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RECOVERY ZONE FACILITY BONDS MAY NOT PROVIDE THE ECONOMIC STIMULUS LOCAL AGENCIES HOPED FOR

By Claudia Gutierrez

On February 17, 2009, President Obama signed into law the $787 billion stimulus bill, The American Recovery and Reinvestment Act of 2009 (ARRA). As part of ARRA, Recovery Zone Facility Bonds (RZFB) were introduced as a groundbreaking type of tax-exempt private activity bond that would tremendously increase financing opportunities for private development projects that have historically not qualified for tax-exempt financing. The list of qualified businesses under the RZFB program is extensive - any trade or business within a designated recovery zone, excluding only a few types of businesses such as residential property, golf courses, country clubs, massage parlors, facilities dedicated to sale of alcohol or gambling, etc.

With the frozen capital markets, many developers have been presented RZFBs as the only source of financing for their stalled development projects. However, before developers devote substantial time and resources in the pursuit of RZFB financing, they need to take a hard look at this program and their own situations to determine if this financing will truly be available and workable in their local jurisdictions.

Out of the seventy-eight cities and counties in the State of California that received an allocation for RZFBs, only thirty-three of them timely completed the plan of issuance due to the California Debt Limit Allocation Committee (CDLAC) on January 31, 2010. As of February 24, 2010, CDLAC anticipates having $132,254,000 available for reallocation for the March 24, 2010 reallocation award round.

So why are RZFBs going unused by so many municipalities and counties that received allocations? Four major challenges appear to be leading to the underutilization of RZFBs.

First, there was initially a great amount of confusion regarding what the RZFBs can really do. The only benefit that RZFBs provide is their tax-exempt status on the debt interest - this is the sole subsidy provided. The debt service must be funded by the private business. There is no cash subsidy. Initially many business owners within designated recovery zones, and even city/county staff, wrongly assumed that RZFBs were more in the nature of a grant. They are not. Accordingly, real debt, obtained with real credit, is still required for the issuance of RZFBs. The required debt can come through private placement (i.e., a bank-issued loan for which tax would be exempt, thereby resulting in a substantially lower interest rate) or in the form of salable municipal bonds, which would be made tax exempt through this program.

Second, few private businesses are in a position to take advantage of RZFBs today. The lack of debt, combined with the lack of confidence in the markets continues to mean that businesses are holding off on further investment for the time being. In the City of Los Angeles, for example, projects that received priority consideration include those that will create a substantial number of permanent new jobs, projects that will pay prevailing and living wages, green projects and those that demonstrate a *high degree of readiness* - these are the types of projects that generally meet the intent of the RZFB program. Not many projects meet such criteria today. Even some of the projects in the City of Los Angeles' plan of issuance (which was timely completed and submitted to CDLAC) that met the basic eligibility requirements established by ARRA will not ultimately be able to secure a credit commitment and close on the bonds by the December 31, 2010 deadline. In many other jurisdictions, there simply may not have been enough projects meeting the very basic requirements for eligibility.

Third, credit is currently extremely difficult to obtain; but, at the same time, interest rates when credit is available are at historic lows. Therefore, RZFBs are not very attractive, and projects that could theoretically attain a "high degree of readiness" in a short period of time are not necessarily accelerated by RZFBs. Moreover, on top of an applicant having to secure its own credit and pay its own debt service, ARRA limits the cost of issuance amount that can be financed through bond proceeds to two percent of the par amount of the bonds. In large municipalities, the average cost of issuance is approximately $200,000. By way of example, for a $5 million RZFB allocation the maximum cost of issuance that can be wrapped into RZFB financing is $100,000, thereby requiring the applicant to fund the outstanding $100,000 from other sources. Many applicants are not in a position to do so without substantial effort and cost.

Fourth, many cities and counties appear to not be focused on RZFBs. According to CDLAC's latest figures, seven cities and counties have voluntarily waived their allocations, twenty-five were non-responsive to CDLAC's January 31, 2010 deadline for plan of issuance submission, and thirteen cities and counties delivered incomplete plans for which review by CDLAC is currently pending. The reasons for such lukewarm response to the RZFB program may be many, but one of those reasons appears to be the challenging times cities and counties are currently facing. With cities and counties suffering tremendous budget deficits and having to implement innumerable layoffs, the result has been lack of necessary staff to monitor the program and accomplish required milestones in a timely manner. By way of illustration, Los Angeles County, the largest allocatee in the State of California with an RZFB allocation of $271,484,000 was among the counties to deliver an incomplete plan of issuance to CDLAC by the mandated deadline. While CDLAC review is still pending on Los Angeles County's plan of issuance, one may wonder as to the County's ability to meet upcoming deadlines. The upcoming critical deadline is August 15, 2010, by which cities and counties in the State of California must provide all supporting documentation for those projects included in their January 31, 2010 plan of issuance.

With these issues in mind, RZFBs may be the right option where the following factors, in addition to the criteria described above, are in place:

- The project is already on the allocation list for the jurisdiction in which it is located;
- The jurisdiction has the staff and commitment to follow through;
- There is either a lending source, e.g., a bank that has committed to provide the debt or an underwriter that has expressed confidence on the marketability of a municipal bond issuance;
- There is enough other money in the deal to cover the substantial legal and other transaction costs associated with the bond issuance; and
- The project and developer otherwise qualify for conventional project financing, even under the current stringent underwriting criteria employed by many lenders. Characteristics of such a situation include committed, and very strong tenants, affordable credit enhancements, and/or strong financial guarantors.

Since so few projects meet these additional criteria, it appears likely that a substantial amount of the RZFB allocations in California will not materialize by year end. With their very limited subsidy and high cost of issuance, RZFBs are not creating a sufficient incentive for private businesses to get into a position to be eligible for the program. Even if the incentive were greater, the reality of today's market will prevent otherwise highly ready projects from obtaining credit commitments in the near future. In addition, the short lifespan on RZFBs is a significant obstacle for both the credit-strapped applicants and the overwhelmed, understaffed cities and counties responsible for administrating the program. As such, RZFBs may not, without a meaningful extension and some added incentives, provide the economic stimulus that local governments and developers had hoped for.

Authored By:

Claudia Gutierrez
(213) 617-5557
CGutierrez@sheppardmullin.com