

# **2018 – 2019 Civil Grand Jury**

## **Community Facilities District Bond Funding in Riverside County Perpetual Debt Under CFD and Service Area Taxes**

### **Background**

CFDS are Community Facilities Districts which purchase bonds that are paid for by special taxes. The issues generated by this practice have captured the concerns of hundreds of thousands of individuals in Riverside County and elsewhere, because of the additional tax burden it places on homeowners. The Riverside County Civil Grand Jury (RCCGJ) can identify and call to justice those involved in outright corruption. There is also a duty to provide cautionary warning with recommendations to avoid repetitions of previous disasters. The RCCGJ has a voice of concern for Riverside County.

Billions of dollars in Mello-Roos (CFD) bonds have been issued by local governments. These bonds are issued for multiple purposes and have financed police, fire, infrastructure, services, schools, sewage plants and freeway overpasses for new developments. CFD bonds have the option of escalation factors which increase 2% a year, saddling the home owner with ballooning payments.

The amount of the Ad Valorem tax, the basic county property tax, which is capped by Proposition 13 limits, is related to fluctuating economic effects on housing values. On the other hand, CFD's are not capped. If the economy is in a downward spiral the costs related to the scheduled bond repayments remain and will continue to perpetually rise.

CFD fund use is difficult to track. Their ultimate consequences are not understood by many homebuyers who will be affected by them. The majority of CFDs are already in place before a home is ever purchased. Home buyers have little insight into the process and do not understand how the money is spent as there is little transparency or concern on CFD bond utilization.

The CFD funding process was authorized by the 1982 Mello-Roos Community Facilities Act, California Government Code §§53311-57550. The process begins when a petition is signed by no less than 10% of registered voters residing in the district. Once the signatures are deemed valid, the land owners (usually the same as on the petition) must vote. The votes are counted at a public meeting of the taxing agency. When the

governing body having jurisdiction, votes to approve, then the bonds are issued. A similar process takes place for CFD Service areas. They are also financed by the same law that authorizes CFD construction bonds. CFD Service areas provide perpetual maintenance and services through these bonds.

## METHODOLOGY

### **Numerous methods and sources were used to research and collect information**

- Mello-Roos Community Facilities Act of 1982, California Government Code §§53311-57550 (Mello-Roos)
- Extensive interviews with home owners who have purchased homes with CFDs
- Reviewed transcripts and video tapes of various city council meetings
- Interviewed sales staff at new development sales offices
- California Debt and Investment Advisory Commission
  - <https://www.treasurer.ca.gov/cdiac>
- *Serrano v. Priest*. 5 Cal.3d 584 (1971) (Serrano I);
- *Serrano v. Priest*. 18 Cal.3d 728 (1976) (Serrano II);
- *Serrano v. Priest*. 20 Cal.3d 25 (1977) (Serrano III);
- BOS Policy B12, Section 1.0 *Land Secured Financing Districts*, Item D Disclosure of potential property owners
- Reported by the Press – Enterprise in multiple articles

### **Reviewed hundreds of documents from five developers doing business in Riverside County including but not limited to**

- Master Development Agreements
- Disclosure Agreements
- Purchase Agreements

## FINDINGS

### Disclosures

1. The Mello-Roos law requires that home buyers be advised at the time of purchase of these bond instruments. Preliminary investigation showed that some disclosures are highly deficient, or lacking altogether. Many homeowners are unaware they have bonds on their homes. The disclosure documents reviewed by the RCCGJ contain, with few exceptions, ambiguous, complex or misleading language. When the disclosures of CFD bonds are made, they are often hidden in fine print and are undecipherable by the average home buyers. This practice shows transparency is not the goal of most seller's agents.

One developer has produced a model disclosure document. This document is clear, unambiguous and spells out the effect of CFD bonds in layman's terms. It specifies how the escalation of tax payments may become unsustainable and can or may cause one to lose their home to foreclosure. It also advises the home purchaser that, under law, an expedited foreclosure is allowed when the CFD taxes are not paid. Unpaid Ad Valorem tax foreclosures can take years, while unpaid CFD taxes can trigger foreclosure in 90 days.

Unannounced visits by the RCCGJ to sales offices revealed either a lack of knowledge or outright false and misleading information about CFDs being given by the sales staff to prospective buyers. When asked if there were CFDs on homes being sold the reply was "no, we don't have any of those." When the finance director was asked the same question, the reply was "I don't know what those are". This same experience was repeated at several sales offices.

#### A False Economic Cost

2. CFD's provide the home buyer initially, with what appears to be, a lower priced home. As a result, this allows them to qualify for a home loan for which they might not otherwise qualify. The buyer may not become aware of the greater long term cost associated with their purchase until much later. The lender often fails to calculate the long term escalation of costs related to the special tax on the home and the long term consequence to the home buyer which could ultimately result in loss of their home.

The CFD or Mello-Roos was the building industry's answer to controlling their costs and providing funding for development projects. Removing the infrastructure costs allow developers to sell homes for less. In reality, it merely lowers the immediate cost by not incorporating the long term cost of CFD bonds for the home owner that are higher than a home financed by conventional terms. As a result, this dependence on Mello-Roos (CFD) financing shifts development costs to the home buyer instead of the developer.

#### Timing of Disclosure and Honesty

3. On site investigations and interviews by RCCGJ of prospective home buyers were told when they asked about taxes; "Oh just the usual". Some were lied to when they asked if a Mello-Roos tax was on the home. One sales person told a potential buyer, "There are no CFD bonds on these homes." There were actually three CFD's on each home. This is either ignorance or dishonesty. The sales person was parsing the truth by saying "no" because they are technically called CFD Bonds and not Mello-Roos. The buyer believes that the Mello - Roos, which has a negative connotation, is not part of their purchase until escrow papers are presented for signature. Only later, at document signing or tax time, does the buyer discover the CFD surprise.

It is common practice for a buyer to be told, at the last minute, about the CFD Bonds, if the bonds were disclosed at all. They may have a buyer for their own home and are nearly ready to move into the new home. This situation deprives the home buyer of an opportunity to make an unpressured and informed decision.

Developers and city officials put forth the argument that it is the responsibility of the home buyer to do their due diligence and understand what they are obligating themselves to. Lengthy documents with obtuse language make it difficult for the average purchaser to comprehend their obligation until the tax bill arrives. Even knowledgeable buyers complained it was written in such a legalistic way that it was undecipherable. This is especially true when it is presented in a de-facto way with no explanation.

### Escalators

4. CFD bonds have escalators limited by law to two percent per year per Bond. The Ad Valorem tax has a one percent escalator under Proposition 13. Unfortunately CFDs have erased all of the intended protection on taxation limits of Proposition 13. Many homes are encumbered with multiple CFD Bonds such as: a Facilities bond, a Service bond and a School bond. These three bonds and the Ad Valorem tax amount to a seven percent escalation of all taxes. That increase compounds annually and means that within six years tax, debt has increased to perhaps more than 50% of the original amount. Financial distress could develop that would affect those on a fixed income especially when an economic downturn occurs. This scenario does not take into account other taxes such as voter approved school bonds, sales tax increases and hospital bonds. Many other taxing agencies can further add to the tax bill.

The bonds often contain a clause that says "After the Bond is paid in full (40 or more years) an amount commensurate with the continuation of facilities and services which need to be rendered may be assessed." In other words the Bond generated tax payments may continue forever. This is another issue where most buyers are not given adequate warning. Escalators are a mechanism used by cities and developers to obtain the greatest amount of revenue from the bond payers. Escalators are not required on the bonds by law, but are allowed. The special tax may be permanent and is within the discretion of the city council to make this tax perpetual under certain formation rules.

### Long Term Development Contract

5. Another practice by tax approving agencies is guaranteeing developers, through a master agreement, hundreds of millions of dollars in pre-approved bonds. This is accomplished without any thought of what the economy will be at the time of issuance. The home buyer's ability to pay

is not part of the equation in the decision making. This creates a process even more precarious and uncertain.

Long term master development agreements extending into double digits have no real limit guaranteeing developers the city's support for CFD entitlements and are irresponsible. This allows uncontrolled development for which a city may not be able to pay.

A recent national public radio program detailed the difficulties of a local Inland Empire city struggling with just such a situation. It was predicted by the city council that their water and sewage bills will have to increase 100% in order to keep up with the development needs. Those costs will fall on residents in the community.

A local city council, when confronted by its citizens about the extreme indebtedness and uncontrolled development, defended its unchecked practice of approving bonds by stating in numerous meetings; "they could not refuse to vote on the purchase of bonds due to a long term development contract". When RCCGJ requested a copy of the document, their legal representative stated that "such a document does not exist". This public comment presents a serious conflict of interest, deceit and fraud upon it's citizens. It could be seen as a conspiracy to mislead the people. Those voting on the CFDs; and in one case those supporting a lawsuit settlement favoring the developer, have received large campaign donations from the very developers whose bond sales they continue to approve.

#### Uncontrolled Development

6. The uncontrolled development made possible by CFD bonds has Riverside County responsible for almost 25% of the total bond debt in all of California. In the words of former Governor Swartzenegger, "These bonds are being used irresponsibly and must be controlled by the legislature to protect unwary citizens". Bonds are initiated by the owner of the land parcel. If there is one land owner, a single vote can encumber tax debt on thousands of people in perpetuity.

#### Bond Fund Security

7. As widely reported, the City of Beaumont had concerns about the fate of \$45,000,000 to \$97,000,000, but the exact amount is unknown due to poor accounting of tax payer's bond money. Seven top city officials were arrested and received, what some believe, was only a slap on the wrist for their manipulation of bond money. They were required to pay a total of \$8,000,000 dollars in restitution, as well as minimal home confinement. These light sentences send a message that misuse of bond monies on the part of individuals is not sufficient to warrant a tougher penalty. This message increases the lack of safety of public bond funds. ***Strangely, the City of Beaumont says that no money was lost from bond proceeds.***

***This does not correspond to the court ordered restitution of the seven defendants.***

The City of Beaumont has filed suit to recover additional money from the defendants. When the city's legal representative was asked by the RCCGJ, "If money is recovered, would it be put back into the bonds from which it was misused?" They answered evasively "No money was stolen or is missing from the bonds!" **Many Beaumont residents, due to the reported manipulation of bond monies, may not receive the services or infrastructure they have a right to expect, but will still have to pay off their bonds.**

#### Need and Use Plan Required

8. Any city or school district, before getting approval of CFD Bonds, must present a specific plan for the need and use of the money and educate the constituency of the community. The current public hearings provide only general information and not specifics. This does not give the public enough information to make relevant and informed comment. The fact that in new developments those who will be ultimately responsible for those tax payments are as yet unknown and is problematic. This planning should be done before any election to buy bonds is held by the land owner (developer).

The California State Education Code requires each district to have an accountability plan to ensure the safety of funds under their control. A school district within Riverside County has recently announced its intent to put CFD Bonds on new homes to build a school. When the RCCGJ requested a copy of the accountability plan for the district, we were told, they do not have one. When asked if they had one for use of the bond money the answer was the same.

This is in a city where the developer has always paid mitigation fees to construct a school for students in the area being impacted by increased development. The school district and city have plans to overlay the two existing CFD Bonds with a third for school construction.

This tactic has been used in other areas and raises serious questions of its constitutionality. The California Supreme Court decision in *Serrano v. Priest* held that unequal amounts of money spent on students in Beverly Hills and Baldwin Park constituted a violation of equal protection under the law. Even though this CFD financing of schools has taken place in some communities, it has not, to our knowledge, been litigated under the parameters of the *Serrano v. Priest* decision.

When the school district was asked, if they considered the change in school finance law changes that could affect the district, the respondent said "no, but if we knew of any please tell them." Cities and school districts

are buying bonds, without planning or voters approval, because they can. They reach into taxpayers pockets without considering the consequences of their actions on the future.

#### Diversion and Recovery of Funds

9. CFD financing appears to be a convenient way for local governments to pay for infrastructure and other needs. Bonds carry many additional responsibilities which requires city and county elected officials to pay close attention.

#### The Debt Burden Growing with Little Limitation

10. Local Governments must be cognizant that many agencies within their sphere of influence have the power to levy taxes. This can and has created prohibitive debt burdens on tax payers. This is especially true in the current practice of placing multiple CFD's on the same property. This overlapping taxation has become analogous to the environment which existed in 1978 which propelled the rebellion of taxpayers and the passage of Proposition 13.

A heavy debt burden can become a critical player in any economic downturn, affecting the local economy and the bond market. Municipalities may find themselves, as in 2008, in a position which limits their flexibility to provide future infrastructure and leads to home foreclosure.

#### CFD Zones, Specific Taxes and Benefits

11. Some enterprising individuals have been creative and developed CFDs which cover an entire city. Tax payers have no guarantee that they will specifically enjoy the benefits they are paying for from bond funds. This is the case in one city where until recently, the entire city was one CFD. Money from bonds was used to fund growth related projects, not related to the bond payer's area, which benefited developers and the city.

#### Financing within Limits

12. The Building Industry Association (BIA) is an organization representing the interest of developers and builders. In a case involving the City of San Ramon, California, they challenged a CFD special tax passed by the San Ramon City Council. This case included several important issues. A facet of the case concerned the right of the city to continue the special tax even if the citizens passed a referendum to remove it. Unfortunately, the case was lost on appeal. The important issue here is that the building industry took conscious efforts to keep the CFD financing within limits.

## Recommendations

**Riverside County Board of Supervisors  
Riverside County Chief Executive Officer (Local Government  
Agencies with taxing authority)  
Riverside County Auditor Controller  
Building Industry Association (BIA), Riverside County  
City of Beaumont  
Riverside County Office of Education**

### Disclosures

1. Prospective buyers should be advised very early in the process about the bonds and their implications in layman's terms. Local taxing agencies should assure that the disclosure language is understandable and candid. An easily readable sign, written in at least ½ inch letters, posted at eye level, should state whether a tract infrastructure is financed by CFD or fees paid by a developer to provide a more informed choice.

### A False Economic Cost

2. A growing controversy in the area of CFDs is that developer fees are being replaced by CFD bond funding on homes. Buyers should have a choice of a purchase price with the CFD and Service area tax **"OR"** the adjusted price with infrastructure costs. This gives them relief from a perpetual tax and benefits them with a lower tax bill. This would allow the potential purchaser to accurately compare the total cost between developer fee and CFD funded homes. Otherwise, there is no way to fairly evaluate costs between different developments. Sales personnel should be fully educated on what this notification means and be able to completely explain this information to potential buyers.

### Timing of Disclosure and Honesty

3. The existence of CFDs on a property should be explained early in the purchase process, not at a point which makes a negative decision costly or overly burdensome. This has been a common theme of homeowners who were questioned. They had no idea of the tax burden that they were taking on or that it could last beyond the maturity and payoff of the bond, in other words a perpetual tax. **Full disclosure should be made by the seller's agent before any document is signed or it is not informed disclosure or consent.**

### Escalators

4. The home buyer should be advised that the special tax payments may be imposed after the bonds are paid off. Buyers should be advised of the outward forecast of the escalators and their impact in five, ten and twenty years. Buyers should be offered the option of buying the home at a price

comparable with the same dwelling without CFD Bonds and the escalators.

#### Long Term Development Contract

5. Long term development agreements should not be part of city or county planning. Clauses should be included to allow exit, based on economic conditions or a vote of the taxing agency to terminate such an agreement.

#### Uncontrolled Development

6. Communities should carefully consider development approval and take into consideration the wishes of their residents. Just because CFD financing is available does not mean it should be used to excess. The heavy loads of debt encumbered by bonds and Service areas puts the community and its residents at risk of overburdening tax loads. Serious consideration must be given to the ability to meet additional infrastructure costs in the long term before approving new CFD's. These additional costs should not be charged by any means to prior residents of the community. Any new costs should be borne by those who generate the need.

#### Bond Fund Security

7. A citizen's oversight committee should regularly investigate how bond money is being spent. Their charge should be to make sure that bond funds are directed for their intended legal purposes. A public report should be made quarterly and any diversions from the intent of the Mello-Roos Act should be reported to the State Controller or appropriate authority.

Any deviations from the required legal reporting to the Security and Exchange Commission must be noted and rectified in a timely manner. Special attention should be given to Service area funds. Oversight committees that include police and fire representation are critical to assure funding is appropriate in order to maintain staffing levels and competitive salaries for protection of the public. It is also recommended that compliance with the law be regularly verified and examined by the Riverside County Auditor.

#### Need and Use Plan Required

8. An accountability plan for tracking and reporting must be developed. Any city or school district, before buying CFD Bonds, must present a specific plan for the need and use of the money and educate the community. Public hearings must provide specifics. This should give the public enough information to make relevant comment and voice their concerns. This should be done before a CFD Bond authorization election is held by the land owner.

This recommendation will in no way redefines or restricts any part of the current law. All are implementable within the current structure of the law.

This will increase transparency for the public, discourage bad acts and prevent reoccurrence of catastrophic losses of bond funds in the future.

#### Diversion and Recovery of Funds

9. When cities pursue the loss of funds through litigation, all recovered funds should be restored, to assure the integrity of the bonds. The city or county agency must not be allowed to divert the funds into other areas. The city or county taxing agency must not be allowed to divert CFD Bond funds that are recovered through litigation to replace "losses". Recovered money must be used to restore the integrity of the bond funds.

#### The Debt Burden Growing with Little Limitation

10. Local government decision makers should be cautious of debt overload within their communities. CFD financing must be guided by long range planning and adherence to state law. Long term agreements with developers such as 25 year development agreements should be avoided. These agreements contain covenants which promise that the city or other taxing entities will pass CFDS for infrastructure for 25 years. There is no way to know, at the time of signing, that the future unknown economic conditions would permit the assumption of additional tax debt. Each project should be considered within current financial contexts. Growth induced infrastructure should be considered on a project-by-project basis. Each special taxing agency should impose a mandatory model for CFD financing for all city or county taxing agencies, in order to avoid tax saturation.

#### CFD Zones, Specific Taxes and Benefits

11. Taxing agencies should assure that CFDs and Service areas are specific in relation to the areas they serve. Those paying the bond and Service area taxes should be the ones benefiting from them. Home owners should not be paying for infrastructure that subsidizes the developer's profits.

#### Financing within Limits

12. City Council should review the approval of CFDs in their community and also review campaign contributions. An over reliance of developer or sub-contractor money in the elective process could influence the judgment of elected officials away from the best interests of the community. The RIVCO CEO should give this immediate attention.

#### Summary

CFDs are complex instruments which most of the home buying public and city council members find difficult to understand. This financing mechanism is sadly being over-used and over-relied upon. Bond contracts of cities reviewed, state they have no responsibility to the bond payers (home owners) for misuse or losses from these bonds. Unfortunately, the City's lack of oversight demonstrates their position. Many of these infrastructure costs in question were originally paid by the developer.

**A critical part of this current threat to home owners and tax payers sadly is, these are costs which were largely mitigated by the developer, in the past, but are now added in advance to the home cost. In the past it was clear to the buyer what the costs of the home was going to be. The CFD instruments now shift to the taxpayer's infrastructure costs which increases the profits of developers. At the same time, this creates long term debt which puts communities and their citizens in financial jeopardy, especially if economic depressions should reoccur.**

Elected officials are the decision makers approving CFD bond purchases. The voting for a CFD is done by the land owner who is often a land developer. This means one or more land owners make a vote to create indebtedness for hundreds or thousands of people. This seems patently unfair but it is the lawful process.

These same land developers and builders contribute to the campaigns of elected officials they feel will be friendly to their needs. They often instruct their sub-contractors to contribute to a Political Action Committees (PACs). Subcontractors that want to work usually comply with these demands, even though under duress. These same elected officials who use developer supported PAC money, are often under the same pressure as sub-contractors, who depend upon the contributions from land developers and builders.

CFD districts in California carry substantial burdens of debt to finance many vaguely described jobs and projects. The scope of Mello Roos (CFDs) grows and so does what many call taxation without representation. This CFD Bond proliferation successfully circumvents Proposition 13. Residents unknowingly subscribe to perpetual bond indebtedness that risks their children and grandchildren's future.

**One critical fact should be remembered; a CFD Bond cannot be created without the approval of the City, County or other taxing authority's approval.**

### Goals

- Oversight committees for CFD Service Areas Funds should include fire protection and law enforcement personnel to provide transparency for CFD bond funds.
- There should be an informal partnership of all tax authorizing agencies in Riverside County to keep the total tax burden manageable.
- Most Riverside County new homes should be presented by builders or sales agents with **BOTH CFD Bond provisions and Developer paid** fee options. As an example by one developer, one housing tract had one side of a tract street priced as a CFD bond financed project.

The other side of the tract street was priced by using the Developer paid fee option, clearly demonstrating the relative strengths of the two methods: **Low up-front pricing vs. known long term costs.**

- Members of the public should insist their elected officials be educated about the many parameters of Bond funding and administration. The public then will be assured the knowledge is available for them to provide proper oversight of city staff to assure reporting obligations and all administrative duties are followed.