PERSPECTIVE

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Deadbeat Developers and Cruel Covenants: Collecting on Delinquent Mello-Roos Taxes

By Daniel Maruccia

Public agencies must consider ways to protect themselves, and taking action to collect is often the only way to uphold an agency's credit rating for the future.

Delinquent Mello-Roos taxes are shaping up to be a potentially disastrous situation for already cash-strapped public agencies. Many agencies do not realize that, while current delinquencies may not create financial challenges today, they may seriously jeopardize a public agency's ability to finance needed facilities in the future. Taking legal action is often the only way to protect an agency's credit rating for future bond issuances.

For many years, numerous public agencies facing facility needs but lacking funds have turned to the Mello-Roos Community Facilities Act of 1982 to borrow money. The act allows formation of a community facilities district (CFD) where real property within this area is levied a special tax. The CFD can then issue tax-exempt bonds and use the special tax revenue to service the bond debt. CFD bond proceeds may be used to finance the purchase, construction, expansion, improvement or rehabilitation of property that benefits the CFD. If developers or others fail to pay the tax, which has been a pervasive program in recent years, bond covenants require public agencies to collect. Failure to do so can mean default and a bad credit rating.

During the recent housing boom, public agencies relied on Mello-Roos bond proceeds to fund new facilities and improvements that often were needed to accommodate new populations. Mello-Roos bonds have been a practical solution for public agencies, and for many years, have served their purpose well. Developers who desired new and improved public facilities to serve the new development, or who were compelled by local government to fund such facilities as a condition of development, worked with local agencies to establish CFDs that would finance those facilities. For developers, if they could sell housing in the development, the cost of the facilities would be paid by taxes from the eventual residents. Unfortunately, the bottom dropped out. Completed houses now sit vacant and construction has slowed, leading some developers to default on loans and declare bankruptcy. What happens then?

With no tax money coming in, public agencies risk default on the bond debt. Default may expose public agencies to legal action and injury to their future ability to issue more CFD debt — through a downgrade of credit ratings — when development picks up again. A low credit rating will impair the ability (or, at least make it more expensive) to undertake all types of future debt financings.

In order to ensure landowners' payment of the special taxes so that CFD bond debt is serviced, the Mello-Roos Act allows for the placement of a lien on all real property in the CFD subject to the tax. If an owner fails to pay the special tax, an action may be filed to foreclose the lien securing the special tax. Further, the liens are subject to accelerated foreclosure laws — the local agency can file suit as early as the day after the tax becomes delinquent, and as late as four years after the final maturity of the CFD bonds.

Commonly, however, local agencies may not have much discretion as to whether or when they must bring a foreclosure action. CFD bond debt is not secured by the public agency's general fund; the special tax revenue secures it. Consequently, in order to make the CFD bonds more attractive to investors (thus bringing a lower interest rate,) such investment involves imposing duties on and extracting other promises from the public agency to closely monitor the CFD tax collections. Typical among these promises, called covenants, is a covenant to institute foreclosure lawsuits when tax payments are not made, under circumstances specified in the CFD bond documents.

While the circumstances triggering a covenant to foreclose vary widely, generally there are two common schemes. First, the public agency may be required to institute foreclosure proceedings on all delinquent parcels when the delinquency rate, CFD-wide, reaches a specified percentage. Second, the trigger may be when the delinquency on a single parcel, or on parcels owing from a single owner, reaches a certain threshold for one tax year or over all tax years. There will also be a deadline by which the public agency must institute foreclosure proceedings. Since the county collects the special taxes and reports the delinquency rate to the public agency somewhere between summer and fall of each year, the clock usually starts upon receipt of that report.

If a public agency fails to observe its covenant, it exposes itself to default on the CFD bond obligation and a potential lawsuit by bondholders to enforce the covenant. The legal fees and costs associated with such an action only add expense for an already cash-strapped agency. Most damaging, however, is the effect such default would have on the public agency's credit rating. The credit rating, which helps investors gauge the relative riskiness of securities such as CFD bonds, likely will be downgraded to reflect any default. That could substantially handicap an agency's ability to issue future bonds or may make issuing future bonds more costly because of higher bond interest rates and bond insurance premiums.

The procedure for filing a foreclosure lawsuit looks like this: First, the public agency's governing body, by formal action, must order the foreclosure of the special tax lien. Second, the public agency records a notice of intent to remove delinquent special tax installments from the tax roll on the title of each parcel for which it seeks foreclosure on the lien securing the special tax. This is referred to as a "Strip Notice." The public agency then requests the county tax collector strip the delinquent assessments from the tax roll. Only then may the public agency file a lawsuit to foreclose the special tax lien.

So, short of filing the lawsuit, which of these steps satisfies a covenant to institute foreclosure proceedings? Since the law is untested here, the answer is possibly none of these steps is sufficient until a foreclosure action is filed. It is sometimes all but impossible to take each of the steps described above by the covenant deadline. The development of a foreclosure lawsuit is particularly time-consuming because every person whose interest in the subject property will be wiped out by the foreclosure must be named in the lawsuit. Should any of these parties not be allowed to defend his or her right to be heard in court, any foreclosure judgment can be overturned. For these reasons it is possible that taking the initial official action — the agency's resolution ordering the foreclosure — would be considered sufficient to satisfy the covenant to institute foreclosure proceedings.

The Mello-Roos Act is designed to help agencies collect unpaid taxes. Along with accelerated timelines for legal action and a generous statute of limitations, the act provides for reasonable attorney's fees and costs when an agency is forced to pursue legal action. An agency faced with a default should, before filing the action, send out a demand letter to the record owner appearing on the tax roll. Oftentimes, the Strip Notice will trigger the owner's default in a mortgage or other loan agreement, and the bank securing the debt will pay off the delinquent CFD taxes rather than risk losing the property.

If foreclosure is necessary, the agency can obtain a judgment foreclosing the lien, forcing a judicial sale, and entitling the agency to enough of the sale proceeds to cover the amount of the delinquent special taxes, attorney's fees and costs, as well as interest and penalties. Typically, an action will settle before advancing far into litigation, with the public agency recovering not only the delinquent amount, but also reasonable attorney's fees and costs, and a modest penalty.

In this economic climate, it is an all-too common scenario that formerly optimistic developers who purchased land, facilitated the development of a CFD and got approval of a tentative subdivision map, have now stopped paying property taxes. Whatever the cause, when property taxes aren't paid, most CFD bond covenants demand that agencies collect — failure to do so could lead to default and a bad credit rating. Public agencies must consider ways to protect themselves, and taking action to collect is often the only way to uphold an agency's credit rating for the future.

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