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REAL ESTATE FINANCE PRACTICE GROUP | JANUARY 2016

Otten Johnson Alert -

Navigating the New and Growing Market of Charter School Construction Financing

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Real estate investors, developers, and lenders are constantly searching for new markets. What if one of the newest, most interesting and capital hungriest markets is already serving roughly 2.9 million people across the country, including just down the street, and historically has low loan default rates and above average returns? This market? Charter schools. This article explores the charter school real estate market and specifically charter school construction loans.

Generally speaking, charter schools are publicly funded schools operated by parents, teachers and community members as semi-autonomous schools of choice within a school district. They are free from many of the rules, regulations and statutes applicable to traditional public schools. And they are proliferating. In the 2014-2015 school year alone, 500 new public charter schools opened in the United States, bringing the total to more than 6,700 and total enrollment to approximately 2.9 million students.

Charter schools receive per pupil funding from their states, but, unlike their traditional counterparts, they rarely have access to property tax revenue. And property tax revenue is usually what finances capital construction projects. In the absence of other financing, charter schools are left to rent space, and their rented spaces are often not particularly well suited for education. But as the demand for charter schools has grown and charter school regulation liberalizes, some states and local governments are more willing to help finance charter school projects. Texas, Colorado and Utah, for example, now backstop tax-exempt bond issues for certain charter schools.

Through its representation of ZB, N.A. dba Vectra Bank Colorado, a leading lender in the market, Otten Johnson has extensive experience in charter school lending transactions. In the vast majority of these deals, a developer has entered into a lease with a charter school. The developer then obtains a loan from a lender to purchase the land (if not already owned) and to renovate existing improvements or construct a build-to-suit school. The lender underwrites the loan by looking at the charter school's expected per pupil funding amount and its current and projected enrollments. The exit strategy for both the borrower-developer and the lender is for the charter school to issue tax exempt bonds and to purchase the property from the borrower-developer using the bond proceeds.

In many ways this mirrors a traditional built-to-suit construction loan for a single tenant property where the borrower owns the fee interest. Indeed, the standard documents are used—including a loan agreement, a deed of trust or mortgage, note, environmental indemnity, subordination and non-disturbance agreement, and guaranties. Repayment is usually interest only until the charter school begins receiving its state payments, at which point amortization begins.

These loans do, however, have idiosyncrasies. The most notable is that the lender takes a security interest in the state payments made to the charter school. Because those are public funds, special laws apply that preclude the state from entering into an agreement with a lender regarding the funds. In Nevada and Texas, state funds must first repose in a bank incorporated in the state. Moreover, if there is a default under the loan, for both legal and practical reasons, the lender cannot halt the stream of state payments to the charter school, as that would shut it down.

To secure a granted and perfected interest in the state payments while comporting with law, the lender will require that the charter school deliver instructions to the state that the charter school's payments be sent to an escrow account. The lender will also prohibit the charter school from modifying those instructions without the lender's consent. Additionally, the lender will require an escrow agreement among the lender, the borrower-developer, the charter school and an escrow agent chosen by the lender. This agreement typically provides that after receiving a state payment, the escrow agent will immediately sweep into a segregated account an amount equal to the rent due to the borrower-developer under the lease. The remainder of the state payment not swept is paid to the charter school. The swept funds are first used to pay the lender its loan payment. Then, so long as there is no default under the loan, the balance of the swept funds is paid to the borrower-developer. In some states, including Texas and Arizona, this arrangement is unavailable. In those states, the lender may instead require that the borrower-developer, the lender, the school, and the school's depository bank enter in an agreement similar to the escrow agreement.

Another idiosyncrasy is obvious but cannot be overstated: charter schools are not in the real estate business. They are rarely involved in construction projects or multiple leases. This means that documents like an SNDA and escrow agreement, while critical to closing, are likely completely foreign to the charter school and may require additional time for review. The lender and borrower-developer will be well-served to involve the charter school as early as possible in the negotiation of these documents.

Otten Johnson's attorneys have substantial experience with helping clients navigate business issues like those highlighted in this alert. For more information, or for help evaluating your current situation, contact any of the attorneys in the Real Estate Finance practice group.

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