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FLORIDA'S FORAYS INTO REGULATION OF STATE AND LOCAL BONDS INJECT MORE UNCERTAINTIES INTO ALREADY UNSETTLED MARKET

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A series of recent decisions in Florida has thrown the state's otherwise placid state and local bond market into disarray. In *Strand v. Escambia County*, the Florida Supreme Court retreated from settled law by requiring taxpayer approval of certain instruments of public financing. Prior to a rehearing in the case, the court issued a revised decision that narrowed its original holding. Its ruling in the rehearing is still pending. In this article, author Peter Leonardis of Jones Day analyzes the *Strand* opinions and explores the legal and economic implications of the court's past and pending rulings.

INTRODUCTION

On Sept. 6, 2007, the Florida Supreme Court issued a unanimous opinion in *Strand v. Escambia County*,¹ (*Original Strand*) that threw into disarray Florida's otherwise placid state and local bond market. The *Original Strand* holding receded from 27 years of settled law regarding local governmental borrowing by requiring voters to approve by referendum both tax increment financing bonds and certificates of participation.

On Sept. 17, 2007, Escambia County filed a motion for rehearing, and numerous interested parties filed amicus briefs.² This case received attention from multiple rating agencies because of its potentially broad impact. On Sept. 28, 2007, the court issued a unanimous, revised opinion (*Revised Strand*) that narrowed its original ruling by

¹ *Strand v. Escambia County*, Dkt. No. SC06-1894, ___So.2d ___ (Fla. 2007).

² Amicus briefs arguing to reinstate the holdings of *Florida v. Miami Beach Redevelopment Agency*, 392 So.2d 875 (Fla. 1980), and *Florida v. School Board of Sarasota County*, 561 So.2d 549 (Fla. 1990), were filed by the attorney general of Florida, the Florida League of Cities, the Florida Association of Counties, numerous school boards, and the North Miami Community Redevelopment Agency.

eliminating references to the certificates of participation. Oral arguments in the rehearing were held on Oct. 9, 2007, and at the time of this writing the court has not yet issued a decision (*Final Strand*).

The uncertain tax implications of these and other challenges involving state and local bonds has caught the attention of the market. Like investors, states and municipalities that issue bonds generally seek stability.

In this article, the author provides a brief exposition of the relevant law and the types of bonds affected by the *Strand* opinions in Florida. This article also explores the legal and economic implications of the court's past and pending rulings.

BACKGROUND

Constitutional Requirements and Judicial Validation in Florida

Since 1930, the Florida Constitution has generally required a voter referendum for any pledge of "ad valorem taxation."³ As an alternative to holding a referendum, local governments in Florida may obtain a court validation, which consists of filing a complaint against the state, taxpayers, property owners, and citizens of political subdivisions, including nonresident property owners.

The complaint must be followed by the issuance of a court order that requires unnamed interested parties to appear at a particular place and time and to show why the complaint should not be granted and the bonds should not be validated. The order must be published for two consecutive weeks, during which time the intervention of any interested taxpayer, property owner and/or citizen is permitted. At the end of those two weeks, the court determines all the legal and factual issues by rendering a final judgment "with the least possible delay" about the validity of the bonds.⁴

FEDERAL INCOME TAX EXEMPTION FOR MUNICIPAL BOND INTEREST

Interest on state and local bonds is exempt from federal income tax under I.R.C. §103 if certain conditions are satisfied. One of the conditions is that the bonds must be valid under local law. Any outstanding tax-exempt state and local bonds found to be invalid under local law lose, both prospectively and retroactively, their federal tax-exempt status. Thus, the constitutional challenge to the validity of bonds raises potential exposure to bondholders for federal income tax assessments for all tax years open under the applicable statute of limitations.

TAX INCREMENT FINANCING BONDS

Tax increment financing bonds (TIFs) are used to finance redevelopment projects within designated geographic boundaries by pledging the incremental increase

³ Fla. Const. art. VII, §12.

⁴ Fla. Stat. §75.01-17.

in ad valorem tax revenue in the surrounding area resulting from the redevelopment projects. The Florida Supreme Court in *Florida v. Miami Beach Redevelopment Agency*⁵ (*Miami Beach*) held that a local government could, without approval by referendum, pledge tax increment revenues as a source of debt service on bonds for capital projects as long as the taxing power was not pledged and the lien on the funds did not attach until they were deposited into a trust account.⁶ Thus, *Miami Beach* established that pledging the incremental tax funds was not a pledge of ad valorem taxation requiring referendum under the Florida Constitution. Accordingly, most local governments in Florida have issued TIFs without a voter referendum in reliance on the authority of *Miami Beach*.

CERTIFICATES OF PARTICIPATION

Unlike TIFs, certificates of participation (COPs) are securities representing undivided interests in lease payments. COPs are commonly utilized by school boards to finance the cost of building schools. As with TIFs, most school boards in Florida have issued COPs without voter approval by relying on the authority of the Florida Supreme Court opinion in *Florida v. School Board of Sarasota County*⁷ (*Sarasota County*).

The *Sarasota County* opinion is analogous to *Miami Beach* in that it affirmed the legality of issuing COPs without a referendum by expressly holding that the phrase "payable from ad valorem taxation" referred only to a pledge of taxing power, not to a pledge to use ad valorem revenues.⁸

THE SHORT-LIVED ORIGINAL STRAND OPINION

The *Original Strand* opinion resulted from an appeal by Dr. Gregory Strand of a Florida circuit court bond validation sought by Escambia County with respect to the issuance of \$135 million of TIFs. The TIFs were being issued to generate funds for use in widening a road. The change of interpretation announced in the *Original Strand* opinion had broad implications. The opinion had an immediate adverse effect on Florida issuers and investors, as well as short- and long-term effects on taxpayers expected to benefit from redevelopment projects financed by TIFs.

RECEDING FROM MIAMI BEACH AND SARASOTA COUNTY

In the *Original Strand* opinion, the Florida Supreme Court held that "we are holding that bonds payable through tax increment financing are subject to the referendum requirement of article VII, section 12. . . . [W]e recede from *Miami Beach*

⁵ *Florida v. Miami Beach Redevelopment Agency*, 392 So.2d 875 (Fla. 1980).

⁶ *Id.* at 898-99.

⁷ *Florida v. School Board of Sarasota County*, 561 So.2d 549 (Fla. 1990).

⁸ *Id.* at 552.

and [*Sarasota County*] to the extent they are inconsistent with our decision in this case."⁹

The *Original Strand's* recession from *Miami Beach*, which addressed TIFs, and *Sarasota County*, which addressed COPs, effectively invalidated future issuances of TIFs and COPs absent a referendum. The *Original Strand* opinion explicitly "receded from" *Miami Beach* and held that, although TIFs are not per se unconstitutional, Escambia County was without authority to issue the bonds without first obtaining approval by voter referendum. In receding from *Miami Beach*, the court held that the phrase "payable from ad valorem taxation" refers "not only to a pledge of the taxing power itself but also to a pledge of ad valorem tax revenues."¹⁰

The *Original Strand* opinion also receded, without discussion, from *Sarasota County*, thereby calling into question the validity of past and future issuances of COPs. The court based its opinion on a textual reading of the constitutional requirement for a referendum by reasoning that "[t]he premise underlying *Miami Beach*, was that the 'payable from ad valorem taxation' language in article VII, section 12 refers only to the pledge of ad valorem taxing power, not to the pledge of ad valorem tax revenues."¹¹

The court's decision relied on the history surrounding the constitutional provision, including the fact that Florida voters had rejected proposals to repeal this provision on two different occasions. Because debt service on TIFs is payable from ad valorem tax revenues, the court reasoned that "bonds that rely upon such financing are bonds 'payable from ad valorem taxation.'"¹² In essence, the court agreed with Dr. Strand's argument that the process used by Escambia County to approve the issuance of the TIFs "is attempting to indirectly pledge ad valorem taxation for the repayment of long-term bonds used to finance a capital project."¹³ The court concluded that Escambia County should be prohibited from doing indirectly what the Florida Constitution forbids it to do directly.

GRANDFATHERING OF PRIOR JUDICIALLY VALIDATED BONDS

In the *Original Strand* opinion, the Florida Supreme Court stated "our decision in this case does not affect bonds that were valid prior to this opinion becoming final. . . As the Court has stated, 'after validation the courts will protect even the purchasers of unconstitutional bonds.'"¹⁴

⁹ *Original Strand* at 27.

¹⁰ *Id.* at 4.

¹¹ *Id.* at 7-8.

¹² *Id.* at 11.

¹³ *Id.* at 6.

¹⁴ *Id.* at 11.

In explicitly grandfathering only previously issued, judicially validated TIFs and COPs, the Court initially called into question both the sufficiency of judicial validation for future issuances of TIFs and COPs and the validity of TIFs and COPs that had been issued under the authority of *Miami Beach* and *Sarasota County*.

THE COST OF VALIDATION FOR FUTURE TIFs AND COPs

From an economic perspective, the insufficiency of judicial validation of bonds going forward would increase the expenses associated with future issuances of TIFs and COPs because holding a referendum is more expensive than either resorting to judicial validation or relying on case law. Ultimately, the increased cost of issuing state and local bonds would be borne by the taxpayers of such municipalities.

QUESTIONABLE VALIDITY OF TIFs AND COPs

If it were not revised, the *Original Strand* opinion would have had dire federal tax consequences for past and present Florida state and local bond holders. By questioning the validity of TIFs and COPs previously issued in reliance of *Miami Beach* and *Sarasota County*, the *Original Strand* opinion also questioned, on a retroactive basis, the federal tax-exempt status of the interest paid by municipalities to owners of such TIFs and COPs.

If the TIFs and COPs were not validly issued, the interest earned would result in higher-than-expected federal tax liability for Florida TIF and COP investors, including potential exposure for past investors for those years open under the applicable statute of limitations. As a result, current bondholders would see the after-tax yield on their investment decrease as a result of higher federal taxes. The decrease in after-tax yield would cause an immediate loss of value on their investment.

Overall, the increased federal tax exposure would:

- further decrease the value of TIFs and COPs compounding the litigation and costs mentioned above; and
- likely result in litigation by investors against Florida municipalities to clarify the tax-exempt status of their investments and to demand compensation for their damages.

Investor litigation would likely delay related construction projects and increase construction costs. Ultimately, the litigation costs and possible remedial payments likely would have been borne by the taxpayers of such municipalities.

An extended period of uncertainty under the *Original Strand* opinion would have increased the expenses of future issuances of state and local bonds by Florida's municipalities. At best, potential investors would have required higher interest rates in order to compensate them for the risk of future retroactively adverse decisions by the Florida Supreme Court. At worst, bond investors might shun the Florida state and local bond market, creating financing challenges for Florida's municipalities.

MARKET REACTIONS

As it turned out, Florida's school boards were the first to be affected by the *Original Strand* opinion. School boards had recently adopted final budgets for the fiscal year ending June 30, 2008, and their five-year educational facilities plans as required by law. Shortly after the *Original Strand* opinion was issued in September, the national credit rating agencies placed Florida's traditionally AAA-rated school board lease obligations on "credit watch." The downgrade disrupted the school boards' annual budgeting, appropriation, and capital planning processes at the beginning of the school year.

Compounding the situation, school boards across Florida are currently struggling to cope with the Class Size Reduction (CSR) Amendment to the Florida Constitution. Article IX, § 1, of the Florida Constitution establishes a mandatory schedule to reduce class sizes to specified maximums starting in 2003 and lasting through 2010.¹⁵ The state provides each district with a portion of the funds to comply with the CSR Amendment. Districts are required to come up with the balance of the funds necessary to comply with the law.

The disruption to school boards was pervasive. As single-purpose government entities, Florida school boards can raise funds only by the commitment of ad valorem tax revenues and lease financing. In other words, the *Original Strand* opinion deprived school boards of the primary financing source (i.e., COPs) needed to fulfill their constitutional and statutory responsibilities to provide capital for projects for the schools within their districts.

The lower credit rating for Florida school board obligations following the *Original Strand* opinion immediately affected the market for future issuances of COPs. School financing obligations that were approved by the boards and scheduled to go to market were shelved due to investment professionals' concerns with the effects of the *Original Strand* opinion. The secondary market for trading Florida school board COPs would have been thrown into disarray if rating agencies continued to issue low ratings. The additional risk and costs to issue COPs may have prevented further issuances, at least in the short term.

Cities, counties, and other general purpose local governments and instrumentalities, were less severely affected than school boards by the *Original Strand* opinion because they have a larger variety of revenue-generating sources. Nevertheless, uncertainty as to the scope and potential retroactive effect of the *Original Strand* opinion affected many ongoing development and construction projects across the state.

Both current and past bondholders of Florida TIFs and COPs faced potentially unexpected tax consequences because, after *Miami Beach*, most Florida TIFs were issued without judicial validation. As of Sept. 1, 2007, the aggregate value of Florida

¹⁵ See Fla. Stat. §1003.03.

state and local bonds, including TIFs and COPs, stood at approximately \$13 billion. Understandably, in the wake of the *Original Strand* opinion, the Florida state and local bond market reacted with alarm and sought clarification of the effect on previously issued TIFs and COPs.¹⁶

REVISED STRAND OPINION

After the court issued its *Original Strand* opinion, Escambia County petitioned for a rehearing. The attorney general of Florida, as well as various school boards, cities, counties, and community redevelopment agencies, filed amicus briefs urging the court to amend its opinion upon rehearing. The Florida Supreme Court ordered oral arguments be held regarding the motion for rehearing of the case on Oct. 9, 2007. The immediateness of the unparalleled disruption and the obvious injustice threatening Florida's school boards and state and local bond investors were likely the catalyst for the revised, unanimous opinion.

Even before oral arguments on the motion for rehearing, the Florida Supreme Court dramatically amended the *Original Strand* opinion on Sept. 28, 2007.¹⁷

RECEDING FROM *MIAMI BEACH*, REINSTATEMENT OF *SARASOTA COUNTY*

In the *Revised Strand* opinion, the Florida Supreme Court reaffirmed its prior decision to "recede from *Miami Beach*."¹⁸ However, in the *Revised Strand* opinion, the court explicitly excluded *Sarasota County* from its application by deleting all references to *Sarasota County* and stating that "our receding from *Miami Beach* does not impact the ultimate holding of [*Sarasota County*], or the validity of similar [COPs] issued or to be issued in reliance thereon [because], the agreements at issue in [*Sarasota County*] do not matur[e] more than twelve months after issuance'.¹⁹

The reinstatement of *Sarasota County* was critical to Florida school boards' funding, which relies on the issuance of COPs. The court heeded the school boards' procedural and substantive arguments for the reinstatement of *Sarasota County*. Escambia County further noted that the court's reliance on the voters' rejection of the two proposals to remove the constitutional requirement for a referendum was unsound. Those proposals contained other constitutional amendments that may have been the focus of voters when rejecting those proposals. Although it fell short of reinstating *Miami Beach*, the court was persuaded by Escambia County's argument to delete all the references to voters' rejection of the constitutional proposals. The school boards' amicus brief pointed out that the Florida Supreme Court does not ordinarily consider or

¹⁶ *Motion for Rehearing by Escambia County* at 8 (filed Sept. 17, 2007).

¹⁷ Although released several days later, the *Revised Strand* opinion retained the date of the *Original Strand* opinion, *i.e.*, Sept. 6, 2007.

¹⁸ *Revised Strand* at 24.

¹⁹ *Id.*, fn. 8 (emphasis added). School board-issued COPs are generally short-term obligations that mature within 12 months after their issue date.

address issues that have not been raised by the parties at trial or in an appeal. The amicus brief further pointed out that *Sarasota County* was never mentioned in any brief filed by either party.²⁰

The *Revised Strand* opinion receded prospectively only from the holding in *Miami Beach* which addressed TIFs.

The Revised Strand opinion factually distinguished COPs from TIFs. In the *Revised Strand* opinion, the court noted that COPs "by which school boards fund capital projects, in discharge of their constitutional and statutory responsibilities for the state's public schools, are substantively different from the use of ad valorem tax revenues for [TIFs] by general purpose local governments."²¹

As noted above, from an economic perspective, the *Revised Strand* opinion increases the expense of future issuances of TIFs and such costs will ultimately be borne by the taxpayers of the municipalities seeking to issue TIFs.

GRANDFATHERING OF ALL PAST ISSUED BONDS

Importantly, in the *Revised Strand* opinion, the Florida Supreme Court held that "our decision in this case does not affect bonds that were issued prior to this opinion becoming final. In other words, this opinion does not retroactively apply to bonds and obligations that have been issued based on the authority of the precedent from which now this court recedes."²²

In explicitly grandfathering all previously issued bonds and limiting its decision in the *Revised Strand* opinion to prospective application, the court effectively eliminates most of the concerns for previously issued bonds, leaving only the issue of the sufficiency of judicial validation for future TIFs.

From an economic standpoint, should judicial validation of bonds be deemed insufficient on a going forward basis, then future issuances of TIFs would face increased expenses. Under such a scenario, Issuers (e.g., counties or other governmental subdivision) would be burdened with the cost of holding a referendum. In addition, the likely delay associated with a referendum and inherent uncertainty of the outcome would contribute to increasing the overall costs. Further, bondholders will require higher interest rates due to the risk of taxability. These costs would ultimately be borne by the taxpayers of such municipalities.

²⁰ *Amicus Brief of County School Boards*, at 5 (filed Sept. 17, 2007).

²¹ *Revised Strand* at 7.

²² *Id.* at 23-24.

THOUGHTS ON *FINAL STRAND*

Although theoretically possible, it is unlikely that the court would revise its *Original Strand* opinion, a unanimous decision, by unqualifiedly reinstating *Miami Beach*. The questions remaining for the *Final Strand* opinion generally are:

- whether the court will allow TIFs to be issued under judicial validation; and
- whether the court will limit the application of *Miami Beach* by distinguishing *Miami Beach*-like TIFs (i.e., TIFs for community redevelopment projects in blighted areas where any increase in property values would likely be the direct result of TIF-financed expenditures) from all TIFs.

WILL THE COURT PERMIT JUDICIAL VALIDATION OF TIFs?

If *Miami Beach* is not reinstated, a cost-benefit analysis suggests that the approval of TIFs by judicial validation may be desirable. On the one hand, the reasoned analysis that can take place in a judicial validation process has a lower social cost (i.e., it is cheaper to society than holding a referendum) and a higher effectiveness (i.e., a single taxpayer with the right reasoning can stop the municipality from becoming excessively indebted, instead of relying on a majority of voting taxpayers being correctly informed). On the other hand, by increasing the individual taxpayer's cost of opposition (i.e., it is cheaper for any given taxpayer to cast a vote than to oppose a judicial validation) it reduces the effectiveness of opposition and creates a "free riding" problem (i.e., each taxpayer is better off if some other taxpayer incurs the cost of opposing the municipality's plan to incur additional indebtedness). The court will have to balance these and other considerations before issuing its final decision, regardless of whether such decision is addressed in the *Final Strand* opinion or in a subsequent case.

WILL THE COURT REINSTATE *MIAMI BEACH* FOR THE ISSUANCE OF CERTAIN TIFs?

Paradoxically, if the court's rationale for receding from *Miami Beach* in *Strand* was motivated by its concern over the excessive indebtedness of municipal bodies in the face of possible economic recession, a *Final Strand* opinion might reinstate the authority of *Miami Beach*, on a limited basis, by distinguishing it from *Strand*. The distinction would focus on the fact that *Miami Beach* dealt with the issuance of TIFs for a community redevelopment project in a blighted area, where any property value increases experienced would be the direct result of the TIF-financed expenditures due to the fact that blighted areas would likely be generating little or no tax revenues. Conversely, the issuance of TIFs for non-blighted areas has the potential to unjustly burden certain taxpayers as a result of property value increases that bear no relationship to the expenditures that the TIF financed (e.g., where property values increase because of factors not related to the TIF-financed project). For example, if increased property values in an area unrelated to a TIF-financed project generate increased tax revenues, which are used to finance the TIF-financed project, then it can be argued that taxpayers from the area generating the increase have lost out on

revenue that could have been used for schools, roads, or other improvements in their own neighborhoods. This would certainly run afoul of the court's intent to empower taxpayers to prevent excessive municipal indebtedness through the use of ad valorem taxation. However, the court could prevent this effect by disallowing the reliance on the authority of *Miami Beach* for the issuance of TIFs in non-blighted areas (such as the one under consideration in Strand).

CONCLUSION

The Florida Supreme Court's swift response prevented a Florida state and local bond market meltdown. Had the court stood by the *Original Strand* opinion or merely abided by a regular schedule for rehearing,²³ the Florida market for TIFs and COPs would likely have been thrown into turmoil because the court was the only entity that could act quickly enough to avoid the most imminent economic consequences of the *Original Strand* opinion. The Florida Legislature could not act quickly enough because overriding a Florida Supreme Court decision would have required an amendment of the Florida Constitution, which, unsurprisingly, is a cumbersome process that would likely not have materialized until January of 2009, at the earliest.²⁴ By that time, many of the adverse effects of the *Original Strand* opinion would have come to fruition.

Given growing concerns about financial markets and a relatively bleak economic outlook in the United States, other states may adopt protectionist measures similar to those pursued in Strand. The referendum requirement provides voters the means to prevent the issuance of debt to be repaid from ad valorem tax revenues. This form of "protectionism" is somewhat counter-intuitive. The amount of ad valorem tax revenue is by definition dependent on market values. Recessions tend to drive real property values down and over time decrease the amount of ad valorem tax revenues available to pay debt service.

If other states follow suit, they would do well to examine the economic impact of the various Strand opinions. State and local bond investors, and rating agencies are sure to watch for the final outcome of Strand and any similar cases in other states.

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²³ The Florida Rules of Judicial Administration require that the Supreme Court deliver an opinion within 180 days after oral argument. Fla. R. Jud. Admin. §2.250(a)(2).

²⁴ Fla. Const. art. XI, §§1 and 3.