MELLO-ROOS COMMUNITY FACILITIES DISTRICTS

TOP 10 TIPS

EVERY LENDER AND PROPERTY OWNER MUST KNOW

Essential reading for everyone with an interest in property located in a community facilities district, including:

- Owners of Mello-Roos CFD Property
- Lenders considering foreclosure on Mello-Roos CFD Property
- Buyers considering purchase of Mello-Roos CFD Property from lenders
- Buyers considering purchase of discounted Mello-Roos CFD Property from defaulting owners
- Buyers of Mello-Roos CFD Property through Bankruptcy Section 363 Sales
- Buyers of Mello-Roos CFD Property through foreclosure of deeds of trust

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A History of Success

For more than 25 years, California municipalities and developers have successfully partnered to finance public infrastructure and services using the Mello-Roos Community Facilities Act of 1982 (the "Mello-Roos Act"). Under the Mello-Roos Act, local agencies can form community facilities districts ("CFDs") in which special taxes may be levied by the CFD (i) to finance directly the authorized infrastructure and services and (ii) to pay debt service on tax-exempt bonds that may be issued to provide financing for authorized infrastructure ("Mello-Roos Bonds"). In fact, Mello-Roos financing has been so popular that much of the undeveloped and partially-developed property in California is encumbered by liens securing Mello-Roos special taxes.

CFDs Today: Good or Bad?

For those interested in acquiring property included within a CFD ("CFD Property"), whether as a lender holding a security interest in CFD Property or as a buyer contemplating the purchase of CFD Property, existence of a CFD historically has been considered a positive factor. In this period of falling property values, tight credit, and loan and tax delinquencies, however, ownership of CFD Property can instead pose significant challenges. Lenders and prospective purchasers must be aware of the unique burdens and benefits of acquiring and owning CFD Property in today's market.

The pages that follow discuss the top 10 tips that every lender and CFD Property owner must know. These tips are grouped into three categories:

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TIP 1: DELINQUENT MELLO-ROOS SPECIAL TAXES ARE COSTLY

The Issue: Delinquent Mello-Roos special taxes bear the same penalties and interest as delinquent general county property taxes.

Special taxes are typically collected on the secured tax rolls of the local county in the same manner, and with the same penalties in the case of delinquency, as general property taxes. Like general county property taxes, the first installment of special taxes is deemed delinquent if not paid by December 10, and the second installment is deemed delinquent if not paid by April 10. Upon the failure to pay an installment of special taxes, a 10% penalty (based on the amount of the delinquent installment) becomes immediately and automatically due and payable. If a delinquency is not cured by June 30 following the due date of the installment, then on July 1, and the first day of each following month, a 1.5% interest charge on the delinquent installment will attach. The 1.5% interest charge is equal to 18% per annum.

For example, if special tax installments due in December and April total $500,000 each (for a combined total of $1 million), and both installments are not paid and remain unpaid through June 30 of the year following the second installment, the amounts due are calculated as follows:

Delinquent December 10 Installment	$ 500,000
10% Penalty	50,000
Delinquent April 10 Installment	500,000
10% Penalty	50,000
Interest from July 1 through June 30	180,000
Total Due	$1,280,000

That's a 28% penalty if the special taxes are not paid by the close of the fiscal year following the delinquencies!

Moreover, interest continues to accrue at 1.5% per month thereafter until repaid, and the delinquent property is also responsible for all costs of collection, plus attorneys' fees.

The Response: If the CFD Property is delinquent, the owner should negotiate with the local agency to reach an agreement regarding the payment of all delinquencies. The local agency has the authority to, and is often willing to, work with a new owner to reduce or waive penalties and interest.

TIP 2: FORECLOSURE MAY OCCUR SOONER THAN YOU THINK

The Issue: When a lender or buyer acquires CFD Property with delinquent special taxes, the CFD may commence foreclosure proceedings sooner than expected.

California law provides that local counties cannot foreclose on tax delinquent property until five years after the initial tax delinquencies have occurred. In these tough economic times, where preserving cash flow is paramount, owners of recently-acquired distressed property may be tempted to defer the payment of property taxes. Despite the severe delinquency penalties and interest that may accrue, these owners may desire to use the five-year time period to allow the market to recover without fear of losing their property to foreclosure.

Unlike with general county property taxes, the foregoing strategy will not work for CFD Property.

If Mello-Roos Bonds have been issued, a CFD may institute foreclosure proceedings at any time following a tax delinquency. When Mello-Roos Bonds are issued, a CFD typically obligates itself to institute legal proceedings to foreclose the special tax lien on delinquent property within a specified period of time following the initial delinquency, typically six months, so as to ensure the timely payment of debt service on the Mello-Roos Bonds.

In addition to an early commencement of foreclosure proceedings, for undeveloped property, the Mello-Roos Act substantially shortens the judicial foreclosure process set forth in the California Civil Code. The judicial foreclosure redemption period (*i.e.,* the period between the service of the writ of sale and the publication of the notice of sale designed to provide property owners a last chance to pay the delinquent taxes) is normally 120 days. For undeveloped CFD Property, however, the redemption period is a mere 20 days.

Moreover, there are other provisions in the Mello-Roos Act that shorten the time frame for conducting judicial foreclosure proceedings.

It should also be noted that a CFD conducts foreclosure proceedings separately from the local county and only with respect to the delinquent special taxes. As a prerequisite to the foreclosure process, the local agency removes the delinquent special taxes from the county secured tax roll, thus relieving the county from any obligation to collect the delinquent special taxes.

The Response: Once CFD Property is acquired, the owner should take steps to cure any special tax delinquencies to avoid foreclosure. The local agency has the power to, and is often willing to, work with a new owner to lessen the impact of the delinquencies, sometimes through the reduction or waiver of penalties and interest.

TIP 3: BEWARE DEFICIENT TITLE REPORTS AND TAX BILLS

The Issue: A typical due diligence review of CFD Property may not reveal Mello-Roos special tax delinquencies or the extent of the true special tax obligation.

Due diligence for any property acquisition should always include a review of a preliminary title report ("PTR") and recent county tax bills. Unfortunately, the PTR and tax bills may not tell the full story.

A PTR should report that the property is located in a CFD, and a copy of the recorded notice of special tax lien typically includes a copy of the special tax formula itself. These documents, however:

- Do **not** show the maximum special tax on the CFD Property, the calculation of which usually requires assistance from the Special Tax Administrator.
- Do **not** show the amount of any delinquencies, penalties, interest, and costs due with respect to the CFD Property.
- Do **not** show the calculation of any special tax buy-downs (see Tip 5) that may be required under the special tax formula.

Recent property tax bills should show current and delinquent Mello-Roos special taxes that appear on the secured county tax roll. The property tax bills, however:

- Do **not** show the amount of delinquencies, penalties, interest, and costs due with respect to CFD Property if, as required prior to foreclosure, the special taxes are removed from the secured county tax roll to be collected by the CFD itself.
- Do **not** show the amount of any escalator in the amount of the special taxes (which will likely be a set percentage, typically 2%, or a percentage tied to a cost index).
- Do **not** show the amount of special taxes that may soon be applicable to the CFD Property, thus providing a false picture of the true special tax obligation, if one or more building permits have recently been issued for the CFD Property causing a reclassification from one land use class to another pursuant to the special tax formula.

The Response: Before acquiring property, a lender/buyer should thoroughly review the Mello-Roos special tax formula in order to fill in the blanks that will likely exist after a typical due diligence review.

TIP 4: TAXATION CAN OCCUR WITHOUT BONDS

The Issue: In today's depressed market, Mello-Roos Bonds are being issued much later in the development cycle, but that doesn't mean that special taxes can't be levied anyway.

Under most Mello-Roos special tax formulas, parcels for which a building permit has been issued are deemed "developed," while the remaining property is deemed "undeveloped." Developed property is typically taxed before undeveloped property.

In some CFDs, the change in property status from undeveloped to developed triggers the levy of special taxes regardless of whether Mello-Roos Bonds have been issued. Local agencies often prefer to tax developed property at the maximum assigned special tax rate immediately following building permit issuance so that homeowners are taxed in the first year following home purchase and the local agency avoids the "sticker shock" that homeowners might feel if the initial special tax levy occurs several tax years after home purchase.

In Yesterday's Market: The automatic levy of special taxes upon the designation of property as developed property rarely presented a problem because Mello-Roos Bonds were issued within a short time thereafter and the total tax rate was generally within acceptable levels.

In Today's Market: Mello-Roos Bonds are issued and purchased much later in the development cycle (see Tip 7) and cash flow is at a premium. Consequently, owners of property for which a building permit has been issued can find themselves with the obligation to pay special taxes even when no Mello-Roos Bonds have been issued.

In many projects, building permits were pulled in anticipation of construction, but the projects subsequently stalled, and now those building permits have expired. Although the building permits have expired, special taxes will still be levied on property at the developed rates. In most special tax formulas, once a property has been deemed developed property for purposes of the special tax levy, such designation cannot be reversed notwithstanding the fate of the building permit.

The levy of special taxes regardless of bond issuance can result in a significant cost to a developer owning CFD Property while waiting for the market to recover, and this cost will be reflected in how a prospective purchaser values CFD Property.

The Response: If Mello-Roos Bonds have not been issued, a CFD can be restructured, which will alleviate or eliminate the potential problem of premature special tax levies. In addition, to the extent special taxes have already been paid, a refund may be obtained for the owner. Such restructuring can also match the special tax rates with the current home prices so that the total tax rate is within acceptable levels without requiring a special tax prepayment.

TIP 5: MANDATORY BUY-DOWNS HURT THE BOTTOM LINE

The Issue: As a result of the recent dramatic drop in home prices, mandatory buy-down provisions have been invoked for CFD Property, adversely affecting developers' bottom lines.

In many Mello-Roos special tax formulas, local agencies provided for a time when home prices might drop far enough that a mandatory buy-down of special taxes would be required to comply with local policies regarding the overall tax rate on CFD Property. Most local agencies limit the overall tax rate on property to an established threshold, commonly 2% of the expected home prices (the "Overall Tax Limit").

As a condition of obtaining certificates of occupancy for units, special tax formulas generally require an analysis of the Overall Tax Limit on a parcel-by-parcel basis. If the overlapping taxes on a parcel exceed the Overall Tax Limit, then the developer is required to prepay a portion of the special taxes so that the resulting amount of overlapping taxes on the parcel is not in excess of the Overall Tax Limit.

In Yesterday's Market: The market over the last decade witnessed increases in property values year after year. In an increasing market, the mandatory buy-down provisions are never invoked, and developers do not need to worry about the cost of prepaying special taxes as a condition for receipt of certificates of occupancy.

In Today's Market: Mello-Roos special tax rates were established based on the anticipated home prices at the time of the formation of the CFD, and, in many cases, the special tax rates brought the overlapping taxes all the way to the Overall Tax Limit at that time. For any CFD formed during the last four years, the expected purchase prices of the homes were likely very high, and the corresponding special tax rates as well. With the recent dramatic drop in home prices, many CFDs find that the high special tax rates and the lower home prices violate the Overall Tax Limit, and the mandatory buy-down provisions have been imposed.

The mandatory buy-down provisions invoke the prepayment provisions of the special tax formula, which are often very costly mechanisms for complying with the Overall Tax Limit.

For a lender seeking to sell CFD Property, or a buyer seeking to purchase CFD Property, the impact of a mandatory buy-down provision can be significant. This potential impact will be reflected in how a prospective purchaser values CFD Property.

The Response: Lenders and prospective buyers should review the mandatory buy-down and prepayment provisions of the special tax formula to determine if there is an ability to minimize the impact of the buy-down provision.

TIP 6: DON'T FORGET ABOUT THE BACK-UP SPECIAL TAX

The Issue: As a result of the scaling down of housing developments, back-up special taxes are more onerous, increasing the total tax burden on CFD Property.

Most special tax formulas for residential projects contain two tax rates:

- The Assigned Tax, based on the size of the units proposed to be constructed.
- The Back-Up Tax, based on the acreage of lots.

The Assigned Tax is the rate that will be charged if development proceeds in accordance with expectations, and it is easy to calculate based on the size of the units being constructed. The Back-Up Tax is not conditioned on home size and is intended to ensure that sufficient special tax revenues will be available to pay debt service on Mello-Roos Bonds if there are changes in home sizes (*e.g.,* downsizing), lot line adjustments (*e.g.,* building one home on two lots), and reductions in approved density (*e.g.,* conversion to ranchettes).

Though the Back-Up Tax is a tax of last resort, and is applicable only on property for which a building permit has been issued, its very presence can have a tremendous impact on the valuation of undeveloped property for one simple reason: property that might be subject to a high Back-Up Tax is more costly to develop.

In Yesterday's Market: Until recently, many changes to development plans were special tax neutral, meaning that a decrease in home size in one product line was typically offset by an increase in home size in another product line. Reducing the number of units to be built was rare, unless a density bonus was granted in another area. Consequently, such development changes either did not trigger the Back-Up Tax or, if they did, the resulting special tax was only slightly higher than the Assigned Tax.

In Today's Market: In response to today's down market, builders are scaling down home sizes and, in some cases, reducing the number of units to be constructed in a development. These two significant changes result in less special tax revenues from Assigned Taxes available to pay debt service on Mello-Roos Bonds, which, in turn, may trigger the imposition of the Back-Up Tax. The larger the downsizing of units, the bigger the difference between the Assigned Tax and the Back-Up Tax. The result is that the smaller units bear a disproportionately high special tax as a percentage of their value. To make the CFD Property marketable to homeowners, and often to comply with the Overall Tax Limit, the Back-Up Tax must be reduced, which means a buy-down of the special tax obligation using the prepayment provisions of the special tax formula.

A prospective buyer of CFD Property facing this kind of Back-Up Tax will demand that the seller perform the buy-down of the special taxes or that the purchase price be significantly reduced to allow the buyer to perform the buy-down after closing.

The Response: Lenders and prospective purchasers of CFD Property should review the back-up special tax provisions of the special tax formula to determine if there is an ability to minimize the impact of the back-up special tax.

TIP 7: THE CURRENT MELLO-ROOS BOND MARKET IS STRUGGLING

The Issue: Mello-Roos bonds are being issued much later in the development cycle, thus increasing the carrying costs of developers.

In Yesterday's Market: With high home prices and available credit, investors in the Mello-Roos Bond market have been historically willing to buy bonds secured by special taxes levied against a project with full entitlements and some horizontal development, which is typically at the beginning of the home construction cycle. Thus, a buyer of CFD Property viewed the CFD as a source of immediate take-out financing.

In valuing CFD Property, the cash flow benefits of the CFD were very high and the risk of non-issuance was very low. Consequently, buyers were willing to pay a premium for CFD Property.

In addition, until recently, interest rates on unrated Mello-Roos Bonds ranged between 4.8% and 7.0%. The low interest rates maximized the amount of bond proceeds available to developers for financing public improvements.

In Today's Market: Investors in the current market for unrated Mello-Roos Bonds are very risk averse. They want diversity of ownership (i.e., lots of homeowners) to minimize development risk, and often require substantial (in some cases, near total) vertical development. Consequently, Mello-Roos Bonds may not be issued until near the end of the home construction cycle, which increases the developer's carrying costs until such take-out Mello-Roos financing can be accomplished.

In valuing CFD Property, the cash flow benefits have diminished and the risk of non-issuance has increased (due, in part, to trepidation on the part of issuers because of high homeowner delinquencies). Buyers do not view CFD Property as favorably as they used to.

In addition, the current interest rates for Mello-Roos Bonds range from 9.0% to 12.0%, which significantly reduces the amount of available Mello-Roos Bond proceeds once the Mello-Roos Bonds are actually issued.

The Response: There are several potential solutions to this challenge, depending on the circumstances: (i) restructure the special tax formula; (ii) eliminate developer requirements that were based on prior market conditions (such as posting a letter of credit); (iii) convert to a pay-as-you-go CFD; or (iv) in a CFD that is financing only fees, prepay the special taxes at a discount that results in the removal of the CFD lien without an increase in cost. A thorough analysis of the CFD and the relevant documents is essential.

TIP 8: MONEYS MAY BE AVAILABLE FOR NEW OWNERS

The Opportunity: A CFD that has issued Mello-Roos Bonds will often have money available that may be utilized by a subsequent owner for construction of authorized public improvements or, in some cases, for any other use the owner desires.

These hidden moneys may include:

- Mello-Roos Bond proceeds on deposit in a construction or acquisition fund that were not requisitioned by the prior owner and may be available to finance additional authorized public improvements.
- Unused deposits made by the prior owner for costs of issuance or for other reasons that may be reimbursed to the new owner and used for any lawful purpose.
- Retention amounts (*i.e.,* amounts that are typically retained by the local agency as security for the one-year maintenance period following completion of improvements) that may be reimbursed to the new owner and used for any lawful purpose.
- Interest earnings on funds and accounts that may be used for the purposes of the fund in which they were earned.

To access these funds, a new owner must succeed to the rights of the prior owner in the various operative documents, such as the acquisition agreement, mitigation agreement, deposit agreement, or joint community facilities agreement.

Typically, the rights set forth in these documents do not run with the land and therefore must be assumed by the new owner.

Often, the consent of the local agencies that are parties to these operative documents are required in order for the assumption to be effective.

A general assignment found in a purchase and sale agreement might not be sufficient to assign rights under the operative documents. And, of course, there is no assignment or assumption when CFD Property is acquired by foreclosure.

The Response: Lenders and potential purchasers of CFD Property should review the relevant operative documents to determine if any moneys remain available to the property owner and, if so, how to access those moneys.

TIP 9: LOOK FOR PAY-AS-YOU-GO FINANCING

The Opportunity: If allowed by the Mello-Roos special tax formula, authorized facilities may be funded directly from the special tax proceeds on a "pay-as-you-go" basis.

In addition to financing public facilities through the proceeds of Mello-Roos Bonds, many Mello-Roos special tax formulas allow local agencies to pay for public facilities on a pay-as-you-go basis directly from the levy of special taxes (as opposed to paying for public facilities exclusively with Mello-Roos Bond proceeds).

In instances where Mello-Roos Bonds have not yet been issued, the pay-as-you-go provisions allow special taxes to be used to finance some or all of the costs of required public improvements (or to reimburse the property owner for costs already incurred). In today's market, applying special taxes directly for the financing of facilities can generate cash flow until the bond market and investor appetite for land-secured Mello-Roos Bonds recovers.

Even in cases in which Mello-Roos Bonds have been issued, the pay-as-you-go provision in the special tax formula may be used to generate additional cash flow by accessing the unused portion of the CFD's special tax capacity (i.e., the authorized special tax levies over and above that which is needed to pay debt service). These special taxes are accessed by levying special taxes up to the maximum amount set forth in the special tax formula, and applying amounts collected in excess of debt service to the payment of public facilities.

The Mello-Roos bond market requires that the special taxes in a CFD provide at least 110% coverage, meaning that the maximum special taxes that may be collected in a fiscal year must be at least 10% more than the maximum debt service payable on the Mello-Roos Bonds in any fiscal year.

For example, if the maximum special taxes that may be levied in a CFD is $1.1 million per year and the maximum debt service on the Mello-Roos Bonds is $1 million, the difference – $100,000 or 10% of the debt service – is authorized to be levied but is not needed for debt service.

Without pay-as-you-go financing, the 10% difference cannot be accessed to pay for facilities. If the special tax formula permits pay-as-you-go financing, then this coverage can be accessed to finance improvements directly.

The Response: Lenders and potential purchasers of CFD Property should review the special tax formula and the relevant documents to determine whether pay-as-you-go financing is available and what limitations, if any, exist with respect to such financing.

TIP 10: PREPAYMENT OF SPECIAL TAXES MAY BE VIABLE

The Opportunity: Prepayment of special taxes may be viable under certain circumstances to enhance the value of CFD Property.

Owners of CFD Property may wish to, or be required to, prepay all or a portion of the special tax obligations to decrease the special tax burden on the CFD Property, thereby increasing its marketability. There are two types of prepayment mechanisms.

The first is to calculate the CFD Property's proportionate share of the outstanding bonds plus any "future facilities costs." If all of the Mello-Roos Bonds that have been authorized have not been issued, or there is additional bonding capacity available, the concept of "future facilities costs" allows the local agency to collect money that otherwise would have been collected from the CFD Property had there been a prepayment when all bonds were issued. This amount can be substantial.

The second mechanism is to calculate the prepayment based on the present value of the maximum special taxes attributable to the CFD Property. In the current real estate market, the maximum special taxes may be based on the disproportionately high Back-Up Tax (see Tip 5), which means the prepayment amount may be substantial.

In either case, if Mello-Roos Bonds have been issued, prepayment of special taxes may also include a prepayment premium.

Under the typical prepayment formula, special tax prepayment is often economically unattractive. Under certain circumstances, however, especially in today's stressed market, the prepayment of special taxes may be a beneficial option.

For example, in a recent transaction in which a CFD was established to finance school, sewer, and water fees, the high special tax rates on the CFD Property compared to its value greatly impeded the marketing of the CFD Property. However, the special tax rates, which were determined at the height of the market, made prepayment unfeasible. Since Mello-Roos Bonds had not yet been issued, the local agency was willing to consider a prepayment of the special taxes in amounts equal to the fees that would have been financed if Mello-Roos Bonds had been issued, and a waiver of all prepayment amounts in excess of such fees. Under this workout proposal, both the developer and the local agency would receive the same benefits had the Mello-Roos Bonds been issued, so the local agency was willing to be creative to reduce the potential property owner's special tax liability.

The Response: Lenders and potential purchasers of CFD Property should review the special tax formula to determine whether prepayment is a viable option.

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Good People

Please contact Lew Feldman or Robert Haight with any questions or if you would like to meet with us to discuss how we might help you with the issues outlined in this publication.

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