
CHARTER SCHOOL BOND FINANCING



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Financings of charter school facilities through the issuance of municipal debt obligations (hereinafter, “bonds”) have become increasingly prevalent since the first charter school financings were completed in the late 1980s, and such financings continue to be utilized as more jurisdictions adopt legislation authorizing the creation of and financial support for charter schools. Charter school financings raise many unique issues under local, state and federal law. This paper identifies many of the more common issues as they pertain to same.

State Law Issues and Considerations

Charter schools are established under the law of the jurisdiction in which they are created. For a charter school to exist in a state (or the District of Columbia) (each hereinafter, a “State”), charter schools must be authorized by the laws of the State in which the school is proposed to be, or already is, located (the “State Charter School Laws”). As of the date of this paper, forty-six (46) States¹ have adopted State Charter School Laws. State Charter School Laws impact the corporate organization of charter schools and their governance structures. The first step in a charter school financing is understanding the specific State Charter School Laws, or lack thereof, for the proposed financing. Additionally, certain State Charter School Laws may apply to non-charter public schools but not to charter schools and *vice versa*. Depending on the State Charter School Laws and the type of charter school, some charter schools are authorized at the State level (such as by a charter school board or the state department of education/schools) or the local level (such as by municipalities, school districts, or community colleges). Various State-specific issues impacting charter school financings are discussed below.

Governmental and 501(c)(3) Status. The following must be evaluated in determining whether a tax-exempt financing or taxable financing must be used: laws of a particular State; corporate or governmental status and powers of a charter school authorizer (an “Authorizer”); corporate or governmental status and powers of the charter school; and structural aspects of the desired financing. Depending upon the characterization of a charter school under the applicable State Charter School Laws, charter schools are organized either as governmental entities, nonprofit corporations, or for-profit corporations. If a charter school does not have a clear legal status under the laws of a particular State, sometimes an affiliated 501(c)(3) entity, such as a supporting foundation, can take the place of the charter school as the qualified borrower/obligor and lease the facility to the charter school. Such borrower/obligor, whether it be the charter school or another supporting entity is sometimes hereinafter referred to as the “Obligor.”

Funding. Although it varies by State, most charter schools receive both federal funding and funding from the State in which they were created, and, in some States, local funding². Most State and local funding consists of periodic payments to the school based upon enrollment in the charter school, typically as described in a charter contract between the school and an Authorizer. These periodic payments may be adjusted during the school year to account for actual enrollment. Some States provide different levels of funding for different levels of education and may also have different levels of funding for special contracts or areas of focus for the school, like deaf or blind specialties, special education, online or small or rural schools. These payments from the State and local funds generally are considered public funds (similar to funds received by school districts)

and may be subject to broader constitutional and statutory limitations. Funding for a charter school is rarely paid in an annual lump sum. Funding is often dependent upon a specific funding mechanism for a particular Authorizer or for charter schools in a particular State.

Funding (both in amount and timing) can also be affected by State budgets, the reporting received by the State or local chartering entity, and the evaluation system that is used for charter schools in a particular jurisdiction. Economic downturns and negative reports may result in lower funding or suspension of the payments. Generally, charter schools are forbidden by State Charter School Laws from charging tuition for students in grades that are free in traditional public schools, which further highlights the importance of governmental funding.³

Financing Structure. The legally permissible bond financing structure for charter schools varies by the laws of each State. As elaborated upon in the “Tax Law Issues and Considerations” section of this paper, depending upon the laws of a particular State, a charter school might be treated as an instrumentality of a governmental unit that can issue tax-exempt bonds on its own behalf. However, generally, a conduit or “on behalf of” issuer is used to issue bonds for the charter school, as described below, as opposed to a stand-alone nonprofit borrowing without a governmental issuer. Some States in which a charter school is not deemed a governmental entity, grant charter schools very broad powers to acquire, construct, own, and operate their facilities and to borrow money for such purposes⁴. In these instances, various financing structures may be used, though a loan agreement/bond indenture structure is common. In other States, a charter school may be (a) prohibited from owning land or facilities⁵, (b) prohibited from borrowing money on a long-term basis⁶, (c) prevented from becoming jointly and severally liable for debt, even when owned by the same entity⁷, or (d) economically incentivized to lease its facilities from a third party or the Authorizer⁸. In these more restrictive instances, a lease or lease-purchase structure may be used, if permitted under the applicable State Charter School Laws. In addition, some States limit the ability to finance and/or refinance charter school facilities to nonprofit entities.

Limitations on Debt and Funding. When financing a charter school with bonds, appropriate due diligence on the amount and nature of the charter school's debt and its interaction with other funding needs to occur. Some State Charter School Laws limit the amount or term of the debt that charter schools can incur.⁹ Further, in some States, charter school funding is not evenly disbursed throughout the year and charter schools look to private entities to provide or level out the cash-flow. These private entities may require a security interest in the charter school's facilities or future revenues as additional collateral and security.

Pledged Revenues; Annual Appropriation. A key element for a charter school financing is the charter school's ability to assign or pledge its revenue stream. Some State Charter School Laws limit, restrict, and, in some instances, forbid a charter school from pledging its revenues altogether.¹⁰ Other State Charter School Laws limit such pledges to lease or loan payments, or for limited purposes, such as capital expenditures. Nevertheless, many States allow charter schools to pledge their revenues as security for bonds, while some States only allow charter schools or Authorizers to incur annual expenditures. For those States, an annual appropriation in an amount equal to that year's payment must be used to avoid violations of the applicable State Charter School Laws. Care must be taken to accurately describe the revenue pledge, and any limitations thereon, in the financing documents.

Intercept. As discussed above, some States¹¹ allow the charter school to pledge or assign its right to receive its funding, or a portion thereof, to a third party. If permitted by the applicable State Charter School Laws¹², the lender or an agent such as the bond trustee, may be able to intercept certain revenues before the charter school receives them. For example, when there is a bond trustee involved, the charter school payments can be paid directly to the bond trustee who will provide notice (and the remaining funds) to the charter school after the required amounts under the financing are paid. However, it should be noted that even when the State has not created a prohibition to an intercept, the Authorizer may have such a prohibition.

If the direct intercept referenced above is not permitted, a “synthetic intercept” may be possible. In such cases, the charter school would have its revenues deposited at a bank authorized to receive them and would enter into a “deposit account control agreement” (or similar contract) allowing the secured party to direct the depository bank to make certain payments prior to the release of funds to the charter school. Synthetic intercept structures also allow the debt service amount and any other required deposits (i.e., reserves) to be paid first, with the remaining amount available to the charter school for its operations and expenses.

Generally, the Authorizer or other entity responsible for distribution of the charter school revenues requires a written direction from the charter school regarding where to deliver or deposit the charter school revenues. Depending upon the applicable State Charter School Laws, that direction can be irrevocable. Often, the Authorizer does not want to receive multiple directions and will allow only one direction per charter contract. Some States and Authorizers still pay charter schools via paper checks.

Obligated School Groups. The expansion of charter schools and their affiliation into charter school systems that span multiple locations within a city, county or State (and, in some cases, systems that have schools in multiple States) has led to revenue pledges of the entire system, similar to healthcare financing. It is important to address how the applicable State Charter School Laws and the Authorizers address revenue sharing across school districts and States.

State Accountability/Evaluation of Charter Schools and Restrictions. The type of accountability or evaluation of the charter school varies by State Charter School Laws and Authorizer, but can include grading (e.g. A-F) or state specific standard testing results. The impact of a failing standard or grade also varies by State. These evaluations are in addition to the federal accountability standards.

In addition to accountability standards which establish benchmarks for a particular charter school, the contract with the Authorizer may contain restrictions. The type of restrictions can vary by State (and even by Authorizer within the particular State) but can include: (i) open enrollment with a maximum number of students (presuming the charter school is not a virtual school); (ii) prohibition of performance based admissions for over-subscribed schools; (iii) being secular in their programs, operations and employment; and (iv) use of funds in compliance with procurement policies.

Tax Law Issues and Considerations

The operational needs of charter schools are typically different from those of traditional public schools and school districts, often creating more complicated tax issues. The following summarizes common tax law issues in a tax-exempt financing for a charter school.

Issuance of Tax-Exempt Charter School Debt. Except as described herein, unlike school districts, most charter schools cannot issue tax-exempt debt on their own behalf, and must use a conduit issuer to issue the tax-exempt bonds benefiting the charter school. Not all conduit issuers have the legislative authority to issue tax-exempt bonds benefiting charter schools, but many States have enacted legislation to establish new entities with the authority to issue tax-exempt bonds to finance charter school facilities or authorize existing entities to issue tax-exempt bonds to finance charter school facilities. These conduit issuers often are authorized to finance charter school facilities solely within the issuer's State, but some conduit issuers' authorizing legislation permits them to issue bonds to finance charter school facilities located in other States. Additionally, in some States, an Authorizer may be able to issue bonds on behalf of its charter schools. State tax exemptions vary among conduit issuers and such exemptions should be confirmed for each conduit issuer prior to selecting the conduit issuer for a charter school financing.

Alternatively, a charter school may issue its own tax-exempt debt without a conduit issuer if the charter school is acting on behalf of a state or political subdivision pursuant to Revenue Ruling 63-20. Revenue Ruling 63-20 provides that obligations of a nonprofit corporation organized pursuant to general nonprofit corporation law of a State will be considered issued on behalf of a state or political subdivision if the following conditions are met: (1) the corporation engages in activities which are essentially public in nature; (2) the corporation is not organized for profit (except to the extent of retiring indebtedness); (3) the corporation's income does not inure to any private person; (4) the state, or a political subdivision thereof, has a beneficial interest in the corporation while the bonds remain outstanding; (5) the unencumbered legal title in the financed facilities vests in the state, or a political subdivision thereof, after the bonds are retired; and (6) the corporation is approved by the state or a political subdivision thereof, which must also approve the specific obligations issued by the corporation. Bond and tax counsel should examine State Charter School Laws when deciding whether a charter school meets the requirements of Revenue Ruling 63-20 (*see, also*, Revenue Procedure 82-26).

Type of Tax-Exempt Bonds Issued. If it is determined that the charter school does not meet the requirements under Revenue Ruling 63-20, it would need to use a conduit issuer for its tax-exempt financing needs. Depending on the tax status of the charter school, those tax-exempt bonds issued by a conduit issuer may be governmental bonds or qualified 501(c)(3) bonds.

A charter school's use of the bond-financed facilities may be determined to be permitted governmental use, and thus the tax-exempt bonds issued on its behalf could be issued as governmental bonds, if the charter school is an instrumentality of a state or political subdivision. For this purpose, many bond counsel look to the test set forth in Revenue Ruling 57-128. The six-part, totality of the circumstances balancing test includes the following factors: (1) whether the charter school is used for a governmental purpose and performs a governmental function; (2) whether performance of the charter school's function is on behalf of one or more states or political

subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the charter school is vested in a public authority or authorities; (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the charter school, and whether such authority exists; and (6) the degree of financial autonomy of the entity and source of its operating expenses. Bond and Tax counsel should examine State Charter School Laws when making a determination that a charter school meets the requirements to be treated as an instrumentality of a state or political subdivision so that its use would be treated as governmental use, meaning that governmental tax-exempt bonds can be issued on the charter school's behalf.

Alternatively, if it is not clear that a charter school is an instrumentality of a governmental unit pursuant to Revenue Ruling 57-128, qualified 501(c)(3) bonds can be issued for the charter school's benefit if the charter school is an organization described in section 501(c)(3) of the Code and the school and the project meets certain requirements.

Costs of Issuance Limitation. If the charter school is not an instrumentality of a state or political subdivision but qualified 501(c)(3) bonds can be used to finance the charter school project, then the financing faces additional restrictions. This is because qualified 501(c)(3) bonds are considered tax-exempt “private activity bonds,” which must satisfy additional limitations beyond those that apply to governmental bonds. For example, the “issuance costs” financed by an issue of qualified 501(c)(3) bonds cannot exceed two percent of the proceeds of the issue (the “Two Percent Limitation”). In some charter school financings, the costs of issuance for the transaction as a whole exceed the Two Percent Limitation. In these instances, the charter school must decide whether to pay the additional costs of issuance expenses from its own sources of funds or add a taxable series of bonds, which typically bear interest at higher rates, to finance the additional costs (the “Taxable Tail”). The use of the Taxable Tail or funds of the charter school for costs of issuance reduces the total amount of issuance costs financed dollar for dollar, but it is not considered Equity when measuring other private business use (as discussed herein).

Private Ownership/Lease Structures. All of the charter school facilities financed with tax-exempt bonds must be owned for federal tax purposes by a state or political subdivision or, in the case of qualified 501(c)(3) bonds, a 501(c)(3) organization or a state or political subdivision.

In some States, or under certain circumstances, it may be necessary or beneficial to structure the transaction so that the charter school is the lessee of bond-financed property rather than the holder of legal title thereof. If the proposed title holder is not itself a qualified user, such as a governmental entity or a 501(c)(3) organization, as applicable, then to avoid private business use or private ownership issues, careful consideration should be given in structuring the relationship between the title owner and the charter school.

One set of alternative structures uses a financing lease, installment sales contract, or other agreement between the title owner and the charter school, under which the charter school would be deemed the beneficial owner of the property for federal income tax purposes. The determination of whether a lease qualifies for such treatment is made on a case-by-case basis. Facts supporting qualification for such treatment could include the following: (i) base rent under the lease includes a principal and interest component which mirror debt service due on the bonds, (ii) the charter

school has a purchase option to acquire the property with the purchase price being the amount necessary to redeem and/or defease the bonds, and such amounts are to be so used, (iii) the title holder's interest in the property is assigned to the trustee to secure the bonds, and (iv) the title owner has no substantial rights to use the bond proceeds or the subject property other than as agent for the bondholders and/or the qualified user (i.e., the title holder's use is solely incidental to a financing arrangement).

Another potential structure is using a true lease, but only financing tenant improvements. Under the facts and circumstances the charter school or governmental unit often can be treated as the beneficial owner of such improvements allowing such improvements to be eligible for tax-exempt financing, generally provided that the term of the lease exceeds the expected economic life of the financed asset by an amount of time sufficient to satisfy the federal tax law requirements. Whether a lessee is treated as the owner of tenant improvements depends on all the facts and circumstances, including but not limited to the term of the lease as compared to the economic life of the financed tenant improvements, whether the financed tenant improvements can readily be removed from the leased space, whether such removal is permitted under the terms of the lease, the charter school agrees to remove the financed tenant improvements if the lease is not extended and whether the lessor and lessee specifically agree that the lessee is treated as the owner for federal income tax purposes.

Fair Market Value of Purchased Property. Obligors may be subject to certain legal restrictions on the acquisition of property at a price above fair market value. Thus, it is important to confirm there is a reasonable basis to demonstrate the price paid is at, or below, fair market value.

Appraisals are a commonly used indicator of fair market value. However, there are situations in which the parties to a transaction may believe an appraisal is unnecessary. For example, sometimes a charter school may set a purchase price by negotiation with an unrelated party in an arm's length transaction or pursuant to a formula in a previously agreed upon purchase option that was determined in a negotiation between the charter school and an unrelated party in an arm's length transaction.

Private Business Use. Generally, there are strict limitations as to the amount of private use that may occur within the charter school facilities financed with tax-exempt bonds. For private business use to be a problem in a bond financing, it must be coupled with private payments (or private security (e.g. a guaranty)). In the examples below, it is likely that both the private business use and private payment tests would be met.

Via Private Charter School Operators. Many charter schools want to outsource all or a portion of their operations. The scope of such outsourcing may be limited to a specific area, like food services, or it may include virtually all operations, like an agreement with a charter school management company. Depending on the legal structure of the charter school and the third-party service provider, these agreements could result in private business use of the charter school facilities financed with the tax-exempt bonds unless they satisfy the safe harbor of Revenue Procedure 2017-13 (the "Management Contract Safe Harbor"). In

addition to meeting other requirements of the Management Contract Safe Harbor, particular attention must be paid to the operator's compensation structure to ensure that no element of the compensation is based on the net profits of the charter school.

Other Private Business Use. Summer camps, food services, and the leasing of bond-financed space are common potential sources of private business use for charter schools. For example, some charter schools want to lease excess space to generate revenues, which may result in private business use. Additionally, some States have proposed legislation mandating leasing excess charter school space to unrelated entities. Many schools, including charter schools, may lease or sublease their facilities during non-school hours to unrelated entities. For qualified 501(c)(3) bonds, private business use may be avoided if the use is by an entity that is also a 501(c)(3) organization, but the proposed use and user require careful tax analysis. Even when the use is by another 501(c)(3) organization for a charitable purpose, private business use may occur. The same holds true when the financed space is used by a for-profit entity. In cases not involving private business use derived from unrelated trade or business use, it may be possible to avoid private business use by structuring the term of the charter school's agreement with the third-party user to fall within certain exceptions to private business use for short-term arrangements. Generally, an agreement with a term of 50 days or less will not result in private business use, if the terms of such agreement are at fair market value, the negotiations for the agreement were at arm's length, and the charter school property was not financed with tax-exempt bonds for the principal purpose of providing it to the private party. Because most charter schools receive federal funding for student food costs, many food service contracts are food supply contracts that do not involve use of the bond-financed space. To the extent that a charter school has a food service contract involving management or the provision of other services, private business use of the charter school facilities financed with the tax-exempt bonds could result unless the contract satisfies the Management Contract Safe Harbor.

If it is anticipated that private business use of the bond-financed charter school facilities will exceed the strict limitations as to the amount of private business use allowed in a tax-exempt bond financing, the charter school has an option to contribute non tax-advantaged cash sources, or "Qualified Equity," to negate or absorb some of the private business use in a "new money" charter school financing. Equity can include a Taxable Tail or funds of the charter school. The Qualified Equity must be expended on costs of the tax-exempt financed charter school facilities no earlier than such funds would be eligible for reimbursement with tax-exempt bonds and no later than the date that the financed charter school facilities are placed in service. If the Qualified Equity meets these requirements, it would be applied first to the private business use portions of the charter school facilities, allowing the tax-exempt bond proceeds to be allocated to the permitted uses of the facilities.

Religious Use. Religious use can be both a tax law issue and a constitutional law issue. In addition to possible private business use that may arise from a third party's use of any portion of the financed charter school facilities for religious purposes, in whole or in part, bond counsel

should consider whether such religious use could impact the validity of the issuance of the tax-exempt bonds. In making such a determination, bond counsel should consider whether such use could result in a violation of the Establishment Clause, Free Exercise Clause, or any other provision of the United States Constitution; the applicable State Charter School Laws, including the applicable State's constitutional and legislative limitations; or the administrative positions and powers applicable to the entity issuing the bonds. If any religious use is anticipated, it is important to note that the use of a Taxable Tail may not be effective to offset the religious use as the Taxable Tail is likely also issued by a governmental conduit issuer and could result in a similar constitutional violation. Any Qualified Equity contribution to offset religious use should be made from other legally available funds.

The Public Approval Requirement of Section 147(f) of the Code. As explained above, some charter school financings involve the issuance of tax-exempt qualified 501(c)(3) bonds. Before the issuance of qualified 501(c)(3) bonds, there must be public approval of both the host jurisdiction and the conduit issuer of such bonds (the “Public Approval”) after a public hearing with reasonable public notice of such hearing (collectively with the Public Approval, the “Public Approval Requirements”) under Section 147(f) of the Code. This may require a transaction to be planned well ahead of time because obtaining Public Approval can take several weeks, or sometimes months in some jurisdictions. Depending on the governmental entities involved in the Public Approval, the Public Approval Requirements may dictate the charter school's choice of conduit issuer. Further, it is wise for bond counsel to have a good understanding of the political climate in the jurisdiction providing Public Approval. It is not entirely uncommon for Public Approval of a charter school financing to be delayed, or withheld entirely, for political reasons.

Financial Covenants. Bond lawyers and tax lawyers often carefully analyze financial covenants contained in the bond documents, such as those described in the “Direct Loan Related Issues – Financial Covenants” section hereof to see if they inadvertently result in funds of the charter school that were not derived from the sale of tax-exempt bonds becoming subject to yield restriction and arbitrage rebate implications. Financial covenants that could result in replacement proceeds include, for example, a requirement to maintain a minimum balance, such as minimum “Days' Cash on Hand,” in a sinking fund or other account to give reasonable assurance that such amounts will be available to pay debt service on the bonds if the Obligor encounters financial difficulties. However, such a covenant would not create replacement proceeds as a pledged fund if: (i) the issuer, or substantial beneficiary, may grant rights in the amount that are superior to the rights of the bondholders or guarantor if applicable; or (ii) the required minimum balance (a) does not exceed the reasonable needs for which it is maintained, (b) is tested no more frequently than every six months, and (c) may be spent without any substantial restriction, other than a requirement to replenish the amount by the next testing date.

Federal Securities Law Issues and Considerations

Often, municipal bonds benefiting charter schools are sold pursuant to a public offering. The number of investors in the charter school financing market has grown over the years, as has demand for more disclosure in an offering and after the issuance of the bonds. In addition to a description of the deal structure and the material financing documents, the following are some of

the relevant topics related to charter school financings that are often included in primary offering disclosure documents (“Primary Disclosure”).

The Charter. Primary Disclosure typically describes key provisions of the charter school's charter, including the term of the charter, any renewal, termination, or revocation provisions; important contractual and regulatory provisions; any restrictions or conditions on the charter school, like restrictions on enrollment or grade limits; charter renewal history, if any; and any conflict of interest provisions.

Revenues, Budget and State Funding Disclosure. Primary Disclosure also typically includes a description of a charter school's revenues, funding information, and the charter school's budget and budgetary process to give investors a picture of the charter school's financial status. The description of revenues often includes the charter school's annual revenues and expenditures, a description of the charter school's pledged revenues, any endowments, receipt of federal funds and grants, and any projected changes to the charter school's revenue sources. In addition to the charter school's revenues and expenses, a description of the charter school's outstanding and planned indebtedness, the charter school's access to liquidity sources if cash flow funding is needed, and an explanation of any financial covenants, such as annual debt service coverage ratios and minimum days' cash on hand requirements, are often included to give investors an accurate picture of the charter school's financial status. Additionally, both the amount and the timing of State, federal, and local payments received by the charter school are often disclosed. Further, an explanation of the budgetary process and comparisons of actual expenditures to budgeted expenditures are often presented in Primary Disclosure. In furtherance of the foregoing, Primary Disclosure often includes a presentation of the charter school's past financial performance and financial projections. If historical financial statements or financial information are included in the Primary Disclosure, care is often taken to highlight any past or present fiscal issues. If financial projections are included in the Primary Disclosure, key assumptions underlying such projections are often described (projected enrollment, increases in revenues or expenses, etc.). Of particular relevance, the U.S. Securities and Exchange Commission has recently argued that it is important to highlight any recent financial difficulties, particularly as such difficulties may bear on the charter school's ability to meet its current or future financial obligations.¹³

Intercept Programs. In addition to the timing and amount of revenues to be received by a charter school from its Authorizer and/or the State, a description of any legally permitted intercept programs that would allow the bondholders (or an agent) to intercept operating funds of the charter school and use such funds to make debt-service payments are often included in Primary Disclosure to the extent an intercept will be implemented or may be implemented at the option of the bondholders.

Collateral Disclosure. Descriptions of security interests in the charter school's assets, a description of the collateral securing the charter school financing, and the terms of security documents for the charter school financing are often included in Primary Disclosure. The form, the payment, termination, and default provisions of any revenue pledge, mortgage on, or lease of the charter school's facility are often included in Primary Disclosure. Additionally, the bond trustee's rights and remedies to such the collateral are often described. Any Uniform Commercial Code security interests in assets of the charter school are often included in this part of the

disclosure. Additionally, if title commitments or any material title issues exist, those are often described in Primary Disclosure.

Academic Performance. The charter school's academic performance, including the applicable federal, State, and local school district academic standards and the school's compliance with such standards are often disclosed. Additionally, any possible consequences related to the charter school's charter for failing to adhere to various academic standards should also be disclosed. Furthermore, if the charter school has received any adverse actions or notices, information regarding such notices are often included. When drafting Primary Disclosure regarding a charter school's academic performance, consideration should also be given to academic performance of the charter school's competitor schools.

Management, Teachers and Third Party Management. A description of the charter school's board of directors, management, staff, and teachers are often included in the disclosure document. Such description typically includes qualifications, experience and the compensation of the management's staff. Additionally, if there are any disciplinary issues for a member described, such issues are often included in the disclosure. If the charter school has a conflict of interest policy for its board of directors, management, staff, and teachers, such policy is typically described.

If the charter school contracts with a third party manager or management company, Primary Disclosure should also include a description of the management services provided, compensation for such services, the term of the management contract, and any conflicts of interest, such as a manager or key principal of management company who also sits, or has a family member who sits, on the charter school's board.

School Location and Service Area, Enrollment and Retention Statistics, and Competition. In addition to consideration of the academic performance of competing schools, information regarding the charter school's location and enrollment and retention performance relative to competing schools in the service area are often included in Primary Disclosure. This information often includes the location of the charter school in relation to other schools in the service area. Additionally, information regarding the charter school's enrollment history, waitlist, recruiting policies, and student and teacher retention history are often described. If the charter school conducted any market studies of the service area, such studies are often described in Primary Disclosure.

The Project and Charter School Facilities. A detailed description of the charter school's existing facilities or new facilities, including any easements, use restrictions, and zoning limitations for the charter school's facilities are often included in the Primary Disclosure. Additionally, a description of the project being financed, including a plan for undertaking such project, is typically included in Primary Disclosure. If the project financed includes the acquisition of a facility, Primary Disclosure may include the purchase price, a description of how such purchase price was determined (e.g., is it an “open market” purchase or purchase pursuant to an option embedded in an existing lease arrangement), as well as any conflicts of interest – for example, if the charter school is purchasing the facility from a founder or “related” management company.

Continuing Disclosure. After a charter school financing that is publicly offered is completed, most charter schools are required to update disclosure to investors (“Continuing Disclosure”). Most often Continuing Disclosure requirements are included in a continuing disclosure agreement or undertaking that the charter school is required to enter into as part of the financing. Continuing Disclosure requirements for charter schools can vary. In addition to the providing the charter school's annual financial and operating data and disclosing any listed events required to be disclosed under SEC Rule 15c2-12, if applicable, the charter school may be required to participate in annual investor calls and provide various documentation regarding the project financed and the charter school's financial status, including construction progress reports, quarterly financial information, operating budgets, no default certificates, certifications as to calculations of financial covenants, and more in such continuing disclosure agreements.

Credit Enhancement Issues and Considerations

The federal government and several States have created mechanisms to enhance the creditworthiness of charter schools seeking financing by offering additional repayment sources, guarantees, or debt service reserve funds. For example, the U.S. Department of Education's Credit Enhancement for Charter School Facilities Program provides grants to eligible entities that add additional repayment sources to improve the charter school's credit to obtain private loans and bonds to acquire real property to be used for a charter school, to construct new facilities, or to renovate existing facilities. This program operates as a federal guarantee of debt and therefore could not be used in connection with a tax-exempt financing.

Certain examples of credit enhancement programs at State and local levels include:

In Arizona, the Arizona Public School Credit Enhancement Program provides a fund that guarantees scheduled principal and interest payments for eligible charter schools.¹⁴

In Colorado, the state has authorized charter school debt up to an aggregate principal amount of \$500 million to be issued which is backed by the state's moral obligation to replenish draws on a charter school's debt service reserve fund. A charter school must obtain an investment grade credit rating to be eligible for such credit enhancement.¹⁵

In the District of Columbia, the Credit Enhancement Revolving Fund provides enhanced credit, lease guarantees, and access to financial assistance to eligible charter schools for the acquisition, renovation, or construction of school facilities.¹⁶

In Indiana, charter schools sponsored by the mayor of Indianapolis are authorized to obtain financing for facilities from the Indianapolis Local Public Improvement Bond Bank. The debt issued through this program may be backed by the state's moral obligation to replenish a debt service reserve fund.¹⁷

In Texas, the Charter School District Bond Guarantee Program for Texas open-enrollment charter schools makes Texas' Permanent School Fund available to guarantee revenue bonds issued on behalf of eligible investment grade rated charter schools for financing charter school facilities. In addition, the Texas Credit Enhancement Program is available to provide debt service reserve

fund guarantees in connection with bond issues for the benefit of qualifying open-enrollment charter schools.¹⁸

In Utah, the Charter School Credit Enhancement Program assists qualifying charter schools in obtaining favorable financing by providing a means of replenishing a qualifying charter school's debt service reserve fund. Additionally, Utah has authorized bonds to be issued which are backed by the state's moral obligation for charter schools that have an investment grade credit rating and meet other eligibility criteria.¹⁹

Many of the foregoing credit enhancement structures require the charter school to engage a rating agency to rate the proposed debt to determine eligibility for the credit enhancement or obtain an investment grade rating, which adds additional time and expense to the financing. It is often challenging for a charter school to receive an investment grade rating, particularly for start-up or expanding charter schools.

Some of the programs described above require evidence of rating and proof of compliance with the program's other requirements, which may include good standing certificates and stable or improving financial operating history. If a charter school's application is approved by a credit enhancement program, it then submits a supplemental rating package indicating such approval to the rating agency. Upon receipt of the enhanced rating from the rating agency, the bond financing proceeds towards pricing and closing.

Before undertaking the time and effort to seek a rating, counsel representing the Obligor might consult with the underwriter and financial advisor, if any, regarding any potential benefits to seeking a rating from a rating agency.

As State support of charter schools evolves, it is expected that the foregoing programs will evolve as well, making it important to stay current on federal laws and State Charter School Laws regarding credit enhancement for charter schools.²⁰

Real Property Issues and Considerations

Charter school financings are typically secured by the charter school and/or related corporation's legal interest in the real property and improvements financed with proceeds of such financings. The lender/underwriter will require certain real estate due diligence, one portion of which is confirming that the Obligor has control over the site. The Obligor must provide evidence of ownership or the right to use the property in the form of a recorded deed, signed purchase contract, a lease, a letter of intent, or other legally binding agreement. Other due diligence items include, but are not limited to, those discussed below.

Title Review and Endorsements. If, as is often the case, time is of the essence, the Obligor should consider engaging a title company early in the financing process. A title company runs the title report and provides title insurance to the Obligor and bond trustee or lender. A title report or commitment details who currently owns the site and what type of liens or encumbrances, if any, affect use and ownership of the property. The information found in the title report verifies and supplements the information that the seller/fee owner provides about the property. Encumbrances may include mortgages, mechanic's liens, easements, zoning violations, rights of way, unpaid

taxes, and other property use restrictions. The lender/underwriter will require that the bondholders receive a valid first lien on the property (except for leasehold interests, in which case the interest of the bondholder will be subordinate to the fee owner), so it will be necessary to remove or discharge any preexisting liens, to the extent possible.

If pre-existing liens or conditions cannot be removed from title, then the Obligor might request an applicable endorsement. Like a rider on a health insurance policy, endorsements add additional insurance coverage to a title policy. There are certain required endorsements, such as ALTA Form 9, Environmental (8.1), Same as Survey, and Deletion of Arbitration. Others, such as Access Endorsement, Zoning Endorsements (especially for start-up schools), and Contiguity, are recommended if they are available in the State in which the property is located and apply to the property.

Title insurance is an insurance policy that protects the rights of the insured against defects and claims in the title to their parcel of real property. While the function of most other forms of insurance is risk assumption of unforeseen future events by pooling the risk for loss, the main purpose of title insurance is to eliminate risks and prevent losses arising out of events that have happened in the past. The lender/underwriter generally requires the insurance policy to be in an amount equal to the par amount of the bonds, which is often more than the value of the property.

Survey. The Obligor typically provides a new or recent survey of the property to be subject to the lien of the mortgage/deed of trust. The property survey shows exact legal boundaries, the location of all utilities, easements, and rights of way, and should match those listed in the title commitment. A topographic survey will illustrate the slopes and other physical features of the site but will not identify any legal rights that are not visible. For this reason, a topographical survey is insufficient for Commitment purposes.

The lender/underwriter will want to confirm that the mortgaged land matches the property they have appraised and otherwise inspected. The legal description of the property on the survey should match exactly to the description found in the title commitment, proposed deed, mortgage, or lease. Typically, the lender/underwriter will require that the survey also be certified to the lender/underwriter and its successors and assigns.

The information found in the survey will be relied upon by the project architect and engineers to prepare the final building design. The title company will also need a copy of the survey for its preparation of the title report.

Appraisals. Lenders/underwriters may require an appraisal to estimate the value of the school facility, particularly if a lender has a required maximum loan-to-value ratio (loan amount ÷ appraised value of the property). In an acquisition, an appraisal may also form the basis for the purchase price of the school facility. In the event of a default with respect to the bonds, a foreclosure of the property may occur. The appraisal represents an estimate of value as of the date of the appraisal; therefore, the lender/bondholder assumes the risk that the property may not be sold at the appraised amount or in an amount sufficient to pay the outstanding obligations due on the bonds.

Environmental Reports. When acquiring new or existing facilities, it is important to consider engaging an environmental consultant at the beginning of the financing process to identify any environmental hazards located on the property. If hazardous substances are found on the property, the property owners may be held liable for costs and other liabilities related to the removal of such substances. If further investigation is required after completion of the Phase I environmental site assessment, a Phase II environmental site assessment may be performed. If a report is stale (i.e. more than six months to a year old), a lender/underwriter will generally require that the Obligor receive an updated report or initiate a new environmental investigation with the consultant.

If the school will be located in an existing facility, the Obligor and counsel might be on the lookout for legacy issues such as lead paint, lead in water, mold, asbestos, underground storage tanks and the like, some of which are outside the scope of a standard Phase I environmental site assessment. Remediation activities may require demolition, removal, monitoring, or other abatement activities which may subject the project to cost overruns or delayed construction, therefore, it is prudent to engage the environmental consultant as early as possible and plan for unexpected events.

Direct Loan Issues and Considerations

General Provisions.

The number of banks or other lenders willing to lend directly to charter schools has grown over the past several years as have the number of direct loan investors interested in charter school financings. While lending requirements vary among these entities (herein, “Lenders”), common issues on direct loan financings often include the following:

Financial Covenants. Lenders may require the charter school agree to certain financial covenants for the life of the financing. These negotiated terms include the following: Loan to Value ratios; debt service coverage and/or days cash on hand ratios; additional indebtedness limitations; maintenance of reserves; and enrollment levels. In addition, in the event of a default, Lenders may want more involved and more quick-acting remedies, such as the right to select a management consultant to provide oversight, to intervene directly in the operation or management of the charter school or to receive a position on the board of directors of the charter school. The following provides a summary of certain covenants commonly found in direct loan charter school transactions.

Loan to Value Ratio. Many Lenders will require specific loan-to-value ratios, similar to standard bank loan terms, which often pose problems for charter schools in new construction financings or certain refundings. The additional equity/asset base required may be an issue.

Additional Indebtedness. Most Lenders will want to restrict additional indebtedness (to avoid dilution of the revenues or their security) unless certain conditions are met. The additional indebtedness limitations need to distinguish

between long-term debt (for additional facilities or improvements) and short-term debt (for day-to-day operations or liquidity). Additional indebtedness requirements may include debt service coverage or days cash on hand ratios, revenue sufficiency or feasibility analysis. Projected financials may also be required. Additional indebtedness tests need to be crafted to be workable for both the Lender and the charter school (so as not to restrict operations).

Debt Service Coverage Ratio; Days' Cash on Hand. Lenders may expect financial covenants regarding the revenues of the charter school. Such ratios often look to debt service coverage and/or days cash on hand ratios, often calculated by a third party. The primary purpose of a debt service coverage ratio is to demonstrate an Obligor's revenues available to pay debt service on outstanding debt or proposed debt. The primary purpose of a days' cash on hand covenant is to demonstrate how many days of cash the Obligor has available to operate its business (i.e. the charter school). The charter school needs to be engaged in negotiating these covenants and understand how the tests are defined and measured (including how often) to avoid a default. It will also be important to describe how a violation of each financial covenant will be treated in relation to the applicable default provisions: for example, whether a consultant can be brought in before a default is declared.

Funds and Accounts. The financing documents will generally provide for the creation of various funds and accounts and for the flow of funds based on the receipt of revenues by the charter school. Such funds may include various sources of revenues (e.g. federal, State, authorizer and lease revenues), which may or may not be pledged as security for the debt and is typically necessary for the continued operation of the charter school. As previously discussed, careful analysis should be given to how each fund should be treated under the federal tax regulations (for example, with respect to pledges and replacement proceeds, as described in “Tax Law Related Issues – Financial Covenants,” above).

Collateral and Security. Lenders in a direct loan situation may also be asked to undertake a subordinate lien position, including to an outstanding bond issue. The collateral and security that the charter school can offer to a Lender varies by the laws of the applicable State and may not match the expectations of the Lender. Therefore, the legally and contractually available collateral and security available for a direct loan will need to be carefully evaluated prior to entering into a term sheet. Appraisals are often required.

Continuing Disclosure Requirements. Continuing Disclosure standards and requirements continue to evolve in both limited offerings and in direct placements. Generally, charter schools will be exempt from rules regarding “material event disclosure” described in the “Continuing Disclosure” section above, if: (A) the offerings are in authorized denominations of \$100,000 or more, and (B) 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. However, provisions in a term sheet may require Continuing Disclosure, even if not

required under SEC Rule 15c2-12. In some cases, such Continuing Disclosure may be made only to the Lender and not to the public.

Conclusion

Charter school bond financings have continued to grow in popularity since first introduced in the 1980s. As of the date of this paper, it is expected that charter school bond financings will continue to occupy a significant portion of the K-12 bond finance space because charter schools continue to grow in both size and quantity, consequently requiring additional and expanded capital facilities. Municipal bonds have become a preferred method of financing such facilities. The purpose of this paper is to provide NABL members with a brief outline of some of the issues that most often arise, but it is not an exhaustive analysis of the many issues encountered in the financing of charter schools. Each charter school and charter school financing is somewhat unique from others in the category. Bond lawyers must note that charter schools are distinguishable from their private or traditional public school counterparts requiring a more comprehensive review of the applicable State Charter School Laws, as well as attention to federal tax law, federal securities law, credit enhancement opportunities, and property-related issues.

APPENDIX

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ENDNOTES

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- ¹ Alyssa Ann Rafa et al., *50-State Comparison: Charter School Policies*, EDUC. COMM’N OF THE STATES (Jan. 28, 2020), <https://www.ecs.org/charter-school-policies/>.
- ² *See generally Charter Schools: How is the funding for a charter school determined?*, 50-State Comparison, EDUC. COMM’N OF THE STATES (Jan. 2020), <http://ecs.force.com/mbdata/MBQuestNB2C?rep=CS2017>.
- ³ *Frequently Asked Questions*, NAT’L CHARTER SCHOOL RES. CTR., U.S. Dep’t of Educ., (September 9, 2020), <https://charterschoolcenter.ed.gov/faqs>.
- ⁴ *See* TODD ZIEBARTH, NAT’L ALL. OF PUB. CHARTER SCHOOLS, *MEASURING UP TO THE MODEL: A RANKING OF STATE PUBLIC CHARTER SCHOOL LAWS*, (11th ed. 2020).
- ⁵ *See, e.g.*, Minn. Stat. § 124E.26 (2016).
- ⁶ *See, e.g.*, COLO. CONST. art. X, § 20(4)(b).
- ⁷ *See, e.g., id.*
- ⁸ *See generally* CAL. EDUC. CODE § 47614.5 (West 2001).
- ⁹ *See, e.g.*, COLO. CONST. art. X, § 20(4)(b).
- ¹⁰ *See, e.g.*, Minn. Stat. § 124E.26 (2016).
- ¹¹ *See, e.g.*, COLO. REV. STAT. ANN. § 22-30.5-406 (West 2009).
- ¹² *See* CAL. EDUC. CODE § 17199.4(a)(4) (West 2001); *see also* CAL. CODE REGS. tit. 4 § 10196(b)(1) (2020).
- ¹³ *See*, Compl., *SEC v. Park View Sch., Inc.*, No. 3:20-cv-08237 (D. Ariz. Sept. 14, 2020); *see also*, Sarah Wynn, *SEC settles fraud charges with Arizona charter school*, The Bond Buyer (last visited September 16, 2020), *available at*: <https://www.bondbuyer.com/news/sec-settles-fraud-charges-with-arizona-charter-school>.
- ¹⁴ ARIZ. REV. STAT. ANN. § 15-2155 (2016).
- ¹⁵ COLO. REV. STAT. ANN. § 22-30.5-407 (West 2014); COLO. REV. STAT. ANN. § 22-30.5-408 (West 2014).
- ¹⁶ D.C. CODE § 38-1833.01(b)(1) (2020) (“To administer the credit enhancement fund for public charter schools under section 603(e) of the Student Loan Marketing Association Reorganization Act of 1996 (20 U.S.C. 1155(e)), subject to the provisions of such section.”).
- ¹⁷ *See generally* IND. CODE ANN. § 5-1.4-5. (West 2020).
- ¹⁸ 19 TEX. ADMIN. CODE § 33.67 (2020).
- ¹⁹ UTAH CODE ANN. § 53G-5-606 (West 2020).
- ²⁰ *See* Ziebarth, *supra* note 4.