

CDA's: A Primer

Prepared for Supervisor Jim Burton
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By

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CDA's: A Primer

Definition¹

A private entity authorized by the Board of Supervisors (upon petition by a majority of property owners, or those owning a majority of the assessed value, within the proposed CDA boundaries) for the purpose of providing, operating, and/or maintaining public infrastructure “as necessary to meet the increased demands placed upon the locality as a result of development within the district.”

Such activities are financed through the issuance of tax-exempt bonds or other types of debt. These bonds are often referred to as “dirt bonds” because they are backed by the value of the vacant land within the district’s boundaries. Repayment is financed through the following mechanisms, either singly or in combination.

- An additional tax assessment is levied upon the owners of land within the boundaries of the CDA district.
 - annual *ad valorem* assessments up to 25 cents per \$100 of taxable market value unless all property owners agree to a higher rate
 - a special one-time assessment
- The local government agrees to pay over a portion or all of the tax revenues generated within the CDA district. This is known as Tax Increment Financing (TIF). Possible tax sources include all or portions of the following:
 - real estate taxes
 - BPOL
 - personal property taxes
 - the local portion of sales tax revenue
 - TOT funds
 - a meals tax
 - any other tax which the local government is authorized to levy

[VA Code 15.2-5158(A)(1). Also, *Community Development Authorities*, Informational Work Session with the Prince William County Board of Supervisors, 15 February 2005, p. 1; *CDAs: The Good, the Bad, and the Opportunity*, Presentation by Ken Powell to the VGFOA Fall Conference 31 October 2008, pp. 3-4.]

¹ CDA's go by different names in different jurisdictions, such as Metropolitan Districts in Colorado, Community Development Districts in Florida, and Infrastructure Development Districts in Georgia.

Legal Authority

Established under VA Code Section 15.2, Chapter 51. [See Reference Material 1].

Powers

[From VA Code 15.2-5114 and VA Code 15.2-5158]

CDA's may:

- Exist as a corporation for 50 years;
- Adopt, amend, and repeal bylaws, rules, and regulations for the conduct of its affairs, maintain an office, hire staff, and adopt an official seal;
- Sue and be sued;
- Enter into contracts;
- Borrow money;
- Issue revenue bonds (the issuance of any bonds does not require the locality's consent unless the consent is specifically required by the ordinance or resolution establishing the CDA);
- Request that the County levy and collect a special tax on real property within the district
- Finance, fund, plan, establish, acquire, construct, enlarge, extend, equip, operate, and maintain the infrastructure improvements listed in the ordinance or resolution establishing the district.

Authorized Infrastructure

[From VA Code 15.2-5158]

Authorized improvements are those listed in the ordinance or resolution establishing the district *“as necessary to meet the increased demands placed upon the locality as a result of development within the district.”*

The statute lists examples, but asserts that the list is not all-inclusive, using the phrase *“including, but not limited to:”*

- Transportation: Roads, bridges, parking facilities, curbs, gutters, sidewalks, traffic signals, street lights.
- Utilities: Storm water management and retention systems; gas and electric lines; water mains and sewer lines (VA Code 15.2-5114).
- Recreation: Parks and “facilities for indoor and outdoor recreational cultural, and educational uses,” including entrance areas, security, fencing, and landscaping.
- Public Safety: Fire prevention and control systems, fire stations, fire plugs, water mains, fire trucks, rescue vehicles, and other equipment.
- Education: School buildings and related structures;
- Senior Housing: Infrastructure and recreational facilities for age-restricted active adult communities with a minimum approved population greater than 1,000.

Pros & Cons

In addition to the reference materials specified within the text below, this section derives from more general material found in Section 2. This includes excerpts from two presentations:

- *Community Development Authorities*, Informational Work Session with the Prince William County Board of Supervisors, February 15, 2005;
- Ken Powell, *CDAs: The Good, the Bad, and the Opportunity*, Presentation to the VGFOA Fall Conference, October 31, 2008.

It also contains the following articles and news stories:

- Janice C. Griffith, *Special Tax Districts to Finance Residential Infrastructure*, The Urban Lawyer;
- David Hitchcock, *Special District Pros and Cons*, American City & County, March 1992;
- Rich McKay, *DeLand, Fla., Community Fears Shadow of New Subdivision*, The Orlando Sentinel, December 17, 2000.

Pros

Supporters claim the following advantages.

1. Incentivizes the development or redevelopment of a particular geographic area as construction of the infrastructure is not dependent upon the government's ability to raise the necessary tax revenue.
2. Accelerates project timing.
3. Increases assessment values of undeveloped land as undeveloped land with infrastructure is more valuable than undeveloped land without infrastructure.
4. Improves the quality of a development as the entity constructing the infrastructure is also the entity that will market the project.
5. Relieves existing taxpayers from subsidizing the costs of new development by encouraging the private sector to finance infrastructure that would normally be paid for by tax revenue as,
 - tax-exempt bonds lower the cost of capital available to private landowners and developers, and
 - repayment stream minimizes the developers' financial exposure for the underlying infrastructure necessary to develop the land by placing the burden of repayment on future owners;
6. Lowers the purchase price of housing in the district because the upfront infrastructure costs are amortized over a longer period and the savings to the developer will be passed onto home buyer.

Cons

Opponents raise the following concerns.

- 1. Incentivizes sprawl as it is financing infrastructure where no infrastructure currently exists, might not exist for decades, and possibly might never have existed.**

The last is demonstrated by the use of CDA financing to underwrite construction of a 30-mile road that would allow access to and enable development of approximately 48,000 acres of desert northwest of Phoenix.

- 2. Provides an unfair competitive advantage to those developers who receive a CDA.**

For example, the establishment of a CDA by the Henrico County Board of Supervisors to fund the infrastructure for a high-end shopping mall resulted in a lawsuit by another mall developer with a competing project in the County. The CDA responded with a lawsuit naming all County taxpayers as defendants, followed by a citizen-initiated lawsuit against the County. [See Section 3 for additional details]

As an alternative to a lawsuit, every other developer in the County may petition the Board to establish a CDA to finance their developments multiplying the number of entities within the County authorized to issue bonds. This was a concern recently raised during a debate over a proposed CDA by the Board of Supervisors in Isle of Wight, VA. [See Section 4 for additional details]

This is a valid concern. According to a 1991 analysis of a proposed private sanitary district in the Route 606 area, Loudoun County's financial advisors at the time warned that with the diminution of the County Board's control over the timing and values of debt issues, "the balkanization of debt issuance authority will be viewed as a negative factor by the rating agencies."² [See Section 9 for the complete report]

- 3. Once approved, there are few controls and limited oversight of the CDA, except those specifically provided for in the resolution or ordinance establishing the CDA.**

This can lead to an overextension of debt obligations beyond the CDA's ability to repay, accusations of political corruption, Ponzi schemes, outright fraud, or the churning of funds to produce fees for financial advisors. JP Morgan and a subsidiary of AIG found themselves under investigation by the IRS for the last. Such investigations can result in the loss of the bonds' tax-exempt status and the creation of a substantial tax liability to the CDA as issuer of the bonds. [Section 5 contains

² Thomas McLoughlin and Ben Mays, "Final Report to the Board of Supervisors on the Proposed Establishment of a Dulles Perimeter Sanitary District," Government Finance Research Center, September 17, 1991.

additional information on the IRS investigation as well as examples of the other issues listed]

- 4. Where the CDA maintains and/or operates the infrastructure, the long-term costs and fees to the landowners will far exceed the original proposals which typically only calculate the revenue stream necessary for repayment of the construction bonds.**
- 5. Homeowners in the district may balk at paying an additional tax, placing pressure on elected officials to lower or eliminate the special tax and return the costs of the development to the entire locality.**

In Frederick County, MD County Commissioners reported receiving “numerous complaints from homeowners in the Urbana CDA from homeowners who say they didn’t realize they would have to pay the CDA tax on top of their property taxes, fire taxes, and homeowner association fees.”³ The County requires disclosure of the tax; however, Commissioner John Lovell, Jr. stated, “The day of signing (house closing documents), the euphoria is such they’ll sign anything even if it says they’ll give up one of their kidneys.”⁴ [See Section 6 for more details]

A similar situation occurred with far greater publicity in Montgomery County, MD. In 2003, the Montgomery County Council established a special tax district for the Clarksburg Town Center development. Councilman Michael Knapp, who represented the area containing the development, voted in favor of the district’s establishment, stating, “It ties the funding for the infrastructure for the community to that community.”⁵ Four years later, under pressure from the new constituents living in the development, Councilman Knapp initiated an effort to abolish all special tax districts in the County. His reasons: Such districts “place an unfair tax burden on residents. It [the special tax district] didn’t work the way people thought it would.”⁶ [See Section 7 for additional details]

- 6. Homeowners in the district may balk at paying municipal taxes for services or facilities outside the district.**

This has occurred with at least one CDA in Colorado, where the Castle Pines North Metropolitan District chose to incorporate as a city in part to avoid paying both County and District taxes. [See Section 8 for additional details]

³ James Rada, “Lake Lingamore, Md., Property Owners May Finally See Development,” *Frederick News-Post*, October 12, 2005.

⁴ *Ibid.*

⁵ Robyn Lamb, “Proposed Montgomery County Community Gets Boost from County Council,” *Baltimore Daily Record*, April 4, 2003.

⁶ Sonia Boin, “Official Seeks to Get Rid of Tax Districts,” *Frederick News-Post*, October 27, 2007.

Alternatively, they may choose to vote as a bloc against the issuance of bonds for facilities outside of the district's boundaries or become a powerful voice against any increases to the general property tax.

7. Limits a local government's ability to finance public projects as debt incurred by the CDA is calculated as underlying debt of the local government. [See reference material in Section 9]

In the 1991 proposed private sanitary district analysis Loudoun County's financial advisors at the time stated, "The aggregate amount of debt for these types of districts will be included on the County's own debt statement as obligations...At some point, the aggregate debt load among more than a single district will begin to impinge on the ability of the County as a whole to sell its own debt. In other words, there may not be an immediate impact on the bond rating but there will surely be a negative impact in the future."⁷

The County's current financial advisors, Davenport & Co., have reiterated the first sentence, and implicitly the second, on more than one occasion.

8. Successful marketing of the bonds often requires commitments from the local government.

The interest rates on CDA bonds and the willingness of investors to purchase such bonds is a function of the perception of how likely the debt service on the bonds will be paid when due. As payment on the bonds can only be assured with successful completion of the project, the bonds present the investor with considerable risk. Prospective investors might then be limited to "persons or institutions familiar with the developers' track records and capable of assessing the potential for economic growth in the area served."⁸ One means of mitigating this risk and expanding the bonds' market is for the local jurisdiction to back the bonds with a moral obligation to assume the debt service in the event of default. Once granted, this may result in either a direct or an indirect requirement for the government to apply public funds to a project.

In 2002 the City of Richmond provided a moral obligation to pay up to \$3 million in debt service on bonds issued by the Broad Street CDA should its revenue stream fall short of projections. In May 2009, this promise required the City to appropriate \$655,000 in public funds to assist the CDA with its June 1st bond payment with the expectation that further revenue shortfalls will require additional appropriations. [See Section 10 for additional details]

Given this experience, it is not surprising that discussions over the use of CDA financing for a minor-league baseball stadium within a mixed-use development have

⁷ McLoughlin and Mays, September 17, 1991.

⁸ Janice C. Griffith, "Special Tax Districts to Finance Residential Infrastructure," The Urban Lawyer, Fall 2007.

dragged on for four years. In an analysis of the most recent proposal, the City's financial advisors, Davenport & Co., conclude the project "to be highly feasible with city credit support and highly unlikely to be financed otherwise."⁹ Further, a decision to provide such support through a guarantee of moral obligation would use nearly 11% of the city's debt capacity. Analysis by the *Richmond Times-Dispatch* further suggested that the revenue projections provided by the developer would fall short of the actual revenue needed. [See Section 11 for additional details]

Closer to home, the Route 28 Transportation Improvement District informed the Loudoun County Board of Supervisors that without a promise of its moral obligation, it would be unable to sell their bonds at an affordable interest rate for the financing of the 10 interchanges. The BOS agreed on an 8-1 vote with Supervisor Jim Burton casting the sole dissenting vote. In the initial years, the assessments were insufficient to generate enough revenue to pay the district's share of the annual debt payment. State transportation funds had to be used to make up the shortfall. While later assessments exceeded those projections, there is no guarantee that the County will not be called upon in the future to provide further public assistance should a downturn in the commercial market occur. [See Section 12 for reference material]

An alternative approach to risk mitigation is to request all necessary land use approvals upfront. In a presentation at the National Federation of Municipal Analysts 1997 conference, a speaker commented, "These deals need permitting and entitlements. They're essential in getting a deal done. But they have to be there before the bonds are issued."¹⁰ [See Section 13 for the full presentation]

9. CDA bonds are particularly vulnerable to default.

As noted above, repayment of a CDA's bonds is dependent upon the successful development of the property. However, the real estate and construction industry are extremely cyclical and often volatile. Oftentimes, the revenue and cost calculations prepared prior to the authority's establishment do not account for the possibility of economic downturns or the business' inherent cyclicity.

"The developer is betting the debt burden can be passed on to home buyers or commercial tenants."¹¹ If the project fails to reach completion, falls behind schedule, lacks viability for whatever reason, or if the underlying assumptions of the financial analysis were simply too rosy, the CDA will be unable to make its scheduled payments. This occurred in California and Colorado in the early 1990's. For example, in December 1990, *The Bond Buyer*, an industry journal, reported 41 defaults on bonds issued by special tax districts in Colorado.¹² Similarly, 29 California CDA's defaulted on their bonds between 1990 and April of 1997,

⁹ Will Jones, "Ballpark Plan Needs City Help," *Richmond Times-Dispatch*, May 19, 2009.

¹⁰ Jim Phillips, "California Land-Secured Financings: The Dirt on Dirt Bonds," Presentation to the National Federation of Municipal Analysts 1997 Conference in *Municipal Finance Journal*, Winter 1998.

¹¹ David Hitchcock, *Special District Pros and Cons*, *American City & County*, March 1992.

¹² As referenced in a footnote by Janice C. Griffith.

according to a presentation at the National Federation of Municipal Analysts 1997 Conference. [See Section 12 for the full presentation].

It is also occurring today in Florida, California, and even Virginia. In the first five months of 2008, 30 municipal bond issues defaulted. More than half occurred in Florida and California, the epicenters of the real-estate bubble. Of the 10 Florida bonds that defaulted in this period, all were sold by community development districts (the term used in Florida) within the last four years. By the end of 2008, there were 14 additional bond defaults in Florida. Again, all were sold by CDD's. An associate professor of Urban and Regional Planning at Florida State University told *The Tampa Bay Business Journal*, "When growth doesn't happen, CDD's are unsustainable."¹³ [See Section 14 for reference materials]

Approximately 20 CDA's in Virginia have issued bonds since 1998. As noted earlier, the City of Richmond paid out \$655,000 this spring to prevent the Broad Street CDA from defaulting on its June 1st payment. Last year, two other CDA's in Virginia collapsed. The first, in Isle of Wight County, had a residential component but had not yet floated bonds. Amid growing financial concerns and an increasingly troubled real estate market, the developer chose simply to cancel the project even though it meant swallowing \$4 million in planning expenses. [See Section 15 for additional details]

The developer of the second, in Williamsburg, was forced into bankruptcy by a corporate creditor, amidst charges of theft and fraud. Five months earlier, the associated CDA had floated over \$32 million in bonds. Concurrently, the developer stopped paying bills to contractors working on the project and debt service on other loans associated with the project, including \$16.3 million borrowed to purchase the land, a \$65 million preconstruction loan, and \$170 million in mezzanine financing. The York County Finance Director sits on the CDA Board. She claimed that the \$17.5 million of the bond funds already released had been subject to rigorous oversight. However, she and the Board of Supervisors were anxious to see a successful sale of the project by the lenders to a new developer who could finish the project and pay off the millions owed to contractors and bondholders. This month, the County reported that the property owners within the district had failed to pay either the 2009 real estate taxes or the special assessment. [See Section 15 for additional details]

Where default occurs, a few landowners become legally liable for bond payments which assumed a diffusion of the debt among a far greater number. In 1990, the Colorado Centre CDA announced that homeowners would face tax increases of \$3 to \$10 per \$100 of assessed value (approximately \$10-\$15,000 on an \$85,000 home) to service the debt on dirt bonds issued by the CDA between 1985 and 1986. While the financial projections, assuming endless growth in the demand for houses in Colorado Springs, called for the sale of 1,500 homes, only 150 had actually sold. When the

¹³ Tim Chapin as quoted by Janet Leiser, "Hole in 'Dirt Bonds' to Deepen as Losses, Defaults Mount," *Tampa Bay Business Journal*, December 10, 2008.

Rev. Michael Greenwalt, a resident of one such district, heard about the increase, he admitted to a reporter, "I was not very pastoral."¹⁴

The homeowners sued. They filed for bankruptcy. They refused to pay. They received threatening nighttime telephone calls: "You will pay back those bonds. You owe me. You're going to lose your home."¹⁵ They considered walking away, abandoning their homes to foreclosure. [See Section 16 for additional details]

A similar story occurred with the Castle Pines North Metropolitan District in Douglas County, Colorado. In this case financial projections required the sale of 600 homes per year to generate the necessary property taxes for debt service on the \$38 million in bonds issued by the district in 1986. However, in 1990, when the district defaulted on its bonds and declared bankruptcy, it had sold less than 500 total units. Court documents estimated that the cost to each homeowner to meet the district's obligations to bond holders would be \$63,000 for houses valued between \$140,000 and \$220,000. It took almost four years and \$2 million in legal fees to reach a bitter settlement, leaving the chair of the creditor's committee to comment, "It's the homeowners that are stuck with the developer's problems...It becomes who is the victim here? The developers are not the ones who are hurt, or have been hurt, or will be hurt. It's a problem of how the development in the state is structured."¹⁶ [See Section 17 for additional details]

Common wisdom is that dirt bonds are sold only to sophisticated, institutional investors. This is not true. In the case of the Colorado defaults, articles abounded about teachers and retirees and other individuals who trusted the promises of brokers than municipal bonds never fail. Earlier this year, investors filed class action suit against several Oppenheimer Municipal Bond Funds, which they claim over-invested in dirt bonds in violation of the funds' stated investment objectives. [See Section 18 for additional details]

In its 1991 analysis of the proposed Dulles Perimeter Sanitary District, Loudoun County's financial advisors offered the following warning:

"[I]f the district is established and the bonds do default, the County Board will find itself in a most difficult position. Individual homeowners within the district will undoubtedly petition the Board of Supervisors for relief from the excessive tax rates being levied on their homes. Will the County Board turn them away because there is no moral obligation pledge, or will some accommodation be sought to protect the residents who have purchased homes within the district and who are obligated to pay exorbitant tax rates? If the County shows the slightest intention of assisting the

¹⁴ "Many Tax-Free Bonds Are Going into Default in CO Land Bust – Weak Regulation and Greed Are Blamed as Investors, Home Buyers Lose Out – Worse than Silverado," *Wall Street Journal*, December 7, 1990

¹⁵ Mike Anton, "Property Owners, Bond Buyers Living in a House of Cards / Foundation of Districts Crumbling," *Colorado Springs Gazette-Telegraph*, January 27, 1991.

¹⁶ Keith DuBay, "Players Do 'Workout' on Colorado's Castle Pines North Deal," *The Bond Buyer*, March 31, 1994.

distressed homeowners within the district, its ability to distance itself from the bankruptcy is diminished.”¹⁷

Bond rating agencies will expect the local government to step in even without the formal guarantee of a moral obligation. According to the County's financial advisors, past and present, such expectation exist even where the State has enacted laws maintaining that CDA debt is neither the debt of the State nor the debt of the local government.

Conclusions

Much of the literature on CDA's and their bonds focuses on failure rather than success. This is because the failures are so spectacular. Certainly, there are successful examples; they simply do not make it into newspapers. The Dulles Town Center CDA is one example. As most of these bonds are unrated, no agency tracks them. Rule 15(c)(2)-12 of the Securities and Exchange Commission does not require continuing disclosure for the bonds. Thus, there may only be limited public information available with regards to the financial solvency of many CDA's. The assumption, then, is that they are doing fine – until they fail to make a payment.

Based upon the experiences of CDA's in California and Colorado in the 1990's, a few critical success factors can be suggested:

- A well-capitalized builder/developer with lots of experience and many successful projects behind them;
- A builder/developer who is willing to put a little skin in the game by adding cash to the proposed financial structure or posting a Letter of Credit;
- A strong, central location;
- Realistic financial forecasts, including a worst case scenario, that do not rely on future property development to generate the revenues necessary to retire the bonds;
- A tax rate that is reasonable throughout the life of the bonds;
- A tight, well-written authorization agreement;
- Local government authorization of debt in excess of the original agreement;
- Significant, continuous oversight by local government officials.

¹⁷ McLoughlin and Mays, September 17, 1991..