City of Independence

MEMORANDUM

City Council Office

DATE: September 6th, 2013

TO: Members of the Audit and Finance Committee

FROM: Zachary C. Walker, City Management Analyst Zachary Walker

SUBJECT: Review of Falls at Crackerneck Creek TIF Plan

The Audit and Finance Committee requested a review at its April 22nd, 2013 meeting of the Falls at Crackerneck Creek Tax Increment Financing Plan to provide further clarity regarding three considerations:

1. What are the key terms of the financing agreement, and has the City abided by these terms?
2. Were all contract documents appropriately reviewed prior to approving the project, and has the expenditure of funds been consistent with City Council approval?
3. What Tax Increment Financing projects have been taken on by other area municipalities? What is their financial liability? How have they managed the liability?

To answer these questions, I have evaluated all necessary information, including ordinances, resolutions, and minutes of the City Council and other City Commissions, related agreements, and print media articles. Additionally, I have met with staff in the City Manager's Office, Law Department, Finance Department, and Public Works Department.

<u>What are key terms of the financing agreement? Has the City abided by these terms?</u>

The Falls at Crackerneck Creek is a tax increment financing project located on approximately 192 acres at the southwest intersection of Interstate 70 and Interstate 470 in southeastern Independence. The project contains multiple agreements addressing various parts of the plan, including the *Crackerneck Creek Tax Increment Financing Plan* (establishes the project area in accordance with state law), the *Leasing Agreement between the City of Independence and Bass Pro Outdoor World, L.L.C.* (outlines the construction and leasing terms for the Bass Pro store), the *Redevelopment Agreement with Crackerneck Creek, L.L.C.* (executes the TIF plan), and the various bond indentures and financing agreements (secures the loans necessary to fund the project). I have reviewed each agreement and find the City to be wholly and entirely complying with all terms set forth.

While I have found the City to be complying with all terms, pledges, and covenants in these agreements, both the appropriateness and the reasoning for the ongoing debt service payments made by the City for this project has been questioned by some. It is the various bond indentures and financing agreements, in concert with the *Redevelopment Agreement*, which sets forth in no uncertain terms that the financing of this project represents a loan made to and ultimately owed exclusively by the City. This may in fact be among the most critical terms related to the project, and a brief assessment of these terms is warranted.

The project presented significant up-front financial costs to the City of Independence for various public improvements within the project area. To provide the funding necessary to address these up-front costs, the City partnered with the Missouri Development Finance Board (MDFB), a body created by the State of Missouri to facilitate economic and infrastructure development projects. Under this program, the City obtained a series of "infrastructure facility revenue bonds". The proceeds from the sale of these bonds financed project costs, with the City responsible for repaying principal and interest for the loan over the life of the project. For each series of bonds issued, a financing agreement was entered into between the City and MDFB to govern the issuance and repayment of these bonds. Moreover, a separate bond indenture was entered into between the City, MDFB, and Commerce Bank, who acts as the Trustee in loaning the funds from the proceeds of the sale of each bond series.

Again, these bonds represent a loan made to the City. Paramount to both the bond indenture and financing agreement for each bond series is the City's stated intention to make loan repayments over the life of the project. The bonds have been secured by lease payments from Bass Pro, a pledge of local and state tax revenues, transportation development district sales tax revenues projected to be generated from the project, deed of trust on the land, and in the event of shortfalls in the above, an annual appropriation pledge from the City to fund the shortfalls. The annual appropriation pledge commits the City to "budget and appropriate, specifically with respect to the Financing Agreement, moneys sufficient to pay all the Loan Payments and reasonably estimated Additional Payments for the next succeeding Fiscal Year." This pledge requires that City staff "shall include in the budget proposals submitted to the City Council, in each Fiscal Year in which the Financing Agreement shall be in effect, an appropriation for all payments required for the ensuing Fiscal Year, it being the intention of the City that the decision to appropriate or not appropriate under the Financing Agreement shall be made solely by the City Council and not by any other official of the City."

This "promise to pay" is at the center of the City's ability to obtain these loans. The minutes from the August 17th, 2004 meeting of the Missouri Development Finance Board shows the Executive Director of the MDFB as stating "It is this appropriation pledge that ultimately secures and makes these bonds marketable." Put simply, these bonds represent a debt issued to the City that would not have been granted without the City's annual appropriation pledge. Bondholders have depended on this pledge in determining reliability of the bonds. While the Official Bond Notification warns investors of a risk for default, that the City has never before defaulted on any of its bonds no doubt eases this concern in the minds of investors. In fact, Moody's Investor Services noted in a May 2013 article that the one-year default rate for Moody's-rated municipal issuers remains very low at an average of 0.030% for the last five years, compared to the 0.009% average for the 1970-2007 period and the 0.012% average over the entire 43-year period of Moody's study. This low rate of default is why municipal bonds are commonly viewed as being among the safest investments.

As one considers this pledge, it would be easy to assume that "the decision to appropriate or not appropriate under the Financing Agreement shall be made by the City Council" allows the City Council to abandon these annual loan payments without consequence. However, this clause requires one to understand the responsibilities that accompany the type of debt issued to the City. Consider the following from the Financing Agreement:

Loan Payments and Additional Payments shall constitute currently budgeted expenditures of the City, and ***shall not in any way be construed or interpreted as creating a liability or a general obligation*** (emphasis added) *or debt of the City in contravention of any applicable constitutional or statutory limitations or requirements concerning the creation of indebtedness by the City, nor shall anything contained herein constitute a pledge of the general credit, tax revenues, funds, or moneys of the City.*

As defined by this section, the series of loans issued to the City cannot be considered general obligation bonds. The Missouri State Constitution permits a city, by vote of two-thirds of the voting electorate, to incur general obligation indebtedness for "city purposes" not to exceed 10% of the assessed value of tangible taxable property. The State Constitution also permits a city, by vote of two-thirds of the voting electorate under special election or four-sevenths under a general election, to incur additional general obligation indebtedness not exceeding, in the aggregate, an additional 10% of the assessed value of taxable tangible property. Moreover, general obligation bonds are secured by the full faith, credit, and taxing power of an issuer. Such bonds constitute debts of the issuer. In the event of default, the holders of general obligation bonds have the right to compel a tax increase to pay the debt.

Instead, these are special obligation bonds, which are secured by a limited revenue source or a promise to pay. In this instance, the obligations are expected to be retired primarily by the incremental tax revenue generated from the development of the project. To assist with marketing of the bonds and incentivize potential bondholders, the City backs these bonds with an annual appropriation pledge. This language is included, then, to clarify the nature of the bonds, but it is not intended to exempt the City from any repayment obligations.

This pledge and any indications that it will be honored are not taken lightly by the Securities and Exchange Commission (SEC), either. The SEC's May 7th, 2013 enforcement action against the City of Harrisburg, Pennsylvania marked the first time the SEC has charged a municipality for misleading statements made outside securities disclosure documents. In that matter, the SEC alleged that statements made by public officials, including the Mayor of Harrisburg's 2009 State of the City address, proved to be misleading when the city missed more than $13 million in debt service payments. It has long been the SEC's position that information about municipal issuers "reasonably expected to reach investors and the trading markets" is subject to the antifraud provisions of the federal securities law. The Harrisburg action states a failure to provide adequate disclosure to investors may increase the risk that other information, including statements by public officials, may be misleading or omit material information in the context in which such information is conveyed.

As further evidence of the significance of this pledge, consider the following detail from each Financing Agreement:

"the City reasonably believes that legally available funds in an amount sufficient to make all Loan Payments and Additional Payments during each Fiscal Year can be obtained. The City further intends to do all things lawfully within its power to obtain and maintain funds from which the Loan Payments and Additional Payments may be made, including making provision for such Loan Payments and Additional Payments to the extent necessary in each proposed annual budget submitted for approval in accordance with applicable procedures of the City and to exhaust all available reviews and appeals in the event such portion of the budget is not approved."

The importance of honoring this obligation also comes in realizing that the City must incur debt to achieve a number of outcomes, not the least of which are associated with operating the City's three utilities. In order to obtain these bonds and to do so at a favorable interest rate, the City must maintain a satisfactory credit rating from the various national rating agencies. Failure to honor the annual appropriation pledge would jeopardize the City's ability to incur future debt. This concept was unequivocally stated by the City Counselor in a July 2012 memorandum, which outlined the following consequences:

1. The City's bond rating will be down-graded to non-investment grade.
2. The City likely will be unable to borrow any funds for a period of time. The financial markets will have no confidence in the City's ability or willingness to make payments on new obligations.
3. The City will immediately be subject to lawsuits from investors related to the non-appropriation.
4. The City's ability to borrow funds in the future would undoubtedly be at a higher rate of interest.

To achieve further certainty on this matter, the City has conferred with a number of development attorneys, financial advisors, and independent bond counsel to study this issue. All have been unanimous and candid in warning the City of their repayment obligation and the consequences should they choose to rebuff these obligations. As such, the City Council has honored its annual appropriation pledge at every turn, and, to date, the City has never defaulted on this or any of its other debt obligations.

It has been suggested at times that the developer of record for this project, Crackerneck Creek, L.L.C., is in fact the party solely responsible for any debt service payment shortfalls, but this notion has been summarily dismissed in reviewing the financing agreements and bond indentures. Moreover, the *Tax Increment Financing Redevelopment Agreement between Crackerneck Creek, L.L.C and the City of Independence* provides further clarity as to where this responsibility ultimately lies. The agreement specifies that the developer may, at its option, make cash payments to the City in an amount sufficient to cover the gap between available funds in the Special Allocation Fund and the amount required to make debt service payments on all outstanding TIF Obligations then due. If the developer declines, the City may declare the developer to be in default. Pursuant to this provision, the City has submitted written notification to the developer when payments are due every six months informing them of the current payment gap. To date, the developer has not made any payments in support of this gap. The developer was quoted in February 2011 by the Independence Examiner as stating they had been unable to do so "because of its other substantial financial commitments and obligations to the project."

Though the *Redevelopment Agreement* presents these payments only as an option to the project developer, it does not leave the City without several options of its own to secure its interests. First, the developer agrees to sell land to the City for the Bass Pro Store and other public property at a cost of $6 million. However, no portion of that is to be paid by the City until the developer has leased the defined retail space in accordance with the agreed-upon leasing schedule, satisfactory financing arrangements have been made by the City, Bass Pro has commenced construction of its store, and all other approvals have been obtained. To date, no funds have been paid by the City to the developer for this land, as the developer has not yet met the terms of the leasing schedule.

Second, this particular agreement states that the developer shall provide the City with written, enforceable leases and shall meet the deadlines set forth in the leasing schedule. Failure to meet these deadlines allows the City to request, in writing, that the developer engage a national leasing firm to assist the project. If failure to meet the leasing schedule continues for three months beyond the written notice, the City shall have the right to terminate the agreement and appoint a new developer. Under these terms, the City provided a written demand to the developer in December 2006 requesting that a national leasing firm be engaged. The developer did not act on the City's written demand, and in June 2007, the City provided written notice to the developer stating that "developer is hereby terminated as the developer of record under the TIF Agreement". That same month, the developer provided a response to the City indicating that the commercial management group Kessinger/Hunter & Co. had been contacted and had indicated a willingness to undertake in its name:

> *"the aggressive full and complete marketing of the project…including targeting of prospects, research of existing Bass Pro Developments nationwide, strategies to encourage cooperative brokerage, exposure on all internet-based marketing and commercial property exchange systems, assisting the city and ownership in public relations and press releases to the local media, (and) preparation and publishing of promotional materials and graphics.*

Following receipt of this communication, the City and the developer finalized a stay of termination in February 2008, thereby allowing the developer additional time-until June 30th, 2008-to acquire the necessary retail development for the project. Since sufficient leasing commitments have not yet been secured, the City may act at any time with the termination of the developer. However, as stated in the August 1st, 2009 MDFB bond report, "selection of a different developer would likely lead to further delays in finding tenants for the project." Because of the obstacles that would arise in recruiting, selecting, and contracting with a new developer, the City continues to retain the services of the original developer so as to not further delay the project. Moreover, the City has pursued additional alternatives outside of the redevelopment agreement to seek resolution to the unfulfilled leasing schedule. For example, in February 2012, the City Council directed the City Manager to seek the assistance of the President of Independence Economic Development in trying to attract additional tenants to the project. This combination of efforts has yielded some success, as evidenced by recent announcements of new tenants in the project.

Finally, this agreement provides for the execution of a deed of trust on the land owned by the developer to secure a promissory note in the City's favor, with the agreed value of the mortgaged property totaling $20 million. This provides additional security to the City for the portion of the TIF obligations that are expected to be covered by revenues for which the City does not have executed leases at the time the City completes the initial debt issuance. Though they have this protection in their favor, City staff has recognized that seizing this property would have two consequences: the property would no longer generate real estate tax revenue that is currently used to satisfy the debt obligation, and the City would inherit property maintenance costs that are currently the responsibility of the developer.

Were all contract documents appropriately reviewed prior to approving the project, and has the expenditure of funds been consistent with City Council approval?

I have previously noted each of the key contracts and agreements associated with this project and found that each has been appropriately reviewed and approved. As this question ponders the "appropriate review" of contract documents, I have also evaluated the level of examination given in considering the financial implications of this project. Having done so, I find that a complete and thorough assessment was conducted at every appropriate juncture in the project, and that the financial implications of the project were well known. Minutes of the TIF Commission meeting contain presentations from various professionals, including the City's Community Development Director, City Counselor, and Finance Director, planning consultants, and a land use economist, among others. Using historical economic trends for the Independence market, these experts presented what were believed to be conservative projections for future growth in the redevelopment area. These projections indicated that the level of growth observed in the previous ten years would provide the level of development necessary to satisfy annual debt service requirements, thereby limiting the City's financial exposure.

These projections were not without an awareness of the potential risks. The development experts who testified at the TIF Commission public hearing were clear in representing that "a project of this magnitude involves risks". The Official Statement for the 2005C Series of bonds distributed by Piper Jaffray (the original bond holder), contained an enumeration of the various risk factors associated with the project. Among the risk factors was the following:

> <u>Financial Feasability of the Crackerneck Creek Project:</u> *The financial feasibility of the Crackerneck Creek project depends in large part upon the ability of the Developer to attract and maintain sufficient numbers of tenants to achieve and then to maintain substantial occupancy throughout the term of the Series 2005C Bonds. The only signed tenant is a 150,000 square foot Bass Pro Shops Outdoor World retail store. Approximately 300,000 square feet of the project has no letter of intent or signed lease. If the Developer fails to achieve and maintain substantial occupancy at the Project, there may be insufficient PILOTS and EATS (particularly EATS) to pay the Series 2005C Bonds and any Additional Bonds issued on a parity therewith.*

Still other risk factors were noted by others. Development Strategies, a leading independent provider of development consulting and appraisal services, cautioned against overbuilding the retail market and stated that the competition for retail would only increase, with large retail projects being planned for Blue Springs and Lee's Summit.

The identification of these risks is not intended to second guess the decisions made by the City, but rather show that even after the risks were understood, the project was still seen as being feasible. Perhaps this is best underscored in a statement by the City's Finance Director in October 2004 article in the Independence Examiner: "We're taking on a risk, but with the way development is occurring, it's a risk that's worth taking."

To that end, I can find no indication that either the legal proceedings or methodologies employed in contemplating the project were anything but appropriate and of sound and well-reasoned judgment.

The second part of this question asks that I ensure that the expenditure of funds has been consistent with City Council approval. I have found no instance of misappropriation of funds during the course of this review that would suggest anything other than strict and mindful adherence consistent with City Council approval for expenditure of funds. Moreover, Section 2.26 of the City Charter requires an independent annual audit to review the financial transactions of the City during the past fiscal year. I have reviewed the annual audits completed during the life of this project, and there are no findings by the independent auditor of any inappropriate or unauthorized activities, nor are there any findings of material weakness associated with the management or maintenance of these funds. Finally, each series of bonds requires the establishment of a special allocation fund, with separate accounts for economic activity taxes (EATS) and for payments in lieu of taxes (PILOTS). These funds are separate from all other revenues of the City, and their activities are closely monitored. In fact, under terms of the financing agreements, the City has provided a Continuing Disclosure Agreement in accordance with SEC Rule 15C2-12 for the benefit of the owners of the bonds to provide annual financial information. All such reporting and audit activities provide the necessary assurance that all expenditures have been made in strict accordance with each respective agreement as intended by the City Council.

What Tax Increment Financing projects have been undertaken by other area municipalities? What has been their financial liability and how have they managed that liability?

The City of Independence is no different from its peer cities in both facing underperforming economic development projects and abiding by its annual appropriation pledge to cover any annual debt service shortfalls. This was echoed by UMKC Professor Emeritus Ross Stephens in a March 2011 article appearing in the Independence Examiner. Ross, whose specialization includes metropolitan and state government and intergovernmental relations, noted that many economic development projects in the last 30 years have relied on tax increment financing, and that many municipalities across the United States are experiencing situations similar to The Falls at Crackerneck Creek project with their bonds. Stephens further stated that municipalities must continue to make the payments to secure their bond rating. "I don't see any quick solutions", Stephens was quoted as saying.

By way of example, the City of Kansas City's budget for Fiscal Year 2013-14 dedicates nearly $16 million of General Fund resources to support underperforming economic development related debt. Chief among those debts are those for the City's downtown redevelopment district, where $14.3 million is budgeted for debt payments. It has been reported that City officials expect to continue to pay a similar amount each year to fulfill the Power & Light District's bonds until they are retired in 2033.

Though each TIF project faces its own unique set of circumstances, what many of these projects have in common is that their projections for economic performance were developed well in advance of the historic economic recession that began to unfold at the onset of the project and continues to linger into the present-day. Of further complication to the Crackerneck Creek project is that it was designed and approved with very specific guidelines to create a unique wilderness/outdoor theme. The redevelopment agreement even outlines a "pre-approved vendor list" for retailers that can be included in the project site. As City officials have previously indicated, they must be careful to not deviate from the permitted land use so as to not risk losing the partnership of the State of Missouri. The City has shown a willingness to make adjustments in the land use outlined in the redevelopment plan when deemed appropriate, such as when an exception was made to allow the sale of automobile services and car repair projects to accommodate a potential Firestone store.

Though quick solutions are not readily available, the City has pursued additional mechanisms that minimize its annual debt service obligation for to the project. For example, the City Council approved an ordinance in April 2013 that refinanced all or a portion of several series of obligations issued for the Crackerneck Creek Tax Increment Financing project. The initial objective of this refinancing is to reduce the debt service costs on the current obligations during the next few years. By refinancing, the City was able to obtain a debt service reduction of $3,147,483 during Fiscal Year 2013-14, $3,122,438 during Fiscal Year 2014-15, and $2,308,913 during Fiscal Year 2015-16. It should be noted that that restructuring the term of the debt to add three years to the end of the term will increase the cost, though the net present value of the increase is $1,553,948.15

Another important feature of refinancing is to prepare for future refinancing of other series of obligations issued for the project. The financing documents provide that the City will use 50% of the savings from the refinancing each year to bring the unassigned fund balance of the General Fund to its target of 5% of projected revenues. With a trend of having a fully funded unassigned fund balance for the General Fund, these future refinancing will have a greater appeal to the rating agencies and the investment market. That will in turn provide for more favorable interest rates, thereby reducing the City's overall obligation.

In addition to refinancing these bonds, the City has also sought to reduce its obligation for this project through initiation of the Interstate 70 and Little Blue Parkway Tax Increment Financing Project. Among the many components of this project is the ability to connect it with other TIF projects, including the Falls at Crackerneck Creek. By linking these projects, the City is able to capture additional Economic Activity Taxes (EATS) and Payments in Lieu of Taxes (PILOTS) and utilize those revenues to fund project costs. By bringing connectivity to these TIF plans, improvements that take place within one area of the TIF benefit the entire region.

To that end, the City would be wise to continue to maintain its current approach by working feverishly and tirelessly to attract the sufficient amount of leases to ease its annual debt service obligations while abiding by its annual appropriation pledge in the interim to secure the necessary bond rating to carry out the many other duties of the City. Moreover, as has been detailed, the City will no doubt continue to identify and pursue other mechanisms to further reduce the City's annual debt service obligation.

<u>Conclusion</u>

This review has been prepared to address specific questions associated with the Falls at Crackerneck Creek Tax Increment Financing project. In providing a response, I have identified the documents and agreements that detail the City's obligations for this project, and have found that the City has abided by and honored these terms. Principal to this discussion is the unmistakable responsibility of the City to make annual appropriations for debt service when revenues prove insufficient to meet obligations. Any indication in the bond indentures or financing agreements suggesting the bonds do not represent a general obligation debt or liability can be attributed to these bonds being special obligation bonds rather than general obligation bonds. It is not intended to rid the City of its repayment obligation. Moreover, the review has made plain that the *Redevelopment Agreement* between the City of Independence and Crackerneck Creek L.L.C. provides only for the developer to make such payments ***at its option***. Because of the real and severe consequences that would follow a default, the City Council has wisely and consistently honored this annual appropriation pledge.

It was further considered if all documents associated with the project were appropriately reviewed, and it was found that such a review was indeed conducted, both procedurally and analytically. All public meetings accompanying the project were legally advertised and all necessary findings and determinations were made when approving all documents and contracts. Moreover, the project was deliberately and critically reviewed to determine its feasibility, with conservative projections confirming its ability to achieve the necessary level of success, even when all known risks were considered. Finally, it was found that all expenditures have been in accordance with City Council approval, with the City's annual independent audit findings and continuing disclosure statements confirming this conclusion.

Lastly, I have found that underperforming economic development projects exist within other municipalities, and that honoring the annual appropriation pledge associated with these projects remains the most definite, if least palatable, means for addressing these obligations and avoiding a series of catastrophic events that would undoubtedly follow a default. With this project, as well as those in other communities, development has not occurred at the rate expected prior to the economic downturn. Independence has done well to strategically and creatively identify means for lowering the annual debt service obligation, such as through refinancing the bonds at a lower interest rate or linking the project to other tax increment financing projects to capture additional revenue sources.

Should you have any questions regarding the findings of this review, please do not hesitate to contact me.