Legislative Analysis

HOUSE FISCAL AGENCY
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BORROWING AGAINST STATE SCHOOL AID

House Bills 5194 and 5195
Sponsor: Rep. Fred Durhal, Jr.
Committee: Appropriations

Complete to 12-7-11

A SUMMARY OF HOUSE BILLS 5194 AND 5195 AS INTRODUCED 12-1-11

The bills would amend provisions within the State School Aid Act and the Revised School Code providing school districts with the authority to borrow against their state school aid payments in order to pay for operational costs as necessary through the issuance of short-term notes (debt). The bills strengthen the language in the acts concerning the pledge of state school aid payments as security for the debt obligations by defining the scope of the pledge of state aid by a district or its emergency manager and creating a statutory lien on the pledged state aid.[1]

House Bill 5194 – Revised School Code

Section 1225 of the Revised School Code (MCL 380.1225) authorizes school districts and intermediate school districts (ISDs) to borrow money, through the issuance of notes, to finance school operations, with the notes being repaid through a pledge of the districts; state school aid payments.

House Bill 5194 amends the Code to further provide that the pledge of state aid by a school district or ISD for the payment of notes is valid and binding from the time when the pledge is made. The pledge of state aid for the benefit of the holders of the notes or for the benefit of others would be perfected without delivery, recording, or notice.

The bill further provides that a school district or ISD operating under an emergency financial manager pursuant to the Local Government and School District Fiscal Responsibility Act could enter into an agreement with the Michigan Finance Authority (MFA) providing for the direct payment (or, intercept) of the pledged school aid payments to be used solely for the purpose of paying debt service requirements of any notes issued under Section 1225.

House Bill 5195 – State School Aid Act

Section 17a of the State School Aid Act (MCL 388.1617a) provides that school districts and ISDs may enter into an agreement assigning all or a portion of their state school aid payments

[1] The Legislature has recently enacted similar bills providing further security to holders of bonds of financially distressed communities, including Detroit (2010 PA 4), Ecorse (2011 PA 36), and Highland Park (2011 PA 143). The subject of HB 5194 and HB 5195 was previously discussed by Robert C. Robb, Emergency Financial Manager of the Detroit Public Schools, before a joint hearing of the Senate and House standing Committees on Education on February 9, 2011, http://session.mihouse.mi.gov/Committees%20New/cselectComm.asp?intcommitteeKey=5.

to the MFA or other trustee for the payment of obligations the district incurred with the MFA.

House Bill 5195 provides that if a district enters into an agreement assigning its state aid pursuant to a State Aid Note issue under the Revised School Code (MCL 380.1225), irrespective of whether the obligation was issued before or after the bill's effective date the portion of the school aid payments paid directly to the MFA or trustee solely for making required debt service payments on the obligation is subject to a lien and trust that is a statutory lien and trust, paramount and superior to all other liens and interests of any kind, for the sole purpose of meeting obligations debt service requirements.

The statutory lien and trust of the assigned state aid would apply to state school aid payments received or to be received by the MFA or the trustee on the bill's effective date or the time school aid payments are allocated to the district. Of note, the bill provides that statutory lien and trust would be subject to any subsequent reduction of the state school aid allocation by operation of law or executive order.

The lien and trust would have priority as established in the repayment agreement, except that the agreement could not impact any existing lien and trust previously created, including any lien and trust applicable to a multi-year repayment agreement. The lien and trust would be valid and binding on any party having a claim of any kind in tort, contract, or otherwise against the school district or ISD irrespective of whether the party had notice of the pledge, and the lien and trust would be perfected without delivery, notice, or recording.

State school aid payments paid or to be paid the MFA or trustee would have to be held in trust for the sole benefit of the debt holders issued under Section 17a or Section 1225 of the Revised School Code. The payments could not be used to pay other debts or liability of the district other than the debt obligations subject to the lien.

FISCAL IMPACT:

State Fiscal Impact: The bill would have no direct fiscal impact on the state, and would not require any additional School Aid funding on behalf of the Detroit Public Schools (or other districts) should it default on its debt obligations. Existing law (Sec. 17a of the State School Aid Act) does not provide for an appropriation of funds and does not constitute state indebtedness. Moreover, the bills provide that the State Treasury could withhold school aid payments as authorized by law, and the statutory lien and trust would be subject to any subsequent reduction of the state school aid allocation by operation of law or executive order.

Local Fiscal Impact: Although the bills apply to all school districts borrowing against their state school aid payments, in the immediate future the bills principally concern the Detroit Public Schools.

As part of a state aid note issue from March 2011, the Detroit Public Schools entered into an agreement with the insurer of bonds issued in 2005[2] to seek legislation that, in essence, insulates school district debt issued for cash-flow borrowing utilizing pledged state aid intercepted by the Department of Treasury (Michigan Finance Authority) from any potential

[2] The bond issue converted one-year notes issued by the district in 2004 into 15-year bonds maturing in 2020.

future bankruptcy filing by the school district.[3] Essentially, the district agreed to pursue the enactment of legislation that,

(a) provides that any portion or installment of state aid otherwise payable to the district but applied to a monthly set aside requirement to make the debt service payments, when due, is not property of the school district; and

(b) eliminates any permissive (consensual) aspect of the assignment of state aid to the trustee by making that assignment a statutory lien;

(c) provides that all future school aid obligations issued by the district will be subordinate (in terms of paying the debt service requirements) to that 2004 district note issue.

Under the agreement if, by December 31, 2011, legislation meeting these requirements or providing the district or emergency manager with the authority to file of bankruptcy is not enacted, the 2004 district notes are subject to accelerated repayments of the $94.5 million in principal otherwise maturing in 2016 to 2020. These accelerated repayments would be in additional to the scheduled principal payments maturing from 2012-2015 totaling $60.7 million as well as accrued interest and a redemption premium (a percentage of the principal amount being redeemed). In accelerating the repayment, the agreement requires that $94.5 million to be paid by 2015, as follows.

Due Date	Scheduled Principal	Additional Principal
6/1/2012	$14,070,000	$21,630,000
6/1/2013	$14,775,000	$22,905,000
6/1/2014	$15,515,000	$24,260,000
6/1/2015	$16,290,000	$25,750,000
	$60,650,000	**$94,515,000**

Reportedly, the school district, which has a deficit elimination plan (DEP) approved by the Department of Education, has not budgeted the additional $21.6 that would be required in its FY 2011-12 budget.

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[3] See, Caitlin Devitt, "Detroit District Sets Deal", *Bond Buyer*, 28 February 2011. The article states, "[a]fter winning long-awaited approval from a bond insurer, Detroit Public Schools plans to enter the market Thursday with $231 million of one-year notes urgently needed to make payroll through August. The note sale previously had been prevented by Assured Guarantee (sic.) Ltd., which insures roughly $170 million of DPS bonds originally issued in 2004. Assured had blocked any new borrowing by warning that it would require DPS to pay back the insured debt if the cash-strapped district borrows more money without waiting for the Michigan Legislature to pass a bill that would in essence protect Assured's bonds in the event of bankruptcy…Assured's new agreement give state lawmakers until Dec. 31 to pass the so-called bond-security bill. If the state fails to pass the measure... DPS would be required to pay Assured back for the bonds starting in 2012 instead of June 2011, and pay them off by 2015."