

IC 21-2-4-2 requires the Debt Service Fund, designated Fund No. 020. The fund is to be used to record all receipts and disbursements for: (1) all debt and other obligations arising out of funds borrowed or advanced for school buildings when purchased from the proceeds of a bond issue for capital construction; (2) a lease to provide capital construction; (3) interest on emergency and temporary loans; (4) all debt and other obligations arising out of funds borrowed or advanced for the purchase or lease of school buses when purchased or leased from the proceeds of a bond issue, or from money obtained from a loan made under IC 20-9.1-6-5, for that purpose; (5) all debt and other obligations arising out of funds borrowed to pay judgments against the school corporation; or (6) all debt and other obligations arising out of funds borrowed to purchase equipment. Included is payment of school bonds and coupons, lease-rental agreements, civil bond obligations assumed through reorganization, veterans' memorial fund repayments and common school fund repayments, but shall not include the principal of emergency and temporary loans obtained for the benefit of any other fund.

Each school corporation in Indiana shall establish a debt service fund for the payment of:

- (1) all debt and other obligations arising out of funds borrowed or advanced for school buildings when purchased from the proceeds of a bond issue for capital construction;
- (2) a lease to provide capital construction;
- (3) interest on emergency and temporary loans;
- (4) all debt and other obligations arising out of funds borrowed or advanced for the purchase or lease of school buses when purchased or leased from the proceeds of a bond issue, or from money obtained from a loan made under IC 20-9.1-6-5, for that purpose;
- (5) all debt and other obligations arising out of funds borrowed to pay judgments against the school corporation; or
- (6) all debt and other obligations arising out of funds borrowed to purchase equipment. The term "debt service" shall include but not be limited to lease rental obligations, school bonds and coupons and civil bond obligations assumed by school corporations reorganized pursuant to IC 20-4-1, and any interest cost on emergency and temporary loans but shall not include the repayment of the principal of the emergency and temporary loans obtained for benefit of any other fund. All receipts and disbursements authorized by law for school funds and tax levies for the lease rental fund, bond fund, sinking fund, civil bond obligation fund, and payment of interest on emergency and temporary loans shall be received in and disbursed from the debt service fund (Indiana Code, 2003).

The Debt Service Fund is used to repay various types of indebtedness the school corporation may encounter. Examples of Debt Service Fund expenditures are: Interest on Tax Anticipation Warrants (TAW), General Obligation Bonds (GOB), Common

School Fund Loans, Lease Rentals (Holding Corporation), and Interest on Emergency Loans.

GENERAL OBLIGATION BONDS

The architects of Indiana's 1851 Constitution provided that no local tax body could issue general obligation bonds in an amount exceeding 2 percent of the assessed value. Subsequent legislation completed the financing roadblock by fixing the level of assessed value at one-third of the actual value of real and personal property (Illyes, 1991). In 2003 the law again changed to fix the level at 100 percent of true tax value, but limited indebtedness for most purposes to one-third of 2 percent of 100 percent of true tax value.

General Obligation Bonds may be sold to purchase equipment, school buses, energy savings equipment and capital construction projects, to name a few. These bonds are usually repaid in five to seven years for bonds issued to finance the construction of additional classroom space. Indiana law requires the Department of Local Government and Finance not approve a bond issue or lease rental unless the local school corporation has:

- Established that additional classroom space is necessary; and
- Conducted a feasibility study, held public hearings, and heard public testimony on using a 12 month school term instead of a nine month school term rather than expanding classroom space (Farm Bureau, 2002).

There is a constitutional limitation on issuance of general obligation bonds to 2 percent of the school corporation's assessed value, but a more restrictive statutory limitation of one-third of that 2 percent.

HOLDING CORPORATIONS

In the years following World War II, Indiana's constitutional debt limit on general obligation borrowing led to a severe shortage of schools. As a result, the Indiana General Assembly passed Chapter 273 in 1947. The act created School Building Corporations—legal entities empowered to issue bonds to construct school facilities and lease them, upon completion, to the sponsoring school districts. Since the bonds are not a direct obligation of the school district, they can be issued in whatever amount is necessary to finance the needed improvements, notwithstanding general obligation debt limits (Illyes, 1991).

School corporations can enter into a lease agreement with school building authorities. These agreements provide that when the holding corporation's bonds are retired, the school building or buildings covered by the lease agreement become property of the school corporation. Lease rental agreements are not considered part of the 2 percent constitutional limit on indebtedness.

School corporations can utilize public or private holding corporations to finance construction and improvements. The holding corporation will acquire the funding, build the building or addition, or remodel the facility and then lease it back to the school corporation for a specific period of time, after which the school corporation assumes full ownership.

- Public holding corporations are authorized under IC 21-5-11. A group of local patrons form a corporation for the sole purpose of building a new building, remodeling, or adding to an existing public school building.
- Private holding corporations are authorized under IC 21-5-12. This holding corporation is authorized to do business under Indiana state law and its purpose is the same as the public holding corporation.

The general guidelines for establishing and utilizing a holding corporation are as follows:

- The school board has to determine the need, method, and period of financing and receive a petition from at least 50 patrons who favor the construction. The maximum length of financing or term for either corporation is 25 years, although the lease may specify a longer term.
- The school board must conduct a public hearing on the project, in accordance with IC 21-51-11-7 or IC 21-5-12-7.
- The school corporation must select an architect. Either the school corporation or the holding corporation may pay the architect.
- The school superintendent should contact the State School Property Tax Control Board.
- An attorney should be hired.
- If a public holding corporation is to be used to finance the project, the attorney must form the corporation following legal procedures outlines.
- The architect must submit plans to:
 - The State Fire Prevention and Building Safety Commission.
 - The local Zoning Board and County Board of Health.
- The architect must prepare plans for public bidding.
- The school board must advertise and hold a public hearing on the lease agreement.
- The school board must execute the lease after advertising and holding the public hearing.
- If a public holding corporation is utilized to finance construction, a competitive bond sale must be conducted; if a private building corporation is utilized, the bond sale may be negotiated.
- The holding corporation must acquire the real estate before construction starts.
- State Fire Prevention and Building Safety Commission approval must be received before notice to proceed with construction is given (Farm Bureau, 2001).

BOND SALE: NEGOTIATED VERSUS COMPETITIVE

Bonds issued by a building corporation, in connection with a school lease financing pursuant to Indiana Code 21-5-12, may be issued using a competitive sale or by negotiating with an investment banker. Various factors should be considered in determining which type of sale is appropriate for a particular school corporation's transaction. The financial advisor, based on his or her experience, will be able to make a recommendation; however, the ultimate decision is with the school corporation.

With a competitive sale, a bond sale notice is published establishing a date or range of dates on which the building corporation will receive bids on its bonds. Generally, the financial advisor will supply the potential underwriters with maturity dates and amounts, either with the notice or just prior to the sale. The financial advisor will generate this schedule of maturity dates and amounts based upon estimated interest rates. The underwriter's bid will contain the interest rates for those maturity dates and amounts and the underwriter's discount.¹ At the time of the sale, the building corporation will receive bids and, after the financial advisor reviews the bids, award the bonds to the underwriter offering the lowest interest cost. Many financial advisors believe that the building corporation will receive the best interest rates on its bonds at a competitive sale *on the date of the sale* because the competition will require the underwriters to offer the best interest rates possible *on that day* to win the bonds. Some school corporations like competitive sales because it avoids the political problem of having to choose an underwriter.

With a negotiated sale, the school corporation chooses an investment banker to underwrite the bonds. The school corporation may use a financial advisor and an underwriter, if it desires, or it may use the investment banker as both financial advisor and underwriter. The underwriter will watch the bond market and choose a day to sell the bonds, which it believes will generate the best interest rates. After the underwriter markets the bonds, the building corporation and the underwriter will execute a bond purchase contract, which locks in the interest rates.

Financial advisors may recommend to a school corporation or a school corporation may decide, on its own, that a negotiated sale would have certain advantages in a particular transaction. The decision to use a negotiated sale is sometimes merely based on the personal preferences and prior experiences of the board of school trustees involved. There are certain factors, however, that tend to suggest that a negotiated sale may be of some advantage.

If a bond issue is very large or if the interest rate markets are very volatile, it may be appropriate to negotiate the issue. With a large issue it becomes difficult for an individual underwriter to submit a bid and, therefore, the underwriter joins a syndicate of underwriters to submit one joint bid. If this happens, competition may be limited or eliminated because of the small number of bids received. Financial advisors' opinions seem to vary as to what size of issue is too large to sell competitively.

¹ Underwriter's discount is the fee the underwriter receives off the top before the bond proceeds are paid to the building corporation at the closing.

There are times when a school corporation tries to control its debt service and tax rate and, therefore, a very deliberate amortization schedule is desired. For example, a school corporation may have a new industry in its district that currently is receiving property tax abatement, but in ten years will embody a large portion of the school corporation's tax base. The financing can then be structured in a way that uses capital appreciation bonds, allowing the debt service to be minimized for the first ten years of the issue until the industry comes on line. Capital appreciation bonds can only be accomplished with a negotiated sale. It is also possible, when a school corporation is paying off other obligations (such as general obligation bonds or leases), to structure the financing to achieve a relatively flat tax rate. Certain tax rate structuring will be more efficient with a negotiated sale.

Another scenario in which negotiated sales become very attractive is when the school corporation has a story to tell. For example, a few years ago a major industry in a particular school corporation announced its closure the day before the school corporation had advertised to receive competitive bids on its bonds. The school corporation talked with an investment banker and explained the community's plans for dealing with the closure. The investment banker, on a negotiated basis, was able to sell the bonds by explaining the events to its potential customers.

Sometimes it is important for a school corporation to sell the bonds as quickly as possible. For example, construction bids may be on the verge of expiring and the school corporation wants to give notice to proceed as soon as possible. Often, negotiated sales can be accomplished more quickly because there is not the fifteen-day advertisement requirement, as there is with a competitive sale.

The choice between a competitive bond sale and a negotiated bond sale is ultimately the school corporation's decision. The financial advisor can provide the school corporation with the various advantages and disadvantages for a particular transaction to assist in the decision (Ice Miller).

CONTINUING DISCLOSURE

The United States Securities and Exchange Commission (SEC) amended SEC Rule 15c2-12 (the "Rule") to impose additional disclosure requirements on issuers of municipal bonds. As originally adopted in 1989, however, the Rule did not obligate an issuer to provide information to the investment community after the bonds were delivered. While most school construction finance in Indiana involves bonds being issued by building corporations, the Rule still requires the school corporation to provide certain information over the life of the bonds.

The amended Rule will impose several requirements on school corporations that sell bond issues or have building corporations bond issues with a principal amount of \$1 million or more. First, before an underwriter can agree to underwrite a bond issue, a school corporation must agree in writing to submit certain financial information and operating data annually (including audited financial statements, if available) to nationally recognized municipal securities information repositories and, if available,

state information depositories.

Second, the amended Rule requires school corporations to agree to provide notice during the life of the bonds to information repositories upon the occurrence of any one of nine material events. These events include:

- A principal or interest payment delinquency
- An unscheduled draw on a debt service reserve fund
- An unscheduled draw on a credit enhancement
- A substitution of a credit or liquidity provider
- Receipt of an adverse tax opinion or the occurrence of an event affecting the tax exempt status of a bond
- A bond call
- The defeasance of a bond
- The release, sale or substitution of any property securing a bond
- A change in the rating of a bond

Third, the Rule will require a school corporation to give notice if it has failed to honor its covenant to submit annual financial and operating information in a timely manner, regardless of whether this is a material violation of the promise.

The amended Rule does provide for some exceptions. Notably, a school corporation is not subject to the Rule, including the preparation of an official statement and the continuing disclosure requirements, if the principal amount of the bond issue is less than \$1 million. Tax warrant financings may also be exempt from the Rule if they mature in nine months or less. Also, a school corporation may be exempted, but only from certain Rule requirements, if it has less than \$10 million of bonds outstanding, including the proposed bond issue. However, the \$10 million exemption is very limited and still requires the school corporation to undertake significant continuing disclosure obligations (Ice Miller).

ADVANCE DRAW

School corporations can apply to the county treasurer for advance draws for property and excise taxes collected early by the county. These advances will be deducted from the normal June and December payments.

EMERGENCY LOAN

If the school board declares by a resolution that an emergency exists, which requires the expenditures of money not included in the budget and tax levy, it may authorize an emergency loan in the same manner as the issuance of bonds, except as to the purpose of the loan. Repayment of the loan will come from the fund it was originally deposited in and the interest will be budgeted in the Debt Service Fund.