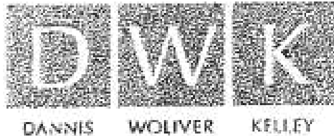

DANNIS WOLIVER KELLEY

SAN FRANCISCO
71 Stevenson Street
19th Floor
San Francisco, CA 94105
TEL 415.543.4111
FAX 415.543.4384

LONG BEACH
301 East Ocean Boulevard
Suite 1750
Long Beach, CA 90802
TEL 562.366.8500
FAX 562.366.8505

SAN DIEGO
750 B Street
Suite 2310
San Diego, CA 92101
TEL 619.595.0202
FAX 619.702.6202

www.DWKesq.com

JANET L. MUELLER
Attorney at Law
jmueller@DWKesq.com

San Diego

CONFIDENTIAL; ATTORNEY-CLIENT PRIVILEGE

May 23, 2011

Joel Montero
Chief Executive Officer
Fiscal Crisis & Management Assistance Team
1300 17th Street - CITY CENTRE
Bakersfield, CA 93301

Re: Temporary Borrowing of Bond Funds;
Our file 3040.1101

Dear Mr. Montero:

Our firm has been asked to provide guidance to the Fiscal Crisis & Management Assistance Team ("FCMAT") regarding the ability of a school district to do a temporary borrowing from bond construction funds pursuant to Education Code §42603 to make up cash flow deficits. This opinion is being provided to FCMAT and should not be construed as advice to individual school districts who may undertake such a borrowing.

We conclude that that a temporary borrowing of bond construction funds to make up cash flow deficits is permissible, as long as nothing in the school district bond documents or covenants prohibits such a borrowing. We also recommend that such a borrowing occur only if critical to the district's fiscal solvency and if made in accordance with the statutory timelines for repayment, as verified by the local county office of education. As explained more fully herein, we believe that in typical cases, bond documents do not prohibit the kind of borrowing contemplated by Education Code §42603.

LEGAL ANALYSIS

A. Temporary Borrowing Authority

Education Code section 42603 gives broad latitude to a school district governing board to temporarily transfer funds from one fund or account to another under specified conditions. That section, entitled "Transfer of Special or Restricted Fund Moneys," provides:

> "The governing board of any school district may direct that moneys held *in any fund or account* may be temporarily transferred to another fund or account of the district for payment of obligations. The transfer shall be accounted for as temporary borrowing between funds or accounts and *shall not be available for appropriation or be considered income to the borrowing fund or account.* Amounts transferred shall be repaid either in the same fiscal year, or in the following fiscal year if the transfer takes place within the final 120 calendar days of a fiscal year. Borrowing shall occur only when the fund or account receiving the money will earn sufficient income, during the current fiscal year, to repay the amount transferred. No more than 75 percent of the maximum of moneys held in any fund or account during a current fiscal year may be transferred." (emph. added).

Although referred to in the statute as a "transfer" of moneys, the use of the authority described in Education Code section 42603 is distinguished in school district accounting from an interfund transfer, which describes a flow of assets from one fund to another without equivalent flow of assets in return and without a requirement for repayment (see, e.g., California School Accounting Manual, Procedure 551, at p. 551-1). Section 42603 borrowings are classified as "temporary borrowings" to distinguish them from true fund transfers, and are recommended by the State Superintendent of Public Instruction and the California Department of Education as an alternative to the issuance of Tax & Revenue Anticipation Notes ("TRANs"), county loans, and other short term borrowings to alleviate cash shortfalls particularly when the State has imposed appropriation deferrals. It is clear from the plain wording of the statute, and from CDE's interpretive guidance, that a temporary borrowing is an accounting mechanism that *does not affect the fund balance* for either the borrowing or lending fund. A temporary borrowing is a general ledger entry only that merely establishes a liability in the general fund for repayment.[1]

As you may know, the construction given to a statute by the administrative officials charged with its enforcement or interpretation, is not necessarily controlling but is entitled to great weight and will be followed by courts unless clearly erroneous or unauthorized (See, e.g., *Los Angeles City School District v. Simpson (1952) 112 Cal.App.2d 70, 75*).

B. Interplay of Temporary Borrowing Authority with Bond Expenditure Laws

Despite Section 42603's direct reference to a school district borrowing from any fund or account, districts are hesitant to do a temporary borrowing from bond construction accounts due to their restricted nature and a belief that borrowing from bond funds to make up for operational shortfalls, even on a temporary basis, runs afoul of California Constitutional

---

[1] / See Fiscal Advisory from California Department of Education, Fiscal Services Division, dated April 15, 2003, to all County and District Superintendents regarding "Fiscal Issues Resulting from Budget Cuts and Appropriation Deferrals," noting with regard to temporary borrowing that "[t]he accounting is a debit to Object Code 9310 *Due From Other Funds* and a credit to *Cash* in the lending fund, and a debit to *Cash* and a credit to Object Code 9610 *Due To Other Funds* in the borrowing fund. These amounts will be carried on the balance sheet until the entry is reversed when the funds are repaid. Note that temporary borrowings are not accounted for as interfund transfers . . .". This same advice is reiterated more recently in a similar CDE advisory issued April 17, 2009.

provisions that implemented both the original bond authority and the "Proposition 39" scheme for issuing bonds with approval of 55% of the local electorate, Education Code sections that implement these constitutional sections and pertain to the manner in which bond funds must be expended after issuance, and federal tax rules governing the tax-exempt status of the bonds. CDE to our knowledge has not issued a definitive opinion on this issue.

For review, Proposition 39, approved by voters in 2000, offered an alternative to the historical and traditional method of approving school bonds in California, which required a 2/3 approval by the local electorate. This alternative method requires only a 55% voter approval. In exchange for the lower voter approval threshold, districts are bound by heightened accountability requirements for the expenditure of bond funds, which are laid out both in the Constitution and Education Code, and include the use of a specific bond project list and the district's "agreement to expend funds only for those purposes and not for any other purposes, including teacher and administrator salaries and other school operating expenses." Financial and performance audits of the funds and projects are required to ensure that the funds are being spent only on voter-authorized projects. The establishment of a citizen's oversight committee is also required to "inform the public concerning expenditure of bond revenues" and "to ensure that no funds are used for school operating purposes." (Ed. Code, §15278; see generally Ed. Code, § 15270 et seq.). Even prior to Proposition 39, however, bond law required that bond proceeds be expended only for purposes specified within the bond measure, as bond measures were considered at least "analogous" to a contract with local voters (see *Associated Students of North Peralta Community College v. Board of Trustees* (1979) 92 Cal.App.3d 672).) So the general concepts of accountability for bond expenditures have not changed fundamentally, even with the advent of Proposition 39.

An additional restriction on the expenditure of bond funds is found in the bond issuance statutes of the Education Code, and applies to traditional and Proposition 39 bond measures. Section 15146(f) states:

> The proceeds of the sale of the bonds, exclusive of any premium received, shall be deposited in the county treasury to the credit of the building fund of the school district, or community college district as designated by the California Community Colleges Budget and Accounting Manual. The proceeds deposited shall be drawn out as other school moneys are drawn out. *The bond proceeds withdrawn shall not be applied to any other purposes than those for which the bonds were issued.* Any premium or accrued interest received from the sale of the bonds shall be deposited in the interest and sinking fund of the district. (emph. added.)

Over the past decade, practices have evolved as the Attorney General and California courts gradually address ambiguous and complex issues related to bonds, oversight, transparency and accountability, including the degree of flexibility school districts enjoy for the use and expenditure of bond proceeds both within and outside of Proposition 39. One of those cases is particularly instructive on this issue.

In *San Lorenzo Valley Community Advocates for Responsible Education v an Lorenzo Valley Unified School District* (2006) (139 Al.App.4th 1356), the Appellate Court considered a myriad of legal issues stemming from a community group's challenge to a district's decision to close

schools. The community group ("SLV CARE") alleged that the school district had violated surplus property laws and California Environmental Quality Act procedures, and that as part of its overall plan to close schools and improve existing schools, the district violated bond financing laws in how it expended its bond funds. At issue were a long list of expenditures, including administrative, salary and training costs of district personnel overseeing bond projects, costs of CEQA compliance, school consolidation costs, bond preparation and issuance costs, construction of particular projects alleged to be outside of the ballot measure, and finally, *bond funds that had been the subject of a temporary transfer*. SLV CARE alleged and the district admitted that it had transferred bond proceeds into the deferred maintenance account, and that a portion of the transferred funds had then been transferred to the district's general fund. The Court considered the testimony of the District's Assistant Superintendent that the transfer "represented an audit adjustment entry to avoid an impermissible year-end deficit, and the money was transferred back." (p. 1405.) The Court concluded that SLV CARE cited no other evidence of impropriety in the fund transfer, and upheld the District's temporary transfer of bond funds.

Even without explicit case authority, it is clear on the face of the various statutory provisions that the laws related to bond proceeds restrictions are concerned that voter-approved revenue be applied to voter-approved capital projects and not diverted to other kinds of expenditures. Although bond funds are deposited to the credit of a building fund and a debt service fund, all district funds are commingled in the County Treasury and merely accounted for as distinct funds, with each fund balance accorded its pro rata share of interest. Even where funds are the subject of a temporary borrowing, the amounts borrowed or lent to another fund do not affect the fund balance of either fund, nor does the borrowing impair the ability of the district to perform bond projects and pay related expenses. Critically, the transferred funds are not withdrawn, spent or used. As is clear on the face of Education Code § 42603, a temporary borrowing must be reversed within specific statutory timelines.

C. Bond Documents/Covenants

When school districts issue bonds, they make commitments to bondholders and other stakeholders to treat bond funds in a particular manner. In our experience, bond issuance resolutions of both school districts and county boards of supervisors (the latter being required in some cases) merely reiterate statutory requirements for the segregation of bond funds into specific accounts to be used only for the purposes for which the bonds were issued. In some instances, school district boards reserve the right to move funds from the County Treasury into other types of investment vehicles and accounts, such as the Local Agency Investment Fund held by the State of California, in order to maximize interest-earning potential on the funds. However, nothing in typical bond issuance resolutions addresses or restricts bond funds from being the subject of a temporary borrowing as defined in Education Code §42603.

In addition, bond proceeds are governed by a myriad of complex rules and regulations of the Internal Revenue Service and U.S. Treasury Department, compliance with which issuing school districts covenant in order to gain the benefit of issuing tax-exempt debt. Violation of such rules can have negative consequences on the exemption from income tax enjoyed by bondholders with respect to interest earned on the bonds, and can create financial liability to bondholders if the tax exempt nature of bonds is impaired by events that occur after bond

issuance. Concerns have been expressed that a temporary transfer of bond funds effectuates an "expenditure" of bond proceeds, as that term is used in applicable Treasury regulations, on unauthorized operational expenses, that may jeopardize the federal tax exemption on bonds.

While this opinion cannot replace an in-depth analysis by a municipal bond taxation specialist on a case-by-case basis, we note again that a temporary borrowing under California law does not effectuate an expenditure of any kind. How and when proceeds are deemed "spent" is an important concept within the Treasury regulations because they define whether bonds qualify as "governmental bonds" as opposed to private activity bonds, and whether the bonds are or become "arbitrage bonds," in which case they lose their tax-exempt status (Int. Rev. Code, § 103). General accounting and allocation rules of the Treasury Department make clear that an issuer "may use any reasonable, consistently applied accounting method to account for gross proceeds, investments and expenditures of an issue," that bond proceeds are not "spent" but "allocated to expenditures," and that an allocation of the gross proceeds of an issue to an expenditure "must involve a current outlay of cash for a governmental purpose of the issue. A *current outlay of cash* means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made." (Treas. Reg. 1.148-6.) In a temporary borrowing, there is no cash outlay of any kind.

Bond documents and tax covenants should be reviewed in conjunction with a decision to do a temporary borrowing of bond funds, but we believe that such an analysis must be done with a detailed understanding of school accounting and the nature of a temporary borrowing not as a use or expenditure of funds, but merely as accounting mechanism that does not affect the fund balance for either the borrowing or lending fund and does not impair the progress of capital projects. We believe that as long as the accounting procedures laid out in the California School Accounting Manual are followed to ensure that bond expenditures, interest earnings and other fund activity can be appropriately tracked for purposes of compliance with federal tax, rebate and arbitrage regulations, typical bond covenants should not act as an impediment to an Education Code §42306 temporary borrowing.[2]

D. <u>Procedural Safeguards</u>

With the level of scrutiny on school district funding and accountability, it is not surprising that districts are hesitant to borrow from bond funds, even as an accounting strategy. Concerns about rising levels of fiscal insolvency by school districts create fear that bond funds, borrowed temporarily, will not be repaid in the event that a district becomes insolvent or subject to state intervention. It is important to note that there are safeguards in place to prevent real budget deficits from being masked through the use of temporary borrowing, which includes transparency of temporary cash transfers between funds and restoration of cash to the proper fund. As you know, county offices of education are charged with fiscal oversight of district budgets and interim financial reports to ensure that school districts can meet all their financial obligations. Districts are required to identify interfund borrowings in their reporting to the county office of education (Cal. Code Regs., tit. 5, §15464 (b)(7).) County offices of education

---

[2] / We recommend that individual districts ask their bond counsel to review bond documents to make sure that their individual tax covenants do not conflict with temporary borrowing strategies.

have the power and duty to assign a fiscal advisor to a district in distress and to bring in FCMAT for expertise in developing plans to aid districts in distress return to fiscal health (Ed. Code, §41326). County offices of education also may impose more strict requirements on the use of interfund borrowing, and to require evidence that cash flows support timely repayment of such funds and will not interfere with existing construction plans or contracts.

Finally, in the event the county office of education determines that a district's cash balances are not sufficient to meet current and ongoing fiscal obligations, the district may apply for an emergency appropriation from the State. However, the State will not authorize emergency loans to school districts for the purpose of meeting cash flow requirements pending the receipt of local taxes or other funds. (Ed. Code, §41320.2(b)). Therefore, it is incumbent on a school district to exhaust its internal and external borrowing resources to make up cash flow shortfalls before applying for a State loan. In the extreme event that a district becomes wholly insolvent and a loan is required, the loan is sized to accommodate the cash the district needs during the life of the loan to meets all anticipated obligations. FCMAT plays a critical role in those determinations (See Ed. Code, §42127.6 & 42127.8; § 41325-41328.). Therefore, bond funds that may have been compromised during a temporary borrowing are fully restored.

Of course, the checks and balances in place to protect restricted bond funds are not an absolute guarantee to their safeguarding, and we understand that the media, the general public, and even municipal officials do not always understand the nuances and unique requirements of school accounting. For this reason, we believe that borrowing from bond building funds should be approached with caution and should be used only when critical to a district's fiscal solvency and when the local county office of education (or FCMAT) can verify feasibility of timely repayment of funds and non-interference with payment of ongoing construction project expenses and obligations.

We are delivering this opinion solely to FCMAT and it does not constitute specific advice to individual school districts which may seek to do a temporary borrowing of bond construction funds.

Please do not hesitate to contact me if you have further questions regarding this matter.

Very truly yours,

DANNIS WOLIVER KELLEY

Janet L. Mueller

JLM:jk
cc: Michelle Plumbtree, Fiscal Intervention Specialist