# SPECIAL ASSESSMENT BONDS: THE KEY TO FINANCING LOCAL INFRASTRUCTURE

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On August 7, 2012, Governor Patrick signed into law a bill which provides municipalities with a local option to approve "special assessment financing" of public infrastructure needed to support private development or to upgrade existing public works facilities. Chapter 23L of the General Laws, which I participated in drafting, is a common method of tax-exempt financing public infrastructure in many other states. It has also been used in Massachusetts when authorized by special legislation, most recently by South Shore Tritown Development Corporation's Southfield project.

Massachusetts communities have historically faced difficulties in financing necessary public infrastructure, and efforts have been underway for many years to solve this problem. A similar bill dealing with special assessment financing has been working its way through the Massachusetts Legislature for several years. The latest version, Chapter 23L, is now law, and provides the "missing link" enabling our communities to tap into a robust, multi-billion dollar market for investment capital for public infrastructure, without placing further stress on scarce municipal resources.

Statement of the Problem. Many desirable private or community development projects must be supported by public infrastructure improvements, such as streets, lighting, storm drainage, water and sewer systems, transit improvements, parking, parks, and recreational facilities. Municipal resources, however, are limited, and municipalities are often unwilling or unable to allocate scarce tax revenues or increase municipal debt burdens to finance public infrastructure for worthy projects.

Some communities – Boston is a notable example – can deal with this problem by requiring developers of major projects, as a condition to permitting, to pay for or construct public infrastructure and dedicate it, free of liens, to a public agency. However, there are problems with financing these costs with a conventional construction loan. Public infrastructure in most cases must be built first, before the private elements of the project and before the project generates any revenues. Although the public infrastructure may enhance the value of the remaining land, the public infrastructure is not suitable collateral – it must on completion be transferred into public ownership free of liens. Dedicated public infrastructure is, to a construction lender, the equivalent of an additional land acquisition cost. This increased lending risk is often reflected in higher equity contribution requirements and/or higher interest rates. Construction financing is typically made on a short-term interest only basis, to be refinanced by a long-term conventional mortgage, and can add considerable costs to the project budget.

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The Search for a Solution. Massachusetts has attempted to deal with this problem through a variety of programs, including direct state grants, state tax credits, and the pledging of expected increases in state or local tax revenues to finance bonds for infrastructure improvements. The common thread of all of these programs is that either the state or one of its municipalities ultimately uses its resources or assumes a credit risk to support private development.

Chapter 23L is different: it is the "developer pays" option. Experience in dozens of other states over many years has proven that developers are willing to pay for local infrastructure if the terms of financing are favorable enough.

Chapter 23L Solves the Problem. Under Chapter 23L, private developers or community groups may file a petition with the municipality for the establishment of a "development zone" within the municipality. Petitions must have the consent of the owners of 100% of the acreage in the development zone, and must include a detailed improvement plan and an estimated budget and timetable to complete the public improvements.

The municipality must hold a public hearing on the petition. If the petition is approved by the municipal governing body, then the municipality will adopt an "assessment plan" to impose special betterment assessments on privately-owned property within the development zone payable over a period up to 25 years. These special assessments will provide the revenues to support long-term tax-exempt bonds issued by MassDevelopment to finance construction of the improvements. Public improvements so financed may be owned only by a public entity.

If the developer sells off portions of the project, as frequently occurs, the special assessments are allocated among the various parcels under rules contained in the assessment plan. The new owners then assume the responsibility for the assessments allocated to them. Basic economics indicates that the sale price of project parcels will be reduced by the existence of the assessment liens, but this has not proven to be a deterrent to successful development.

*The great benefit of the Chapter 23L program is that, unlike other methods of financing public infrastructure, the entire cost of construction, financing and maintaining the improvements is borne by the property owners in the development zone, not by the municipality or the state. At the same time, it provides the developer with a long-term, fixed rate financing at a low tax-exempt rate.*

Special Assessment Financing Works! There is nothing novel or experimental about special assessment financing. It has been employed for years in over 35 states, including California, Florida, Illinois and Maryland. Issuance of special assessment bonds peaked at about $5 billion in 2007, has declined since the 2008 financial crisis, and is increasing as the housing and commercial real estate markets improve. The five largest special assessment bond underwriters sold 573 issues of tax-exempt special assessment bonds totaling $8.6 billion in principal amount from 2005 to 2009.

Special assessment financing involves the issuance of tax-exempt revenue bonds to finance infrastructure improvements which are paid by special betterment assessments on privately-owned real estate in the development zone. Because these bonds are secured by tax liens on the property, they are high-credit, tax-exempt, long-term securities very attractive to investors. Developers like special assessment bonds because they provide a long-term, low-interest source of funding for pre-construction expenditures, which does not interfere with construction or permanent project financing. The municipality benefits from enhanced property tax revenues from the project, without a reduction of its scarce tax revenues or an increase in its municipal debt burden.

Typical Bond Terms. Special assessment bonds are typically issued in underwritten public or private offerings managed by underwriting firms specializing in this area. Banks and other institutional lenders do not usually possess the expertise to enter this market, but there is no legal impediment to their doing so.

Under Chapter 23L, revenue bonds are issued by MassDevelopment (a state agency) under a bond indenture to finance the public infrastructure. Revenue bonds are a form of "conduit" financing, under which neither MassDevelopment or any public body assumes any payment risk. A prominent legend to this effect must appear on the bonds and any marketing material. The bonds are secured by the special assessment taxes imposed on the private property in the development zone; tax collections are deposited with the bond trustee and passed through as principal and interest payments to the bondholders.

The bond proceeds are deposited with the bond trustee in several funds. The largest is the "project fund" which is used to pay the costs of constructing the public improvements, using a construction draw-down process. Many indentures also provide for a "capitalized interest fund" which is used to pay interest on the bonds during the construction period. In some cases, the indenture may provide for a "debt service reserve fund" of up to 10% of the principal amount of the bonds, which is available to pay debt service on the bonds in the case of delinquency in payment of the underlying special assessment taxes. This fund can also be used to pay debt service and can be applied to abate special assessments at the end of the financing. Issuance costs are added to the principal amount of the bonds and may be briefly deposited in an "issuance cost fund." Moneys in these funds are invested in short-term highly rated securities, such as treasury bills, and this investment income is available to pay project costs, debt service and issuance costs from the appropriate fund.

Like a conventional construction loan, interest only is payable on the bonds during the construction period for the public infrastructure. Unlike a conventional construction loan, however, special assessment bonds have long-term maturities. The maximum bond term under Chapter 23L is 25 years (although many bonds issued in other states have a 35 year maturity). The special assessments are calculated, usually with the assistance of a consultant, at a rate sufficient to pay debt service over the term of the bonds. The bonds of course bear interest at a tax exempt rate, which under current market conditions, is about 60% to 65% of the taxable equivalent rate.

Many special assessment bonds have a “no acceleration” feature which limits the bondholders’ remedies in the case of a default resulting from a delinquency in payment of special assessments. In that case the bondholders may not demand payment of the entire outstanding principal amount, but may enforce the right to collect assessments from the delinquent owners.

The Bondholders’ Perspective. Bondholders like special assessment bonds because they are secured by *taxes*, which have a superpriority over any mortgages or other liens. Once the project is constructed and permanently financed, a default in payment of special assessments is quite remote, and the bonds are thus regarded as very high credit securities. The bondholders are at risk during the construction period, but these risks can be mitigated by strict underwriting criteria (discussed below). Nonetheless, a catastrophe such as the bursting of the “housing bubble” in 2008 can result in defaults. Even in the worst case, however, the state and its municipalities have no credit exposure, and only the developer and the bondholders have to face the consequences of default.

Underwriting Criteria. Underwriters of special assessment bonds will subject the development to intensive due diligence prior to bringing the bonds to market, including feasibility, marketing, engineering, and environmental studies, and may impose restrictions or conditions to satisfy underwriting criteria. These may include a capitalized interest fund or a debt service reserve fund, as discussed above. Because of the construction period risk, an appraisal of the value of the land, *as improved by the public infrastructure funded by the bonds,* is an essential component of the underwriter’s due diligence. For unrated debt, bondholders usually look for an appraised value-to-lien ratio of two or three times the principal amount of the bonds. Bonds may also provide for compliance with a debt service coverage ratio or a ratio of special assessments to appraised value of the assessed properties. The financial strength, experience and reputation of the developer is a vital factor. Generally speaking, a larger number of assessed property owners is preferable to a smaller number.

Summary. The benefits of Chapter 23L include the following:

- *Chapter 23L Is A Local Option, Not an Entitlement.* Chapter 23L does not create an entitlement for developers. Under Chapter 23L, it is *entirely optional* with the municipality, which may elect in its sole discretion to take advantage of its provisions in any given case, and to condition its approval of a special assessment project as it deems appropriate. It is also optional with the landowners in the development zone. Although a special assessment is a form of taxation, a development zone cannot be created without consent of all property owners in the zone. Those property owners would not logically consent to special assessments unless they perceived that the benefits outweigh the cost.

- *Chapter 23L Does Not Add Additional Debt Burdens To Municipalities*. Under Chapter 23L, the property owners in the development zone, not the municipality, have the obligation to finance the new public infrastructure improvements. The costs of the

infrastructure, and the debt service on the associated bonds, are paid by special betterment assessments on the privately-owned real property in the development zone. By law, the state and its municipalities have no liability on the special assessment bonds, which are "revenue bonds" secured only by the special assessments on the property in the development zone. In the case of a default on the bonds, the bondholders, not the state or the municipality, bear the entire risk of the investment. Moreover, betterment assessments are not included in tax revenues subject to Proposition 2 ½ limitations.

- *Chapter 23L Will Enhance Municipal Tax Revenues*. The municipality in which a development zone is created benefits from enhanced tax revenues from new construction added to the municipal tax base. Of course, new development is not costless, and may increase municipal expenses, including fire and police protection and (for residential developments) costs of public education. However, these are all factors which a municipality can evaluate in deciding whether or not to approve a specific improvement project.

- *Chapter 23L Does Not Affect Zoning or Land Use Regulation*. Private development in a Chapter 23L development zone is subject to all state, federal and local zoning and land use regulations applicable to conventional development projects.

- *Chapter 23L Can Be Used To Finance Municipal Improvement Programs*. Chapter 23L may be used to finance community development projects as well as to support private development. For example, neighborhoods needing upgrades to sewage disposal systems, roads or other public works may petition the municipality to fund the improvements by special assessments under Chapter 23L rather than by municipal tax revenues or general obligation bonds. Or business owners in a city with a downtown area with inadequate parking can petition the municipality to construct a new parking garage financed by assessments against the downtown property owners. The requirement that 100% of property owners in a development zone consent to special assessments may encourage "free-riding" and present an impediment to some community development projects. The original legislation filed in the Legislature provided for 80% approval for this reason, but the final legislation was amended to increase this percentage to 100%.

- *Special Assessment Bonds May Be Used Only For Public Infrastructure*. Under Chapter 23L, all proceeds of special assessment bonds must be used for public infrastructure improvements and costs of issuance. Under Chapter 23L, and under Federal income tax rules as well, all project infrastructure must be owned by public entities and bond proceeds may not provide property used for private activities.

- *Chapter 23L Can Enhance District Improvement Financing*. Chapter 40Q, enacted in 2003, permits municipalities to finance public infrastructure for development projects by issuing general obligation or revenue bonds secured by a pledge of the increased real estate tax revenues for the private project over a baseline amount. This

financing technique is called "tax increment financing" in other states, but that term was preempted by a different type of tax incentive; in Massachusetts, it is called "district improvement financing," or "DIF." The DIF program has a flaw: The increased tax revenues come on line only after completion of construction of the private development project. This can be a long time after the issuance of the DIF bonds, particularly if there are construction, regulatory, or other delays. Since debt service during this extended period may exceed the capitalized interest fund, bond underwriters have been reluctant to underwrite DIF revenue bonds without additional credit enhancement. Section 7 of Chapter 23L solves this problem by permitting special assessments under Chapter 23L to be used as a back-up to the incremental tax revenues, thus providing additional security for the bondholders.

Conclusion. Chapter 23L embodies a proven financing program successfully used in many other states to attract billions of dollars of investment capital for public infrastructure. It is a local option, not an entitlement, which allows each municipality to choose the rate of economic growth which best fits its needs. No state or local general tax revenues or credit are involved. Chapter 23L promises to be the rocket fuel needed to propel economic growth in Massachusetts.