November 14, 2001

OPINION Opinion No. 01-03
OF
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Attorney General

BY: Martha A. Daly
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TO: The Hon. Pauline J. Ponce
Representative, New Mexico House of Representatives
1020 South Mulberry
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QUESTION:

May a board of education of a school district issue general obligation refunding bonds in a principal amount that exceeds the principal amount of the outstanding bonds being refunded?

CONCLUSION:

Subject to the approval of the Department of Finance and Administration, a board of education may issue general obligation refunding bonds in a principal amount that is greater than the principal amount of the outstanding bonds being refunded, provided the proceeds of the refunding bonds are used only for the purpose of refunding existing school district general obligation indebtedness, as provided by law, and not for new capital outlay projects, operating costs of a school district or other purposes besides refunding.

FACTS:

Your question arises in the current environment of historic low levels of interest rates, which provides school districts (like other public bodies generally) with an opportunity to refinance their general obligation bond indebtedness, usually to achieve present value savings, if an increase in principal (which is a common ingredient when going from high to low interest rates)

is permissible. Your letter of request contains two different hypothetical situations, which are discussed in detail in the analysis portion of this opinion.

ANALYSIS:

The law on this practice is not uniform across the country. Some jurisdictions prohibit the practice by statute, while in others, statutes expressly authorize it. In still others, constitutional provisions authorize this practice. Finally, some state courts have interpreted their state constitutions to ban it. Thus, this question is strictly controlled by the law of each jurisdiction.

Typically, a bond refunding is accomplished by generating sufficient proceeds from the sale of the refunding bonds to retire the refunded bonds, either by immediately calling them (a "current refunding") or funding an escrow account which over time will earn sufficient income to pay off the original bonds and all interest and premiums associated with the refunding issue (an "advance refunding"). By statute, a school board in New Mexico may issue general obligation refunding bonds to refund outstanding bonds whenever it deems such action is "necessary or advisable". See NMSA 1978, § 6-15-12 (1975). The amount of the refunding bonds is left to the board to determine, which amount similarly must be "necessary and advisable." Id. The refunding bonds must mature no later than twenty-five years from the date of issuance of the refunding bonds. See NMSA 1978, § 6-15-13 (1983). These refunding bonds, which are paid from annual property tax levies, may be exchanged dollar for dollar for the bonds being refunded, or may be sold as directed by the board. See NMSA 1978, §§ 6-15-14 (1975) and 6-15-15 (1963). The proceeds of the refunding bonds must be applied only for the purpose of refunding any of the general obligation bonded indebtedness of the school district which has or will become due and payable (or which has or will become payable at the option of the school district, or with the consent of the bondholders, or by any other lawful means). Id.; see too NMSA 1978, §§ 6-15-11 (1983) and 6-15-20(A) (1981). Finally, any issue of school district general obligation refunding bonds must first be approved by the Department of Finance and Administration. § 6-15-11, supra.[1]

Thus, by statute, the principal amount of the refunding bonds is decided by the school board, subject only to its determination that the amount is "necessary and advisable". [2]

Further, the constitutional provision pertaining to school district debt imposes no restrictions on these refunding bonds. Article IX, Section 11 of our constitution requires voter approval of

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[1] These statutes also authorize municipal and county refunding bonds on these same conditions.

[2] In contrast, Oklahoma, for example, allows by statute the principal amount of refunding bonds to be greater than the principal amount of the bonds being refunded only if the total principal and interest of the refunding bonds is less than the total principal and interest of the bonds being refunded. See 62 O.S. Supp 1984, § 755(A).

"original issue" or "new money" school district general obligation bonds. It also limits the purposes for which the bonds may be issued, and sets a six percent limit on the total amount of indebtedness. Those restrictions, however, are expressly not applicable to refunding bonds by the language of Section 15 of Article IX:

> [N]othing in this article shall be construed to prohibit the issue of bonds for the purpose of paying or refunding any valid state, county, district or municipal bonds and it shall not be necessary to submit the question of the issue of bonds to a vote as herein provided.

Based on this provision, our Supreme Court held that refunding bonds in the principal amount of $42,000, issued to refund outstanding debt of $41,500 and which resulted in bonded debt of the district in excess of the six percent limit set in Section 11, did not violate that section, since Section 15 declares Section 11 to be inapplicable to refunding bonds. Southwest Securities v. Bd. of Ed., 40 N.M. 59, 63, 54 P.2d 412 (1936).

Additionally, our authorizing statutes declare, in pertinent part:

> The issuance of refunding bonds by any county, municipality or school district for the purposes and in the manner authorized by this article or under the provisions of any other law thereunto enabling, shall never be interpreted or taken to be the creation of an indebtedness such that the same would require the approval of the qualified electors of the county, municipality or school district, and no such approval shall be required for the issuance of such refunding bonds except as is specifically required by the law under which said refunding bonds are sought to be issued or have been issued.

§ 6-15-20(F), supra.

Some have read this provision to require voter approval when the principal amount of refunding bonds exceeds the principal amount of the outstanding "original issue" bonds (the principal amount of which received voter approval prior to issuance). In contrast, we read this provision to be an earlier codification of an analysis similar to that applied by our highest court to a refunding structure wherein certain of the outstanding bonds would not be called for redemption on the first date they become callable. There, in upholding a municipality's power to engage in an advance refunding, the court held:

> To our view, where there are funds in an irrevocable escrow account available to meet an indebtedness, the obligation cannot be termed an 'outstanding' indebtedness, in the ordinary sense. [citing authorities] In our opinion, the plan here involved may be analogized to that of a sinking fund, and it is generally held that sinking funds are not debts within the meaning of constitutional debt-limit provisions. [citing authority]

City of Albuquerque v. Gott, 73 N.M.439 at 443, 389 P.2d 207 (1964) (Explanatory note added). The court goes on to explain:

> While it is true, technically speaking, upon the issuance of the refunding bonds there will appear to be an indebtedness which exceeds the constitutional limitation, however, this is more a matter of form than of substance. We cannot presume that elected officials are dishonest, but will, to the contrary, assume that they will fulfill their legal duty. Any other result would, in effect, prohibit the issuance of refunding bonds, unless the original bonds are cancelled simultaneously. With modern methods of finance, this is an obvious impossibility, and even though the precise plan may not have been contemplated by the constitution makers, in our view it does no violence to the provisions of the constitution. Where the proceeds of the refunding bonds are placed in escrow or a trust fund, for the sole purpose of paying off the original indebtedness, the latter bonds cannot be considered as an increase in the indebtedness of the city.

73 N.M. at 443-444.

As summarized earlier, the statutes authorizing school district refunding bonds do not require voter approval. Further, although Article IX, Section 11 requires voter approval for "orginal issue" bonds, Section 15 of that same section expressly exempts refunding bonds from that and all other requirements of Section 11. Southwest Securities, supra. Similarly, although § 6-15-20(E) requires that "[I]n no event shall the aggregate amount of bonded indebtedness of any county, municipality or school district exceed the maximum allowable amount as determined pursuant to the statute applicable to such county, municipality or school district," the other statutes authorizing school district refunding bonds set no maximum allowable amount of bonded indebtedness. And the debt limitation found in Section 11 of Article IX of our constitution is rendered inapplicable to refunding bonds by Section 15. Id.

The Gott opinion does not indicate the principal amount of the refunding bonds there under review, or whether it was in excess of the principal amount of the outstanding bonds. It does speak in terms of there being "no increase in debt."[3] But the same analysis utilized by our

[3] It is on this basis—that refunding bonds do not result in an increase in voter-approved debt—that a number of courts have held that the principal amount of refunding bonds cannot exceed the principal amount of the bonds being refunded. See, e.g. Beaumont v. Faubus, 239 Ark. 801, 809, 394 SW2d. 478, 484 (1965); Board of Ed. of Cty. of Hancock v. Slack, 174 W.Va. 437, 446, 327 SE 2d. 416, 426 (1985); Kansas City Life Ins. Co. v. Evangeline Parish School Bd., 58 F. Supp. 39, 46 (D. Ct. W.D. La. 1944). That same analysis was used by the Idaho Attorney General to determine that the principal amount of advance refunding bonds could not exceed the principal amount of bonds being refunded. See 1977 WH 25101 (Idaho A.G. No. 77-39). Yet none of these jurisdictions appear to have a constitutional provision similar to our Article IX, Section 15. Further, a provision in the constitution of at least one other state jurisdiction contains language expressly authorizing the principal amount of a refunding issue to be in excess of the

Supreme Court in Southwest Securities, supra (where the principal amount of the refunding bonds was greater than the principal amount of the outstanding bonds), when applied here, leads to the conclusion that refunding bonds in a principal amount in excess of the principal amount of the bonds being refunded is permissible, subject to approval of the refunding issue by the Department of Finance and Administration.[4]

Our conclusion does not mean, of course, that a school district can issue refunding bonds in amounts greater than required for refunding purposes, and thus avoid the limitations imposed by Article IX, Section 11 and the statutes authorizing new money issues. As the statutes authorizing refunding bonds make clear, the proceeds of refunding bonds can be used only for the purpose of refunding existing school district general obligation indebtedness. See §§ 6-15-11, 6-15-15, 6-15-20(A), supra. They cannot be used for new capital outlay projects, or to fund operating costs of a school district, or for other purposes besides refunding.

Finally, although we conclude here that there is no legal impediment to issuing refunding bonds in a principal amount in excess of the principal amount of the bonds being refunded, we emphasize the statutory requirement that each refunding issue receive approval by DFA. The two structures cited in your letter exemplify why such approval is required. The first is an economic savings refunding that proposes to refund outstanding bonds in the principal amount of $5,000,000 at an interest rate of 6 % per annum with refunding bonds in a principal amount of $5,250,000 at an interest rate of 5 % per annum. Although this refunding will increase the aggregate debt of the school district by $250,000, it results in real savings for the district: a gross present value savings of 5.432% of the outstanding bonds, which in turn generates an annual tax

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principal amount of the bonds being refunded. See 1994 WL 81295 (Ga. A.G. No. 94-8), citing Article IX, Section V, Par. III of the Georgia constitution.

[4] Policy arguments support this conclusion as well. A technique frequently employed in this state to avoid having the principal amount of the refunding bonds in excess of the principal amount of outstanding bonds—the inclusion of premium bonds (in various forms, including "supplemental" and "B coupon" bonds), which bonds are sold at a price above the principal amount of the bond—itself may raise other financial concerns. We have been advised by the state's financial advisor that premium bonds increase the cost to the issuing public body of the standard call provisions that it would normally utilize, as the investor would amortize the premium to the call date and effectively increase the cost of funding to the issuing public body. Thus, the issuer pays a penalty when it employs this method to avoid a principal amount in excess of the outstanding bonds. It is the advisor's view that, from a financial perspective, the practice of issuing premium bonds is generally more detrimental to the issuing body's financial interest than issuing refunding bonds in a principal amount greater than that of the bonds being refunded. Similarly, if the necessity of issuing premium bonds resulted in restrictions on or elimination of normal optional redemption provisions, the issuance of those premium bonds would be more detrimental to the issuing body's ability to issue debt in the future than issuing refunding bonds whose principal amount exceeded that of the outstanding bonds.

decrease of at least 12.5%. DFA has advised that in the past such a structure has received DFA approval.

The second, referred to in your letter as a debt service/tax rate restructuring (also known as a "non-economic" transaction), assumes a dramatic economic downturn which results in a 12% decrease in the taxable assessed valuation of property in the school district. In this scenario, the district has outstanding bonds in the principal amount of $6,000,000 bearing interest at 5 % per annum. The district proposes to issue refunding bonds in the principal amount of $6,160,000 at the same interest rate (5 % per annum) with a maturity schedule that extends the time for payment by three years. Here, the district increases its aggregate debt by $160,000, and realizes a present value loss of –2.25% on the outstanding bonds. The stated purpose of this refunding is for tax rate relief as opposed to economic savings. We have been advised that DFA, in the exercise of its discretion, may have serious reservations about approving refunding bonds proposed under this type of scenario because this structure significantly limits future bonding activity. For that reason, increased scrutiny by DFA would be justified, including reviewing the financial condition of the school district as a whole, and exploring alternatives (such as calling only certain bonds by lot, rather than refunding the whole issue). DFA has advised us that any school district contemplating this type of refunding should notify that agency of the district's intention at the earliest point, well before the issue is marketed or priced, so that any necessary review or restructuring can be completed in a timely manner.

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