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The State of South Carolina
# OFFICE OF THE ATTORNEY GENERAL

HENRY MCMASTER
ATTORNEY GENERAL

July 6, 2005

The Honorable Lawrence K. Grooms
Senator, District No. 37
131 Indian Field Drive
Bonneau, South Carolina 29431

Dear Senator Grooms:

In a letter to this office you raised several questions regarding an alternative funding plan for schools in Dorchester County. You specifically stated that

> [i]n Dorchester County, the school district has established a "third party corporation". The corporation, named "Growth", will build the schools, etc. Currently, the school is borrowing approximately $120 million (for starters). The bonds used to pay for the schools in incremental pieces (the school will buy back a piece of each building per year) should be taxed as debt service (according to the school district). Currently, this school district was only $4 million away from reaching their 8% debt limit. Therefore, the payments are being structured so that they will not exceed the 8% debt limit, but amount to only one payment towards the purchase of the school building.

You indicated that it is your understanding that the school district may sever the contract at any time. Referencing such, you have raised the following questions:

1. Does this financing method qualify legally as debt service?
2. Should a county auditor even question what is or is not debt service, or should that determination be made solely by the school's governing body and then the amount needed reported to the county auditor to set the tax levy?
3. Exactly what is the auditor's responsibility regarding setting the levy for debt service?

## Law / Analysis

A prior opinion, dated November 13, 2000, is responsive to your question as to whether the referenced financing method in Dorchester County qualifies as debt service. That opinion dealt with the question of whether a proposed agreement between the Greenville County School District and a private business to construct and improve numerous facilities for use by the school district violated

S.C. Code Ann. § 11-27-110. Such provision subjects lease purchase or financing agreements to a governmental entity's constitutional debt limit.

As recognized in the 2000 opinion, Article X, Section 15 of the State Constitution provides that a school district may incur general obligation debt in an amount up to 8% of the assessed value of all taxable property in the school district. In order to incur debt over the 8% amount, the school district must obtain voter approval in a referendum. In an attempt to obtain funding for large projects without running afoul of this constitutional limit upon general obligation debt, school districts adopted new methods for financing such projects.

A review of one such plan was made by the State Supreme Court in *Caddell v. Lexington County School District*, 296 S.C. 397, 373 S.E.2d 598 (1988). In that case, a school district had leased to a non-profit corporation for a term of thirty years all the land and school buildings requiring renovation. Pursuant to the plan, the corporation would sell certificates of participation to obtain funding for the project. With the funding, the schools could be renovated and then leased back to the school district on a yearly basis. The rent payments were in an amount sufficient to pay both the interest and principal due on the certificates. The agreement contained a non-appropriation clause, under which the school district could decline to renew the lease without penalty.

In *Caddell*, the Court determined that the lease purchase agreement did not constitute "debt" under Article X, Section 15 of the Constitution. The Court particularly noted that liability of the school district under the agreement was contingent; the district could terminate the lease at any time without penalty. In the worst case scenario, the school district would lose the use of the facilities for a limited time, but the ownership of the land and buildings would not be impaired. The Court also rejected the argument that the school district's agreement was a "subterfuge" to maneuver around the constitutional debt limit. In reaching its conclusion that the debt limit was inapplicable, the Court suggested either legislative action or a constitutional amendment to address such arrangements.

In 1994, the Court in its decision in *Redmond v. Lexington County School District*, 314 S.C. 431, 445 S.E.2d 441, again upheld a lease purchase agreement involving a school district's efforts to obtain funding following the defeat of a bond referendum. As in *Caddell*, the Court once more rejected any argument that the spirit of the constitutional debt limit was being circumvented by a lease purchase approach. The Court also pointed to the absence of legislation designating lease purchase agreements as general obligation debt and suggested that should such a bill be enacted by the General Assembly, similar litigation would reach a very different result. *Id.* at 435, 445 S.E.2d at 444.

In response to *Cadell* and *Redmond*, in 1995, the General Assembly enacted Act No. 55, 1995 Acts and Joint Resolutions, presently codified at § 11-27-110. This legislation provides that payments pursuant to a lease purchase or financing agreement are subject to the constitutional debt limit of a governmental entity. As a result, school districts are effectively prohibited from entering into lease purchase agreements similar to those in *Caddell* and *Redmond*. Therefore, § 11-27-110

represents the General Assembly's response to the Court's holdings in these decisions. Accordingly, § 11- 27-110 must be interpreted in light of this historical context.

We are advised that the Dorchester funding plan is virtually identical to that addressed in the November 13, 2000 opinion. Relevant there, as well as with respect to your particular question, is the definition of "financing agreement" now found in § 11-27-110 (A)(6). Such provision states as follows:

> "financing agreement" means any contract entered into after December 31, 1995, under the terms of which a governmental entity acquires the use of an asset which provides:
> (a) for payments to be made in more than one fiscal year, whether by the stated term of the contract or under any renewal provisions, optional or otherwise;
> (b) that the payments thereunder are divided into principal and interest components or which contain any reference to any portion of any payment under the agreement being treated as interest; and
> (c) that title to the asset will be in the name of or be transferred to the governmental entity if all payments scheduled or provided for in the financing agreement are made, but the term excludes any refinancing agreement and contracts entered into in connection with issues of general obligation bonds or revenue bonds issued pursuant to authorization provided in Article X of the Constitution.

Such definition of "financing agreement" determines whether the scope of the prohibition of § 11-27-110 reaches the alternative funding plan utilized by the Dorchester County school district.

In the November 13, 2000 opinion, we concluded (with certain caveats, explained below) that a court would likely hold that "financing agreement," as defined by § 11-27-110(A)(6), was not involved in the Greenville County school district's plan and thus the prohibitions of § 11-27-110 did not apply. There, we described the Greenville plan as follows:

> [t]he proposed financing arrangement under the Greenville County School District's plan includes the creation of a nonprofit corporation which serves as an intermediary between the school district and those responsible for the actual building and renovations. The school district plans to enter into a base lease with the nonprofit corporation in which the corporation will have occupancy rights of all the facilities to be renovated for a term exceeding the term of financing. In consideration for the lease, the corporation agrees to arrange for the construction and renovation of certain facilities for the district. The district, the corporation, and the building contractors will enter into an agreement in which the builders agree to perform the necessary construction of the facilities owned by the corporation. So long as the school district makes payments to the corporation, the school district has the right to occupy the premises. Significantly, as the school district makes payments to the corporation, the

corporation will convey an undivided interest in all the improvements to the school district. In other words, if the school district pays an amount equal to 1/20 of the total cost of the project, the school district has purchased 1/20 of the improvements. As distinguished from the agreements in Caddell and Redmond, the school district does not pay "rent" comprised of a payment of the interest and principal due under the certificates. Instead, the school district pays a lump sum to purchase an undivided interest in the improved property. Should the school district decide to terminate the agreement before the full amount of the improvements is purchased, the facilities will be immediately divided according to the ownership interest of the parties. For example, if the school district chooses to terminate the arrangement after purchasing an undivided 25% interest in the improvements, the school district will own 1/4 of the facilities, with the intended goal of the agreement to transfer whole facilities as opposed to parts thereof.

The differences between the Greenville County School District's plan and the Caddell and Redmond plans are critical to determining the application of §11-27-110. To apply, the agreement must fall within the statute's definition of "financing agreement." The statute requires that in the financing agreement, (a) the payments must be made in more than one year, (b) the payments are divided into principal and interest, and (c) title is transferred if all payments are made. All three elements are necessary. In the Greenville County School District plan, the payments are not divided into principal and interest, but one payment which purchases an undivided interest. To illustrate the difference: as with any loan, payments are typically comprised of both interest any principal. In the early stages of repayment, the payment is applied mostly to the interest. At some point, as the interest is paid down, the portion of the payment applied to the principal increases. If a debtor defaults on the loan in the early stages of repayment, little equity has accumulated in the underlying collateral. In the Greenville County School District plan, each payment purchases a distinct undivided interest in the improvements. If the school district defaults, or chooses not to renew the lease, the school district owns the value of the entire amount paid on the improvements. In fact, with each payment, the interest is conveyed to the school district, arguably defeating the third requirement of the statute. Although separate title to a particular facility would not be transferred until the school chooses not to renew the lease, the school is not required to make all payments under the agreement before any title is transferred. These two differences–the purchase of an interest and the immediate transfer of title–distinguish the Greenville County School District's plan from those in Caddell and Redmond.

With respect to your question of whether the financing plan utilized by the Dorchester County school districts constitutes debt service, clearly it does. However, based upon the same reasoning and analysis of the 2000 opinion, such financing arrangement is not prohibited by § 11-27-110. Again, as we understand it, in the Dorchester County situation, the school district has

established a "third party corporation" entitled "Growth" which will build the schools. You stated that currently the school is borrowing initially approximately $120 million. Bonds are being used to pay for the schools in increments whereby the school will buy back a portion of each building per year. The payments are being structured so that they will not exceed the 8% debt limit, but amount to only one payment towards the purchase of the school building.

Therefore, as in the Greenville situation, there are major distinctions between the Dorchester County plan and the express prohibitions contained in § 11-27-110. As a result, while the payments constitute debt service, the Dorchester County plan would likely not be deemed by a court to be a "financing agreement" within the meaning of § 11-27-110. If the amount paid as debt service does not exceed 8% of the assessed value of all taxable property in the school district, there is no requirement to obtain voter approval in a referendum as required by Article X, Section 15 of the State Constitution. As was the case in the Greenville situation, a general obligation bond issuance for a year or less in order to purchase a portion of the school property is unlikely to be deemed by a court to violate § 11-27-110 or Article X, § 15 of the Constitution.

However, we caution, as we did in the November 13, 2000 opinion, that despite the literal language of § 11-27-110, and notwithstanding the express definition of "financing agreement" set forth therein, a court could conclude that the statute is applicable to the Dorchester County financing plan. As stated in the November, 2000 opinion,

> [o]f necessity, the court would have to find that the statute's reach is broader than the literal language thereof. The court would have to determine that the agreement in question was in substance prohibited by the "anti-lease purchase law" even if not in form. Only a court, with the ability to take testimony, admit evidence and find facts, etc. could make that determination.

You also inquired as to whether a county auditor should even question what is or is not debt service or should that determination be made solely by the school's governing body with the amount then needed reported to the county auditor in order to set the tax levy. Additionally, you have asked what exactly is the auditor's responsibility regarding setting the levy for debt service.

With respect to the authority of a school district to incur general obligation debt, Article X, § 15 of the State Constitution authorizes school districts to incur such debt, but only in such manner and upon such terms and conditions as the General Assembly prescribes by law and within the limitations of that provision. The term "general obligation debt" is defined by such provision as "...any indebtedness of the school district which shall be secured in whole or in part by a pledge of its full faith, credit and taxing power." The referenced constitutional provision further states that

> (3) General obligation debt may be incurred only for a purpose which is a public purpose and which is a corporate purpose of the applicable school district. The power to incur general obligation debt shall include general obligation debt incurred by any

> school districts for the purposes permitted by Section 13 of Article VIII of this Constitution. All general obligation debt shall mature within thirty years from the time such indebtedness shall be incurred.

Therefore, Article X, § 15 imposes no requirement as to amortization and the term limit of any debt is only a maximum maturity of thirty years.

Consistent with such constitutional provision is S.C. Code Ann. § 11-27-50 which states in pertinent part:

> The board of trustees or other governing body (the governing body) of each of the school districts of the State shall be empowered to incur general obligation debt for their respective school districts as permitted by Section 15 of New Article X and in accordance with its provisions and limitations. All laws relating to such matters shall continue in force and effect after the ratification date, but all such laws are amended as follows:
>
> > 1. If no election be prescribed in such law and an election is required by New Article X, then in every such instance, a majority vote of the qualified electors of the school district voting in the referendum herein authorized is declared a condition precedent to the issuance of bonds pursuant to such law. The governing body of each of the school districts shall be empowered to order any such referendum as is required by New Article X or any other provisions of the Constitution, to prescribe the notice thereof and to conduct or cause to be conducted such referendum in the manner prescribed by Article 1, Chapter 71, Title 59, Code of Laws of South Carolina, 1976.
> > 2. If an election be prescribed by the provisions of such law, but is not required by the provisions of New Article X, then in every such instance, no election need be held and the remaining provisions of such law shall constitute a full and complete authorization to issue bonds in accordance with such remaining provisions.
> > 3. If a statutory debt limitation be prescribed by any such law, then in lieu thereof, the debt limitation shall be that resulting from the provisions of Section 15 of New Article X.

In accordance with the foregoing constitutional and statutory provisions, a school board has the authority to issue general obligation bonds (and bond anticipation notes) for public and corporate purposes and has the power to determine the term for the indebtedness. See, *Op. S.C. Atty. Gen.*, January 18, 2005.

Pursuant to S.C. Code Ann. § 59-73-20, "(t)he school districts of the several counties of the State are hereby made and declared to be the divisions of the counties for taxation for all school purposes." S.C. Code Ann. §§ 59-71-10 et seq. are provisions of this State's "School Bond Act". These statutes authorize school districts to issue general obligation bonds "...for the purpose of defraying the cost of capital improvements to any amount not exceeding the constitutional debt limitation applicable to such operating school unit...." See: § 59-71-30. Section § 59-71-150 provides as follows:

> [f]or the payment of the principal and interest on such bonds as they respectively mature and for the creation of such sinking fund as may be necessary therefor the full faith, credit and resources of the operating school unit are irrevocably pledged and *there shall be levied annually by the auditor of each county wherein such operating school unit is located*, and collected by the treasurer of such county in the same manner as county taxes are levied and collected, *a tax, without limit, on all taxable property in such operating school unit sufficient to pay the principal and interest of such bonds as they respectively mature and to create such sinking fund as may be necessary therefor.* (emphasis added).

In a prior opinion, dated March 20, 1985, we concluded that this provision

> ...relates to a tax levy to retire a bonded debt of a school district. The statute, by its language, levies the tax for the repayment of the bonds. There is no discretion vested in the governing body or other officials thereof as to whether the tax is to be levied. The only tax is for the auditor to determine the number of mills necessary to raise the required revenue.

The 1985 opinion references the decision of *Stackhouse v. Floyd*, 248 S.C. 183, 198, 149 S.E.2d 437, 445-446 (1966) wherein the State Supreme Court similarly stated:

> [p]laintiffs also contend that the Act is unconstitutional in that it delegates to the Auditor the authority to tax and the discretion to fix the amount of the tax to be levied to provide debt service on the bonds. The Act, however, gives no such discretionary power to the Auditor but rather compels him to levy annually "a tax sufficient to pay the principal and interest of the bonds as they respectively mature and to create such sinking fund as may be necessary therefor." The amount of the levy, therefore, is established by the maturity schedule of the bonds and the interest rate. *The Auditor acts in a ministerial fashion as the agent of the General Assembly in this matter.* (emphasis added)

*See also*, *Op. S.C. Atty. Gen.*, December 4, 1998 ["the auditor's role is limited in determining the millage for the school district .... The Auditor does not possess any discretion in doing so, but act[s] in a ministerial capacity only."]; *County of Lee v. Stevens*, 277 S.C. 421, 289 S.E.2d 155 (1982)

[citing § 12-39-180, Supreme Court concludes that the setting of the tax rate belongs to county governing body, not the Auditor]. Accordingly, as these opinions and cases indicate, it is not the responsibility of the county auditor to question what is or is not debt service. Instead, the determination of such amount is to be made solely by the school's governing body with the amount needed then reported to the county auditor in order to set the tax levy. When a bond is issued or indebtedness created, the auditor is required to levy a tax to provide for the debt service on the bonds. Therefore, a county auditor is required to levy and collect the amount required for payment of general obligation bonds – in this instance, to levy and collect the amount to pay the debt service on the general obligation bond for that year. The auditor is not an approving body but, assuming the proper form is observed, is bound by law to act.

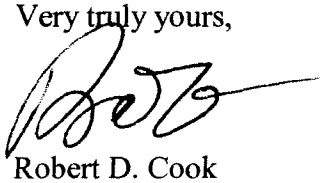
## Conclusion

In response to your specific questions, we would answer as follows:

1. Yes, "debt service" is involved in the Dorchester financing arrangement, but it is "debt service" upon short term general obligation bonds issued each year to purchase a portion of the school facilities involved. As we understand it, such a financing arrangement is virtually identical to an arrangement fully addressed in our opinion of November 13, 2000.

2. The Auditor of Dorchester acts in a ministerial capacity and thus is required to levy and collect that amount necessary to fully pay the debt service on the general obligation bond for that year. Such bond issuance is to finance the purchase of a portion of the school facilities, as discussed above.

Very truly yours,



Robert D. Cook
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