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BILL ANALYSIS

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House Bill 5194 (Substitute S-1 as reported)
House Bill 5195 (Substitute S-1 as reported)
Sponsor: Representative Fred Durhal, Jr.
House Committee: Appropriations
Senate Committee: Appropriations

CONTENT

House Bill 5194 (S-1) and House Bill 5195 (S-1) would amend the Revised School Code and State School Aid Act, respectively, by adding language to the existing statutes governing the pledging of State school aid payments for the repayment of notes issued to borrow money. Under Section 1225 of the Revised School Code, districts and intermediate districts may borrow money and issue notes, and may pledge State school aid payments for the repayment of such notes. In so doing, historically districts and intermediate districts have been able to enjoy a more highly rated bond issue than they would without the pledging of State aid, and thereby incur lower borrowing costs, or they have gained access to credit when it otherwise would not have been available. However, according to the Department of Treasury, the financial markets have changed because of the 2008 credit crisis and investors have demanded additional assurances with respect to the repayment of debt.

House Bill 5194 (S-1) would amend Section 1225 to do the following:

-- State that a pledge by a local district or intermediate school district (ISD) for the payment of notes issued pursuant to Section 1225 "is valid and binding from the time when the pledge is made".
-- State that a pledge made pursuant to Section 1225 for the benefit of the holders of notes or for the benefit of others "is perfected without delivery, recording, or notice".
-- Allow a district or intermediate district for which an emergency manager has been appointed, or a district or intermediate district that has an approved deficit elimination plan, to enter into an agreement with the Michigan Finance Authority (MFA) providing for the direct payment to the MFA (or to a trustee designated by the MFA) of the district's or intermediate district's State school aid pledged and to be used for the purpose of paying the principal and interest on the notes issued under Section 1225 and secured by State school aid.

House Bill 5195 (S-1) would amend Section 17a of the State School Aid Act to do the following:

-- Add subsection (4) to state that if a district or intermediate district for which an emergency manager has been appointed, or that has an approved deficit elimination plan, enters into or has entered into an agreement assigning all or a portion of its State aid payment to the Michigan Finance Authority or its trustee (as Section 17a allows), then that portion of State aid "is subject to a lien and trust that is a statutory lien and trust, paramount and superior to all other liens and interests of any kind, for the sole purpose of paying the principal of and interest on the obligation".

-- State that the lien and trust established under this subsection would have a priority as established by the agreement, except that the agreement would not impair any existing lien and trust.
-- State that the lien and trust created under subsection (4) for the benefit of holders of the obligation issued pursuant to Section 17a, would be valid and binding against a party having a claim of any kind in tort, contract, or otherwise against the district or intermediate district that issued the obligation secured by a pledge of State school aid. The State school aid paid to the MFA would be held in trust for the sole benefit of the holders of the obligation issued pursuant to Section 17a or Section 1225 of the Revised School Code and would be exempt from being levied upon, taken, sequestered, or applied toward paying the debts or liabilities of the district or intermediate district other than for the payment of the obligation to which the lien applied.

In summary, the proposed changes under House Bill 5194 (S-1) and House Bill 5195 (S-1) seek to place a lien upon the State school aid payments used by districts or intermediate districts as security for issuing notes in order to borrow money (typically for short-term cash-flow borrowing purposes). The proposed changes likely would provide investors with additional security by creating a statutory lien on State school aid payments to school districts and ISDs to be intercepted and directly paid (on behalf of the districts or ISDs) to the MFA or to its trustee. Under current law, State school aid payments may be pledged, but without a statutory lien, a bankruptcy court may nullify the dedicated payment stream of State school aid to the repayment of the notes.

BACKGROUND

The proposed changes relate to a February 2011 agreement between the Detroit Public Schools (DPS) and the bond insurer of DPS's bonds issued in 2005 to pay off the deficit at that time, to be repaid over 15 years. The agreement requires either that DPS and its financial manager be without the authority to file for bankruptcy under Michigan law, or that legislation be enacted that insulates from bankruptcy the State school aid payments pledged for the repayment of the bonds issued in 2005. Since the former has not occurred, the latter is being pursued under House Bills 5194 (S-1) and 5195 (S-1).

If the legislation is not enacted, then the February 2011 agreement between DPS and the bond insurer will allow the insurer to require accelerated repayments from DPS on the outstanding bonds. The schedule for the accelerated repayments would require an additional $21.6 million in payments from DPS in the 2011-2012 school year. According to the Department of Treasury, an accelerated payment of $21.6 million was not built into DPS's projected fiscal year (FY) 2011-12 budget; therefore, the legislation could provide improved cash flow because the district would not have to increase its outstanding debt or reduce its projected expenditures in FY 2011-12, since the accelerated repayment would not be required.

Again, if the legislation is not passed, DPS will need to pay off the outstanding debt on the 2005 bonds issued by 2015 rather than by 2020. The accelerated schedule will require an additional $21.6 million payment in 2012, $22.9 million in 2013, $24.3 million in 2014, and $25.7 million in 2014. However, after that point, the bonds will be repaid, and no further payments (for the 2005 debt) will be required. It should be noted that the accelerated payments will not be *extra* costs, but rather represent a requirement that outstanding debt be repaid at a faster rate than budgeted by DPS, if the legislation is not enacted.

MCL 380.1225 (H.B. 5194)
MCL 388.1617a (H.B. 5195)

FISCAL IMPACT

The bills would have no fiscal impact on the State.

For districts and intermediate districts affected by this legislation, the fiscal impact is indeterminate, but likely positive. If this legislation is viewed by bond insurers as strengthening the guarantees for bond issues secured by State school aid payments, then it is possible that bonds would be issued with better credit ratings than under current law. If this were the final result, then the interest rate charged on those bond issues likely would be less than in the absence of the legislation, resulting in local savings.

For Detroit Public Schools and its current situation, the immediate fiscal impact would be that the district would not be required to make an accelerated $21.6 million repayment of its outstanding debt issued in 2005. However, since this repayment would otherwise occur, but at some time between 2015 and 2020 under the nonaccelerated schedule, the true fiscal impact on the district would be the likely additional cash-flow borrowing costs that would be necessary in 2012 in order to pay the $21.6 million accelerated repayment, or the necessary reductions in costs that would have to occur in the absence of additional borrowing. Since the school fiscal year is nearly half over, the district likely would have difficulty making $21.6 million in new cuts to fund the accelerated repayment, and if the district were required to borrow, then additional interest costs would be incurred. This legislation would allow the district to avoid the accelerated repayment, and in so doing, avoid likely additional interest costs on debt borrowed to pay the accelerated repayment.

Date Completed: 12-15-11 Fiscal Analyst: Kathryn Summers

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