

# California State Auditor

B U R E A U O F S T A T E A U D I T S

## **Marks-Roos Bond Act Borrowings:**

*Several Cities Misused the Program and Some Financed Risky Projects Which May Result in Investor Losses*



September 1998  
97127

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# CALIFORNIA STATE AUDITOR

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September 9, 1998

97127

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the use of bond proceeds issued under the Marks-Roos Local Bond Pooling Act of 1985 (act). This report concludes that the cities of Waterford and San Joaquin have exploited the act to generate lucrative fees by financing highly speculative projects that do not directly benefit their cities. The cities established Public Finance Authorities (PFA) which issued \$148.9 million in bonds to finance projects located throughout the State and, in return, received \$1.3 million in fees. However, they exercised little control over the projects to ensure their viability and control costs, and many of the projects are not generating sufficient revenues to make debt payments. Unless the PFAs are able to raise the money to make these payments, they will default on the bonds. The cities of Lake Elsinore, Coalinga, and Oroville also engaged in questionable, though less egregious, practices. Finally, although the other seven cities did not appear to have misused the act, four exposed bondholders to increased risk by financing projects outside their jurisdictions.

Respectfully submitted,

KURT R. SJOBERG  
State Auditor

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# SUMMARY

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## RESULTS IN BRIEF

The Legislature created the Marks-Roos Local Bond Pooling Act (act) in 1985 as a flexible tool for local agencies to finance needed capital improvements or other projects benefiting the public. However, many cities have used their authority under the act inappropriately. Waterford<sup>1</sup> and San Joaquin established public financing authorities (PFAs) and issued bonds to finance highly speculative projects throughout the State that do not directly benefit their cities. In exchange for financing the projects, the cities received a portion of the bond proceeds for costs unrelated to administering the bonds or to the financed projects. Together, these cities received \$1.3 million in fees for issuing \$148.9 million in Marks-Roos bonds.

In addition, the two cities did not adequately control the projects. As a result, both financed projects that do not have proper permits or approvals, and one paid too much to acquire some assets. For example, we estimate that, because it relied on a deficient appraisal report commissioned by the seller, one of San Joaquin's PFAs may have paid up to \$9.2 million too much for land it purchased. Furthermore, because this property's use is currently limited under the California Land Conservation Act, the PFA may not be able to fully develop it until January 1, 2008. The delay or potential failure to fully develop this land is likely to cause the PFA to default on \$23 million of its debt.

Further, the cities, or other members of the PFAs, did not adequately perform administrative duties, such as monitoring project progress, reviewing project costs, maintaining accounting records, and obtaining financial audits. This lack of control resulted in one PFA reimbursing a developer for a \$100,000 loan to a political organization and paying twice for services costing \$27,000.

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### **Audit Highlights**

*Our review of the 12 cities' use of Mark-Roos bond proceeds disclosed these issues:*

- ✓ Two cities, San Joaquin and Waterford, financed risky projects not directly benefiting their residents in exchange for lucrative fees. Because many of the projects financed are not generating revenue sufficient to meet upcoming debt payments, millions in bonds are at risk of default.*
  - ✓ Three other cities, Lake Elsinore, Coalinga, and Oroville, engaged in questionable, though less egregious, uses of the act.*
  - ✓ The remaining seven cities did not misuse the act, but four, Avenal, Dos Palos, Selma, and Wasco, may have exposed investors to increased risks.*
- 

<sup>1</sup> Technically, the city of Waterford is a member of only one PFA. However, for this report, we do not distinguish between the PFA established by the city of Waterford and those established by the Waterford PFA because the PFA's governing board is the city council.

More alarmingly, many projects have not generated revenues sufficient to pay the principal and interest due to investors, nor are they likely to do so in the near future. If PFAs are unable to raise the money to make required bond payments, they will default on the bonds. Despite the risk of default, the cities' PFAs continue to finance highly speculative projects.

We also noted less severe yet still questionable uses of the act in the cities of Lake Elsinore, Coalinga, and Oroville. The Lake Elsinore PFA paid up to \$1 million in duplicate bond issuance costs. The Coalinga PFA financed a golf course over 100 miles away in Merced in return for a fee of \$345,000. Oroville transferred over \$200,000 of interest earned on Marks-Roos bond proceeds to its general fund. Additionally, although the cities of Avenal, Dos Palos, Selma, and Wasco did not appear to abuse their Marks-Roos authority, they exposed investors to increased risks by financing projects outside of their jurisdictions. Finally, based on their responses to our survey of the 12 cities we reviewed, the cities of Atwater, Ione, and Placerville do not appear to have misused their authority under the act. In fact, Ione has never issued Marks-Roos bonds.

Whether the actions of Waterford and San Joaquin are legal is not clear—this question is best left to the legal system. However, these actions appear inconsistent with the intent of the act. Not only have some of these actions put individual investors at risk, but according to the California Debt and Investment Advisory Commission (CDIAC), defaulting on bonds could affect the ability of governmental agencies throughout the State to raise funds for needed capital projects.

To be effective, the flexibility that the act offers local agencies must be accompanied by responsibility and accountability. The local agencies and government officials who approve misuses of the program should be held responsible and accountable for their actions. Immediate steps are warranted to ensure this flexibility is exercised appropriately by local agencies.

## RECOMMENDATIONS

The Legislature should determine if it intends cities to receive, in addition to their administrative costs, bond proceeds for projects unrelated to those for which the bonds are issued. If the Legislature did not intend this, it should amend the act to both clarify its meaning and impose an appropriate penalty for local agencies who violate its wishes.

In addition, the state treasurer should convene a task force that includes representatives from the municipal marketplace to discuss further options for legislative change that would rein in the abuse of the act.

The district attorney's office in each county should consider prosecuting the members of the governing boards of the PFAs if it finds these officials have misused public funds.

PFAs should take the following actions:

- Issue Marks-Roos bonds only when doing so will result in a significant local public benefit, as defined in the act, and use the proceeds only for the purposes for which the bonds were issued as well as related costs.
- Before financing projects, take prudent steps to ensure the projects will be reasonably able to repay the debt. This should include commissioning independent feasibility studies and appraisals and requiring that projects have necessary permits, entitlements, and plan approvals.
- Independently monitor the projects during construction.
- Properly account for bond proceeds and arrange for the accounts and records to be audited each year by a certified public accountant.

Finally, to mitigate the adverse effects of their actions, the cities should immediately take the following measures:

- Stop using interest earned on Marks-Roos funds for unrelated purposes.
- Return any unearned fees they have received from bond proceeds to the respective bond trustees for payment of debt service or other appropriate use.

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# INTRODUCTION

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Public agency officials are often faced with decisions on how to fund long-term projects as well as pay for immediate financial needs. If an agency such as a city cannot or does not wish to use cash reserves to pay for its projects or supplement its budget, then it may consider using debt-financing. The California Debt and Investment Advisory Commission (CDIAC) lists 15 different debt financing options available to public agencies, including various types of bonds, notes, leases, and certificates of participation. One of these options is the Marks-Roos bond.

## **MARKS-ROOS LOCAL BOND POOLING ACT OF 1985**

The Marks-Roos Local Bond Pooling Act (act) was created in 1985 as a way for local governmental agencies to fund needed working capital, public capital improvements, or other projects that would provide significant benefits to the public. The act allows local agencies, through joint powers authorities (JPAs), to join together to issue bonds to finance needed projects. A JPA that is involved in the issuance of debt is often referred to as a public financing authority. Elected officials from the local agencies often compose the governing boards of the JPAs, and one of the members is generally responsible for administrative activities, such as authorizing payments and keeping accounting records.

Although the title of the act suggests establishing bond pools—consolidating the financing of several projects into a single bond issue—the broad financing powers conferred upon JPAs by the act are not confined to this purpose. Rather, the act contains a number of more substantial changes to California’s municipal bond law, leading to greater flexibility in issuing bonds.

Broadly speaking, the act authorizes JPAs to issue bonds to assist local agencies in financing public capital improvements, such as buildings, parks, sewers, and streets, and to provide working capital or cover liability and other insurance needs whenever

significant public benefits accrue. The act defines significant public benefits as the following:

- Demonstrable savings in effective interest rate, bond preparation, bond underwriting, or bond issuance costs.
- Significant reductions in user charges levied by a local agency.
- Employment benefits from undertaking the project in a timely fashion.
- More efficient delivery of local agency services to residential and commercial development.

Unlike other municipal bond laws, the act does not authorize the imposition of taxes or fees to be pledged to the repayment of the bonds. Instead, the bonds are secured by revenues that will be raised by the local agencies under separate statutory authority. The act is also unique in that the JPA need not comply with the laws that are in effect when issuing other bonds, such as the procedural requirement of competitive bidding and voter approval, as well as term and structural restrictions. Indeed, all that is required to issue Marks-Roos bonds is for the JPA to adopt a resolution.

### **LIMITED LIABILITY**

Under the act, member agencies and governing boards have no liability for the Marks-Roos bonds issued by JPAs; moreover, JPAs can limit their own liability. Although the JPA is generally liable for repayment of the bonds it issues, it may elect to limit this liability. The local agency members of the JPA cannot be held accountable for bonds issued by the JPA unless they expressly agree to assume such liability, nor can individuals on the governing boards of the JPAs.

### **MARKS-ROOS USES**

Although several financing alternatives are available to JPAs, Marks-Roos bonds are by far the most often employed. According to data compiled by CDIAC, \$24.4 billion, or 55 percent, of the \$44.5 billion in bonds issued by JPAs between 1987 and

1997 were Marks-Roos bonds. Of the \$182 billion in long-term debt issued by all local agencies during this period, Marks-Roos bonds issued by JPAs accounted for over 13 percent.

Because the act is flexible, JPAs use it to finance a wide variety of projects, including insurance, pension funds, and short-term cash flow needs. However, they most often use the act to finance public capital improvement projects.

## **CAPITAL PROJECTS**

Executing public capital improvement projects is a multifaceted process that includes a great deal of planning and persistent monitoring. This process typically takes place in three phases: the initial planning of the project, the selection of a financing method, and the supervision of the project's completion.

First, to ensure that an agency meets the needs of the communities it serves, it develops a capital outlay plan identifying projects that are necessary or desirable for its jurisdiction. At this stage, the agency studies the proposal to determine feasibility. It then selects a developer, normally through a competitive process, that will be able to deliver the desired project. It also determines whether sufficient revenues will be available to pay for the project or to repay debt if it finances the project.

Once an agency identifies the capital financing needs, it assembles a financing team. Appendix A lists the principal participants in a bond transaction team and their respective roles in the financing process. Throughout the selection of the type, size, and timing of the structure to finance the project, the agency generally remains fully involved to ensure that its goals and objectives are achieved at the best possible price.

The agency, as issuer, is ultimately responsible for any decisions made or actions taken. Regardless of the type of financing used, careful and thorough preparation is a critical factor to success. In choosing whether to proceed with a debt financing, an agency weighs the benefit to be gained from the financing against the related costs, as well as ensuring that there is a clearly defined public purpose for issuing the debt.

Finally, after the agency has raised the funds needed to finance the capital project, construction begins. During this phase, the

agency monitors the project until its completion to ensure that it proceeds according to plan. It also compares requests for payments with the services received and ensures that the project is within the established budget.

## **SCOPE AND METHODOLOGY**

The Joint Legislative Audit Committee requested the Bureau of State Audits to conduct an audit of Marks-Roos bonds issued by public financing authorities (PFAs) in 12 cities identified by the CDIAC: Atwater, Avenal, Coalinga, Dos Palos, Ione, Lake Elsinore, Oroville, Placerville, San Joaquin, Selma, Wasco, and Waterford.

To understand the roles and responsibilities of the PFAs and other participants in a bond transaction, we first reviewed the Marks-Roos Local Bond Pooling Act of 1985, related statutes and regulations, and the CDIAC's California Debt Issuance Primer. We also interviewed CDIAC staff to evaluate the agency's role and determine the extent to which it oversees and assists local governments.

We interviewed staff and in some instances reviewed records from other governmental agencies, including the Internal Revenue Service, CDIAC, the Department of Corporations, and the Stanislaus County District Attorney's Office, to discover the results of any investigation of this issue that had already taken place.

To determine whether any financial irregularities had been reported, we requested and reviewed any audits of the cities and their PFAs completed in the past three years.

To identify the intended use of the proceeds, we reviewed official statements for all Mark-Roos bonds issued by each of the 12 cities. The official statements provide disclosures to investors about the bonds, such as how the proceeds will be used and how they will be repaid. We also sent surveys to each city.

Based on our analysis of the official statements, we then selected three cities—San Joaquin, Waterford, and Lake Elsinore—where we performed additional on-site fieldwork. At these cities, we examined records and supporting documentation for the

Marks-Roos bonds issued by their PFAs to discover if proceeds were used appropriately. We tested a sample of payments to determine if they were allowable under the bond indenture (a listing of rules that govern the bond) and the Marks-Roos Act. Then, to determine if the cities received improper payments from their PFAs, we reviewed payments made by the PFAs to the cities. We also analyzed a sample of transfers made between bond accounts to ensure the transfers were allowable under the bond indenture.

For many of the PFAs involving Waterford, other members were designated to administer the project. In several cases, the member selected by the PFA was an Indian tribe or a nonprofit corporation. We did not perform on-site reviews of these entities. However, we were able to obtain and review certain documents, such as trustee statements and invoices, and to the extent possible, perform the above procedures.

Finally, we also conducted on-site investigations at five other cities identified in the audit request. However, unlike the field-work performed in the three cities above, these efforts were limited to reviewing specific allegations that had been brought to our attention by concerned citizens during our audit.

We will contact the District Attorney's office in all counties in which we identified potential illegal activity and will offer our documentation and assistance in any actions they may choose to take.

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# CHAPTER 1

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## ***Two Cities Exploited the Marks-Roos Act to Generate Lucrative Fees by Financing Risky Projects***

### CHAPTER SUMMARY

The cities of San Joaquin and Waterford (cities) exploited the Marks-Roos Local Bond Pooling Act of 1985 (act) to generate lucrative fees for themselves and their project partners. The cities, with other entities, formed Public Finance Authorities (PFAs) and issued Marks-Roos bonds to public investors for funding highly speculative real estate projects. In return for issuing \$148.9 million in debt, the cities received fees totaling \$1.3 million. The Office of the Attorney General has informally determined that these fees, because they are not related to costs of the project for which the bonds were issued or costs incurred by the cities to administer the bonds, are illegal<sup>2</sup>. Most projects, such as golf courses, residential infrastructure, and a gaming facility, are located in other areas throughout the State and do not directly benefit the sponsoring city's residents.

Moreover, before issuing bonds, the cities and other members of the PFAs did not adequately assure the feasibility of some of these projects. Consequently, some of the PFAs, which are responsible for repaying the bonds, sponsored undertakings without clear permits, land use approval, or entitlements. For example, two related projects for a golf course and accompanying housing in Madera County are planned on land currently restricted to agricultural or open-space use. Although these restrictions do not affect the golf course, they do prevent the development of the residential lots that are expected to generate most of the revenue needed to repay the debt on these projects.

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<sup>2</sup> Although attorney general opinions, formal or informal, do not have the effect of law, they do represent the legal opinion of the State's legal advisor, and as such, formal opinions can be cited as legal authority in court.

Further, some PFAs did not exercise adequate control over project costs and payments. One paid up to \$9.2 million too much for land. Another PFA paid invoices totaling \$27,000 twice; it also reimbursed a developer for a \$100,000 loan to a political organization. In addition, these PFAs delegated responsibility for managing some projects to the developers and failed to account for the use of all funds and obtain annual audits.

Most importantly, at this time, many of the projects have not generated sufficient revenues to pay the principal and interest costs due, nor are they likely to in the near future. As a result, many individual investors may lose money. Furthermore, if the PFAs default on these bonds, it could adversely affect municipal bond sales by undermining investor confidence.

### **THE CITIES AND OTHER MEMBERS OF SOME PFAs MAY HAVE VIOLATED PROVISIONS OF THE ACT**

Since 1990, the 13 PFAs of which San Joaquin and Waterford are members have issued over \$184.1 million in Marks-Roos bonds. Many of these PFAs have potentially violated the provisions or intent of the act in three specific ways: They have financed projects that, because of their locations, do not benefit the members' residents; they have accepted a portion of bond proceeds that the Office of the Attorney General (attorney general) has informally opined is illegal; and they have formed PFAs with Indian tribes and certain nonprofit corporations that are not authorized to participate in the program. Appendix B lists the 13 PFAs and their members, and identifies those PFAs that paid fees to their members.

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***Because some projects are outside of the PFA members' jurisdictions, they provide no apparent benefits for local residents.***

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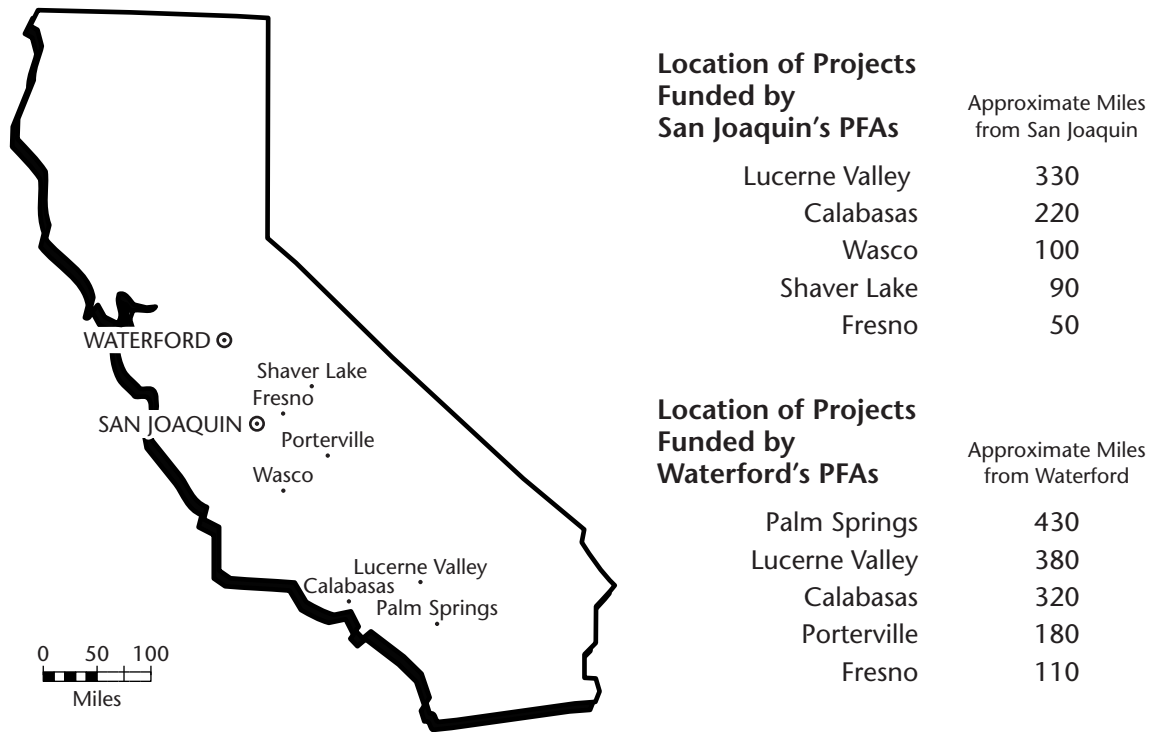
In reviewing the location of projects financed by these 13 PFAs, we found that approximately \$144.4 million (78 percent) of the bonds the PFAs issued were for capital projects, such as golf courses or gaming facilities, outside their members' geographical boundaries. Thus, the revenues and benefits generated from these projects will not accrue to the PFA members' populations. Figure 1 on page 13 shows the projects' locations in relation to the cities.

The act allows PFAs to issue Marks-Roos bonds when there is a significant public benefit for doing so. However, because these projects are outside the members' jurisdictional boundaries, they



**FIGURE 1**

**Some Projects Were More Than 400 Miles From the Cities That Financed Them**



provide no apparent benefits—such as reduced costs, public facilities, or job opportunities—for local residents. For example, construction of a golf course in Palm Springs, 430 miles from Waterford, will not provide any public benefit to the residents of Waterford. Likewise, financing the infrastructure for a gated community near Shaver Lake in the Sierra Nevada Mountains will not help the farming community of San Joaquin, located approximately 90 miles away.

In each of these instances, the PFAs adopted a resolution stating that the bonds were being issued to provide a public benefit; however, according to the attorney general, only the entity actually receiving the benefit can make such a finding. To prevent this misuse of the bonds, effective January 1, 1999, the act will specifically prohibit the financing of projects outside a PFA's geographical jurisdiction. Contrary to the intended policy, though not yet illegal, San Joaquin and Waterford have continued to issue bonds to finance projects outside their jurisdictions.

Although the projects securing the bonds do not benefit the members, the payments they receive for financing these projects do benefit them. In fact, according to officials from the cities of San Joaquin and Waterford, the cities participate in these PFAs for the sake of receiving payment. In exchange for issuing the bonds, the PFA members receive a portion of the total bond proceeds. In many instances, the fee they receive is unrelated to the members' costs of administering the bonds or the project for which the PFA issued the bonds. Table 1 shows the amount received by each member.

**TABLE 1**

PFA Members Received Thousands of Dollars in Fees

Local Agency Name	Total Fees Received
City of San Joaquin	\$868,450
City of Waterford	475,275
Merced County Board of Education	139,000
Chukchansi Indian Tribe	125,000
City of Mendota	85,375
City of Isleton	82,875
Pacific Rim Economic Development Corporation	50,000
Shoalwater Bay Indian Tribe	50,000
Lucerne Valley Unified School District	44,300

**Some Payments to PFA Members May Be Illegal**

The cities and other members may have received this money in violation of the act. The act authorizes PFAs to issue bonds for capital projects and allows them to use bond proceeds to reimburse their members for their administrative expenses. However, it limits these payments to the members' actual administrative costs and specifically states that payments of bond proceeds to members in excess of actual administrative costs are illegal. The Office of the Attorney General concluded, in an informal opinion, that members of the PFA may not receive bond proceeds for projects unrelated to the project for which the PFA issued the bonds. Nonetheless, the cities could provide no evidence that all of the payments they received were used for administrative expenses or for costs related to the projects for which the bonds were issued.

For example, of the amount San Joaquin received, it set aside 15 percent for administrative expenses, using the remainder to help finance a community center, a fire station, computer equipment, and for other expenses unrelated to the golf courses and other projects responsible for repaying the debt. Similarly, the city of Waterford used some of the fees it received to pay for local infrastructure projects unrelated to the gaming facilities, golf courses, and other projects securing the bonds. Although the cities are aware of the attorney general's opinion, they have continued to receive money for their own uses, relying on the advice of their bond counsel that such payments are legal.

Contrary to the attorney general's position, the bond counsel for the PFAs believes that the section of the act that states it is unlawful for a PFA or any of its members to receive payments from bond proceeds except for fees charged for their costs of issuance and administration pertains only to administrative costs and does not limit the PFA's ability to give its members bond proceeds for their public capital improvements. He contends that to conclude otherwise is contrary to the intent of the entire Joint Exercise of Powers Act. He did not specifically address the attorney general's conclusion that the bond proceeds can be used to pay costs related only to the project for which the bonds were issued. After reviewing both the bond counsel's analysis and the attorney general's opinion, our legal counsel concurred with the attorney general's opinion.

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***Even if unearned fees are found to be legal, they still unnecessarily increase the financial burden on the project.***

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Even if this unearned fee practice is found to be legal, we maintain it is not prudent because it unnecessarily increases the financial burden on the projects securing the debt. To pay these unearned fees to members, PFAs issue more debt. Consequently, the project must generate sufficient revenue not only to pay the actual costs of issuing the bonds and constructing the project, but also enough to cover fees paid to the PFA members. These additional costs increase the risk that projects will be unable to generate enough revenue to repay the debt, which could ultimately cause the PFA to default.

Finally, the cities may have inappropriately formed PFAs with Indian tribes and certain nonprofit corporations. The attorney general, in an informal opinion, concluded that an Indian tribe, or political subdivision of an Indian tribe, is not a local agency and, therefore, cannot be a member of a PFA. Moreover, in a formal opinion, the attorney general stated that a city and a nonprofit public benefit corporation created by the city may not establish a PFA. For the 13 PFAs related to the cities of Waterford

and San Joaquin, four include Indian tribes and four include ineligible nonprofit corporations as members. The cities formed these PFAs before the Office of the Attorney General issued its opinion.

### **The Cities of San Joaquin and Waterford Did Not Adequately Control Capital Projects Financed With Marks-Roos Bonds**

Although the PFAs created by San Joaquin and Waterford have financed capital construction projects costing millions of dollars, the members did not exercise the degree of control normally expected over the use of public funds. As described in the Introduction, executing and financing public capital improvement projects is a multifaceted process, involving project planning, finance selection, and project monitoring. However, in many of these Marks-Roos transactions, the underwriter acted as a broker bringing together two groups: developers with projects in need of funding and cities with the ability to form PFAs and access the municipal bond market. For a fee, the PFAs issued bonds to finance the projects; however, they exercised little control over the capital project process to ensure the viability of projects and to control costs.

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*PFAs did not ensure that projects would be viable and able to repay the debt.*

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The cities' PFAs did not take adequate precautions to ensure that the projects being financed would be able to repay the debt. In a number of instances, they relied on studies commissioned by the developer or underwriter to determine feasibility, despite the vested interest of these parties in seeing that the bonds were issued. To ensure they received unbiased assessments of the project's potential, the PFAs should have commissioned their own studies.

Additionally, the PFAs did not always ensure that projects had all necessary permits, final plan approvals, and important entitlements before the bonds were sold. As a result, they have subjected their bondholders to significant risks. If the developer fails to receive the proper project approvals, the project cannot be completed, and the PFA is likely to default on its bond payments.

For example, in 1997 San Joaquin's Four Corners PFA issued bonds and purchased land to build a public golf course. The bonds are to be repaid with golf course revenues and assessments on residential lots. However, this land is under contract within the California Land Conservation Act, commonly known as the Williamson Act, until January 1, 2008. The Williamson

Act allows the local government, in this case Madera County, to contract with private landowners for the purpose of restricting specific properties to agricultural or related open-space use. In return, the landowners pay substantially reduced property taxes while the local governments receive an annual subsidy from the State.

Although the Williamson Act restrictions do not prevent the development of the golf course, they do prevent development of the residential lots planned for this property. As yet, the land has not been released from the Williamson Act restrictions. In fact, according to the Madera County Planning Department, the developer has not applied for release from the restrictions. Even if the developer is released from the Williamson Act contract, before he can prepare the residential lots for sale, the county must approve the project, a process the planning department estimates will take at least one year. Therefore, it is questionable whether the residential lot sales will take place in time to make debt payments scheduled to begin in October 1999. Failure to fully develop this land could cause the PFA to default on \$23 million of its debt.

### **One PFA Paid Too Much for Land**

Additionally, San Joaquin did not always ensure that its PFAs paid a fair price for the property securing the bonds. For example, its Four Corners PFA purchased 388 acres of unimproved land within a 1,271-acre project from the developer and paid the appraised value of \$13.1 million, or \$34,000 an acre. However, the appraisal, commissioned by the developer, does not take into account that, because of restrictions imposed by the Williamson Act, the land cannot be used for residential development. Further, the appraised value was contingent upon the completion of a golf course that remains incomplete today. Since the developer had purchased the entire 1,271 acres a few months earlier for approximately \$12.7 million, or \$10,000 an acre, we estimate the PFA may have paid up to \$9.2 million more than the land was worth. Because it paid too much for the land, the bonds the PFA issued to purchase the land may not be adequately secured. We discuss the effects of over burdening the land with debt later in this chapter.

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*The developer purchased the land for \$10,000 an acre and sold it to the PFA a few months later for \$34,000 an acre.*

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### **Cities Failed to Adequately Monitor Projects**

Finally, the cities, or other responsible PFA members, did not adequately perform such administrative responsibilities as

monitoring project progress, reviewing project costs, maintaining accounting records, and obtaining financial audits. The act requires that PFAs provide a strict accountability of all funds and obtain an annual audit of their accounts and records.

In some instances, the cities have irresponsibly delegated their project management duties. For example, Waterford relies on the project's developer, rather than an independent party, to ensure that work is performed and that services being billed have actually been received. On the other hand, San Joaquin employs a more appropriate control; an engineering firm separate from the developer reviews the project's progress and verifies the validity of the developer's invoices. However, neither city performs a detailed review of the invoices, but instead relies on the bond counsel to approve the propriety of various project costs paid with bond proceeds. Yet, when asked, the cities' bond counsel stated that he only determines if the invoice falls within the nature of the project before submitting it to the PFA for final approval. Although we found no improper payments at the PFAs San Joaquin and Waterford administered, the lack of strong oversight and review can lead to erroneous or improper payments, as illustrated below.

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*PFAs did not obtain required audits and lacked records supporting bond activity.*

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The California Desert PFA, of which Waterford is a member, made at least two inappropriate payments. In the first instance, it paid twice for the same services, which cost more than \$27,000. In the other instance, it failed to question an invoice from a developer who was not associated with the project being financed. We asked the developer to provide documents supporting his claim for payment. The documents he provided showed he was claiming reimbursement for a loan he had made to an Indian gaming political organization. Thus, because the PFA did not question the invoice, it essentially made a \$100,000 political contribution, which is an improper use of bond proceeds.

The San Joaquin and Waterford PFAs also failed to obtain the required annual audits and lacked records supporting the bond issue activity. For example, even though the Jensen Ranch and Four Corners PFAs have already spent more than \$22.9 million on two golf course projects, neither had accounting records detailing the costs for the land and related expenditures, and neither presented these assets in audited financial statements. Furthermore, Waterford also failed to maintain accounting records for its PFAs, and, although it commissioned an accounting firm to audit the Waterford PFA, the accountant was unable

to attest to the accuracy of the financial statements because of the lack of records.

## SPECULATIVE PROJECTS PLACE MANY BOND ISSUES AT RISK OF DEFAULT

Two of Waterford’s PFAs have already defaulted on \$9.2 million of their debt. In addition, by the end of the year, five of San Joaquin’s and Waterford’s PFAs, which financed projects outside their members’ jurisdictions, must raise enough money to make \$15.3 million in principal and interest payments. Table 2 presents these five PFAs and the amounts they owe. However, most of the projects are currently not generating sufficient revenues to make the upcoming debt-service payments. As a result, many of these issues may also be at risk of default.

**TABLE 2**

### Some Projects’ Revenues Are Unlikely to Meet Debt Payments Due by Year End

Public Financing Authority	Total Unpaid Principal	Principal and Interest Payments Due August to December 1998
<b>Projects Currently Generating Revenue</b>		
Sierra Nevada PFA	\$ 7,410,000	\$ 296,400
<b>Projects Not Currently Generating Revenue</b>		
Jensen Ranch PFA	25,615,000	1,024,087 <sup>a</sup>
Four Corners PFA	12,800,000 <sup>b</sup>	13,312,000
California Desert PFA	14,900,000	581,813
Rancho Lucerne Valley PFA	2,750,000	96,250
Subtotal Not Currently Generating Revenue	56,065,000	15,014,150
<b>Grand Total</b>	<b>\$63,475,000</b>	<b>\$15,310,550</b>

<sup>a</sup> The Jensen Ranch PFA failed to make its April 1998 interest payment of \$312,000. This amount is not included in the table.

<sup>b</sup> According to the official statement, the PFA intended to refund this short-term debt with new bonds in 1997. However, to date, it has refunded only \$3 million; the \$12.8 million balance is due to be paid by December 15, 1998.

Of the two projects presently close to completion, only one, the Sierra Nevada PFA's gated community, appears to be generating sufficient revenues to pay its \$296,400 interest payment. The other, the Jensen Ranch PFA's golf course, is expected to generate only \$15,500 in its first year of operation, a fraction of the \$1 million due to investors in October. Although the Jensen Ranch PFA intended to use revenues derived from residential lot sales, as well as from the golf course, to repay the debt, as of August 1998, construction had not begun on the infrastructure for the residential portion. The three projects responsible for the remaining \$14 million are not generating any revenue. Unless the PFAs can find a way to make their debt payments, approximately \$56 million in bonds are at risk of default.

### **Most Projects Have Not Generated Enough Revenues to Meet Debt Payments**

Because most projects have not generated sufficient revenues to make the debt payments when due, the PFAs have made required payments by either borrowing money from other PFAs, using bond proceeds, or issuing new debt. The different PFAs are thus becoming interrelated by a series of complex transactions, including loans and refinancings. Figure 2 on page 21 shows the interrelationships that exist among four PFAs funding three projects in the Rio Mesa Area Plan in Madera County: Riverbend Ranch, Jensen Ranch, and the Bluffs at Riverbend. Together, these three projects are based on a plan to construct two public golf courses and several related housing developments.

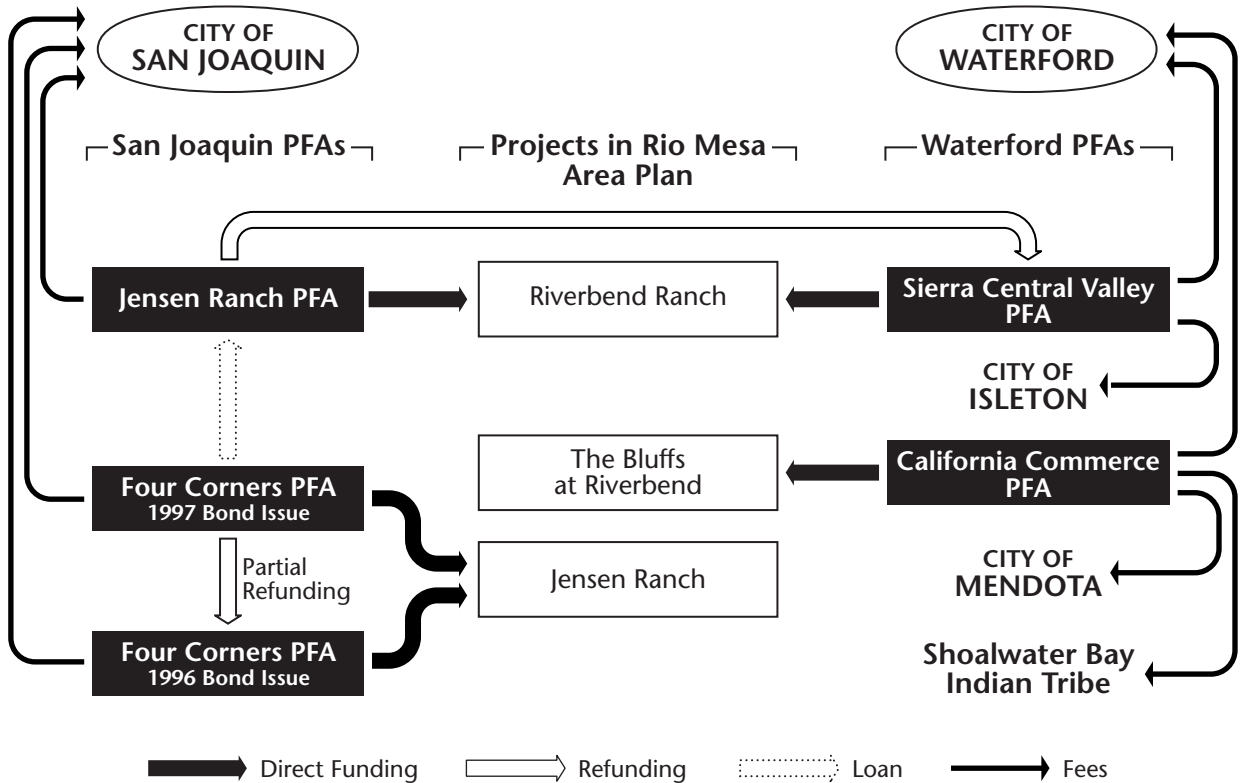
The 1997 Four Corners bond issue demonstrates how complex some of these transactions are. In 1997, the Four Corners PFA issued bonds and used \$3 million of the proceeds to refund a portion of a 1996 Four Corners short-term bond anticipation debt, and loaned \$9.6 million to the Jensen Ranch PFA. The Jensen Ranch PFA in turn used \$7.6 million of the proceeds to refinance an earlier bond from the Sierra Central Valley PFA that had funded portions of Riverbend Ranch.

In the absence of project revenues, these complex transactions have allowed the PFAs to avoid default. However, recent legislation, effective January 1, 1999, will make this loaning and the rolling over of debt for projects outside a PFA members' geographical jurisdiction illegal. Thus, unless they issue additional bonds before January 1, 1999, or form new PFAs with local



FIGURE 2

Some PFAs Are Becoming Interrelated by a Series of Complex Transactions



agencies having jurisdiction over the projects, many PFAs will need to find other revenue sources to meet debt payments or default on their bond issues.

Although issuing more bonds may solve the immediate problems, it may imperil some projects already heavily encumbered by debt. Each additional bond a PFA issues increases the burden on the project’s revenue and reduces the funds available to repay debt. For instance, according to the official statement, the Jensen Ranch PFA proposes to use developer impact fees and lot assessments to retire the debt on its related outstanding bond issues. Anticipated sales prices for these lots range from \$98,625 to \$201,300 with an average lot value of \$148,210. However, each lot sale is already burdened with \$111,286 in assessments and impact fees—\$75,000 to repay \$16 million in bonds and \$36,286 to repay a \$9.6 million loan. This leaves an average of only \$37,000 per lot to pay any additional debt. Because of issuance costs, refinancing the existing debt would further erode the \$37,000.

*Issuing more bonds to solve immediate problems may imperil some projects already heavily encumbered by debt.*

### **Some PFAs Plan to Use Other Means to Pay Debts**

According to San Joaquin, instead of issuing more bonds to pay the existing debt, the developer for the Jensen Ranch PFA plans to sell two of the three parcels of land securing the \$16 million Jensen Ranch PFA bonds and use the proceeds, estimated to be \$8 million, to reduce the amount owed. The city believes the anticipated golf course revenues will be sufficient to make the principal and interest payments on the remaining debt. The developer then plans to use the fees and assessments from the sale of residential lots to repay the \$9.6 million loan.

However, San Joaquin's plan is deficient in several areas. First, with regard to repaying the bonds, the developer has not yet sold either of the two parcels, even though one parcel, valued at \$3 million, has been in escrow since February 1998. Additionally, according to the trustee for the bond issue, the developer cannot sell these properties without first obtaining written consent from the trustee. As of August 12, 1998, the developer had not informed the trustee of the proposed sales, much less requested consent to sell them. Moreover, although the golf course is near completion, it is expected to net only \$15,500 in its first full year of operation. Thus, we question the PFAs ability to pay the \$1 million interest due in October 1998.

Finally, with regard to repaying the loan, the first principal payment of \$1 million is due in October 1999. In addition, three semiannual interest payments of \$369,600 each are due between October 1998 and October 1999. However, as of August 21, 1998, work has not even begun on the residential portion of the project. Thus, it is unlikely that revenue from the sales of lots will be sufficient to make the upcoming interest payments let alone that first principal payment.

### **Bond Defaults Could Have Widespread Results**

If the PFAs default on the bonds funding these risky projects, many investors may lose their money. Although the cities should be alarmed at the prospect of these defaults, San Joaquin officials have stated they believe that, since the official statement for each bond covers all aspects of the issue, the risk of loss lies with the investor. Even though this may be true, because municipal bonds are perceived to be among the safest investments, individual investors may not be as wary as they should. Thus, the city's "buyer beware" attitude seems inappropriate for a government entity.

---

*San Joaquin maintains a "buyer beware" attitude.*

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In the event of default, the trustee on behalf of bondholders—which include many individual investors—will have to institute foreclosure proceedings against the various PFAs to attempt to recover the bondholders’ investments. Since it appears that at least one PFA paid too much for its assets, bondholders may not be able to recover all their money. The Department of Corporations interviewed some of these investors and discovered that, in at least one case, a bondholder had put as much as 25 percent of his life savings into these issues.

The impact of the bond defaults is not limited to the affected Marks-Roos investors; the State’s municipal market may also be affected. Investors may question the safety of investing in municipal bonds. According to the California Debt and Investment Advisory Commission, this lack of trust may make investors less inclined to loan money to municipal governments in the future and potentially increase future municipal borrowing costs. Additionally, for cities that default, the adverse publicity may reduce their ability to issue any type of bonds. Without access to the capital markets, a city would be hard-pressed to pay the costs of the infrastructure it needs to accommodate its residents.

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***PFA board members violating the Penal Code may be at risk of prosecution and disqualification from holding office.***

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Furthermore, although the PFAs’ governing board members are not personally liable for the bonds, according to our legal counsel, these board members may be held criminally liable for the municipalities receiving bond proceeds in excess of their actual costs of issuing and administering the bonds. As a result, PFA board members may be at risk of prosecution and disqualification from holding public office. California Penal Code, Section 424, states that, if persons charged with the safekeeping of public moneys, including bond proceeds, use the funds for any purpose not authorized by law, they can be imprisoned for up to four years and are disqualified from holding office in the State.

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# CHAPTER 2

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## ***Although Most Other Cities Used the Marks-Roos Act Appropriately, Some Engaged in Questionable Practices***

### **CHAPTER SUMMARY**

In addition to Waterford and San Joaquin, three other cities—Lake Elsinore, Coalinga, and Oroville—also engaged in questionable practices regarding their public financing authorities (PFAs), although their actions were less egregious than those discussed in Chapter 1. In specific instances, each of these cities made questionable decisions. The Lake Elsinore PFA paid duplicate bond issuance costs. The Coalinga PFA financed a golf course in Merced in return for an excessive \$345,000 fee. Oroville financed general fund activities with \$200,000 of interest earned on Marks-Roos bond proceeds, though it appropriately revised the bond indenture, or the terms of the bonds, before doing so. Of the seven remaining cities that do not appear to have abused the program, four exposed bondholders to increased risks by financing projects outside their jurisdictions.

### **CERTAIN CITIES HAVE ENGAGED IN QUESTIONABLE PRACTICES**

Some actions of the Lake Elsinore PFA resulted in excessive costs. On three separate occasions, the PFA used a Marks-Roos bond issue to purchase a simultaneously released Lake Elsinore community facilities district bond issue. This action resulted in the PFA paying duplicate issuance costs of up to \$1 million. Although the Marks-Roos Local Bond Pooling Act of 1985 (act) allows the PFA to purchase the securities of a local agency if a significant public benefit results, we could see no such benefit from these transactions. In another instance, the PFA paid a consultant \$75,000 to find a buyer for a bond issue, even though it had already paid an underwriter to perform this duty.

We also identified a questionable use of bond proceeds by the city of Coalinga. The Coalinga PFA financed the construction of a golf course 100 miles away in Merced in return for a fee of \$345,000. Although the money remains unspent in the PFA's bank account, the city advised us that the payment was to cover its costs of administering the project financing. However, it did not keep track of its costs and, therefore, was not able to support the amount.

---

***At three cities we found these questionable practices:***

- ✓ One incurred more than \$1 million in excessive costs.***
  - ✓ A second received \$345,000 in excessive fees.***
  - ✓ A third transferred over \$200,000 in bond interest to its general fund.***
- 

Since the PFA's responsibilities were limited to financing the golf course, the amount appears excessive. At the time it charged these fees, the act did not limit them to actual costs. However, by charging excessive fees, the PFA unnecessarily burdened the project revenues needed to repay the debt, thus increasing the risk of default. Indeed, in June 1998, the Merced County Board of Education, the local agency overseeing the construction of the golf course, reported that golf course revenues do not appear to be adequate to meet debt service payments for the bonds, and, unless it can refinance the bonds, the PFA will likely have to default. Although it's unlikely that the excessive fees would cause default, they would be a contributing factor.

Finally, since 1996, the city of Oroville has made questionable transfers to its general fund of over \$200,000 in interest earned on the proceeds of a Marks-Roos bond sale. Generally, the interest earned on the bond proceeds is used to make future debt payments. Although it appears that the city legally revised the bond indenture to allow it to make these transfers, it is not the intent of the act to create a revenue-generating cash pool for the city. Moreover, by transferring this money to its general fund, the city reduces the amount available to make the bond's principal and interest payments.

### **OTHER CITIES DID NOT ABUSE THE ACT BUT SOME MAY HAVE EXPOSED INVESTORS TO INCREASED RISKS**

Based on their responses to our survey, it does not appear that the cities of Avenal, Atwater, Dos Palos, Ione, Placerville, Selma, and Wasco used their Marks-Roos authority improperly. In fact, Ione was never a member of a PFA issuing a Marks-Roos bond. However, though their actions were not illegal, the cities of Avenal, Dos Palos, Selma, and Wasco exposed their bondholders to increased risks by financing projects outside of their jurisdictions.

The four cities each established PFAs with their respective redevelopment agencies. These PFAs used bond proceeds to finance at least one project outside of their members' jurisdictions. However, unlike the cities we discuss in Chapter 1, the member cities did not receive a fee for doing so. Avenal, Dos Palos, and Wasco could not recall why they financed projects outside their jurisdictions. Selma did it to help smaller agencies that could not access the bond market due to their size.

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***Although their actions were not illegal, four cities exposed their bondholders to increased risks by financing projects outside their jurisdiction.***

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Although financing projects outside a PFA's jurisdiction is currently allowed by law, the Legislature and governor recently approved a bill that will make it illegal. According to the sponsors of the bill, an agency financing a project outside its geographical jurisdiction cannot adequately oversee the project. For example, on the advice of its financial advisor, the Avenal PFA used proceeds from Marks-Roos bonds to purchase bonds issued by Nevada County (county) and the city of Ione. When the county and Ione defaulted on their bonds, the Avenal PFA filed a lawsuit against its financial advisor and others to recover its investment. Ultimately, the PFA sold the bonds to the advisor. Had the PFA failed in its attempt to sell the bonds, it may have been forced to default on its Marks-Roos bond issue.

Unlike the Avenal PFA, the Wasco and Dos Palos PFAs have defaulted on some of their Marks-Roos bond issues. These bonds financed projects both within and outside their jurisdictions. Although the Selma PFA also financed projects outside its jurisdiction, none of these projects have caused the PFA to default.

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# CHAPTER 3

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## ***Conclusions and Recommendations***

### **CONCLUSIONS**

Five of the 12 cities we were asked to review misused their authority under the Marks-Roos Local Bond Pooling Act of 1985 (act). The severity of the misuse in the five cities varied; however, the consequences in each case could be significant. In return for a fee, the cities of San Joaquin and Waterford used their public financing authorities (PFAs) to issue Marks-Roos bonds that financed highly speculative projects, sometimes hundreds of miles from their jurisdictions. In issuing these bonds, the cities chose to follow legal advice contrary to the Office of the Attorney General’s opinions, which deemed some of their actions illegal, and to ignore the intent of the Legislature as clarified in recent legislation.

If any of these projects fail, bondholders—many of whom are individuals—could lose some or all of their investments. Despite this, the cities of San Joaquin and Waterford continue to issue additional bonds through their PFAs for highly speculative projects. Although their actions were less egregious, the cities of Lake Elsinore, Coalinga, and Oroville also used the act in questionable ways. Lake Elsinore paid duplicate bond issuance costs, Coalinga received an excessive fee for financing a golf course 100 miles away, and Oroville transferred interest earnings to its general fund.

Whether the actions of these PFAs are legal is not clear; this question is best left to the legal system. However, these actions appear inconsistent with the intent of the act. Not only have some of these actions put individual investors at risk, but according to the California Debt and Investment Advisory Commission, bond defaults could adversely affect the ability of governmental agencies to raise funds for needed capital projects. The act provides great flexibility to local agencies in raising funds for capital projects and other uses. However, to be effective, this flexibility must be accompanied by responsibility and accountability. The local agencies and government officials who approve misuses of the program should be held responsible

and accountable for their actions. The Legislature and appropriate enforcement agencies should take immediate measures to ensure this flexibility is exercised appropriately by local agencies.

## RECOMMENDATIONS

The Legislature should determine if, in addition to administrative costs, it intends cities to receive bond proceeds for projects unrelated to those for which the bonds are issued. If this is not the Legislature's intent, it should amend the act to clarify its meaning. It should also consider amending the act to impose an appropriate penalty on local agencies that receive proceeds in excess of their administrative costs. Finally, it should consider adding a provision that makes any asset purchased with bond proceeds subject to the bondholders' claim in the event of default.

In addition, the state treasurer should convene a task force that includes representatives from the municipal marketplace to discuss further options for legislative change that would rein in the misuse of the act.

Meanwhile, the district attorney's office in each county should consider prosecuting the members of the governing boards of the PFAs if it finds these officials have misused public funds. If deemed appropriate, county district attorneys' offices should also consider issuing cease and desist orders to PFAs that approve the issuance of additional bonds for illegal uses.

To more fully comply with the intent of the act and protect the public good, the PFAs should take the following actions:

- Issue Marks-Roos bonds only when it will result in a significant local public benefit, as defined in the act.
- Ensure that bond proceeds are used only for the purpose for which the bonds were issued and related issuance and administrative costs.
- Before financing projects, take prudent steps to ensure the projects will be reasonably able to repay the debt. This should include commissioning independent feasibility studies and appraisals and requiring that projects have necessary permits, entitlements, and plan approvals.

- Independently monitor the projects during construction.
- Maintain detailed records to properly account for bond proceeds.
- Arrange for a certified public accountant to audit the accounts and records each year.

Finally, to mitigate the adverse effects of their actions, the cities should immediately take the following measures:

- Discontinue forming PFAs with ineligible organizations.
- Stop transferring interest earned on Marks-Roos funds for unrelated purposes.
- Return any unearned fees to the respective bond trustees for repaying the debt.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG  
State Auditor

Date: September 9, 1998

Staff: Sylvia L. Hensley, CPA, Audit Principal  
David E. Biggs, CPA  
Patrick Adams  
Douglas Gibson, CPA  
Kathryn Lozano

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# APPENDIX A

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## ***Principal Participants in a Bond Transaction***

Many different participants are involved in the process of issuing a bond or other debt instrument. Usually, the issuer is the central participant in the financing; however, several other legal, financial, and custodial participants have important roles. The following is a summary of the principal participants in a bond transaction, as well as a brief discussion of the role each plays.

<b>Participant</b>	<b>Role of Participant</b>
<b>Issuer</b>	The issuer is the legal entity that is borrowing money by issuing bonds. The issuer has statutory authority to issue municipal debt instruments for various purposes. The issuer selects the rest of the bond participants. Subject to legal constraints, the issuer retains ultimate control and responsibility over the details of the financing structure.
<b>Bond Counsel</b>	The Bond Counsel is the attorney or firm that gives the legal opinion confirming that the bonds are valid and binding obligations of the issuer, and that the interest on the bonds is either exempt or not exempt from federal and state income taxes.
<b>Underwriter</b>	The underwriter purchases bonds from an issuer with the intent to resell the bonds to investors.

*Continued on the next page*

Participant	Role of Participant
<b>Financial Advisor</b>	The need of a financial advisor may depend on the financial sophistication of the issuer's staff. When used, a financial advisor may review the financial feasibility of projects, recommend an appropriate financing structure, examine the timing of the sale of bonds, and suggest appropriate investments for bond proceeds.
<b>Trustee</b>	The trustee is selected by the issuer to perform the administrative duties related to a bond issue. These may include establishing and holding the funds related to the bond issue, protecting the interests of bondholders by monitoring contractual compliance, paying interest and principal to bondholders, and acting as a liaison to bondholders.

# APPENDIX B

## Composition of San Joaquin's and Waterford's Public Financing Authorities

### City of SAN JOAQUIN

Amount of Mark-Roos Bonds Issued	PFA Members
Central California PFA \$10,500,000	Cities of <i>San Joaquin</i> , Riverbank, Escalon, Calipatria, Chowchilla, Santiago Water District
Four Corners PFA <sup>1,2</sup> \$35,650,000	<i>City of San Joaquin</i> , San Joaquin Economic Development Corporation
Jensen Ranch PFA <sup>1,2</sup> \$16,000,000	<i>City of San Joaquin</i> , San Joaquin Economic Development Corporation
Mid Valley PFA <sup>1,2</sup> \$3,285,000	<i>City of San Joaquin</i> , San Joaquin Economic Development Corporation
Rancho Lucerne Valley PFA <sup>1,2</sup> \$13,750,000	<i>City of San Joaquin</i> , <i>Waterford PFA</i>
San Joaquin PFA \$3,230,000	<i>City of San Joaquin</i> , San Joaquin Redevelopment Agency
Sierra Nevada PFA <sup>1,2</sup> \$17,910,000	<i>City of San Joaquin</i> , San Joaquin Economic Development Corporation

### City of WATERFORD

Amount of Mark-Roos Bonds Issued	PFA Members
California Commerce PFA <sup>1,2</sup> \$10,125,000	Waterford PFA, cities of Isleton and Mendota, Shoalwater Bay Indian Tribe, Merced County Board of Education, <i>Pacific Rim Economic Development Corporation</i>
California Desert PFA <sup>1,2</sup> \$25,000,000	Waterford PFA, Shoalwater Bay Indian Tribe, city of Mendota, Merced County Board of Education, <i>Pacific Rim Economic Development Corporation</i>
Lucerne Valley PFA <sup>1</sup> \$4,430,000	<i>Waterford PFA</i> , Lucerne Valley Unified School District
Malibu Canyon PFA <sup>1,2</sup> \$6,120,000	Waterford PFA, city of Mendota, <i>Shoalwater Bay Indian Tribe</i>
Rancho Lucerne Valley PFA <sup>1,2</sup> See San Joaquin PFAs	<i>Waterford PFA</i> , city of San Joaquin
Sierra Central Valley PFA <sup>1,2</sup> \$16,575,000	Waterford PFA, city of Isleton, <i>Chukchansi Indian Tribe</i>
Waterford PFA \$21,515,000	<i>City of Waterford</i> , Waterford Redevelopment Agency

Source: Official statements

Note: Italics denote the member responsible for recordkeeping.

<sup>1</sup> Members of these PFAs received fees.

<sup>2</sup> These PFAs financed projects outside their members' geographical jurisdictions.

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*Agency's Response to the Report Provided as Text Only:*

CITY OF COALINGA  
155 W. Durian Avenue  
Coalinga, California 93210  
(209) 935-1533  
FAX (209) 935-5912

**Memo**

**To:** Dave Biggs, Audit Supervisor for the State of California  
**From:** George Edes, City Manager of the City of Coalinga  
**Subject:** Response to 1993 Series C- Merced Golf Course Audit Findings  
**Date:** August 28, 1998

In the Chapter Summary section, please change the number of other cities from **three to two**. Also, please delete **Coalinga** altogether. In addition to that, delete the entire second paragraph that states, **the Coalinga PFA financed a golf course in Merced in return for an excessive \$345,000 fee, and.**

Please delete the entire paragraph in the section for Certain Cities Have Engaged in Questionable Practices. The City does not feel as though the act was questionable.

①\*

*Signed by George Edes with notation: "More to Follow"*

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# COMMENTS

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## ***California State Auditor's Comments on the Response From the City of Coalinga***

To provide clarity and perspective, we are commenting on the city of Coalinga's response to our audit report. The following number corresponds to the number we have placed in the response.

- ① We disagree. As we state on page 26 of our report, the fee that the PFA received was excessive.

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*Agency's Response to the Report Provided as Text Only:*

CITY OF LAKE ELSINORE  
130 South Main Street  
Lake Elsinore, California 92530  
(909) 674-3124 Fax: (909) 674-2392

August 27, 1998

California State Auditor  
555 Capitol Mall Suite 300  
Sacramento, CA 95814

The City Council of Lake Elsinore has totally re-structured its finance team of professionals and is dedicated to the work out policy adopted two years ago. The City has advanced over \$500,000.00 to assist in this effort. If the recession recovery continues at the current pace the total work out plan will surely be accomplished. The work out program will dismantle the Special District Pool Bonds to individual District offerings.

*Signature of Bob Boone*

Bob Boone  
Administrative Services Director

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*Agency's Response to the Report Provided as Text Only:*

ORRICK, HERRINGTON & SUTCLIFFE LLP  
Old Federal Reserve Bank Building, 400 Sansome Street  
San Francisco, California 94111-3143  
(415) 392-1122 Fax: (415) 773-5759  
Internet: pisrael@orrick.com Direct Dial: (916) 329-7921

August 27, 1998

Kurt R. Sjoberg  
State Auditor  
Bureau of State Audits  
555 Capitol Mall, Suite 300  
Sacramento, California 95814

Re: Draft California State Auditor Report on Marks-Roos Bond Act Borrowings

Dear Mr. Sjoberg:

At the request of our client, the City of Oroville ("Oroville"), we have reviewed the excerpts relating to Oroville provided by your office from the copy of your report entitled "Marks-Roos Bond Act Borrowings: Several Cities Misused the Program and Some Financed Risky Projects Which May Result in Investor Losses" (the "Report"). This letter constitutes our comments relating to the excerpts provided. In particular, as discussed below, we believe that it is particularly unfair to criticize Oroville for violating an intent of the Marks-Roos Bond Act (the "Act") that was only included in an amendment to the Act enacted years after the Bonds were issued and the financial relationships between the parties were settled.

In the Report, Oroville is criticized for making questionable decisions relating to the Oroville Public Financing Authority Revenue Bonds, Series 1993A (the "Bonds"). In particular, the report states that Oroville made "questionable" transfers of interest amounts earned on the proceeds of the Bonds to its general fund. The Report states that generally interest earned on the bond proceeds is used to make future debt payments. The Report acknowledges that the revision of the bond indenture relating to the Bonds in 1996 to make the transfers is legal. However, the Report says, it is not the intent of the Marks-Roos Act to create a "revenue-generating cash pool for the city." Finally, the Report states that, "by transferring these amounts to its general fund, the city reduces the amount available to make the bond's principal and interest payments." The Report recommends that the city stop transferring interest earned on Marks Roos funds for unrelated purposes.

This summary includes several errors and misstatements:

- (1) Interest earnings on the reserve fund for the Bonds were never used to make future debt payments.

①\*

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\*California State Auditor's comments on this response begin on page 47.

- ② (2) The intent of the Act cited in the report was not part of the Act at the time the Bonds were issued and the financial relationship between the parties was established.
- ③ (3) The transfers of reserve fund earnings to Oroville did not reduce the amount available to make payments of principal and interest on the Bonds.
- ④ (4) The transfers of reserve fund earnings to Oroville were pursuant to a legal amendment to the Bond documents, did not put any bondholders at risk in any manner, and accordingly was not “questionable.”

The Bonds were issued on January 5, 1993. The proceeds of the bonds were used to make a loan (the “Agency Loan”) to the City of Oroville Redevelopment Agency (the “Agency”), to pay the costs of issuing the Bonds, and to fund a reserve fund. These uses were and are all permitted under Government Code Section 6590. The repayments to be made by the Agency under the Agency Loan exactly meet the principal and interest requirements on the Bonds. The repayments of principal and interest on the Bonds are also insured Ambac Assurance Corporation. As a condition of issuing its insurance policy, Ambac required that the Bonds have a reserve fund. Thus, the primary source of repayment of all principal and interest on the Bonds is the Agency repayments; if the Agency repayments fall short, the reserve fund is to be drawn upon; and if the repayments and the reserve fund fall short, Ambac will pay all principal and interest on the Bonds. Earnings on the reserve fund, to the extent not needed in any year to pay debt service on the Bonds (and they are not needed for that purpose so long as the Agency makes full payments under the loan agreement) go into the surplus fund and are not used thereafter for debt service. As amended, the Bond documents allow Oroville to withdraw moneys from the surplus fund. Thus, no actions taken at the time the Bonds were issued or afterward have resulted in a reduction of amounts that were available to make payments of principal and interest on the Bonds.

The reserve fund is invested. Because the repayments by the Agency pay all principal and interest on the Bonds, the investment earnings on the reserve fund are surplus moneys and were never intended to be used to pay future debt payments on the bonds.<sup>1</sup> These

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<sup>1</sup> By contrast, other less secure Marks-Roos bond issues may require the use of the earnings on the reserve to pay principal and interest on those bonds. In such a case, the earnings from the reserve could not be taken by the Authority or by one of its sponsors without potentially affecting the ability to make full payment of debt service on those bonds. However, we emphasize that the structure for the Bonds did not and does not require the earnings on the reserve to ensure payment of the Bonds.



surplus moneys collected for three years from the date of issuance of the Bonds. In 1996, the Public Finance Authority, with the consent of Ambac, amended the bond indenture to allow these surplus moneys to be paid to the City. As acknowledged by the Report, this amendment was a legal amendment of the bond indenture.

It might be argued that the costs to the Agency would have been reduced if the earnings on the reserve fund (if any) were applied to reduce the Agency's payments each year. We acknowledge that position is correct. However, we note that the loan from the Authority to the Agency was entered into in January 1993, and that the surplus equal to the earnings on the reserve fund was built into the transaction at that time. At the time the loan was made, the Marks-Roos law did not limit the charges that could be made by the Authority (or its member agencies) with respect to loans made to local agencies. Chapter 229 of the Statutes of 1995 amended Government Code Section 6588(o) in 1995 to provide that "the fee charged to each local obligation acquired by the pool shall not exceed that obligations proportion share of [the costs of issuance and administration." In addition, Government Code Section 6584.5 was amended in 1996 by Chapter 833 of the Statutes of 1996 to provide that it was the Legislature's intent that

it is not lawful under this article for an authority or any of its member agencies to charge fees to local agencies or receive payments from the proceeds of the sale of bonds issued or acquired by the authority, except for fees charge pursuant to subdivision (o) of Section 6588 to recover the authority's costs of issuance and administration.

By these amendments, the Legislature changed the Marks-Roos Act to indicate the intent that the act is not designed to "create a revenue-generating cash pool" for members of an authority.<sup>2</sup> However, those amendments are not retroactive and do not change the relationship between the Agency and the Authority created in 1993. It is unfair and misleading for the Report to claim that the use by Oroville (and by the Public Financing Authority) of the surplus created under the structure of the 1993 loan agreement and the Bonds is a "questionable act" violating an intent in the Marks-Roos Act that was not put into the Act until at least two and a half years (and more properly effective four years) after the structure was established.

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<sup>2</sup> Thus, it is clear that the Public Financing Authority could not today issue new Marks-Roos Bonds and make a new loan to the Agency that would create a similar surplus.

Kurt R. Sjoberg  
August 27, 1998  
Page Four

It is our position that the original structure of the Bonds and the loan gave rise to the surplus, a surplus that was permitted under the Act at the time. The use of the surplus by Oroville is neither questionable nor results in any jeopardization of the principal or interest payments on the Bonds.

Very truly yours,

*Signature of Perry E. Israel*

Perry E. Israel

# COMMENTS

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## **California State Auditor's Comments on the Response From the City of Oroville**

To provide clarity and perspective, we are commenting on the city of Oroville's response to our audit report. The numbers correspond to the numbers we have placed in the response.

- ① Legal counsel for the city of Oroville misstates our report. We did not say that Oroville used interest earnings to make future interest payments. On page 26, we state that, in general, interest earned on bond proceeds is used to make future debt service payments. The California Debt Issuance Primer supports this statement.
- ② The legal counsel is partially correct. The intent of the act cited in the report was not part of the act at the time the bonds were issued; however, it was the intent of the act when the city began transferring the interest earnings to its general fund.
- ③ We disagree. According to city officials, before transferring the interest earnings to its general fund, Oroville used the earnings to reduce the amount of its redevelopment agency's principal and interest payments.
- ④ We do not question the legality of the amendment of the bond documents; however, we question the city's decision to transfer interest earnings to its general fund. The city made this decision after the Legislature amended the act to prohibit such transfers.
- ⑤ Legal counsel misses the point. We are not questioning the decisions the city made in 1993. We are questioning the decision it made in 1996. Legal counsel acknowledges that, with the enactment of the 1995 amendments, the Legislature clarified that the act is not designed to create a revenue-generating cash pool for PFA members. Thus we stand by our conclusion that the city's decision to transfer interest to its general fund is a questionable use of Marks-Roos bond proceeds.

*Blank page inserted for reproduction purposes only.*

*Agency's Response to the Report Provided as Text Only:*

CITY OF SAN JOAQUIN  
21900 Colorado, P.O. Box 758  
San Joaquin, California 93660  
(209) 693-4311 Fax: (209) 693-2193

August 26, 1998

Mr. Kurt R. Sjoberg  
State Auditor  
555 Capitol Mall, Suite 300  
Sacramento, CA 95814

#### RESPONSE TO MARK-ROOS BOND ACT BORROWING AUDIT

Dear Mr. Sjoberg:

Thank you for the opportunity to review and comment on portions of the draft report of the Marks-Roos Bond Act Borrowings Audit. As we understand it, this audit arose largely on the basis of requests by Mr. Peter Schaafsma, Executive Director of the California Debt and Investment Advisory Commission (CDIAC) and Assemblymember Scott Wildman, who is not only a member of CDIAC, but also the Chairperson of the Joint Legislative Audit Committee. See Mr. Wildman's letter of December 17, 1997. (Attached)

When Mr. Schaafsma requested this audit he indicated that "CDIAC has received reports from officials and concerned citizens in some of these communities to the effect that portions of the monies raised by these bond sales can not now be properly accounted for." Further, ". . . assertions have been made that hundreds of thousands of dollars have disappeared from the accounts" and that reports have been received that ". . . efforts have been made to cover up the accounting and financial irregularities." Mr. Schaafsma wrote that "While we are unable to independently verify any of the reports we have received, the sheer number of situations we have learned of from independent sources argues that something is amiss."

When information concerning these allegations was sought pursuant to the Public Records Act, Senior Staff Counsel for the State Treasurer reported that Mr. Schaafsma had no written record of any of these purportedly numerous reports. Against this factual backdrop, the City of San Joaquin is therefore especially pleased that your rigorous and lengthy audit "found no improper payments at the PFAs San Joaquin ... administered ..."

Mr. Kurt R. Sjoberg  
State Auditor  
August 26, 1998  
Page 2

As noted in your draft report, the California Attorney General has promulgated both an informal opinion and a formal opinion relating to Marks-Roos bond transactions. As each of these opinions have issued, the City of San Joaquin has been informed by reputable and experienced bond counsel that its bonds issuance are in conformity with these opinions and the applicable law. In addition, the City has received direction from its representative in the Legislature that Senate Bill 147 was not adopted as urgency legislation and does not take effect until January 1, 1999.

The City is therefore surprised that your report implies that the acts of the City or its related PFA's are contrary to law or that criminal prosecution may be warranted. Holding public office has always been considered service to one's community and has involved a level of sacrifice. However, we cannot imagine that any one will make the sacrifice of serving in public office if one is subject to the threat of criminal prosecution after following the advice of legal counsel and other qualified professionals.

The audit report's juxtaposition of speculative worst case scenarios of possible default and investor loss against the alleged "buyer beware" attitude of City officials is misleading and unfair. It is clear that this type of financing involves a high degree of investor risk, and the official statements of each issuance make every effort to fully disclose those risks to those who choose to invest. However, to the best of my knowledge, every investor in any bond issued by the City-related entity has been fully paid. It is to be hoped that the City and its related Public Finance Authorities will be permitted to continue to use all legal means to provide investors will full payment.

Again, thank you for this opportunity to comment on portions of your draft report,

Sincerely,

CITY OF SAN JOAQUIN

*Signature of Shahid Hami*

Shahid Hami  
City Manager

SH/dlb  
Enclosures

*Agency's Response to the Report Provided as Text Only:*

CITY OF SAN JOAQUIN  
21900 Colorado, P.O. Box 758  
San Joaquin, California 93660  
(209) 693-4311 Fax: (209) 693-2193

August 27, 1998

Marianne P. Evashenk  
Chief Deputy State Auditor  
California State Auditor  
555 Capitol Mall, Suite 300  
Sacramento, CA 95814

Re: Corrections and Revisions to Draft Audit Report  
"Marks-Roos Bond Act Borrowings"

Dear Ms. Evashenk:

We have reviewed portions of the draft of the above audit report, and believe that the following corrections and revisions should be made:

Pages 4, 17, 25:

The appraisal report used as the basis of the purchase price for 388 acres was not deficient, and did not result in overpayment of \$9.2 million. Contrary to your assertions, the appraiser did consider the current restrictions imposed upon the land by the Williamson Act. The fact that the developer had recently purchased the land pursuant to a very favorable purchase option is irrelevant to the market value of the land, and in no way establishes an amount of overpayment, or your apparent conclusion that the land is not adequate security for the bonds. (1)\*

Recent sales of property in the immediate vicinity confirm the value appearing in the appraisal report. The Developer informs us that Zephyr Capital Company sold 80 acres of land located almost contiguous to and directly south of the Jensen Ranch property to Bob McCaffrey at a price of over \$25,000 per acre. This sale occurred prior to the adoption (2) by the County of Madera of the Rio Mesa Area Plan and the approval of the State Route 41 Finance Agreement. This land was also encumbered by Williamson Act restrictions, but would obviously be worth much more today given the approval of the above entitlements and the near completion of Freeway 41.

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\*California State Auditor's comments on this response begin on page 59.

Marianne P. Evashenk  
Chief Deputy State Auditor

August 27, 1998

Page 2

Another sale in the area was by the Cobb family for over 30 acres of land on May 1, 1995 for \$60,000 per acre. This property is located a short distance south of the Zephyr property mentioned above. This sale was negotiated following approval by the County of the Rio Mesa Area Plan, but prior to the approval by the County of the SR 41 Finance Agreement which committed the County to approved development in conformance with that Plan. The Cobb property was not subject to the Williamson Act.

Pages 5, 24, 25:

- ④ With respect to the Williamson Act, the Developer filed a notice of non-renewal with the County of Madera on February 7, 1997. Amendments to the Williamson Act at Government Code Section 51256 now permit an owner to rescind a Williamson Act agreement and simultaneously place other land under an agricultural conservation easement. The Developer may use the amended provisions to apply the Williamson Act restrictions to other property he owns outside the project area. Furthermore, the Developer has the right of immediate cancellation of the Williamson Act restrictions pursuant to the State Route 41 Finance Agreement between the County of Madera and the Developer (See Paragraph d. at page 9).

Pages 6, 17:

- ⑤ CDIAAC has regularly and repetitively voiced this speculation regarding the outcome of bond defaults. The facts seem to suggest that investors and the securities markets are more sophisticated and discriminating than CDIAAC. Enclosed is an article from the August 28, 1996 issue of Bond Buyer:

In the event of a default, the (Mello-Roos) bonds would register as a limited obligation that would not effect the county's credit.

"The market pays attention to how Mello-Roos issuers respond to a problem, but this is a nonevent for credit ratings," said David Brodsky, a vice president with Moody's Investors Service. "People often discuss what the impact is on the Street in response to the issuer that defaults. In instances where districts get into trouble, the market seems to understand and is capable of making distinctions that the issuer isn't to blame."

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.



Marianne P. Evashenk  
Chief Deputy State Auditor

August 27, 1998

Page 3

As we understand it, the intended function of CDIAC is to protect California's municipal bond market and to advise California public agencies on debt and investment issues. Instead, CDIAC seems to make a point of issuing alarmist statements that can only undermine confidence in the municipal market. Mr. Schaafsma's recent statements in response to an opinion of the California Attorney General suggests that San Joaquin's PFA's do not legally exist, and their bonds are not legal. See the Fresno Bee, June 24, ♦ 1998 at page C1 and following.

In issuing his opinions, has Mr. Schaafsma considered the effects of the Legislature's Validating Acts? Senate Bill 1380, enrolled June 23, 1998 embraces entities created pursuant to Government Code Section 6500 and nonprofit public benefit corporations. Section 3 of S.B. 1380 validates all entities formed under color of law, and Section 6 validates the bonds issued. The Validating Act has cured any defect that might have existed in the bonds referenced by Mr. Schaafsma.

Page 14:

If the goal of your audit report is a full and fair presentation of the facts and the varying policy views, it may be appropriate to note that the sources consulted by the audit staff (with the exception of the Internal Revenue Service) have, at the very least, vested interests that may bias the opinions they provide. Pronouncements and opinions by CDIAC's Mr. Schaafsma, as demonstrated above, are obviously biased toward promoting his view of Marks-Roos Bonds. The Stanislaus County District Attorney's office conducted a search and seizure pursuant to a search warrant that is currently under review in the Fifth District Court of Appeal. Claims for violations of civil rights and other injuries arising from the search are currently pending and will be pursued against Stanislaus County and members of its District Attorney's Office. The Stanislaus County District Attorney subsequently filed charges against the claimant for Government Code Section 1090 violations. Similar allegations had previously been considered and dismissed by that County's grand jury. (6)

The Department of Corporations has brought suit against the underwriter and a principal of the Developer in the Jensen Ranch project. The Department's requests for a preliminary injunction were denied, and an independent monitor was appointed by stipulation. The opinions advanced in your draft report regarding the legality of San Joaquin's uses of bond proceeds are not supported by the Court's comments in the Department's lawsuit.

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

Marianne P. Evashenk  
Chief Deputy State Auditor

August 27, 1998

Page 4

- ♦ At pages 61 and 62 of the enclosed transcript of the hearing on the preliminary injunction, the Court indicated that these bonds were “authorized by the Legislature” and that the policy questions “as to the efficacy, viability, and propriety of this type of financing arrangement. That’s a legislative determination.”

- 7 If there was any real question about the legality of these bond transactions, why didn't the Department of Corporations make that question part of its litigation? The Department's efforts to enjoin alleged misleading and untrue statements in connection with the sale of securities would have been significantly strengthened if statements about the legality of the bonds were also untrue. If these bond transactions are in violation of the Act, why did the Department of Corporation's lawyers fail to correct the Court's understanding that they were “authorized by the Legislature”?

If Mr. Schaafsma and CDIAC have concerns about the legality of these bond transactions, why hasn't he or his agency brought a cross-validation action or similar legal challenge? If he has concerns that these bond issues undermine the California municipal bond market, wouldn't a legal challenge be more effective than inflammatory (and legally inaccurate) press releases?

The cumulative effect of Mr. Schaafsma's activities in connection with Marks-Roos Bonds has not worked to improve the market or protect the investor, but the reverse. To the extent that your audit only repeats the suspect viewpoints of the agencies that you interviewed, your agency will have made headlines, but will fail to have advanced the Legislative debate on these types of financing.

Page 16:

- 8 We have been advised by bond counsel that the 1996 informal Attorney General's opinion does not refer to the project funds received by San Joaquin's PFAs. In Part I of the 1996 opinion, it is noted that CDIAC's question assumes “The fees are not for project or working capital purposes. The question also assumes that the fees are not a loan authorized by the Act and that the fees are not restricted and may be used for any purpose.” The 1996 opinion concluded that “...a joint powers authority may not expend any portion of the proceeds of its bond issue to pay “fees” to members of the authority if the payments have no direct relationship to the administrative costs of the member incurred as part of the bond issue or to construction of the capital improvements at issue...” The project funds received by San Joaquin's PFAs have always been understood to be restricted to purposes enumerated in the Act.

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

Marianne P. Evashenk  
Chief Deputy State Auditor

August 27, 1998

Page 5

The funds have only been used for construction or acquisition of capital facilities, or to facilitate administration of the bonds.

Pages 18, 19, 20, 21 and 22:

The draft report identifies three potential violations of the Act. The first violation purportedly arises because the project locations do not benefit the member's residents. Section 6586 of the Act requires the local agency to make a finding of significant public benefit, but does not include a requirement of local benefit. Section 6585 (f) defines a local agency to include an authority, and as noted in the recent *Rider v. City of San Diego* decision of the California Supreme Court, a financing authority "has no geographic location or boundaries". (98 Daily Journal D.A.R. 8535 at 8537.) Thus a finding by a financing authority that a project or financing will create significant public benefits is not currently required to relate to the residents of any locale.

The local benefit requirement will arise when S.B. 147 becomes effective and requires that projects be within the territory of a member agency. If the local benefit requirement was current law, then S.B. 147 was mostly unnecessary. Finally, as noted in the attached July 9, 1998 letter from Assemblyman Cruz M. Bustamonte's legislative consultant, S.B. 147 will not be effective until January 1, 1999. The Legislature has frequently demonstrated that it knows how to enact urgency legislation to take effect immediately: there is no violation where a practice continues to be legal. ♦

9

The second potential violation is addressed in our remarks with respect to page 16.

The third potential violation arises from the use of public nonprofit benefit corporations as members of joint powers authorities. Except for the Attorney General's 1998 opinion, no decision or statutory authority has suggested that nonprofit corporations were not suitable members. Any defect caused by using a nonprofit corporation as a member was long ago cured by the Legislative Validating Acts (see for example, S.B. 1380). San Joaquin has not used a nonprofit corporation as a member of its PFA's since the issuance of the Attorney General's opinion. ♦

10

On more careful examination of the relevant legal authorities, it should be apparent that San Joaquin has not engaged in any violations of the Act.

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

Marianne P. Evashenk  
Chief Deputy State Auditor

August 27, 1998

Page 6

Page 27:

- ⑪ The Jensen Ranch and Four Corners PFAs document the cost of land acquired in their respective Official Statements and in the transcripts of the bond proceedings.

Page 28:

- ⑫ The Jensen Ranch PFA's golf course will open soon. Property will be sold to retire \$16,000,000 of that project's offerings. On the remaining \$9,615,000 balance, interest has been capitalized until October 15, 1999. Residential development is expected to
- ⑬ occur before then to retire that debt.

- ⑭ The Four Corners PFA's obligations of \$12,800,000 are Bond Anticipation Notes, originally issued with the understanding that they would be refunded before maturity. That transaction by its own terms is not supposed to be generating revenue at this stage.

- ⑮ According to the Underwriter, the Rancho Lucerne transaction has \$2,750,000 outstanding due on December 15, 1999, not the \$3,750,000 shown in your report. Interest has been paid by the Developer when due. Two parcels are expected to be sold in the spring of 1999 that will pay off this principal amount.

Page 29 and Figure 2:

- ⑯ Please note that the Bluffs at Riverbend is a single transaction; it has not been involved in any refinancings or other transactions which would tend to make it "interrelated" with other projects. The Developer has made interest and principal payments over the last two years when due.

Page 30:

The legislation referred to on this page appears to be S.B. 147. San Joaquin will work with existing law and with the restrictions of S.B. 147 to bring these projects to a successful completion and to protect the investors.

- With respect to the Jensen Ranch PFA and its obligations, please refer once again to
- ♦ David Fitzgerald's letter of July 27, 1998 to Mr. Phil Jelich, Deputy Auditor (attached).

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

Marianne P. Evashenk  
Chief Deputy State Auditor

August 27, 1998

Page 7

Page 32:

Please review the indentures of trust on these transactions. In the event of default, the trustee or the authority, and not the bondholders, will have the duty to institute foreclosure proceedings. (17)

Page 33:

The draft report's recommendation of possible criminal prosecution rests upon your apparent conclusions that violations of the Marks-Roos Act have occurred. Please see the above discussions concerning those alleged violations: it should be apparent that the violations alleged are not in fact violations. Publication of this threatening and defamatory recommendation is irresponsible at the very least.

Penal Code Section 424 applies to natural persons: there is no basis for claiming that it applies to a legislative or governing body of a public entity. It is logically absurd to suggest that a public body can embezzle from itself. If public officials cannot rely and act upon the advice of legal counsel or other professionals without threat of criminal prosecution, our system of government by elected citizens is at an end. Again, one must wonder why CDIAC or other governmental agencies have not explored a civil resolution of these questions rather than threatening criminal prosecutions. (18)

Please call me with any questions you may have regarding these comments.

Yours truly,

*Signature of Shahid Hami*

Shahid Hami  
City Manager  
City of San Joaquin

enclosures

*Blank page inserted for reproduction purposes only.*

# COMMENTS

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## ***California State Auditor's Comments on the Response From the City of San Joaquin***

To provide clarity and perspective, we are commenting on the city of San Joaquin's response to our audit report. The numbers correspond to the numbers we have placed in the response.

- ① We disagree. Although the appraisal report acknowledges the Williamson Act restrictions, in valuing the property, the appraiser did not take them into account. In fact, the appraisal report states that the proposed residential development is legally permissible even though, as stated on page 17, the Williamson Act restricts the land from this proposed use.
- ② The city's response does not address the issue. As we state on page 17, the PFA may have paid up to \$9.2 million more than the land was worth. Using the city's comparable purchase price of \$25,000 an acre, the PFA's purchase of \$34,000 an acre, as shown on page 17, is still \$9,000 an acre, or \$3,492,000, more than the land was worth.
- ③ The city's use of this example is incorrect. The Cobb family sale is not comparable since this property was not subject to the Williamson Act restrictions.
- ④ We are relying on information provided by the Madera County Planning Department (department). As stated on page 17, according to the department, the developer has not applied for a release from these restrictions.
- ⑤ The state treasurer has more confidence in the California Debt and Investment Advisory Commission (CDIAC) than the city. We asked that the state treasurer provide a policy statement on the effects a default would have on the municipal market; however, the State Treasurer decided the CDIAC would be the appropriate agency to provide such a statement.

- ⑥ We have ensured a full and fair presentation of the facts. In gathering evidence to support our report, we obtained information from the city, as well as many other sources. We independently analyzed the information, obtained independent legal opinions, and arrived at our own conclusions.
- ⑦ Nowhere in our report do we question the legality of the city's PFAs' bonds. Rather, we question the legality of the city's receipt of bond proceeds unrelated to its costs of administering the bonds or the bond project.
- ⑧ The advice given to the city is wrong. The Office of the Attorney General clarified its informal opinion on this matter in stating that bond proceeds could be used for ". . . capital improvements for which the Marks-Roos bonds were issued, not [for] unrelated capital improvements which the JPA members could decide to finance with the fees they received when the bonds were sold."
- ⑨ The city is missing the point. On page 13, we state that although not yet illegal, financing projects outside a PFA's geographical jurisdiction is contrary to intended policy.
- ⑩ The city overstates the effects of the validating acts. According to our legal counsel, although the legality of the bonds is resolved by the validating acts, illegal acts by the PFA or its board members would not be absolved.
- ⑪ As stated on page 18 of our report, our concern is not that the bond documents did not reflect the cost of its land, but rather that the PFA did not include these amounts in their accounting records.
- ⑫ The city's plans continue to change. As we report on page 22, just a few weeks ago, the city planned to sell two parcels of land valued at \$8 million to reduce the amount of debt outstanding on the Jensen Ranch PFA's golf course. It now plans to pay off the entire \$16 million by selling property, but does not identify the property. The city also does not state how it will raise the \$1 million needed to make the debt payments due in October 1998. Additionally, the city fails to mention that the sale of the parcel valued at \$3 million, which we also discuss on page 22, has recently fallen through. We have not revised our report to reflect the change in the city's plans, and we continue to question the PFA's ability to repay this debt when due.



- 13 The city’s response is inaccurate. The \$9.6 million loan agreement does not provide for the use of loan proceeds to make interest payments. Further, the city has no evidence showing that its PFA had received the first \$312,000 interest payment due in April 1998. Although the loan agreement and promissory note call for semiannual interest payments beginning in April 1998, the city could provide no evidence that the April 1998 interest payment had been made.

In a letter dated September 1, 1998, the city stated that, because the Four Corners PFA had capitalized interest—set aside bond proceeds to pay interest on the bonds—through October 1999, the PFA had forgiven the \$1.4 million interest due on the loan through that date. However, the city did not provide any formal documents, such as an amended loan agreement or promissory note, or a PFA board resolution, supporting this change. Furthermore, we question the propriety of such a change. Since the loan payments will be used to repay the Four Corners PFA bonds, by forgiving the \$1.4 million in interest, the PFA reduces the amount available to pay bondholders. For these reasons, we have not changed Table 2 or the text on page 19.

Additionally, the city states that residential development will begin before October 1999; however, as we state on page 22, construction of the infrastructure for the residential lots had not even begun as of August 1998. Thus, we continue to question whether the developer can complete and sell enough lots to raise the \$1 million needed by October 1999.

- 14 We agree, and we acknowledge that the PFA intended to refund this amount in footnote 1 in Table 2. Our point is that the PFA must find a way to refund this obligation by December 15, 1998.
- 15 We agree and changed the text accordingly.
- 16 We agree. As depicted in Figure 2 on page 21 of our report, the Bluffs at Riverbend is financed solely through the California Commerce PFA.
- 17 We revised the text to clarify that the trustee must institute foreclosure proceedings on behalf of the bondholders in the event of default.

- ⑱ We disagree. Our legal counsel has concluded that the PFA board members would be subject to the provisions of Penal Code Section 424.

*Agency's Response to the Report Provided as Text Only:*

**WATERFORD PUBLIC FINANCING AUTHORITY  
PO Box 199  
Waterford, California 95386  
August 28, 1998**

**Response To Draft  
Marks-Roos Bond Act Borrowings  
State Auditor's Report**

Mr. Kurt R. Sjoberg, State Auditor  
555 Capitol Mall, Suite 300  
Sacramento, California 95814

## EXECUTIVE SUMMARY

- ◆ The City of Waterford has reviewed the Draft Marks-Roos Bond Act Draft Audit Report (copy enclosed). After our initial surprise at the lack of factual data and the multitude of “opinions” in the report, the common question most of the readers expressed is best summarized by “where’s the beef”.
- ①\* The fact of the matter is that to the best of our knowledge, no investors to date have lost their investment in bonds the Waterford Public Financing Authority has been involved with.
- ② Frankly we expected more from an audit. We expected conclusions to be drawn from presented factual data and an even handed presentation. This does not appear to be what we have received. We do not wish to imply that the unrated Marks-Roos Bonds with which the Waterford Public Financing Authority has been involved do not have risk. These investments do entail risk. All
  - ◆ one has to do is read the required disclosures (sample attached) to see that risk outlined. We are also not implying that the Waterford Public Financing Authority is perfect and cannot benefit from the 20:20 vision hindsight provides.
- ◆ As you review the report and the attached data we would encourage you to look for the “beef”; the basic questions of **how many investors have lost money in the bonds with which the Waterford Public Financing Authority is involved and what aspects, if any, of these bonds are illegal.**
- ③ While there is a lot of opinion and some fact on what the Waterford Public Financing Authority may have done wrong, there does not seem to be any recognition that a lot of things were done right. The fact that the Waterford Public Financing Authority has been active in Marks-Roos bonds since 1990 with no losses to bond investors seems immaterial in this report. To us this is the most important thing and a goal we have worked hard to accomplish.

- An important item worth mentioning in this executive summary is that we feel the auditors presentation in the draft report presented is inaccurate in key areas. One of those key areas is the auditor’s frequent interpretations of the Attorney General’s Informal Opinion. We were unable to trace many of these interpretations back to the wording in the Attorney General’s Informal Opinion. It would be advisable for the State Auditor to get concurrence from the Attorney General in writing for the interpretations of the Attorney General’s Informal Opinion used frequently throughout this report. We do not believe that many of the Auditor’s interpretations of the Attorney General’s Informal Opinion have any legal basis or authority.
- ④

- The report is confusing. While we understand why the State Auditor may want to include multiple entities into a single report, it does make it difficult to determine what opinion and/or finding applies to what entity. If it is not clear to us, with our familiarity with Public Financing Authorities, it is probable that it will not be clear to the media and the public. The different time frames presented in the report also generates confusion. Sometimes the report appears to be referring to a current situation then sometimes a past situation that has long since been resolved.
- ⑤

We feel the confusion between entities and time, the frequent reliance on interpretations of the

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\* California State Auditor’s comments on this response begin on page 79.

- ◆ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

Attorney General's Informal Opinion, and what we perceive to be inaccuracies in the report may lead the reader to erroneous conclusions and be damaging to bond investors, the very people the report says it is concerned about. We feel significant revisions to mitigate these matters is necessary. (6)

General and specific comment sections follow this executive summary. Please bear in mind that the Waterford Public Financing Authority had less than five days to respond to a report that the Auditors spent months compiling. We have done our best to research the facts in the short time available to us and will attempt to stay with factual issues or questions rather than opinions.

Due to the short response time allocated to us most of the members of the Waterford Public Finance Authority has not had an opportunity to review this document. We will forward any comments we receive from any of these members as they are received.

## GENERAL COMMENTS

- 1) Throughout the report the term “Waterford” is used extensively. Bond activity occurred in the Waterford Public Financing Authority and other Public Financing Authorities of which the Waterford Public Financing Authority was a member. We think it is very important to specifically identify which entity the activity refers to. This also would help clarify things in the multi entity reporting format you have apparently adopted.
- 2) Has the audit and the auditors considered the effect of the bond validation acts periodically passed by the California State Legislature in this report?
- 3) As stated previously the auditors apparently relied extensively on a California Attorney General’s informal opinion throughout their report. In many instances the auditors (or perhaps their counsel) appeared to interpret this opinion since we were unable to find some of their statements within the informal opinion and/or the parameters established in the Attorney General’s opinion seemed to be “stretched” to cover situations that they may not have been intended to cover. California Attorney General’s informal opinions are intended to apply only to the very specific issues addressed under a stated set of assumptions and circumstances and are generally not to be relied upon to establish anything other than the specific issues they addressed at that point in time. They cannot be cited as an authoritative source in a court of law. We do not think the Attorney General has or will approve the interpretations and applications of his opinion in this report.
- 4) Have the audit and the auditors considered the fairly recent “Rider” court decision in their report? As contrasted to Informal Attorney General’s opinions this California Supreme Court decision is an authoritative source that can be cited in legal proceedings. We feel there are several areas of “Rider” that have a direct bearing on the audit. We would encourage the auditors to look closely at this case.
- 5) The draft report implies that the current use of the Marks-Roos Act to benefit local agencies without a geographically related project is a new application of the act. The Auditor’s summary of the act’s history fails to recognize that: A) prior to the change in the Internal Revenue Code regarding arbitrage numerous local agencies formed finance authorities solely for the purpose of earning arbitrage; and B) in the early 1990s members of financing authorities benefitted from blind pools which loaned money to nonmember agencies earning a “spread” between the loan interest rate and the pool bond interest rate.
- 6) The use of the term “project” throughout this report is inconsistent and will cause misinterpretation and confusion to report readers.

## SPECIFIC COMMENTS

All comments are referenced to the draft report numbering. If the report is revised, these references will have to be changed to assist users in understanding the comments. We feel the draft report should be released with the final report to insure full disclosure.

1) Title page:

The term “misused” is judgmental. Would it not be better to present the facts and let the reader determine by the facts presented what has occurred?

12

2) Table of contents page and page 4:

The use of terms that are subjective rather than objective are, in our opinion, inflammatory.

Again would not the reader and investors be better served by the reporting of facts that speak for themselves? As it turns out the Waterford Public Financing Authority does use its “fee” revenue for purposes as outlined in the Marks-Roos Act including administration. That administration appears to be ongoing, even for issues that were closed years ago and the debt retired. These

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“fees” (as they are referred to in the report) total less than 1% (.87% to be more precise) of the bond proceeds. This is much less than what the state and federal governments justify as

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“administration” on many of their grants. Fixed fee agreements with the state and federal government on grants is a common arrangement. Is the auditor holding the Waterford Public Financing Authority to a higher standard than what applies to the state and federal government?

Conversations with past and current Waterford Public Financing Authority officials indicate that these bond issues involve significant administrative work. This is borne out by a review of the files of the Waterford Financing Authority and time recordation by a current Public Financing Authority Official. We are only talking about administration in this instance without the other

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uses of funds that are authorized under the act. In view of these facts the term “Lucrative” does not seem to be a fair description of the “fees” Waterford received. Some of the other terms which we think are inappropriate for an audit report will be addressed in other areas of this response. When looking at fees in similar bond issues and the administrative costs associated with many Federal and State grants it is evident that the Waterford Public Financing Authority should have asked for more funds to meet administrative costs. We are currently evaluating this.

3) Page 4:

Benefit to the local area is a condition of the projects the Waterford Public Financing Authority is involved with. We have and will continue to be in compliance with this requirement.

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- 4) Page 4: "Fees" unnecessarily increasing the financial burden on the project:  
As previously stated with regards to your allegation in specific comment 2, the imposition of "fees" consistent with what is authorized in the Marks-Roos Act that totaled .87% (computed using the numbers in the draft audit report) hardly seems like a significant factor. In addition
- 17) these bonds and associated matters require agreement among the parties. If any aspect of a bond issue and associated matters is deemed to imperil the project it is probable that agreement would not be reached.
- 5) Page 4: "... did not adequately control...":  
This again is subjective rather than objective language. The fact that no investor in bonds that the Waterford Public Financing Authority was responsible for administering has lost their investment, or for that matter lost interest income, over the past eight years contradicts this statement.
- 1) This again is subjective rather than objective language. The fact that no investor in bonds that the Waterford Public Financing Authority was responsible for administering has lost their investment, or for that matter lost interest income, over the past eight years contradicts this statement.
- 6) Page 4: "...do not have proper permits or approvals..."  
To the best of our knowledge, in all the projects that the Waterford Public Financing Authority was, and is administering, either the necessary permits and approvals were in place or the project was disclosed as a development project with its current status of entitlement, along with the
- 18) scope of the project. (See attached Offering Statement for an example of disclosures)
- 7) Page 4: "...paid too much to acquire some assets..."  
In all of the Public Financing Authorities the Waterford Public Financing Authority has, or is administering, property purchase prices are documented by appraisals. These appraisals were reviewed and in some instances revised as a result of these reviews. To the best of our
- 19) knowledge the Waterford Public Financing Authority or the issuing Authority, whichever was applicable in the respective Issue, did not pay more than fair market value for any assets.
- 8) Page 5:  
We can only respond to the actions of the Waterford Public Financing Authority and the public financing authorities of which the Waterford Public Financing Authority was a member. In view of this fact we ask the auditors to separate the reports for the entities involved. This would be a prudent step to take so that each entity is accountable only for their actions and readers of these reports have an accurate picture of what is being reported. The current report format has a
- 20) high probability that the acts of one entity being attributed to another or all entities. This ambiguity could cause preventable damage to investors. This is of great concern to us.
- 9) Page 5: "...\$100,000.00 loan..."  
The Waterford Public Financing Authority was not the administrating entity for the Public Financing Authority that made this disbursement. Never-the-less we are researching this finding.
- 21) Initial indications are that this payment from the trustee was an installment payment to a property owner for the purchase of land to be used for public purposes. If such is the case, then what the owner did with the funds after the receipt of payment for the real property being acquired has

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.



really nothing to do with the Authority and would be beyond the control of the Public Financing Authority, because at that point the money is no longer bond proceeds.

10) Page 5: "...paying twice for services..."

The Waterford Public Financing Authority was not the administrating entity for the Public Financing Authority that made this disbursement. Never-the-less we are researching this finding and, if a duplicate payment was made, we will diligently pursue recovery.

11) Page 5: Last paragraph:

The best response to this statement is to look at the disclosures in the Offering Statement supplied with this response. To the best of our knowledge the Offering Statements and Prospectus describe the projects and the risks involved with investing in these projects very well. These investments do involve risks, as do most investments. To date, over the eight-year period the Waterford Public Financing Authority has been involved with bond issues of this nature, no investors in the Public Financing Authorities we administer have not lost principal and have not been deprived of interest on their investment. As far as our continued involvement, the Waterford Public Financing Authority desires to finish the projects that have been started. Is the auditor recommending that we abandon the projects that are in process potentially leaving the current investors with an incomplete project and increasing the chances of bondholders' losses? ♦

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12) Page 6: CDAIC reference:

This statement has not been borne out by history. The City of New York and Orange County are a typical example of past bond and credit problems having little or no effect on the ability of the same governmental entities to raise money in the capital markets much less different entities. The inference that the marketplace cannot distinguish between high risk unrated debt and those rated AAA is just plainly not true. The Security and Exchange Commission requires the extensive disclosure you see in the enclosed Offering Statement example. We have also enclosed ♦ a newspaper article where a representative of Moody's, a well known national reputable investment rating firm, also states this fact. ♦

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13) Page 6: Last Paragraph:

We certainly agree that entities should be responsible for their actions but we do not know of any local agency or public officials that have misused the program. The Waterford Public Financing Authority has made every effort to comply with the law. We believe that we have been successful in these efforts.

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14) Page 7 & 8: Recommendations:

We agree with the recommendation of the auditor and have, and will continue to be in compliance with these recommendations.

15) Page 16: Inflammatory language:

Please see specific comments 1 and 2. This is a repeated item in the report and the response is the same.

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

16) Page 16: Reference to the informal Attorney General's opinion:

- ④ This is a good example of what we have been cautioning against. We feel the Attorney General would go ballistic to find out that he "...has informally opined that these fees, because they are not related to the costs of the project for which the bonds were issued or cost incurred by the cities to administer the bonds are illegal..." This to us is a blatant misstatement no matter how much someone tries to explain it by footnote or reference. Due to the limitations of Attorney General's informal opinions we are not certain it should be used at all in an objective audit report
- ②⑤ but to extensively interpret it and weave the interpretations or even excerpts of it throughout the report is misleading.

17) Page 17: Indian Casino:

- ②⑥ This is an example of how a "multi entity" report can cause a reader to attribute an action to an entity which is not true. The Waterford Public Financing Authority has not financed any casinos and has no desire or intention of doing so.

18) Page 17: Golf Courses:

- We think it would be advisable to clarify the definition of "project" for this report. It is used in many areas and may confuse the reader. Are we using "project" as it is used in the Marks-Roos Act or a more generic definition? It appears to us it is being used in at least that many ways and this contributes to inconsistencies in the report. For instance the Waterford Public Financing
- ②⑦ Authority has not built any golf courses as projects or any golf courses at all at this point in time. We are however, involved with Public Financing Authorities that have as projects the building of public infrastructure and development that includes a golf course as a part of the project. This is not an unusual or illegal act.

19) Page 17: "...cities and other members of the PFA..."

- ②⑧ The City of Waterford is not a member of any public financing authority. Because of this fact we surmise that this audit finding has nothing to do with the City of Waterford but is the
- ⑦ Waterford Public Financing Authority somehow involved? The report should be clear in these areas and a reader should not have to infer or surmise anything. To be conservative we cannot rely on assumptions as we respond to this report. This necessitated the next item in our specific responses.

20) Page 17: "...sponsored undertakings without clear permits..."

- The Waterford Public Financing Authority is currently involved as a member of two Authorities. Before the Waterford Public Financing Authority agreed to be a member of the issuing Authority on each of the projects due diligence was performed. The Waterford Public Financing Authority as a member of a Public Financing Authority is only active in two projects at this time. Members of the Public Financing Authority and/or its Finance Officer, who also served as an officer in
- ②⑨ some of the authorities, have visited the sites of the projects on least on an annual basis as part of the due diligence. Many meetings were held with developers, local agencies, appraisers and others. Feasibility studies were performed and/or reviewed. Without more detail we cannot respond further to this comment. We feel it would be professional for the auditors to specifically

identify whom this comment is written about. We can support our visits to the sites and meetings with notes, correspondence, expense records and other records. On one of these visits a video tape of the applicable projects was made and is also available.

21) Page 17:

Many of the items on this page have been previously addressed. Please refer to specific comments 5, 6, 8, 9, 11 and 12.

22) Page 17: Accounting and Audits

This is addressed in specific comment 33.

23) Page 17: "...delegated responsibility to the developer..."

With more specifics we could respond to this finding, if it is applicable to the Waterford Public Financing Authority. Again with this multi entity reporting format it is not clear to us who the findings apply to. It would also be helpful to know what records or funds were not accounted for. Also, please see specific response 33.

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24) Page 17: Project revenues:

Please refer to the enclosed Offering Statement as an example of the disclosures made on these bonds. The project revenues are disclosed in these documents. There are risks associated with these bonds. Extensive disclosures are required by the Securities and Exchange Commission and we agree that these disclosures are necessary. We made them. Beginning investment classes emphasize the risk/return relationship. Is there an additional issue here we are not seeing? This subject was also covered in specific comment number 11.

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25) Page 17: "...adversely affect municipal bond sales throughout the state..."

This has been mostly addressed in specific item 12.

26) Page 18: Most of the page:

Much of this has been addressed in previous specific comments 2,3,11,16,17,18 and in the executive summary and general comments. In addition we have enclosed maps of other Public Financing Authority projects as examples. We would not want the readers of this report to feel that the geographic location of the projects is something unique to the Waterford Public Financing Authority. The dispersion of participants throughout the state and Roving Joint Powers agreement appear to have been the practice of many public financing authorities throughout the years. While we do not agree with the auditors on the issues related to this, we have not formed any Roving Joint Powers Agreements since the Attorney General's Informal Opinion and are only pursuing projects that have already commenced. Again we feel the auditors are misusing the Attorney General's opinion and may be leading readers of this report to erroneous conclusions. We do not feel the Attorney General will support the State Auditor's interpretations and most, if not all, of the uses of his informal opinion in this report. Once the confidentiality requirement is lifted, we intend to contact the Attorney General about this,

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

however by that time we hope that you have done this yourself and can enclose his comments, should he choose to make them, with whatever form the final report may take. The Attorney General has looked at many of the Public Financing Authorities the Waterford Public Financing Authority is involved with and as of this date has not challenged the legitimacy of any of these authorities or their use of bond proceeds.

27) Page 19: "...though not yet illegal..."

- 31) This statement appears to contradict the statement "...have potentially violated the provisions of the Act..." on the preceding page (page 20).

- 32) 28) Page 19: "...opined informally that only the entity actually receiving the benefit can make such a finding...."

This interpretation of the Attorney General's informal opinion appears to be another example why the use of the informal opinion should be reconsidered by the auditor. We could not find this wording in the Attorney General's informal opinion anywhere. We will try not to bring this subject up again except in our summary since the point should be well illustrated by now.

29) Page 19: "...In many instances the fee they received was unrelated..."

- 33) Does this apply to the Waterford Public Financing Authority? Is the auditor representing that administration is the only permitted use of bond proceeds to which a local entity is entitled under the Marks-Roos Act? How much of the fees were unrelated to administration and how was this determined?

30) Page 22 "...our legal counsel concurred..."

- 34) In our opinion it would have been far better for the Auditor to obtain a legal opinion from their attorney on the specific issue in question instead of having him review other attorney's opinions which may not have been even intended for the use where they were applied. If the auditors have not already done so we would encourage them to have their attorney review this report in its entirety.

31) Page 22 "...may have inappropriately formed PFAs with Indian tribes..."

- When the contents of the Attorney General's Informal Opinion became known to the Waterford Public Financing Authority the authority did not enter into any Public Financing Authorities that included Indian tribes. If we understand the Auditors "points" in this sentence the Waterford Public Financing Authority was never a member of a financing authority that included "...certain nonprofit corporations...". Please refer to the enclosed correspondence from the Attorney General in response to our request for a copy of the informal opinion. We infer from this that the Attorney General had concerns that this informal opinion may be applied to situations that may not be appropriate.

32) Page 26 "Waterford irresponsibility delegated their project management duties..."

More specifics in the report would allow a reader to determine for themselves if the Waterford Public Financing Authority (versus the city of Waterford) was irresponsible. We certainly

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

delegated, appropriately some aspects of the project to the developer. We know of no erroneous payments in any of the Public Financing Authorities Waterford was responsible for administrating and again no investors have lost their investment or interest income in any financing authority the Waterford Public Financing Authority has administered. To state that the authority did not have adequate procedures is not borne out by the facts. Currently, review procedures are in place. Over the eight years the Waterford Public Financing Authority has been active in these Marks-Roos bonds we are sure there were a variety of procedures in place but the results speak for themselves.

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33) Page 27 "... to audit the Waterford PFA, the accountant was unable to attest to the accuracy..."

It is unfortunate that both the independent public accountant and the State Auditor were on site after the resignation of the City's Finance Director, who was also an officer in the Public Finance Authority. Due to this fact many records could not be located by the remaining staff and the independent public accountant chose not to use the records that were in the possession of the trustee. This may have been a violation of the independent public accountant's contract which we may pursue. At the present time the City is rebuilding its staff and if the auditor needs to see any specific records we would be happy to assist them in this endeavor. Relying extensively on records maintained by the trustee, which is audited and is usually the trust department of a major bank, is not an unusual occurrence for bonds. The State Auditor knows this since many of the records accessed by the auditor were in the custody of the trustee.

34) Page 33 Reference to Penal Code:

We would appreciate it if the auditor would explain why he felt the inclusion of this section added to the report and any specific reasons as to its applicability to the Waterford Public Financing Authority or any of its board members. It might be prudent on the part of the State Auditor to review Penal Code Section 518 with its legal counsel prior to leaving the Penal Code citation in its Final Report. It appears, based on the tone of the Report and the biased source(s) of a significant part of the information, which we have demonstrated through references in our comments as not credible, is intended at least in part, to obtain an official act of the Waterford Public Financing Authority Public Officers, to wit: to not participate as a member of Public Financing Authorities, through the wrongful use of force or fear, (Citation of Penal Code Section in the Report), or under color of official right (the right to do a legislative requested audit). As stated in the message of the California State Auditor at WEBMASTER@BSA.CA.GOV, quoting in relevant part: "As the State Independent External Auditor we provide independent, nonpartisan, accurate....in compliance with generally accepted auditing standards." We submit that the Report which we received and are commenting upon is neither independent, nonpartisan, accurate or completed in compliance with generally accepted governmental auditing standards.

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35) Page 27 "...Two of Waterford's PFAs have already defaulted on \$9.2 million of their debt..."

When we talked to the auditor about this statement he basically said that this is true, there have been two defaults involving Public Financing Authorities that Waterford has been, or is involved

- with. What is unsaid here, which we think should be included in a report that purports to be objective (please see a copy of excerpts from the State Auditors Home Page on the Internet), is the fact that these “defaults” are the only ones that have occurred over the eight years the Waterford Public Financing Authority had been involved with Marks-Roos bonds. Additional facts that we would expect in an objective report are: A) that one default has been cured to the satisfaction of the investors and B) the other default should be resolved within thirty days, again with the investors satisfied. We are not hiding the fact that these bonds entail risk. That risk is disclosed. Perhaps this is an appropriate time to state to the readers of this report that unrated bonds and other debt instruments have been on the financial market for decades. Bonds incorporating many of the characteristics of Mark-Roos debt are not an unusual occurrence and are not new to the financial markets. Perhaps the attached California Municipal Bond Advisor will give the readers some idea of the scope of this market as well as the enclosed California Lawyer reference.

36) Page 28 Table  
 This table is not current and is therefore inaccurate. It should be updated to show current status.

37) Page 29 and PFA Interrelated Graph:

These pages again illustrate the point that the auditor should issue separate reports with the entities audited. While we think we understand the point the auditor is trying to make our knowledge of the following facts generate a lot of questions about what we think that point is:

- A. The three Sierra Central bonds have been retired and the investors paid.
- B. The Waterford Public Financing Authority is no longer involved with Riverbend Ranch.
- C. The Waterford Public Financing Authority is no longer involved with Jensen Ranch.
- D. The Waterford Public Financing Authority has never been involved with Four Corners.

38) Page 32 Reference to Department of Corporations Survey:

- Our information leads us to believe that the information on the Department of Corporations survey is not current. If a compilation of this survey has been made, or the information is available to make a compilation it would be useful to attach it to this report. Information on how many persons were contacted, how many responded and what the end results were as of a current date would enable a reader to develop their own opinion as to this report item. The attached public record demonstrates why we have concerns about this survey. While this is apparently public record we have obscured the name of the individual because it does contain personal financial information. The conflicting information obtained by the Department of Corporations versus what was later presented to the court raises some interesting questions.

39) Page 34 “...to ignore the intent of the Legislature as clarified in recent legislation....”

- To rationalize that because the current legislature passed a law; that this clarifies the intent of the legislature twelve years ago is a real reach! This is objectivity? In addition the intent of the Marks-Roos Act has been left unchanged since 1985 and is set forth in Section 6586 of the

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

Government Code.

40) Page 36 and 37 Recommendations

The Waterford Public Financing Authority has and will continue to adhere to the recommendations that are good management and in conformance with the law. We have substantially complied with this in the past and will continue to do so in the future. We do not however agree with the auditor's interpretation of many of the aspects of the Marks-Roos Act, and the Attorney General's Informal Opinion. We seriously doubt that the Attorney General would be in agreement either.

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## CONCLUSIONS

- There were many more points that we could have made during the report but they would have more or less been repeats of previous comments. We stand by our assertions in the executive summary. This draft report is not objective, contains inaccuracies, is misleading and is
- ◆ confusing. It is also redundant. We have enclosed some documents in our attachments which are not referenced in our comments that generate questions which we were not able to resolve in the less than five days we were allowed to compile a response. We doubt if we will ever be able to answer most of these questions so we will let the report readers draw their own conclusions or theories. To us it is apparent that influential people at the state level do not like these bonds. They are entitled to their opinion however we feel that they should then devote their efforts in a constructive manner to changing the law instead of trying to find fault with the small Central Valley communities that these audits targeted. This does not seem accidental since the original list proposed included some fairly large cities that have the resources and political clout to defend themselves. These entities, the cities of Brea, Los Angeles and Modesto were somehow dropped from the list that was ultimately communicated to the State Auditor. To the best of our knowledge the State Auditor had nothing to do with this deletion. Please refer to the Taxpayers Association of Madera County letter enclosed.

We would strongly urge the State Auditor to please have their counsel and the State Attorney General review the entire report before it is released. We think these parties will share many of our concerns. If significant changes are not made to this report a high potential for damage to investors exists. This is why a clear, factual and objective report is necessary. This is not it!

As stated previously the Waterford Public Financing Authority is not perfect and there are findings in this report and things we learned during the audit and report process we will use to improve no matter how they may be presented. These investments entail risk. They are unrated bonds. Unrated bonds have been sold for decades. The risks have been disclosed. To date no investor has lost principle or earnings in the Public Financing Authorities that the Waterford Public Financing Authority is involved with. The bonds are legal and conform with the law. Where's the beef?

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◆ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.



## Exhibits ♦

Rancho Lucerne Valley Public Financing Authority Offering Statement

Printout Of A Portion of Data On OF The State Auditors Web Site

Copy Of The February 1, 1998 Issue of the California Municipal Bond Advisor

August 4, 1998 Hargrove & Costanzo Letter

Maps Of Various Public Financing Authorities

David Fitzgerald Memo of 8-27-98 To Chuck Deschenes

Copy Of California County's Land-Backed Deal On Brink Of Default Article

Copy Of California Attorney General's Informal Opinion

Copy Of Taxpayers' Association Of Madera County August 4, 1998 Letter to Maddy

Copy Of Taxpayers' Association Of Madera County July 29,.1998 Letter To State

Copy Of Arch Zellick July 16.1998 Letter To Mimi Budd

Copy Of Mini Budd July 17,1998 Letter To Arch Zellick

Copy Of Scott Wildman December 17, 1997 Letter To Himself

Minutes From October 15, 1997 California Debt Advisory Commission Meeting

Conflicting Declarations Regarding" Department Of Corporations" Survey

Copy Of Draft Marks-Roos Bond Act Borrowing: Audit Report

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♦ We have not included attachments in the report; however, they are available for review at the Bureau of State Audits.

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# COMMENTS

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## ***California State Auditor's Comments on the Response From the City of Waterford***

To provide clarity and perspective, we are commenting on the city of Waterford's response to our audit report. The numbers correspond to the numbers we have placed in the response.

- ① The city understates the effect of its actions. Although we could not determine that, to date, any investors have lost money, as we state on page 19 of the report, Waterford's actions have put many investors at risk. In fact, the city's PFAs have already defaulted on two separate bond issues.
- ② We stand behind our report. We based our conclusions on the facts of each situation, and we considered all points of view. In fact, the city does not dispute our conclusion that it received unearned fees for financing highly speculative projects.
- ③ Our report does not question the legality of the bonds issued by PFAs; rather, we question whether the fees cities receive unrelated to the bond projects or administering the bonds are legal and prudent.
- ④ The city is incorrect. The Office of the Attorney General (attorney general) stated that our wording is consistent with its opinions. Specifically, it is illegal for PFA members to receive bond proceeds for projects unrelated to the project for which the bonds were issued, as Waterford did.
- ⑤ The city is obscuring the point. It is clear in our report that certain actions of the PFAs, both past and present, are not appropriate for governmental agencies and are potentially illegal. We included the PFAs created by Waterford and San Joaquin in Chapter 1 of our report because their purposes were similar and sometimes intertwined.
- ⑥ We disagree. The findings contained in this report are supported by sufficient, competent evidence.

- ⑦ We agree that the Waterford PFA and other PFAs in which it was a member issued the bonds. Appendix B lists the members of all Waterford PFAs. Further, we identify specific PFAs in our report when we discuss certain findings. The use of the Waterford PFA, which is controlled by Waterford city council members, to establish other PFAs financing highly speculative projects was a calculated decision. According to the city's legal counsel, it used the PFA when entering these deals to shield the city from potential liability. Although this may be an important legal distinction, when considering the propriety of a governmental entity's participation in a project, it is not significant.
- ⑧ Yes, we considered the validating acts. Our legal counsel determined that the validating acts passed by the Legislature do not affect the findings in our report.
- ⑨ The Rider decision concludes that a PFA has independent authority to issue bonds without complying with the restrictions that apply to its members. This decision has no impact on any of our conclusions.
- ⑩ The city has missed the point. Past legislative action taken to dissuade agencies from benefiting improperly from Marks-Roos bonds should make it clear to the city that its PFAs' actions were improper.
- ⑪ We disagree. The context in which the term "project" is used in our report makes our meaning clear.
- ⑫ We feel the facts presented in Chapter 1 support the conclusion that Waterford misused the act.
- ⑬ The city is incorrect. As indicated on page 14 of our report, the attorney general concluded that using bond proceeds for unrelated projects is illegal.
- ⑭ We do not question the propriety or legality of the city receiving bond proceeds as reimbursement for administrative costs related to the Marks-Roos bonds. However, on page 14 of our report, we question fees the city received that were unrelated to the project for which the bonds were issued or for administering the bonds. As stated on page 14 of our report, according to its officials, the city participated in such projects for the unearned fees.

- ⑮ The term “lucrative” is entirely appropriate. Although the amounts the city received may have been only a small percentage of the bond proceeds, they were significant compared to its annual general fund expenditures. In fiscal year 1995-96, the city received \$233,000 in fees from its PFAs, which was more than 21 percent of its \$1.1 million general fund expenditures for that year.
- ⑯ The city is mistaken. As we state on page 13 of our report, according to the attorney general, only the local agency that benefits from the financed project can make the finding of significant public benefit.
- ⑰ Although the fees are probably not significant enough to cause a project to fail, they, nonetheless, unnecessarily increase its financial burden.
- ⑱ The city has again missed the point. We are not questioning the adequacy of its disclosures, we are questioning whether it should be financing projects that lack proper permits. As we state on page 22 of our report, municipal bonds are perceived to be among the safest investments. Therefore, financing highly speculative projects in other jurisdictions, even if these risks are disclosed, is not a prudent use of the PFA’s Marks-Roos authority.
- ⑲ We agree. We revised the summary to clarify we found no evidence Waterford paid too much to acquire assets.
- ⑳ We feel that the report accurately reflects the conditions we observed. When a condition applied to a number of PFAs, we used general terms. However, when we cited specific examples, we identified the PFAs.
- ㉑ The city’s response is not logical. As we state on page 18 of our report, the developer that received this payment was not associated with the PFA’s financed project. Even a cursory review of the developer’s invoice would have alerted the PFA to this fact. Furthermore, even if the scenario the city describes were true, the PFA exercised poor expenditure controls by making a payment directly to the developer on behalf of one of its contractors.

- 22 We do not recommend that any projects be abandoned. The city should attempt to transfer projects it is already involved with to more suitable financing sources as soon as possible. If it cannot do so, the city should honestly assess the viability of the project, and, if unfavorable, cancel it before investor losses increase.
- 23 The city's response ignores the increased costs a defaulting city incurs in accessing the municipal bond market. The California Debt and Investment Advisory Commission states that defaults would affect, not eliminate, governmental agencies ability to raise funds. An agency that has recently defaulted on an obligation will likely incur increased borrowing costs.
- 24 We disagree. As we state on page 12 of our report, several actions of the Waterford PFAs were improper, perhaps illegal, and support the conclusion that it misused the act.
- 25 As stated on page 15 of our report, our legal counsel concurred with the opinions of the attorney general.
- 26 The city is partially correct. The Waterford PFA has never financed a casino. However, it was a member of the Sierra Central Valley PFA, which issued a \$1.4 million bond in 1995 to finance the purchase of land for a gaming facility. To avoid any confusion, we have replaced the word "casino" with "gaming facility."
- 27 We do not state that Waterford PFAs built any golf courses. Further, we do not question the legality of the PFAs' financing golf courses. However, as we state on page 13 of our report, we do question the propriety of financing a golf course 430 miles away in Palm Springs. We also question the legality of the city receiving fees unrelated to the project for which bonds were issued or for the administration of the bonds.
- 28 The city is incorrect. The city and its redevelopment agency compose the Waterford PFA. Both the Waterford PFA and Waterford Redevelopment Agency are controlled by members of its city council. The Waterford PFA joined with other agencies to form the PFAs in question.
- 29 We are aware that city officials exercised some control over the projects. However, we do not agree that these efforts constitute the degree of control expected over public funds. We noted aspects of Waterford's controls over capital projects that were

deficient. As we state on page 16, the city relied on studies commissioned by the developer or underwriter to determine feasibility, despite the vested interests of these parties in seeing that the bonds were issued. This was true for at least five of Waterford's PFAs. Additionally, on page xx we state that Waterford relies on the project developer, rather than an independent party, to ensure that work is performed and that services being billed have actually been received. This was true for at least two of Waterford's PFAs.

- ③① The city is referring to our chapter summary. The details are clearly laid out in the text of the chapter that follows. On page 16, we state that Waterford sometimes relied on feasibility studies commissioned by the project developer or underwriter. Additionally, on page 18, we state that Waterford relies on the developer to ensure that work is performed and that services being billed have been received. We feel this information is adequately specific to allow the city to respond if it chooses to do so. Although we did not feel that the specific PFA names were important for our report, the PFA names were available to the city had it asked.
- ③② To clarify the report, we have added the word "intent" on page 12.
- ③③ According to the attorney general, our wording is consistent with its informal opinion. Section III of the opinion states that the local agency benefiting from the bond project makes the significant public benefit finding.
- ③④ Because the city did not maintain accounting records for the Waterford PFA, we were unable to determine its actual administrative costs. However, as we state on page 14 of the report, according to the city officials, the city participated in these projects to receive unearned fees. Furthermore, according to the mayor, the city used approximately \$180,000 for expenses unrelated to the administration of the bonds from which it received the fees.
- ③⑤ Our legal counsel has reviewed all pertinent sections of the report and provided his independent opinions, which are the basis for the legal conclusions we make in our report.

- ③⑤ The city's logic is cause for concern. The need for adequate controls is not dependent upon the presence of improprieties. Indeed, they are intended to prevent improprieties from occurring. Just because we did not identify in our sample any improper payments made by PFAs the city is responsible for administering, does not mean they do not exist. The city's lack of controls cultivate an environment in which errors and improprieties may go undetected.
- ③⑥ The city incorrectly suggests we are extorting an official act from the Waterford PFA as defined in Penal Code 518. Our legal counsel opined that criminal charges may be applied to some actions of the PFAs' board members. We state on page 29 of our report that the courts must ultimately decide if the board members' actions were illegal. We felt we would be negligent if we did not advise the board members of the possible consequences of their actions. Furthermore, our audit fully meets all applicable audit standards.
- ③⑦ The city's response is deceptive. Although it is true that one of Waterford's defaults has been resolved, the city fails to mention that it was resolved by a San Joaquin PFA refunding the debt.
- ③⑧ A single error was present in Table 2, which we have corrected.
- ③⑨ Although we present an example from the Department of Corporations survey to illustrate our point, we did not rely on the survey. Thus, information on the sample size and results is not relevant.
- ④⑩ The city again misses the point. Following legislation making the financing of projects outside a PFA's members' jurisdiction illegal, Waterford continued to finance such projects through its PFAs. Although the effective date of the legislation is not until January 1, 1999, the city should understand the intended policy.



cc: Members of the Legislature  
Office of the Lieutenant Governor  
Attorney General  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
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