

Commentary

A Lender's Guide to Mello-Roos and Assessment Liens

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As the real estate recession in Southern California continues, lenders are carefully evaluating the risks associated with troubled real estate projects in their loan portfolios. Many lenders find that the real property securing their loans have been encumbered by liens imposed by special districts. The liens usually secure tax-exempt bonds issued to finance public improvements and services for the territory within the district. This Commentary describes the most common types of special districts and outlines issues lenders should consider when making loans secured by real property encumbered by special district liens.

Assessment Districts

Assessment districts have been utilized extensively in California during the twentieth century to finance infrastructure improvements such as streets, water, sewer and utilities. The California Streets and Highways Code contains numerous assessment acts and bond acts that authorize the formation of assessment districts, the levy of assessments and the issuance of bonds secured by assessments. The most commonly used laws are the Municipal Improvement Act of 1913 (California Streets and Highways Code, Section 11000 et seq.), which provides for the formation of assessment districts, and the Improvement Bond Act of 1915 (California Streets and Highways Code, Section 8500 et seq.), which allows for the issuance of bonds secured by assessments (collectively referred to herein as the "Assessment Law").

A city, county or other public entity can form an assessment district and, after a public hearing, levy an assessment on the real property in the district to finance public improvements, like streets or roads. The district can finance those public improvements that confer a special, measurable, direct benefit to each parcel of the real property in the district. Because the assessment on each parcel is directly proportionate to the benefit received by that parcel, the assessment is not a tax and does not require a two-thirds vote of the electorate under Proposition 13.

An assessment engineer determines the benefit that each parcel receives from the improvements and apportions the cost of the improvements accordingly. The assessments set forth in the assessment engineer's report are specific dollar amounts representing each parcel's proportionate share of the cost of the improvements. The assessment lien placed on the real property has priority over all other liens, except liens securing ad valorem property taxes, special taxes and previously imposed assessments. The assessments appear on the property owner's tax bill and are due and payable at the same time as property taxes. The assessment is a non-recourse obligation that runs with the real property. If the property owner fails to pay the assessment, the public entity can judicially foreclose on the real property for the amount of the delinquent installments of principal and interest on the assessments. The purchaser of the real property at the foreclosure sale takes the property subject to the lien for all future installments of the assessments.

Mello-Roos Community Facilities Districts

The Mello-Roos Act of 1982 (California Government Code, Section 53311 et seq.) (the "Mello-Roos Act") provides a mechanism for certain public entities, such as cities, counties, schools, local districts and joint power authorities, to finance public infrastructure and certain governmental services. The public entity forms a community facilities district and, after a public hearing and approval of two-thirds of the electorate in the district, the district may levy a special tax on the real property within its boundaries. The district can apply the special tax revenues, or proceeds from bonds secured by special taxes, to finance general benefit facilities and services, as well as the special benefit improvements traditionally financed with assessment districts.

Because the special tax is a tax, it is subject to the voter approval requirements of Article XIIA of the California Constitution. However, since the district is only empowered to levy a tax within the boundaries of the proposed district, the special tax need only be approved by two-thirds of the electorate within the proposed district. If there are fewer than twelve registered voters within the district, approval by two-thirds of the land owners within the district is sufficient. Land owners receive one vote per acre of real property that they own in the district. This feature of the Mello-Roos Act enables developers to retain control of the voting process when developing unimproved land.

There is no statutory requirement regarding the method of apportioning the special tax other than the tax must be "fair and reasonable". Consequently, developed land may be taxed at a rate different from undeveloped land to facilitate a more equitable allocation of cost. The tax rate, method of apportionment and/or authorized amount of special tax may be modified at any time by a vote of the electorate or land owners as applicable, so long as the modification does not impair the security of outstanding bonds. To date, most Mello-Roos taxes have been structured on the basis of density of development, square footage of construction or flat acreage charges. The special tax formula usually contains a "back-up" tax based on acreage to insure that sufficient special tax revenues will be available to pay debt service on the bonds if development in the proposed district does not occur as projected at the time the special tax formula is approved.

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The special tax is secured by a lien on the real property in the district that is co-equal to property taxes, other special taxes and the first assessment lien placed on the real property. If the property owner fails to pay the special tax, the public entity can foreclose on the real property for the amount of the delinquent special taxes. The special tax obligation cannot be accelerated and the public entity can only recover the amount of the delinquent taxes with interest and penalties. Any purchaser at a foreclosure sale acquires the property subject to the lien for future special taxes.

Special District Checklist for Lenders

Because assessment and special tax liens have priority over all private liens, it is essential that private lenders evaluate the impact of assessment and Mello-Roos financing on their real property security and take steps to protect their security. Additionally, because any private foreclosure occurs subject to the assessment and special tax liens, lenders forced to foreclose on troubled real estate projects often find themselves owners of real property encumbered by special district liens. Therefore, lenders should familiarize themselves with the terms of the special district financings that run with the real property and consider whether prepayment or refinancing are economically attractive options.

Can Senior Liens Be imposed Without Your Consent?

Both the Assessment Law and the Mello-Roos Act require that the legislative body of the special district file a notice of the assessment or special lien with the county recorder after the assessment or special tax has been approved. After the recordation of the lien, all persons are deemed to have constructive notice of the lien. A close examination of a title report should reveal any existing assessment or special tax liens on real property unless, as sometimes happens, the notice of tax or assessment lien doesn't make it to the County Recorder's Office in time to be placed on the tax rolls. Additionally, subsequent special district liens can be imposed without the consent of private lenders. Although the Assessment Law and the Mello-Roos Act both mandate that all owners of real property in a proposed special district receive notice and an opportunity to protest prior to the imposition of the lien, neither body of law requires the consent of private lienholders. Consequently, unless the loan documents require that the borrower inform the lender of special district financing - whether Mello-Roos or assessment liens - a lender may find that senior assessment or special tax liens have been imposed on the real property without its knowledge or consent. Therefore, it is important that any loan document require that the borrower notify the lender prior to the imposition of or upon obtaining notice of any special district liens.

Is Your Real Property Security Interest Safe?

In response to market pressures, public entities issuing assessment and special tax bonds usually covenant to commence foreclosure proceedings promptly - often within 150 days - after notification that a property owner is delinquent in payment of assessments or special taxes. The rapid foreclosure requirements required by investors represent a significant distinction between special district liens and traditional property tax liens. Additionally, the recent case, Yancy v. Fink (1991 4th Dist.) 226 Cal. App. 3d 1334, 277 Cal. Rptr. 415, establishes that there is no right of redemption in an assessment district foreclosure proceeding. While the case does not directly address the applicability of rights of redemption for Mello-Roos Act foreclosures, the Mello-Roos Act foreclosure proceedings are analogous to assessment district foreclosures and it seems likely that the holding of Yancy v. Fink also applies to Mello-Roos Act foreclosure proceedings. Because liens imposed by private lenders are junior to the assessments and special taxes, they will be extinguished by the special district foreclosure sale. A private lender can extinguish all junior liens and take the property without risk of redemption by the former owner, if the lender is the successful bidder at a judicial foreclosure sale. However, this is a risky course of action since the private lender's security interest will be extinguished if another party is the successful bidder. Consequently, usually the most prudent method for a lender to protect its security interest is to pay any delinquent assessments and special taxes and foreclose non-judicially upon the junior lienholders' interests, and live with the risk of redemption.

Acquiring Real Property With Special District Liens: What Should You Do With Your Special District Financing?

Private lenders forced to foreclose on troubled real estate projects often find that they have assumed special district financing. Lenders should closely examine the terms of the special district financing to evaluate the prepayment and refinancing options.

Challenging the Validity of the Special District Lien.

Both the Assessment Law and the Mello-Roos Law limit the time within which the validity of the assessment or special tax can be challenged. Any action challenging the validity of the lien must be commenced within thirty days after the assessment is levied or the special tax is approved by the voters. Therefore, unless the lender challenges the lien immediately after it is imposed, it will normally be precluded from challenging the validity of the lien.

However, as described above, the assessment on each parcel of real property must be directly proportionate to the benefit that parcel receives from the improvements financed by the assessment district. If development of the real property does not occur as projected at the time the assessment is levied, the assessment on the parcels that are not developed or that are developed at a lower density may be disproportionately high for the benefit received from the improvement. In that case, the Assessment Law provides for a reassessment of the real property. A lender acquiring real property with an assessment lien should therefore evaluate whether the amount of the assessment is appropriate and request that the public entity reassess the parcel if the land use of the real property has changed since the assessment engineer's report was prepared.

Prepayment of the Special District Obligation.

Lenders acquiring real property with special district liens may wish to repay the obligations to decrease interest expense associated with the real property and to increase the real property's marketability. Since the

assessments levied on each parcel of real property represent a specific dollar amount, the prepayment amount for an assessment lien is easily calculated. Because assessments are easily and frequently prepaid, assessment district bonds usually provide that assessment prepayments (which include a 3-5% call premium) can be applied to redeem bonds.

Prepayment of special taxes, however, is often less attractive economically. Until 1986, the Mello-Roos Act did not contain provisions authorizing prepayment. Bonds issued prior to 1987 may not be capable of prepayment. Additionally, even when prepayment of special taxes is authorized, many public entities resist including prepayment mechanisms for special taxes because of the difficulties inherent in calculating and administering special tax prepayments. The special tax on a specific parcel of real property may vary depending on the land use and rate of development in the district. Consequently, because the special tax is not a specific identifiable amount, the prepayment amount of the special tax is not easily calculated. Generally, the property owner must prepay the special tax at the highest "back-up" tax rate, which is generally a square footage tax imposed when property doesn't develop as anticipated. Prepayment of special taxes at a prepayment price that is calculated at the higher tax rate will also include a prepayment premium. The combination of these elements generally makes special tax prepayment economically unattractive.

Refinancing the Special District Bonds.

Depending on current market conditions, it may be beneficial to consider refinancing the special district bonds to reduce the cost of borrowing. The ease of refinancing will depend on the redemption provisions for the bonds. Investors demand a higher yield on bonds with no protection against early redemption. Consequently, most bonds contain redemption premiums, which increase the cost of refinancing. Additionally, many bonds, especially Mello-Roos bonds, cannot be redeemed for the first ten years. If the bonds have call protection, the bonds must be refinanced through a so-called "advance" refunding. The proceeds from the refunding bonds will be deposited in an escrow fund to finance principal and interest payments due on the original bonds until the original bonds can be redeemed. The economic viability of an advance refunding will depend on the market conditions at the time of the refinancing. If there is no call protection, the bonds can be refunded through a current refunding in which the proceeds from the refunding bonds can be used to immediately retire the original bonds. Usually a difference of 1.5 to 2% in the interest rate on the outstanding bonds and to-be-issued bonds is necessary to realize enough savings to pay for the cost of the refinancing.

Whichever course of action a lender selects, early and frequent contact with experienced lender's counsel, the bond issuer, the bond owners and their respective counsel, is essential to properly implement a course of action in this very technical and politically sensitive area. But, an ounce of prevention is obviously much more valuable than a pound of cure. Lenders should make a careful analysis of special district liens at the time they make land-based loans, monitor the imposition of additional liens on the real property and carefully analyze the terms of any special district financing they assume when acquiring real property.

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