Coates' Canons Blog: Debt Financing Primer: Enhanced Security for Project Development Financings

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Blight City is looking to revitalize a portion of its downtown. Over the past ten years the area has fallen into disarray and contains many abandoned, dilapidated buildings. Working with a couple of local developers, the city has developed plans to purchase and demolish one of the buildings and construct a large parking garage in its place. The city also plans to improve several of the existing roads leading into downtown and to pave a few additional side streets. The local developers intend to purchase the other buildings and either refurbish or replace them with modern, mixed-use structures. The local developers have secured several long-term leases with retailers to occupy the bottom floors of the new buildings. The new city parking garage will benefit these tenants (although no commercial entity will be guaranteed parking spaces for employees or customers.) The total projected cost to the city for the public infrastructure projects is $30 million. After exploring all of the debt financing alternatives, city officials believe that project development financing is their best option. That means that the city will pledge as security for the loan the incremental *ad valorem* tax revenue that is generated by the new development in the downtown area (project development district) that is spurred by the city's investment in the parking garage and other infrastructure projects. The city also intends to use this incremental tax revenue to make its annual debt service payments on the loan. (To learn more about project development financing, click **here**.) However, after running the preliminary numbers with a financial advisor and the Local Government Commission, the city realizes that the interest rate on such a borrowing is likely to be too high to make the financing feasible. Is there anything the city can do to lower the borrowing cost associated with the project development financing?

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Maybe. There are many factors that influence the cost of borrowing for a particular project. One of the factors is the security pledged for the borrowing. The security pledged for a borrowing represents the contractual rights of the lender (investors) in the event of a default. In other words, the security represents what the lender (investors) legally can force the borrowing unit to do or to give up if the unit does not make its debt service payments. In general, the stronger the security is for a particular borrowing the lower the risk to investors of not being repaid. And, also in general, the lower the risk is to investors of not being repaid, the lower the cost of borrowing to the unit.

For example, if a unit issues general obligation bonds, the security for the bonds is the full faith and credit (unlimited taxing power) of the unit. That means that if a unit does not make its debt service payments the investors can force the unit's governing board to increase its property tax rate to whatever rate necessary to repay the loan. This is a very strong form of security because it is not directly tied to the project(s) for which the borrowed funds are being used. Regardless of what the government does with the borrowed funds the investors are (very, very likely) going to be repaid. At the other end of the spectrum, the security for a project development financing (more commonly referred to as a tax increment financing) is the incremental increase in property tax revenue generated within the project development district due to new development in the district that was incentivized by the public improvements which were financed with the borrowed funds. This security is very speculative; it depends on the success of the public project(s) that are financed with the borrowed funds *and* the private development to increase the value of the taxable property in the project development district to a sufficient level to make the debt service payments.

In North Carolina, local governments are authorized to "enhance" the security pledged for a project development financing to mitigate the risk to investors of default (and thereby at least potentially reduce the cost of borrowing) in *one or more* of the following ways:

1. Minimum Assessed Value

The first method to “enhance” the security for a project development financing does not actually involve an additional security pledge. Instead, it allows the unit to guarantee a minimum assessed value for the taxable property within the project development district. A unit may enter into an agreement with the owners of real and personal property located in the project development district whereby the owners agree to a minimum assessed value of the property located within the district. *See* **G.S. 159-108**. The minimum assessed value ensures that there will be incremental value and, accordingly, incremental revenues, even if no new private development occurs in the district or the new private development does not increase the value of the property in the district as expected. (The minimum assessed value of property located within the project development district applies to all property taxes assessed against the property, including those assessed by taxing units that did not establish the district.)

To date there have been two project development financings for which bonds actually have been issued in North Carolina. One of the projects involves a mixed-use development in the Town of Woodfin. In March 2007, the Local Government Commission gave conditional approval for the issuance of $26.5 million in project development financing bonds to be issued in phases by Buncombe County on behalf of the Town for streets, roads, utilities and other public infrastructure improvements in the Woodin Downtown Corridor Development Financing District to be constructed in conjunction with a mixed-use residential, retail and commercial development to be built over 7 to 10 years. The bonds are to be repaid from the incremental tax revenue generated by the private development. The private developer, county, and town also entered into a **Minimum Assessment Agreement** (**see Appendix D**) that requires that tax values on the developer’s property be set annually at a level that will guarantee additional tax revenue sufficient to pay annual debt service if needed. (For more information on this financing, click **here**.)

2. Pledge Mortgage Interest in Financed Asset

The second method to “enhance” the security for a project development financing is to pledge, mortgage, or grant a security interest in, the real or personal property that is financed or improved with the borrowed funds from the project development financing. *See* **G.S. 159-111**. If a unit does not meet its debt service obligations the investors may foreclose on the pledged asset(s).

3. Pledge Additional Revenue Other Than Unit-Issued Taxes

The third method to “enhance” the security for a project development financing is to pledge any additional unrestricted revenues that accrue to the unit other than unit-issued taxes. These revenues can take a variety of forms, including proceeds from property sales in the project development district; net proceeds from revenue-generating activities in the project development district (including leases); and any other unrestricted revenues (other than unit-levied taxes) of the unit. For municipalities, the most significant unrestricted revenue source is local sales and use tax proceeds. (Counties may not pledge this revenue because local sales and use taxes are levied by counties.) A unit may enter into a covenant committing to take action to generate any of the above-listed revenues.

The other project development financing in North Carolina to date involved the acquisition of a newly constructed theater intended to serve as an anchor to an entertainment complex located along Interestate-95 in Roanoke Rapids. The city borrowed $ 21.5 million to purchase the theater in 2007. As security for the loan, the city pledged the following: (1) the lease payments from the company with which the city contracted to manage the theater; (2) the city’s property taxes on the incremental value within the project development district; and (3) the city’s share of local sales and use taxes. In addition to these city revenue sources, the city also obtained a letter of credit from Bank of America, under which the bank agreed to pay the debt service on the debt. The letter of credit extended until March 15, 2010, and was secured by a deed of trust on the theater. (For more information on this financing, click **here**.)

Counties and municipalities also may pledge special assessment revenue as additional security for a project development financing. *See* **G.S. 159-111; G.S. 153A-210.4; G.S. 160A-239.4**. A special assessment is a charge levied against property to pay for public improvements that benefit that property. As detailed in this **local finance bulletin**, currently there are two different special assessment authorities. The traditional special assessment authority (**G.S. 153A, Art. 9** (counties); **G.S. 160A, Art. 10** (municipalities)) is limited to select infrastructure projects (for counties—sewer systems; water systems; improvements to subdivision and residential streets; beach erosion and flood control projects; watershed improvement projects, drainage projects, and water resource projects; street lights and street lighting in residential subdivisions, and for municipalities—sewer systems; water systems; storm sewers and flood control facilities; streets and sidewalks; and beach erosion and flood control projects). The new special assessment authority (**G.S. 153A, Art. 9A** (counties); **G.S. 160A, Art. 10A** (municipalities)) covers a broader array of infrastructure projects, including all the projects that may be funded with project development financing. *See* **G.S. 153A-201.2** (counties); **G.S. 160A-239.2** (municipalities). A unit could impose an assessment on the private properties in the project development district that benefit from the public improvement that is being funded with the proceeds of the project development financing. This revenue stream then could be pledged as additional security for the financing. (Note that the new special assessment authority is set to expire July 1, 2013.)

4. Pledge Full Faith and Credit of Unit

The fourth method to "enhance" the security for a project development financing is to pledge the full faith and credit of the unit. *See* **G.S. 159-111(a).** In order to pledge the full faith and credit (unlimited taxing power), the unit must follow all of the procedural requirements in **G.S. 159, Art. 4** (in addition to the requirements in **G.S. 159, Art. 6**). And, the unit must hold a successful voter referendum on the borrowing. (If the unit does not pledge its full faith and credit as additional security, no voter approval is required for project development financings.)

Links

- www.sog.unc.edu/node/1100
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-108.html
- www.sog.unc.edu/sites/www.sog.unc.edu/files/24.%20Limited%20Offering%20Memorandum.pdf
- www.sog.unc.edu/node/1108
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-111.html
- www.sog.unc.edu/node/1107
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_153A/GS_153A-210.4.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-239.4.html
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- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_153A/Article_9.html
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