



STATE OF IDAHO

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ATTORNEY GENERAL OPINION NO. 90-8

TO: The Honorable Jerry L. Evans  
State Superintendent of Public Instruction  
Department of Education  
STATEHOUSE MAIL

Norman N. Hallett, Ed.D.  
Superintendent  
Joint School District No. 2  
911 Meridian Street  
Meridian, ID 83642

Per Request for Attorney General's Opinion

QUESTION PRESENTED:

The Meridian School District currently has the opportunity to issue refunding bonds to refund its outstanding bonded indebtedness at more favorable interest rates. However, because other funds are not available to fund the refunding escrow account, it is necessary to sell the refunding bonds at a premium to adequately fund the refunding escrow account, as permitted by Idaho Code § 57-504(2). This would be accomplished by setting interest rates on the refunding bonds above current market interest rates, but below interest rates on the bonds being refunded. Is the sale of the refunding bonds at a premium consistent with Idaho Constitution, art. 8, § 3?

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CONCLUSION:

Idaho Constitution, art. 8, § 3, requires an election to increase the indebtedness of a district. The section is not violated by issuance of refunding bonds which result in a net present value savings to a district without increasing the outstanding indebtedness of the district. The outstanding indebtedness of the district is not increased by selling the refunding bonds at a premium (i.e., selling the refunding bonds above par) provided the premium is used for refunding purposes.

BACKGROUND:

We understand the question you raise arises out of a refunding bond issue planned by Meridian School District. In 1985, the Meridian School District issued bonds which were approved by the requisite two-thirds majority of the voters. Those bonds are currently outstanding in the amount of \$7,215,000 and bear interest rates from 8.9% to 11% per annum. Most of the bonds would fall due in 1999, 2000, and 2001 but are redeemable prior to maturity on September 1, 1995, at 102% of the principal amount of the bonds.

The district wishes to undertake an advance refunding of the 1985 bonds pursuant to Idaho Code § 57-504. Under the plan, refunding bonds would be issued and the proceeds used to buy U.S. Government securities. The securities would be held in trust until the 1985 bonds become callable at which time the 1985 bonds would be redeemed. The district expects to receive a net present value savings of over \$200,000 after all expenses resulting from lower interest rates on the refunding bonds than on the 1985 bonds.<sup>1</sup>

To finance the escrow account of the refunding bonds it is necessary to generate a premium above the par value of the outstanding 1985 bonds. This can be accomplished by setting the interest rates on the refunding bonds higher than current market interest rates. Investors will pay more than par for the bonds

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<sup>1</sup> Prior to redemption of the 1985 bonds, the district would not benefit from lower interest rates since Internal Revenue Code § 149(d)(4) and corresponding regulations deny tax exempt status to state and local government advance refunding bonds which are designed to obtain a material financial advantage based upon arbitrage, apart from savings attributable to lower interest rates. Thus, Meridian School District may not earn a greater yield on the federal securities than is paid on the refunding bonds. However, substantial interest benefits would be received by the district from lower interest rates following the call of the 1985 bonds.

to receive the higher interest rates. The premium would be generated in this case by the use of interest coupons designated as "B" coupons by industry convention, which are additional interest obligations.<sup>2</sup> However, as noted above, the average interest rates on the refunding bonds would still be set lower than the average interest rates on the 1985 bonds resulting in a net present value savings to the district.

As discussed below, such a refunding plan does not increase the indebtedness of the district within the meaning of Idaho Constitution, art. 8, § 3. Rather, it has the legal effect of exchanging new obligations for the prior obligations providing a material benefit to the district. Where the premium generated from sale of the refunding bonds is used for the refunding plan, Idaho Constitution, art. 8, § 3, is not violated.

ANALYSIS:

Idaho Constitution, art. 8, § 3, provides in pertinent part:

No county, city, board of education, or school district, or other subdivision of the state, shall incur any indebtedness, or liability, in any manner, or for any purpose, exceeding in that year, the income and revenue provided for it for such year, without the assent of two-thirds (2/3) of the qualified electors thereof voting at an election to be held for that purpose, nor unless, before or at the time of incurring such indebtedness, provisions shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and also to constitute a sinking fund for the payment of the

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<sup>2</sup> Bonds normally involve both a principal obligation and an interest obligation. The interest obligation may be evidenced by coupons which may be redeemed at various interest payment dates. We understand such coupons are designated "A" coupons by industry convention. However, for marketing purposes bonds are sometimes issued with two sets of coupons designated by convention "A" coupons and "B" coupons. For example, a bond maturing in 10 years might have a 6 percent "A coupon" for the entire 10 years and also a 3 percent "B coupon" payable only during the last 5 years of the bond. The "B" coupons frequently are sold separately from the bonds to investors whose investment needs differ from the bondholder buying only the "A" coupons. In this case, at the time the bonds become either callable or when due all "B" coupons will have been paid. Such "B" coupons represent an additional rate of interest for a portion of the bond period.

principal thereof, within thirty (30) years from the time of contracting the same . . . .

Thus, an election would be necessary prior to issuance of refunding bonds by a school district if the bonds were deemed to be an added "indebtedness, or liability" of the district.

The Idaho Supreme Court has considered on several occasions whether refunding bonds constitute such an "indebtedness, or liability." In the early case of Veatch v. City of Moscow, 18 Idaho 313, 109 Pac. 722 (1910), the Idaho Supreme Court considered whether the issuance of refunding bonds by the City of Moscow without an election would be contrary to art. 8, § 3, Idaho Constitution. The court concluded as follows:

We therefore conclude that the issue of a refunding bond by a municipality does not increase or create a debt, and that the issue of such bonds for the purpose of funding an existing legal indebtedness is not required to be submitted to a vote of the qualified electors, but that the city council or village trustees by ordinance may authorize the issue of such refunding bonds when it can be done to the profit and benefit of the municipality and without incurring any additional liability.

18 Idaho at 319-20 (emphasis added).

In Sebern v. Cobb, 41 Idaho 386, 238 Pac. 1023 (1925), the court upheld the issuance of refunding bonds by a drainage district:

The issue of a refunding bond does not generally create a new indebtedness, and it is so held by the great weight of authority, but it simply changes the form of the indebtedness and usually reduces the rate of interest. There is no presumption that the officers of a municipality will not make proper application of the funds procured from the sale of refunding bonds. Veatch v. City of Moscow, 18 Idaho 313, 21 Ann. Cas. 1332, 109 Pac. 722.

We have not been cited to nor have we found any constitutional or statutory inhibitions, such as construed in those cases which hold to the contrary, against making the provision for the issuance and sale of refunding bonds, as contemplated by chapter 21, even though, during a period between the sale of the refunding bonds and receipt of the money and the ultimate call and redemption of the outstanding issue.

there exists a double lien upon the property of the land owners. Bearing in mind that the proceeds of the refunding sale are especially applicable to the redemption of the outstanding issue, around which, of course, all due safeguards should be and are thrown,

41 Idaho at 400-01 (emphasis added).

This case is important in clarifying that although refunding bonds may result in a temporary increase in the amount of bonds outstanding, it must be presumed that the funds will be properly applied. Therefore, the refunding bonds change the form of indebtedness but do not create new indebtedness. Also, the court points out that the refunding bonds are to be applied to the redemption of the outstanding issue, and that all due safeguards should be established to ensure this result.

In Lloyd Corp. v. Bannock County, 53 Idaho 478, 25 P.2d 217 (1933), the court held that the issuance of refunding bonds by Bannock County for the purpose of retiring warrant indebtedness did not create an indebtedness or liability prohibited by art. 8, § 3, Idaho Constitution.

Marsing v. Gem Irrigation Dist., 56 Idaho 29, 48 P.2d 1099 (1935), held that extending the due date of refunding bonds for 40 years (beyond the then 20-year provision in art. 8, § 3, Idaho Constitution), did not amount to the incurring of indebtedness within the meaning of art. 8, § 3. The court stated:

It is not every indebtedness that must be retired within twenty years, only that which increases the debt of the organizations mentioned, and refunding bonds do not increase the debt but merely continue the obligations theretofore issued.

56 Idaho 32.

The Idaho cases thus make it clear that refunding bonds can involve significant restructuring of indebtedness without resulting in an increased indebtedness within the meaning of Idaho Constitution, art. 8, § 3. However, the cases set forth several principles which must be kept in mind in designing refunding plans.

Veatch, supra, held that a district may authorize refunding bonds "when it can be done to the profit and benefit of the municipality and without incurring any additional liability." 18 Idaho at 319-320. In our opinion, a substantial net present value savings to a taxing district, such as the savings involved in the Meridian refunding, satisfies the requirement that

refunding "be done to the profit and benefit" of the district. We would note that other benefits have also been found to satisfy the requirement that the refunding benefit the district. For example, retiring warrant indebtedness was upheld in Lloyd Corp., supra, and extension of the maturity date of a bond issue was upheld in Marsing, supra.

Sebern, supra, pointed out that where "the proceeds of the refunding sale are especially applicable to the redemption of the outstanding issue" the refunding did not increase the district's indebtedness within the meaning of Idaho Constitution, art. 8, § 3. Rather, it simply changed the form of the indebtedness. The language of Sebern quoted above requiring application of refunding proceeds to redemption of the outstanding bonds is aimed at ensuring that there will not be a diversion of refunding proceeds resulting in a failure to redeem the outstanding bonds. However, the requirement that refunding proceeds be used for refunding purposes is also significant in relation to refunding plans generating a premium, as is apparent from the following example.

Assume a district held an election authorizing general obligation bonds in the amount of \$10,000,000 to build school buildings. If a district could set artificially high interest rates on the bonds such that investors would pay \$15,000,000 for the bonds, the electors would have been greatly deceived. \$15,000,000 would be available for building projects and repayment obligations would equate to a \$15,000,000 bond issue. Such a result would almost certainly be held to violate Idaho Constitution, art. 8, § 3. In our opinion, the constitution would be equally offended by a refunding bond which accomplished the same result.

Dickson v. County of Elliot, 357 S.W.2d 852 (Ky. App. 1962), provides an example of the above problem. In that case, bonds were sold at interest rates which generated a premium used for project construction purposes. This effectively provided more money for the building project than the voters had authorized and the court treated the premium as additional principal. The Dickson case points out the importance of the Idaho Supreme Court's statement in Sebern that "the proceeds of the refunding sale are especially applicable to the redemption of the outstanding issue."

The planned refunding by the Meridian School District would use all proceeds of the refunding bonds (including the premium) for refunding purposes consistent with Sebern, supra. It would provide a net present value savings of over \$200,000 for the Meridian School District. This is consistent with Veatch, supra, which concluded that a city council could authorize the issue of refunding bonds "when it can be done to the profit and benefit of

the municipality." The planned Meridian refunding bonds would not create a new indebtedness, but would "simply change the form of the indebtedness" as discussed in Sebern and Veatch, supra.

In summary, Idaho Constitution, art. 8, § 3, is not violated by issuance of refunding bonds which result in a net present value savings to a district without increasing the outstanding indebtedness of the district. The outstanding indebtedness is not increased by selling refunding bonds at a premium provided the premium is used for refunding purposes.

AUTHORITIES CONSIDERED:

1. *Constitutions*

Idaho Constitution, art. 8, § 3.

2. *Statutes*

Idaho Code § 57-504.

3. *Cases*

*Dickson v. County of Elliot*, 357 S.W.2d 852 (Ky. App. 1962).

*Lloyd Corp. v. Bannock County*, 53 Idaho 478, 25 P.2d 217 (1933).

*Marsing v. Gem Irrigation Dist.*, 56 Idaho 29, 48 P.2d 1099 (1935).

*Sebern v. Cobb*, 41 Idaho 386, 238 Pac. 1023 (1925).

*Veatch v. City of Moscow*, 18 Idaho 313, 109 Pac. 722 (1910).

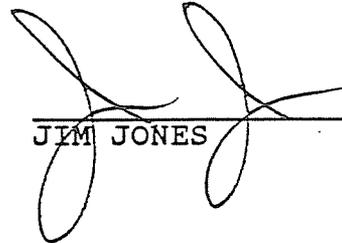
4. *Other*

Internal Revenue Code § 149(d)(4).

The Honorable Jerry L. Evans  
Norman N. Hallett, Ed.D.  
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Dated this 4th day of December, 1990.

JIM JONES  
Attorney General  
State of Idaho



A handwritten signature in black ink, consisting of several loops and a long horizontal stroke, positioned above a solid horizontal line.

JIM JONES

Analysis By:

DAVID G. HIGH  
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Chief, Business Regulation and  
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