

Legislative Analysis



SCHOOL DISTRICT BORROWING AGAINST STATE SCHOOL AID

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House Bills 5194 and 5195 as passed by the House
Sponsor: Rep. Fred Durhal, Jr.
Committee: Appropriations

Complete to 12-14-11

A REVISED SUMMARY OF HOUSE BILLS 5194 AND 5195 AS PASSED BY THE HOUSE 12-8-11

The bills would amend provisions within the State School Aid Act and the Revised School Code providing school districts with the authority to borrow against their state school aid payments in order to pay for operational costs as necessary through the issuance of short-term notes (debt). The bills strengthen the language in the acts concerning the pledge of state school aid payments as security for the debt obligations by defining the scope of the pledge of state aid by a school district under an emergency manager or with an approved deficit reduction plan and creating a statutory lien on the pledged state aid.¹

House Bill 5194 – Revised School Code

Section 1225 of the Revised School Code (MCL 380.1225) authorizes school districts and intermediate school districts (ISDs) to borrow money, through the issuance of notes, to finance school operations, with the notes being repaid through a pledge of the districts' state school aid payments.

House Bill 5194 amends the Code to further provide that the pledge of state aid by a school district or ISD for the payment of notes is valid and binding from the time when the pledge is made. The pledge of state aid for the benefit of the holders of the notes or for the benefit of others would be perfected without delivery, recording, or notice.

The bill further provides, in a new Section 1225(2), that a school district or ISD operating under an emergency financial manager pursuant to the Local Government and School District Fiscal Responsibility Act or with an deficit reduction plan approved by the Department of Education under the State School Aid Act (MCL 388.1702) could enter into an agreement with the Michigan Finance Authority (MFA) under Section 17a(4) of the State School Aid Act (added by HB 5195) providing for the direct payment (or, intercept) of the pledged school aid payments to be used solely for the purpose of paying debt service requirements of any notes issued under Section 1225.

¹ The Legislature has recently enacted similar bills providing further security to holders of bonds of financially distressed communities, including Detroit (2010 PA 4, HB 5626), Ecorse (2011 PA 36, SB 318), and Highland Park (2011 PA 143, HB 4716).

House Bill 5195 – State School Aid Act

Section 17a of the State School Aid Act (MCL 388.1617a) provides that school districts and ISDs may enter into an agreement assigning all or a portion of their state school aid payments to the MFA or other trustee for the payment of obligations the district incurred with the MFA.

House Bill 5195 provides that if a district enters into an agreement assigning its state aid pursuant to a State Aid Note issue under Section 12255(2) of the Revised School Code (added by HB 5194), irrespective of whether the obligation was issued before or after the bill's effective date, the portion of the school aid payments paid directly to the MFA or trustee solely for making required debt service payments on the obligation 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 meeting obligations debt service requirements.

The statutory lien and trust of the assigned state aid would apply to state school aid payments received or to be received by the MFA or the trustee on the bill's effective date or the time school aid payments are allocated to the district. Of note, the bill provides that statutory lien and trust would be subject to any subsequent reduction of the state school aid allocation by operation of law or executive order.²

The lien and trust would have priority as established in the repayment agreement, except that the agreement could not impact any existing lien and trust previously created, including any lien and trust applicable to a multi-year repayment agreement. The lien and trust would be valid and binding on any party having a claim of any kind in tort, contract, or otherwise against the school district or ISD irrespective of whether the party had notice of the pledge, and the lien and trust would be perfected without delivery, notice, or recording.

State school aid payments paid or to be paid the MFA or trustee would have to be held in trust for the sole benefit of the debt holders issued under Section 17a or Section 1225 of the Revised School Code. The payments could not be used to pay other debts or liability of the district other than the debt obligations subject to the lien.

FISCAL IMPACT:

State Fiscal Impact: The bill would have no direct fiscal impact on the state, and would not require any additional School Aid funding on behalf of the Detroit Public Schools (or other districts) should it default on its debt obligations. Continuing law (Sec. 17a of the State School Aid Act) does not provide for an appropriation of funds and does not constitute state indebtedness. Moreover, the bills provide that the State Treasury could withhold school aid payments as authorized by law, and the statutory lien and trust would

² Similar language already exists within Sec. 15(2) of the Shared Credit Rating Act, 1985 PA 227, MCL 141.1065 concerning the pledge or assignment of revenue to the Michigan Finance Authority or trustee.

be subject to any subsequent reduction of the state school aid allocation by operation of law or executive order.

Local Fiscal Impact: Although the bills apply to all school districts under an emergency manager or with an approved deficit reduction plan borrowing against their state school aid payments, in the immediate future the bills principally concern the Detroit Public Schools.³

As part of a state aid note issue from March 2011, the Detroit Public Schools entered into an agreement with Assured Guaranty Ltd., the insurer of bonds issued in 2005⁴ to seek legislation that, in essence, insulates school district debt issued for cash-flow borrowing utilizing pledged state aid intercepted by the Department of Treasury (Michigan Finance Authority) from any potential future bankruptcy filing by the school district.⁵ Essentially, the district agreed to pursue the enactment of legislation that,

(a) provides that any portion or installment of state aid otherwise payable to the district but applied to a monthly set aside requirement to make the debt service payments, when due, is not property of the school district; and

(b) eliminates any permissive (consensual) aspect of the assignment of state aid to the trustee by making that assignment a statutory lien;

(c) provides that all future school aid obligations issued by the district will be subordinate (in terms of paying the debt service requirements) to that 2004 district note issue.

Under the agreement if, by December 31, 2011, legislation meeting these requirements or prohibiting the district or emergency manager from filing for bankruptcy is not enacted, the 2004 district notes are subject to accelerated repayments of the \$94.5 million in principal otherwise maturing in 2016 to 2020.⁶ These accelerated repayments would be in

³ According to a listing maintained by the Department of Education about 40 school districts and public school academies had deficits for the fiscal year ending June 30, 2010, http://www.michigan.gov/mde/0,4615,7-140-6530_6605-106599--,00.html.

⁴ The bond issue converted one-year notes issued by the district in 2004 into 15-year bonds maturing in 2020. See the official statement of the Michigan Municipal Bond Authority, Revenue Bonds (School District of the City of Detroit), Series B, <http://emma.msrb.org/MS233923-MS209231-MD406803.pdf>.

⁵ See the official statement of the Michigan Finance Authority State Aid Revenue Notes (School District of the City of Detroit), Series 2011A-1 and Series 2011A-2, <http://emma.msrb.org/EP505814-EP394393-EP791603.pdf>. The notes were subsequently refinanced through a longer-term bond issue of the Michigan Finance Authority, secured by the pledge and intercept of the school district's state school aid payments, with a final maturity date of June 1, 2021. See the official statement of the Michigan Finance Authority Revenue Bonds (School District of the City of Detroit), Series 2011, <http://emma.msrb.org/EP581850-EP455639-EP855648.pdf>.

⁶ Under Section 23 of the Local Government and School District Fiscal Accountability Act, 2011 PA 4, MCL 141.1523, the emergency manager of a local government or school district may recommend to the Governor and the State Treasurer that the local government or school district be authorized to file for bankruptcy under Title 11 of the United States Code if the emergency manager deems that no reasonable alternative to rectifying the financial emergency exists. The Governor's approval of the emergency manager's plan to file for bankruptcy shall be based on (a) a determination by the emergency manager that no feasible financial plan can be adopted that can

additional to the scheduled principal payments maturing from 2012-2015 totaling \$60.7 million as well as accrued interest and a redemption premium (a percentage of the principal amount being redeemed). In accelerating the repayment, the agreement requires that \$94.5 million to be paid by 2015, as follows.

Due Date	Scheduled Principal	Additional Principal
6/1/2012	\$14,070,000	\$21,630,000
6/1/2013	\$14,775,000	\$22,905,000
6/1/2014	\$15,515,000	\$24,260,000
6/1/2015	\$16,290,000	\$25,750,000
	\$60,650,000	\$94,515,000

Reportedly, the school district, which has a deficit elimination plan (DEP) approved by the Department of Education, has not budgeted the additional \$21.6 that would be required in its FY 2011-12 budget.

BACKGROUND INFORMATION:

In testimony before a joint meeting of the Senate and House education committees on February 9, 2011, then-Detroit Public Schools Emergency Financial Manager Robert C. Bobb testified that, on the eve of its March 2011 note issue,

"DPS has an urgent need for Bond Security Legislation that will help the district borrow for immediate short term cash flow needs in March 2011. As you may be aware, the Detroit Public Schools signed a covenant with the insurer of a long term borrowing that the district undertook through the State in 2005. As a part of that borrowing the [State and the] district gave Financial Security Assurance (FSA), now Assured Guaranty Municipal Corp. (Assured), the right to sign off on future short term cash flow borrowings that the district would have to undertake. The district's current cash flow situation necessitates that the district borrow two times a year for cash flow purposes – once in March and once in August. This March the district will once again have to engage in a short term borrowing in order to make payroll, and in order to do so must obtain Assured's waiver to proceed with the borrowing.

Because of all the national headlines raising concerns about municipal and school district bankruptcies, Assured is looking to protect the DPS debt it insures from a potential filing even though the district has no plans to engage in such an action. We have seen firsthand the impact on the district's borrowing costs that investor concerns can have-in 2009, when we were in the throes of difficult labor negotiations, the interest rate on our one year note went from below 5% to 9.5%—tax exempt. This translated to a \$10 million increase in our cost of borrowing.

satisfactorily rectify the financial emergency of the local government in a timely manner or (b) a determination by the emergency manager that a plan, in effect for at least 180 days, cannot be implemented as written or as it might be amended in a manner that can satisfactorily rectify the financial emergency in a timely manner.

We believe that securing Assured's waiver this March will be difficult if the Legislature does not take swift action on the legislative proposal that was put together to address Assured's concern. The proposal, put together by my team, would insulate Assured, and other investors in school district cash flow borrowings, from the impact of a Chapter 9 Bankruptcy filing, and will help to ensure that the debt service on the 2005 long term refinancing that DPS engaged in will continue to be paid by the school district. In addition, this legislative proposal, if enacted, will prevent a doubling up of the debt service on the 2005 long term refinancing (from \$22 million a year to over \$39.3 million a year), thus further complicating the district's cash flow needs. This is Assured's back-up position. I urge the legislature to take swift action on this proposal, which will have a positive benefit not just for the Detroit Public Schools, but for the more than 300 other Michigan school districts which borrow each year to manage their cash flow needs."⁷

Subsequently, DPS reached an agreement with Assured Guaranty that enabled the district to move forward with the note issued. On this point, an article in *Bond Buyer* stated, "[a]fter winning long-awaited approval from a bond insurer, Detroit Public Schools plans to enter the market Thursday with \$231 million of one-year notes urgently needed to make payroll through August. The note sale previously had been prevented by Assured Guarantee (sic.) Ltd., which insures roughly \$170 million of DPS bonds originally issued in 2004. Assured had blocked any new borrowing by warning that it would require DPS to pay back the insured debt if the cash-strapped district borrows more money without waiting for the Michigan Legislature to pass a bill that would in essence protect Assured's bonds in the event of bankruptcy...Assured's new agreement gives state lawmakers until Dec. 31 to pass the so-called bond-security bill. If the state fails to pass the measure... DPS would be required to pay Assured back for the bonds starting in 2012 instead of June 2011, and pay them off by 2015."⁸

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

⁷ <http://www.house.mi.gov/SessionDocs/2011-2012/Testimony/Committee5-2-9-2011.pdf>

⁸ See, Caitlin Devitt, "Detroit District Sets Deal", *Bond Buyer*, February 28, 2011.