

Charter Schools:



Borrowing With Tax-Exempt Bonds

EUGENE H. CLARK-HERRERA and DARRIN L. GLYPH



DISCLAIMER: Nothing contained in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of the use of tax-exempt bonds by charter schools, from which better informed requests for advice, legal and financial, can be formulated.

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CHAPTER ONE

Introduction

The charter school movement has evolved for nearly two decades, yet the challenge of securing affordable facilities continues to confront nearly every charter school. The landscape of solutions now includes government-sponsored, private sector, and collaborative programs that provide facilities or facilities financing. Borrowing through the issuance of tax-exempt bonds has emerged as an effective option to obtain low-cost facilities financing.

Nonprofit corporations have borrowed money using tax-exempt bonds for many years. Because charter schools in many states may, or in some cases must, be organized as nonprofit corporations, they have recently begun borrowing money using tax-exempt bonds in similar fashion.

As the tax-exempt bond market has experienced a substantial expansion in the types of nonprofits using such financing (previously dominated by hospitals and universities), individual charter schools and groups of commonly managed charter schools are borrowing on a tax-exempt basis, spurred by increasing demand for facilities, better understanding of the benefits of tax-exempt financing, and greater market acceptance of charter school credits. Not only large, established charter school management organizations (CMOs) with substantial financial resources need apply, but also relatively small, even start-up, charter schools without established credit may be financeable under certain circumstances.

The purpose of this pamphlet is to provide charter schools that might not have previously considered or fully understood tax-exempt financing with relevant information about the benefits of, their eligibility for, and the procedures associated with, such financing.

The Authors. The authors are co-chairs of the Charter School Finance Group within the Public Finance Department at Orrick, Herrington & Sutcliffe LLP. Orrick is the nation's premier tax-exempt bond counsel firm, ranked number one for nearly two decades,¹ with extensive experience in all types of nonprofit corporation and educational institution financings, including charter schools.

1. Rankings for securities transactions of various types are performed annually by Securities Data Company, which has ranked Orrick number one in the country as bond counsel for tax-exempt bonds nearly every year since prior to 1990. On average, Orrick handles more than 300 bond issues as bond counsel, aggregating more than \$16 billion, a year.

CHAPTER TWO

Why Use Tax-Exempt Bonds?

A. Options

In funding capital projects, charter schools generally have at least five choices:

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

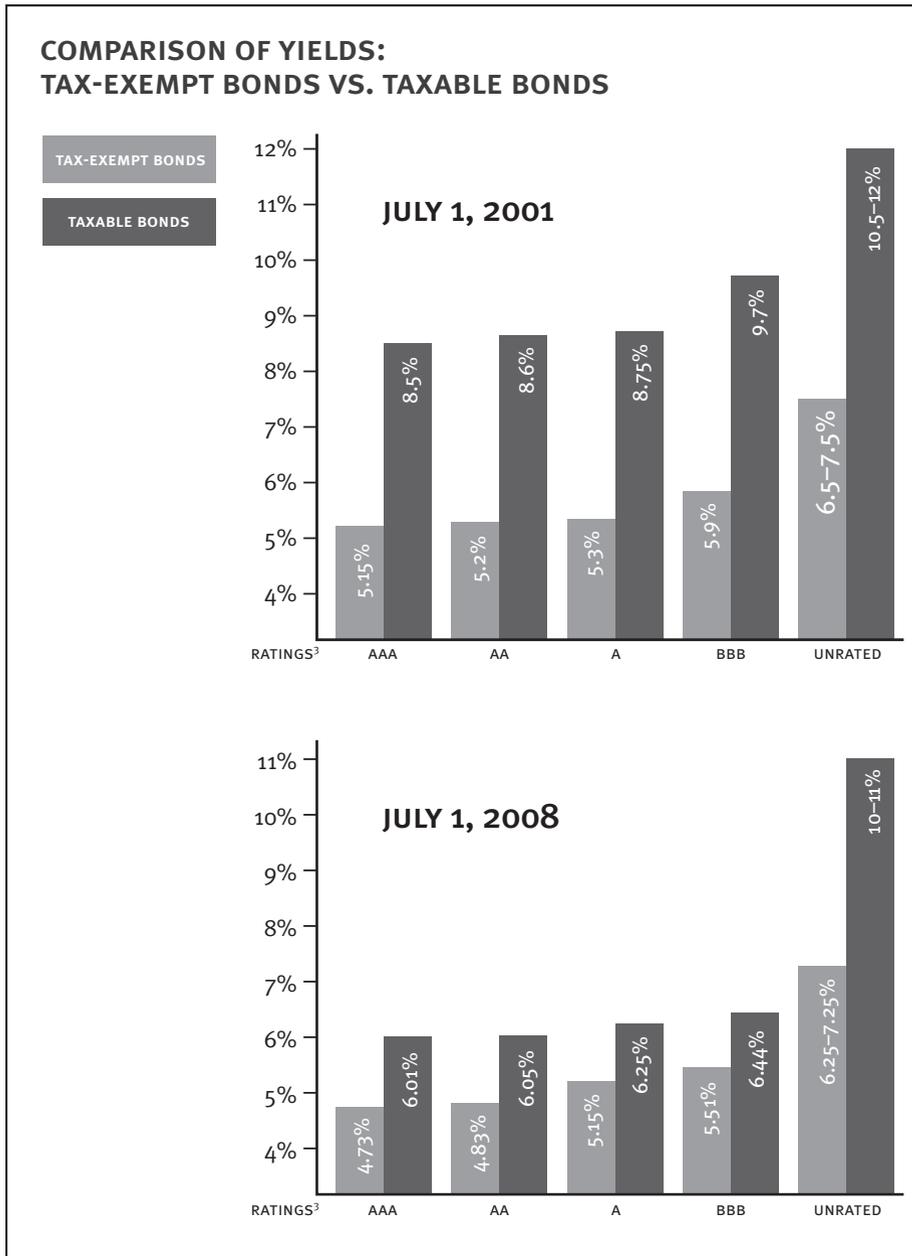
Of these, tax-exempt financing is often the best option because it offers the lowest cost of borrowing, greater flexibility and usually the best terms. While each charter school's specific circumstances are unique, and may make other options more advantageous, tax-exempt bonds should always be included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

B. Comparison to Taxable Debt

Better Rates. The public capital markets typically offer lower interest rates than private loans or bank financing (more competition produces lower rates).²

However, tax-exempt financing normally offers lower interest rates than taxable debt no matter how either type is sold. Because interest paid on tax-exempt debt is exempt from federal income tax (and usually income tax of the state in which issued as well), the investor/lender requires less interest to produce the same after-tax return as taxable debt would produce. The difference varies from time to time based on market factors but is usually two or more full percentage points less than comparable taxable debt.

For example, interest rates on 30-year bonds sold around July 1, 2001 and around July 1, 2008 were roughly as follows:



While the difference (or “spread”) between taxable and tax-exempt rates fluctuates over time, the fundamental lower cost of tax-exempt debt remains constant.

Better Terms. Tax-exempt debt generally has more flexible terms than conventional taxable debt, whether in the form of a bank loan or negotiable securities. Tax-exempt debt generally may be issued on a long-term (20 to 30 year) fixed interest rate basis, compared to most taxable debt, which is usually issued with a shorter term at a variable interest rate indexed to the prime lending rate, U.S. Treasury notes or bonds, or LIBOR. If preferred, tax-exempt debt also may be issued on a variable rate basis, based on one of the foregoing indices or a tax-exempt index such as that maintained by the Securities Industry and Financial Markets Association.

The tax-exempt bond market usually accepts financing of 100% of a project's cost, in contrast to a typical bank or traditional loan financing, which may be limited to 70–75% of the value of the asset financed. The financial covenants required in connection with tax-exempt financing are also usually less onerous and restrictive than those required in taxable debt financings. These covenants cover such matters as limitations on the ability of the borrower charter school to incur additional debt or encumber property, required levels of liquid assets or asset to liability ratios, conditions on the acquisition or disposition of property and on mergers or consolidations.

In summary, tax-exempt financing offers better interest rates and usually more flexible terms and conditions than taxable financing. How does tax-exempt financing compare to the option of non-debt financing with operating or facilities revenues, charitable contributions or other accumulated funds?

C. Comparison to Available Funds and Contributions

The availability of tax-exempt financing presents one of those rare circumstances in which it may be better to borrow than to pay with accumulated or donated funds, even if there are ample available funds.

As discussed above, one of the benefits of tax-exempt financing is lower interest rates. These rates are based on market rates for tax-exempt obligations, which can provide investors with the same after-tax return as taxable obligations at lower interest rates, because this interest is not subject to income tax in the hands of the investor/lender. Accumulated funds, including donations, of nonprofit corporations can normally be invested in taxable obligations earning higher rates of return (on which the nonprofit corporation does not, however, pay any tax). As a result, by spending proceeds of tax-exempt debt instead of accumulated funds, a charter school will normally have the opportunity to invest those accumulated funds, that it would otherwise have spent, in taxable obligations yielding more than it must pay

in interest on the tax-exempt debt. This earnings advantage can be quite substantial and the accumulated funds can serve as a kind of endowment.

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

This earnings advantage, based on the spread between taxable and tax-exempt interest rates, is sometimes called "arbitrage." The federal tax requirements for the tax-exemption of interest on bonds govern when such arbitrage is permitted. See further discussion below in Chapter 8, "Interplay Between Bonds and Fund-Raising."

Thus, though it is somewhat counterintuitive, available funds may be better held and invested while tax-exempt borrowing is used to finance facilities. What about utilizing sources of grant funds or low-cost loans from federal or state agencies or local charter authorities?

D. Comparison to Governmental Financing Programs

Several states and local government agencies have developed charter school facilities financing programs to address the dire need in the marketplace.⁴ Such programs offer facilities financing at no cost (through grants) or at very low interest rates (through a variety of programs). By necessity of public policy, these programs tend to involve a variety of eligibility requirements, costly procurement procedures, public bidding rules, and rigorous ongoing compliance provisions. In particular, most such programs mandate governmental ownership of the financed facilities. By comparison, charter schools that use tax-exempt bonds retain ownership of the financed facilities, and thereby exercise control over the design and future use of such facilities, as well as, in most cases, the ability to leverage the asset to finance expansion or future renovations. Further, tax-exempt financings generally involve less restrictive qualifications (such as site location and design) and fewer ongoing oversight and reporting requirements as compared with governmental grant or loan programs.

Governmental grant and loan programs may also involve significantly greater periods of time to access funding. As described in more detail below in Chapter 10, “Steps to Issuing Bonds and the Finance Team,” a typical bond financing schedule ranges from 90–120 days, start to finish (absent unexpected complications). A typical governmental grant or loan program, on the other hand, may involve a year or more from application to receipt of funds. Moreover, governmental funding may be subject to problems affecting the funding source, independent of the applicant’s eligibility.

Finally, the only limitation on the size of a charter school’s borrowing with tax-exempt bonds is the charter school’s ability to pay. So long as a charter school can meet the debt-service obligation, projects generally can be fully funded (that is, 100% debt-financed) with tax-exempt bonds. By contrast, regardless of a charter school’s ability to pay, few governmental charter facilities financing programs provide all of the funding needed to cover the cost of a project (and those that do are even more competitive). Instead, many programs provide partial funding (to spread resources among a greater number of charter schools) giving rise to a shortfall between what is needed and what is provided. The shortfall necessitates access to additional sources of funding by the charter school in order to complete the facilities project.

Thus, while a federal or state agency or local chartering authority may be able to offer comparable or even zero cost of funds relative to tax-exempt financing, the program requirements, limitations, timing and restrictions on balance may render such programs ultimately less attractive. How do tax-exempt bonds compare to federal tax credit financing programs?

E. Comparison to Federal Tax Credit Financing

Federal tax law establishes the exemption from federal income tax on interest earned on municipal bonds, including those issued on behalf of nonprofit corporations such as charter schools, thereby stimulating the flow of private capital to public infrastructure financing. The tax code also stimulates public infrastructure development by providing tax credits to certain lenders or investors who lend or purchase and hold bonds issued through certain programs to finance certain types of public capital improvements, such as affordable housing developments, or capital improvements in certain locations, such as qualified

low-income communities. Recently, tax credit financing has been used successfully for charter school facilities located in qualified areas or serving qualified populations of students, providing a relatively low cost of capital similar to tax-exempt bonds.⁵

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

- ***Location of facilities/population served.*** There are no restrictions on the geographic location or student population served by a charter school financed with tax-exempt bonds; while existing tax credit financing programs require the charter school to be located in a qualified geographic area⁶ or to serve qualified students.⁷
- ***Availability of funding.*** Generally, there is no statutory limit on the dollar amount of tax-exempt bonds that may be issued in a given year by a given municipal issuer on behalf of a charter school or all charter schools; however, tax credit loans and bonds are dependent on the availability of tax credits, as determined by Congress on a periodic basis for the nation as a whole. A charter school must apply for and receive the right to use tax credits, if available. Once the allotment of tax credits in a given year has been allocated to various tax credit loans or bonds in a given tax credit financing program, no further financings may be completed through such program unless and until Congress provides for a new allotment of tax credits.
- ***Term of loan subsidy.*** Tax-exempt bonds for charter schools are typically structured as long-term financings (20 to 30 years), and the tax exemption of interest is designed to remain in effect for the life of the bonds (so long as the charter school adheres to the terms of the financing); however, existing tax credit financing programs provide a maximum of 7 to 15 years subsidy to the charter school (depending on the program), regardless of whether loan amortization is longer. Generally, when the subsidy period ends in a tax credit financing (because investors have recognized or “used” all the tax credits), the charter school bears an increase in the cost of its debt or must refinance the debt to

maintain affordability. Tax-exempt bond financing may be available to refinance a tax credit financing at the end of the subsidy period. See Chapter 4, “Eligible Uses of Bond Funds” regarding refinancing rules.

Every charter school’s circumstances are unique, from the scale, timing and location of a project, to the resources available or accessible, to a school’s specific financial management and programmatic objectives. Charter schools need to analyze the various facilities financing options in view of their specific circumstances, in order to determine the relative benefits of tax-exempt and tax credit financing.

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2. A brief explanation of this dynamic involves simple economic supply/demand rules. A bank loan typically involves one lender, who enjoys great leverage over the borrower in negotiating the terms of the loan. A private placement of a bond issue or note issue similarly involves one or a very limited number of private investors, who again, enjoy leverage in negotiations because no one else is competing for the opportunity to buy the bond or note (i.e., to provide the loan). In a public offering, bonds are offered for sale to the entire marketplace of municipal bond investors. This creates competition (greater demand) for the right to purchase the bonds, and thus shifts some of the leverage in negotiating financing terms (depending on a variety of credit factors) back toward the borrower. For discussion of other factors affecting borrowing cost, see Chapter 5, “Credit Considerations.”
 3. Ratings refer to independent appraisals of the credit quality of the bonds and the likelihood of their repayment performed by one or more of the credit rating agencies: Standard & Poor’s Corporation, Moody’s Investors Service or Fitch Ratings. The ratings are expressed as letter grades AAA, AA, A, BBB (expressed as Aaa, Aa, A and Baa by Moody’s) from highest to lowest investment grade ratings, with +/- or numerical subcategories. Ratings are considered very important by the underwriters in marketing the bonds and by investors in determining what interest rates will induce them to purchase the bonds. Charter school bonds are often sold without a rating, although usually at higher interest rates. See Chapter 5, “Credit Considerations” for more information.
 4. See “Making Charter School Facilities More Affordable: State-Driven Policy Approaches” published in December 2008 by the Office of Innovation and Improvement of the U.S. Department of Education, available at www.ed.gov/admins/comm/choice/charterfacilities/charterfacilities.pdf.
 5. For a discussion of recent examples of tax credit financing for charter school facilities, see “Charter School Facilities Finance: How CDFIs Created the Market, and How to Stimulate Future Growth” by Annie Donovan, a working paper published in 2008 by the Center for Community Development Investments in the Community Affairs Department of the Federal Reserve Bank of San Francisco, available at www.frbsf.org/cdinvestments/; see also, “2007 Charter School Facility Finance Landscape” published in April 2007 by the Educational Facilities Financing Center of the Local Initiatives Support Corporation, available at www.lisc.org/resources.
 6. The New Markets Tax Credit (NMTC) program rules require charter schools to be located in qualified low income communities. Certain exceptions apply, regarding low population density and high migration patterns. See the NMTC rules at www.cdfifund.gov/what_we_do/programs_id.asp?programID=5. Also, see below footnote #7 regarding Qualified Zone Academy Bond program requirements.
 7. In the Qualified Zone Academy Bond (QZAB) program, three eligibility requirements must be met: (1) the charter school is either located in an Empowerment Zone or Enterprise Community or there is a reasonable expectation that at least 35 percent of the school’s students are eligible for free or reduced-price lunch under the federal lunch program (National School Lunch Act), (2) the charter school has an education program designed in cooperation with business and receives a private business contribution that is not less than 10 percent of the net present value of the proceeds of the bond, and (3) the charter school has an education plan that is approved by their chartering authority and in which students are subject to the same standards and assessments as other students in the district. See the QZAB program rules at www.ed.gov/programs/qualifiedzone/generalqzab.html.

CHAPTER THREE

Timing of Project Acquisition

The acquisition of charter school facilities financed with tax-exempt bonds may take either of two basic paths:

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

The choice of whether to acquire the facility before or after the period of time during which the facility is not ready for occupation (the “construction period”) influences the structure and purpose of the tax-exempt bond financing. More commonly, the former approach is taken, which gives rise to at least two options for structuring the tax-exempt bond financing: (a) construction financing undertaken separately from the tax-exempt financing of the permanent loan, versus (b) tax-exempt financing that covers both the construction and permanent loan. In the latter approach, tax-exempt bonds are only needed for the permanent financing.

A. Separate Construction and Permanent Financing

The inherent economic problem associated with the construction period (which may be one to three years) is how to pay the debt service for a loan associated with a new facility while continuing to pay occupancy expense for the existing facility in which the charter school is operating. In essence, during the construction period, the charter school could be obligated to pay double for its facilities, once for those it currently occupies, and again for those it plans to move into.

Generally, tax-exempt financing is not used for short-term (one to three years) loans for construction of facilities, and instead for construction financing the charter school must utilize lending institutions that specialize in making construction loans for charter school facilities projects. These institutions specialize in undertaking construction risk (the risk of delayed or failed project completion), and bring to bear expertise in project finance, management and construction, in order to ensure timely and effective project completion. These short-term loans are typically predicated on the availability of some form of long-term (or “permanent”) financing to repay (or “take out”) the short-term loan, and are typically structured to mature in a lump sum upon project completion with no payments (or only interest payments) due in the interim. During construction, the charter school will follow the steps outlined in Chapter 10, “Steps to Issuing Bonds and the Finance Team,” culminating in the issuance of bonds on or around the maturity date of the construction loan which will coincide with the completion of the project.

B. Combined Construction and Permanent Financing

A tax-exempt bond financing can be (and is often) structured to cover both construction financing and permanent financing. The economic problem of paying for two facilities at once is typically solved by financing the debt-service obligation of the charter school during the construction period. In other words, the loan is structured such that principal does not begin to amortize until after scheduled construction completion, and interest payments are made from the proceeds of the loan itself (known as “capitalized interest”) during the same period (and often for a short additional contingency period).⁸ However, timely project completion remains of paramount concern.

Because completion of the project is a prerequisite to the charter school’s occupancy and use, the construction financing risk in this case is shifted (because no construction lender is involved) to the tax-exempt bond investors. Delays in or failure of completion could give rise to a scenario where the charter school is obligated to repay the bond debt service as well as continue to pay the occupancy expense for its existing facilities, thus extra precautions are taken in this approach to ensure timely and on-budget project completion. Since investors are taking both construction risk and permanent financing risk, they will expect detailed disclosure regarding the project plans, the construction or project manager, the

general contractor, and the terms of the construction contract itself, in addition to the ordinary disclosure about the charter school's finances and operations.⁹ This approach is more suitable for charter schools that have substantial internal expertise (either at the staff or board level) in project finance and management, or that have access to such expertise through consultants, financial advisors and attorneys.

C. Acquiring a Completed Facility

A burgeoning industry within the charter school movement includes a small number of private, nonprofit real estate development organizations specializing in the construction and renovation of facilities for charter schools.¹⁰ These private developers arrange their own financing (or otherwise arrange access to capital) for site acquisition and construction or renovation of the project, while working closely with the charter school to design the facility and establish a timeline for completion. This arrangement may be particularly beneficial because, in addition to its own financing, the private developer brings valuable expertise in local real estate markets, charter school architectural design, general contracting and construction, procurement, and project management (little of which exists within a typical charter school's staff or board of directors).

In this approach, the charter school follows the steps outlined in Chapter 10, "Steps to Issuing Bonds and the Finance Team," during the construction period, culminating in the issuance of bonds on or around the completion of the project. The proceeds of the bond issue are used, primarily, to finance the purchase of the completed project from the developer (at a price at least sufficient to cover the developer's original acquisition cost and construction costs). This option solves the inherent economic problem of paying for two facilities, because the charter school does not pay for the construction financing (instead the developer has borne this cost). The charter school easily transitions from paying for its existing facility to paying the debt service on its new facility upon the closing of the bond financing.

8. Federal tax rules generally permit proceeds of tax-exempt bonds to be used for this purpose for up to three years after issuance of the bonds. See Chapter 4, "Eligible Uses of Bond Funds" for more detail.

9. See Chapter 7, "Market Disclosure" for explanation of the charter school's information disclosure obligations in connection with a tax-exempt bond issue.

10. Three prominent examples include, in California, Pacific Charter School Development (see www.pacificcharter.org), in New York, Civic Builders (see www.civicbuilders.org) and, in Washington D.C., Building Hope (see www.buildinghope.org).

CHAPTER FOUR

Eligible Uses of Bond Funds

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

A. Capital Expenditure Projects

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

B. Refinancing Prior Debt

Refinancing outstanding taxable debt, including construction financing, tax credit financing, bank loans and mortgages, is a very common use of tax-exempt bonds, particularly (but by no means exclusively) by first time users of tax-exempt debt. The primary limitation is that the proceeds of the prior debt were used for capital

projects that would have qualified for original financing with tax-exempt bonds as described in immediately preceding subsection A.

Tax-exempt bonds can also be (under certain circumstances) used to refinance (or “refund”) prior outstanding tax-exempt bonds, although, generally, only one so-called “advance refunding” is permitted. An advance refunding is defined as issuing the refunding bonds more than 90 days before repayment of the bonds to be refunded. In an advance refunding, proceeds of the new bonds are invested in a special trust fund until the date of repayment of the prior bonds.

C. Reimbursing Prior Capital Expenditures

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

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

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

a capital project should be the adoption of an official intent reimbursement resolution. Properly drafted, it can be fairly general, simple, and nonbinding. There is no cost or liability to not issuing the bonds or not using the proceeds for reimbursement. Bond counsel will normally provide such a resolution upon request without charge. See Chapter 10, “Steps to Issuing Bonds and the Finance Team.”

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

D. Operating Funds (or “Working Capital”)

While use of tax-exempt bonds to finance operating expenses (or “working capital”) is not specifically prohibited, the tax rules governing the tax exemption of interest on the bonds generally make such financings impractical, except in some cases for an amount not exceeding 5% of the bond proceeds (net of reserves) if used as working capital in connection with the project being financed with the balance of the bond issue.¹¹

E. Costs of Issuance, Capitalized Interest, Reserves

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

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

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

F. Investment of Proceeds

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

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

The yield is determined at the time of issuance of the bonds, and functions as a ceiling for certain investment earnings purposes. For instance, the proceeds of

bonds issued to advance refund a prior issue of tax-exempt bonds (as in subsection B, page 15) may only be invested in a manner that does not produce earnings above the yield on the refunded bonds. On the other hand, proceeds of tax-exempt bonds issued to fund acquisition or construction of capital projects (as in subsection A, page 15) may, so long as certain conditions are met, be invested without regard to the yield on the bonds, creating the opportunity to earn arbitrage and apply those earnings to pay project costs.

During the fifth year after issuance of tax-exempt bonds, the charter school will be required to file a return with the IRS, declaring any arbitrage earnings associated with the bonds. Based on the applicable tax rules, if the charter school has earned too much arbitrage, then certain amounts may be required to be returned (or “rebated”) to the IRS. The complex rebate rules generally follow the policy premise that the federal subsidy created by the income tax exemption on the charter school’s bonds is limited, and any excess subsidy garnered through disallowed arbitrage earnings must be returned to tax payers. Thus, careful investment planning in consultation with qualified tax counsel is vital to a properly structured tax-exempt financing that maximizes arbitrage earnings and minimizes rebate liability.

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

CHAPTER FIVE

Credit Considerations

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

Investors rely on a variety of sources of information in assessing the charter school's creditworthiness or risk profile, and in making their investment decisions. These may include, (a) the school's financial statements and operating information (including asset values and unusual positive or projected cash flows), (b) academic research and press coverage regarding the school, (c) information regarding the chartering authority, its legal framework and relationship with the charter school, (d) assessments and evaluations by the chartering authority, if any, (e) physical inspection of the charter school site and operations, (f) the charter school's primary market disclosure, and (g) the analyses of third-party credit rating agencies, if

applicable. Most of this information is already in existence when a charter school begins the process of a bond financing, with the exception of the primary market disclosure (or “official statement”) and the credit rating. At the time a transaction is commenced, counsel will work closely with the charter school to prepare the official statement, which will ultimately be provided for investor review prior to the sale of the bonds. See Chapter 7, “Market Disclosure” for detail about the official statement. In addition, if the charter school so elects, application will be made to one or more credit rating agencies for review of the transaction and rendering of a credit rating.

A. Rating Agency Criteria

Credit rating agencies play an important role in tax-exempt bond financing, giving investors comfort that a standards-based third-party review of the risk profile of the charter school and the proposed transaction has been undertaken. An “investment grade” credit rating is considered “BBB” or higher.¹² Recently, the three major credit rating agencies have gained better understanding of the charter school movement as a whole, and more particularly the characteristics of charter schools that contribute to their ongoing success or failure.¹³ In addition, several charter schools have established sufficiently strong operating histories to receive investment-grade ratings on their tax-exempt bonds. While this area of credit analysis continues to evolve, some common analytical themes have emerged among the three agencies. Generally, to garner an investment-grade credit rating, charter schools must satisfy the following criteria (although each specific school’s circumstances will ultimately be determinative):

1. Authorizing Statutory Scheme. The charter school authorizing statutory scheme is viewed as strongest if it provides for an impartial review and approval process for new and renewing charter applications. The length of charters (longer is better), the level of oversight and communication (more frequent is better), and the predictability of state funding (more predictable is better), all influence this analysis as well. Often, the specific relationship a charter school has with its chartering authority will be reviewed (good working relationship is better). An ideal charter law provides for early identification of problems that may lead to charter revocation, and the opportunity for a charter school to take corrective action to avoid revocation.

2. Program and Market Position. Generally, the charter school's program is viewed as strongest if it serves a specific need in the enrollment area that competing public schools do not serve (either through a unique curriculum or higher quality, or both), and sufficient demand for the program is evidenced by a well-documented and regularly updated waiting list. Other factors include the growth trend of the charter school's enrollment area (growing is better), the program's reputation (research-based validation and positive press coverage) and the charter school's relationship with parents and other community constituents (indicating support). Finally, the prospect of future competition is also analyzed (i.e., is the number of charters limited, do other barriers to entry exist, or could competing schools be established in the future?).

3. Management Team and Organizational Structure. The strongest charter school management team represents a broad array of organizational expertise, including programmatic, financial, managerial, operational, and legal knowledge. Leadership is clearly vital, however over-dependence on the skills of one founder can jeopardize a charter school's longevity. Thus, effective cross-training of key personnel, institutionalized management policies and practices, and effective financial, debt management, and operational controls all benefit the credit rating process. In order to borrow using tax-exempt bonds, the charter school most likely must be organized as a nonprofit corporation, exempt under Section 501(c)(3) of the Internal Revenue Code. Both individual schools and larger CMOs (or groups of collectively managed charter schools) may be eligible to borrow.

4. Financial Management and Operating History. A minimum of three to five years operating history, ideally having successfully completed at least one charter renewal process, is uniformly viewed as the strongest scenario for investment-grade credit rating. Sound financial management practices (as evidenced by prior financial reports and the existence of strong internal controls and procedures) are equally important, the former not likely possible without the latter. Rating agencies have uniformly acknowledged that the most prominent cause of charter school failure is financial mismanagement, and thus focus heavily on these characteristics in the rating process. Important factors in this analysis include maintenance of operating reserves, adherence to existing reserve policies over

time, effective cash flow management, regular oversight and reporting, financial contingency planning for unexpected challenges, and a strong history of budgeted to actual performance.

5. *Debt Management and Financial Planning.* Undertaking the construction of a new facility or the acquisition of an existing facility involves incurring significant debt, relative to a charter school's operating income. Review of a charter school's debt management policies and practices, and projections related to the incurrence of new debt also play an important role in credit review. Typically, a charter school is viewed as strong if its debt burden consumes no more than 15–20% of its operating revenues (both historically and prospectively in light of the proposed financing). Dependence on future enrollment growth to meet debt-service obligations is viewed as risky, and thus conservative, data-driven projections should be employed, if needed. Favorable factors in this analysis include the availability of per-pupil state funding for facilities, appropriate project scale (i.e., completion of the project with one financing is better than dependence on obtaining future financing for a phased project where enrollment depends on project completion), and sound capital facilities maintenance practices (not dependent on future borrowing).

6. *Bond Transaction Legal Provisions.* Finally, rating agencies will analyze the protections bondholders will be afforded under the terms of the various transaction documents that form the contract between the charter school and its bondholders. The strongest security features include a mortgage lien on the financed facility, the maintenance of a debt-service reserve fund (pledged and solely available to cover debt-service payments in case of a shortfall), restrictions on future incurrence of long-term debt (either by satisfaction of an affordability test or by outright prohibition), and covenants to maintain operating revenues at a specified level over expenditures (ensuring debt-service coverage). An investment-grade rating is likely dependent, in part, on the existence of all of these features in the legal documents. See Chapter 9, "Transaction Structure and Documentation" for more information about legal documentation.

Each transaction is analyzed individually, and no one factor in the analysis is determinative. Because these factors are viewed together, strength in one or more

categories may outweigh weakness in another. Once a rating is assigned by a rating agency, whether above or below investment grade, the rating must be disclosed to prospective purchasers of the bonds. Thus, bond counsel works closely with the underwriter and other professionals involved in the transaction to present the transaction in the best possible light to rating agencies.

B. Unrated Bonds

Generally, the review of a charter school's bond transaction by an independent credit rating agency that results in the assignment of an investment-grade credit rating provides a higher level of confidence to investors, and allows the bonds to be offered to a larger investor audience and thus sold at lower interest rates. However, many charter school tax-exempt bonds are sold without ratings based on the creditworthiness of the charter school. The evolving investor community analyzing charter school bonds is largely comprised of sophisticated institutions accustomed to conducting rigorous due diligence review of credit risk prior to making an investment decision (and may also be motivated, in part, to advance the purposes of the charter school movement through such capital investments). Thus, while a credit rating is helpful in obtaining more favorable borrowing rates, it is not a prerequisite.

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

12. For explanation of the credit rating scale, see Chapter 2, footnote #3.

13. The three major credit rating agencies and their most recent charter school credit ratings publications are as follows: Fitch Ratings, see "Public Finance—Higher Education Criteria Report—Criteria for Rating Charter Schools," January 23, 2007, available at www.fitchratings.com; Moody's Investors Service, see "Rating Methodology—Charter Schools," November 2006, available at www.moodys.com; and Standard & Poor's, see "Standard & Poor's Public Finance Criteria 2007—Charter Schools" at p. 194 (2007), available at www.standardandpoors.com. (Note these websites may require registration.)

CHAPTER SIX

Credit Enhancement

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

Credit enhancement for charter schools is an evolving industry. Credit enhancement for any type of tax-exempt bonds (not only for charter schools) traditionally takes two basic forms, bank letters of credit and bond insurance. For charter schools, specifically, however, other innovative forms of credit enhancement are being developed by a variety of institutional supporters of the charter school movement. Credit enhancement represents an area of tremendous potential for innovation to expand charter school access to capital financing through tax-exempt bonds.

A. Bank Letter of Credit

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

of credit provider, and garner a lower cost of borrowing. Because variable-rate bonds do not guarantee a certain rate of interest over time, but by definition periodically change interest rates, such bonds are usually more suitable for larger, more sophisticated tax-exempt borrowers (such as large hospitals or health care networks). However, many charter schools have used letters of credit issued by local, regional and national banking institutions to enhance their tax-exempt bonds for transactions ranging from under \$10 million to over \$20 million. A variety of financial instruments (beyond the scope of this booklet) can be used in combination with letter of credit-backed variable-rate tax-exempt bonds to mitigate the risk over time of fluctuating interest rates.

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

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

B. Bond Insurance

Bond insurance resembles a letter of credit or other guarantee, with the insurance company agreeing to pay the obligations of the insured party as needed for a specified period of time in exchange for an initial premium payment. Bond insurance policies are generally structured to cover the entire term of the bond, and thus are commonly used with long-term fixed-rate tax-exempt bonds, and cover timely payment of interest and principal in case of borrower nonpayment. To date, few charter school bond financings have utilized bond insurance because this arrangement adds an additional layer of cost and credit review to the transaction that may not be economically justified. Further, few bond insurance companies have been willing to underwrite charter school bond financings (at any price) due to perceived credit risk, thus rendering the marketplace for charter school bond insurance almost nonexistent. For those transactions that have been insured, the charter school's bonds were sold with the stronger credit rating of the bond insurance company, garnering a lower cost of borrowing. As the charter school movement continues to expand, financial market participants can play a role in the expansion of charter school bond insurance through educating the insurers, other market participants and policy makers.

C. Other Guarantors and Credit Enhancement Vehicles

As the charter school movement gains momentum and while access to facilities financing remains a challenge, the need for nontraditional forms of credit enhancement has gained prominence. Limited credit enhancement programs for charter school tax-exempt bonds have been developed by federal¹⁴ and state¹⁵ agencies and private institutions,¹⁶ which may serve as models for future program development.

Several reform-oriented charitable foundations have invested substantially in the charter school movement, impacting charter facilities policy development broadly as well as supporting high-performing individual charter schools. Such foundations could leverage their financial resources in a variety of ways to enable charter schools to access tax-exempt financing (that might not

otherwise be eligible) or do so at significantly lower rates. Examples include: (a) guaranteeing a charter school's timely debt-service payments (akin to a bond insurer), (b) purchasing a subordinate portion of a project's tax-exempt debt (thereby deleveraging the charter school's balance sheet from the tax-exempt bond investor's perspective), and (c) pledging a pool of funds to perform either of these functions for a regional or state-wide portfolio of charter school projects.

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14. For example, the U.S. Department of Education maintains the Credit Enhancement for Charter School Facilities Program, which can be utilized to provide credit enhancement for charter school tax-exempt bonds as well as other types of charter school facilities financing. For further information, see www.ed.gov/programs/charterfacilities/index.html.
 15. For example, the state of Colorado maintains a credit enhancement program for charter school tax-exempt bonds whereby a moral obligation is pledged on behalf of the charter school to secure repayment of the bonds. For more information, see www.colorado.gov/cs/Satellite/Treasury/TR/1190277266181. In Washington, D.C., the Office of Public Charter School Financing and Support manages several federally funded programs for charter school facility financing, including a direct loan fund, credit enhancement fund and grant program. For more information, see www.osse.dc.gov.
 16. For example, the Illinois Facilities Fund, a private nonprofit corporation, developed a credit enhancement program for charter school tax-exempt bonds with a grant from the federal Credit Enhancement for Charter School Facilities Program. For more information, see www.iff.org/resources/content/1/4/5/documents/CEGImpactReport2.pdf.

CHAPTER SEVEN

Market Disclosure

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

A. Publicly Offered Bonds

The offering and sale of securities is regulated by federal laws codified primarily in the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”). Charter school bonds constitute “securities” for purposes of the Securities Act and the Exchange Act. For most corporate securities, a public offering must be preceded by filing a registration statement with the SEC pursuant to the Securities Act, and the corporation is required to make periodic reports to the SEC pursuant to the Exchange Act. Municipal securities, on the other hand, including those of most charter schools, are exempt from the registration requirements of the Securities Act and from the reporting requirements of the Exchange Act. However, the offering and sale of charter school bonds is not exempt from the anti-fraud provisions of the Securities Act or the Exchange Act. In addition, the SEC’s rules governing underwriters of

municipal bonds effectively require charter schools to make periodic disclosure of certain information relevant to the security of their bonds unless certain exemptions apply.

1. Official Statement. The offering document in a public offering of charter school bonds is usually called an “official statement.” If the bonds are being offered on a more limited basis, the offering document might be called an “offering circular,” a “private placement memorandum” or a “limited offering memorandum.” In any case, the offering document contains the charter school’s official statements; that is, the statements about itself, its financial condition, the bonds, the project to be financed with the bonds and the sources of repayment of the bonds upon which it intends investors to rely. A preliminary official statement is distributed before the official statement and before the financing terms are final. It is used by the underwriter to solicit interest in the bonds. The final official statement contains the final terms of the financing, including the principal amounts, interest rates and maturity dates of the bonds and the uses of the bond proceeds.

To determine what ought to be contained in a charter school’s official statement, the charter school and its financing professionals must carefully consider the charter school’s situation and the terms of the bonds proposed to be issued, and from these form a judgment as to what information must or should be included to ensure that the official statement (i) contains the information needed for a potential investor to make an informed investment decision, and (ii) does not contain any material misstatements or omissions. The threshold for adequate disclosure is the concept of *materiality*: information is deemed “material” if there is a substantial likelihood that knowledge of that information would be important to a reasonable investor’s investment decision. What information is material in any given case depends, of course, on the circumstances of the issuing charter school and the nature of the bond issue.

Coordination of the preparation of the official statement is generally undertaken by the charter school’s disclosure counsel. This party prepares a draft official statement on the basis of information provided by the charter school (with respect to itself, its operations and its financial condition) and the terms of the financing documents prepared by bond counsel (with respect to descriptions of

financing documents and tax law matters). Different members of the financing team review and comment on different portions of the official statement drafts, often as part of scheduled drafting sessions. Parties also conduct a “due diligence” investigation with respect to the official statement involving inquiries of charter school officials and review of supporting documentation. A preliminary official statement and an official statement are generally not printed and distributed until all concerned parties are comfortable that the information included is accurate and complete.

2. *Charter School Responsibilities.* The antifraud provisions of the Securities Act and the Exchange Act require that the information provided in connection with the offer or sale of securities must not contain any untrue statement of a material fact and must not omit to state a material fact necessary to make such information not misleading. This is of critical importance to the charter school. The charter school is primarily liable for any material misstatements or omissions regarding its operations or finances made in the documents used to offer and sell the charter school’s securities. The charter school may not transfer this primary liability to its underwriter, general counsel, bond or disclosure counsel or any of the other parties involved in the financing. Such parties might be liable in their own right, but their liability will not absolve the charter school of its primary liability. Consequently, the charter school and its staff must make every effort to ensure that the charter school’s offering documents are accurate and complete, and that the bond counsel and disclosure counsel be of the highest quality and have significant resources.

3. *Underwriter Obligations and Rule 15c2-12.* Underwriters of municipal securities are also subject to the antifraud and other provisions of the securities laws. To protect themselves from liability, underwriters (usually with the assistance of their counsel) must conduct an investigation of the charter school’s affairs and generally will require, as a condition to their obligation to purchase the bonds, the delivery of certifications and opinions as to the completeness and accuracy of the charter school’s offering materials.

In addition, Rule 15c2-12, adopted by the SEC under the Exchange Act, places specific burdens upon the underwriters of municipal securities. First,

unless an exemption is available, Rule 15c2-12 requires an underwriter, prior to any bid, purchase, offer or sale of a municipal security, to obtain and review the official statement, which the issuer “deems final as of its date,” exclusive of certain pricing and underwriting information. In order to comply with Rule 15c2-12, the underwriter generally requires the charter school to certify that it deems the preliminary official statement final as of its date (which is generally the date it is electronically posted or printed). Second, unless an exemption is available, Rule 15c2-12 also requires the underwriter to contract with the issuer to receive a sufficient number of copies of a final official statement within seven business days after the final agreement to purchase bonds. As a result, such an undertaking on the part of the charter school is now typically included in the bond purchase agreement.

Rule 15c2-12 also requires the underwriter to obtain a commitment from the charter school to provide continuing disclosure during the entire life of the bond issue, including a commitment to disclose certain material events whenever they occur. See “Continuing Disclosure” below. Generally, Rule 15c2-12 exempts from its requirements primary offerings of charter school bonds in authorized denominations of \$100,000 or more, if such bonds (i) are sold to no more than 35 sophisticated investors purchasing for their own accounts, (ii) have a maturity of nine months or less, or (iii) at the option of the bond owner, will be repurchased from the bond owner at no less than par at least as frequently as every nine months. In addition, certain charter schools and certain charter school bond issues are exempt from the continuing disclosure requirements discussed below.

4. *Continuing Disclosure.* SEC Rule 15c2-12 requires issuers of municipal bonds and certain other “obligated persons” to contract to provide continuing information during the life of their bond issues. The three exemptions from Rule 15c2-12 described above apply to these requirements. In addition, issues maturing in 18 months or less are exempt from the annual disclosure requirement, and only limited annual disclosure is required of charter schools with less than \$10 million in outstanding bonds at the time of the issuance. Nevertheless, these exemptions do not excuse qualifying charter schools from the disclosure of certain material events.

Rule 15c2-12 requires the underwriter of \$1 million or more in municipal securities to “reasonably determine” that each issuer and any other “obligated

person”¹⁷ has undertaken in a written agreement (typically referred to as a continuing disclosure agreement) for the benefit of holders of the securities to provide (by filing with certain specified information repositories) four categories of information:

- Certain “annual financial information,” of the type presented in the official statement, for each obligated person for whom financial information or operating data is presented in the final official statement, or for obligated persons meeting certain objective criteria.
- Audited financial statements of the obligated person(s), when and if available, if not provided with the annual financial information.
- Notice of the occurrence of any of 11 extraordinary events (as specified in the Rule), if material, in a timely manner.
- Notice of any failure to file the required annual financial information.

The promise to make the annual reports and the material event reports must be included in a document or agreement which is enforceable by bond owners, such as an indenture, must be reflected in the bond purchase agreement, and must be described fully in the official statement. Noncompliance must be reported to the repositories and disclosed in future official statements for five years, with possible adverse market consequences for the charter school’s bonds.

5. Interplay of Rule 15c2-12 and the Antifraud Provisions. The SEC’s antifraud rules apply to disclosures intended to influence securities markets. Under accepted legal principles, annual reports and material event disclosures must therefore be accurate and not omit any material information needed to make the disclosures not misleading. Material misstatements or omissions in the annual or event reports may be the basis for claims of securities fraud under federal or state securities laws, actionable by the SEC or private plaintiffs (bond owners or other investors), with substantial potential liability for the charter school.

B. Private Placement of Bonds

The first tax-exempt financings undertaken by charter schools were privately placed bonds; almost necessarily, given the uniqueness of charter schools and the fact that no charter school bonds had theretofore been issued or sold in the capital markets.

Over time, with greater market understanding of charter school bonds, public offering has become the standard method of sale. As described above, the general rule is that a public offering will elicit the lowest cost of borrowing. However, certain conditions may make private placements at least worth considering:

1. In some cases, a charter school may have a private foundation or high net worth individual or institution that is interested in directly supporting the project financing, and would be interested in offering attractive pricing for the private purchase of the bonds.
2. A charter school may not be able to sell bonds on the public markets, due to credit issues (such as limited operating history, or other unique characteristics), but must complete a facilities project in order to continue operations, and therefore may seek a private placement to a specialized category of institutional high-yield investor (where the cost of capital will likely be highest).
3. Certain governmental agency financing programs may require the charter school to issue a tax-exempt security for private purchase in order to effectuate the financing of the project.

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

17. An “obligated person” is defined to mean “any person who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold.” It is generally accepted that a person’s obligation must be for a material portion of the annual debt service in order for that person to be an obligated person. For charter school bonds, the charter school is ordinarily the only obligated person. A joint powers authority or other governmental entity acting as the issuer on behalf of a charter school is not deemed an obligated person, because the source of debt service is the charter school.

CHAPTER EIGHT

Interplay Between Bonds and Fund-Raising

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

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

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

As described in Chapter 4, “Eligible Uses of Bond Funds,” the federal tax requirements governing the tax exemption of interest on bonds prohibit certain types of arbitrage. One type of arbitrage that is prohibited is that which results from using the proceeds of tax-exempt bonds to “replace” moneys that have been raised or set aside, and restricted or earmarked, specifically to finance the same project to which the tax-exempt bond proceeds would be applied.¹⁸ However, so long as the donations were not restricted to use on acquiring or constructing the project or other funds that may have been accumulated were not specifically and formally earmarked for the project, then use of tax-exempt bonds instead of such donations or accumulated funds generally would be permissible. For this reason,

in situations that may involve this choice, it is advisable to consult bond counsel as early as possible regarding these issues and any related fund-raising program. It is usually easier to raise funds for a project than for endowment, and bond counsel can offer advice about how to phrase fund-raising campaign literature and pledge documentation (including in some cases how to recast pledges already received) in a manner designed not to interfere with the fund-raising objective but at the same time to preserve the maximum opportunity for tax-exempt financing and for permissible arbitrage.

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

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

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

the circumstances are too varied and the applicable tax rules often too complex and subtle to cover more thoroughly here, advice of highly qualified bond counsel with substantial experience in this area is needed and should be accessed at the earliest possible stage. See Chapter 10, “Steps to Issuing Bonds and the Finance Team.”

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

CHAPTER NINE

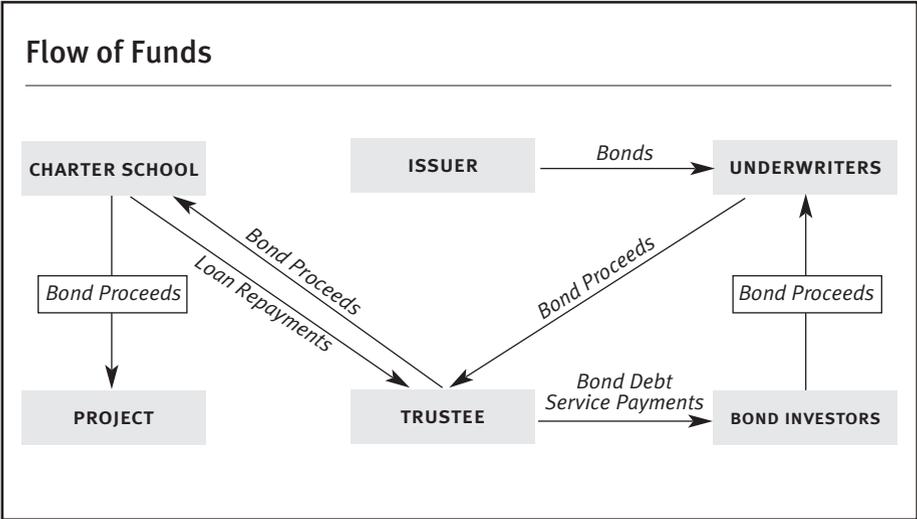
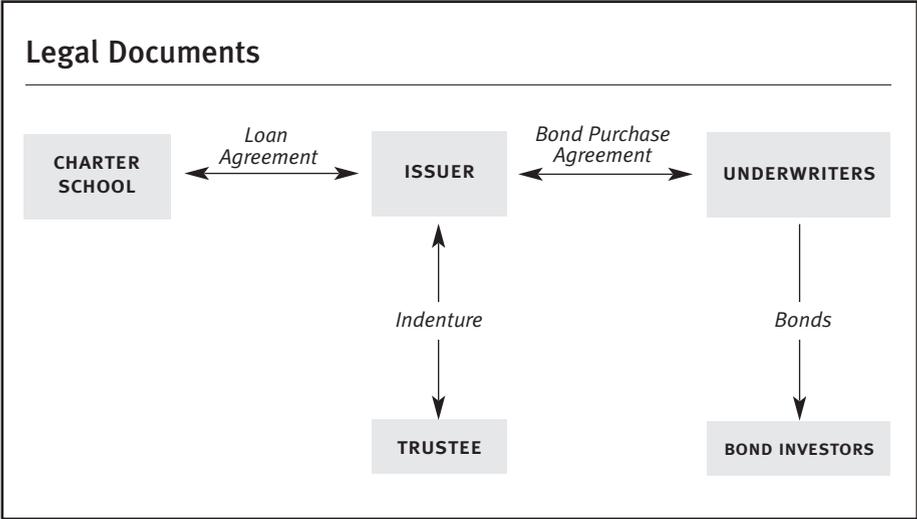
Transaction Structure and Documentation

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

1. The Bonds are issued by a state or local governmental entity (the “Issuer”) which, under applicable state law, has the power to issue bonds for nonprofit corporations (including charter schools) for projects or purposes (the “Project”) of the type purposed.¹⁹ The Bonds are issued pursuant to an indenture or trust agreement (the “Indenture”) between the Issuer and a trustee bank (the “Trustee”). The Trustee holds the bond proceeds until requisitioned for the Project, plus the debt-service reserve fund and the bond repayment fund.
2. The Bonds are sold by the Issuer to an underwriter or underwriters (the “Underwriters”) pursuant to a bond purchase agreement (the “Bond Purchase Agreement”) between the Issuer and the Underwriters, which is approved by the charter school. The Bonds are resold to investors in the tax-exempt market using an official statement (the “Official Statement”) describing the Bonds and other information that investors would want to know in deciding whether to buy the Bonds, which includes financial and operating information about the charter school.
3. The proceeds of the Bonds are loaned to the charter school pursuant to a loan agreement (the “Loan Agreement”) between the charter school and the Issuer (which assigns most of its rights, including the right to receive repayments of the loan from the charter school, to the Trustee as security for the Bonds pursuant to the Indenture). The Loan Agreement sets out the terms of

repayment of and security for the loan. There may or may not be a deed of trust on the Project or other property to further secure the loan. If so, it is also assigned to the Trustee.

- 4. The proceeds of the Bonds are used by the charter school to finance the Project, fund the debt-service reserve fund and pay the costs of issuance of the Bonds.



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

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

As described above in Chapter 7, the Official Statement is the disclosure document used in most tax-exempt bond financings. It describes the Bonds and contains the information material to bond investors in deciding whether or not to purchase the Bonds. It may involve some effort on the part of the charter school personnel to compile this information, and the charter school will be responsible for certifying that the portion of the Official Statement pertaining to it meets the

federal securities laws standard of not containing any misstatement of material fact or omitting to state any material fact necessary to make the statements contained therein, in light of the circumstances under which made, not misleading. If the Bonds receive a credit rating, then the rating will be included on the cover of the Official Statement.

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

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

CHAPTER TEN

Steps to Issuing Bonds and the Finance Team

A. Steps

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

1. Consult Bond Counsel. Bond Counsel is the law firm primarily responsible for rendering an opinion on the validity and tax exemption of the Bonds and for drafting the legal documents to be executed by the charter school and the Issuer in connection with the Bond issue and may prepare the Official Statement. While Bond Counsel typically represents the Issuer, and the charter school is represented by its own counsel, Bond Counsel's fees (like all other expenses of the transaction) are paid by the charter school and most (but not all) Issuers permit the charter school to choose or at least recommend Bond Counsel. It is important to have a Bond Counsel very experienced in charter school bond financings and, given the tax driven nature of most such financings, particularly experienced in the complex tax laws that govern the tax exemption of interest on the Bonds.

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

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

2. Engage the Underwriter. The Underwriter is an investment banking firm, selected by the charter school, that is responsible for marketing the Bonds—for helping to structure the financing, for helping to organize the charter school’s financial information for inclusion in the Official Statement and for presentation to the rating agencies to obtain ratings on the Bonds and/or to credit providers, and for purchasing (i.e., underwriting) the Bonds for resale to investors. Its counsel is primarily responsible for preparing the Bond Purchase Agreement and may prepare the Official Statement. Consulting an experienced Underwriter early (that has experience in structuring and marketing tax-exempt bonds for charter schools) is crucial to determining whether it is possible to market Bonds for the charter school, at what expected rating and interest rates, and to work out the basic structure of the financing with Bond Counsel.

3. Adopt Reimbursement Resolution. See discussion in Chapter 4, “Eligible Uses of Bond Funds.” Bond Counsel will normally provide this resolution on request without charge.

4. Determine with Bond Counsel and Underwriter what public entity will serve as the Issuer of the Bonds. In some states or in some situations, there may be several possible issuers with different policies, procedures, politics, governing laws, applications and fees.

5. Bond Counsel prepares and circulates to the working group initial drafts of Indenture and Loan Agreement.

6. If applicable (see Chapter 7), the charter school works with the Underwriter and Disclosure Counsel (either Bond Counsel or Underwriter's counsel may serve in this role) to prepare a draft of the portion of Official Statement that sets forth the relevant financial and operating information about the charter school and/or the Project.

7. Underwriter's counsel prepares and circulates to the working group initial draft of Bond Purchase Agreement; Disclosure Counsel prepares and circulates to the working group initial draft of the Preliminary Official Statement.

8. One or two rounds of meetings or conference calls to discuss the foregoing documents followed each time by circulation of revised drafts.

9. Draft documents are submitted to the rating agencies and/or credit enhancement providers, if applicable.

10. Another round of document review to take into account any comments or requirements of the rating agencies, etc. followed by circulation of substantially final drafts.

11. Meeting of the governing board of the charter school to approve the Bond issue and authorize execution of the legal documents to which it is a party or signatory.

12. Hearing on and approval of the Bonds by the Issuer (or government entity in which the Project is located if not the Issuer) after at least 14 days published notice (usually combined with step 13).

13. Meeting of the governing board of the Issuer to adopt the bond resolution authorizing issuance of the Bonds and execution and delivery of the legal documents and distribution of the Official Statement.

14. The Underwriter mails the Preliminary Official Statement to potential purchasers of the Bonds (or posts it on the internet and e-mails notice of its availability).

15. Pricing of the Bonds (i.e., setting the interest rates to be borne by the Bonds) by the Underwriter (based on interest by investors) in consultation with the Issuer and the charter school.

16. Sale of the Bonds by execution of the Bond Purchase Agreement between the Issuer and the Underwriter, approved by the charter school.

17. Preparation of a final Official Statement containing the final sale information for delivery to purchasers of the Bonds at or before receipt of their purchase confirmations.

18. Closing—delivery of the Bonds to the Underwriter in exchange for the purchase price, simultaneously with delivery of final executed copies of the legal documents, and various certificates, receipts and opinions.

B. Timetable

A typical Bond issue for a nonprofit corporation takes approximately 90–120 days from start to finish. For example, assume at least 30–40 days for steps 1–7 (i.e., structuring the issue and circulating first drafts of the basic legal documents), another 40–60 days for steps 8–13 (i.e., to finalize documentation and obtain approvals, ratings and, if applicable, credit enhancement), 7–10 days for steps 14–16 (i.e., for the Underwriter to market the bonds), followed in about two weeks with step 18 (the closing).

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

C. Other Essential Members of the Finance Team

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

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

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

Investment Advisor/Bidding Agent. As described in Chapter 3, the charter school may seek to utilize a structured investment to maximize interest earnings on funds held by the Trustee. An investment advisor or bidding agent assists the charter school in determining the optimal structure for such investments, and assists in complying with the public bidding rules applicable to the procurement of such investments. The Underwriter can serve in this role, or an independent investment advisory firm can be retained for this limited purpose.

Rebate Analyst. As described in Chapter 3, a tax filing is required in the fifth year following issuance of the bonds to report any arbitrage earnings to the IRS, and

provide for payment of any rebate liability that may be associated with investment earnings on the bond proceeds. Rebate analysts often charge a nominal fee to undertake annual monitoring of the investment earnings and responsibility for the required rebate filing.

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

About the Authors

Eugene H. Clark-Herrera, an associate in the San Francisco office, focuses his practice on financing for school and college facilities, as well as city and county facilities and infrastructure. His practice includes serving as bond and disclosure counsel on revenue and tax-supported bond financing involving counties, cities, redevelopment agencies, school and college districts, charter schools, airports, and student and multi-family housing projects. Mr. Clark-Herrera has experience with a variety of financing structures and characteristics, including pension obligation bonds, synthetic fixed rate bonds, various reinvestment vehicles and auction rate bonds.

Mr. Clark-Herrera also serves on the Board of Directors of the nonprofit Mural Music & Arts Project, an arts-based youth development organization he founded in East Palo Alto, California, to educate, inspire and empower teens through the arts.

Prior to joining Orrick, Mr. Clark-Herrera was a public school teacher and science curriculum developer in the South Bronx and Washington Heights neighborhoods of New York City from 1993 to 1998. He is an alumni of the Teach for America Corps.

Darrin L. Glymph, a partner in the Washington, D.C. office, is a member of the Public Finance Department. Mr. Glymph's practice focuses primarily on transactional matters, such as financings for charter schools and other non-profit organizations, economic development incentives, general obligation and revenue financings, securities law matters and legal issues relevant to state and local governments. Mr. Glymph has represented large municipalities as well as New

York and regional banks in a variety of matters pertaining to the issuance of bonds and the offering and the sale of conduit revenue bonds.

Mr. Glymph has worked on over 15 transactions for charter schools, including the nation's largest tax-exempt financing for an individual public charter school, in which he served as borrower's counsel. Mr. Glymph has represented a large municipality on several public-private partnership transactions utilizing payment in lieu of taxes (PILOT), tax increment financing (TIF) and qualified zone academy bonds (QZABS). He regularly advises clients on tax incentive programs and creative approaches to financing economic development projects.

Mr. Glymph has served as chairman, director or member of several boards and commissions including the Small and Local Business Opportunity Commission (D.C.), Center City Public Charter School, EdBuild, Center for Youth and Family Investment, D.C. Mayor's Task Force for Procurement Reform, Industrial Development Authority of the City of Richmond, Virginia, the United Way of Greater Richmond and the Boy Scouts of America.

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