *Glossary of Municipal Securities Terms: Debt Service*, MUN. SEC. RULEMAKING BD., <http://www.msrb.org/Glossary/Definition/DEBT-SERVICE.aspx> [<https://perma.cc/7PPD-ML6E>].

28. In calendar year 2015, California school districts issued approximately \$10.4 billion of general obligation bonds (out of \$11.6 billion of total school district debt). CAL. DEBT AND INV. ADVISORY COMM’N, CDIAC No. 16.09, 2015 SUMMARY OF CALIFORNIA PUBLIC DEBT ISSUANCE 1-3 (2015) [hereinafter CDIAC, 2015 SUMMARY], <http://www.sto.ca.gov/cdiac/reports/annual/2015/summary.pdf> [<https://perma.cc/H4GZ-856K>]. Texas school districts issued approximately \$14.5 billion of general obligation bonds (out of \$14.6 billion of total school district debt) in Texas fiscal year 2016. TEX. BOND REVIEW BD., 2016 LOCAL GOVERNMENT ANNUAL REPORT 40 (2016) [hereinafter TBRB, 2016 REPORT], www.lrb.state.tx.us/pub/lgs/fy2016/2016LocalARFinal.pdf [<https://perma.cc/QZM3-XXTK>].

29. CAL. EDUC. CODE § 15250 (Deering 2013); TEX. EDUC. CODE ANN. § 45.003(b)(1) (West 2012).

30. CAL. DEBT AND INV. ADVISORY COMM’N, CDIAC. NO. 06-04, CALIFORNIA DEBT ISSUANCE PRIMER, at C-2 (2006) [hereinafter CDIAC PRIMER], <http://www.treasurer.ca.gov/cdiac/debtpubs/primer.pdf> [<https://perma.cc/RF46-N72N>].

31. CAL. EDUC. § 15250; TEX. TAX CODE ANN. § 26.04 (West Supp. 2017).

32. Of the \$73.8 billion of outstanding general obligation bonds and limited tax bonds of Texas school districts as of August 31, 2016, \$68.3 billion was guaranteed by the program. TBRB,

Bonds are usually issued in a group (referred to as a series) with different maturities. Sometimes a single issuance consists of more than one series, particularly when the bonds being issued have different characteristics, such as having been approved by voters at different elections, being issued for different purposes, or having different tax-exempt status.³³

B. *Restrictions on Debt*

Most states have constitutional restrictions, statutory restrictions, or both on the amount and terms of debt that local governments within their borders may issue.³⁴ These restrictions are intended to serve a variety of purposes, including promoting fiscally sound decision-making, reducing the risk of default, preventing excessive burdens on taxpayers, and promoting interperiod equity (the concept that the burden of paying for a facility should be spread fairly over the period during which the facility is used).³⁵

2016 REPORT, *supra* note 28, at 37, 47. The Texas Permanent School Fund was established to benefit Texas public schools. Bonds guaranteed by the fund receive the highest ratings from all three agencies that rate municipal bonds. TEX. EDUC. AGENCY, TEXAS PERMANENT SCHOOL FUND DISCLOSURE STATEMENT FOR BOND GUARANTEE PROGRAM 1, 17 (June 28, 2017) [hereinafter TEXAS PERMANENT SCHOOL FUND DISCLOSURE STATEMENT], <http://tea.texas.gov/WorkArea/DownloadAsset.aspx?id=51539615528> [<https://perma.cc/23BR-2G52>] (click “I Agree”).

33. *See, e.g.*, SAN DIEGO UNIFIED SCH. DIST., \$65,434,441.70 SAN DIEGO UNIFIED SCHOOL DISTRICT 2012 GENERAL OBLIGATION REFUNDING BONDS (DEDICATED UNLIMITED *AD VALOREM* PROPERTY TAX BONDS) SERIES R-1, \$56,869,830 SAN DIEGO UNIFIED SCHOOL DISTRICT 2012 OBLIGATION REFUNDING BONDS (DEDICATED UNLIMITED *AD VALOREM* PROPERTY TAX BONDS) SERIES R-2, <http://emma.msrb.org/EP611468-EP478356-EP878739.pdf> [<https://perma.cc/K99D-RQDN>] (showing an example of two series of bonds as part of a single issuance).

34. *See* U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, M-186, STATE LAWS GOVERNING LOCAL GOVERNMENT STRUCTURE AND ADMINISTRATION 10 (1993) (describing the prevalence of several types of restrictions); Paul G. Farnham, *Re-examining Local Debt Limits: A Disaggregated Analysis*, 51 S. ECON. J. 1186, 1187 (1985) (noting all but five states have restrictions on the use of debt by local governments); Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1255–56 (2009) (“Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects . . .”); James E. Spiotto, *The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress*, MUN. FIN. J., Spring 2013, at 1, 6–8 (discussing the limits states have placed on the debt municipalities may issue).

35. *See* U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, STATE CONSTITUTIONAL AND STATUTORY RESTRICTIONS ON LOCAL DEBT 37–39 (1961) (identifying reasons for restrictions, including potential negative impacts of excessive debt on the borrowing government, other local governments and the state); Gillette, *supra* note 34, at 255–56 (discussing the reasons debt limitations were created, including protecting taxpayers and promoting interperiod

Debt limits take different forms, such as requirements for voter approval—often supermajority approval—limits on the amount of total debt, and limits on the tax rate expected to be levied to service debt.³⁶ In addition, states typically impose constraints on the structure and terms of debt and on the purposes for which bond proceeds—the amount received by the issuer, consisting of the principal amount of the bonds plus original issue premium or minus original issue discount³⁷—can be used. The restrictions that apply to California and Texas school district general obligation bonds are described below.

Voter Approval Requirements. Both California and Texas require voter approval of school district general obligation new money bonds.³⁸

School districts in California may obtain voter approval under either of two authorization regimes.³⁹ The California Constitution generally requires that general obligation bonds, issued by a local government, be approved by two-thirds of the residents in the local government's territory voting on the matter (referred to in this article as the "California Two-Thirds Regime").⁴⁰ A provision was added to the California Constitution in late 2000 that allows school districts to issue general obligation bonds to finance school facilities with the approval of 55% of the residents of the district voting on the matter (referred to in this article as the "California 55% Regime").⁴¹ Obtaining the approval of 55% of the voters is much easier than obtaining approval of 2/3 of the voters.⁴² As a result, virtually

equity); Spiotto, *supra*, note 34 at 10 (identifying prevention of financial crises and defaults as a reason for the imposition of debt limits).

36. See U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, *supra* note 35, at 27 (noting there are numerous types of restrictions on borrowing; and highlighting limits on the amount of debt, tax rates, and voter approval requirements); Farnham, *supra* note 34, at 1187 (identifying limits on the amount of debt and referendum requirements as the two major types of restrictions on debt).

37. See *infra* section II.D. (discussing original issue premium and original issue discount).

38. CAL. CONST. art. XVI, § 18; TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).

39. CAL. CONST. art. XVI, § 18.

40. *Id.* art. XVI, § 18(a).

41. *Id.* art. XVI, § 18(b). Community college districts and county offices of education can also obtain approval under the California 55% Regime, but other local governments cannot. *Id.*

42. While 79.4% of local educational bond measures presented to voters from 2001 through 2014 (including both California 55% Regime and California Two-Thirds Regime measures) passed; the success rate would have been only 36.9% if the California 55% Regime had not been available. KEVIN DAYTON, CAL. POLICY CTR., FOR THE KIDS: CALIFORNIA VOTERS MUST BECOME WARY OF BORROWING BILLIONS MORE FROM WEALTHY INVESTORS FOR EDUCATIONAL CONSTRUCTION 16 (2015).

all voter authorizations for school district bonds since 2001 have been obtained under the California 55% Regime.⁴³ Districts occasionally still use the California Two-Thirds Regime, however, because of the additional requirements imposed under the California 55% Regime.⁴⁴

To issue general obligation new money bonds, Texas school districts must obtain the approval of a majority of the residents of the district voting at an election held for that purpose.⁴⁵ Once voter approval is obtained, bonds often are issued in multiple issuances over a period of several years.⁴⁶

Expected Tax Rate Limits. In addition to voter authorization requirements, both California and Texas restrict the issuance of school district bonds by imposing limits on the tax rates for debt service that are expected to result (referred to herein as “expected rate limits”); though the California limits do not apply as broadly as the ones in Texas, as discussed below.

California school districts may issue new money bonds approved under the California 55% Regime, only if the tax rate expected to be needed—to pay debt service on bonds approved at a single election—does not exceed \$30 per \$100,000 of assessed valuation for elementary school districts and high school districts, or \$60 per \$100,000 for unified school districts (which include both elementary and high schools) in any year through the maturity of the bonds.⁴⁷ This restriction does not apply to bonds approved under the California Two-Thirds Regime.⁴⁸ Further, since the expected rate limit applies to bonds approved at a single election only, school districts can go back to voters at a subsequent election and ask

43. Only 110 of the 1,147 local educational bond measures presented to voters from 2001 through 2014 were under the California Two-Thirds Regime. *Id.*

44. These requirements include the expected rate limit described *infra* at notes 47–50 and accompanying text, and the formation of a citizens’ oversight committee, among others. CAL. EDUC. CODE §§ 15264–15288 (Deering 2013).

45. TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).

46. *See* CAL. DEBT AND INV. ADVISORY COMM’N, CDIAC NO. 14-01, K-14 VOTER APPROVED GENERAL OBLIGATION BONDS: AUTHORIZED, BUT UNISSUED 1–2 (2014) [hereinafter CDIAC, VOTER APPROVED GENERAL OBLIGATION BONDS: AUTHORIZED BUT UNISSUED] (indicating school districts issue their bonds for as many as 5-10 years after voter approval is obtained); *Bonds 101: Questions and Answers*, MY TEXAS PUBLIC SCHOOL, <https://www.mytexaspublicschool.org/The-School-System/Funding/Bonds-101-Questions-and-Answers.aspx> [<https://perma.cc/B9XA-62FS>] (noting bonds may be sold in multiple sales over a period of time).

47. CAL. EDUC. §§ 15268, 15270(a).

48. *Id.*

them to reauthorize the bonds, effectively doubling the limit. In fact, at least eleven school districts obtained reauthorization from voters in 2012, and at least another three did so in 2014.⁴⁹ However, district officials may be reluctant to seek additional voter approval for a variety of reasons, including: because they do not believe they will obtain it; because they see a significant political cost to requesting the approval; or because they need to issue bonds quickly.⁵⁰

The Texas limit, in contrast, applies to all general obligation bonds issued by a school district and cannot be modified by the voters in the district.⁵¹ Texas law requires that, before a school district issues general obligation new money bonds, it must demonstrate that it has “a projected ability to pay the principal of and interest on the proposed bonds and all previously issued bonds . . . from a tax at a rate not to exceed \$0.50 per \$100 of valuation” (adjusted to \$0.45 per \$100 for subsequent bond issuances in some circumstances as described in the following paragraph).⁵²

Both California and Texas school districts must comply with expected rate limits at the time bonds are issued.⁵³ Should a higher tax rate ultimately be necessary to pay debt service, the higher tax must be levied.⁵⁴ Texas law allows expected rate limits to be calculated based on either historic assessed valuations or projections within specified

49. See INST. FOR SOC. RESEARCH, CTR. FOR CAL. STUDIES, CAL. STATE UNIV., SACRAMENTO, CALIFORNIA COUNTY, CITY AND SCHOOL DISTRICT ELECTION OUTCOMES, 2012 ELECTIONS, SCHOOL DISTRICT OFFICES AND BALLOT MEASURES 19–38 [hereinafter INST. FOR SOC. RESEARCH, 2012 ELECTIONS], <http://elections.cdn.sos.ca.gov/county-city-school-district-election-results/2012/school-district-report-2012.pdf> [<https://perma.cc/Y2X3-JM6A>] (providing the data from which these figures were derived); INST. FOR SOC. RESEARCH, CTR. FOR CAL. STUDIES, CAL. STATE UNIV., SACRAMENTO, CALIFORNIA COUNTY, CITY AND SCHOOL DISTRICT ELECTION OUTCOMES, 2014 ELECTIONS, SCHOOL DISTRICT OFFICES AND BALLOT MEASURES 19–39 [hereinafter INST. FOR SOC. RESEARCH, 2014 ELECTIONS], <http://elections.cdn.sos.ca.gov/county-city-school-district-election-results/2014/schooldistrict-report-2014.pdf> [<https://perma.cc/2TR2-FE5G>] (providing additional data needed for these statistics); see, e.g., DALE SCOTT, WIN WIN: AN INSIDER'S GUIDE TO SCHOOL BONDS 108–09 (2013) (describing an example of school bond elections).

50. The election process takes time, and bonds may be approved under the California 55% Regime only at statewide election or at a regularly scheduled local election (typically in June and November). CAL. EDUC. § 15266(a) (Deering 2013).

51. TEX. EDUC. CODE ANN. § 45.0031(a) (West 2012).

52. *Id.* § 45.003. Districts may include state assistance that can legally be used for debt service.

Id.

53. CAL. EDUC. §§ 15268, 15270(a); TEX. EDUC. § 45.0031(a).

54. CAL. EDUC. § 15250 (Deering 2013); TEX. TAX CODE ANN. § 26.04 (West Supp. 2017).

parameters.⁵⁵ If a district uses projections and the tax rate necessary to pay debt service ultimately exceeds the expected rate limit, the limit is adjusted to \$0.45 for subsequent issuances.⁵⁶ California law provides no specific guidance on how to determine compliance and no penalty if actual rates are higher than the limit.⁵⁷

California Limit on Debt as a Percentage of Assessed Valuation. California school districts may not issue general obligation new money bonds if the total principal amount of general obligation bonds outstanding after the issuance would exceed 1.25% of the assessed value of taxable property of the district (2.50% for unified school districts).⁵⁸ These caps can be—and in fact are—sometimes waived by the California State Board of Education.⁵⁹ While requests for waivers of this limit are relatively infrequent, they are typically granted.⁶⁰

Other Restrictions on Structure and Terms of Debt. California and Texas also impose statutory restrictions on the structure and terms of school district general obligation new money bonds. For example, these bonds may be outstanding for no more than 40 years in either state, with shorter maximum terms for CABs as a result of the passage of AB 182 and HB 114.⁶¹ The maximum interest rate and maximum yield (taking into account original issue discount) for general obligation bonds issued by California school districts is 12% (8% for CABs as a result of AB 182).⁶² While in Texas, the maximum net effective interest rate (taking into account original issue premium, discount and compounding of interest) is 15%.⁶³ Different restrictions apply to refunding bonds.⁶⁴

55. TEX. EDUC. §§ 45.0031(b)–(c) (West 2012). Most districts use historic assessed valuations. *See infra* note 201.

56. TEX. EDUC. § 45.0031(e) (West 2012).

57. CAL. EDUC. §§ 15268, 15270(a).

58. *Id.* §§ 15102, 15106, 15268, 15270(a).

59. DAYTON, *supra* note 42, at 44.

60. Of fifty-one requests made between 2000 and 2014, forty-eight were approved and three were withdrawn. *Id.* at 45. In contrast, the Board of Education has never granted a waiver of the expected rate limit. *July 2016 Agenda Item #W-10 3*, CAL. STATE BD. OF EDUC. (2015), <http://www.cde.ca.gov/be/ag/ag/yr16/agenda201607.asp> [https://perma.cc/78UT-SW3S].

61. CAL. EDUC. § 15144 (Deering 2013); CAL. GOV'T §§ 53508(f), 53508.5 (Deering 2011 & Supp. 2017); TEX. EDUC. § 45.001(b) (West 2012); TEX. GOV'T CODE ANN. § 1201.0245(b)(1) (West Supp. 2017). *See infra* Section V for discussion of AB 182 and HB 114.

62. CAL. EDUC. § 15143 (Deering 2013); CAL. GOV'T §§ 53508(d), 53508.5, 53531, 53532 (Deering 2011 & Supp. 2017).

63. TEX. GOV'T § 1204.006 (West 2013); *see also id.* §§ 1204.003, 1204.004, 1204.005 (setting forth computations).

Bonds that are issued on a tax-exempt basis (that is, bonds the interest on which is excluded from income for federal income tax purposes) are also subject to extensive requirements under the Internal Revenue Code of 1986 and related regulations.⁶⁵ These requirements are intended to ensure that proceeds of tax-exempt bonds are used for purposes and activities deemed appropriate by the U.S. Congress and to prevent local governments from issuing more tax-exempt bonds than they need, issuing the bonds too far in advance of the time proceeds are used, or allowing the bonds to remain unpaid for longer than is necessary.⁶⁶

Permitted Uses of Proceeds. California and Texas school districts may use general obligation bond proceeds only for certain purposes.

School districts generally may use proceeds of bonds approved under the California Two-Thirds Regime to acquire, construct and improve school lots and facilities.⁶⁷ Bonds issued under the California 55% Regime also may be used to finance furniture and equipment.⁶⁸ California districts are further limited to financing projects that are described in the bond measure approved by the voters.⁶⁹ In addition to paying direct project costs, districts may use bond proceeds to pay the costs of the bond issuance (including fees paid to financial advisors, underwriters, and lawyers) and capitalized interest (interest on the bonds prior to expected completion of the project or soon thereafter).⁷⁰ California school districts may not use general obligation bond proceeds for operating expenses.⁷¹

Texas school districts generally may use proceeds of general obligation bonds to construct, acquire, improve and equip school sites and facilities, and to acquire school buses.⁷² Districts may also use proceeds to pay

64. The most relevant of these restrictions in California and Texas are described in Sections V.A., V.B., and V.C., *infra*.

65. 26 U.S.C. §§ 103, 141–150 (2012); *see also* INTERNAL REVENUE SERV., OFFICE OF TAX EXEMPT BONDS, PUBLICATION 4079 TAX-EXEMPT GOVERNMENTAL BONDS (2016) (providing a summary of some of the United States Treasury regulations that apply to tax-exempt bonds).

66. *See* STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1151–56 (1987), <http://www.jct.gov/jcs-10-87.pdf> [<https://perma.cc/CB7U-YWP3>] (discussing the reasons for the Tax Reform Act of 1986).

67. CAL. CONST. art. XIII A, § 1(b)(2); CAL. EDUC. § 15100 (Deering 2013).

68. CAL. CONST. art. XIII A, § 1(b)(3); *id.* art. XVI, § 18(b); CAL. EDUC. §§ 15100, 15266(b) (Deering 2013).

69. CAL. CONST. art. XIII A, § 1(b)(3); *id.* art. XVI, § 18(b); CAL. EDUC. § 15122 (Deering 2013); CAL. GOV'T CODE § 53410 (Deering 2011).

70. CAL. EDUC. §§ 15146(h), (j) (Deering 2016).

71. CAL. CONST. art. XIII A, §§ 1(b)(2), 1(b)(3)(A); CAL. EDUC. §§ 15100, 15266(b).

72. TEX. EDUC. CODE ANN. § 45.001(a) (West 2012).

costs of issuance and capitalized interest.⁷³ Proceeds may not be used to pay operating expenses.⁷⁴ Texas districts, like those in California, are limited to financing projects that are within the scope approved by the voters.⁷⁵

C. *Repayment of Principal*

Typically, principal of each bond is paid at maturity or over a period of years leading up to maturity.⁷⁶ However, because bonds are usually issued in a series with multiple maturities, principal payments are typically made over the life of a series of bonds, though the amount of such payments may vary from year to year.⁷⁷

D. *Return on Investment*

Municipal bonds provide return to investors in the form of interest, original issue discount, or both.⁷⁸ The interest rate on the bonds may be

73. TEX. GOV'T CODE ANN. §§ 1201.042(a), (d) (West Supp. 2017).

74. This prohibition has one limited exception that allows for the operation of the facility itself during construction and for one year after. *Id.* § 1201.042(a).

75. CAL. CONST. art. XIII A, § 1(b)(3); *id.* art. XVI, § 18(b); CAL. EDUC. § 15122 (Deering 2013); CAL. GOV'T CODE § 53410 (Deering 2011); TEX. ELEC. CODE ANN. § 52.072(e)(1)(B) (West Supp. 2016); TEX. GOV'T § 1201.042(e) (West Supp. 2017).

76. When principal is required to be paid over a period of years leading up to maturity, the principal payments are referred to as “mandatory sinking fund payments” and the bonds are referred to as being subject to “mandatory sinking fund redemption” in the amount of the payments. *See* TBRB, 2016 REPORT, *supra* note 28, at 126 (defining a term bond and how payments are made). Payments are allocated to investors by lot, meaning the bondholders do not know in advance which holders will be repaid early. *See, e.g.*, MOJAVE UNIFIED SCH. DIST. \$8,040,000 GENERAL OBLIGATION BONDS OF SCHOOL FACILITIES IMPROVEMENT DISTRICT NO. 1 OF THE MOJAVE UNIFIED SCHOOL DISTRICT (KERN COUNTY, CALIFORNIA) ELECTION OF 2014, SERIES 2015, at F-2 (2015) [hereinafter MOJAVE ISD 2015 OFFICIAL STATEMENT], <http://emma.msrb.org/ER913004-ER713242-ER1114694.pdf> [<https://perma.cc/W6PY-TR86>] (describing selection of bonds for redemption as “randomly” and “by lot”); SCHERTZ-CIBOLO-UNIVERSAL CITY INDEP. SCH. DIST., OFFICIAL STATEMENT DATED SEPTEMBER 18, 2014, at 4, 8 (2014), <https://emma.msrb.org/EP831962-EP644201-EP1045821.pdf> [<https://perma.cc/AE26-L62A>] (describing the selection of bonds for redemption “by lot”).

77. *See* Andrew Ang & Richard C. Green, Discussion Paper, *Lowering Borrowing Costs for States and Municipalities Through CommonMuni*, HAMILTON PROJECT, Feb. 2011, at 10 (“Since 1995, the average municipal bond series has contained thirteen separate bonds . . .”).

78. Investors may also earn capital gains if they trade municipal bonds in the secondary market, but this does not directly affect local government issuers, and, therefore, is not a focus of this article. *See What to Expect When Selling Municipal Bonds Before Maturity*, MSRB, <http://www.msrb.org/msrb1/EMMA/pdfs/Selling-Before-Maturity.pdf> [<https://perma.cc/WRG8-N3L2>] (describing factors that can affect the price of bonds in the secondary market).

set at a fixed rate at the time they are issued: a rate that changes periodically based on market conditions or a predetermined index.⁷⁹ Virtually all California school district general obligation bonds bear interest at a fixed rate, and only a very small percentage of Texas school district general obligation bonds do not. Some local government bonds are sold at a discount from their stated principal amount, meaning the investor pays less than the face amount of the bond.⁸⁰ This discount is referred to as “original issue discount.”⁸¹ Original issue discount has the effect of increasing the yield on the bond (the return to the investor) above the nominal interest rate.⁸²

Most of the time, local governments issue bonds on which they pay interest periodically (usually semiannually) throughout the term of each bond.⁸³ Bonds on which interest is required to be paid in this manner are referred to as “current interest bonds” or “CIBs.”⁸⁴ Sometimes, local governments, instead, issue bonds of the type that are the focus of this paper—CABs—on which interest is added to principal (“compounded” or “accreted”) periodically rather than being paid.⁸⁵ The compounded

79. *Glossary of Municipal Securities Terms: Fixed Rate*, MUN. SEC. RULEMAKING BD., <http://msrb.org/Glossary/Definition/FIXED-RATE.aspx> [<https://perma.cc/4YXK-GTV2>]; *Glossary of Municipal Securities Terms: Variable Rate*, MUN. SEC. RULEMAKING BD., <http://msrb.org/glossary/definition/variable-rate.aspx> [<https://perma.cc/82ZN-Y63R>].

80. CDIA PRIMER, *supra* note 30, at C-18.

81. *Id.*; *Glossary of Municipal Securities Terms: Original Issue Discount Bond or OID Bond*, MUN. SEC. RULEMAKING BD., <http://msrb.org/Glossary/Definition/ORIGINAL-ISSUE-DISCOUNT-BOND-OR-OID-BOND.aspx> [<https://perma.cc/JG97-GZFM>].

82. *The Underwriting Process*, MSRB EDUCATION CENTER, <http://www.msrb.org/EducationCenter/Municipal-Market/Lifecycle/Primary/Underwriting-Process.aspx> [<https://perma.cc/FG5D-2FJE>].

83. See John E. Petersen, *Innovations in Tax-Exempt Instruments and Transactions*, NAT'L TAX J., Dec. 1991, at 11, 15 (describing the traditional bond payment structure); ORANGE CTY. GRAND JURY, SCHOOL BONDS—THE UNTOLD STORY OF ASSESSED VALUES 7 (2014) [hereinafter ORANGE CTY. GRAND JURY, SCHOOL BONDS], http://www.ocgrandjury.org/pdfs/2013_2014_GJreport/BondsReport.pdf [<https://perma.cc/XUP9-84GV>] (“A CIB typically pays the interest due twice a year and the principal is repaid either at the end of the term of the bond or in a series of annual principal payments toward the end of the term of the bond.”).

84. See ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 7 (describing the CIB).

85. Local governments also issue “convertible capital appreciation bonds,” which are a hybrid of current interest bonds and capital appreciation bonds. *Bond sales: Questions and Considerations for Districts*, CAL. SCH. BDS. ASS'N, <https://www.csba.org/GovernanceAndPolicyResources/~/media/CSBA/Files/GovernanceResources/GovernanceBriefs/201212GBBondSales.a> shx [<https://perma.cc/KE6P-8GEP>]. Interest on these bonds compounds until a specified conversion date, then is paid periodically on the sum of the original principal amount plus the

interest itself then bears interest until it is paid, together with principal, at maturity.⁸⁶ The sum of the principal plus the compounded interest to be paid at maturity is referred to as the “maturity amount” or “maturity value” of the CAB.⁸⁷

It is common for local governments to issue bonds with a small amount of original issue discount (typically—though not always—less than 3%).⁸⁸ Local governments today rarely issue deeply discounted bonds, including “zero coupon bonds,” on which no interest is paid and all return on investment is in the form of original issue discount, though they did so more frequently in the early 1980s.⁸⁹ Zero coupon bonds are the economic equivalent of CABs and have largely been replaced by CABs, primarily because of differences in their treatment in calculating compliance with debt limits.⁹⁰

California and Texas school districts often issue general obligation bonds at a premium, meaning the investor pays more than the face amount of the bond and the yield on the bond is lower than the nominal

interest compounded through the conversion date. These raise the same concerns as CABs, though to a lesser degree, and are not addressed separately in this article. See SCOTT, *supra* note 49, at 22 (describing convertible CABs, and indicating they are a variation of CABs).

86. See 2015–2016 L.A. CTY. CIV. GRAND JURY, CAPITAL APPRECIATION BONDS AND OTHER SCHOOL BOND DEBT: CONSEQUENCES OF POOR FINANCIAL PRACTICES FINAL REPORT 105 (2016) [hereinafter L.A. CTY. CIV. GRAND JURY REPORT], <http://grandjury.co.la.ca.us/pdf/LOSANGELESCOUNTY2015-2016CIVILGRANDJURYFINALREPORT.pdf> [<https://perma.cc/C25B-8ELF>] (“CABs are a repayment structure similar to both U.S. Savings Bonds and what in the mortgage industry is called a ‘balloon loan,’ where all principal and interest is due at maturity.”); see also ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 7 (explaining the interest on a CAB is not paid until maturity). Principal and interest are sometimes paid near maturity for bonds subject to mandatory sinking fund redemption. See *supra* note 76 (explaining this concept).

87. *Glossary of Municipal Securities Terms: Maturity Value*, MUN. SEC. RULEMAKING BD., <http://msrb.org/Glossary/Definition/MATURITY-VALUE.aspx> [<https://perma.cc/BJB2-6LMQ>].

88. See CDIA PRIMER, *supra* note 30, at C-18 (noting bonds with discounts in excess of two or three percent are “deep discount bonds”).

89. See Alan Walter Steiss, *New Financing Instruments for State and Local Capital Facilities*, PUB. BUDGETING & FIN., Fall 1988, at 24, 28 (indicating zero coupon municipal bonds were introduced in the late 1970s and became popular soon thereafter); Robert Metz, *Market Place: Zero-Coupon Municipals*, N.Y. TIMES (Mar. 31, 1982), <http://www.nytimes.com/1982/03/31/business/market-place-zero-coupon-municipals.html> [<https://perma.cc/5SNA-VPNK>] (asserting the first major issue of zero coupon municipal bonds was in 1982).

90. See *infra* Section III.C.

interest rate.⁹¹ This results in additional proceeds—sometimes substantial additional proceeds (particularly in Texas)—from the financing.⁹²

A single issuance of bonds may include both current interest bonds and capital appreciation bonds, and also a combination of bonds issued at a discount, at face value, and at a premium.⁹³

III. THE TROUBLE WITH CABs

The use of CABs causes three significant problems. First, CABs allow local governments to benefit today's taxpayers at the expense of tomorrow's. This is inconsistent with the concept of interperiod equity. Second, CABs generally have higher yields than current interest bonds. Lastly, because compounded interest on CABs is not counted against state constitutional and statutory debt limits—that are based on the total amount of debt that can be issued or outstanding—the use of CABs encourages the perception that less debt is being incurred than is, in fact, the case.

A. *CABs Are Incompatible with Interperiod Equity*

In the context of local government debt issued to finance capital projects, “interperiod equity” or “intergenerational equity” is the concept that the burden of paying taxes to finance a facility should be spread fairly over the period during which taxpayers benefit from the facility.⁹⁴

91. See Jason Chung, *Selling at Premium: How School Districts Can Pay Costs of Issuance*, FIELDMAN ROLAPP & ASSOCIATES SCH. FIN. NEWS (Oct. 2012) (on file with author) (“For many years California school districts have generated extra upfront cash from their bond proceeds by purposefully inflating their coupon rates for the investors who end up purchasing these premium bonds.”); TEX. BOND REVIEW BD., CAB SUMMARY REPORT 1 (2016), www.brb.state.tx.us/pub/lgs/fy2016/CABs%20Summary%202016.pdf [https://perma.cc/5V3M-5AVU] (describing the practice of issuing general obligation bonds in the form of CABs at a premium).

92. California law does not permit premium to be used for project costs. CAL. EDUC. CODE § 15146 (Deering 2016). While there has been criticism of the practice, premiums have been sometimes used to pay issuance costs. Chung, *supra* note 91; Letter from Kamala D. Harris, Att’y Gen., State of Cal., to Wendy H. Wiles, Robert E. Anslow & Jeffrey A. Hoskinson, Bowie, Arneson, Wiles & Giannone (Mar. 11, 2011) (on file with author). Texas law permits premium to be used for any costs related to the purpose for which the bonds were issued. TEX. GOV’T CODE ANN. § 1201.042(d)(4) (West 2013). Furthermore, Texas law caps the principal amount of school district general obligation refunding bonds at the principal amount of the bonds being refinanced. See *infra* Section IV.F. for discussion of how this encourages the use of premium CABs.

93. TBRB, 2016 REPORT, *supra* note 28, at 11, 41, 106.

94. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 693 (4th ed. 1984); M. David Gelfand, *Seeking Local Government Financial Integrity Through*

Achieving interperiod equity is one of the justifications for financing capital projects by borrowing, rather than by requiring, current taxpayers to pay the full cost of a facility that will be used for many years.⁹⁵ But interperiod equity also is violated if future taxpayers are required to pay a disproportionate share of the cost of a project.⁹⁶

Spreading the costs of facilities fairly over their lives encourages an optimal, or closer to optimal, level of investment in capital improvements. Requiring facilities to be paid for with current revenues is likely to result in too few capital improvements.⁹⁷ Conversely, “the ability to shift the costs forward may . . . induce elected officials to incur too much debt,” because “they can get the credit for the new project immediately, while the blame for the additional taxes needed to pay off the debt will be borne by their successors.”⁹⁸

Because property taxes to pay debt service on general obligation bonds generally are not levied until near the time these amounts must be paid, any structure—under which the bulk of the debt service is not due until at or near maturity (a “back-loaded” structure)—disproportionately burdens

Debt Ceilings, Tax Limitations, and Expenditure Limits: The New York City Fiscal Crisis, the Taxpayers' Revolt, and Beyond, 63 MINN. L. REV. 545, 550-51 (1979).

95. MUSGRAVE & MUSGRAVE, *supra* note 94, at 693-94; Maria Emilia Freire, *Managing External Resources*, in MUNICIPAL FINANCES: A HANDBOOK FOR LOCAL GOVERNMENTS 325, 327 (Catherine Farvacque-Vitkovic & Mihaly Kopanyi, eds. 2014); Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 917 (2003); Gelfand, *supra* note 94, at 550-51; Lori Raineri & Darien Shanske, *Municipal Finance and Asymmetric Risk*, 4 BELMONT L. REV. 65, 69 (2017). Using debt to spread the cost of a project over its life is not a new idea. See JOHN A. FAIRLIE, MUNICIPAL ADMINISTRATION 330 (1910) (“At the present time the municipal debts are incurred for the erection of permanent works, so as to distribute the cost of construction over the period for which the works will be in existence.”).

96. Gelfand, *supra* note 94, at 550.

97. See GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016) (noting paying for facilities when they are built “is likely to result in a less than optimal rate of public capital formation”); Raineri & Shanske, *supra* note 95, at 69 (arguing if capital projects are funded only with current revenue, large capital projects “could hardly ever be built”).

98. Briffault, *supra* note 95, at 917-18; see also ROBERT S. AMDURSKY ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE 207-08 (2nd ed. 2013) (observing local officials have incentives to over utilize debt); Gelfand, *supra* note 94, at 549-51 (providing historical context around the need for debt limitations and indicating that future taxpayers are the primary beneficiaries of debt ceilings); Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1322-24 (1991) (“[A]s courts dealt with legislative attempts to evade constitutional restrictions, judicial opinions, too, reflected the view that constitutional limitations were necessary to retrain legislative tendencies to incur too much debt.”).

future taxpayers.⁹⁹ Long-term capital appreciation bonds—on which no debt service (including interest on compounded interest) is paid until at or near maturity—take this to an extreme. In the case of the 2011 Poway Transaction, for example, taxpayers will pay nearly \$1 billion between 2033 and 2051 on \$105 million of debt (\$126 million of proceeds including principal and original issue premium) for upgrades and modernization of schools;¹⁰⁰ it is not hard to imagine that the facilities will again need to be modernized even before the first debt service payment is made.

Even if, as appears to be the case in some instances, school districts use CABs to try to maintain substantially level tax rates throughout the life of the debt, interperiod equity may be compromised. First, even if their tax rates are not higher because assessed valuations rise over time as projected, future taxpayers may pay a disproportionate share of the facilities financed with the CABs, particularly if assessed valuations were projected to rise more rapidly than inflation¹⁰¹ or if already outstanding debt that matures in the near—to medium—term is also factored into the calculation. Second, future taxpayers bear the risk that property values will not increase as expected or (less likely) will decline. Should this occur, they will have to pay higher tax rates for debt service, and the district's ability to issue additional debt may be constrained as long as the CABs remain outstanding.¹⁰²

If total debt service on school district general obligation bonds were fully capitalized into real estate values—that is, if property values accurately reflected the cost of future debt service—CABs would not disproportionately burden future property owners.¹⁰³ Scholars have reached varying conclusions about the extent to which taxes are capitalized

99. An increase in debt service over time that reflects expected inflation would be appropriate; otherwise future taxpayers would be paying less in real dollars than current taxpayers are. The concern is with structures in which a substantial portion of debt service is delayed.

100. POWAY UNIFIED SCH. DIST., 2011 OFFICIAL STATEMENT, *supra* note 14, at 1–2, 5, 13–14.

101. This is more likely to occur in states that do not impose strict limits on assessed valuation increases.

102. Requiring future taxpayers to bear the risk of assessed valuations growing more slowly than projected is particularly troubling because school district officials have incentives to make optimistic assumptions about future property value growth. *See infra* Section IV.E.

103. *See* Clayton P. Gillette, *Direct Democracy and Debt*, 13 J. CONTEMP. LEGAL ISSUES 365, 392 (2004) (noting greater capitalization results in more closely aligned interests of current and future taxpayers).

into home values, though it appears that some capitalization occurs.¹⁰⁴ However, even if property taxes are fully capitalized in some circumstances, it is unlikely that the possibility of higher future taxes—because of a school district’s debt structure—would be. Information about a school district’s general obligation debt level and debt service structure is not typically provided to prospective purchasers by realtors or title companies, making it unlikely that this information would be known to a buyer.¹⁰⁵

Furthermore, even if a buyer had this information, he or she would also need information about current assessed valuations in the school district and would need to either obtain and evaluate existing projections of assessed valuation growth and the assumptions on which they were based,¹⁰⁶ or develop his or her own projections in order to predict the impact of debt service on future tax rates. To obtain a complete picture, a prospective purchaser would have to gather and analyze information for every local government within the territory of which the property was located.¹⁰⁷ The difficulties and uncertainties of determining the impact of CABs on future tax rates make it unlikely that they are fully capitalized.¹⁰⁸

104. *See id.* (noting some capitalization results in a limited ability to pass on tax increases to new buyers); *see also* WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOMES VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE AND LAND USE POLICIES 47–51 (2005) (discussing various capitalization studies and concluding that anticipated taxes are fully capitalized).

105. While information about a school district’s debt service structure is available from documents posted on the Municipal Securities Rulemaking Board’s (MSRB’s) Electronic Municipal Market Access website (emma.msrb.org), or by making a public records request to the district, it is not likely that many prospective purchasers do this.

106. *See* DAYTON, *supra* note 42, at 75 (noting assessed valuation projections may not be available at all). A new California law that requires school boards to obtain assessed valuation projections that take into consideration those of the county assessor, in advance of calling a bond election, (*see infra* note 308 and accompanying text) and the new requirements imposed by AB 182 and HB 114, with respect to CABs, may help to some extent (particularly the provisions of HB 114).

107. There could be several of these, including a county, a city, a community college district, and other special districts in addition to the school district.

108. Even William Fischel, who argues in favor of capitalization, notes that capitalization is 100% only for anticipated taxes. FISCHEL, *supra* note 104, at 49–51. While Fischel was discussing anticipated changes in the law, the same concept would apply if potential purchasers could not determine the amount of the future taxes. *See also* Darien Shanske, *Public Tax Dollars for Private Suburban Development: A First Report on a National Phenomenon*, 26 VA. TAX REV. 709, 751–58 (2007) (arguing Mello-Roos assessments are not fully capitalized). Mello-Roos taxes, which are authorized under the Mello-Roos Community Facilities Act of 1982 (codified at California Government Code Sections 53311–53368.3), are more likely than a school district’s general obligation debt structure to be fully capitalized. Notices of Mello-Roos assessments that include information about the rate and

B. *CABs Cost More*

Yields often are higher on CABs—and zero-coupon bonds—than on current interest bonds, particularly in a low interest rate environment like that of recent years. There are three reasons for this. First, because CABs do not receive any payment on the bonds until at or near maturity, investors are more concerned about adverse changes in the condition of the issuer or changes in market conditions that would negatively affect the price at which the investor would be able to sell the CABs in the secondary market, and about the risk of default (though defaults of local government bonds, and particularly of general obligation bonds, are extremely rare).¹⁰⁹ Second, when interest rates are low, investors demand a higher rate because, in effect, the interest earned on CABs is automatically reinvested in the same bond (and cannot be invested in anything else).¹¹⁰ Since investors expect interest rates to go up in the period during which the bonds are outstanding, they charge a premium for the foregone investment opportunities. Third, there generally are fewer buyers for CABs in the secondary market than there are for CIBs, which means that it may be harder to sell them.¹¹¹ Based on a review of data for the last business day

method of apportionment of the tax are filed with the county recorder as a special lien and hence could be found in a title search. *See* CAL. GOV'T. CODE § 53328.3 (Deering 2008) (stating the notice of lien must be filed with the county recorder); *see also* CAL. STS. & HIGH CODE §§ 3114.5, 3115.5 (Deering 2008) (establishing the information required to be included in the filing and noting the lien will continue in full force and effect until the tax obligation has been paid and satisfied). Furthermore, because Mello-Roos taxes cannot be based on assessed values—and instead are based on features like lot size, whether or not the lot is developed, or the purpose of the lot—potential buyers typically have the information necessary to calculate their maximum tax rates based on the formula in the recorded notice. *But see* FISCHER, *supra* 104, at 49–50 (describing a 1994 study by A. Quang Do and C. F. Sirmans concluding that Mello-Roos taxes are fully capitalized). Shanske argues against the study's conclusion. Shanske, *supra*, at 755–58.

109. Only ninety-five issuers defaulted on bonds rated by Moody's Investors Service (one of the three entities rating municipal bonds) between 1970 and 2014, and of these, only eight involved general obligation bonds (though four of these occurred in 2012 and 2013). *US Municipal Bond Defaults and Recoveries, 1970–2014*, MOODY'S INVESTORS SERV., 10 (July 24, 2015), https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBM_1006917 [<https://perma.cc/7CAJ-SRCH>]. This compares to a total of 15,400 ratings at the end of 2014, 8,600 of which were ratings on general obligation bonds. *Id.* at 6.

110. MUN. SEC. RULEMAKING BD., ABOUT ORIGINAL ISSUE DISCOUNT BONDS 3, <http://www.msrb.org/msrb1/pdfs/Original-Issue-Discount-Bonds.pdf> [<https://perma.cc/L76F-FM5G>].

111. James Ramage, *As Spread for Zeros Shrink, Debate on Their Value Grows*, THE BOND BUYER (Mar. 8, 2013, 1:43 PM), http://www.bondbuyer.com/issues/122_47/muni-investors-see-yield-in-zero-coupon-bonds-as-activity-picks-up-1049482-1.html [<https://perma.cc/63LD-PU5E>] (quoting

of March and September from 1996 to 2015, in the vast majority of cases, AAA-rated CABs had higher yields than comparable CIBs, and in the most extreme case, 1.18% higher yields.¹¹²

In addition, the interest on CABs compounds over many years, which increases the overall cost, though not—absent the higher yields described in the preceding paragraph—the present value of the stream of debt service payments. Issuers generally pay approximately \$2 to \$3 of debt service for every \$1 of principal on CIBs.¹¹³ In contrast, issuers reportedly pay between \$3.50 and \$23 for every \$1 of principal on CABs.¹¹⁴ The ratio of proceeds to debt service would be lower for bonds issued at a premium. For the top one-hundred most expensive CABs outstanding in Texas as of August 31, 2016, districts paid between \$2.85 to \$10.87 of debt service for every \$1 of proceeds, as compared to less than \$2 for the typical CIB.¹¹⁵

C. CABs Conceal the Full Amount of Debt

As discussed in this section, interest that compounds on CABs is not counted against state constitutional and statutory debt limits even though, once it compounds, there is no substantive reason to distinguish the interest from the original principal. Failing to count compounding interest for debt limit purposes is likely to be contrary to the expectations of voters, gives the impression to the public (and to school board members

Matt Fabian of Municipal Market Advisors) (stating CABs (referred to as “zeros” in the article) lack broad investor demand).

112. The Municipal Market Monitor (TM 3), NonCall and Zero Yield Curves as of 09/30/2015 (2016) (on file with author). There were some instances in which yields on AAA-rated CABs were the same or slightly lower than the rate on AAA-rated CIBs with the same term (up to 0.06% and primarily for one, two, and three-year bonds). *Id.* The difference in interest rates for CABs and CIBs varies depending on the term of the bond and changes from day to day. In the very high interest rate environment of the early 1980s, interest rates on CABs and zero-coupon bonds were lower than those on comparable CIBs. *See infra* note 138 and accompanying text.

113. Cal. S. Governance & Fin. Comm., A.B. 182 School Bonds Bill Analysis (Revised) (July 11, 2013), 2013–2014 Leg., Reg. Sess., at 2 (Cal. 2013), available at http://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201320140AB182 [<https://perma.cc/J8VK-V2B4>]; *see Lovett, supra* note 12 (reporting average school bonds usually cost two or three times what was initially borrowed in repayment); *see also Weikel, supra* note 12 (“Most school bonds . . . require roughly \$2 to \$3 to be paid back for every \$1 borrowed.”).

114. *See* Cal. S. Governance & Fin. Comm. A.B. 182 School Bonds (Revised) (July 11, 2013), 2013–2014 Leg., Reg. Sess., at 2 (Cal. 2013), available at http://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201320140AB182 [<https://perma.cc/XYX4-98N2>] (indicating the debt to principal ratios for CABs varies widely).

115. TBRB, 2016 REPORT, *supra* note 28, at 106–08.

and officials) that less debt is being incurred than actually is, and, in effect, allows issuers to circumvent these limits. This is particularly concerning in situations—such as that of California and Texas school district general obligation bonds—where voter approval of debt is required.¹¹⁶

Compounding interest on CABs is not counted against limits on the amount of debt that can be issued or outstanding, such as the amounts authorized by voters in Texas and California and the limit on debt as a percentage of assessed valuation in California.¹¹⁷ This exclusion is such a fundamental component of the CAB that it is included in the definition of “Capital Appreciation Bonds” published by the MSRB—a self-regulatory organization created under federal securities laws to regulate the municipal bond market—which states that:

[B]ecause the investment return is considered to be in the form of compounded interest rather than accreted original issue discount [as it would be for a zero-coupon bond] . . . only the initial principal amount of a CAB would be counted against a municipal issuer’s statutory debt limit.¹¹⁸

In Texas, ballot propositions and election orders are required to include the “principal amount” of the bonds,¹¹⁹ and premium—used to pay costs of the project for which the bonds were issued—is also counted against the voter-authorized amount.¹²⁰ In California the “amount” of the bonds that must be included on the ballot is interpreted to mean the principal amount.¹²¹

However, there is a strong argument that once interest has been added to the original principal amount of the CABs, it should be treated as debt and counted against debt limits.¹²² Clearly, from a commercial

116. CAL. CONST. art. XVI, § 18; TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).

117. See *supra* Section II.B. for discussion of these limits.

118. *Glossary of Municipal Securities Terms: Capital Appreciation Bond*, MUN. SEC. RULEMAKING BD., <http://www.msrb.org/Glossary/Definition/CAPITAL-APPRECIATION-BOND-CAB.aspx> [https://perma.cc/KL84-R3F6]. In contrast, the full amount payable at maturity is counted for zero coupon bonds. *Id.*

119. TEX. ELEC. CODE ANN. §§ 3.009(b)(3), 52.072(e)(1)(A) (West Supp. 2016).

120. TEX. GOV'T CODE ANN. § 1201.042(e) (West Supp. 2016).

121. CAL. EDUC. CODE § 15122 (Deering 2013). In California, original issue premium cannot be used to pay project costs. CAL. EDUC. § 15146 (Deering 2016).

122. In Texas, where premium—used to pay costs of the project for which the bonds were issued—is already counted against the debt limit (as described in Texas Government Code Section

perspective, compound interest is treated as new debt as it accrues, in turn attracting its own interest;¹²³ and, not surprisingly, under accrual basis accounting—which recognizes receipts and obligations when they are incurred—the interest on CABs is treated as a liability as it compounds.¹²⁴ Most companies and government utilities in the U.S. use accrual accounting.¹²⁵ Financial statements filed with the Securities and Exchange Commission (SEC) are presumed to be misleading or inaccurate if they are not prepared in accordance with generally accepted accounting principles,¹²⁶ which require accrual accounting because it provides “a better basis for assessing the entity’s past and future performance than information solely about cash receipts and payments”¹²⁷ Under the Internal Revenue Code, taxable income of large corporations is generally required to be determined on an accrual basis.¹²⁸ Under standards promulgated by the Governmental Accounting Standards Board (GASB), government-wide financial statements—which show information about

1201.042(e)); interest should be included only to the extent doing so does not result in double-counting.

123. See DAVID C. GARLOCK, ET AL., FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS 20 (6th ed. 2014) (“In effect, the lender is making one or more additional loans to the borrower by letting the accrued interest remain unpaid, and so charges interest on these additional loans.”).

124. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 8, CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING ¶ OB17 (2010) [hereinafter FASB STATEMENT NO. 8] (describing accrual accounting as showing the effects of transactions on the economic condition of the entity at the time the effects occur, notwithstanding the timing of cash payments).

125. See GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 34, BASIC FINANCIAL STATEMENTS—AND MANAGEMENT’S DISCUSSION AND ANALYSIS—FOR STATE AND LOCAL GOVERNMENTS, at Preface (1999) [hereinafter GASB STATEMENT NO. 34] (explaining “[m]ost governmental utilities and private-sector companies” utilize accrual accounting, which reports all revenues and costs for current and long-term assets).

126. SEC, 17 C.F.R. § 210.4-01(a)(1) (2016).

127. FASB STATEMENT NO. 8, *supra* note 124, ¶ OB17; see also FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6, ELEMENTS OF FINANCIAL STATEMENTS ¶ 134 (1985) (describing accrual accounting and related concepts, and explaining that accrual accounting provides information that cannot be obtained by cash basis accounting); D. EDWARD MARTIN, ATTORNEY’S HANDBOOK OF ACCOUNTING, AUDITING AND FINANCIAL REPORTING §§ 2.04(3), 3.02(5) (4th ed. 2015) (stating the accrual basis of accounting “has been developed to provide the most accurate picture of an entity’s operations”).

128. 26 I.R.C. §§ 446, 448 (2016); see also DEPT OF THE TREASURY, INTERNAL REVENUE SERVICE, PUBLICATION 538: ACCOUNTING PERIODS AND METHODS 9–10 (Dec. 2012), <https://www.irs.gov/pub/irs-prior/p538--2012.pdf> [<https://perma.cc/7CYJ-XG48>].

the governmental entity as a whole—are prepared on an accrual basis.¹²⁹ Further, treating the interest on capital appreciation bonds differently from the original issue discount on zero coupon bonds—even though they are functionally the same—values form over substance.

The California Debt and Investment Advisory Board (CDIAC) has indicated that California local governments should include the full accreted value of CABs as “debt outstanding” in annual debt transparency reports,¹³⁰ suggesting they view compounded interest as debt.

The Texas Bond Review Board (TBRB) noted, in its local government annual reports for 2011, 2012, and 2013, that debt was understated because CABs were reported at their initial principal amount rather than their maturity value.¹³¹ This statement was dropped from the reports beginning in 2014, presumably because data on maturity values of CABs also were included in those reports.¹³² The disclaimer for the Texas

129. GASB STATEMENT NO. 34, *supra* note 125, ¶¶ 6(b)(1), 12(e), 16. Under GASB standards, local governments also prepare fund financial statements, which have a shorter-term focus and are intended to demonstrate compliance with budgets and legal and contractual requirements. *Id.* ¶ 6(b); *see also* GOVERNMENTAL ACCOUNTING STANDARDS BD., WHITE PAPER: WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS – AND SHOULD BE – DIFFERENT 7 (2013) (noting fund accounting focuses on control and accountability over public money and on whether there are sufficient resources in the short-term). GASB requires the use of a “modified accruals basis” in the fund financial statements for funds used to account for activities that are governmental in nature (like those related to general obligation bonds). *Id.* ¶ 79. Thus, interest on CABs is not reflected until it is due in this portion of the financial statements. *See id.* at Preface (using the example of taxes collected at the time they are needed to pay debt service as an example of the short-term focus of fund financial statements); *see also* CAL. DEP’T OF EDUC., SCH. FISCAL SERVS. DIV., CALIFORNIA SCHOOL ACCOUNTING MANUAL 101-3 (2016), <http://www.cde.ca.gov/fg/ac/sa/documents/csam2016complete.pdf> [<https://perma.cc/F387-YNLY>] (indicating un-matured interest on long-term debt is recorded when it is due under the modified accrual basis).

130. CAL. DEBT AND INV. ADVISORY COMM’N, GUIDANCE ON COMPLYING WITH SB 1029, at 4 (Dec. 4, 2016), <http://www.treasurer.ca.gov/cdiac/sb1029/guidance.pdf> [<https://perma.cc/BH87-ADFC>].

131. TEX. BOND REVIEW BD., LOCAL GOVERNMENT ANNUAL REPORT 2011, at 10 (2012), <http://www.brb.state.tx.us/pub/lgs/fy2011/2011LocalARFinal.pdf> [<https://perma.cc/9ZJG-7PT9>]; TEX. BOND REVIEW BD., LOCAL GOVERNMENT ANNUAL REPORT 2012, at 10 (2013), <http://www.brb.state.tx.us/pub/lgs/fy2012/2012LocalARFinal.pdf> [<https://perma.cc/GEQ3-RLDK>]; TEX. BOND REVIEW BD., LOCAL GOVERNMENT ANNUAL REPORT 2013, at 10 (2014) [hereinafter TBRB, 2013 REPORT], <http://www.brb.state.tx.us/pub/lgs/fy2013/2013LocalARFinal.pdf> [<https://perma.cc/VW3C-YUR5>].

132. TEX. BOND REVIEW BD., LOCAL GOVERNMENT ANNUAL REPORT 2014, at 10–11 (2015), <http://www.brb.state.tx.us/pub/lgs/fy2014/2014LocalARFinal.pdf> [<https://perma.cc/FNT2-T39C>]; TEX. BOND REVIEW BD., LOCAL GOVERNMENT ANNUAL REPORT 2015, at 11–12 (2015) [hereinafter TBRB, 2015 REPORT], <http://www.brb.state.tx.us/pub/lgs/fy2015/>

Comptroller's "Texas Transparency" website—which provides information about state and local government finances—indicates that compounded interest on CABs is not included in the debt figures provided on the site,¹³³ which suggests that readers, absent the disclaimer, might otherwise assume they were.

IV. REASONS LOCAL GOVERNMENTS ISSUE CABs

General obligation bonds are especially likely to be issued as CABs. Virtually all CABs issuances in California and Texas in 2015 were general obligation bonds.¹³⁴ There are several possible reasons for this. In many cases, fees and charges can be raised without voter approval or with the approval of a lower percentage of voters than would be required to issue general obligation bonds.¹³⁵ Perhaps the political cost of raising property taxes is higher than those of raising fees or charges, or possibly even other types of taxes (such as sales taxes) that support revenue bonds. Fees, charges, and other types of taxes generally are not subject to restrictions comparable to the expected rate limits; this may be another factor making it less likely that revenue bonds will be issued as CABs.¹³⁶ Further, because general obligation bonds are payable from property taxes assessed specifically for that purpose, and not from other funds of the issuer, there is a disconnect between the funding of the issuer's mission and the payment source for the bonds. That is, because payment of debt service does not directly affect a school district's ability to educate students, officials may be less focused than they otherwise would be on the structure

2015LocalARFinal.pdf [https://perma.cc/2WPP-ANJL]; TBRB, 2016 REPORT, *supra* note 28, at 11–12.

133. *Transparency*, COMPROLLER.TEXAS.GOV, <https://www.comptroller.texas.gov/transparency/local/debt/counties.php> [https://perma.cc/3CBU-JXQL].

134. This assessment is based on data from the CDIAC and the TBRB. California 2015 Issuances, *supra* note 9; TBRB Issuances FY 2007–2015, *supra* note 9.

135. In California, some charges and fees do not require voter approval. MAC TAYLOR, CAL. LEGIS. ANALYST'S OFFICE, A LOOK AT VOTER-APPROVAL REQUIREMENTS FOR LOCAL TAXES 3–5 (2014), <http://www.lao.ca.gov/reports/2014/finance/local-taxes/voter-approval-032014.pdf> [https://perma.cc/VQP9-SD68]. Others require approval by a majority of voters. *Id.* Taxes, other than property taxes, require approval by either a majority or a two-thirds supermajority of voters, depending on the nature of the tax. *Id.*

136. While revenue bond indentures often prohibit the issuance of additional debt, unless the ratio of projected annual revenues to debt service is at a specified level, these negotiated ratios may be less likely to impose a real constraint on an issuer's ability to issue debt. In part, this is because in many cases, additional expected revenues from the facilities being financed can be included in the calculation.

and impact of those payments. In contrast, fees, charges, and other taxes often can be used to pay both operating and capital costs. In Texas, the requirement that the principal amount of general obligation refunding bonds must not exceed the principal amount of the refinanced bonds also encourages the issuance of general obligation bonds in the form of premium CABs.¹³⁷

The following sections discuss several reasons why California and Texas school districts issue general obligation bonds in the form of CABs. More than one reason may contribute to an issuance.

A. *In Some Instances, CABs Can Result in Lower Overall Debt Service*

In some cases, school districts use capital appreciation bonds because doing so either alone or as part of a transaction that also includes current interest bonds, results in lower overall debt service.

While this generally is not the case today, in high interest rate environments—such as in the 1980s—the yield on CABs is lower than on CIBs because “[t]he investor accepts a somewhat lower rate of return to lock up a relatively high rate of interest for an extended period of years. Moreover, the investor has no worries about reinvesting coupon income, possibly at disadvantageous rates.”¹³⁸

In some market conditions, using capital appreciation bonds in conjunction with current interest bonds allows issuers to achieve lower overall debt service (without violating expected rate limits, or while maintaining level tax rates or keeping tax rates below levels promised to voters).¹³⁹ In circumstances where short-term interest rates are lower than long-term interest rates, issuing long-term CABs may allow the rest of

137. See *infra* Section IV.F. (explaining Texas’s requirements for refunding bonds).

138. See Metz, *supra* note 89 (demonstrating the bond maturity values for long term bonds); see also Petersen, *supra* note 83, at 20 (“Long-term original discount bonds attract investors whose objective is the accumulation of future wealth and who anticipate that their future reinvestment rates may be lower than present coupon rates.”); see also Scott H. Williamson, *Tax-Exempt Zero Coupon Bond Pricing*, 35 NAT’L TAX J. 497, 497 (1982) (“In order for rational investors to be willing to purchase ZCBs at lower yields than those on equivalent CCBs, there must be some features of ZCBs which are attractive. Often mentioned is the absence of coupon reinvestment rate risk. This usually implies the possibility that rates may fall.”); Michael Quint, *Credit Markets: Rates Show Little Change*, N.Y. TIMES (June 3, 1982), <http://www.nytimes.com/1982/06/03/business/credit-markets-rates-show-little-change.html> [https://perma.cc/N9RF-JHZ2] (noting the issuer will “automatically reinvest the interest payments at the stated rate”).

139. See *infra* Section IV.B. for a discussion of the use of CABs to avoid violating expected rate limits and Section 0 for discussion of the use of CABs to avoid near-term tax rate increases.

the bonds to be issued as shorter-term CIBs (rather than the alternative of issuing only longer-term CIBs) to take advantage of lower interest rates on shorter-term debt.¹⁴⁰ More than 80% of the issuances of general obligation CABs by California school districts in 2015 were part of a transaction that also included CIBs.¹⁴¹ However, absent concerns about keeping tax rates below a specified level, similar or even lower overall debt service often could be achieved by issuing only shorter-term current interest bonds—or even a combination of shorter-term and longer-term current interest bonds (but no capital appreciation bonds)—because interest would not be compounding and because, in most circumstances, rates on CABs are higher than on CIBs.¹⁴²

B. *CABs Allow Districts to Provide Facilities While Avoiding Near-Term Tax Increases*

School districts and other issuers structure debt with payments concentrated at the end of the repayment schedule—long-term CABs are an extreme example—to provide facilities without increasing taxes for current property owners. Because taxes generally are not levied to pay principal and interest on general obligation bonds until near the time such debt service must be paid,¹⁴³ interest that compounds over the life of a CAB is not reflected in tax rates until near maturity.

This use of CABs can be motivated by the political benefits of providing new facilities to current taxpayers without requiring them to pay the cost of the facilities, the desire to keep promises to voters about tax rates, or the inclination to maintain substantially level tax rates. Because these reasons all are ultimately efforts to avoid tax rate increases, albeit viewed from different perspectives, all three are addressed under this heading.

140. See *CDIAC Webinar – Bond Math II Transcript* (Oct. 7, 2011), <http://www.treasurer.ca.gov/cdiac/webinars/2011/20111007/transcript.pdf> [<https://perma.cc/5WYD-YG67>] (explaining it is possible to structure the amount of bond allocated between CABs and CIBs in a way that lowers the overall cost for the entire bond issue).

141. This percentage calculation is drawn from data provided by the CDIAC. California Issuances 2015, *supra* note 9; See also *CDIAC Webinar – Bond Math II Transcript*, *supra* note 140 (noting usually CABs are issued with CIBs); L.A. CTY. CIV. GRAND JURY REPORT, *supra* note 86, at 103, 111–12 (indicating that of the twelve CABs evaluated, only one was not issued in combination with CIBs).

142. See *supra* Section III.B. for discussion of interest rates on CABs.

143. CAL. EDUC. CODE § 15250 (Deering 2013); TEX. TAX CODE ANN. § 26.04 (West Supp. 2017).

Providing Facilities to Today's Taxpayers at the Expense of Tomorrow's. There is a significant incentive for locally elected officials to use debt to provide immediate benefits to constituents while ignoring potentially negative long-term issues that may eventually surface.¹⁴⁴ Even if current constituents are concerned about the future burden, that concern will be merely one factor of many that contributes to their decision on whether to re-elect local officials.¹⁴⁵

Elected officials may be reluctant to propose bond measures that increase tax rates because of the political ramifications of doing so. This may be one reason that “they postpone maturity dates [on] the principal for a long period of time.”¹⁴⁶ Issuing CABs, and, thus, postponing interest payments, simply takes this one step further. Moody's Investors Service has indicated that one reason school districts use CABs is to respond to taxpayer requests “to build new schools and maintain low student-to-teacher ratios” without significantly increasing taxes.¹⁴⁷

The voters, school board members, and district officials who authorize and issue bonds today, and whose children benefit from the facilities financed with the proceeds of those bonds, likely will not pay the debt service on CABs that do not mature for many years. As stated by the then-treasurer of California, “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.”¹⁴⁸

It appears that concern about keeping property tax rates low (at least in the near term) was one reason that, in 2009, the California legislature eliminated a requirement that general obligation new money bonds, issued by California local governments under the state's Government Code, have

144. AMDURSKY, *supra* note 98, at 207–08 (“[L]ocal officials, who will want to demonstrate constructive activity to constituents before the next election, have incentives to overutilize debt, paying scant attention to long-term adverse effects.”).

145. *Id.* at 208.

146. JACKSON L. FLANIGAN ET AL., *MANAGING SCHOOL INDEBTEDNESS: A COMPLETE GUIDE TO SCHOOL BONDING* 83–84 (2d ed. 1995).

147. Yvette Shields, *Illinois School Districts' Use of CABs Not all Negative, Moody's Reports*, THE BOND BUYER (Apr. 17, 2007), <http://www.bondbuyer.com/news/-268763-1.html> [https://perma.cc/N4RP-T442].

148. Shane Shifflett, Sharon Pieczenik, & Trey Bundy, *Controversial School Bonds Create Debt for the Next Generation*, REVEAL (Jan. 31, 2013), <https://www.revealnews.org/article/controversial-school-bonds-create-debt-for-the-next-generation> [https://perma.cc/896D-QEXN] (quoting Bill Lockyer, former treasurer of California).

substantially level debt service,¹⁴⁹ which had the effect of making it easier for school districts to issue longer term CABs. The California Governor's Office of Planning and Research indicated that the amendments would allow issuers to "use increasing property values to keep property taxes at their lowest possible rate through final maturity of the bonds."¹⁵⁰ Put another way, district officials would be able to defer debt service until a time further in the future when they projected that assessed valuations would be higher and the same property tax rate would generate more revenues than today.¹⁵¹

Keeping Promises to Voters. School district officials use CABs to keep promises to voters about both tax rates and capital projects. When voters are asked to approve a school district bond measure in California, the bond measure must include the purposes for which the bonds are to be used.¹⁵² Texas law similarly requires that the document ordering the election and the ballot proposition describe the purposes of the bonds.¹⁵³ California law also requires that voters be provided the "best estimate" of the tax rate for the bonds in the first year after bonds are expected to be issued, the year after the last bonds are expected to be issued, and the year in which the rate is estimated to be highest.¹⁵⁴ While there is not a comparable requirement in Texas (where either the estimated tax rate or the maximum interest rate—but not both—must be included in the

149. See Assemb. B. 1388, 2009–2010 Leg., Reg. Sess. (Cal. 2010) (changing the law to eliminate the requirement that bonds "be structured to amortize so that the maximum annual debt service payment . . . does not exceed the minimum annual debt service payment by more than 10%").

150. CAL. GOVERNOR'S OFFICE OF PLANNING AND RESEARCH, A.B. 1388 ENROLLED BILL REPORT 4 (2009).

151. See *infra* Section IV.E. for discussion of assumptions about future assessed valuation growth.

152. See CAL. CONST. art. XIII A, § 1(b)(3)(B) (mandating the proposition presented to the voters include "[a] list of the specific school facilities projects to be funded"); see also CAL. EDUC. CODE § 15122 (Deering 2013) (requiring "the purposes for which the proceeds of the sale of bonds are to be used" to be printed on the ballot box in a bonds election); CAL. GOV'T CODE §§ 53410(a), (b) (Deering 2011) (mandating any local bond measure subject to voter approval include a statement "indicating the specific purposes of the bond").

153. TEX. ELEC. CODE ANN. §§ 3.009(b)(2), 52.072(e)(1)(B) (West Supp. 2016).

154. CAL. ELEC. CODE § 9401(a) (Deering 2016), amended by Assemb. B. No. 1194, 2017–2018 Leg., Reg. Sess. (Cal. 2017). The 2017 amendment to the California Election Code will require the statement to include the "best estimate of the average annual tax rate required to fund the proposed bond measure for the duration of its debt service" and to "identify the final fiscal year in which the tax is anticipated to be collected[.]" instead of providing the tax rate for the first year after the first bonds are expected to be issued and the first year after the last bonds are expected to be issued. Assemb. B. No. 1194, 2017–2018 Leg., Reg. Sess. (Cal. 2017).

election order),¹⁵⁵ districts do, at least in some cases, make information about the expected tax rate impact of the bonds available on their web sites.¹⁵⁶ In some instances (probably often), districts do not indicate that actual tax rates for debt service may be higher than expected.

Even where not legally required, districts make promises and provide information to voters about expected tax rates and planned capital projects. School districts opted to include language promising no increase in taxes on approximately 15% (13 out of 88) of the school district bond measures on local ballots in California in 2010.¹⁵⁷ Furthermore, as was noted in the prior paragraph, some school districts present the projected tax impact of bond measures on their web sites and in information provided to the community.¹⁵⁸ Some districts also provide information (with varying degrees of detail) on their web sites about the projects to be financed.¹⁵⁹

155. TEX. ELEC. § 3.009(b)(5) (West Supp. 2016).

156. See *Alvin ISD Trustees Call for November Bond Election*, ALVIN INDEP. SCH. DIST., <http://www.alvinisd.net/site/default.aspx?PageType=3&ModuleInstanceID=29749&ViewID=7b97f7ed-8e5e-4120-848f-a8b4987d588f&RenderLoc=0&FlexDataID=27512&PageID=23385> [https://perma.cc/UCY4-GAR4] (noting tax rates would increase by a maximum of \$.083 per \$100 of assessed valuation if a \$245 million bond issue were passed by voters in November 2015); see also *YISD Estimated Property Calculator*, YSLETA INDEP. SCH. DIST., <https://bisweb.yisd.net/YISDPropertyTaxCalculator/YISDPropertyTaxCalculator.aspx> [https://perma.cc/C5DJ-44V9] (allowing anyone who visits the website to calculate the effect of the November 2015 bond measure on property taxes).

157. This percentage is calculated based on data provided by the Institute for Social Research Center for California Studies at California State University, Sacramento. INST. FOR SOC. RESEARCH CTR. FOR CAL. STUDIES CAL. STATE UNIV. SACRAMENTO, CALIFORNIA COUNTY, CITY AND SCHOOL DISTRICT ELECTION OUTCOMES, 2010 ELECTIONS, 17–30 (2010), <http://elections.cdn.sos.ca.gov/county-city-school-district-election-results/2010/school-district-report-2010.pdf> [https://perma.cc/R48H-6MHZ]. Notably, there were significantly fewer measures containing such language in 2012 (8 out of 136) and in 2014 (6 out of 163). INST. FOR SOC. RESEARCH, 2012 ELECTIONS, *supra* note 49, at 19–38; INST. FOR SOC. RESEARCH, 2014 ELECTIONS, *supra* note 49, at 19–39.

158. See *Alvin ISD Trustees Call for November Bond Election*, *supra* note 156; see also *YISD Estimated Property Calculator*, *supra* note 156 (providing a way to calculate the effect of the November 2015 bond measure on property taxes); *Measure S*, HERMOSA BEACH CITY SCH. DIST., <http://hbcsd.org/District/23252-Untitled.html> [https://perma.cc/GYP2-XBX5] (indicating the tax rate for a 2016 bond measure would be \$29.50 per \$100,000 of assessed value).

159. See *Alvin ISD Trustees Call for November Bond Election*, *supra* note 156 (describing projects to be financed with bond proceeds); see also *Bond Site Maps*, HERMOSA BEACH CITY SCH. DIST., <http://hbcsd.org/District/23249-Untitled.html> [https://perma.cc/8EQJ-TG88] (providing site maps for Hermosa Beach City School District and descriptions of projects at each site); *Bond Projects by Campus*, YSLETA INDEP. SCH. DIST., <https://www.yisd.net/domain/2563> [https://perma.cc/A5A3-LXPK] (identifying bond-funded school district projects by campus).

While property taxes must be raised if necessary to pay debt service on any bonds that are issued—and districts are not legally obligated to complete all the projects described—at least some district officials appear to view these types of statements as commitments that they endeavor to keep. For example, the official statement for CABs issued by the San Diego Unified School District in 2012 to refinance outstanding debt stated:

Due to lower assessed valuations of taxable property within the District than were projected at the time of issuance of the outstanding bonds, the District currently projects that the tax rate necessary to pay outstanding bonds . . . will exceed the tax rate [identified in the materials for the bond measure passed by the voters] unless actions are taken to restructure the outstanding bonds. The District is undertaking the plan of restructuring described below in order to reduce debt service in fiscal years 2011–12 and 2012–13 and establish a tax rate reserve, which will allow the District to continue to implement its capital improvement program through the issuance of additional authorized general obligation bonds within the tax rate identified . . .¹⁶⁰

The desire to keep tax rates at or below promised levels appears to be one of the primary reasons for the controversial Poway Transaction.¹⁶¹ Napa Valley Unified School District also reportedly issued CABs for this reason.¹⁶²

District officials may feel greater pressure to keep promises to voters by issuing CABs when assessed values for real property have declined—or have not increased—as anticipated at the time a bond measure was passed. This situation is more likely to arise when districts base tax rate estimates

160. SAN DIEGO UNIFIED SCH. DIST., \$65,434,441.70 SAN DIEGO UNIFIED SCHOOL DISTRICT 2012 GENERAL OBLIGATION REFUNDING BONDS (DEDICATED UNLIMITED *AD VALOREM* PROPERTY TAX BONDS) SERIES R-1, \$56,869,830 SAN DIEGO UNIFIED SCHOOL DISTRICT 2012 OBLIGATION REFUNDING BONDS (DEDICATED UNLIMITED *AD VALOREM* PROPERTY TAX BONDS) SERIES R-2, <http://emma.msrb.org/EP611468-EP478356-EP878739.pdf> [<https://perma.cc/K99D-RQDN>].

161. ESI INT'L, INC., POWAY UNIFIED SCHOOL DISTRICT BUILDING FOR SUCCESS PROGRAM FINANCING BOND TRANSACTION PROPOSITION C, SERIES B REPORT OF INVESTIGATION 12–14, 16, 19 (2013), <http://voiceofsandiego.org/wp-content/uploads/2013/05/51002d5d73afa.pdf> [<https://perma.cc/CK8S-4MQ5>].

162. Shifflett, Pieczenik, & Bundy, *supra* note 148; *see infra* note 314 (noting Napa Valley Unified School District has since refinanced some of its CABs).

and planned projects on optimistic assumptions about assessed valuation growth.¹⁶³

Maintaining Substantially Level Tax Rates. Property owners “find it easier to live with a more or less stable tax rate.”¹⁶⁴ Significant changes in property tax rates from year to year would make planning difficult, and likely would result in angry and frustrated taxpayers and possibly higher delinquency rates. Thus, school districts typically endeavor to impose a relatively level tax burden over time.¹⁶⁵

The use of CABs assists school districts in maintaining substantially level tax rates in two ways. First, in situations where school districts have outstanding general obligation bonds that have relatively high debt service payments in the near term, a district may issue CABs with maturity dates after all or most of the existing bonds have matured so that debt service payments on the new bonds (and hence collection of the related property taxes) begin after debt service on existing ones has declined significantly or ended. Second, school districts may assume that assessed valuations will have risen by the time that debt service payments need to be made years in the future, meaning that more revenues will be generated at the same tax rate.¹⁶⁶

C. *School Districts Use CABs to Continue to Issue Debt Without Violating Limits on Expected Tax Rates*

Both California and Texas law impose expected rate limits, which prohibit school districts from issuing general obligation new money bonds if the expected tax rate to pay debt service on all the district's general obligation debt (in Texas), or on all the general obligation bonds approved under the California 55% Regime at a specific election (in California)

163. See *infra* Section IV.E. (discussing the assumptions about future assessed valuation growth).

164. MUSGRAVE & MUSGRAVE, *supra* note 94, at 693.

165. Seth Rosenblatt, *Proposed Restrictions on School Bonds Would Harm Districts*, EDSOURCE (Mar. 24, 2013), <http://edsources.org/today/2013/proposed-restrictions-on-school-bonds-would-harm-districts/29136#.UpeIaKX7W8Q> [<https://perma.cc/H6HT-AZYN>]; see also Diana Lambert & Phillip Reese, *Each \$1 from Bonds to Cost Schools \$18*, SACRAMENTO BEE (Oct. 17, 2012, 7:06 AM), <http://web.archive.org/web/20130515133055/http://www.sacbee.com/2012/10/17/4917486/eac-h-1-from-bonds-to-cost-schools.html> [<https://perma.cc/3U8N-XFAX>] (indicating the Folsom Cordova Unified School District Superintendent stated that the district had structured its bonds so that taxpayers would pay a similar amount in taxes for twenty-five years).

166. See *infra* Section IV.E. for discussion of assessed valuations and related assumptions.

exceeds a statutory limit.¹⁶⁷ These restrictions are a major reason California and Texas school districts issue CABs. As Fitch Ratings—one of the three entities providing credit ratings on municipal bonds—noted, “[B]y delaying repayment, CABs provide a financing vehicle when tax rate or debt level restrictions would prevent issuance of current interest bonds.”¹⁶⁸ Fitch Ratings also indicated that tax rate limits or promised tax rates—combined with growing enrollments and stagnant or declining assessed valuations—or both, were among the primary reasons for increased CABs issuances in California and Texas.¹⁶⁹ In a white paper generally critical of longer-term CABs, the Los Angeles County Treasurer and Tax Collector conceded that districts might need to use them to avoid violating the expected rate limit.¹⁷⁰

When debt service on a school district’s outstanding general obligation bonds—or, in California, general obligation bonds approved under the California 55% Regime at a particular election—is already at the expected rate limit, the district cannot legally issue current interest bonds because even a small amount of debt service before some of the outstanding bonds are repaid would cause the district to exceed the limit in any year. However, a district can issue CABs that mature after some or all the existing debt matures and annual debt service declines.

School districts that cannot issue CIBs without violating the applicable expected rate limit have the option of issuing lease revenue bonds or certificates of participation (COPs), or not issuing debt at all; some do exercise these options.¹⁷¹ Lease revenue bonds and COPs are paid from

167. CAL. EDUC. CODE §§ 15268, 15270(a) (Deering 2013); TEX. EDUC. CODE ANN. § 45.0031(a) (West 2012); see also *supra* Section II.B., “Limits on Expected Tax Rates” (discussing the expected rate limits in Texas and California).

168. Fitch Ratings Press Release, *supra* note 9.

169. *Id.*; see also Aman Batheja, *Swelling School Districts Find a Costly Way to Grow Within State Debt Limits*, TEX. TRIB. (Aug. 29, 2014, 6:00 AM), <https://www.texastribune.org/2014/08/29/fast-growing-school-districts-use-controversial-fi/> [<https://perma.cc/JH79-5V2P>] (“[I]n recent years, critics have raised concerns as some fast-growing school districts have used the bonds to sidestep the 50-cent test and sharply increase their overall debt.”).

170. Letter from Mark Saladino, Treasurer & Tax Collector, Cty. of L.A., to Sch. Fin. Prof’ls 2 (May 16, 2011), <https://ttc.lacounty.gov/Proptax/docs/White%20Paper%20-%20School%20GO%20Bonds.pdf> [<https://perma.cc/UXK9-M384>].

171. The percentage of school district and community college district general obligation debt that had been authorized by voters, but had not been issued, grew dramatically during the economic downturn in California. CDIAC, VOTER APPROVED GENERAL OBLIGATION BONDS: AUTHORIZED BUT UNISSUED, *supra* note 46, at 2.

district general funds (primarily state aid),¹⁷² and are used as a means to avoid voter authorization requirements and other restrictions that apply to general obligation bonds.¹⁷³ However, districts prefer to issue general obligation bonds rather than these alternatives for two reasons. First, unlike property taxes, other revenues generally cannot be increased to accommodate the debt service, and school districts prefer to use this finite resource to operate the district and educate students. In fact, districts sometimes obtain voter authorization to refinance lease revenue bonds and COPs with general obligation bonds. For example, Mojave Unified School District issued voter-approved bonds to repay COPs in 2015.¹⁷⁴ Second, interest rates on lease revenue bonds and COPs are typically higher because they are riskier to investors, generally have lower credit ratings than general obligation bonds,¹⁷⁵ and, in Texas, because the Texas Permanent School Fund cannot guarantee these obligations.¹⁷⁶

School districts in California (unlike those in Texas) also can obtain another voter approval and issue bonds that otherwise cause debt service

172. See CAL. DEBT ADVISORY COMM'N, CDAC NO. 93-8, GUIDELINES FOR LEASES AND CERTIFICATES OF PARTICIPATION 50 (1993) [hereinafter CDAC GUIDELINES] (discussing the difficulties school districts have generating funds locally and noting that school districts receive the bulk of funding from the state); Shama Gamkhar & Jerome Olson, *Factors Affecting School District Choice of Bonds*, NAT'L TAX ASS'N PROC. OF ANN. CONF. ON TAX'N, Fall 2002, at 396, 405 (stating Texas school district lease revenue "bonds can be repaid only with state aid (not taxes)"). To use lease revenue bonds or certificates of participation, which are functionally the same, the third party acquires property or the school district leases property to a third party and the third party subleases the property back to the district at a rental rate that is sufficient to make payments on the lease revenue bonds or COPs issued by the third party. CDAC PRIMER, *supra* note 30, at 126, 185–86.

173. CDAC GUIDELINES, *supra* note 172, at 50; Craig L. Johnson & John Mikesell, *Certificates of Participation and Capital Markets: Lessons from Brevard County and Richmond Unified School District*, PUB. BUDGETING & FIN., Fall 1994, at 41, 42, 52; see also Gamkhar & Olson, *supra* note 172, at 405 (finding districts that are less likely to win a bond election are more likely to issue lease revenue bonds).

174. MOJAVE ISD 2015 OFFICIAL STATEMENT, *supra* note 76, at Cover, 2, 7.

175. CDAC GUIDELINES, *supra* note 172, at 16; Shama Gamkhar & Mona Koerner, *Capital Financing of Schools: A Comparison of Lease Purchase Revenue Bonds and General Obligation Bonds*, PUB. BUDGETING & FIN., Summer 2002, at 21, 24, 30–32; see Gamkhar & Olson, *supra* note 172, at 397; see also Beverly S. Bunch & Tina Smith, *The Viability of Lease Purchases as a Means for Funding School Facilities*, 27 J. OF EDUC. FIN. 1049, 1058–60 (2002). Bunch and Smith also found that issuance costs were higher, but noted that the savings from avoiding a bond election would partially offset these costs. *Id.* at 1058–59.

176. 19 TEX. ADMIN. CODE Ann. §§ 33.65(b)(4), (7), (10), (12), (d)(1) (2017).

to exceed the expected rate limit,¹⁷⁷ though they may be reluctant to or may not be able to do so in time to meet their funding needs.

When school districts perceive a need to issue bonds quickly, they may issue CABs if they would otherwise be legally prevented from issuing general obligation bonds at all. As was noted in Section IV.B., school district officials place importance on completing the capital projects that they have told voters they will undertake. If a project is already under way, and additional funds are needed to complete it, the pressure is likely even more intense. Further, many districts have pressing infrastructure needs that must be met to serve students in a safe, comfortable environment. For example, repairing or replacing leaking roofs was listed in dozens of California school district bond measures in 2014 as a use of bond proceeds.¹⁷⁸ When California districts have issued bond anticipation notes (short-term interim debt) that are maturing, they have to either issue general obligation bonds to repay them (even if they must do so in the form of CABs) or repay them from the general fund (something they may not be able to do without compromising the education provided to students, if at all).¹⁷⁹ Districts also issue CABs to take advantage of state and federal assistance programs that are of limited duration or to take advantage of market conditions, such as low interest rates or low construction costs.¹⁸⁰ For example, the Santa Ana Unified School District in California indicated it used CABs to take advantage of low construction costs, low interest rates, and state matching funds to issue federally subsidized Qualified School Construction Bonds (QSCBs) and Build America Bonds (BABs), and to build needed school facilities.¹⁸¹

177. TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN. § 45.0031 (West Supp. 2016); CAL. EDUC. CODE §§ 15268, 15270(a) (Deering 2016).

178. INST. FOR SOC. RESEARCH, 2014 ELECTIONS, *supra* note 49, at 19–39.

179. One California financial advisor referred to bond anticipation notes as a “financial weapon of mass destruction” in a discussion of the untenable situation they can create for school districts. SCOTT, *supra* note 49, at 172–73 (discussing the dangers of BANs to school districts).

180. See ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 7–8 (noting the use of CABs allows school districts to take advantage of state matching funds and federal subsidies).

181. *Frequently Asked Questions Regarding Capital Appreciation Bonds Related to Measure G*, SANTA ANA UNIFIED SCH. DIST. 1–2, <http://www.sausd.us/cms/lib5/CA01000471/Centricity/Domain/113/FAQ%20on%20Capital%20Appreciation%20Bonds.pdf> [http://perma.cc/77LD-3A33]. While this district’s objective was to keep tax rates near the levels promised to voters rather than within the expected rate limits, it provides an example of many of the incentives for districts to issue CABs. QSCBs and BABs were both programs of limited duration (QSCBs had to be issued within six months after receiving an allocation in California and the BABs program expired in 2010) that provided a direct federal subsidy to districts that issued taxable bonds. TBRB, 2015

Poway Unified School District engaged in the interim funding transactions that it ultimately refinanced in the controversial Poway Transaction to access state matching funds, avoid cost increases, and complete projects as quickly as possible.¹⁸²

Expected rate limits appear to have a disproportionate impact on certain types of districts. Property-poor districts, which have low assessed valuation per student, are more likely to be constrained by debt limits that are based on property values.¹⁸³ Taxes collected at the expected rate limit will raise a lower amount of money per student in a property-poor district than in a wealthier one.¹⁸⁴ An unsuccessful bill to amend Texas's expected rate limit in 2015 would have increased the cap only for sixty school districts designated as fast-growing, suggesting that the authors of the bill believe these districts are particularly affected by the limit.¹⁸⁵

Of course, the other side of limits on expected tax rates is that they impose at least some constraint on future tax rates, because a district would not legally be able to incur its debt in such a form that it expected debt service to exceed those limits in any year. Even though school districts have incentives to make optimistic assumptions about future valuation growth,¹⁸⁶ districts are unlikely to make assumptions that have absolutely no basis.

D. *School Districts May Issue CABs to Meet the Needs of a Rapidly Growing Population*

Rapidly growing districts may be especially inclined to issue CABs. As Fitch Ratings expressed, "For rapidly growing areas, the primary appeal [of

REPORT, *supra* note 132, at 16; *see* CAL. EDUC. § 12001.6(C)(13) (Deering 2013) (stating QSCB allocations go back to the state after six months).

182. ESI INT'L, INC., *supra* note 161, at 11, 14–15. While the district undertook Poway Transaction to avoid exceeding a tax rate promised to voters rather than to comply with the expected rate limit, the principle is the same.

183. ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 11–12; *cf.* Eric J. Brunner & Kim Rueben, *Financing New School Construction and Modernization: Evidence from California*, 54 NAT'L TAX J. 527, 535–36 (2001) (discussing the same principle as would apply to the expected rate limit in the context of a limit on overall debt as a percentage of assessed value).

184. ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 11–12, 32.

185. Tex. H.B. 506, 84th Leg., R.S. (2015); *see* Tex. H. Research Org., Bill Analysis, Tex. H.B. 506 84th Leg., R.S., at 3 (2015); *see also infra* Section IV.D. for discussion of fast-growing districts.

186. *See infra* Section IV.E. (discussing incentives to make optimistic assumptions about future valuation growth and the impact of incorrect assumptions).

CABs] is that needed capital improvements can be funded immediately, but the repayment burden is shared with the larger future population.”¹⁸⁷

Furthermore, because there is generally a lag between increases in property values and increases in assessed valuations,¹⁸⁸ student numbers may grow before the larger overall population is reflected in higher assessed valuations. The Author’s/Sponsor’s Statement of Intent for HB 114 indicated that “[i]n recent years, Texas school districts and local government entities have increasingly turned to CABs because our growing populations are demanding new facilities and capital development that far outpace our local wealth and resources. Usually, immediate development is needed but there are limited other financing options. . . .”¹⁸⁹ Of the top ten public school districts in Texas based on maturity amount of CABs outstanding as of August 31, 2015,¹⁹⁰ seven had enrollment growth (expressed as a percentage) above that of the state as a whole over the ten-year period from state fiscal year 2005–2014 and six had enrollment growth far above that of the state as a whole for that same period.¹⁹¹ This suggests a correlation between rapid growth and the use of CABs.

187. Fitch Ratings Press Release, *supra* note 9.

188. Byron F. Lutz, *The Connection Between House Price Appreciation and Property Tax Revenues* 48 FIN. & ECON. DISCUSSION SERIES, Sept. 12, 2008, at 6–8, 12. The lag between increases in property values and assessed values likely is higher in California, where there are strict limits on increases in assessed values absent a sale of the property.

189. S. Comm. on Fin., Bill Analysis, Tex. H.B. 114, 84th Leg., R.S. (2015).

190. TBRB, 2015 REPORT, *supra* note 132, at 41.

191. Statewide enrollment grew 17.2% over this period. See TEX. EDUC. AGENCY, POCKET EDITION: 2004–05 TEXAS PUBLIC SCHOOL STATISTICS (2005), <https://rptsvr1.tea.texas.gov/perfreport/pocked/2005/pocked0405.pdf> [<http://perma.cc/8SBG-8ZRZ>] (showing the statewide enrollment during the 2004–2005 school year); TEX. EDUC. AGENCY, POCKET EDITION: 2013–14 TEXAS PUBLIC SCHOOL STATISTICS (2014), <http://tea.texas.gov/communications/pocket-edition/> [<http://perma.cc/K72Z-QH2X>] (detailing statewide enrollment for the 2013–2014 school year). Over the same period, enrollment growth for each district, based on data in the indicated official statements, was as follows: Leander: 78.9%; Wylie: 77.8%; Forney: 96.5%; Grand Prairie: 20.8%; Ennis: 4.4%; Frisco: 175.8%; Denton: 55.4%; Schertz-Cibolo-Universal City: 82.8%; Galena Park: 9.7%; and Irving: 10.1%. LEANDER INDEP. SCH. DIST., OFFICIAL STATEMENT DATED JUNE 4, 2015 app. B-2 (2015), <http://emma.msrb.org/ER894732-EA566660-EA962666.pdf> [<http://perma.cc/X6C9-EJEV>]; WYLIE INDEP. SCH. DIST., OFFICIAL STATEMENT DATED OCTOBER 7, 2015 app. B-2 (2015), <http://emma.msrb.org/EP875003-EP677587-EP1079225.pdf> [<http://perma.cc/JY4P-S3N4>]; FORNEY INDEP. SCH. DIST., OFFICIAL STATEMENT DATED JUNE 25, 2014 app. A-1 (2014), <https://emma.msrb.org/EA616377-EA482625-EA879233.pdf> [<http://perma.cc/M82D-QH2Y>]; GRAND PRAIRIE INDEP. SCH. DIST., OFFICIAL STATEMENT DATED FEBRUARY 24, 2015 app. B-1 (2015), <http://emma.msrb.org/EP847035-EP655527-EP1057221.pdf> [<http://perma.cc/N24N-6JFS>]; ENNIS INDEP. SCH. DIST., OFFICIAL

It may be that rapidly growing districts are endeavoring to achieve interperiod equity through their use of CABs. Because, in many cases, they are building to accommodate a student population that they expect to continue to grow, they may be trying to protect today's population from having to pay for more infrastructure than it needs or can use, while providing for the needs of a larger future population. These districts also may expect that their use of CABs will result in substantially level tax rates because they expect assessed valuations to grow with the population. Unfortunately, if growth does not occur as expected, it will be a small population in the future that bears the brunt of the decisions being made today.

The limits on expected tax rates discussed above are a significant force pushing rapidly growing districts to issue CABs rather than CIBs. As an official of a district in Texas that grew from 7,200 students in 1994 to 36,750 in 2014 put it, "Yes, [using CABs] costs more, but when you're at [the expected rate limit] and another 1,200 children come in, we think 'Where are we going to put them?'"¹⁹² They are not, however, the sole reason CABs are used. In the State of Texas, for example, of the forty fastest-growing districts, eleven are at the \$0.50 rate cap and nine are even lower, within \$0.05 of it.¹⁹³ The other half of these districts presumably

STATEMENT DATED APRIL 14, 2015 app B-3 (2015), <http://emma.msrb.org/ER867185-EA558387-EA954554.pdf> [<http://perma.cc/922N-JYZF>]; FRISCO INDEP. SCH. DIST., OFFICIAL STATEMENT DATED NOVEMBER 10, 2015 app. B-4 (2015), <http://emma.msrb.org/EP887477-EP687043-EP1088743.pdf> [<http://perma.cc/WZ5G-CY5J>]; DENTON INDEP. SCH. DIST., OFFICIAL STATEMENT DATED AUGUST 4, 2015 app. B-1 (2015), <http://emma.msrb.org/EA740427-EA580195-EA976220.pdf> [<http://perma.cc/GNY5-MCUZ>]; SCHERTZ-CIBOLO-UNIVERSAL CITY INDEP. SCH. DIST., OFFICIAL STATEMENT DATED SEPTEMBER 18, 2014 app. B-2 (2014), <http://emma.msrb.org/EP831962-EP644201-EP1045821.pdf> [<http://perma.cc/AE26-L62A>]; GALENA PARK INDEP. SCH. DIST., OFFICIAL STATEMENT DATED FEBRUARY 7, 2007 app. B-2 (2007), <http://emma.msrb.org/MS256496-MS231804-MD451932.pdf> [<http://perma.cc/27PP-MX4V>]; GALENA PARK INDEP. SCH. DIST., OFFICIAL STATEMENT DATED JUNE 24, 2015 app. B-3 (2015), <http://emma.msrb.org/ER902702-ER705499-ER1107106.pdf> [<http://perma.cc/L7MM-X8JA>]; IRVING INDEP. SCH. DIST., OFFICIAL STATEMENT DATED DECEMBER 10, 2014 app. B-1 (2014), <http://emma.msrb.org/ER825383-ER638136-ER1039800.pdf> [<http://perma.cc/78ST-4N72>]. These districts ranged in size from less than 6,000 students to more than 45,000 students in state fiscal year 2014.

192. Batheja, *supra* note 169 (quoting Ellen Skoviera, Assistant Superintendent for Business and Operations, Leander Independent School District); see Fitch Ratings Press Release, *supra* note 9 (discussing the benefits to growing districts that come with CABs, but also identifying potential risks); see also Lisher, *supra* note 12 (noting CABs have been used to accommodate expected "exploding growth" in student numbers).

193. MOAK, CASEY & ASSOCS., FINDING BALANCE: A GUIDE TO ENROLLMENT, DEBT, & STATE FACILITIES SUPPORT, A REPORT BY THE FAST GROWTH SCHOOL COALITION TO THE 85TH

are using CABs for reasons other than to comply with the expected rate limit.

E. *The Impact of Incorrect Assumptions About Growth in Assessed Valuations*

When assessed valuations decline or do not increase as was projected at the time a bond measure was proposed, districts are more likely to issue CABs to maintain tax rates at desired levels or to comply with expected rate limits while completing promised projects. In California, statewide assessed valuations declined in fiscal year 2009–2010 for the first time since the State Board of Equalization began keeping records in 1933.¹⁹⁴ This likely contributed to the significant increase in the aggregate principal amount of CABs issued by California school districts—both in absolute terms and as a percentage of all general obligation bonds issued—from 2007 to 2011.¹⁹⁵ Furthermore, districts and their advisors have incentives to use, and sometimes do use, optimistic assumptions about assessed valuation growth when providing estimated tax rates in order to increase the likelihood that the bond measure will pass.¹⁹⁶

Equally, if not more troubling, district officials and their advisors have incentives to use aggressive assumptions about assessed valuation growth when evaluating whether taxes for debt service are expected to be within

TEXAS LEGISLATURE 10 (2016), http://fastgrowthtexas.org/wp-content/uploads/2016/09/FastGrowth_Interim_Report_2016.pdf [<http://perma.cc/284N-75DV>].

194. Press Release, Cal. Bd. Of Equalization 4th Dist. – Los Angeles, Total Statewide Property Values Decline (Aug. 25, 2009), <http://www.boe.ca.gov/news/2009/73-09.pdf> [<http://perma.cc/G2ZR-QF7K>].

195. While the aggregate principal amount of general obligation bonds issued by California school districts declined from approximately \$6.6 billion in 2007 to \$5.1 billion in 2011, the principal amount of these bonds issued as CABs increased from approximately \$540 million in 2007 to \$1.1 billion in 2011. CDIA data includes 192 school district general obligation bond issuances (80 of which included CABs) in 2007 and 274 school district general obligation bond issuances (89 of which included CABs) in 2011. See Jensen, *Calif. Capital Appreciation Bonds Have Unintended Consequences*, *supra* note 13 (describing declining real estate values as a reason that some school districts issued CABs); see also Cal. Assemb., Bill Analysis (Sept. 5, 2013), Assemb. B. 182, 2013–14 Leg., Reg. Sess., at 3 (Cal. 2013) (noting CABs became more popular after home prices declined); Cal. S. Educ. Comm., Bill Analysis (June 24, 2013), Assemb. B. 182, 2013–14 Leg., Reg. Sess., at 3–4 (Cal. 2013) (attributing increased use of CABs to lower housing prices); L.A. CTY. CIV. GRAND JURY REPORT, *supra* note 86, at 127 (indicating all twelve of the school districts that issued CABs reviewed in the report had experienced slower assessed valuation growth or even assessed valuation decline).

196. See SCOTT, *supra* note 49, at 23 (describing an example of aggressive assumptions about assessed valuation growth). As of 2017, California law requires school boards calling for a bond election to obtain assessed valuation projections that take into consideration projections of the county assessor. Assemb. B. 2116, 2015–16 Leg., Reg. Sess. (Cal. 2016).

the rates previously promised to voters and whether a bond issuance complies with the expected rate limit. Using aggressive assumptions allows districts to issue more bonds, and the fallout of higher tax rates will land on future, rather than current, officials and taxpayers.

California law (unlike Texas law) does not provide guidance on what assumptions are to be used in projecting assessed valuations for purposes of calculating compliance with the expected rate limit.¹⁹⁷ The Orange County Grand Jury reviewed assumptions about estimated tax rates for three school districts in the county that issued CABs; it concluded that all three had assumed unreasonably high growth in assessed valuations, and that the taxpayers in these districts were likely to have to pay taxes in excess of the expected rate limit in the future.¹⁹⁸

In Texas, if a district's actual tax rate is higher than projected and exceeds the expected rate limit, that district is subject to a lower limit in the future.¹⁹⁹ The impact of this penalty is not clear. On one hand, it may encourage districts to use conservative assumptions about assessed valuation growth or to use historic, rather than projected assessed valuation, in determining compliance.²⁰⁰ Most districts in Texas use the historic test.²⁰¹ On the other hand, it may encourage some districts to use financing structures in which the bulk of the debt service is not due until at or near maturity—including, at the extreme, long-term CABs—to postpone the risk of exceeding the limit.

197. A 2010 bill in California would have imposed broad limits on the growth that could be assumed in projections for determining compliance with the expected rate limit, but it did not pass. Assemb. B. 2552, 2009–2010 Leg., Reg. Sess. (Cal. 2010). While it does not apply directly to calculating compliance with the expected rate limit, AB 2116 may impact the projections used by school districts for determining compliance. This bill is discussed *supra* note 196, and *infra* note 300 and accompanying text.

198. ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 4.

199. TEX. EDUC. CODE ANN. § 45.0031(e) (West 2013).

200. See ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 4 (claiming school districts would likely not exceed the mandated tax rate if they were conservative in their growth assumptions for assessed values).

201. For example, data from the TBRB indicates seventy-five school districts issued general obligation bonds in August 2015. TBRB Issuances FY 2007–2015, *supra* note 9. Official statements for sixty of the school districts indicated that the districts had not used projected property values to satisfy the test, three stated that they had and five were silent. See Texas, ELECTRONIC MUNICIPAL MARKET ACCESS <https://emma.msrb.org/IssuerHomePage/State?state=TX> [<https://perma.cc/E8CJ-3ZP8>] (providing information for Texas municipal securities issuers including issuers' official statements). Official statements for the remaining seven were not available. *Id.*

F. *Texas Par-to-Par Requirement for Refundings*

Texas school districts may not issue general obligation refunding bonds without obtaining voter approval unless the principal amount of the refunding bonds is no greater than the principal amount of the bonds being refinanced.²⁰² This means school districts need to generate original issue premium to pay costs of issuing the refunding bonds and to pay interest on the refinanced bonds through their maturity or redemption date.²⁰³ This amount can be significant, particularly for bonds that are refinanced far in advance of their redemption or maturity date.²⁰⁴ One way Texas school districts comply with this requirement is by issuing CABs that generate significant original issue premium.²⁰⁵

G. *School District Officials May Not Understand the Impact of CABs*

It appears that in some instances, school district boards do not understand what capital appreciation bonds are, what their impact is, or even that they are being issued. Many school board members do not have the experience and background to understand the impact of CABs, at least not without explanation and guidance from district officials and outside financial advisors. While school board members frequently are committed, intelligent, and educated individuals who work hard for their school districts, the legal qualifications for serving are minimal.²⁰⁶

202. TEX. CONST. art. VII, § 3(e); TEX. GOV'T CODE ANN. § 1207.003(b) (West 2012); see LAWRENCE FIN. CONSULTING LLC, PUBLIC FINANCE UPDATE 1 (2013), <http://www.lfctexas.com/wp-content/uploads/2013/11/April-2013-Issue.pdf> [https://perma.cc/H424-N8DP] (noting school districts must abide by the par-to-par requirement).

203. See LAWRENCE FIN. CONSULTING LLC, *supra* note 202, at 1 (describing how CABs are used by school districts to meet the par-to-par requirement for refunding).

204. See *id.* (noting the high interest expenses for advance refunded bonds).

205. See *id.* (claiming school districts must use CABs to cover issuance costs and interest amounts on advance refunded bonds); see also NORTON ROSE FULBRIGHT, WHAT HAPPENED IN AUSTIN: 10 NEW LAWS THAT MATTER 17–18 (2015), <http://www.nortonrosefulbright.com/files/20150722-what-happened-in-austin-ten-new-laws-that-matter-130804.pdf> [https://perma.cc/B9WL-FBDD] (suggesting the par-to-par test partially explains why “Texas[] school districts are the largest issuer of capital appreciation bonds”).

206. In California, anyone who is at least eighteen years old, a citizen of California, a resident of the school district, a registered voter, and not disqualified under the California Constitution or state law from holding civil office, is eligible. CAL. EDUC. CODE § 35107(a) (Deering 2013). In Texas, anyone who is a U.S. citizen, at least eighteen years old, has not been determined by a final court judgment to be mentally incapacitated, has not been convicted of a felony, and has resided in Texas for twelve months and in the territory where the office is located for six months, is eligible. TEX. ELEC. CODE ANN. § 141.001(a) (West 2015).

Further, in many cases, school boards are presented with bond resolutions that authorize the issuance of both CIBs and CABs; they then delegate to their officers the decision of which type of bonds will be issued and the terms of the bonds (within specified parameters).²⁰⁷ These decisions typically are not made until closer to the time the bonds are sold and after the board has approved the transaction because market conditions affect the final structure.

Then California State Treasurer, Bill Lockyer, and California Superintendent of Public Instruction, Tom Torlakson, noted that school board members and the public have not always been fully informed about the costs and risks associated with CABs.²⁰⁸ Some school board members have stated that they could not recall approving CABs or were not aware of the impacts of issuing them.²⁰⁹

The failure to count compounded interest against voter-authorized amounts and against the California limit on total debt as a percentage of assessed valuation exacerbates the problem by making the true level of debt created by these bonds less apparent.²¹⁰

Furthermore, school district officers and employees may not have sufficient experience to understand the full impact of CABs, at least

207. See Leander Indep. Sch. Dist., Res. Authorizing The Issuance, Sale and Delivery of Leander Independent School District Unlimited Tax Refunding Bonds, in One Or More Series; Authorizing Preparation of an Official Statement; Authorizing a Pricing Officer to Approve the Amount, Interest Rates, Price, Redemption Provisions and Other Terms Thereof and Certain Other Procedures and Provisions Related Thereto; and Containing Other Matters Related Thereto, at 6 (2015), <https://v3.boardbook.org/Public/PublicItemDownload.aspx?ik=37700942> [<https://perma.cc/W7NM-YB2K>] (appointing an officer to determine the types of bonds to be issued); San Carlos Sch. Dist. Bd. of Educ., Res. No. 8:15/16, at 7 (2015), sancarlos.agendaonline.net/public/Meeting/Attachments/DisplayAttachment.aspx?AttachmentID=217007&IsArchive=0 [<https://perma.cc/LC8F-CPRR>] (declaring an authorized officer has the power to approve bonds in the form of CABs, CIBs or Convertible CABs). Notably, one school district's bond resolution granted broad authority to authorized officers to determine the terms of the bonds within parameters, but specified that CIBs be used to the maximum extent "determined . . . to be in the best interest of the District" Merced City Sch. Dist. Bd. of Educ., Res. No. A-75-2015-2016, at 8, <http://www.mcsd.k12.ca.us/files/user/1/file/Board%20of%20Education/2015-16%20Board%20Meetings/Agendas/10-27-15%20Board%20Meeting%20Agenda.pdf> [<https://perma.cc/C6Z8-NLYZ>].

208. Press Release, Cal. Dep't of Educ., State Schools Chief Tom Torlakson, State Treasurer Bill Lockyer Caution School Districts Against Issuance of Capital Appreciation Bonds (Jan. 17, 2013) [hereinafter Press Release, Cal. Dep't of Educ.], <http://www.cde.ca.gov/nr/ne/yr13/yr13rel12.asp> [<https://perma.cc/4823-9MQL>].

209. Shifflett, Pieczenik, & Bundy, *supra* note 148; Lambert & Reese, *supra* note 165.

210. See *supra* Section III.C.

without guidance from outside financial advisors.²¹¹ Most cities and counties have few resources dedicated to debt management, and their external financial advisors frequently know more about bonds—and even about the issuer’s own debt portfolio—than the issuers do;²¹² the same is likely true of school districts, particularly smaller ones. Even large issuers don’t always understand the agreements they make.²¹³ Smaller communities tend to have smaller financial staffs, and the differences in capacity are likely to impact management of the issuer’s debt.²¹⁴ An empirical study of municipal bond sales in Oregon concluded that small communities pay higher interest rates on their general obligation bonds than larger communities, all else being equal, and attributed this to them having more limited staffs with less expertise.²¹⁵ Smaller school districts likely confront the same issues—particularly when evaluating a less common financing structure like CABs.

Recognizing their lack of in-house expertise, school districts and other local governments often engage an external financial advisor.²¹⁶ Among other things, financial advisors assist issuers in developing a financing plan,

211. See SAN MATEO CTY. CIV. GRAND JURY, CAPITAL APPRECIATION BONDS: TICKING TIME BOMBS 7 (2013), http://www.sanmateocourt.org/documents/grand_jury/2012/bonds.pdf [<https://perma.cc/G6D9-6AZT>] (“A southern California school chief business officer lamented the lack of financial expertise that leaves many districts unqualified to navigate complex bond deals – or to do business with high-powered financial advisers[.] ‘They’re swimming with the sharks . . . These are principals and assistant superintendents of curriculum, and they’re being promoted to the role of a chief business officer.’”).

212. Monique Moyer, *Current Issues Facing Bond Issuers and Their Financial Advisors*, MUN. FIN. J., Summer 2003, at 17, 18; see also U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT 9–11 (1965) [hereinafter U.S. ADVISORY COMM’N, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT] (examining the difficulty smaller communities have with bonds due to their lack of expertise); Ang & Green, *supra* note 77, at 8 (“Furthermore, when municipalities negotiate with investment banks and other financial intermediaries to issue debt, municipalities often have less expertise and relatively few resources to guide their decision[-]making. This is detrimental not only to investors, but also to municipalities themselves.”); Jayaraman Vijayakumar & Kenneth N. Daniels, *The Role and Impact of Financial Advisors in the Market for Municipal Bonds*, 30 J. FIN. SERVICES RES. 43, 44 (2006) (stating local communities often lack the sophistication and knowledge to navigate the debt issuance process and, therefore, utilize financial advisors to assist them).

213. See Stephan Whitaker, *Financial Innovations and Issuer Sophistication in Municipal Securities Markets* 4 (Fed. Res. Bank of Clev., Working Paper No. 14–04, 2014) (identifying this as a contributor to the Orange County, California and Detroit, Michigan bankruptcies).

214. Bill Simonsen et al., *The Influence of Jurisdiction Size and Sale Type on Municipal Bond Interest Rates: An Empirical Analysis*, 61 PUB. ADMIN. REV. 709, 710–11 (2001).

215. *Id.* at 713–15.

216. Vijayakumar & Daniels, *supra* note 212, at 44.

structuring transactions, and negotiating with underwriters.²¹⁷ In some cases, financial advisors receive fees that are either contingent on the closing of the bond financing, tied to the size of the issuance, or both (though California law prohibits compensation of financial advisors based on a percentage of the amount of bonds sold).²¹⁸

Municipal bonds are typically sold to the public through an investment bank acting as an underwriter.²¹⁹ The underwriter's compensation is a percentage of the total principal amount sold.

The MSRB, which regulates underwriters and other participants in the municipal securities market, notes that "compensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest, because it may cause the underwriter to recommend a transaction that it is unnecessary or to recommend that the size of the transaction be larger than is necessary."²²⁰ The same analysis applies to financial advisors that are compensated in this manner.

While the vast majority of financial advisors and underwriters are honorable, experienced professionals, there may be instances in which financial advisors and underwriters encourage school districts to issue bonds—including CABs—when it is not in their best interest to do so, either because they are maximizing their compensation or because they are too focused on their clients' short-term objectives. Concerns about the manipulation of local governments by financial advisors led to the passage of federal legislation in 2010 that required these advisors to register with the SEC, imposed fiduciary duties on them, and instructed the MSRB to

217. A 2003 study found that using a financial advisor reduced underwriter compensation for negotiated general obligation bond offerings. *Id.* at 66.

218. CAL. GOV'T CODE § 53592 (Deering 2011).

219. Bonds are sold in either a competitive or negotiated sale. In a competitive sale, an issuer sells the bonds to the lowest bidding underwriter. In a negotiated sale, the issuer selects an underwriter to purchase the bonds on negotiated terms. In both cases, the underwriter then sells the bonds to investors. Typically, an underwriter in a negotiated sale plays a much more active role in the transaction than would an underwriter in a competitive sale. Negotiated sales are by far the most common sale method for California and Texas school district general obligation bonds, based on data provided by CDIAC. California Issuances 2015, *supra* note 9; *Local Publications – Bond Issuance*, TEX. BOND REV. BD., http://www.brb.state.tx.us/publications_local.aspx#BI [https://perma.cc/444R-FYDC].

220. MUN. SEC. RULEMAKING BD., RULE G-17 CONDUCT OF MUNICIPAL SECURITIES AND MUNICIPAL ADVISORY ACTIVITIES 3 (2012) [hereinafter MSRB, RULE G-17], <http://www.msrb.org/pdf.aspx?url=http%3A%2F%2Fwww.msrb.org%2FRules-and-Interpretations%2FMSRB-Rules%2FGeneral%2FRule-G-17.aspx%3Ftab%3D2> [https://perma.cc/XQ3W-EQ6W].

regulate them.²²¹ Similar concerns about underwriters have led to increased regulation of underwriters, including requirements that underwriters disclose conflicts of interest to issuers.²²²

V. CALIFORNIA AND TEXAS LEGISLATION LIMITING THE USE OF CABs

A. *Opposition to CABs*

School districts in California and Texas have issued general obligation bonds in the form of CABs since at least the 1990s.²²³ Changes to California law that took effect in January 2010 eliminated the requirement that bonds issued under the relevant California Government Code provisions (including school district bonds with final maturity dates in excess of twenty-five years) generally had to have substantially level debt service.²²⁴ This had the effect of making it easier for school districts to issue CABs with final maturity dates later than twenty-five years after the date of issuance. The percentage of California school district general obligation bond issuances—consisting in whole or in part of CABs and with final maturities later than twenty-five years after the date of issuance—increased significantly beginning in 2010.²²⁵

Capital appreciation bonds began receiving negative attention in both California and Texas in 2012 and 2013. Newspapers and web sites published articles with titles like: “Risky Bonds Tie Schools to Huge

221. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 975 (2010) (codified at 15 U.S.C.A. § 78o-4) (West 2010) (“[W]ith respect to municipal advisors—[the Municipal Securities Rulemaking Board shall] prescribe means reasonably designed to prevent acts, practices, and courses of business as are not consistent with a municipal advisor’s fiduciary duty to its clients[.]”).

222. See MUN. SEC. RULEMAKING BD., RULE G-17, *supra* note 220, at 2–3 (describing fair dealing and requiring that underwriters disclose conflicts of interest to issuers).

223. See ELECTRONIC MUN. MKT. ACCESS (EMMA), <https://emma.msrb.org/> [<https://perma.cc/522H-DPJY>] (providing data on the history of CAB issuances).

224. Assemb. B. 1388, 2009–2010 Leg., Reg. Sess. (Cal. 2009). There were exceptions under prior law, including for issuances that made amortization of overall general obligation bond debt more level. *Id.*

225. Of school district general obligation issuances that included CABs, the following percentages had final maturity dates in excess of twenty-five years: 21% in 2007, 33% in 2008, 24% in 2009, 64% in 2010, 72% in 2011, 80% in 2012, 69% in 2013, 70% in 2014, and 58% in 2015; as a result of the passage of AB 182, final maturities in excess of twenty-five years in 2014 and 2015 would have to be CIBs, CABs issued to refinance outstanding bonds, or CABs qualifying for limited transition period exceptions. California Issuances 2002–2014 (2015) (unpublished data) (on file with author); California Issuances 2015, *supra* note 9.

Debt;”²²⁶ “California Schools Finance Upgrades by Making the Next Generation Pay;”²²⁷ and “Texas Schools Pass Debt on to the Next Generation.”²²⁸ The California State Treasurer and State Superintendent of Public Instruction issued a joint letter urging school districts not to issue any CABs until the state legislature and the Governor completed their consideration of reform proposals.²²⁹ Grand juries in three California counties investigated the use of CABs in their counties and issued scathing reports.²³⁰

A bill was unsuccessfully introduced in California in 2013 that declared the legislature’s intent to ban the use of CABs by school districts.²³¹ In Texas, bills were unsuccessfully introduced in 2013, 2014 and early 2015, which would have prohibited or limited the use of CABs that are payable from property taxes.²³²

While those efforts did not succeed, California law was amended effective January 2014 to restrict the use of CABs by school districts and community college districts;²³³ and Texas law was modified effective September 2015 to constrain the use of CABs by all local governments.²³⁴

226. Weikel, *supra* note 12.

227. Lovett, *supra* note 12.

228. Lisher, *supra* note 12.

229. Press Release, Cal. Dep’t of Educ., *supra* note 208.

230. SAN DIEGO CTY. GRAND JURY, SCHOOL DISTRICT DILEMMA: BONDS OR BONDAGE? (2013), http://www.sdcourt.ca.gov/grandjury/reports/2012-2013/School_District_Dilemma_Bonds_Bondage.pdf [<https://perma.cc/9EFQ-7Z5F>]; SAN MATEO CTY. CIV. GRAND JURY, *supra* note 211; SANTA CLARA CTY. CIV. GRAND JURY, OUR SCHOOL DISTRICTS DO NOT NEED ZEROS (2013), http://www.sccourt.org/court_divisions/civil/cgj/2013/SchoolDistrictZeros.pdf [<https://perma.cc/A9UK-HXGJ>]. The Orange County, Contra Costa County, and Los Angeles County grand juries also released reports on capital appreciation bonds, but not until after AB 182 had passed. ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83; CONTRA COSTA CTY. CIV. GRAND JURY, CAPITAL APPRECIATION BONDS (2015), http://www.cc-courts.org/civil/docs/grandjury/Report_1501_ComplianceAndContinuityCommitteeReport.pdf [<https://perma.cc/P8N3-33S7>]; L.A. CTY. CIV. GRAND JURY REPORT, *supra* note 86.

231. S.B. 685, 2013–2014 Leg., Reg. Sess. (Cal. 2013).

232. Tex. H.B. 3416, 83d Leg., R.S. (2013); Tex. S.B. 449, 83d Leg., R.S. (2013); Tex. H.B. 83, 83d Leg., C.S. (2013); Tex. S.B. 103, 84th Leg., R.S. (2015); Tex. H.B. 1750, 84th Leg., R.S. (2015); Tex. H.B. 2099, 84th Leg., R.S. (2015).

233. Community college districts are similar to school districts, but provide two-year tertiary education. Cal. Cmty. Colls. Chancellor’s Office, *Board of Governors*, CA.GOV, <http://extranet.cccco.edu/SystemOperations/BoardofGovernors.aspx> [<https://perma.cc/BJ88-UZ2T>].

234. Assemb. B. 182, 2013–2014 Leg., Reg. Sess. (Cal. 2013); Act of May 26, 2015, 84th Leg., R.S., ch. 991, §§ 1–3, sec. 1201.0245, 2015 Tex. Gen. Laws 3517, 3519 (codified at TEX. GOVT CODE § 1201.0245).

B. *Limits on CABs in California*

California AB 182 took effect in January 2014.²³⁵ The legislation narrowed the parameters within which school districts and community college districts (but not other local governments) could issue general obligation new money CABs.²³⁶ In particular, the new law reduced the maximum term for these CABs from forty to twenty-five years,²³⁷ and the maximum interest rate on these CABs from 12% to 8%.²³⁸ In addition, AB 182 added a requirement that general obligation new money CABs with terms of more than ten years be subject to redemption at the option of the issuer no later than ten years after their date of issuance.²³⁹ This means that rather than having to keep its CABs outstanding through their final maturity, a school district would be able to repay them after ten years, should it desire to do so, without having to negotiate with bondholders or obtain their consent. AB 182 also added a requirement that the ratio of debt service (for CABs, the maturity amount) to principal for a series of CABs not exceed four to one.²⁴⁰

Like governing boards of all local governments in California, school boards are subject to open meeting and public notice requirements.²⁴¹ AB 182 added additional notice and information requirements for school board approvals of general obligation new money CABs issuances.²⁴² Public notice of the proposed approval of a general obligation new money CABs issuance must be given for two consecutive school board

235. Assemb. B. 182, 2013–2014 Leg., Reg. Sess. (Cal. 2013).

236. The State Board of Education may waive these provisions for bonds that refinance bond anticipation notes issued before December 31, 2013, if certain conditions are met. CAL. EDUC. CODE § 15144.3 (Deering Supp. 2017).

237. CAL. EDUC. § 15144 (Deering 2013); CAL. GOV'T CODE §§ 53508(f), 53508.5 (Deering 2011 & Supp. 2017).

238. CAL. EDUC. § 15143 (Deering 2013); CAL. GOV'T §§ 53508(d), 53508.5, 53531 (Deering 2011 & Supp. 2017).

239. CAL. EDUC. § 15144.2 (Deering 2016); CAL. GOV'T § 53508.5. Presumably, this option has some cost in the form of higher yields, particularly when interest rates are high, since it creates the risk that investors will have to reinvest not only earning on, but also principal of, the CABs in lower yielding securities before the scheduled maturity date of the CABs.

240. CAL. EDUC. § 15144.1 (Deering Supp. 2017); CAL. GOV'T § 53508.5.

241. See CAL. GOV'T §§ 54950–54963 (Deering 2016) (defining “local agency” as including “school district[s] . . . or any board, commission or agency thereof” and stating the chapter’s provisions for open and public meetings).

242. These requirements also apply to CIBs that mature more than 30 years after issuance. CAL. GOV'T § 53508.6 (Deering Supp. 2017).

meetings,²⁴³ and the resolution approved by the school board authorizing the issuance must include the financing term and time of maturity, the ratio of debt service to principal, and the estimated change in assessed value of taxable property in the district over the term of the bonds.²⁴⁴ In addition, the board must be presented information concerning the overall cost of the CABs, a comparison to the overall cost of CIBs, the reason CABs are being recommended, and a copy of required disclosures regarding underwriter conflicts of interest.²⁴⁵

The provisions of AB 182 do not apply to bonds that are issued to refinance existing debt. In California, school districts may issue general obligation refunding bonds only if they result in overall debt service savings²⁴⁶ and do not mature any later than the bonds that are being refinanced.²⁴⁷

C. *Limits on CABs in Texas*

Texas HB 114 took effect September 1, 2015.²⁴⁸ HB 114 applies to CABs issued by local governments and secured by *ad valorem* taxes.²⁴⁹ HB 114 reduced the maximum term of CABs from forty to twenty years.²⁵⁰ The new law also added a provision that allows CABs to be issued only if the total debt service on all the local government's general obligation CABs will be no more than 25% of total debt service on all the local government's outstanding general obligation bonds.²⁵¹

Texas local government boards, like those in California, are subject to open meeting and public notice requirements.²⁵² HB 114 imposed additional informational requirements for the issuance of CABs.²⁵³ Specifically, governing boards must receive information about the total

243. CAL. EDUC. § 15146(b)(2) (Deering 2016); CAL. GOV'T § 53508.5.

244. CAL. EDUC. § 15146(b)(1)(E) (Deering 2016); CAL. GOV'T § 53508.5.

245. CAL. EDUC. § 15146(c) (Deering 2016); CAL. GOV'T § 53508.5.

246. CAL. GOV'T § 53552 (Deering 2011).

247. *Id.* § 53553(e).

248. Act of May 26, 2015, 84th Leg., R.S., ch. 991, §§ 1–3, sec. 1201.0245, 2015 Tex. Gen. Laws 3517, 3519 (codified at TEX. GOV'T CODE § 1201.0245).

249. TEX. GOV'T CODE ANN. § 1201.0245(b) (West Supp. 2017).

250. TEX. EDUC. CODE ANN. § 45.001(b) (West 2012); TEX. GOV'T § 1201.0245(b)(1) (West Supp. 2017).

251. TEX. GOV'T § 1201.0245(g) (West Supp. 2017).

252. TEX. GOV'T §§ 551.001–551.146 (West 2017 & Supp. 2017).

253. Act of May 26, 2015, 84th Leg., R.S., ch. 991, § 1, sec. 1201.0245, 2015 Tex. Gen. Laws 3517, 3519 (codified at TEX. GOV'T § 1201.0245).

debt service to maturity, the fees to be paid to financing team members and other outside vendors, the projected tax impact and assumptions on which the projected tax impact is based.²⁵⁴ The governing board also must determine whether there are any potential conflicts of interest with any of the professionals involved in the bond issuance.²⁵⁵ Amended Texas law also requires that local governments post information about the proposed issuance and existing debt, including the information described in the two preceding sentences, to their websites and update the information about outstanding debt and total debt service regularly.²⁵⁶

As of September 1, 2017, general obligation refunding bonds are exempted from the requirements of HB 114.²⁵⁷ HB 114 prohibits local governments from extending the maturity date of CABs, including by refinancing them, unless the extension reduces the amount of debt service payable through maturity or in other limited circumstances.²⁵⁸ Unlike California law, Texas law does not otherwise prohibit extending the maturity of refinanced general obligation bonds and allows refunding transactions that do not result in debt service savings if the governing body of the issuer makes a finding that the issuance is in the best interests of the issuer.²⁵⁹

D. *Comparing the Two Approaches*

There are significant similarities between the California and Texas CAB legislation. Both reduce the maximum term of capital appreciation

254. TEX. GOV'T § 1201.0245(b)(2) (West Supp. 2017).

255. *Id.* § 1201.0245(b)(3).

256. *Id.* §§ 1201.0245(b)(4), (d).

257. Act of May 22, 2017, 85th Leg., R.S., ch. 529, § 1, sec. 1201.0245(j), 2015 Tex. Sess. Law Serv. (codified at TEX. GOV'T § 1201.0245(j)). The amendment addressed unintended consequences of HB 114, such as prohibiting issuers that were already over the 25% limit from issuing refunding CABs unless the refunding brought the issuer below the limit, even if the refunding resulted in a lower debt service attributable to CABs and debt service savings, with limited exceptions.

258. TEX. GOV'T §§ 1201.0245(h), (i) (West Supp. 2017). But note that refunding bonds issued under Chapter 1207 of the Government Code are not subject to Section 1201.0245, as recently amended. Act of May 22, 2017, 85th Leg., R.S., ch. 529, § 1, sec. 1201.0245(j), 2015 Tex. Sess. Law Serv. (codified at TEX. GOV'T § 1201.0245(j)).

259. TEX. GOV'T § 1207.008 (West 2012). However, refunding bonds guaranteed by the Texas Permanent School Fund Bond Guarantee Program cannot have a later final maturity date than the bonds they are refinancing and must result in present value debt service savings. 19 TEX. ADMIN. § 33.65(d)(2)(C) (2017). Most Texas school district bonds are guaranteed by this program. *See* TEXAS PERMANENT SCHOOL FUND DISCLOSURE STATEMENT, *supra* note 32 and accompanying text.

bonds,²⁶⁰ likely in response to concerns about the higher cost of CABs and possibly, to some extent, to address concerns about interperiod equity (though this remains an issue even with the shorter terms). Both include additional information requirements and, while those requirements are not identical, both require the provision of information about overall debt service and the assumptions that are being made about growth in assessed valuations,²⁶¹ suggesting that these are important for both governing board members and the public. Further, both endeavor to make the public more aware of the issuance of CABs and the impact on the district's debt service levels and on property taxes. California requires the issuance of CABs to be discussed at two board meetings for which public notice has been given and requires certain information be presented to the board.²⁶² Texas goes further and requires that, in addition to being presented to the board, information must be posted on the issuer's website and updated regularly.²⁶³ Both pieces of legislation require disclosure to the board of conflicts of interest,²⁶⁴ likely in response to concerns that issuers are being encouraged to issue CABs when it is not in their best interests to do so.

General obligation refunding bonds need not comply with the new limitations in either California or Texas.²⁶⁵ This is likely because the expectation is that refunding bonds are issued only if they result in overall debt service savings to taxpayers. As noted above, in California this is the only circumstance in which general obligation refunding bonds can be issued.²⁶⁶ While Texas law allows refunding transactions that do not result in debt service savings, the vast majority of refunding transactions probably create savings for two reasons: (1) it is a requirement for bonds

260. CAL. EDUC. CODE § 15144 (Deering 2013); CAL. GOV'T CODE §§ 53508(f), 53508.5 (Deering 2011 & Supp. 2017); TEX. GOV'T § 1201.0245(b)(1) (West Supp. 2017); TEX. EDUC. CODE ANN. § 45.001(b) (West 2012).

261. CAL. EDUC. §§ 15146(b)–(c) (Deering 2013); CAL. GOV'T § 53508.5; TEX. GOV'T §§ 1201.0245(b), (d).

262. CAL. EDUC. §§ 15146(b)–(c); CAL. GOV'T § 53508.5.

263. TEX. GOV'T §§ 1201.0245(b), (d).

264. CAL. EDUC. § 15146(c)(4) (Deering 2013); TEX. GOV'T § 1201.0245(b)(3); CAL. GOV'T § 53508.5.

265. See Act of May 23, 2017, 85th Leg., R.S. ch. 529, §§1–3, sec. 1201.245(j), 2017 Tex. Sess. Law Serv. (West) (to be codified at TEX. GOV'T CODE § 1201.245(j)) (exempting refunding CABs from additional restrictions effective September 1, 2017).

266. See CAL. GOV'T § 53552, 53553(e) (Deering 2016) (stating California school districts may issue general obligation refunding bonds only if they result in overall debt service savings and do not mature later than the bonds that are being refinanced).

to be guaranteed by the Texas Permanent School Fund Bond Guarantee Program; and (2) because if they do not create savings, board members must make a public determination to proceed despite the increased costs.²⁶⁷ School districts in California and, in most instances, in Texas, may not extend the maturity of previously issued CABs.²⁶⁸

One significant difference between the two laws is that the California limits apply only to school districts and community college districts, while the Texas limits apply to all local governments.²⁶⁹ This may be because school districts and community college districts dominate general obligation bond issuances in California in a way that they do not in Texas,²⁷⁰ presumably a reflection of the fact that school districts and community college districts in California can use the California 55% Regime, while other California local governments must use the California Two-Thirds Regime.²⁷¹ In both states, the controversy surrounding CABs focused on school districts; and school districts were responsible for

267. TEX. GOV'T § 1207.008 (West 2012); 19 TEX. ADMIN. § 33.65(d)(2)(C) (2017). Most Texas school district bonds are guaranteed by the Texas Permanent School Fund Bond Guarantee Program.

268. Refunding bonds guaranteed by the Texas Permanent School Fund Bond Guarantee Program cannot have a later final maturity date than the bonds they are refinancing. 19 TEX. ADMIN. § 33.65(d)(2)(C). Most Texas school district bonds are guaranteed by this program. See U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, *supra* note 35.

269. Compare CAL. GOV'T § 53508.5 (imposing capital appreciation bond limits on school and community college districts), with Tex. Gov't § 1201.0245(b) (West Supp. 2017) (restricting authority to issue capital appreciation bonds for a broad range of local governmental bodies).

270. School districts and community college districts were responsible for 95.1% of California local government general obligation bond issuances and 89.5% of the total principal amount of such bonds issued in 2015. See CDIAC, 2015 SUMMARY, *supra* note 28, at 2–4 (showing community college and K–12 school districts issued \$13,512,973,914 of \$15,095,823,914 in aggregate principal amount of government general obligation bonds in 409 transactions out of a total of 430 local government general obligation bond issuance in 2016). School districts and community college districts were responsible for 57.9% of the outstanding principal amount of debt supported by *ad valorem* property taxes in Texas as of August 31, 2015. See 2016 TEX. BOND REV. BD., LOCAL GOVERNMENT ANNUAL REPORT 5 (2016), www.brb.state.tx.us/pub/lgs/fy2016/2016LocalARFinal.pdf [<https://perma.cc/H3QB-NCUB>] (detailing public school and community college districts held \$78,278.3 million of \$135,185.1 million in local government debt). While these figures are not entirely comparable, they suggest that local governments other than school districts and community college districts, issue a significantly greater proportion of general obligation bonds in Texas than they do in California.

271. See DAYTON, *supra* note 42, at 16 (noting only 110 of the 1,147 local educational bond measures from 2001 through 2014 were presented to voters under the California Two-Thirds Regime). All Texas local government general obligation bonds are subject to approval by a majority of residents voting at an election. TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN § 45.003(a) (West 2012).

most of the CABs issued in the five years leading up to the passage of the relevant legislation.²⁷² Both pieces of legislation are limited to bonds that are paid from *ad valorem* property taxes.²⁷³

Another notable difference is that Texas legislation focuses on the issuer's overall debt portfolio, while California legislation focuses on the cost of a series of CABs in isolation. Even though both states place limits on debt service, Texas compares debt service on CABs to overall debt service, while California evaluates the debt service on each series of CABs in isolation.²⁷⁴ This is generally consistent with the two states' approaches to expected rate limits; the focus in Texas is on overall debt portfolio and the focus in California is on a more limited universe (a series of bonds in the case of the ratio of total debt service to principal, and bonds authorized at a single election in the case of expected rate limits). It is surprising, though, that the California test looks at the series of bonds on its own and not in conjunction with all the bonds that are issued at the same time, or at all the bonds that were authorized at a particular election.

VI. WHAT IS THE SOLUTION?

There are several ways that misuse of CABs could be—and in the case of AB 182 and HB 114, has been—addressed. This section discusses several potential solutions, which fall within three broad categories: prohibiting or restricting the use of CABs; reducing the incentives to issue CABs; and providing additional information to local governments and communities, and additional guidance to local governments. While this discussion is focused on school districts, the analysis also applies to other local governments.

272. Based on data provided to the author by CDIAC, school districts in California were responsible for 72.5% of the aggregate principal amount of CABs issued in California during the period from 2008 to 2012. In Texas, 65.5% of the total principal amount of CABs issued during the period from state fiscal years 2009 through 2013 were issued by public school districts. *See* TBRB, 2013 REPORT, *supra* note 131, at 10 (computing the percentages by adding the public-school district CAB amount for fiscal years 2009–2013 and dividing that number by the total principal amount of CABs issued for fiscal years 2009–2013).

273. TEX. GOVT. § 1201.0245(b); CAL. EDUC. CODE § 15140.5 (Deering Supp. 2017); CAL. GOVT. §§ 53506(a), 53508.5 (Deering 2011 & Supp. 2017).

274. *Compare* CAL. EDUC. § 15144.1 (Deering Supp. 2017) (explaining a method of analysis that looks at each series of general obligation bonds in isolation), *with* TEX. GOVT § 1201.0245(g) (West Supp. 2017) (describing a method of CAB analysis that takes account all of the issuer's general obligation bonds).

A. *Prohibiting or Restricting the Use of CABs*

Misuse of CABs could be eliminated by prohibiting or restricting their use. The focus of these solutions is preventing districts from taking advantage of incentives to benefit today's population at the expense of tomorrow's, and addressing concerns about the lack of expertise of school district officials. However, an outright prohibition—or even carefully drafted restrictions—on the use of CABs could prevent their use in circumstances where the benefits outweigh the costs (especially when the expected rate limit or another legal constraint would otherwise prevent the issuance of debt at all) and likely would have disparate impacts on districts with different characteristics. These concerns might be addressed by allowing districts to issue CABs, or CABs outside specified parameters, with the approval of a state agency, or by providing alternative funding sources.

Prohibiting the Use of CABs. One means of eliminating the misuse of CABs is to ban them entirely. School districts in Michigan were banned from issuing capital appreciation bonds in 1994.²⁷⁵ In 2013, legislation was unsuccessfully introduced in California that declared the legislature's intent to prohibit school districts from issuing CABs.²⁷⁶ Similarly, legislation that would have prohibited the issuance of all CABs by Texas local governments was introduced in 2013, and legislation that would have prohibited the issuance of CABs payable from *ad valorem* property taxes by Texas local governments was introduced in 2014 and 2015, though none of these measures passed.²⁷⁷

Restricting the Use of CABs. The misuse of capital appreciation bonds could be reduced or eliminated by restrictions on the issuance of this type of debt. Both California's AB 182 and Texas's HB 114 adopted this approach (as well as that of providing additional information), narrowing the parameters within which school districts (and, in the case of Texas, other local governments) can issue CABs payable from *ad valorem* property taxes.²⁷⁸ While one can debate whether the restrictions in

275. MICH. COMP. LAWS ANN. § 380.1351b (West 2016).

276. See S.B. 685, 2013–2014 Leg., Reg. Sess. (Cal. 2013) (“It is the intent of the Legislature to enact legislation that prohibits a school district from issuing capital appreciation bonds.”).

277. Tex. H.B. 1750, 84th Leg., R.S. (2015); Tex. S.B. 103, 84th Leg., R.S. (2014); Tex. H.B. 3416, 83rd Leg., R.S. (2013).

278. Assemb. B. 182, 2013–2014 Leg., Reg. Sess. (Cal. 2013); Act of May 26, 2015, 84th Leg., R.S., ch. 991, §§ 1–3, sec. 1201.0245, 2015 Tex. Gen. Laws 3517, 3519 (codified at TEX. GOV'T CODE § 1201.0245).

AB 182 or HB 114 strike the appropriate balance, carefully tailored legislation could prevent the most problematic CABs issuances.

Problems with Prohibiting or Restricting the Use of CABs. A prohibition or restriction that applied only to CABs, but not to other back-loaded debt structures, would only partially address concerns about interperiod equity, though it would eliminate one of the most egregious violations of the principle. However, the restriction could be drafted to apply to all back-loaded debt structures. For example, prior to 2010, many California local government general obligation bond issuances (including school district bonds with maturities in excess of twenty-five years) were required to have substantially level debt service with limited exceptions.²⁷⁹

An outright prohibition or even the most carefully drafted restrictions on the use of CABs—or back-loaded debt structures, generally—might preclude districts from beneficial transactions such as financing needed facilities or obtaining savings by refinancing debts,²⁸⁰ or might push them towards using less desirable financing options. These issues would be of particular concern for rapidly growing school districts, property-poor districts and districts where assessed valuations have declined—all of which may be particularly likely to issue CABs to avoid violating estimated tax rate limits.²⁸¹

Waivers. Allowing a state entity to authorize CABs issuances that would otherwise be prohibited would provide additional flexibility and input from experts.²⁸² A statewide agency approving bonds or waiving

279. CAL. GOV'T CODE § 53508.5 (Deering 1993), *repealed by* Assemb. B. 1388, 2009–2010 Leg. Reg. Sess. (Cal. 2009).

280. *Supra* note 257 and accompanying text.

281. *See supra* Section IV (discussing rapidly growing school districts, property-poor districts, and districts where assessed valuations have declined).

282. Another alternative would be to give a county official or agency, such as the County Treasurer or County Department of Education, authority to grant a waiver. *See* Statement by Dan McAllister, San Diego County Treasurer-Tax Collector, Capital Appreciation Bonds 5 Point Plan Goals (2016) (on file with author) (suggesting, prior to the passage of AB 182, that school district CABs be approved by either the County Superintendent of Schools or the County Board of Supervisors, and that issuances outside of certain parameters be approved by the County Superintendent of Schools); *see also* CAL. ASS'N OF CTY. TREASURERS & TAX COLLECTORS, SCHOOL FINANCE COMMITTEE, SCHOOL FINANCE HANDBOOK FOR TTCS 18–19 (2015) (suggesting greater county involvement in school district general obligations that fall outside of specified parameters); L.A. CTY. CIV. GRAND JURY REPORT, *supra* note 86, at 127 (recommending greater involvement by County Office of Education, Auditor, Treasurer-Tax Collector and others in school district financings). While county officials and agencies would be more familiar with the needs of the region, allowing waivers at the county level is likely to lead to inconsistent policies within the state and,

restrictions on bond issuances is not a novel concept. In California, the State Board of Education currently waives the limit on general obligation debt as a percentage of assessed valuation for school districts and is authorized to waive some of the new restrictions on CABs in limited circumstances.²⁸³ In North Carolina, local governments cannot issue any general obligation bonds without the approval of the North Carolina Local Government Commission.²⁸⁴

CDIAC and the TBRB might be the appropriate entities to grant waivers of restrictions on CABs in California and Texas, respectively.²⁸⁵ CDIAC's role is to provide "information, education and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals,"²⁸⁶ while TBRB's mission is, in part, "to support and enhance the debt issuance and debt management functions of state and local entities."²⁸⁷ CDIAC and TBRB would have the general financial expertise and, particularly if they were responsible for granting waivers of the limitations on CABs, the expertise with CABs specifically, to determine whether a waiver was appropriate in a particular case. In California, the State Board of Education would be another possibility—this board already provides some waivers.²⁸⁸

particularly in smaller counties, the person or people responsible for granting the waiver may not have significantly more expertise than the individuals at the school district.

283. See DAYTON, *supra* note 42, at 45 (noting that between 2000 and 2014, fifty-one waivers of the limit on general obligation debt as a percentage of assessed valuation were requested, of which forty-eight were approved). The State Board of Education may waive provisions of AB 182 for bonds that refinance bond anticipation notes issued before December 31, 2013, if certain conditions are met. CAL. EDUC. CODE § 15144.3 (Deering 2016).

284. N.C. GEN. STAT. ANN. § 159-51 (West 2016). North Carolina law also provides that for issuances that include CABs, the North Carolina Local Government Commission may require that annual debt service on the bonds be as nearly level as possible, may limit the amount of CABs and may require that the use of CABs will not increase the aggregate amount of debt service on the bonds. *Id.* § 159-100(b).

285. Others have suggested that CDIAC could fulfill a similar function, at least with respect to transactions that are more likely to be problematic, perhaps in conjunction with lowering voter approval requirements. See David Gamage & Darien Shanske, *The Case for a State-Level Debt-Financing Authority*, 67 ST. TAX NOTES 188, 193 (2013) (identifying CDIAC as an appropriate entity to approve debt issuances in conjunction with a reduction in voter approval thresholds for local government debt).

286. CAL. DEBT & INV. ADVISORY COMM'N, *About CDIAC*, CAL. ST. TREASURER, <http://www.treasurer.ca.gov/cdiac/introduction.asp> [<https://perma.cc/H6GU-GYLB>].

287. Tex. Bond Review Bd., *Agency Overview*, http://www.brbb.state.tx.us/agency/about_brbb.aspx [<https://perma.cc/HEY3-GUKP>].

288. See DAYTON, *supra* note 42, at 44–45 (analyzing waiver requests and approvals between 2000 and 2014).

Alternative Funding. Banning or restricting the use of CABs would have the effect of restricting the funding available to school districts that could not issue CIBs without violating the applicable expected rate limit. If the facilities these districts would otherwise finance are needed, an alternative funding source would have to be found.

In new developments, developer fees are one option. California school districts are authorized to levy fees on developers for the construction or reconstruction of school facilities,²⁸⁹ though Texas school districts do not have this authority under current law.²⁹⁰ Bonds payable from other property-based taxes that are not subject to the expected rate limit, such as Mello-Roos taxes in California, are another alternative, particularly for new developments (where a developer can approve the tax before there are multiple property owners).²⁹¹ However, both of these forms of financing are more advantageous to developing areas than to existing communities, and increasing their use may further encourage urban sprawl²⁹² and exacerbate already existing funding disparities.

Alternatively, the state could provide additional loans and grants, ideally in a way that targets districts with the greatest needs and that are most adversely impacted by the prohibition or restriction on the use of CABs. It is likely there would be political resistance to perceived redistribution of wealth from some regions of the state to others,²⁹³ and there is a risk that

289. CAL. EDUC. CODE § 17620(a)(1) (Deering 2016).

290. See TEX. LOC. GOV'T CODE ANN. §§ 395.001, 395.012 (West 2015 & Supp. 2017) (providing impact fees may be collected only for specified purposes, which do not include schools).

291. The "vast majority of the [Mello-Roos districts] in Orange County are created and debt incurred before any of the ultimate taxpayers acquire their property." ORANGE CTY. GRAND JURY, MELLO-ROOS: PERPETUAL DEBT ACCUMULATION AND TAX ASSESSMENT OBLIGATION 3 (2015), http://www.ocgrandjury.org/pdfs/2014_2015_GJreport/Mello-Roos_Website.pdf [<https://perma.cc/RA9V-UQ6M>]. The same is likely true elsewhere. See *supra* note 108 (discussing Mello-Roos taxes in further detail).

292. See Darien Shanske, *Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis*, 43 U. MICH. J.L. REFORM 663, 669 (2010) (suggesting Mello-Roos taxes encourage urban sprawl).

293. Some suggest "[p]eople are much more willing to tax themselves to pay for public education in their own local communities[]" than in other communities. Isabel Rodriguez-Tejedo & John Joseph Wallis, *Lessons for California from the History of Fiscal Constitutions*, 2 CAL. J. OF POL. & POL'Y, no. 3, 2010, at 1, 15, available at <http://escholarship.org/uc/item/72b124q1> [<https://perma.cc/L857-B46P>]; see FISCHER, *supra* note 104, at 98–118 (asserting the court-mandated shift of school funding from local communities to the state led to the 1978 voter approval of Proposition 13, which severely limits property taxes in California). This proposition was debated in the UCLA Law Review. See Kirk Stark & Jonathan Zasloff, *Tiebout and Tax Revolts: Did Serrano Really Cause Proposition 13?*, 50 UCLA L. REV. 801, 801 (2003); see also William A. Fischel, *Did John Serrano*

political factors would result in a less than optimal distribution of these resources. Nevertheless, grants or loans may be a better solution than the alternatives of denying these districts needed facilities, allowing them to issue CABs through a waiver program, or pushing them towards using more expensive and less desirable lease revenue bonds or certificates of participation.²⁹⁴ A targeted state grant or loan program could instead assist in addressing some of the inherent inequity of a system that relies largely on property tax revenues to finance capital projects for school districts: that tax rates in property-poor districts must be higher than in property-rich districts to pay for comparable facilities.

B. *Reducing Incentives to Use CABs*

Reducing incentives to use CABs could eliminate many instances of misuse, and might have other benefits as well. While some circumstances that encourage the use of CABs—such as rapidly growing student populations or the desire to maintain substantially level tax rates—cannot be changed, others can. Some of these are discussed below.

Re-evaluating Tax Rate Limitations. Debt limits and other restrictions may simply encourage the development of alternative means of accomplishing the same objectives; means that 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.”²⁹⁵ CABs are an

Vote for Proposition 13? A Reply to Stark and Zasloff's "Tiebout and Tax Revolts: Did Serrano Really Cause Proposition 13?" 51 UCLA L. REV. 887, 887–88 (2004). While Stark and Zasloff disagree with Fischell's position, they do note that shifts from local to state funding of public schools may reduce the level of such funding. Stark & Zasloff, *supra*, at 854. Based on data from the Institute for Social Research Center for California Studies at California State University, Sacramento, more than 70% of school district general obligation bond ballot measures in 2014 included language to the effect that funds would be spent locally or could not be taken by the state. INST. FOR SOC. RESEARCH, 2012 ELECTIONS, *supra* note 49, at 19–39.

294. See Gamkhar & Koerner, *supra* note 175, at 38 (noting property-poor districts are more likely to use lease revenue bonds, which may increase disparities because of the higher interest rates on these bonds); see also *supra* notes 189–95 (discussing reasons these are less desirable). In addition, because the school district obligations in these transactions are characterized as lease payments, the nature of these transactions may be obscured from the public.

295. See JEFFREY I. CHAPMAN, PUB. POL'Y INST. OF CAL., PROPOSITION 13: SOME UNINTENDED CONSEQUENCES 15 (1998), http://www.ppic.org/content/pubs/op/op_998jcop.pdf [<https://perma.cc/NZX2-RX5H>] (discussing the effects of Proposition 13, which reduced property taxes and eliminated general obligation bonds until subsequent constitutional amendments added the California Two-Thirds Regime and later the California 55% Regime); see also Briffault, *supra* note 95, at 925–27 (suggesting debt limits have not significantly affected the amount of debt but have made it

example of this to the extent they are used to avoid violating the expected rate limits. Thus, it is critical that the expected rate limits be evaluated to determine whether they are appropriate or should be modified.

Current expected rate limits may be unduly restrictive and create more problems than they solve. Assessed valuations may have increased at a slower rate than inflation,²⁹⁶ and as a result, taxes at the specified limit may be less burdensome than was contemplated when the restrictions were put in place. A legislature might conclude that the relevant expected rate limit should be higher or even eliminated in some or all circumstances. For example, in 2015, the Texas Legislature considered a proposal to raise the estimated tax rate for rapidly growing school districts as long as they met certain conditions.²⁹⁷ A 2011 Texas bill would have replaced the current test with a cap on the amount of outstanding debt as a percentage of assessed valuation.²⁹⁸ While these bills ultimately failed, it is possible a legislature would find a different modification appropriate (or find the same modification appropriate at a different time). The elimination or relaxing of expected rate limits almost certainly would reduce the use of CABs.

On the other hand, a legislature might determine that the applicable expected rate limitation is appropriate, or even that the limit should be more restrictive. Expected rate limits certainly provide protection to current taxpayers and at least some protection to future taxpayers.²⁹⁹ If a limit is retained, additional protection should be provided to future

more expensive and less transparent). *But see* Farnham, *supra* note 34, at 1198 (finding limits reduce debt levels but voter approval requirements do not).

296. This is particularly true in California, where Proposition 13 (passed in 1978) limits assessed valuation increases. CDIA PRIMERS, *supra* note 30, at 85–86. 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. LEGIS. ANALYST'S OFFICE, CALIFORNIA'S PROPERTY TAX 1 (2012), http://www.lao.ca.gov/handouts/state_admin/2012/CA_Property_Tax_4_11_12.pdf [<https://perma.cc/E3QD-MNWP>].

297. Tex. H.B. 506, 84th Leg., R.S. (2015).

298. Tex. H.B. 2168, 82nd Leg., R.S. (2011).

299. A binding limit on tax rates would provide greater protection, but because it also would increase the risk to bondholders, interest rates on the bonds would be higher and the ability to issue debt might be constrained. The expected rate limit for California school districts was originally drafted as a tax rate cap, but was transformed into an expected rate limit before it took effect because of these concerns. *See* Assemb. B. 1908, 1999–2000 Leg., Reg. Sess. (Cal. 2000) (authorizing a cap on the tax rate to be levied to pay debt service on bonds authorized under the California 55% Regime); SCOTT, *supra* note 49, at 12–14 (explaining the initial requirement of California AB 1908 as an “absolute, ironclad limit on tax rates to be levied to repay bonds under Prop. 39” and the change to a limit on the projected tax rate, and describing its replacement with an expected rate limit).

taxpayers. For example, the legislature could impose reasonable parameters on assessed valuation growth assumptions for purposes of calculating compliance as the Texas legislature has endeavored to do, or could require that projections take into account those made by the county assessor, as a new California law requires for school boards ordering bond elections.³⁰⁰ Reducing the ability of school districts to issue bonds based on overly optimistic assumptions about assessed valuation growth would be likely to reduce the use of CABs and other back-loaded debt structures. A prohibition on CABs or a requirement that property taxes be levied as interest compounds also would protect future taxpayers, though these options come with significant problems.³⁰¹

Par to Par Refunding Requirement. The Texas constitutional provision that limits the amount of school district general obligation refunding bonds that can be issued without voter approval to the principal amount of the bonds being refinanced,³⁰² and similar provisions, should be reevaluated. It may be that replacing this restriction with one that requires that the refunding bonds result in overall debt service savings or even annual debt service savings would better protect taxpayers and would eliminate one of the motivators for CABs in states that have provisions of this type.³⁰³

Modifying the Promises Made to Voters. School districts use CABs to simultaneously meet commitments to voters about tax rates and capital projects.³⁰⁴ While a state would not be likely to (nor should it) prohibit school districts from disclosing planned capital projects or estimated tax rates to voters, it could require that other information be provided to change the perception of what is being promised. This could discourage, or at least reduce the motivation for, using CABs. For example, requiring the total expected cost of repayment of the debt to be included with ballot

300. TEX. EDUC. CODE ANN. §§ 45.0031(b), (c) (West 2012); *see* CAL. EDUC. CODE § 15100(c) (Deering 2016) (requiring school boards ordering bond elections to obtain assessed valuation projections that take into account those made by the county assessor). Although there is no similar mandate for determinations of compliance with expected rate limits, having the requirement in another context increases the likelihood that the same practice will be followed here.

301. *See supra* Section VI.A., “Problems with Prohibiting or Restricting the Use of CABs” and *infra* “Collecting Property Taxes Throughout the Life of the CABs.”

302. *See supra* Section IV.F.

303. Admittedly, where, as in Texas, the provision is in the state constitution, it will be more difficult to modify the provision since doing so would require a constitutional amendment.

304. *See supra* Section IV.B., “Keeping Promises to Voters.”

materials, as became required in California beginning in 2015,³⁰⁵ might deter districts from using more expensive debt structures. Similarly, requiring disclosure of the assumptions used in estimated tax rate calculations, a clear statement that actual rates may be higher in ballot materials—and perhaps anywhere else that districts publish the estimated rates—and statements that projects might not be completed in some circumstances (for example, if issuing the bonds necessary to complete them were projected to raise tax rates over specified levels), or some combination of or all of the above, could reduce the sense that estimated rates and listed projects are “promises.”³⁰⁶ Even if this did not reduce the use of CABs, it would make important information more readily available to the public.

Establishing reasonable parameters for assessed valuation growth assumptions for purposes of calculating projected tax rates included with ballot materials also might reduce the use of CABs because there would be less likelihood that school district boards and officials would face difficulties keeping the “promise[s]” made to voters about tax rates and capital projects.³⁰⁷ A California law that requires school boards ordering an election to obtain “reasonable and informed projections of assessed property valuations that take into consideration projections of assessed property valuations made by the county assessor”³⁰⁸ beginning in 2017 is a step in the right direction. Although the new law does not specify a projection methodology or require that the assessor’s projections be used, there likely is a benefit to the board having this information from the party that is responsible for determining the taxable value of property in the county. Further, while the requirement does not speak directly to the projections that are provided to voters, it is likely that school boards would provide tax rate estimates based on these projections or if they did not, that they would have a reasoned basis for basing estimates on different projections.

In addition, counting interest on CABs against voter authorization and, in California, limits on debt as a percentage of assessed valuation, would

305. CAL. ELEC. CODE § 9401(a)(4) (Deering 2016).

306. See ORANGE CTY. GRAND JURY, SCHOOL BONDS, *supra* note 83, at 31, 33 (suggesting districts make assessed valuation assumptions supporting historical data and an explanation of the basis for the assumptions available to voters).

307. See *supra* Section IV.E. for discussion of these assumptions.

308. CAL. EDUC. CODE § 15100(c) (Deering 2013 & Supp. 2017).

more clearly comply with the binding promises made to the voters not to issue debt exceeding these limits. This is discussed in Section VI.C.

Re-evaluating Matching Fund Requirements and Providing Alternative Funding Sources. State grants that cannot be accessed unless the district is contributing funds to the project encourage districts to issue CABs to maximize the amount the district can contribute to the project (and hence the amount of state funding it can receive). These incentives should be considered when evaluating the costs and benefits of matching fund programs and contemplating alternative funding approaches. Similarly, alternative funding sources for school districts, particularly for districts that may have stronger incentives to issue CABs, may alleviate some of the pressures to use this financing structure.

Collecting Property Taxes throughout the Life of the CABs. If state law required school districts to collect property taxes to pay interest as it compounded, they likely would issue far fewer capital appreciation bonds since one of the principal reasons they use CABs is to avoid tax increases in the near term (because of expected rate limits or otherwise). Districts would still have the flexibility to issue CABs (at least if they weren't constrained by expected rate limits) if doing so were the most cost-effective financing method in the circumstances.

To the extent a district did issue CABs, taxpayers would be paying for debt service through the life of the bonds, addressing one of the major problems with this type of debt. School districts and other issuers could either pay the principal and interest compounded on that principal over a period of several years, or invest amounts collected until the time payment is due on the bonds.³⁰⁹ While requiring funds to be put aside far in advance of scheduled payment dates is uncommon for tax-exempt bonds, some taxable municipal bond transactions include these provisions.³¹⁰

309. In the case of tax-exempt bonds, school investment of these amounts would be subject to provisions of Section 148 of the Internal Revenue Code and related regulations that restrict the yield on such investments to the yield on the bonds. 26 U.S.C. § 148 (2012).

310. *See, e.g.*, ALHAMBRA UNIFIED SCH. DIST., \$13,199,720.85 ELECTION OF 2008 GENERAL OBLIGATION BONDS, SERIES B (TAX-EXEMPT), \$11,800,800.00 ELECTION OF 2008 GENERAL OBLIGATION BONDS, SERIES B-1 (QUALIFIED SCHOOL CONSTRUCTION BONDS – DIRECT PAYMENT TO ISSUER) (FEDERALLY TAXABLE) 15 (2011), <http://emma.msrb.org/EP494671-EP385881-EP782826.pdf> [<https://perma.cc/D27A-VHLH>] (indicating sinking fund deposits are required although the bonds are not subject to mandatory sinking fund redemption); S. SAN ANTONIO INDEP. SCH. DIST., OFFICIAL STATEMENT DATED AUGUST 3, 2010, at 5–7 (2010), <http://emma.msrb.org/EA402884-EA315370-EA711082.pdf> [<https://perma.cc/X7CG-BL8P>] (stating requirement that sinking fund deposits be made with respect to bonds that are not subject to

Requiring taxes to be levied as interest compounds would be consistent with accrual accounting principles, under which interest would be treated as an expense as it compounds.³¹¹ Such a requirement also would be consistent with the treatment of interest that is not paid until maturity (such as interest on CABs) and original issue discount for federal income tax purposes. Under the Internal Revenue Code and related regulations, these amounts generally are included in income and deducted as expenses as they accrue over the term of the debt.³¹²

However, requiring the collection of taxes to pay interest as it compounds would prevent districts that were constrained by expected rate limits from issuing general obligation bonds at all. Like prohibiting or restricting the use of CABs, this approach could prevent districts from completing needed projects, and might disproportionately affect rapidly growing and property-poor districts. As a result, a waiver program or alternative funding sources might be needed.

C. *Providing Additional Information, Training, Guidance, or a Combination of These*

A third approach, driven by concerns that school districts issue CABs without understanding the ramifications of doing so, is to require that additional information be presented to district officials and the public, to provide training and support to governing boards and officials, and to strengthen the ability of districts to negotiate with financial advisors and underwriters. In a similar vein, counting compounded interest against voter-authorized amounts and, in California, the limit on debt as a percentage of assessed valuations, would make the true amount of debt being incurred clearer both to school district board members and officials, and to the public.

mandatory sinking fund redemption). Mandatory deposits likely would preserve the economic benefit of CABs when interest rates are high better than mandatory prepayments because investors presumably require that CABs subject to mandatory prepayment have a higher yield to account for the possibility that they would have to reinvest not only earnings but also principal at lower yields prior to the scheduled maturity date.

311. See *supra* notes 123–29 and accompanying text.

312. See GARLOCK, *supra* note 123, at ch. 2, 5 (describing the applicable rules and exceptions); see also INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. NO. 1212, GUIDE TO ORIGINAL ISSUE DISCOUNT (OID) INSTRUMENTS (2016), <https://www.irs.gov/publications/p1212> [<https://perma.cc/66QK-R3UY>] (explaining how OID is included in income and providing some exceptions). These rules treat CABs and zero-coupon bonds identically. GARLOCK, *supra*, note 123, at 28, para. 201.

Requirements to Provide Information. Both AB 182 and HB 114 require that school boards and the public receive additional information about CABs issuances, including information on overall debt service and the assumptions that are being made about growth in assessed valuations.³¹³ Some districts have refinanced their CABs in recent years, even when doing so increased taxes in the short run, presumably in response to greater awareness and negative public attention given to CABs.³¹⁴ On the other hand, issuances of general obligation CABs by California school districts increased significantly in 2015 despite the additional information requirements included in AB 182.³¹⁵ However, even if additional information does not ultimately reduce issuances of CABs, it will increase board members' and district officials' understanding of the implications of the actions they are taking and public awareness, thereby possibly preventing some of the most problematic issuances.

313. See Assemb. B. 182, 2013–14 Leg., Reg. Sess. (Cal. 2013) (mandating the presentation of additional information to school boards and the public on bonds sales that allow for the compounding of interest); see also TEX. GOV'T CODE ANN. §§ 1201.0245(b), (d) (West Supp. 2017) (requiring additional information be provided to the school board, included in the board's minutes and posted on the district's website). The California Association of County Treasurers and Tax Collectors similarly recommends that boards considering a bond measure receive information about the assumed assessed valuation growth rates reflected in tax rate projections and information about historic assessed valuation growth. See CAL. ASS'N OF CTY TREASURERS AND TAX COLLECTORS, *supra* note 283, at 9, 18 (recommending the board be presented with information about assumptions, expected use of CABs and other information).

314. At least nine school districts and community college districts have refinanced CABs in recent years. See *Napa School Bonds Converted to Save Taxpayers Money*, VALLEJO TIMES-HERALD, (Jan. 25, 2016, 4:03 PM), <http://www.timesheraldonline.com/general-news/20160125/napa-school-bonds-converted-to-save-taxpayers-money> [<https://perma.cc/2F35-2Y6G>]; see also *District Completes Successful Bond Sale*, DUBLIN UNIFIED SCH., <https://www.dublin.k12.ca.us/site/default.aspx?PageType=3&DomainID=1&ModuleInstanceID=1197&ViewID=047E6BE3-6D87-4130-8424-D8E4E9ED6C2A&RenderLoc=0&FlexDataID=31507&PageID=1> [<https://perma.cc/K6AK-5Y53>]. Some of these transactions resulted in higher tax rates in the near term. Keeley Webster, *California School CABs Make Comeback*, THE BOND BUYER (Jan. 28, 2016, 12:55 PM), <http://www.bondbuyer.com/news/regionalnews/california-school-cabs-make-comeback-1095112-1.html> [<https://perma.cc/GW2T-K278>]. However, the Poway Unified School District did not refinance its CABs after extensive discussion and three public meetings, perhaps because of the public opposition to possibly raising tax rates without obtaining voter approval. See POWAY UNIFIED SCH. DIST., BOARD BRIEFS: HIGHLIGHTS FROM THE OCT. 13, 2014 BOARD OF EDUCATION MEETING 1–2 (2014), <https://www.powayusd.com/board/boardBriefs/2014-15BoardBriefs/10-13-14PUSDBoardBriefs.pdf> [<https://perma.cc/VH34-NADV>] (showing 53.75% of the voters opposed the CABs because of tax concerns).

315. See CAL. DEBT & INV. ADVISORY COMM'N, *Capital Appreciation Bond Issuance – After the Passage of AB 182*, DEBT LINE, June 2016, at 3 (showing an increase in CAB issuance of \$665 million from 2014 to 2015).

Another step in the direction of transparency would be to require school districts and other issuers to post debt service schedules for all their general obligation bonds as well as estimates of future tax rates and the assumptions underlying those estimates on their websites, or, better yet, to provide this information to the state for posting on sites like the Texas Comptroller's "Texas Transparency" site³¹⁶ and the California Treasurer's "Debt Watch" site.³¹⁷ While, at least in many cases, overall debt service schedules can be located on the MSRB's electronic municipal market access web site,³¹⁸ members of the public likely would not know to go to a site designed for municipal bond investors and might have difficulty locating the information. Information about estimated future tax rates and the assumptions underlying those estimates would be even more difficult to locate. Having this information readily available would improve transparency and would be a step towards capitalization of debt service structures into home values.

Training and Other Support. Additional education of school boards and district staff members would increase their understanding of the implications of capital appreciation bonds, and of debt financings generally.³¹⁹

In addition to training, information about what other districts are doing and the fees and interest rates that other districts pay could assist districts in their decision-making. It is particularly difficult for issuers and their advisors to compare fees and valuations for more complicated types of bonds³²⁰ (since CABs are far less common than CIBs they likely would fall in this category). While some information about costs of issuance and

316. *Transparency*, TEXAS COMPTROLLER, <https://comptroller.texas.gov/transparency/> [<https://perma.cc/F5FX-KARY>].

317. *Debt Watch*, CALIFORNIA STATE TREASURER, <http://debtwatch.treasurer.ca.gov/> [<https://perma.cc/7XW2-SJTS>].

318. ELECTRONIC MUN. MKT. ACCESS (EMMA), *supra* note 223.

319. Others have recommended providing more education and training about bonds and debt management. See U.S. ADVISORY COMM'N, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT, *supra* note 212, at 43–45 ("Just as many State tax agencies are now providing in-service training for local assessors, so should the States be instructing local finance officers in the intricacies of borrowing money."); see also Bill Simonsen, et al., *supra* note 214, at 715 (recommending counties or states provide "advisory services and technical assistance," including training, to smaller governments, though noting that training alone may not be sufficient).

320. Ang & Green, *supra* note 77, at 10.

interest rates is available from CDIAC and the TBRB,³²¹ the information is not complete. For example, the yield is provided for the entire bond issue, not for each series or maturity, and there is a lag between the time fees and interest rates are established and the time the information is available through these entities; other local governments are unlikely to know the specific reasons for variations in costs. While this information is valuable, it does not provide issuers with all the information they need to evaluate the rates they are receiving.

Other types of assistance also would be beneficial. For example, the Los Angeles County Treasurer and Tax Collector's Office developed a set of form documents that several school districts used to competitively bid for bond counsel, financial advisors and underwriters.³²² Such forms have reportedly saved the districts "tens of thousands of dollars."³²³ The availability of one-on-one guidance from an entity like CDIAC or the TBRB, or even the option of having one of these entities or another state agency manage the bond issuance process for school districts on a purely voluntary basis would be valuable.³²⁴ In addition to potentially preventing school districts from entering into transactions that would be disadvantageous and helping eliminate information asymmetries regarding fees and interest rates, access to disinterested technical expertise could enable districts to evaluate the risks of more complex or unusual transactions and enter into these transactions when it was beneficial to do so.³²⁵

Additional Regulation of Financial Advisors and Underwriters. Financial advisors and underwriters are already regulated at the federal

321. CAL. DEBT AND INVEST. ADVISORY COMMISSION, <http://www.treasurer.ca.gov/cdiac/index.asp> [<https://perma.cc/J7GR-MYAB>]; TEX. BOND REV. BD., <http://www.brb.state.tx.us/> [<https://perma.cc/56CD-LQAK>].

322. Memorandum from Mark J. Saladino, Cty. of L.A. Treasurer and Tax Collector to Mark Ridley-Thomas, et al., 2 (Aug. 8, 2013) (on file with author) [hereinafter Memorandum from Mark J. Saladino].

323. *Id.*

324. The Advisory Commission on Intergovernmental Relations made similar suggestions in 1965. U.S. ADVISORY COMM'N, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT, *supra* note 212, at 46–47, 55–58. More recently, commentators suggested creating a nonprofit that, among other things, would provide affordable, independent advice to municipalities. Ang & Green, *supra* note 77, at 6, 13–15, 17.

325. *See* Whitaker, *supra* note 213 (noting lack of expertise may lead smaller local governments to avoid complex transactions even when they would be beneficial).

level,³²⁶ but additional state regulation also may be appropriate. This would not be unprecedented. California already has laws that regulate some aspects of the relationship between local governments and their financial advisors³²⁷ and other laws have been proposed but not adopted.³²⁸

State and local government agencies might also take independent actions to curtail underwriter and financial advisor behavior that they deem inappropriate. For example, in 2012 the California Treasurer threatened to exclude underwriters involved in “egregious” California school district CABs issuances from state bond issuances if they did not restructure the transactions, though he ultimately did allow them to participate in the state’s bond issuances.³²⁹ In 2016, the California treasurer announced that underwriters, financial advisors, and bond counsel that make cash or in-kind contributions to, or provide certain types of services in support of, bond election campaigns in the state would not be eligible to provide services on state bond issuances.³³⁰ Similarly,

326. For example, the activities of underwriters and municipal advisors are regulated under the Securities Exchange Act of 1934 (which is codified at Title 15 of the United States Code at Section 74(o-4)) and the Municipal Securities Rulemaking Board establishes rules that underwriters and municipal advisors must follow. See *MSRB Rules and Guidance*, MUNICIPAL SEC. RULEMAKING BOARD., <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx> [<https://perma.cc/WFD6-QQ5B>] (providing text of the MSRB rules governing underwriters and municipal advisors).

327. See, e.g., CAL. GOV'T CODE §§ 53591, 53592 (Deering 2011) (requiring written contracts and prohibiting financial advisors from being compensated on the basis of a percentage of the amount of bonds sold and from purchasing bonds for which they served as financial advisor directly from the issuer).

328. For example, bills have been introduced that would have prohibited local governments from hiring underwriters, financial advisors, or lawyers to provide services for issuances of general obligation bonds if those outside consultants had provided campaign services in support of or contributed to the ballot measure under which the bonds were approved. Assemb. B. 621, 2013–2014 Leg., Reg. Sess. (Cal. 2014); Assemb. B. 1045, 2011–2012 Leg., Reg. Sess. (Cal. 2012); S.B. 623, 2009–2010 Leg., Reg. Sess. (Cal. 2010); S.B. 1461, 2009–2010 Leg., Reg. Sess. (Cal. 2010); Assemb. B. 2011, 2007–2008 Leg., Reg. Sess. (Cal. 2008). One of these bills also would have prohibited local governments from hiring the same firm as financial advisor and as underwriter for a bond issue. Assemb. B. 621, 2013–2014 Leg., Reg. Sess. (Cal. 2014).

329. See Randall Jensen, *California CAB Underwriters May Pay in Spring*, THE BOND BUYER (Nov. 6, 2012, 2:26 PM), http://www.bondbuyer.com/issues/121_215/california-cab-underwriters-may-pay-in-spring-1045638-1.html [<https://perma.cc/5DKX-WHS4>]; see also Randall Jensen, *Lockyer Caves on CAB Penalty*, THE BOND BUYER (Feb. 11, 2013), http://www.bondbuyer.com/issues/122_29/california-treasurer-bill-lockyer-set-multi-billion-calendar-for-spring-1048596-1.html [<https://perma.cc/HV9J-2QTZ>].

330. See Press Release, Cal. State Treasurer, Chiang and County Treasurers Move to Stop ‘Pay-to-Play’ School Bond Campaigns (July 27, 2016), <http://www.treasurer.ca.gov/news/releases/2016/20160727.asp> [<https://perma.cc/3863-ADVJ>] (“[M]unicipal finance firms seeking

Los Angeles County prohibits underwriters that make cash contributions or provide in-kind services to promote school district or community college district general obligation bond ballot measures in California from selling county debt.³³¹

Counting Compounded Interest Against Debt Limits. As was discussed in Section III.C., interest that compounds on capital appreciation bonds is not counted against voter-authorized amounts and limits on total debt outstanding. Counting compounded interest for these purposes would be consistent with its accounting and tax treatment and would make the true amount of debt clearer to both school district officials and to the public.

Rather than requiring school districts to determine compliance with debt limits as the interest compounds, state law could instead mandate that the anticipated compounded interest (to the extent not already included in the portion of original issue premium counted against voter authorization) be included in compliance calculations at the time the bonds are issued. This would eliminate the risk that a limit would not be met at the time the interest compounds. For example, if assessed valuations declined after bonds were issued, the interest might violate a limit on debt as a percentage of assessed valuations like the one applicable to California school districts even if it would not have (had it been included at the time the bonds were issued)—a risk that bond purchasers presumably would be unwilling to bear without charging higher interest rates as compensation. In addition, this approach would impose a smaller administrative burden on districts than a requirement that they recalculate compliance each time interest compounds. If a series of CABs were to be repaid prior to maturity, any interest that did not ultimately compound could be available again for a concurrent or future bond issuance.

state business will be required to certify that they make no contributions to bond election campaigns.”); *see also* Form Letter from John Chiang, Cal. State Treasurer (July 27, 2016), http://www.treasurer.ca.gov/news/releases/2016/20160727_letter.pdf [<https://perma.cc/6QY7-BQAE>] (defining “bond campaign services” as services such as “fundraising, public opinion polling, election strategy and management, organization of campaign volunteers, get out the vote services, development of campaign literature, and advocacy materials”).

331. *See* CTY. OF L.A. TREASURER AND TAX COLLECTOR, REQUEST FOR STATEMENT OF QUALIFICATIONS LOS ANGELES COUNTY UNDERWRITER POOL app. A at 2 (2015), [<https://perma.cc/4XQK-YLKV>] (“Firms in the Underwriter Pool are prohibited from making cash contributions or providing in-kind services to promote or facilitate California school or community college district campaigns for general obligation bond ballot measures.”); *see also* Memorandum from Mark J. Saladino, *supra* note 322 (describing the reasons for the prohibition).

Counting the full amount of interest at the time the debt is issued would arguably result in over-counting against the voter-authorized amount since the present value of interest that will compound in the future is less than the total dollar amount of that interest. Furthermore, counting all interest that is expected to compound against limits on outstanding debt as a percentage of assessed valuations—such as the limit that applies to California school districts—at the time of issuance would, in effect, make these limits more restrictive to the extent that a district had outstanding debt that was scheduled to be repaid before the interest would compound. Nevertheless, the cost of this approach is small when compared with the problems created by testing the total debt against the limit as interest compounds.

While the result of such legal changes might simply be that voters are asked to (and do) approve higher amounts of debt and that California school districts apply for waivers of the outstanding debt limit more frequently, these changes would still have a positive impact in that the full amount of debt would be clearer to elected officials, administrators and voters.

VII. CONCLUSION

As the use of CABs by California and Texas school districts demonstrates, local governments have incentives to defer debt service to benefit today's population at the expense of future residents, and these incentives are intensified in some circumstances.

In theory, the problems associated with CABs and with back-loaded debt service structures, generally, could be solved by requiring substantially level debt service (allowing adjustment for expected inflation) on all bond issuances, and by treating compounding interest as debt service and requiring taxes to be levied in an amount sufficient to pay the interest as it compounds. This would prevent the disproportionate burdening of future taxpayers while still allowing CABs to be used when they resulted in lower debt service costs.

In practice, however, this solution would make it more difficult for issuers to maintain level tax rates, and in many instances, would result in higher near-term tax rates—particularly in districts that already have outstanding debt and in rapidly growing areas. Districts that already have outstanding debt would not be able to structure new debt around their existing debt. In rapidly growing areas, facilities are being constructed to

support a growing population and are expected to be paid by a larger future assessed valuation base. Higher near-term tax rates would make it politically more difficult to issue debt and might result in underinvestment in infrastructure. Furthermore, requiring substantially level debt service would prevent some issuers that are subject to expected rate limits from incurring any debt or making any significant investment in infrastructure.

Thus, states are confronted with the challenge of restricting the ability of local governments to issue CABs (or back-loaded debt generally), or reducing their incentives to do so without driving them to use less desirable financing options, preventing the construction of needed facilities, or impeding refinancings that result in lower debt service. The appropriate solution will vary from state to state and may differ for different types of local governments depending on factors such as: other state laws, the importance that a state places on local control, the severity of infrastructure needs, and the availability of alternate funding sources. Nevertheless, some general principles apply.

First, addressing the incentives that lead local governments to issue CABs is likely to be more effective than restricting or prohibiting CABs or back-loaded debt. Even the most carefully tailored restrictions will prevent some transactions that are socially desirable and allow some transactions that are not. Further, issuers and their advisors will search for ways to meet their objectives without violating the restrictions. The means they employ—such as lease revenue bonds, COPs, and potentially others—are likely to be more expensive or less transparent than general obligation CABs would have been, and may also create other problems.

Thus, as an initial step, states should evaluate their existing laws to determine whether these laws are fulfilling their intended purposes and to what extent they are increasing incentives to issue CABs. For example, states that impose expected rate limits on some or all local governments (as California and Texas do on school districts), should evaluate these limits since they are one of the principal reasons that CABs are used. If these limits are to be retained, states should consider setting reasonable parameters for calculating projected assessed valuations. States with par-to-par refunding restrictions should consider the merits of those limits and whether they can be modified.

States also should consider whether aspects of their systems for financing infrastructure are increasing incentives to issue CABs and, if so, whether these systems should be modified. States that only provide funding for capital projects if local governments provide matching funds

may choose to reconsider these requirements. States may also consider implementing or expanding grant or loan programs that target areas of particular need such as rapidly growing districts or property-poor districts with aging infrastructure. Of course, infrastructure funding is complex and there are numerous considerations involved in the structuring of financing programs. Incentives to issue CABs are but one factor that should be evaluated.

Second, adequate training about debt and capital financing for local government board members and officials and access to expertise is very important. Training and access to experts would allow local governments to make better decisions for their communities not only with respect to CABs and other back-loaded debt, but with respect to infrastructure financing generally. The extent to which the involvement of state experts in financings is mandated or is at the option of the local government, likely will vary from state to state depending on the importance that a state and its residents place on local control.

Finally, making information about the amount and structure of local government debt and about expected future tax rates and the assumptions underlying them to both local government board members and officials, and to the public is important. Counting compounded interest against debt limits (at least absent a requirement that taxes be levied to pay that interest as it compounds) is a critical component of this. Clear, accurate, and accessible information is important for local governments to make good decisions and for the public to be able to effectively participate in the democratic process.

Given the important role that local government debt plays in the construction of public infrastructure in United States and the country's looming infrastructure needs, these problems cannot be ignored.