DISCLOSURE GUIDELINES FOR LAND-BASED SECURITIES

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California Debt Advisory Commission
Disclosure Guidelines for Land-Based Securities
Acknowledgements

September 12, 1996

To all interested parties:

On behalf of the California Debt Advisory Commission, I am pleased to release *Disclosure Guidelines for Land-Based Securities*, a comprehensive set of recommendations intended to assist local government issuers of land-based securities in complying with the amendments to Rule 15c2-12 adopted by the U. S. Securities and Exchange Commission in November, 1994. This publication is part of the California Debt Advisory Commission's ongoing efforts to provide educational and technical assistance to state and local government agencies in California.

These *Guidelines* were developed in response to the concern that conflicting interpretations of how Rule 15c2-12 should apply to land-based financings might expose some local agencies and public officials to securities fraud liabilities. The most difficult implementation question that issuers must resolve is whether real estate developers should be considered *obligated persons* under the rule subject to initial and continuing disclosure obligations. The *Guidelines* recommend that issuers approach this question not solely within the context of Rule 15c2-12 itself, but rather through the broader framework of the materiality standard in federal securities law. If developer financial information is material to investors in land-based securities, then it should be disclosed, both to the primary market and secondary market for these securities.

In releasing these *Guidelines*, the Commission hopes to advance the notion that improvements in disclosure for land-based securities should improve liquidity in the market for these securities - which ultimately should benefit issuers. I commend these *Guidelines* to the attention of local officials and market participants.

Warmest regards,

Matt Fong
California State Treasurer
Chairman, California Debt Advisory Commission

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INTRODUCTION

In recent years, the Securities and Exchange Commission (SEC) has undertaken a two-pronged initiative to improve disclosure and deter fraud in the municipal securities market. First, the SEC adopted amendments to Rule 15c2-12 (the "Amendments") which indirectly require issuers of municipal securities, for the first time, to provide continuing disclosure to the securities market. Second, the SEC has stepped up enforcement of federal securities laws and regulations that apply to municipal securities transactions, bringing over 20 enforcement actions against participants in the municipal securities market in recent years. Clearly, federal oversight and regulation of municipal finance is on the rise, and it is incumbent upon practitioners, both public and private, to know the rules of the game.

- ***Purpose of CDAC Disclosure Guidelines for Land-Based Securities***. Nowhere is the need for education and guidance more acute than in the area of land-based financing (i.e., Mello-Roos and special assessment bonds). Since the adoption of the Amendments in November 1994, there has been a great deal of uncertainty in California over whether real estate developers initiating land-based financings should be required to disclose financial information to the securities market, in departure from past practice. In light of this uncertainty, CDAC became concerned that conflicting interpretations of the Amendments may expose some public officials to securities law fraud liabilities. It also became clear to CDAC that many public officials and staff need to develop a better understanding of the overall framework of municipal securities regulation. To assist public officials in developing disclosure documents that fulfill their requirements under law and minimize their exposure to fraud liabilities, CDAC has developed these *Disclosure Guidelines for Land-Based Securities.* The *Guidelines* are advisory only and are not intended to create a legal obligation to disclose any or all items of information discussed herein.

SECTION I: THE REGULATORY FRAMEWORK

As a matter of policy, the Rule 15c2-12 Amendments adopted by the SEC in 1994 represent a fundamental reform to the municipal market. By establishing a framework for the timely flow of information to the secondary market for municipal securities, the Amendments further the common objectives of all federal securities law - to protect investors and deter fraud in the market. But as a matter of law, Rule 15c2-12 regulates securities brokers and dealers, not issuers of municipal securities, and only indirectly requires issuers to provide continuing disclosure. The narrow construction of the rule limits its usefulness as a source of substantive guidance for issuers. The rule reserves for issuers the discretion to shape the form and content of their continuing disclosures, based upon certain materiality determinations reached by the issuer and its financing team at the time of the initial offering.

- ***Rule 15c2-12 Amendments.*** The Rule 15c2-12 Amendments prohibit a broker-dealer from acting as an underwriter in a primary offering of municipal securities (a "participating underwriter"), in principal amount of $1 million or more, unless it has reasonably determined that the issuer or an obligated person has undertaken to provide annual financial information and notices of material events to various information repositories. The Amendments define *annual financial information* to include financial information and operating data of the type included in official statements. The Amendments also specify eleven events that may be material for continuing disclosure purposes, including principal and interest payment delinquencies, nonpayment related defaults, and unscheduled draws on debt service reserves. For the most part, the Amendments eschew line item disclosure requirements in favor of issuer determinations as to the types of financial information and operating data to be disclosed and the obligated persons to whom it will relate.

- ***Developers as Obligated Persons.*** The central implementation question posed by the Amendments is whether developers should be considered *obligated persons* and therefore be subjected to initial and continuing disclosure obligations. This section recommends that issuers approach this question not solely within the constricts of Rule 15c2-12 itself, but rather through the broader framework of the materiality standard in federal securities law. If developer financial information is material to investors in land-based securities, then it should be disclosed, both to the primary market and secondary market for these securities. The decision to designate a developer an *obligated person* is merely a procedural matter that follows from this more fundamental determination.

- ***Materiality of Developer Financial Information***. The U.S. Supreme Court has held that a fact is material for disclosure purposes if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. In applying this materiality standard, the issuer may assume that a reasonable investor would consider it important to be informed of any foreseeable factor that might jeopardize the timely payment of debt service. This section explains why the creditworthiness of land-based securities issued to facilitate development is inextricably tied to the successful development and sale of properties in the financing district. It follows that in an undeveloped or partially developed financing district, the information needs of investors are not confined to the legal security for the bonds, but extend to indicators of the feasibility of the development project itself. In particular, a reasonable investor would consider it important to be informed of facts concerning the developer's experience, its plan for financing the development, and the sources of capital committed to that financial plan.

- ***Fraud Liabilities for Inaccurate or Incomplete Disclosures.*** The liabilities that issuers and their elected officials may incur for inaccurate or incomplete continuing disclosures are framed by the antifraud provisions of federal securities law, rather than Rule 15c2-12. Pursuant to the rule, issuers enter into contracts to provide continuing disclosure as a condition of having their bonds underwritten. If such a contract is breached, bondholders presumably can sue to force compliance. But once made, continuing disclosures are subject to the prohibitions on material misstatements or omissions found in the antifraud provisions - Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, including Rule 10b-5 promulgated thereunder - which apply to all communications of issuers expected to reach the capital markets. From a liability standpoint, the significance of Rule 15c2-12 is that it creates the occasion to disclose.

SECTION II: DISCLOSURE GUIDELINES FOR LAND-BASED SECURITIES OFFERINGS

Under Rule 15c2-12, the final official statement is the point of reference for determining the types of financial information and operating data to be reported annually and the obligated persons to whom this information will relate. A sometimes overlooked provision of the Amendments revised the definition of *final official statement* for purposes of the Rule, adding the requirement that financial information and operating data be provided for those persons, entities, funds and accounts that are material to an evaluation of the offering. As a result, Rule 15c2-12 now regulates, albeit indirectly, the contents of official statements in primary offerings. *The implication for issuers and their financing team members is that disputes over what should be disclosed and who should be required to disclose on a continuing basis must be resolved at the time of an offering, and the resulting determinations must be incorporated in the official statement and continuing disclosure contract(s) prepared at this time.*

- ***Security for the Bonds***. As a general rule, official statements should disclose complete information regarding the purposes of the offering, the plan of financing, the sources of payment, and any other security for the bonds, as well as all other material information. Additionally, official statements should identify and describe the relevant provisions of the state constitution and statutes and local resolutions that authorize and limit the issuance of the securities. Official statements prepared for land-based securities offerings historically have presented appropriate detail in these areas. The *Guidelines* in this section address the source of payment, land values and the covenant for superior court foreclosure.

- ***The Developer***. It is the view of CDAC that a major developer initiating a land-based securities offering to facilitate development should be designated an obligated person and subjected to disclosure requirements if the developer is in control of information that is material to bondholders. By designating a developer an obligated person and identifying the categories of financial information and operating data that it must disclose on an initial and continuing basis, the governmental issuer ensures that this flow of information will reach investors while minimizing its liability for the accuracy and completeness of this information. The key *Guidelines* in this section address disclosure of information concerning the management experience of the developer and the developer's audited financial statements.

- ***The Development Plan***. Because investors in land-based securities have an interest in the diversification of property ownership that results from the successful development and sale of property in the financing district, official statements should provide sufficient information for an assessment of the feasibility of the development plan. Investors consider it important to be informed that the key developer or developers have lined up sufficient funds to complete the project. This in turn necessitates the disclosure of key financial information concerning project costs, revenues and financing. While the facts and circumstances in each case dictate the appropriate level of disclosure, in general, the scope of the development plan is an important determinant of disclosure. The *Guidelines* in this section address the description of the project, land use entitlements and the developer's financing plan.

SECTION III: GUIDELINES FOR CONTINUING DISCLOSURE

In a land-based securities issue, continuing disclosure obligations fall on the issuer - the city, county, school district, special district or other public entity responsible for forming the Mello-Roos CFD or assessment district - and any developer satisfying criteria established by the issuer for the purpose of selecting obligated persons. During the initial stages of development, investors will closely monitor the developer's continuing disclosure to see if the project is generating cash flow according to expectations, so that the developer can cover its costs, including its special tax and assessment obligations. Interest in the developer's continuing disclosure will diminish over time as property ownership diversifies, and the informational needs of investors will narrow to factors commonly associated with the credit analysis of tax-backed securities, such as delinquency rates and assessed valuations.

- ***Continuing Disclosure Undertaking of the Issuer.*** A Mello-Roos CFD or an assessment district is administered by the governmental entity responsible for its establishment. In the documents authorizing the sale of land-based securities, the issuer - the city, county, school district, special district, or other public entity - covenants to keep accurate records and accounts of special tax or assessment collections and all transactions relating to the construction or acquisition of the project being financed. Thus, the issuer of the bonds is in control of key items of information relating to the security of the bonds that should be included in the Annual Report it prepares in fulfillment of its continuing disclosure undertaking. The *Guidelines* in this section address the status of the bonds, special tax/assessment collections, delinquency information, foreclosure status, land values, land ownership, land use, issuer financial statements, as well as material event reporting.

- ***Criteria for Designating Developers "Obligated Persons."*** There is more involved in crafting the developer's continuing disclosure undertaking than simply designating "the developer" to be an obligated person. To ensure the continuous flow of developer financial information to investors, several issues arising from the logistics of real estate development must be addressed at the outset. In a large-scale project, for example, development responsibilities may in fact be diffused among dozens of entities. Additionally, the issuer must account for the fact that not all significant development interests, however defined, may be identifiable at the time of the offering, since property can change hands at any time during the course of development. Rule 15c2-12 addresses contingencies such as these by allowing issuers to designate objective criteria in their continuing disclosure undertakings for the purpose of determining whether an entity is an obligated person. This section discusses the development of criteria for reaching obligated person determinations that reflect material financial indicators and any nonfinancial impediments to development.

- ***Succession of the Continuing Disclosure Obligation.*** One implementation difficulty posed by land-based financing concerns the succession of the continuing disclosure obligation from initial developers to successor developers who satisfy the issuer's continuing disclosure criteria. The enforceability of the continuing disclosure obligation is questionable, since the obligation is tied to property ownership, which is freely transferable. As a result, the successor developer is not party to the bond documents into which the issuer's continuing disclosure criteria are incorporated. In researching this issue, CDAC staff found that the only arguably enforceable way to impose a continuing disclosure obligation on all successor developers who satisfy the issuer's criteria is to record a covenant against the property itself. CDAC recommends, consequently, that issuers record a continuing disclosure covenant against the property which incorporates the criteria established by the issuer for the purpose of reaching obligated person determinations. The covenant should terminate at the time the developer no longer satisfies the criteria.

- ***Continuing Disclosure Undertaking of the Developer.*** The developer should be primarily responsible for the continuous flow of information to the secondary market concerning the status of the development project. In particular, the developer should disclose information on *actual* absorption relative to *projected* absorption. Information about absorption - the time frame in which property is developed and sold - is critical to investors because lot sales provide the cash flow necessary to sustain the development project and result in the diversification of property ownership, which improves the credit quality of the bonds. Additionally, the developer should disclose information on the sources of capital committed to its financial plan for development.

Introduction

The *Guidelines* in this section address development activity, the financing plan, financial statements, retail/commercial vacancy rates, as well as developer material event reporting.

INTRODUCTION

In recent years, the Securities and Exchange Commission (SEC) has undertaken a two-pronged initiative to improve the quality of disclosure in the municipal securities market. First, the SEC adopted amendments to Rule 15c-12 (the Amendments) which indirectly require issuers of municipal securities, for the first time, to provide continuing disclosure to the securities market. Essentially, the Amendments require issuers of municipal securities to update annually the financial and operating data disclosed in their official statements and to disclose certain material events on a continuing basis. Second, the SEC has stepped up enforcement of federal securities laws and regulations that apply to municipal securities transactions. In recent years, the SEC has brought over 20 enforcement actions against participants in the municipal securities market. Clearly, federal oversight and regulation of municipal finance is on the rise, and it is incumbent upon practitioners, both public and private, to know the rules of the game.

Nowhere is the need for education and guidance more acute than in the area of land-based financing (i.e., Mello-Roos and special assessment bonds). Since the adoption of the Amendments in November 1994, there has been a great deal of uncertainty in California over whether real estate developers initiating land-based financings should be required to disclose financial information to the securities market, in departure from past practice. In light of this uncertainty, CDAC became concerned that conflicting interpretations of the Amendments may expose some public officials to securities fraud liabilities. It also became clear to CDAC that many public officials and staff need to develop a better understanding of the overall framework of municipal securities regulation. To assist public officials in developing disclosure documents that fulfill their requirements under law and minimize their exposure to fraud liabilities, CDAC has developed these *Disclosure Guidelines for Land-Based Securities.* The *Guidelines* are advisory only and are not intended to create a legal obligation to disclose any or all items of information discussed herein.

LAND-BASED FINANCING IN CALIFORNIA

In California, *land-based* or *land-secured* financing refers to public debt issuance under the Mello-Roos Community Facilities Act of 1982 and the various special assessment acts authorized by California law. *Land* is the asset securing bonds issued under these laws. More precisely, Mello-Roos and assessment bonds are secured by liens on specified parcels of real property within a defined area (the financing district), and are neither general obligations of municipal issuers nor personal debts of property owners. Both the Mello-Roos Act and the special assessment acts provide for judicial foreclosure at the option of the governmental issuer to remedy delinquencies. Most land-based securities are issued to finance the construction or acquisition of infrastructure in real estate development projects. Bonds issued for this purpose sometimes are called *dirt bonds*, because the ultimate security for bondholders at the time of initial issuance of such bonds is the value of the raw, undeveloped land in the financing district. In addition to California, land-based financing is used extensively in Nevada, Arizona, Colorado, Texas and Florida.

The emergence of land-based financing as a principal form of public borrowing in California can be traced to the voter approval of Proposition 13 in 1978. The dramatic reductions in local property tax revenues resulting from this measure, coupled with the constraints on new taxes and general obligation bonds it imposed, presented local governments with the challenge of finding new ways to finance capital projects, particularly in developing areas. Cities and counties began to rely more on *developer exactions* - requiring developers to pay fees or install infrastructure as a condition of approving their land use plans. But merely shifting responsibilities to developers did not in and of itself solve the problem. The infrastructure required for a substantial new development - roads, schools, sewers, water distribution systems, parks, libraries and the like - is so costly that it generally must be financed over time. Yet, developer fees do not offer a sufficiently reliable revenue stream to secure bond issuance, and most developers realistically can not raise sufficient funds from private sources to cover all of their responsibilities.

As a result, local governments turned increasingly to *special assessments* in the aftermath of Proposition 13. Special assessments are legally distinct from taxes and therefore exempt from the constitutional restrictions on taxation imposed by Proposition 13. But the legal requirement for *special benefit* (discussed below) prohibited local governments from financing some of the more substantial infrastructure requirements of growth, such as schools, highways, and police and fire stations, through assessments. The need for a more flexible local revenue source for capital projects led to the enactment of the Mello-Roos Community Facilities Act of 1982. The key provisions of the special assessment acts and the Mello-Roos Act are discussed below.

California Special Assessment Acts

Special assessments (also called *benefit assessments*) are charges imposed on property to pay for the construction, acquisition, or maintenance of public improvements that confer a *special benefit* on that property beyond that conferred on the public generally. A special benefit, generally, means that the financed improvement increases the value of the property in proportion to the amount assessed to pay for that local improvement. Special assessments are legally distinct from taxes, in that taxes do not have to be levied on the basis of benefit received. Because of this distinction, the special assessment acts are not subject to the restrictions on taxation imposed by Propositions

13 and 62. Special assessments, unlike most taxes, do not require voter approval.[1] Instead, special assessments are subject to *majority protest* provisions of law. Under the Municipal Improvement Act of 1913, for example, if owners of a majority of property in a proposed assessment district protest its formation, the proposal must be dropped for at least one year, unless the governing board of the agency instituting the proceedings overrides the protest by a four-fifths vote. In any case, if the decision is to proceed and bonds are to be issued, a notice of assessment is recorded in the office of the county recorder, and an assessment lien attaches to the property.

There are numerous special assessment acts in California law. Additionally, the state's 88 charter cities may adopt their own assessment laws under the *municipal affairs* doctrine of the state Constitution, as long as those laws do not otherwise violate the state Constitution. The key special assessment acts date from the early part of this century: the Improvement Act of 1911, which specifies procedures for establishing assessment districts, levying assessments and issuing bonds; the Municipal Improvement Act of 1913, which specifies procedures for establishing assessment districts and levying assessments, but not for issuing bonds; and the Improvement Bond Act of 1915, which authorizes the issuance of bonds only. Most assessment bonds are issued under the authority of the 1915 Act.

The Mello-Roos Act

The Mello-Roos Community Facilities Act of 1982 authorizes cities, counties, school districts, special districts, joint powers authorities or other municipal corporations or districts to form community facilities districts (CFDs) for the purpose of financing infrastructure and certain services. CFDs are formed for funding purposes only and are governed by the governmental entity which authorizes their formation. CFDs are authorized to issue bonds secured by special taxes to finance both localized improvements, such as streets and sewers, and more regional facilities, such as schools and freeway interchanges. The formation of the CFD, the levy of the special tax, and the issuance of bonds require two-thirds voter approval. If a special tax proposal receives two-thirds approval and bonds are to be issued, a notice of special tax lien is recorded in the office of the county recorder, and a special tax lien attaches to all nonexempt property in the CFD.

Although the two-thirds voter approval requirement poses a substantial barrier in established communities, the Act provides that if fewer than 12 registered voters reside in a proposed CFD, the landowners vote on a one-acre-per-vote (or portion thereof) basis. Most CFDs are in fact initiated by developers through a landowner vote for the

[1] The Howard Jarvis Taxpayers Association and the Paul Gann Citizens Committee, taxpayer watchdog groups founded by the late sponsors of Proposition 13, plan to put a ballot initiative before the voters in November 1996, *The Right to Vote on Taxes Act*, that would add an amendment to the State Constitution severely restricting local governments' ability to raise revenues through special assessments and fees.

purpose of financing the installation of public infrastructure in real estate development projects. Local governments and developers generally prefer Mello-Roos financing to assessment financing in larger-scale development projects for a variety of reasons: the Mello-Roos special tax does not need to meet a special benefit test, and consequently can be used to address a wider range of facility and service needs; the special tax can be set at rates to provide greater than 1.0 debt service coverage; and the special tax may be set at lower rates for undeveloped land, minimizing a developer's holding costs. Since 1983, nearly $6 billion in Mello-Roos special tax bonds have been issued in California.

DRAFT *GUIDELINES* RELEASED ON MARCH 21, 1996

On March 21, 1996, CDAC released *Disclosure Guidelines for Land-Based Securities* in draft form. In general, the draft *Guidelines* recommended the disclosure of much more detailed information concerning developers than historically has been the case in land-based financing. The draft *Guidelines* consisted of four sections: an *Introduction* which provided background on land-based financing in California; *The Regulatory Framework*, which discussed Rule 15c2-12 and municipal securities regulation generally; *Disclosure Guidelines for Land-Based Securities Offerings*, which addressed primary market disclosure; and *Guidelines for Continuing Disclosure*, which addressed continuing disclosure for land-based securities.

The draft *Guidelines* identified for issuers the question of whether developers should be considered *obligated persons* and therefore be subjected to initial and continuing disclosure obligations as the central implementation question posed by the Rule 15c2-12 Amendments. The draft *Guidelines* recommended that issuers approach this question not solely within the constricts of Rule 15c2-12 itself, but rather through the broader framework of the materiality standard in federal securities law. If developer financial information is material to investors in land-based securities, then it should be disclosed, both to the primary market and secondary market for these securities. Insofar as the creditworthiness of land-based securities is tied to the successful development of real estate, the informational requirements of potential investors are not confined to the legal security of the bonds, but extend to indicators of the feasibility of the development project itself - information concerning the developer's experience, its financial plans for implementation of the project, and the sources of capital committed to that plan.

The draft *Guidelines* were distributed widely to municipal issuers and industry professionals, generating 30 comment letters and numerous phone calls and informal communications.

FINAL *GUIDELINES* APPROVED BY CDAC ON SEPTEMBER 12, 1996

The final *Disclosure Guidelines for Land-Based Securities* were approved by CDAC on September 12, 1996. The final *Guidelines* incorporate most of the suggestions received on the first draft, as well as some new material. Most of the suggestions were technical in nature, and every effort was made to ensure the accuracy of the *Guidelines*. The final *Guidelines* follow the same format as the draft and do not alter its central precept; that the materiality of developer financial information is the central consideration in implementing the continuing disclosure provisions of Rule 15c2-12. The key changes in the final *Guidelines* are summarized in the *Appendix*.

DISCLAIMER

CDAC cautions issuers that adherence to these *Guidelines* will not provide a safe harbor from SEC enforcement action. Securities fraud determinations depend upon the facts and circumstances surrounding a particular transaction, and the only authority for resolving questions of materiality and disclosure are the federal courts. CDAC has prepared these *Guidelines* to assist issuers in understanding and fulfilling their obligation to disclose material information to investors. Each provision of these *Guidelines* may not be applicable to every land-based securities offering. The specific facts and circumstances of each offering must be evaluated by the issuer, assisted by its legal and financial professionals, in order to determine the appropriate disclosure. Compliance with these *Guidelines* does not assure compliance with federal securities law; nor does noncompliance constitute a violation of these laws.

SECTION I

THE REGULATORY FRAMEWORK

As a matter of policy, the Amendments to Rule 15c2-12 adopted by the SEC in 1994 represent a fundamental reform of the municipal market. By establishing a framework for the timely flow of information to the secondary market for municipal securities, the Amendments further the common objectives of all federal securities law - to protect investors and deter fraud in the market. But as a matter of law, Rule 15c2-12 regulates securities brokers and dealers, not issuers of municipal securities, and only indirectly requires issuers to provide continuing disclosure. The Amendments and the Adopting Release, for the most part, neither specify written lists of required information nor provide definitive standards concerning what information should be disclosed. Rule 15c2-12 is a market regulation rule primarily concerned with *when* disclosure should occur rather than *what* should be disclosed. The narrow construction of the rule limits its usefulness as a source of substantive guidance for issuers.

The form of indirect regulation embodied in Rule 15c2-12 is attributable to statutory constraints on the SEC's authority in the area of municipal securities. Municipal securities are exempt from all but the general antifraud provisions of the key federal securities laws - the Securities Act of 1933 and the Securities Exchange Act of 1934 - which were enacted to curb speculative and abusive trading practices that contributed to the stock market crash of 1929. In general, these laws mandate registration and continuing reporting requirements for corporate securities issues. At the time these reforms were enacted, the municipal market was viewed as relatively free of abusive practices and was, moreover, dominated by institutional investors who were not perceived as needing the same protections as individual investors. In the interest of federal-state comity, Congress did not wish to impose comprehensive regulation on the municipal market absent a compelling reason to do so. The overall scheme of federal securities laws and regulations administered by the SEC thus was designed for corporate securities and is oriented toward the activities of securities brokers and dealers.

Over time, the growing participation of individual investors in the municipal market has eroded much of the original policy rationale for exempting municipal disclosure practices from comprehensive regulation, but political barriers to the direct regulation of municipal issuers have remained. Accordingly, the scope of federal regulation of municipal securities has expanded, but within this constraint. The Securities Act Amendments of 1975 brought municipal securities brokers and dealers under federal regulation and created the Municipal Securities Rulemaking Board (MSRB), a self-regulatory agency with broad rulemaking authority over municipal securities brokers and dealers. But Congress prohibited the SEC or the MSRB from requiring, directly or indirectly, the filing of any document with the SEC or the MSRB prior to the sale of municipal securities. Under the Tower Amendment, Congress further prohibited the MSRB (but not the SEC), from requiring municipal issuers, directly or indirectly, to furnish the MSRB or prospective investors with any documents, including official statements. The Securities Acts Amendments of 1975 thus established a limited regulatory scheme for the municipal securities market that did not entail direct regulation of municipal issuers. Since that time, the SEC has extended its reach into the municipal market by issuing reports and releases outlining its views on the responsibilities of market participants under existing law, and by devising rules to promote market efficiency in the distribution and trading of municipal securities.[2]

[I. A] SEC RULE 15C2-12

The original Rule 15c2-12, adopted by the SEC in 1989, requires any broker-dealer acting as underwriter in a primary offering of municipal securities (a "participating underwriter"), in the principal amount of $1 million or more, to obtain and review and make available to potential investors the official statement that the issuer has deemed final (complete except for certain information pertaining to the pricing that may be excluded) prior to making a purchase, offer or sale of municipal securities. The stated purpose of the rule is to deter fraud in the market by facilitating the underwriter's due diligence review and increasing the likelihood that investors will receive an official statement containing all material information necessary to make an investment decision. As such, the rule is consistent with and furthers the objectives of Section 15(c)(2) of the Exchange Act, which deals generally with the regulation of securities brokers and dealers. But the unstated objective of the rule, and its most significant effect on the municipal market, is to indirectly require issuers of municipal securities to produce official statements on a timely basis.

While the adoption of Rule 15c2-12 in 1989 established the precedent of indirect regulation of municipal disclosure practices by the SEC through broker-dealers, it did not mandate dramatic changes in public debt administration, since the vast majority of issuers already were in the habit of preparing official statements, if not always on a timely basis. But issuers of municipal securities historically have not provided continuing disclosure to the secondary market for municipal securities, and the adoption of Amendments to the rule in November 1994 requiring them to do so, albeit indirectly, necessitated an overhaul of public debt administration practices. The Amendments

[2] Notably, the SEC has stated its views on the disclosure obligations of municipal issuers and others under federal securities law in the release accompanying the proposed amendments to Rule 15c2-12. See *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*. SEC Release 33-7049 (March 9, 1994).

therefore represent a much more far reaching reform to the municipal market than the original rule.

The Amendments, codified in part as SEC Rule 15c2-12(b)(5), prohibit a broker-dealer from acting as an underwriter in a primary offering of municipal securities (a "participating underwriter"), in principal amount of $1 million or more, unless it has reasonably determined that the issuer or an obligated person has undertaken to provide annual financial information and notices of material events to various information repositories. The Amendments define *annual financial information* to include financial information and operating data of the type included in official statements. The Amendments also specify eleven events that may be material for continuing disclosure purposes, including principal and interest payment delinquencies, nonpayment related defaults, and unscheduled draws on debt service reserves.[3] By requiring underwriters to reasonably determine that issuers will commit to continuing disclosure as a condition of underwriting their bonds, the Amendments indirectly impose continuing disclosure requirements on issuers of state and local government securities.

For the most part, the Amendments eschew line item disclosure requirements in favor of issuer determinations as to the types of financial information and operating data to be disclosed and the obligated persons to whom it will relate. The issuer and its financing team must reach these determinations by applying the key principles of federal securities law, principally the materiality standard of Rule 10b-5 (discussed below), to the facts and circumstances of the individual case.[4] Financial information and operating data concerning the issuer and/or any obligated person deemed material and disclosed in the official statement is incorporated into the continuing disclosure contract the issuer and/or obligated person enters into for the benefit of bondholders. The contract, rather than the Amendments, primarily defines the issuer's and/or obligated person's continuous disclosure obligations, which may vary from transaction to transaction depending upon the source of payment for the securities and other factors.[5]

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[3] See *[III. A-2] Issuer Material Event Reporting* in *Section III: Guidelines for Continuing Disclosure*, pp. 38-39.

[4] As adopted, the Amendments incorporate the dominant theme of the more than 450 comment letters the SEC received on the Amendments as first proposed, expressed most prominently in the Joint Response to the Proposed Rule prepared by 13 industry and trade groups, including the Government Finance Officer's Association, as follows:

> "The Joint Response rejects the notion that a single, uniform disclosure rule can be applied across the board to all municipal issuers and proposes a flexible approach that permits issuers to determine the form and content of information to be provided to the market on a case-by-case basis using the materiality standard as a guidepost" *Joint Response to the Securities and Exchange Commission on Releases Concerning Municipal Securities Market Disclosure*, July, 1994. Executive Summary, page iii.

[5] See Robert Fippinger, The Securities Law of Public Finance (New York: Practicing Law Institute, 1995) *[6.8-1] Statutory Basis for the 1994 Amendments*, pp. 334.11-334.13.

The lack of specificity in the Amendments ultimately represents a concession to pragmatism on the part of the SEC, the recognition that the diversity of the municipal market does not lend itself to uniform disclosure regulations. The municipal market consists of securities issued for diverse purposes under the authority of thousands of separate statutes in different states. There is considerable variation of material information between classifications of municipal securities, and sometimes within classifications. There is diversity among the states in terms of constitutional and statutory provisions governing debt administration, accounting, financial reporting, and auditing. By contrast, the regimen of corporate line item disclosure administered by the SEC works well because similarities in the legal structures and financial reporting practices of corporations enable standardized SEC reporting forms to elicit material information. To superimpose an analogous system on the municipal market would require the SEC either to customize a regulation to suit the diversity of the municipal market or mandate uniform debt issuance and administrative procedures among the issuers of municipal securities, alternatives of questionable feasibility.

[I. B] DEVELOPERS AS OBLIGATED PERSONS

A disclosure regulation grounded in the contextual application of the materiality standard continually presents the challenge of moving from the abstract to the concrete. With respect to land-based financing, the critical implementation issue is whether real estate developers should be designated obligated persons under the Amendments and be subjected to continuing disclosure obligations. The *obligated person* concept in the Amendments extends disclosure responsibilities to entities other than governmental issuers responsible for payment of debt service, and is defined in pertinent part as follows:

> The term "obligated person" means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering.[6]

Under this definition, conduit borrowers such as private hospitals and universities that enter into contracts to pay debt service are obligated to provide ongoing disclosure of material information. The governmental issuer, which typically bears no direct liability for payment of debt service, is not the focus of disclosure in a conduit financing.

Real estate developers, unlike conduit borrowers, do not enter into contracts to pay debt service on land-based securities issues that would trigger disclosure obligations

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[6] SEC Rule 15c2-12(f)(10). This definition, however, specifically excludes providers of municipal bond insurance, letters of credit, or other liquidity facilities.

under the definition. But the definition does not condition the obligation to disclose solely upon such contracts. The phrase "other arrangement to support payment" [of debt service] was inserted to promote a broader interpretation of the continuing disclosure obligations of nongovernmental entities. The phrase seems purposefully vague, and can easily be interpreted to include the representations that a developer makes about its intentions to develop properties, since the financing often is initiated on behalf of the developer, who will be responsible for tax or assessment payments during the development phase.

California's public finance community initially balked at the notion of subjecting developers to continuing disclosure obligations. Official statements prepared for land-based securities offerings in California historically have not disclosed information concerning developer finances, for the reason that the special tax or assessment lien securing a Mello-Roos or assessment bond issue is not a personal obligation of the property owner. According to this view, any sort of developer financial disclosure would therefore be meaningless and potentially misleading, to the extent it implied that bondholders have recourse to assets other than the land in the financing district.[7] Disclosure documents for land-based securities have emphasized instead the value of the land in the financing district, which represents the ultimate security for bondholders.

[I. B-1] Footnote 74

The SEC was made aware of concerns about subjecting developers to continuing disclosure requirements during the comment period for the Proposed Amendments. This question was addressed in Footnote 74 of the Adopting Release, the relevant portion of which states:

> ...major taxpayers in a municipal general obligation issue would not be included in the definition; however, an undertaking covering a developer that is the sole landowner in a development district assessment financing in which the future collection of assessments to service the borrowing is dependent upon the developer as part of the financing may be appropriate.[8]

Footnote 74 offers mostly a common sense approach to implementing the *obligated person* definition in land-based financings. The message appears to be that the issuance of municipal securities as a development tool raises unique credit issues that deserve attention in disclosure documents. By stating that a continuing disclosure undertaking covering a developer *may* be appropriate, Footnote 74 recognizes the link between the creditworthiness of land-based securities and the successful development of real estate. But Footnote 74 falls short of providing definitive criteria for determining

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[7] See *Position Paper on the Application of Rule 15c2-12 to Land-Secured Financings*, ad hoc committee on California Assessments, Special Taxes and Other Financing Facilities (CASTOFF), June 16, 1995.

[8] SEC Release 34-34961 (Nov. 10, 1994) n. 74

disclosure responsibilities in land-based financings, and attempts to decode its language for hidden meanings have tended to produce more in the way of frustration than illumination. But perhaps this is because we have been looking in the wrong place.

[I. C] MATERIALITY OF DEVELOPER FINANCIAL INFORMATION

Applying the continuing disclosure provisions of Rule 15c2-12 in individual cases requires a certain nimbleness of mind, the ability to tack back and forth between broad principles of federal securities law and the discrete mandates of the Rule itself. Yet the debate over the past two years concerning the disclosure obligations of developers has erred toward intense scrutiny of the Amendments at the expense of reasoned evaluation of the materiality of developer financial information to investors in land-based securities. It may be that market participants were conditioned to viewing the continuing disclosure obligation of nongovernmental entities solely in terms of Rule 15c2-12 by the significant obligor concept in the proposed amendments, which would have imposed continuous reporting obligations on any entity satisfying specified criteria. But the obligated person concept incorporated into the final Amendments qualitatively transformed the continuing disclosure obligation, by making it contingent upon a materiality determination reached by the issuer at the time of an offering.[9] With respect to a land-based securities offering, the crucial question therefore is whether developer financial information and operating data is material to potential investors. If so, this information should be disclosed both at the time of the offering and continually. The decision to designate a developer an obligated person is merely a procedural matter that follows from this more fundamental determination.

[I. C-1] Rule 10b-5 Materiality Standard

The obligation to disclose material information is derived from the antifraud provisions of federal securities law, which prohibit fraudulent or deceptive practices in the offer and sale of securities. The language of the antifraud provisions applicable to municipal securities - Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, including Rule 10b-5 promulgated thereunder - is generally similar, though the courts have found substantive distinctions in determining fraud liabilities.

[9] The Adopting Release draws this distinction in its discussion of the shift from the criteria-based significant obligor concept in the Proposed Amendments to the materiality-based obligated person concept in the final rule:

> "Unlike the significant obligor concept in the Proposed Amendments, there is no need to include a specified percentage of payment in the definition of obligated persons, because the issuer and other participants will determine at the time of preparation of the final official statement which obligated persons are material to an Offering. In making that materiality determination, the parties to a financing will evaluate the facts of the Offering." SEC Release 34-34961, 59 F.R. at 59596.

Rule 10b-5, the principal antifraud provision under which SEC enforcement actions and investor lawsuits are brought, states the following:

> It shall be unlawful for any person, directly or indirectly....to make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances they are made, not misleading....[10]

The U.S. Supreme Court has held that a fact is material for disclosure purposes if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.[11] Materiality then is the standard for accuracy and completeness in disclosure, and municipal issuers should appreciate how it applies in the different contexts of their primary and secondary market disclosures. In light of this standard, *the goal of the issuer in preparing an official statement is to provide a complete, accurate, and objective description of all relevant factors that a reasonable investor needs to make an informed investment decision.* The official statement should clearly present material financial, demographic and legal information and may include or reference feasibility reports, appraisals or other market studies. Under the annual financial reporting requirement imposed by Rule 15c2-12, however, the issuer or obligated person is required to update only a subset of the information included in the official statement - the *financial information* and *operating data* concerning the issuer or obligated person. The issuer is not obligated to continually disclose all material information.[12] Yet continuing disclosures are subject to the prohibition on material misstatements or omissions found in the antifraud provisions, which apply to all communications of issuers expected to reach the securities markets. The issuer therefore must determine whether its continuing disclosure needs to be augmented in some manner so that it will not be misleading in light of the circumstances in which it is made.[13]

The liabilities that issuers and their elected officials may incur for inaccurate or incomplete continuing disclosures are framed by the antifraud provisions, rather than Rule 15c2-12.[14] Rule 15c2-12 itself, as a market regulation rule, does not appear to

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[10] 17 CFR § 240.10b-5.

[11] The standard originally was set forth by the Supreme Court in the context of a proxy solicitation case, *TSC Industries v. Northway*, 426 U.S. 438,449 (1976), and later expressly adopted as the standard for Section 10 (b) and Rule 10b-5 of the Exchange Act in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

[12] The event reporting requirements of the Rule to which issuers are subject, however, encompass most of the occurrences that pose a threat to the timely payment of debt service and which investors would find material.

[13] See Fippinger, *[6.8-2] The 1994 Amendments and the Antifraud Rules*, pp. 334.14 - 334.19.

[14] Any enforcement action brought by the SEC against a municipal issuer must be founded on one of these two statutory provisions mentioned above: Section 17(a) of the Securities Act or Section 10(b) of the Exchange Act, including Rule 10b-5 promulgated thereunder. The SEC is authorized to seek injunctive relief in federal courts whenever it appears that any person is engaged in or is about to engage in any act or practice that would constitute a violation of either act. The SEC also is authorized to institute administrative cease-and-desist proceedings and issue orders to enjoin persons

impose liabilities on issuers. Pursuant to the rule, issuers enter into contracts to provide continuing disclosure as a condition of having their bonds underwritten. If such a contract is breached, bondholders presumably can sue to force compliance. But once made, continuing disclosures are subject to the prohibitions on material misstatements or omissions found in the general antifraud provisions of federal securities law - which apply to all communications of issuers expected to reach the capital markets. *From a liability standpoint, the significance of Rule 15c2-12 is that it creates the occasion to disclose.*

In applying the materiality standard to official statements and continuing disclosure contracts being prepared for land-based securities offerings, the issuer may assume that a reasonable investor would consider it important to be informed of any foreseeable factor that might jeopardize the timely payment of debt service.[15] To ascertain whether financial information or operating data concerning developers is integral to the assessment of risk in land-based securities, and therefore material to investors, requires a brief digression into the role of land-based securities in real estate development.

[I. C-2] Credit Analysis Of Land-Based Securities

Real estate development typically occurs in two stages: *land development* and *building construction.* Land development refers to site acquisition, grading, infrastructure installation, and the other activities necessary to convert raw land into improved building sites or *pads* suitable for building. Building construction refers to the construction of residential, commercial and industrial structures for sale to end users. These two phases often but not always are carried out by different real estate developers. In the type of large-scale residential development common in California, developers often improve raw land for sale to *merchant builders* who contract with clients to construct residential units, or build such units on speculation, and assume the risk that they will find buyers for their product. Alternatively, the initial developer may take the project from start to finish.

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from committing further violations of the securities laws. Persons who violate federal securities laws also may be subject to civil and criminal penalties.

[15]In this regard, there is an important distinction between the *disclosure* of material risks and the *elimination* of such risks; the law requires the former, but not the latter. Most land-based securities are unrated and are purchased by institutional investors such as mutual funds that are adept at assessing the risks of complex credits. (By the same token, there is a larger retail market for land-based securities in California than in other states that issue these securities). The *suitability* of a security for a particular investor is a separate issue from disclosure, and is the subject of separate regulations that impose liabilities on brokers, rather than issuers.

[I. C-1(a)] Early Stages of Development Pose Greatest Risk. Most land-based securities are issued during the land development phase to finance the construction or acquisition of infrastructure necessary to convert raw land into improved building sites. This early stage of development, when property ownership is concentrated in the hands of one or a few developers, is the period of greatest credit risk for investors, because delinquencies on the part of a major property owner can deplete a reserve fund and trigger a bond default. A developer may run out of money and fall delinquent on its special tax or assessment installments for any number of reasons, but the most likely is that demand for its completed product simply does not materialize as expected. Given the long lead times required to plan a new development, secure government approvals and complete financing, a project conceived during boom times may encounter a slumping market upon arrival. Additionally, the developer may experience cost overruns, due to poor planning or problems with subcontractors or suppliers - or even the weather.[16] Anything that derails the development process may precipitate a liquidity crisis on the part of the developer and increase the odds of default.

If property values in a Mello-Roos CFD or assessment district are adequate, delinquencies should not result in investment losses to bondholders, since foreclosure sales should generate sufficient proceeds to pay delinquent principal and interest plus penalties.[17] For this reason, disclosure documents pay a great deal of attention to property values and value-to-lien ratios.[18] But land values during the early stages of development are highly volatile, which can undermine the accuracy of appraisals prepared for unimproved property. An appraiser who prepares a *discounted cash flow analysis* relies on the same market demand or *absorption* study used by the developer in its business plan or *pro forma*.[19] No developer undertakes a project that does not pencil out on paper; hence, the failure of a development project indicates that key assumptions in the developer's business plan were wrong - put simply, the project did not generate revenues as expected, or cost more than expected. If, in retrospect, the absorption study proved to be overly optimistic, then the appraisal overvalued the land, since the discounted cash flow analysis incorporated the same assumptions about the rate of development and sales prices of improved properties in the district.[20] Inaccurate appraisals present a problem for bondholders, since special tax and assessment liens have no intrinsic value independent of property values. In recent years, as the California real

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[16]See *[II. C-2] Land Use Entitlements* in *Section II: Disclosure Guidelines for Land-Based Securities Offerings*, p. 25.

[17]See *[II. A-3] Covenant for Superior Court Foreclosure* in *Section II: Disclosure Guidelines for Land-Based Securities Offerings*, p. 20.

[18]See *[II. A-2] Land Values* in *Section II: Disclosure Guidelines for Land-Based Securities Offerings*, pp. 19-20.

[19]The absorption study should be conducted first and be woven into the appraisal and pro forma prepared subsequently.

[20]In mathematical terms, a slower rate of absorption depresses land values by lengthening the discounting period. If, alternatively, the absorption study overestimates the sale prices of improved properties, lowering those estimates to reflect actual sales prices would depress land values by reducing net cash flow in each discounting period, even if the same rate of absorption is used.

estate market has weathered a protracted slump, several foreclosure sales have in fact failed to generate minimum acceptable bids, resulting in investment losses to bondholders.

Even if land values are adequate, the judicial foreclosure process itself is time-consuming, and a relatively uncomplicated action may take one or two years to complete, possibly resulting in an interruption of debt service. If the developer files for bankruptcy, the action usually will take longer, as the bankruptcy court likely will grant a stay of the judicial foreclosure covenant pending its approval of a plan to dispose of the developer's assets. For all of these reasons, investors in land-based securities have a keen interest in the success of the development project for which their bonds were issued, and are loath to rely on judicial foreclosure as a remedial action.

[I. C-2(b)] Diversification of Property Ownership Improves Credit Quality. As development activity progresses and property ownership diversifies, debt service payments become less vulnerable to delinquencies of major property owners, improving credit quality. Additionally, the development of property not only improves value-to-lien ratios, enhancing the security of liens on the property, but also usually results in a mortgage on the property which is second in priority to the district lien (and any other tax-supported lien) and thus gives the mortgage company the incentive to protect its security by making sure that the tax liens are paid. A developed CFD with diversified property ownership can in fact be quite a strong credit, since the excess debt service coverage can generate sufficient revenues to offset all but the most pessimistic delinquency scenarios (assessment bonds, by contrast, are secured by fixed liens that do not provide excess debt service coverage). Mature CFDs with diversified property ownership may be eligible to receive an investment grade credit rating, and many issuers in this position do so in conjunction with a refunding of the bonds.

In some fully developed districts a single taxpayer - typically a large employer - may constitute a significant portion of the tax base, perhaps 10 percent or more. Such tax base concentration, though never desirable, poses less troublesome credit questions if the major taxpayer is an established employer, rather than a developer engaged in improving the property. An ongoing business does not present the risks of development - cost overruns, construction delays, and slow absorption - that can jeopardize the timely payment of debt service. If the developed tax base is highly concentrated in retail and commercial uses under common ownership, some ongoing disclosure on lease rental revenues and vacancy rates may be appropriate.[21] But, in general, investor concerns about taxpayer liquidity diminish upon the completion of development.

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[21] See *[III. B-3(d)] Retail/Commercial Vacancy Rates* in *Section III: Guidelines for Continuing Disclosure*, p. 47.

[I. C-3] Disclosure Implications for Issuers

For the reasons explained above, the creditworthiness of land-based securities issued to facilitate development is inextricably tied to the successful development and sale of properties in the financing district. It follows that in an undeveloped or partially developed financing district, the information needs of investors are not confined to the legal security for the bonds but extend to indicators of the feasibility of the development project itself. In particular, a reasonable investor would consider it important to be informed of facts concerning the developer's experience, its plan for financing the development, and the sources of capital committed to that financial plan.

In the course of preparing these *Guidelines*, CDAC staff consulted with several mutual fund managers and analysts responsible for purchasing land-based securities - a group that collectively may be regarded as *reasonable* investors in these securities. These investors uniformly view the business plan or *pro forma* prepared by the developer as essential to the evaluation of land-based securities offerings. Opinion was divided on the value of developer financial statements; most analysts believe that financial statements are of secondary value, but a vocal minority asserts that the information often included in the statements, such as developer equity invested in the project, bank loans and deeds of trust on the property, can be very helpful in evaluating the ability of the developer to carry out its development program as planned.[22]

Insofar as it has not been industry practice to disclose developer financial information in official statements, investors have obtained it directly from developers, which has created a problem of partial disclosure in the market for land-based securities. If information such as developer pro formas, business plans or financial statements are material to one group of investors, it is material to the financial markets as a whole and should be included in official statements and, where appropriate, continuing disclosures. The determination that a developer is an obligated person should never be a matter of contention between the issuer and the developer: the issuer has the authority to withold bond financing unless the developer consents to obligated person status. The *Disclosure Guidelines* in the sections which follow largely address how to incorporate developer financial information into both initial and continuing disclosures.

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[22]Whatever the value of audited financial statements may be, the decision to designate a developer an obligated person automatically triggers the obligation to disclose the developer's audited financial statements annually, if available. See *[III. B-3(c)] Audited Financial Statements* in *Section III: Guidelines for Continuing Disclosure*, p. 47.

SECTION II

DISCLOSURE GUIDELINES FOR LAND-BASED SECURITIES OFFERINGS

Under the Amendments to Rule 15c2-12, the final official statement is the point of reference for determining the types of financial information and operating data to be reported annually and the obligated persons to whom this information will relate. Defining continuing disclosure obligations in terms of the official statement was an efficient rulemaking act on the part of the SEC: it avoided nettlesome form and content questions while ensuring that information continuously reported will remain relevant to investors, as long as the corresponding materiality determinations reached at the time of the offering remain valid. *The implication for issuers and their financing team members is that disputes over what should be disclosed and who should be required to disclose on a continuing basis must be resolved at the time of an offering, and the resulting determinations must be incorporated in the official statement and continuing disclosure contract(s) prepared at this time.*

A sometimes overlooked provision of the so-called "continuing disclosure amendments" to Rule 15c2-12 revised the definition of *final official statement* for purposes of the Rule, adding the requirement that financial information and operating data be provided for those persons, entities, funds and accounts that are material to an evaluation of the offering.[23] As a result, Rule 15c2-12 now regulates, albeit indirectly, the contents of official statements in primary offerings. This informational requirement complements the prohibition against material misstatements and omissions in disclosures found in the antifraud provisions of federal securities law, by identifying the subset of material information that constitutes the building blocks of continuing disclosure: financial and operating data of persons, entities, funds and accounts material to the evaluation of an offering.

With respect to land-based securities, the informational requirement for final official statements in Rule 15c2-12 necessitates an evaluation of the materiality of financial information and operating data relating to the developer. As discussed in the previous sections, detailed financial information and operating data concerning developers historically has not been disclosed in official statements for land-based securities offerings, for the reason that holders of the securities have no recourse to the assets of developers, apart from the land securing the bond issue. But financial information need not relate to the legal security for a bond issue for it to be material to investors. The nonrecourse

[23] As adopted in 1989, Rule 15c2-12 defined the term *final official statement* as a document or set of documents prepared by the issuer or its representative setting forth information concerning the issuer and the securities to be issued.

nature of land-based securities may make the disclosure of information concerning the feasibility of development projects more, not less, important, since a developer is less likely to abandon a project with a greater chance of success.

[II. A] SECURITY FOR THE BONDS

As a general rule, official statements should disclose complete information regarding the purposes of the offering, the plan of financing, the sources of payment, and any other security for the bonds, as well as any other material information.[24] Additionally, official statements should identify and describe the relevant provisions of the state constitution and statutes and local resolutions that authorize and limit the issuance of the securities. Official statements prepared for land-based securities offerings historically have presented appropriate detail in these areas. The *Guidelines* below provide background information on the key security features of land-based securities.

[II. A-1] Source of Payment

[II. A-1(a)] Mello-Roos Bonds

Describe the Rate and Method of Apportionment of the Special Tax. Include an estimate of debt service coverage.

Debt service on Mello-Roos bonds is paid from special taxes levied on real property. Because the Mello-Roos Act does not specify how the special tax should be apportioned, it is left to the local legislative body to decide how the tax is to be structured, subject to the restrictions that the tax may not be based on property values (i.e., an *ad valorem* tax) or on criteria related to income or sales. In practice, most special taxes are apportioned according to physical units of property, such as a per parcel or square footage basis. The special tax formula must specify a maximum tax rate and in most cases the formula assigns different tax rates to developed and undeveloped property, and to residential, commercial and industrial uses. The maximum tax can be set at a rate to provide greater than 1.0 debt service coverage. The special tax actually levied usually is lower than the maximum rate, and is sized each year to meet debt service requirements on bonds outstanding plus any additional amount needed to replenish the reserve funds and offset administrative expenses of the district.

The official statement should include a summary of the rate and method of apportionment of the special tax, identifying the rates to be applied to different classifications of property and estimating debt service coverage. Additionally, the official statement should discuss the mechanism for determining and apportioning prepayments in

[24] See *Section III: Securities Being Offered*, in *Disclosure Guidelines for State and Local Government Securities*. Government Finance Officers Association. Chicago: 1991.

whole or in part. More complete documentation on the rate and apportionment of the special tax should be included as an appendix to the official statement. Finally, the official statement should include an estimate of the total tax burden on the land, since cumulative tax burdens in excess of 2.0 percent of value may be a significant deterrent to sales.

[II. A-1(b)] Special Assessment Bonds

Describe the formula for assessing each classification of property in the assessment district.

Debt service on special assessment bonds is paid from special assessments levied on real property. Special assessments, unlike taxes, must be levied on the basis of the special benefit a property derives from the public improvement financed through the assessment. An engineer's report must be prepared that identifies the cost of the public improvement and distributes the cost to individual parcels according to the benefit received by each. In practice, special assessments, like special taxes, usually are levied on a per parcel or square footage basis, but may also be levied on the basis of other benefit formulas, such as front footage in the case of street improvements.

The official statement should include the engineer's report distributing assessment liens to each classification of property in the assessment district. Additionally, the official statement should include an estimate of the total tax burden on the land, for the reason mentioned above.

[II. A-2] Land Values

State the appraised value of the property and describe the appraisal methodology on which it was based. State the value-to-lien ratio for the bond issue.

The value of the land and improvements in a Mello-Roos CFD or an assessment district relative to the amount of tax-supported debt secured by liens on property in the district is referred to as the *value-to-lien* ratio. The value-to-lien ratio essentially measures the collateral of holders of land-based securities. The land is not collateral in the sense that a default transfers title to bondholders, but rather that adequate land values (in excess of liens) offer the best assurance that bondholders will receive all principal and interest payments due - if necessary, through the foreclosure and sale of delinquent properties.

Special tax and assessment liens have no intrinsic value independent of property values. The value-to-lien ratio, therefore, is among the most important items of information for disclosure documents to communicate. But it also is imperative that land values be derived from reasonably accurate appraisals. State law establishes a minimum 3:1 value-to-lien requirement for Mello-Roos special tax bond issues and requires local agencies to adopt standards for appraisals undertaken to establish this ratio. Pursuant to Government Code Section 53345.8 (a), CDAC has developed advisory appraisal standards that local agencies may adopt to fulfill their requirement under law.[25] Although assessment bond offerings are subject to neither the 3:1 value-to-lien ratio nor the appraisal standard requirement, CDAC recommends that agencies voluntarily comply with these requirements.

Insofar as the large number of parcels in the financing district typically precludes presentation of value-to-lien ratios on a parcel-by-parcel basis, the official statement should group this presentation by categories (3:1, 4:1, etc.) Any parcels falling below the 3:1 ratio should be separately identified.

[II. A-3] Covenant for Superior Court Foreclosure

State the time-frame for initiating judicial foreclosure proceedings on delinquent special tax or assessment liens.

Resolutions authorizing Mello-Roos special tax and special assessment bond issues typically include a covenant requiring the agency to initiate judicial foreclosure proceedings under specified circumstances and within a specified time period after special tax or assessment payments have become delinquent. To pursue this remedy, an agency first must file a lawsuit in Superior Court to request a judgment to foreclose on the delinquent lien. Upon receiving a judgment, the property may be sold at a foreclosure sale. The minimum bid at the foreclosure sale must be equal to the amount of the delinquency, plus penalties, interest, court costs and attorneys' fees. The foreclosure action may collect only these amounts; there is no acceleration of the lien (except in the case of 1911 Act assessment bonds which rarely are issued and where the bondholder, rather than the issuer, brings the action). Amounts recovered in the action in excess of that needed to replenish the reserve fund are used to extinguish any other liens on the property.

The official statement should summarize the covenant for Superior Court Foreclosure entered into by the agency, specifying the time-frame for initiating judicial foreclosure proceedings on delinquent parcels, and the time when payments will be considered delinquent (following the December 10th or May 10th tax or assessment installment). Additionally, the official statement should specify whether any extensions will be granted for individual property owners or classes of property owners, and the circumstances under which extensions will be granted.

[II. B] THE DEVELOPER

[25] *Appraisal Standards for Land-Secured Financings*, California Debt Advisory Commission. May 1994 publication 94-6.

For the reasons discussed earlier in these *Guidelines*, it is the view of CDAC that major developers initiating land-based securities offerings generally should be designated as *obligated persons* and subjected to disclosure requirements. By designating developers as *obligated persons* and identifying which items of financial information must be disclosed on an initial and continuing basis, governmental issuers ensure that this flow of information will reach investors. In addition to assuming responsibility for providing specified information, developers designated as *obligated persons* also assume liability for the accuracy of the information disclosed.

[II. B-1] Description of Property Ownership

Describe in general terms the form of organization of the entity undertaking the real estate development project, including the legal and working relationships of the principal participants and their roles with respect to the development project. Include a summary of property ownership.

In discussions about real estate development, there is a tendency to use the term "developer" rather loosely in reference to the key entity or entities with primary development responsibilities. The types of legal entities engaged in real estate development actually span a range of complexity from straightforward single asset partnerships to highly complex syndications involving holding companies and corporate ownerships. The most common structure is the partnership (general, limited and family), but individuals, corporations, real estate investment trusts (REITs), and pension trusts also are active in the real estate development business. These forms of ownership differ primarily in terms of (1) the treatment of income for tax purposes, (2) limitations on legal liability for losses, (3) the level of management control that equity investors may exercise, and the (4) marketability and transferability of ownership interests. The ownership structure chosen for a given project reflects the investment objectives of its key investors.

Entangled ownership interests and development responsibilities pose an impediment to the development of accurate disclosure documents. For disclosure purposes, it is most important to identify the entity that holds title to the property, which is on record at the county recorders office. Other ownership interests and property encumbrances should be described as clearly and concisely as possible.

[II. B-2] Continuing Disclosure Obligation

Specify criteria for designating developers "obligated persons" subject to initial and continuing disclosure requirements under SEC Rule 15c2-12.

Because property can change hands during the course of development, it is not possible to identify all obligated persons that will be material to the securities being offered at the time of an offering. The Amendments address this contingency by allowing issuers to make obligated person determinations over time through the use of objective criteria. This approach ensures that financial information and operating data will be provided for any developer meeting the objective criteria at the time the disclosure occurs. The objective criteria established for this purpose, and the developers satisfying these criteria initially, must be identified in the official statement.[26]

[II. B-3] Management Experience

Provide an overview of the relevant experience of the principal executive, administrative, financial and operating officers functioning on behalf of the developer. Include a detailed review of the developer's previous experience in projects for which land-based securities were issued.

Not all of the factors relevant to the evaluation of real estate development projects can be quantified. In the view of many credit analysts, the experience of the developer is the single most important predictor of the success of a proposed development project. Experience is important because the development process is fraught with regulatory, construction and market risks, which likely are to be navigated more skillfully by a developer with a proven record of success.

It often is noted that the special tax and assessment liens are nonrecourse, meaning that a developer can "walk away" from these obligations if the development project is not proceeding according to plan. Although it is true that the only recourse is to foreclose on delinquent liens, many developers choose to keep current on their tax obligations to preserve their reputations, even if they are losing money. Prospective investors in land-based securities should be provided detailed information on past special tax and assessment delinquencies and foreclosure actions for which the developer was responsible, as well as the actions that ultimately were taken to cure these events.

[26] See *[III. B-1] Criteria for Designating Developers "Obligated Persons"* in *Section III: Guidelines for Continuing Disclosure*, pp. 40-43.

[II. B-4] Audited Financial Statements

Provide audited financial statements, if available, for each developer designated an obligated person.

The debate over the appropriate application of the Amendments to land-based financings began as a dispute over the audited financial statements of developers, pitting the National Federation of Municipal Analysts (NFMA), who wanted this information disclosed, against developers and most underwriters and bond lawyers, who didn't. As the public finance industry honed in on this issue, it became clear that developer financial statements are of secondary analytical value to the business plan or *pro forma* prepared by the developer for the project in question. Information in audited financial statements by definition is dated by the time it is released. While it allows for the review of *past* financial performance, it is not sufficient to assess the capability of a developer to meet its *future* obligations. Evaluating land-based securities offerings on the basis of developer financial statements has been likened to driving by looking in the rear view mirror.

Nonetheless, there remains a great divergence of opinion on the question of the materiality of developer financial statements. Many analysts believe strongly that this information is essential for reviewing the creditworthiness of equity investors in development projects for which land-based securities are issued. This may be particularly important if the pro forma indicates that the project is scheduled to receive equity contributions in the future. Additionally, information often included in the statements, such as developer equity invested in the project, bank loans and deeds of trust on the property, can be very helpful in evaluating the ability of the developer to carry out its development program as planned. In the final analysis, materiality is a judicially determined standard, and the materiality of developer financial statements in any case can only be determined conclusively in the federal courts.

Whatever the materiality of developer financial statements may be, the Amendments require that audited financial statements be disclosed annually, if available, for all obligated persons. This may result in the following disclosure paradox: the issuer and its financing team determine that a developer's financial statements are not material for disclosure purposes, and therefore should not be included in the official statement; yet the developer satisfies the issuer's objective criteria for obligated persons, and therefore will be required to disclose its audited financial statements, if available. In this situation, it would be advisable to include the financial statements of the developer in the official statement, anyway, as a precaution. Insofar as materiality is a judicially determined standard, the issuer cannot be assured, outside of court, that it reached the proper conclusion concerning the disclosure of a developer's financial statements. If the bond issue eventually defaults due to the insolvency of the developer in question, the failure to disclose its audited financial statements may be introduced as evidence in an action brought either by the SEC or an injured investor against the issuer under Rule 10b-5.

The convoluted ownership structures of many development projects pose a more practical problem for issuers to consider: Does the development entity or entities satisfying its objective criteria for obligated persons represent the real parties in interest (that is, the real money parties) of the development project? The entity legally responsible for paying special tax or assessment installments, to whom the obligated person criteria is likely to apply, may be only a "shell" organization for the real parties in interest. If this is the case, then the financial statements disclosed may not be material; while the financial statements of the real parties in interest that are not disclosed may be material. There is no way to resolve this situation through the application of generic guidelines, as the variety of organizational structures defies classification, and it is not feasible or desirable to formulate obligated person criteria that encompass all entities with direct or peripheral development responsibilities. All the issuer can reasonably do is to adjust its objective criteria for obligated persons so that those persons identifiable and material to the financing at the time of the offering are designated as obligated persons.

[II. C] THE DEVELOPMENT PLAN

Because investors in land-based securities have an interest in the diversification of property ownership in the financing district, official statements should provide sufficient information for an assessment of the feasibility of the development plan.[27] Investors want to see evidence that the key developer or developers have lined up sufficient funds to complete the project. This in turn necessitates the disclosure of key financial information concerning project costs, revenues and financing. While the facts and circumstances in each case dictate the appropriate level of disclosure, in general, the scope of the development plan is an important determinant of disclosure. Specifically, each developer designated an obligated person should disclose the extent of its development plans and how it intends to finance them. Simply stated, each obligated person should describe how it plans to get from Point A to Point B, and state the key assumptions underlying its projections.

[27]This requirement may be satisfied by the inclusion of a feasibility report that incorporates pro forma cash flows and other relevant information.

[II. C-1] The Project

Describe the size and scope of the proposed development, including its proposed mix of residential, commercial and industrial uses. Discuss the extent of development planned by each developer as an obligated person. Include a summary of the absorption schedule.

The official statement should describe the plan of development for which the land-based securities are being issued. The plan of development should include a general estimate of the price ranges for each lot size or finished product, in current dollars. Each developer designated an obligated person should describe its role in the development.

[II. C-2] Land Use Entitlements

Describe the land use entitlements and other government approvals which need to be obtained for the development to proceed and the status of those entitlements and approvals.

The necessity of obtaining land use entitlements, environmental approvals and other government approvals represents a source of credit risk to bonds issued to facilitate the development of real estate development projects. It is not uncommon for Mello-Roos bonds or assessment bonds to be issued before all necessary land use entitlements are granted. Although a city or county would not intentionally approve the formation of a financing district and the issuance of bonds if it did not intend to grant all necessary entitlements, this source of regulatory risk exists until development rights are *vested* - meaning that they cannot be revoked by either local government or the electorate. Additionally, Mello-Roos bonds may be issued by school districts and special districts that have no control over land use regulatory decisions.

To minimize the financial risks posed by the land use approval process, developers and local agencies typically negotiate development agreements, which exempt the development project from future changes in land use regulations, such as amendments to general and specific plans, changes in zoning or subdivision ordinances, or new building regulations. In order to secure these assurances, the developer typically agrees to dedicate land to public uses and/or contribute funds for public purposes beyond what otherwise would be required by law. These agreements and arrangements should be discussed thoroughly.

[II. C-3] The Financing Plan

Identify the costs of development and the sources of funds to pay these costs - equity, debt, and public financing.

As a general rule, real estate projects do not generate sufficient operating income during the development phase to defray all development costs. As a consequence, the developer must raise enough capital to cover these costs, until such time that the project generates revenues. For disclosure purposes, investors in land-based securities issued to facilitate development would consider it important to know that the developer has sufficient liquidity to cover the costs of its planned development activity, including special taxes and assessment installments. Incorporating project financing information into disclosures need not be costly, since the information of concern to bondholders already is prepared as part of the developer's *pro forma* (which amounts to a feasibility analysis undertaken by a developer for any project proposal). The problem has been that this information does not reach potential investors uniformly, resulting in partial disclosure of material information.

Below is an admittedly simplified summary of a developer pro forma which nonetheless illustrates the general categories of project financial information that may be material for disclosure purposes.

Developer Pro Forma - Summary of Cash Flows

(Dollars in thousands $000) Revenues	1996	1997	1998	1999	Totals
Lot Sales					
lots		50	150	300	500
price		$90	$90	$90	
Gross Cash Flow		$4,500	$13,500	$27,000	$45,000
Expenses					
Land	$5,000				$5,000
Public Improvements	$5,000	$2,500			$7,500
Private Improvements		$2,500			$2,500
Special Tax		$500	$350	$150	$1,000
Total Expenses	$10,000	$5,500	$350	$150	$16,000
Sources of Funds					
Bond Construction Funds	($5,000)				($5,000)
Equity Investment	($2,500)				($2,500)
Project Cash Flow		($4,500)	($350)	($150)	($5,000)
Bank Loan	($2,500)	($1,000)			($3,500)
	($10,000)	($5,500)	($350)	($150)	($16,000)

In this example, a developer plans to improve 300 lots for sale to merchant builders over a four-year period. A Mello-Roos bond issue will provide $5 million to pay for installation of the public improvements needed to make the lots suitable for construction (streets, sewers, water, etc.) The size of the Mello-Roos bond issue is circumscribed by the necessity of maintaining a 3:1 value-to-lien ratio; as a result, only two-thirds of the public improvements eligible for public financing are financed in this manner. The remaining $2.5 million in public improvements, along with the $8.5 million in private development costs (land acquisition, private improvements, and special tax payments) will be paid for through developer equity (including project cash flow) and bank loans. The project is expected to generate $45 million in gross cash flow between 1997 and 1999, which will be used to defray costs, retire debts, and provide the return on equity.

Whether or not continuing disclosure subsequently will be required of merchant builders who purchase improved lots from an initial developer would be determined on a case-by-case basis, depending upon whether or not the builder satisfies the criteria established by the district for determining obligated persons.

The *Guidelines* below discuss how to incorporate these categories of information into disclosure documents.

[II. C-3(a)] Project Costs

The first step in assessing the feasibility of a development proposal is to estimate the total cost of development, which serves as the basis for determining the amount of capital that must be raised to complete the project. Development costs include not only the *hard costs* of land acquisition, labor, materials and developer's profit, but also the *soft costs* of planning, permitting, financing and marketing the finished product. If the developer is to realize its profit projections, the actual costs of planning, construction and marketing cannot overrun its cost estimates. If the developer experiences cost overruns, it might run out of money prior to the completion of development, potentially jeopardizing the timely payment of debt service on bonds issued to facilitate development, as well as other costs. Official statements for land-based securities should therefore review developer cost estimates.

[II. C-3(b)] Project Revenues

The next step in evaluating the feasibility of a development proposal is to estimate the amount of revenue that will be generated from the sale of improved properties. The revenues generated from the sale of improved properties allows the developer to retire its construction loans and return equity and profit to investors. The time-frame in which properties can be developed and sold is referred to as the ***rate of absorption***. The rate of absorption provides a benchmark for the ongoing credit analysis of land-based securities. If demand for the finished product does not materialize as expected, the developer will have to hold properties longer than expected, and may run out of money to pay carrying costs, including tax and assessment payments. By definition, the rate of absorption is also the rate of diversification of property ownership in the district. The diversification of property ownership strengthens the credit quality of land-based securities by making the bonds less vulnerable to delinquencies of major property owners.

The estimated absorption rate also is central to the appraisal of land value. Under the *discounted cash flow* methodology which typically is used to value land in the early stages of development, the projected rate of absorption is used to estimate the project's gross cash flow over time, from which development costs are subtracted to arrive at net cash flow, which then is discounted by an appropriate discount rate to arrive at the present value of the raw land. The estimated rate of absorption also is integral to the development of the rate and method of apportionment of the special tax. Since special tax formulas typically apply different tax rates to developed and undeveloped property, the rate of absorption allows the special tax consultant to estimate the amount of revenue generated by the special tax throughout the development process.

Due to the significance of the absorption estimate, an ***absorption study*** typically is prepared by a consultant specializing in the field. The absorption consultant undertakes a detailed examination of economic and demographic data to estimate how quickly properties can be improved and sold to builders and/or end users. The consultant first reviews economic indicators such as employment growth to project regional population growth and the likely demand for residential, commercial and industrial development. The consultant then estimates the proportion of overall demand that will be captured by the development project in question by product type. This requires the consultant to assess the supply of existing inventory and product under construction relative to anticipated demand, and to reach a subjective judgment as to the competitiveness of the subject property. Finally, the consultant develops an *absorption schedule*, which projects the dates of sale and sale prices of improved properties to merchant builders and end users.

CDAC recommends that the governmental issuer retain control over the selection of the absorption consultant, but bill the developer for the cost of the study. The results of the absorption study should be incorporated into appraisal at the instruction of the issuer. The issuer should include a summary of the absorption study in the official statement. Actual absorption should then be tracked relative to these projections as part of the continuing disclosure prepared by developers.

[II. C-3(c)] Funding Sources

The costs of development run into the millions of dollars for any large-scale development project. To cover these costs, the developer must obtain commitments from equity investors and lenders in sufficient amounts. The developer's ability to do so will turn on two factors: (1) its own reputation and track record, which serves as the best indicator of the likely success of the development proposal; and (2) the preparation of detailed pro forma cash flow statements that indicate the project will generate enough cash flow to satisfy lenders and provide investors with an adequate rate of return.

[II. C-3(c)(i)] Equity. The equity investor owns or holds title to the real estate under development and puts its capital at risk in the expectation of earning a return on its investment from the development and sale of properties. Equity investments are channeled through the legal ownership structures discussed earlier in this section, principally partnerships, corporations, REITs and pension trusts. The developer initiating a project must, by necessity, invest its own capital and/or attract other sources of capital to pay for a large proportion of *front end* costs such as planning, land acquisition, grading and feasibility studies. The intention of the developer at this juncture is to invest enough in the project to demonstrate its feasibility to potential lenders. The cash flow generated by the sale of developed properties is divided by contractual arrangement between lenders and equity investors after operating expenses have been paid. Lenders get paid first, in an amount negotiated in advance. The lower risk of debt is reflected in its higher priority on the right to project cash flows. Equity investors are entitled to the residual cash flow, which may be positive or negative. The return on equity is uncertain in amount.

The equity investment in a real estate development project demonstrates the commitment of the principal developers to the project, which helps to attract debt financing. Of particular interest to lenders, including investors in land-based securities issued to facilitate development, is the amount of cash equity invested in the project. *Cash equity* refers to the actual dollar amount invested in the project for land and improvements, as well as legal fees and entitlements. This concept differs from appraised value, which might be considerably higher, if land has appreciated between the time the developer acquires the property and development commences. Appraised value is a relevant measure of the legal security of bondholders, as discussed at the outset of this section. But cash equity may serve as a better measure of the commitment of the developer, and should be disclosed in official statements, if available.

The equity contributions of investors to real estate development projects should be thoroughly discussed in official statements and quantified in the section which summarizes the developer's financial plan.

[II. C-3(c)(ii)] Bank Debt. Most developers seek to *leverage* their capital investments by borrowing as much as possible of the amount needed to cover development costs. This allows the developer to maximize its own rate of return (since lenders are entitled only to a fixed amount and do not share in profits) and limit the amount of capital it must put at risk to complete the project.[28] For their part, lenders want to see some equity commitment on the part of the borrower, whether that borrower is a real estate developer or a consumer seeking a home or car loan. In addition to demonstrating commitment, the equity participation protects the lender against declines in the value of the asset that serves as collateral for the loan. By loaning the developer only 50 percent of its development costs, for example, the lender will be in better position to liquidate the assets securing the loan should it become necessary to foreclose on its private lien or deed of trust.

The terms and conditions under which private lenders extend credit to developers at each stage of the development process reflects the risks associated with that phase. The demand for real estate is highly cyclical, sensitive to changes in employment and interest rates. Given the long lead times involved in planning new development and securing financing and necessary government approvals, there are no guarantees that demand will materialize as expected once a project finally comes on line. There is a saying among real estate lenders that "land does not turn into money until it is sold" - in other words, the farther that development activity is from the point of final sale, the greater the risk involved.[29] The economic principle underlying the reticence of real estate lenders is that fluctuations in the demand for real estate ultimately are reflected in the value of raw land. If the price of finished housing declines, the value of building lots must also go down, since declining housing prices will affect the price that builders will pay for lots. In the builder's calculus, a slumping housing market obviously lowers the price it can expect to receive on a finished house, but it does not reduce the costs of labor and materials; nor does it diminish the profit margin that the builder expects to receive for its efforts. The only variable that the builder can control to offset a decline in housing prices is the price that it is willing to bid for improved lots. For construction activity to be profitable at lower housing prices, the price of improved lots must decline by a sufficient amount.

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[28]To complicate matters, there are certain hybrid credit structures under which lenders receive an equity interest.

[29]This aphorism applies most literally in cases where the developer carries the project through all of its phases - planning, land acquisition, construction and marketing - and does not realize revenues until the sale of the finished product. But it also is relevant in the more typical scenario where the developer improves raw land for sale to merchant builders, since a slowdown in the housing market will dampen demand for improved lots.

Land Development Loans. Banks, savings and loan institutions, REITs, pension funds and other lenders may extend *land development loans* to developers to finance the costs of acquiring and improving raw land. Land development loans can be secured only after the developer demonstrates that the project is viable by financing some portion of land acquisition, engineering and design work through equity investments, and producing marketing or feasibility studies that cast the proposed development in a positive light.

Because land development is the riskiest stage of the development process, lenders establish higher equity requirements. The current maximum loan-to-value ratio for a land development loan, which may be dictated by law for certain federally chartered lending institutions, is 65 percent. The term of the loan parallels the anticipated rate of absorption, anywhere from 1 to 3 years up to 6 or 7 years, or more. Developers may in advance agree to terms to extend the loan in the event of slower-than-expected absorption. As with construction loans, proceeds are disbursed in installments, taken down in stages as work is completed. Lenders are repaid from the proceeds from the sale of improved lots. As collateral, lenders receive a first mortgage on the property, that is often accompanied by a deed of trust on the property, which is subordinate to all property taxes, special taxes and special assessments. Additionally, the lender may require the developer to post a performance bond or additional collateral.

Construction Loans. The same lenders may extend construction loans to developers and merchant builders for the purpose of financing the construction of residential, commercial or industrial product for sale to end users. Construction loans are structured in a manner similar to land development loans in terms of security and draw schedules, but construction loans are shorter-term, typically 1 or 2 years. The construction loan is *taken out* or retired with the proceeds of the *permanent financing* (i.e., mortgage) obtained by the purchaser of the finished product, or the builder itself, if the builder wishes to retain ownership and lease the property.

All bank loans and lines of credit should be thoroughly discussed in the official statement and quantified in the section which summarizes the developer's financial plan.

[II. C-3(c)(iii)] Public Finance. The third source of capital available to cover development costs, in addition to equity and debt, is public financing, principally the issuance of land-based securities - Mello-Roos and assessment bonds. Public finance is a form of debt financing that differs from private debt financing in several important respects. First, public finance is a form of long-term financing that amortizes debt over a 20 to 30 year period. Private land development loans and construction loans, as noted above, are forms of short-term financing that must be *taken out* with long-term mortgage loans by the ultimate property owners. Second, land-based securities are debts not of developers but of government entities. As such, land-based financing represents a source of "off-balance sheet" financing to developers, which is particularly appealing. Moreover, the developers' outlays for special tax and assessment installments can be minimized through the use of capitalized interest, and in the case of Mello-Roos bonds, lower tax rates on undeveloped land.

Increasingly since the passage of Proposition 13 in 1978, cities and counties in California have conditioned development approval upon the developer providing for the installation of necessary public infrastructure, through developer fees, exactions and public financing. In such an environment, public financing usually represents the lowest costs of funds available to the developer. Certain legal and economic factors, however, impinge upon the use of public financing for development purposes. First, only facilities authorized by law are eligible for financing. The Mello-Roos Act and the various assessment acts authorize the levying of special taxes and assessments and the issuance of bonds for the purpose of financing specified facilities that typically are publicly owned and operated, such as schools, roads, sewers and parks. For the most part, these are public purpose facilities eligible for tax-exempt financing under federal and state law. In certain instances, taxable bonds may be issued to finance eligible private development costs. But not all private costs of development are eligible for land-based financing, even on a taxable basis.

Second, the amount of public infrastructure that may be financed through the issuance of land-based securities is constrained by land values, or more specifically the value-to-lien ratio. Under state law, Mello-Roos bond offerings must achieve a minimum 3:1 value-to-lien ratio, and most issuers of assessment bonds, though not required to do so, voluntarily adhere to this standard. Additionally, the amount of debt issuance is constrained by limits on the total tax and assessment burden in new development projects voluntarily adhered to by local agencies. Experience has shown that the marketability of new developments may be impaired once the total residential property tax burden exceeds 2 percent of value (including the 1 percent ad valorem property tax rate levied pursuant to Proposition 13 along with special taxes and assessments). While value-to-lien ratios and tax burdens vary from project to project, some observers estimate that on average only 65 percent or so of eligible facilities can be publicly financed because of these constraints. The rest must be funded through debt and equity.

All sources of public financing should be thoroughly discussed in official statements and quantified in the section which summarizes the developer's financial plan.

SECTION III

GUIDELINES FOR CONTINUING DISCLOSURE

The financial information and operating data presented in the final official statement with respect to issuers and obligated persons establishes the framework for continuing disclosure under the Amendments to Rule 15c2-12. In a land-based securities issue, continuous reporting requirements fall on the issuer - the city, county, school district, special district or other public entity responsible for forming the Mello-Roos CFD or assessment district - and any developer satisfying criteria established by the issuer for the purpose of selecting obligated persons (as discussed below). The issuer will report information and material events concerning the status of bond funds and accounts and tax collections, while the developer will report information and material events concerning the progress of development and its overall financial condition. During the initial stages of development, investors will closely monitor the developer's continuing disclosure to see if the project is generating cash flow according to expectations, so that developer can cover its costs, including its special tax and assessment obligations. Interest in the developer's continuing disclosure will diminish over time, as property ownership diversifies, and the informational needs of investors will narrow to factors commonly associated with the credit analysis of tax-backed securities, such as delinquency rates and assessed valuations, which are included in the issuer's continuing disclosure.

As suggested above, the criterion that should be used for assigning disclosure responsibility for specific items is the *control of information.* The governmental issuer should assume responsibility for disclosing items such as delinquency rates and the balances in bond funds and accounts, while the developer should assume responsibility for disclosing information on the status of development activity and the capital structure of the project. Separating disclosure responsibilities in this manner should absolve local governments from liabilities for incomplete or inaccurate developer disclosures.

[III. A] CONTINUING DISCLOSURE UNDERTAKING OF THE ISSUER

A Mello-Roos CFD or an assessment district is administered by the governmental entity responsible for its establishment. The issuer - the city, county, school district, special district, or other public entity - does not pledge general governmental revenues to the repayment of bonds, and therefore financial information relating to the issuer generally will not be deemed material to investors and included in the official statement. In the documents authorizing the sale of land-based securities, the issuer covenants to keep accurate records and accounts of special tax or assessment collections and all transactions relating to the construction or acquisition of the project being financed. Thus, the issuer is in control of key items of information relating to the security of the bonds and therefore should enter into an undertaking to provide annual financial information and event reporting for the benefit of bondholders.

[III. A-1] Contents Of Issuer Annual Report

The information items listed below are derived from continuing disclosure undertakings prepared by issuers of Mello-Roos and assessment bonds since the effective date of the Amendments and evaluation criteria established by various institutional investors in land-based securities.[30] This list is comprehensive, and all items may not be appropriate for individual continuing disclosure undertakings. Certain references to ratios may or may not be appropriate in individual instances. The list is not intended to create disclosure requirements or a legal obligation to provide any or all items of information.

[III. A-1(a)] Status of Bonds

1. Principal amount of bonds outstanding.

2. Balance in the improvement fund or construction account and statement as to estimated sufficiency to complete bond financed improvements (not required after completion).

3. Balance in capitalized interest fund or account.

4. Balance in debt service reserve fund, and statement of the reserve fund requirement. Statement of projected reserve fund draw, if any.

5. Balance in other funds and accounts held by issuer, fiscal agent or trustee related to the bond issue.

[30] Continuing disclosure is not a new requirement for issuers of Mello-Roos bonds. Issuers of Mello-Roos bonds sold on or after January 1, 1993, are required to file annual financial information with CDAC with respect to balances in funds and accounts of such bonds and special tax delinquencies. Since January 1, 1994, issuers of Mello-Roos bonds also are required to report draws on reserve funds and payment defaults to CDAC, regardless of when the bonds were sold. On a voluntary basis, the California Public Securities Association has in recent years funded comprehensive studies on the fiscal status of Mello-Roos bond issues and 1915 Act assessment bond issues. These sources provide the basic analytical framework that has been incorporated into continuing disclosure undertakings prepared for land-based securities offerings issued since July 3, 1995.

6. Statement as to the types and maturities of investments held in funds and accounts. Certification that actual investments are in accordance with permitted investments.

7. Additional direct and overlapping debt, as well as all *authorized* direct and overlapping debt.[31]

[III. A-1(b)] Special Tax/Assessment Collections

1. Amount of special tax/assessment levied and received (and amount of maximum special tax). Break down by developed and undeveloped land according to categories established in the rate and method of apportionment.

2. Breakdown of special tax/assessment levied and collected for top 10 payers of special taxes or assessments in district. Identify acreage for each taxpayer.

[III. A-1(c)] Delinquency Information

1. Special tax or assessment delinquency rate for most recent year available.

2. Total amount of delinquencies.

3. Number of parcels delinquent in payment.

4. Amount of penalties and interest that applies to delinquencies.

5. Statement of whether district has fulfilled its covenants, within the time parameters established in the official statement, to initiate judicial foreclosure proceedings upon delinquent properties.

[31] The amount of authorized debt is important for assessing the potential for dilution of value-to-lien ratios and burdensome overlapping tax rates, and therefore may be material for disclosure purposes. Overlapping debt information is not in the issuer's control, and the issuer likely will need to retain consulting services to obtain this information annually for reporting purposes. Insofar as this information does not directly pertain to the operations of an obligated person (the issuer), it is not clear that this information, even if material, should be considered *annual financial information and operating data* that must be disclosed under the Amendments.

6. Identity of each delinquent taxpayer responsible for 5 percent or more of total special tax/assessment levied, and the following information:[32]

    - assessor parcel number
    - assessed value of applicable properties
    - amount levied, amount delinquent by parcel number
    - status of foreclosure proceedings

[III. A-1(d)] Foreclosure Status

1. Summary prepared by foreclosure counsel, if applicable, identifying whether there are any conditions preventing or impairing the timely resolution of the foreclosure process.

2. Summary of results of foreclosure sales or transfers (if applicable).

[III. A-1(e)] Land Values

1. Total assessed value of all parcels subject to the special tax or assessment, and previous year's assessed value. Distinguish between developed and undeveloped property.

2. Updated appraisal, if available.

3. Value-to-lien ratios of parcels based on assessed valuation, grouped by category.[33]

4. Summary and discussion of pending tax appeals.

[32] Development companies may be divided into different subsidiaries for the purposes of holding land and developing properties. Some developers may also act as home builders through one or more merchant builder entities. In reporting delinquent taxpayers, the developer and related entities should be identified, if possible.

[33] In partially developed districts, overall value-to-lien ratios may present a distorted picture of the creditworthiness of outstanding bonds, if value is concentrated in the developed part of the district. Property values in the undeveloped part of the district may not be adequate to generate sufficient proceeds in the event that delinquent liens must be foreclosed upon. Disclosure documents should identify any parcels that fall below the 3:1 ratio.

[III. A-1-(f)] Land Ownership Summary

List of landowners subject to 5-20 percent or more of the annual special tax or assessment levy (as of March 1 of the current fiscal year, from records of the County Assessor). Include following information:

1. Name

2. Assessor parcel number

3. Acreage

    - fully developed (final inspection for all parcels).

    - under development (building permit has been taken out on at least one parcel but final inspections for all parcels have not occurred).

    - undeveloped (no building permits have been taken out).

4. Land use classification.

5. Assessed value (land and improvements).[34]

6. Trust deeds (if available). List the amount and identify the properties subject to the deeds and the owners of the property.

[III. A-1(g)] Land Use Summary

Any changes in land use classification from the time of issuance.[35]

[34] In accordance with constitutional restrictions imposed by Proposition 13, real property is only assessed to market value when it is brought on to the tax rolls or at the time that is sold. Otherwise, property assessment increases are limited to 2 percent annually. As a consequence, assessed values have lagged market values, often substantially, for most of the period since the passage of Proposition 13. Although market value is a better measure of bondholder security than assessed value, property in Mello-Roos CFDs and assessment districts typically is appraised at market value only at the time of an offering. Rule 15c2-12 does not require that property be reappraised for continuing disclosure purposes. Reporting assessed valuations annually at least gives investors an indication of the trend in market values.

[35] Changes in land use classifications are particularly relevant for Mello-Roos bond issues because of the resulting reconfigurations of tax burdens on property, which may affect the marketability, and hence, the feasibility, of the project.

[III. A-1(h)] Audited Financial Statements

Under Rule 15c2-12(b)(5)(i)(B), the audited financial statements of obligated persons are required to be disclosed annually, if available. The governmental issuer of land-based securities always falls under the definition of *obligated person* by virtue of its contractual commitment to pay debt service through the funds and the accounts of the Mello-Roos CFD or assessment district.[36] The issuer therefore must disclose its audited financial statements annually, if available. The audited financial statements may be incorporated into the issuer's annual report, or may be delivered separately.[37]

This regulatory requirement will create a burden for the issuer, unless it already is sending its audited financial statements to the NRMSIRs under its continuing disclosure agreement for another bond issue, and may satisfy its requirement for the land-based securities issue by reference. If not, the issuer must send its audited financial statements to the NRMSIRs, even though this information is not material to the financing and will not be disclosed in its official statement.

[III. A-2] Issuer Material Event Reporting

As part of its continuing disclosure undertaking, the issuer should agree to give, or cause to be given, notice of the occurrence of any of the following events with respect to the bonds, if material:

1. Principal and interest payment delinquencies.

2. Non-payment related defaults

3. Unscheduled draws on debt service reserves reflecting financial difficulties.

4. Unscheduled draws on credit enhancements reflecting financial difficulties.

5. Substitution of credit or liquidity providers, or their failure to perform.

6. Adverse tax opinions or events affecting the tax-exempt status of the bonds.

7. Modifications to rights of bondowners.

[36] To avoid confusion, these *Guidelines* do not refer to governmental issuers of land-based securities as obligated persons, even though issuers satisfy the criteria specified in Rule 15c2-12(f)(10).
[37] The issuer's annual report will update the financial information and operating data disclosed in its official statement, which may be based upon unaudited numbers.

8. Bond calls.

9. Defeasances.

10. Release, substitution, or sale of property securing repayment of the Bonds.

11. Rating changes.

12. Commencement of any foreclosure proceedings against properties securing the Bonds, identifying the parcels, their ownership, and the amount of the delinquency.[38]

[III. A-3] Termination Of Issuer Reporting Obligation

The issuer's undertaking should specify that its reporting obligation will terminate upon the legal defeasance, prior redemption or payment in full of all of the bonds.

[III. B] CONTINUING DISCLOSURE UNDERTAKING OF THE DEVELOPER

There is more involved in crafting the developer's continuing disclosure undertaking than simply designating "the developer" to be an obligated person. To ensure the continuous flow of developer financial information to investors, several issues arising from the logistics of real estate development must be addressed at the outset. In a large-scale project, for example, development responsibilities may in fact be diffused among dozens of entities - perhaps one or a few large developers plans to improve lots for sale to merchant builders, who in turn will purchase 5, 10, 15 or 20 lots at a time. Subjecting all of these entities to continuing disclosure obligations may result in an unwieldy flow of information that ultimately detracts from, rather than enhances, the credit analysis of land-based securities issued on behalf of the project. The issuer therefore must distinguish between the various development interests involved in a project for disclosure purposes, determining which ones are in control of information material to investors. Additionally, the issuer must account for the fact that not all significant development interests, however defined, may be identifiable at the time of the offering, since property can change hands at any time during the course of development.

[38] This is the only material event of the list that is not specified in Rule 15c2-12(b)(5)(i)(C).

The need to discern between development interests for disclosure purposes essentially is a question of materiality. As recommended in *Section I: The Regulatory Framework*, the decision to designate a developer an obligated person should follow from the more fundamental determination that financial information pertaining to the developer is material to investors.[39] But while reaching obligated person determinations through the prism of materiality may work fine with respect to developers active at the time of an offering, the Amendments do not permit this approach to be applied prospectively.[40] Instead, the rule addresses contingencies such as those presented by land-based financings by allowing issuers to designate objective criteria in their continuing disclosure undertakings for the purpose of determining whether an entity is an obligated person.[41]

[III. B-1] Criteria For Designating Developers "Obligated Persons"

The provision of the Amendments allowing for the use of objective criteria to reach obligated person determinations was designed to provide issuers of pooled financings with the flexibility to assign continuing disclosure obligations over time. This approach ensures that as the composition of the bond pools change over time, financial information and operating data will be provided about those persons who at the time of the disclosure meet the objective criteria. The Amendments permit, but do not require, this approach for nonpooled issuers. Land-based financings, though different from pooled financings in most respects, are a good candidate for the criteria-based approach insofar as the logistics of real estate development preclude identification of obligated persons at the time of an offering.

The Amendments do not specify minimum standards for or otherwise dictate the content of the criteria used to designate obligated persons, leaving this to the discretion of the issuer.[42] The Amendments specify that if the issuer chooses to develop objective criteria, it must disclose the criteria in its official statement and apply the criteria

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[39] See discussion in *[I. C] Materiality of Developer Financial Information* in *Section I: The Regulatory Framework*, pp. 11-16.

[40] Assessing the materiality of financial information pertaining to successor developers as they acquired property for development purposes, and somehow imposing the continuing disclosure requirement on any deemed material, would present a logistical challenge for issuers, to say the least. It would seem that a bias against reaching subsequent materiality determinations would be ingrained in such a dubious procedure. The Adopting Release indicates that the SEC considered and rejected this approach:

> "...some commentators suggested replacing the entire definition of significant obligor with the concept of materiality, in which the issuer and the other offering participants would determine, on a continuing basis, whose information would be provided." SEC Release 34-34961, 59 F.R. at 59595.

[41] Paragraph (b)(5)(i)(A) of Rule 15c2-12.

[42] The Adopting Release notes, however, that in the case of bond pools, the criteria presumably will include the percentage of payment support of debt service. This also is recommended as the key criterion for land-based securities, as discussed herein.

consistently both at the time of the offering for the purpose of primary market disclosure and thereafter for the purpose of continuing disclosure.

While the use of objective criteria alters somewhat the process for reaching obligated person determinations, it should not sever the connection between continuing disclosure obligations and materiality. The issuer, after all, is responsible for developing the criteria, and in doing so, will reflect upon the facts and circumstances evident at the time of the offering. The *prospective* application of objective criteria does, however, introduce a measure of conjecture to the obligated person determinations automatically triggered in the future, insofar as objective criteria developed at the time of an offering cannot possibly account for future facts and circumstances. But if, over time, the criteria for some reason no longer seem appropriate, the issuer may consider amending the developer's undertaking.[43]

[III. B-1(a)] Percent of Special Tax/Assessment to be Levied in the Coming Year

The design of objective criteria for obligated person determinations is an exercise in translating the subjective reasoning of materiality determinations into discrete measurements and categories. Of paramount importance is the selection of a benchmark to measure the scope of a developer's involvement in the project. The simplest measure for doing so is land ownership. The issuer may require, for example, any developer owning more than a certain percentage of property in a district - say 20 percent - to enter into a continuing disclosure undertaking. But tax burdens do not always correlate to measurements of property ownership in Mello-Roos CFDs, since different tax rates usually apply to developed and undeveloped land. A developer may own 15 percent of the land in a CFD, for example, but be responsible for 30 percent of the special tax expected to be levied in the coming year; alternatively, a developer may own 30 percent of the land, but be responsible for only 15 percent of the special tax expected to be levied in the coming year. If the issuer assigns continuing disclosure obligations to any developer owning 20 percent or more of the property in the CFD, an obligation would be triggered in the first case but not the second. Similar distortions can arise in assessment districts (though the apportionment of assessments typically mirrors property ownership.) Thus, land ownership may not be the best criterion for deciding which developers should be subject to continuing disclosure obligations.

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[43]The Adopting Release notes that an undertaking may not be amended unilaterally by either the issuer, an obligated person, or any other party. "Contrary to the suggestion of some commentators, the undertaking would be meaningless if issuers and obligated persons could unilaterally determine that certain types of information no longer were material." SEC Release 34-34961, 59 F.R. at 59599. The circumstances under which an undertaking may be amended are enumerated in the letter from Robert L. D Colby, Deputy Director, Division of Market Regulation to John S. Overdorff, Chair and Gerald J. Laporte, Vice-Chair, Securities Law and Disclosure Committee of the National Association of Bond Lawyers, July 23, 1995 (NABL 1), Question 2.

A better criterion for assigning continuing disclosure obligations to developers is the ***percent of the special tax or assessment expected to be levied in the coming year***. This criterion correctly identifies developers who represent a significant portion of a district's tax base. In the example above, the issuer would have attained the opposite and appropriate result if it had specified that any developer responsible for 20 percent or more of the special tax expected to be levied in the coming year would be required to enter into a continuing disclosure undertaking.

Threshold of Special Tax/Assessment Payment. This criterion of course must be refined to provide for specific threshold for triggering the obligation to disclose - the 20 percent figure cited in the example above has emerged as something of an industry standard, but it is not a legal requirement. In settling upon a threshold, it once again makes sense for the issuer to approximate a materiality determination, relying on its perception of the creditworthiness of the key developers involved and the risk inherent in the project itself. The issuer may wish to investigate financial information pertaining to all developers involved in the project at that juncture, and conduct financial analysis to ascertain how long the bond issue can sustain delinquencies by key developers.

CDAC staff has reviewed official statements for several land-based securities offerings issued after July 3, 1995 (the effective date of the Amendments) and found that the maximum threshold for establishing continuing disclosure obligations for developers ranges from **5 to 20 percent** of the special tax or assessment to be levied in the coming year.[44] In the view of CDAC, this range seems reasonable, and reserves appropriate flexibility for local agencies to reach determinations after considering the facts and circumstances of each case. A lower threshold may be appropriate if the tax base is diffused and the issuer is concerned that delinquencies of a few builders (each responsible for less than 20 percent of the expected levy) could jeopardize the timely payment of debt service.

The issuer's criteria should further specify that continuing disclosure requirements shall apply only to landowners planning or actively engaging in the development of property in the district, as opposed to passive landowners. This advice is consistent with that provided by the SEC in Footnote 74 of the Adopting Release, which states that the status of a person as a major taxpayer is not alone sufficient reason for subjecting that person to continuing disclosure obligations.

The issuer also should consider whether the development entity or entities satisfying these criteria represent the real parties in interest (that is, the real money parties)

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[44]The 5 percent figure is the lowest of agencies using the criterion of special tax to be levied in the coming year. The absolute minimum threshold was not specified in terms of percent of the tax levy, but in the form of a continuing disclosure covenant recorded against individual lots, terminating upon the sale of the lots to retail purchasers.

of the development project. If the legal landowner that is responsible for paying special tax or assessment payments is only a "shell" behind the real party in interest, then the issuer needs to consider whether financial information concerning the real party in interest is material to the securities. If so, the issuer should adjust its criteria accordingly. Unfortunately, it is impossible to offer more detailed advice within the framework of these *Guidelines*, insofar as the variety of possible development structures defies classification. All the issuer can reasonably do is to make sure that its objective criteria for obligated persons will result in the disclosure of financial information of those persons identifiable and material to the financing at the time of the offering.

Finally, the issuer should consider whether its criteria reflect any nonfinancial impediments to development which may be material to investors. Although financial considerations will predominate the issuer's deliberations, the situation may arise, for example, where a developer who otherwise would not satisfy the issuer's objective criteria has not received all land use approvals necessary for the project to proceed, a fact that likely would be deemed to be material to investors. In such a case, the issuer may want to designate the developer an obligated person and require it to enter into a continuing disclosure undertaking, so that the developer would be responsible for releasing information on changes in the status of its land use approvals to the securities markets. It is conceivable that other circumstances may arise where an issuer's objective criteria should reflect nonfinancial factors.

In the view of CDAC, the criteria above are adequate for the purpose of reaching obligated person determinations for developers. Implicit in these criteria is the premise advanced in these *Guidelines* that developer financial information generally is material to investors in land-based securities; the criteria merely allow the issuer to identify significant developers, both in the present and future. It is conceivable that these criteria can legitimately be elaborated and refined, to better approximate a materiality determination. But issuers facing pressures to adopt more elaborate criteria should be cautioned that such proposals may be advanced as a guise for absolving developers individually or as a class from continuing disclosure obligations, since any set of criteria can be massaged to this end. Thus, a straightforward approach would appear to have significant benefits.

[III. B-2] Succession Of The Continuing Disclosure Obligation

While the use of objective criteria allows the issuer to *identify* developers as obligated persons, both at the time of an offering and thereafter, criteria alone are not sufficient to bind successor developers to the continuing disclosure obligation. A successor developer is not party to the bond documents into which the criteria are incorporated - be it the indenture, trust agreement, or resolution of issuance. At the time of an offering, the issuer can require developers satisfying the criteria to enter into continuing disclosure undertakings as a condition of issuance, but the issuer has no leverage over successor developers. The issuer cannot, for example, coerce a successor developer to enter into a continuing disclosure undertaking by withholding the benefits of the financing, since the infrastructure already is in the ground (or even if it is not, the issuer cannot postpone construction or otherwise alter its contractual obligations to bondholders). The succession of the developer's continuing disclosure obligation is threatened by the fact that land is freely transferable (and is in fact likely to change hands during the course of development, perhaps several times).

Neither the Amendments nor the Adopting Release identify succession of the continuing disclosure obligation as a problem under the criteria-based approach, probably because this issue does not arise in the context of pooled financings, where the issuer can function as the "gatekeeper" for the bond pool, requiring subsequent obligated persons to enter into undertakings as a condition of participation.

Over the past year, the public finance industry in California has formulated a response to the problem of succession in the form of an "Assumption Agreement" concept built into the original developer's continuing disclosure undertaking. Under this approach, the original developer agrees to negotiate as a condition of the sale of land it owns at the time of an offering to any successor developer (who satisfies the objective criteria), that the successor developer enter into a continuing disclosure undertaking substantially in the form of the original developer's. If the original developer is unable to negotiate an Assumption Agreement with the successor developer, then the original developer remains obligated to disclose annual financial information on the land it owned at the time of the offering. Conditioning the termination of an original developer's disclosure obligation in this manner gives it the incentive to negotiate an Assumption Agreement with a successor developer.

The flaw in the Assumption Agreement concept is that it is ineffective in cases where property ownership transfers through the operation of law - specifically, through a bankruptcy or foreclosure - rather than through a negotiated purchase and sale. In a bankruptcy filing, the petitioner's assets, including, for example, a developer's land holdings in a Mello-Roos CFD or assessment district, are disposed of in accordance with a plan approved by the bankruptcy judge. The bankrupt developer has no opportunity to negotiate an Assumption Agreement with whoever ultimately assumes ownership of the land; nor can the issuer interject itself into the bankruptcy proceedings. The issuer similarly is bereft of options if a bank forecloses a deed of trust on property in a Mello-Roos or assessment district and assumes ownership of the property (or sells it to another developer). In light of the troubled history of many land-based financings in California, the Assumption Agreement approach seems inadequate for ensuring the succession of the developer's continuing disclosure undertaking.

[III. B-2(a)] Recording Development Conditions, Covenants, and Restrictions

In crafting the developer's continuing disclosure undertaking for a $14 million Mello-Roos bond issue in 1995, the County of Los Angeles developed an alternative approach to ensuring the succession of the developer's continuing disclosure obligation.[45] The County's experience with land-based financing in the years prior to the effective date of the Amendments had sensitized it to this issue: the County had formed six Mello-Roos CFDs to facilitate development projects; in two, the original developer went through or came close to bankruptcy; in another, a bank foreclosed its deed of trust and assumed ownership of an entire improvement area within the CFD. In light of its experience, the County had misgivings about the Assumption Agreement concept, and, working with its attorneys, found that the only arguably enforceable way to impose a continuing disclosure obligation on all successor developers is to record a covenant against the property itself.[46]

For a covenant recorded against property to be valid, it must relate to the use, repair, maintenance or improvement of property, or the payment of taxes and assessment on property, and satisfy other conditions. Such covenants typically relate to the maintenance of landscaping or prohibit the physical alteration of dwellings in planned developments. A covenant regarding continuing disclosure obligations is not a typical covenant to do or refrain from doing certain acts upon land for the benefit of others. Nevertheless, the agreement to perform the covenant (i.e., to provide annual financial information and event reporting) is a condition precedent to the issuance of bonds to finance public improvements for the benefit of property owners in the district. The failure to agree to perform the covenant will impede and possibly preclude the construction and acquisition of necessary public facilities in the district, to the detriment of property owners.

Insofar as there is no case law in this area, no attorney can give an unqualified opinion that a continuing disclosure covenant recorded against the land in a Mello-Roos CFD or assessment district will be enforceable in all circumstances. Nevertheless, the County, prior to recording a "Declaration of Covenants Regarding Disclosure Obligations" on the lots in the CFD, received a qualified legal opinion that the covenant should be enforceable by the County against the original and successor developers. The opinion noted that with respect to bankruptcy, a trustee or debtor-in-position would have the power to assume or reject the covenant if it is deemed to be an executory contract. There are no standards set forth in the Bankruptcy Code for determining the propriety of

[45]CFD No. 3 Valencia/Newhall Area (Stephenson Ranch).

[46]Title 3, Part 1, Division 3 of the California Civil Code provides that covenants made by a covenantor to do or refrain from doing acts on his own land will run with the land and therefore be binding on successors and assignees of the covenantor if the convenants are duly authorized and executed.

such a rejection. A Bankruptcy Court would likely apply a business judgment test to determine the effect that such a rejection would have on the estate of the debtor.

In summary, the succession of the developer's continuing disclosure undertaking must be addressed if the Amendments are to effect permanent improvements to the quality of information provided to the secondary market for land-based securities. Insofar as a continuing disclosure covenant recorded against the land in a Mello-Roos CFD or assessment district offers the only conceivably enforceable method of ensuring succession of the continuing obligation on developers who obtain property through the operation of law, rather than negotiated purchase and sale, CDAC recommends that issuers consider this approach. The covenant should incorporate the criteria established by the issuer for the purpose of reaching obligated person determinations, and should terminate at which time the developer no longer satisfies the criteria.

[III. B-3] Contents Of Developer Annual Report

The developer should be primarily responsible for the continuous flow of information to the secondary market concerning the status of the development project. In particular, the developer should disclose information on *actual* absorption relative to *projected* absorption. The sale of improved properties is critical to investors because it generates the cash flow necessary to sustain the development project and results in the diversification of property ownership that improves the credit quality of the bonds. The release of information showing that absorption is tracking below expectations may influence the value of outstanding securities and indicate to investors that further investigation into the status of the district's finances is warranted. Additionally, the developer should disclose information on the sources of capital assembled to finance the development project.

[III. B-3(a)] Summary of Development Activity

The developer should provide a general description of progress made in the development plan, and any significant changes in the development plan, since the last annual report. The developer should track *actual* absorption relative to *projected* absorption according to the framework established in the official statement, and identify any material deviations in actual versus expected sale prices. The developer should include the following.

1. Issuance of building permits.

2. Final inspections and certificates of occupancy.

3. Sale or transfer of property of the top 10 landowners subject to a special tax or assessment supporting the bonds to non-affiliated parties.

[III. B-3(b)] Summary of Financing Plan

The developer should describe any significant changes in the financing plan for the development project.

1. Material changes in project costs.

2. Changes in status of bank loans/equity participation.

3. Provide consolidated cash flow statements for the development project for the most recent year available.

[III. B-3(c)] Audited Financial Statements

Rule 15c2-12(b)(5)(i)(B) ***requires*** that obligated persons disclose their audited financial statements annually, if available. This requirement is not contingent upon the materiality of the information included in the audited financial statements. The audited financial statements may be incorporated into the developer's annual report, or may be delivered separately.[47]

[III. B-3(d)] Retail/Commercial Vacancy Rates

For districts where the tax base is highly concentrated in retail and commercial uses, it may be appropriate to provide continuing disclosure on vacancy rates. This will necessitate the appropriate adjustments in the issuer's obligated person criteria.

[III. B-4] Developer Material Event Reporting

Certain continuing disclosure undertakings of developers prepared to-date have included material event reporting requirements applicable to developers. As part of its continuing disclosure undertaking, it may be appropriate for the developer to agree to give, or cause to be given, notice of the occurrence of any of the following events, if material:

[47] The developer's annual report will update the categories of financial information and operating data disclosed in the official statement for which it is obligated, which may be based upon unaudited numbers.

1. The conveyance by the developer to any other entity of the property subject to twenty percent (20%) or more of the special tax or assessments servicing outstanding bonds.

2. Any change in the legal structure of the developer.

3. Any failure by the developer to pay when due general property taxes, special taxes or assessments with respect to its property in the district.

4. Any previously undisclosed amendments to the land use entitlements or environmental conditions or other governmental conditions that are necessary to complete the development plan.

5. Any previously undisclosed legislative, administrative or judicial challenges to the development plan.

6. Any denial or termination of credit, any denial or termination of, or default under, any line of credit or loan or any other loss of a source of funds that could have a material adverse effect on the developer's most recently disclosed financing plan or development plan or on the ability of the developer to pay special tax payments when due.

[III. B-5] Termination Of Developer Reporting Obligation

The provisions of the Amendments for terminating the continuing disclosure obligations of obligated persons are fairly limited. Essentially, the Amendments state that the written undertaking may provide for the termination of the continuing obligation to provide annual financial information and notices of material events if and when the obligated person no longer remains an obligated person.[48] The Adopting Release elaborates on the circumstances under which the continuing disclosure obligation of an obligated person may terminate. With respect to obligated persons determined through the use of objective criteria, the Adopting Release states that obligated persons that no longer meet the objective criteria will no longer need to provide ongoing information.[49] Otherwise, the obligation may terminate once an obligated person no longer has ***any*** liability for repayment of the municipal securities, whether through termination or expiration of its commitment to support payment, or as a result of a defeasance of the municipal securities.[50] Thus, the termination provisions pertaining to persons obligated

[48]SEC Rule 15c2-12(b)(5)(iii).
[49]SEC Release 34-34961, 59 F.R. at 59597.
[50]SEC release 34-34961, 59 F.R. at 59600. The SEC reiterated this position, and clarified that materiality would not govern an obligated person's continuing obligation to comply with an undertaking in its response to Question 15 of NABL 1, supra at 41.

through the application of objective criteria are more liberal than those applying to persons obligated through direct materiality determinations.

A review of land-based securities issuances since July 3, 1995 (the effective date of the Amendments) indicates that the termination provisions commonly incorporated into developers' undertakings include (1) the legal defeasance, prior redemption or payment full of all of the bonds, (2) the date at which the developer no longer satisfies the criteria established by the issuer for determining obligated persons, and (3) the receipt by the issuer of an opinion from a nationally recognized bond counsel substantially to the effect that the information provided by the developer no longer is necessary. The first two termination provisions comply with Rule 15c2-12(b)(5) but the third, which relies on the materiality determination by a bond counsel, does not.

Issuers should be cautioned that the criteria they establish for obligated person determinations may result in a premature termination of the developer's continuing disclosure undertaking. In several offerings to-date, the criteria established for obligated person determinations have referenced not only the developer's obligation to support payment on the securities (expressed in terms of percent of the expected levy or property ownership) but also the improvement status of the developer's land holdings. Specifically, the criteria apply only to developers holding raw land; once the lots have been improved through the installation of infrastructure, the obligated person designation terminates. In the view of CDAC, this approach is flawed in that it mistakenly assumes that the principal risk to bondholders pertains to the installation of the infrastructure itself rather than the ability of the developer to continue meeting its special tax or assessment obligations in the event of slower-than expected lot sales. To be sure, the status of improvements is important to investors and should be disclosed. Yet the greater risk to bondholders - that posed by the financial insolvency of the developer - not only remains after infrastructure is installed, but intensifies the longer the original developer holds the improved lots past its planned absorption period. Terminating the developer's continuing disclosure obligation at the time that investors may be most interested in developer financial information does not appear to be consistent with the spirit of the Amendments. In the view of CDAC, it is far better to rely upon the criterion of the percent of expected special tax or assessment levy the developer is expected to be responsible for in the coming year, as discussed above.

In summary, the developer's undertaking should specify that the developer's reporting obligation will terminate upon (1) the legal defeasance, prior redemption or payment in full of all of the bonds, or (2) the point at which the developer no longer satisfies the criteria established by the district for reaching obligated person determinations.

APPENDIX

REVISIONS IN FINAL *DISCLOSURE GUIDELINES FOR LAND-BASED SECURITIES*

As noted in the *Introduction*, a draft copy of the *Disclosure Guidelines for Land-Based Securities* was released on March 21, 1996 and circulated to interested parties for review and comment. This *Appendix* summarizes the revisions to the draft that were incorporated into the final *Guidelines*.

Informational Requirement of Final Official Statements. Although the draft *Guidelines* contained an extensive discussion of the materiality of developer financial information, the draft failed to note that the Rule 15c2-12 Amendments revised the definition of *final official statement* to require that financial information and operating data be provided for those persons, entities, funds and accounts that are material to an evaluation of the offering. By adding this informational requirement, Rule 15c2-12 now indirectly regulates the contents of official statements in primary offerings. Any reasonable effort to comply with the Rule in the context of a land-based securities offering therefore will entail an evaluation of the materiality of financial information and operating data relating to key developers. The final *Guidelines* make it clear that the final official statement is the point of reference for determining the types of financial information and operating data to be reported annually and the obligated persons to whom this information will relate. (See page 17).

Deletion of Issuer Oversight Procedures. The draft *Guidelines* included a summary of the securities fraud liabilities of issuers of municipal securities and recommended oversight procedures to assist issuers and their elected officials in minimizing their exposure to these liabilities. Commentators generally felt that this material should stand alone, because it has general applicability to municipal securities issuance. CDAC staff accepted this recommendation and deleted from the final *Guidelines* the sections on *Fraud Liabilities of Governmental Issuers* and *Recommended Standards of Care in Authorizing Land-Based Securities Offerings* that were included in the *Regulatory Framework* section of the draft (though some of the information in the deleted sections has been retained in the final Guidelines). The deleted sections will be expanded upon and published separately in 1997.

Continuing Disclosure of Developer Financial Statements. Many developers objected to the conclusion in the draft *Guidelines* that they should be designated obligated persons under any circumstances, because they resist the disclosure of their financial statements to the securities market. In some instances, this position may justified by the fact that the financial statements do not present information relevant to the project at hand. For this reason, the draft *Guidelines* recommended that developer financial statements be disclosed only if they are material. Rule 15c2-12 *requires* obligated persons, however, to disclose their audited financial statements annually, if available, regardless of their materiality. This point is clarified in the final *Guidelines*. (See page 47).

Succession of the Continuing Disclosure Obligation. One implementation difficulty posed by land-based financing concerns the succession of the continuing disclosure obligation from initial developers to successor developers who satisfy the issuer's continuing disclosure criteria. The enforceability of the continuing disclosure obligation is questionable, since the obligation is tied to property ownership, which is freely transferable. A successor developer is not party to the bond documents into which the issuer's continuing disclosure criteria are incorporated - be it the indenture, trust agreement, or resolution of issuance. In researching this issue, CDAC staff found that the only arguably enforceable way to impose a continuing disclosure obligation on all successor developers who satisfy the issuer's criteria is to record a covenant against the property itself. This option is preferable to relying on the initial developer to negotiate a transfer of the obligation with successor developers, which will not work if property changes hands through the operation of law (bankruptcy or foreclosure) rather than through a negotiated purchase and sale. The final *Guidelines*, consequently, recommend that issuers record a continuing disclosure covenant against the property itself. The covenant should incorporate the criteria established by the issuer for the purpose of reaching obligated person determinations, and should terminate at which time the obligated person no longer satisfies the criteria. (See pages 43-46.)

Illustration of Developer Pro Forma. The draft *Guidelines* recommended the disclosure, if material, of the types of project financial information that typically is included in the developer's *pro forma* or business plan. Commentators agreed, but pointed out that there is considerable variety in the types of pro formas prepared by developers, and that CDAC should lay out more clearly the minimum requirements for developer pro formas for disclosure purposes. The final *Guidelines* include an illustration of a simplified developer pro forma which identifies the categories of information that may be material for disclosure purposes. (See page 26.)

Termination Of Developer Reporting Obligation. The draft *Guidelines* recommended that the developer's continuing disclosure undertaking specify that the developer's reporting obligation will terminate upon (1) the legal defeasance, prior redemption or payment in full of all of the bonds, (2) the point at which the developer no longer satisfies the issuer's continuing disclosure criteria, or (3) the receipt by the issuer of an opinion from a nationally recognized bond counsel substantially to the effect that the information provided by the developer no longer is necessary. The first two termination provisions comply with Rule 15c2-12(b)(5) but the third, which relies on a materiality determination by a bond counsel, does not, and consequently was deleted from the final *Guidelines*. (See page 48.)

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