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MEMORANDUM

TO	John Walsh, Office of the General Counsel Los Angeles Unified School District
FROM	Eugene Clark-Herrera, Orrick, Herrington & Sutcliffe, LLP and Mike Keeley, Law Office of Mike Keeley
DATE	July 7, 2008
RE	Charter School Finance Program Options Using GO Bond Proceeds

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Thank you for facilitating another constructive discussion on Tuesday, July 1. As you know a diverse group of stakeholders including the representatives of the California Charter Schools Association and Mayor Villaraigosa's office have asked us to spearhead efforts to identify legal obstacles to new facilities financing programs utilizing the proceeds of the Los Angeles Unified School District's ("District") general obligation bonds for non-District-operated charter schools. Specifically, the District's previous bond measure have provided that bond proceeds could be made available for charter facilities financing only if the District owns the asset financed with the proceeds of the bonds. We are seeking to construct programs in which the District's bond proceeds would be leveraged with other sources of capital (e.g., other tax-exempt bond proceeds or private capital) resulting in the acquisition and/or construction of non-District-owned charter school facilities. This memo describes specific proposed transaction structures that we believe to be permissible under the basic constitutional bonding authority pursuant to Proposition 39. We request that the District's Office of General Counsel ("OGC"), with assistance from outside counsel, analyze whether these proposed structures are feasible in light of federal tax law and other state law governing the District's operations.

We recognize that various policy issues exist with respect to each proposed structure that the Board of Education (the "Board") will need to evaluate as part of the implementation of any new financing program. This memo also identifies these issues to the extent we are able to recognize them. We are not seeking to accelerate the resolution of these policy issues, but we are hoping that we have an accurate list or catalogue of the issues that could drive the fundamental viability of the various programs. As indicated, we don't expect the District's bond counsel to render an unqualified opinion as to the viability of any hypothetical program, but we do request bond counsel's assistance in identifying all of the material legal obstacles to such programs.

We understand that on July 22 the Board may vote to present a new bond authorization to the electorate this November. The stakeholders we represent believe the questions posed here can be addressed before this vote on July 22. As you know some of these stakeholders have been disappointed with the results of prior school bonds, and have indicated that their support for the potential November bond is in part predicated on whether the District is willing to embrace more flexible programs for charter schools. We have worked to frame this exercise in a way that we believe can be resolved before July 22, and we invite further dialogue if you believe this is not feasible.

This memo presents the overview of each proposed new financing program.

I. TERMINOLOGY

For purposes of this memo, the following terms will be used:

1. "Operator" is the entity that holds a valid charter authorized by the District and that operates (or plans to operate) a charter school in the District. In general Operators lease facilities from Owners to take advantage of lease/rental payment reimbursement rules under state law ("SB 740"). In general, and for all purposes of this memo, Operators are nonprofit corporations exempt under Section 501(c)(3) (though there are some for-profit charter school operators, this memo assumes such entities would be excluded from the proposed financing programs).

2. "Owner" is the entity that acquires and/or constructs the charter school and leases it to the Operator. Owner typically borrows capital from Lender and obtains equity from philanthropic sources to finance the facility. Owner can be a nonprofit tax-exempt corporation or a for-profit school facilities development company. For all purposes of this memo, Owners will be assumed to be 501(c)(3) tax-exempt organizations (either independent third-parties or wholly controlled entities of the charter school).

3. "Lender" is a source of capital, such as a banking institution or an institutional investor that purchases tax-exempt private activity bonds (or "501(c)(3) bonds"). In some instances, charter schools have multiple lenders — e.g., a traditional bank may finance 60% to 80% of the project cost, and a "mission based lender" may provide an additional 10-30% of project costs as a subordinate loan. Alternatively, a charter school may finance 100% of the project with proceeds of an issue of 501(c)(3) bonds (issued through a conduit governmental joint powers authority).

4. "Operating Lease" is the lease from Owner to Operator. In some instances these leases include options to purchase in favor of the Operator; in other instances (typically where the Owner and Operator are related in some way, such as by having a common corporate parent), there is no such option.

II. CAPITAL INFUSION STRATEGIES

There are at least four mechanisms by which the District can invest capital in an Owner's charter school facilities project using proceeds of its general obligation bonds under the basic constitutional authority to "acquire and construct" or "lease" school facilities.

A. Subordinate Loan/Grant

District provides capital to Owner as a loan or as a recoverable grant. Owner promises to (i) construct school in accordance with applicable law, (ii) enter into Lease with Operator, and (iii) cause financed project to be operated as a charter school at the specified location for life of loan/grant. Covenants that "run with the land" would be recorded against the financed property (as provisions of the lease or a via a tax/regulatory agreement between Operator, Owner, Lender and District) to ensure use of the financed property as a charter school for the life of the loan/grant. District, Owner and Lender would enter into an intercreditor agreement to govern the workout/foreclosure process, should the original Operator default on its Operating Lease and a replacement Operator is required.

Tax issues: would bond funds be characterized as loan or grant for purposes of IRC Sec. 141(c)?

B. Purchase of Charter School Debt

If an Owner is constructing a facility using tax-exempt private activity bonds, typically the Owner engages an institutional trustee to act on behalf of the bondholders. This institutional trustee handles collection and asset management services, but will also play a role in workout or default situations if necessary. In this structure the District could efficiently infuse capital into a given project by using bond proceeds to purchase Owner's tax-exempt private activity bonds (the "Subordinate Bonds") under its statutory power to invest bond proceeds in other governmental bonds. Thus, the District would be the owner of the charter school's bonded debt. The Subordinate Bonds would be payable on a subordinate basis to the Owner's other tax-exempt private activity bonds (the "Senior Bonds") which are sold to finance the majority of the facility (perhaps 80%). District, Owner and Lender (in this case Lender would likely be represented by the institutional trustee) would enter into an intercreditor agreement to govern the workout/foreclosure process, should the original Operator default on its Operating Lease and a replacement Operator is required. Again, a tax/regulatory agreement would be recorded against the financed property to ensure use of the facility as a charter school for the term of the lease (or for some other specified period).

C. Prepaid Lease

District enters into a lease with Owner pursuant to which Owner as Landlord agrees to construct charter school in accordance with applicable law. Lease requires District to prepay rent from general obligation bond proceeds. District then subleases to Operator; if Operator fails to operate a charter school, District has remedies in the lease which include replacing Operator. Note in this approach either (x) District leases and subleases the entire school, in which event District may be obligated to pay rent whether or not Operator is paying rent (in effect serving as a guarantor of Operator's rent payments), or (y) District leases only the portion of the facility its financing supports, and District is not on the hook for facility costs beyond the portion it has financed. For example, if the District's bond proceeds finance construction of 2 out of 20 classrooms, perhaps the District's lease only pertains to those two classrooms, not to the entire facility. If the District wishes to control use of the entire facility, perhaps the District is forced to rent the entire facility from Owner, and sublease the entire facility to Operator. In either event an intercreditor agreement among District, Owner and Lender would be utilized to govern workout and foreclosure procedures. Further, the lease (or a tax/regulatory agreement) would be recorded against the financed property to ensure use of the facility as a charter school for the term of the lease (or for some other specified period).

Tax issues: would lease payment be characterized as a capital expenditure or working capital expenditure? If the latter, what implication for the maximum maturity of District's bonds?

D. Ground Lease to Charter School

District purchases land with bond proceeds and enters into long term ground lease with Owner for a nominal amount of rent. Owner agrees to (i) construct school in accordance with applicable law, (ii) enter into sublease with Operator, and (iii) cause financed property to be operated as a charter school at the specified location for life of the lease (or for some other specified period). The ground lease (and/or a tax/regulatory agreement) would be recorded against the financed property to ensure use of the facility as a charter school for the term of the ground lease (or for some other specified period).

Tax issues: does Owner/Operator's use of bond financed property comply with private use rules?

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III. CREDIT ENHANCEMENT

There are at least three mechanisms by which the District can guarantee an Owner's charter school facilities financing using proceeds of its general obligation bonds under the basic constitutional authority to "lease" school facilities.

A. Guarantee Lease Payments

District issues general obligation bonds on a taxable basis (to avoid hedge bond rules) and deposits proceeds into a trust fund to function as a debt service reserve fund for Operator/Owner facilities lease financing. Funds held in the trust are available to pay rental payments on Operators' leases that are financing leases as part of the acquisition/lease or construction of charter school facilities. District's bond proceeds are only utilized to pay such rent in the event Operator fails to pay rent. District's promise to pay rent on behalf of Operator from bond proceeds allows Lender to offer Owner more cost-efficient borrowing rate. The lease (or a tax/regulatory agreement) would be recorded against the financed property to ensure use of the facility as a charter school for the term of the lease (or for some other specified period).

Tax issues: would District's bonds be characterized as refunding bonds (refunding the Owner's tax-exempt bonds)? If so, can District's bonds be characterized as refunding bonds for tax purposes, but as new money for state law (Ed Code) purposes?

B. Moral Obligation Guarantee

This program would be substantially similar to program in Section III(A) above, where the District would provide a mechanism for guaranteeing Operator's rent payments under a financing lease, however the District's guarantee would take the form of a promise to issue general obligation bonds when and if necessary, rather than in advance for deposit to a trust/reserve fund. Deemed a "moral obligation", the District's promise to issue its bonds as needed would allow the Operator/Owner to access a more cost-efficient borrowing rate. Variations on this structure could include a mechanism whereby District utilizes existing building fund monies to make any Operator rent payment necessary under the program, and issues tax-exempt general obligation bonds to reimburse such expenditures. Under this program, the District could earmark a certain portion of its voted authorization for the purpose, without having to issue bonds until needed to satisfy the moral obligation. Again, the financing lease (or a tax/regulatory agreement) would be recorded against the financed property to ensure use of the facility as a charter school for the term of the lease (or for some other specified period).

Tax issues: are lease payments working capital or capital expenditures?

C. Contingent Lease Agreement

Substantially similar to proposal III(A) above, except the mechanism for the guarantee of the Operator's rent payments would be a contingent lease agreement. The District would enter into a lease agreement with Owner pursuant to which District's obligation to pay rent only arises if and when the Operator is unable to pay rent. The outcome is the same, being that District's agreement to guarantee Operator's rental payment obligation enables Owner to access a more cost-efficient borrowing rate. In order to fulfill its contingent lease obligation, District could either issue bonds on a taxable basis and hold such funds in trust until needed to pay rent, or District could earmark a portion of its voted authorization for such purpose and only issue bonds on a tax-exempt basis when and if needed.

Tax issues: are lease payments working capital or capital expenditures?

IV. LEGAL ISSUES

Each proposed program structure presents a variety of legal issues (aside from tax law issues) that must be analyzed in order to determine the feasibility of such program. Legal issues that have been discussed thusfar in previous meetings include:

- Field Act compliance – does District's capital or guarantee trigger Field Act compliance for entire facility? Does acquisition/renovation of existing facility versus new construction affect the outcome?
- Public bidding requirements – does District's capital or guarantee trigger public bidding requirements for awarding contracts in re renovation or new construction of facility?
- Bankruptcy law – what rights, if any, would Lender have against District in event of Operator/Owner bankruptcy?

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