COUNCIL AGENDA: 06-21-11
ITEM: 7.4

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

# Memorandum

**TO:** HONORABLE MAYOR AND CITY COUNCIL

**FROM:** John Stufflebean

**SUBJECT:** SEE BELOW

**DATE:** May 31, 2011

Approved

Date 6/8/11

**COUNCIL DISTRICT:** 3

**SUBJECT: TERM SHEET FOR THE PROPOSED NEW MARKETS TAX CREDIT TRANSACTION FOR THE ENVIRONMENTAL INNOVATION CENTER**

## RECOMMENDATION

Adopt a resolution authorizing the City Manager to negotiate and execute a term sheet with JPMorgan Chase N.A., Brownfield Revitalization LLC, Northern California Community Loan Fund, and HEDC-New Markets Inc. to secure New Markets Tax Credit financing for the San José Environmental Innovation Center, and to pay for the potential costs associated with closing the financing transaction in an amount not to exceed $300,000.

## OUTCOME

Approval of this recommendation will enable the City to begin finalizing the agreements necessary for the closing of the New Markets Tax Credit (NMTC) financing transaction which will generate approximately $6,000,000 in net proceeds to pay for a portion of costs related to the construction of the San José Environmental Innovation Center (EIC).

## BACKGROUND

The NMTC program, enacted by Congress and administered by the U.S. Department of the Treasury, was created to promote economic development in distressed areas. Each year, the Treasury's Community Development Financial Institution Fund competitively allocates tax credits to eligible organizations known as community development entities (CDEs). CDEs then solicit private equity investments in exchange for a federal income tax credit totaling 39% of the qualified equity investment (QEI) made into a qualified active low-income community business (QALICB) that sponsors a project benefiting the community in which it resides. Investors tend to be major financial institutions—such as JPMorgan Chase, U.S. Bank, Bank of America, and Wells Fargo—whose primary interest in a project is their ability to reduce their federal tax liability by claiming the tax credits over a seven-year compliance period.

Due to the complexity of the transaction, the City retained the National Development Council (NDC) in December 2010 and Kantor Taylor Nelson Boyd & Evatt PC (Kantor) in February 2011 to assist with the negotiation and completion of the financing. Specifically, NDC advises staff in the structuring of the NMTC transaction, identifying interested CDEs and investors, and closing the transaction. Kantor serves as the City's special legal counsel and, working under the direction of the City Attorney's Office, has the responsibility of drafting the required documents for the transaction and providing advice to the City in this specialized area.

On May 17, 2011, Council adopted a resolution authorizing the City Manager to: (1) establish an independent QALICB; (2) appoint the five members of the QALICB Board of Directors and replacement board members if any of the appointees are unable to serve through the closing of the NMTC; (3) negotiate and prepare the agreements necessary to complete the NMTC transaction; and (4) evaluate the feasibility of using Commercial Paper as an interim or alternative financing mechanism for NMTC.

The QALICB's board members will have an independent fiduciary duty to the QALICB and will be authorized to execute agreements of behalf of the QALICB. For the purpose of closing the transaction, the QALICB board will be expected to execute qualified low-income community investment loans (QLICI) and various agreements with the City to enable the QALICB to own the project for tax purposes, and authorize the City to finish construction of the EIC and operate the facility thereafter. Staff was informed after May 17, 2011, that the QALICB needs to have independent authority to replace its own board members. The City Manager will not have the ability to replace board members once the board is established.

Subsequently, with the assistance from NDC, staff has identified the investor and CDEs that would participate in the NMTC transaction for the EIC. JPMorgan Chase (Chase) would invest approximately $9,100,000 in exchange for the right to claim approximately $12,500,000 in tax credits over a seven-year period following the close the transaction. The CDEs—Northern California Community Loan Fund, Brownfield Revitalization LLC, and HDEC-New Markets Inc.—would provide a total tax credit allocation of approximately $32,000,000.

## ANALYSIS

To arrive at substantially final closing documents, a term sheet must first be executed for the investor and CDEs. While terms can be subject to change, and final approval by all parties, the term sheet does include certain nonnegotiable financial obligations. The most significant obligation is the CDEs and investor will require the City to assume any cost incurred during the negotiation process if the transaction fails to close. These costs include legal services, accounting services, environmental and other due diligence work required to close the transaction.

Term Sheets

Term sheets from investors and CDEs typically include the following transaction details:

- a project description including detailed budget, who will be the general contractor, a description of who will occupy the premises and relevant lease agreements;
- the NMTC allocation provided by each CDE;
- the investment structure including the amount of the equity provided by the investor, leverage and one-day loan amounts, and identifying the managing members of the investment fund;
- designation of the responsible party for administering the release of funds from the disbursement account through the final completion of the EIC project construction;
- general loan terms including security, guaranties and indemnifications, insurance (e.g. title insurance), reserves, and the drawing of funds from the disbursement account;
- transaction fees, expenses, underwriting and reporting requirements; and
- closing conditions.

Staff will issue a supplemental memorandum to identify the specific components of the term sheet between the City, Chase, and the three CDEs.

Completion and Payment Guaranties

NMTC financing transactions generally involve private development, and the CDEs and investor require the project sponsor to provide guaranties to ensure that the project continues to qualify for tax credits and the financing structure remains in place for the seven-year compliance period. Due to legal prohibitions on public sector agencies, the City cannot provide such guaranties but may be able to agree to more limited obligations. Staff will not know until the parties begin negotiation whether the CDEs and investor will accept the following terms.

1. The CDEs will seek a completion guaranty from the City to finish construction of the project including payment to the contractor for any cost overruns. The loans from the CDEs to the QALICB can only be used for approved construction related costs, and compliance and closing costs. Since the funds for construction, including a 10% contingency, will be available at the close of the financing, the City could agree to use the development budget for its stated purposes. However, under Article 16 Section 18 of the California Constitution, cities are prohibited from assuming an obligation that is in excess of its current general fund revenue or is a current promise to pay from future general fund revenues. Specifically, the City could not agree to pay for the cost of construction beyond the available funding or to rebuild the EIC in the event of a catastrophic event such as a fire or earthquake. If a catastrophic even occurred, such as an earthquake, destroying all or a portion of the facility, the loan agreement would need to address expectations as to any insurance proceeds recovered from the damaged building.

2. CDEs may seek a payment guaranty from the City to promise to pay debt service on the QLICI loan. Since the City, as a master tenant of the EIC, would otherwise have an obligation to pay rent equivalent to the debt service, Kantor has advised that the investors may not require a payment guaranty.

As the City would enter into a master lease agreement with the QALICB, the City would be required to make rent payments of approximately $260,000 per year as consideration for the beneficial use of the EIC. The QALICB would then use this revenue to pay debt service on its low interest QLICI loans. The interest rate on the QLICI loans will be substantially below market rate at approximately 1.0%. Payments would be interest only during the seven-year compliance period. The CDEs will then use these interest payments to provide the investment fund a return on its QEI. The investment fund must then use the $260,000 to make interest payments on the loan from the City. The interest rate on the City's leverage loan will be approximately 1.0%. Thus, the initial rent payments by the City to the QALICB would return to the City in the form of interest payments.

<u>NMTC and Environmental Indemnifications</u>

The investor may require the City to indemnify the investor in the event that the City causes the QALICB to trigger a recapture of the tax credits. As an indemnitor, the City would assume significant potential liability to the investor for the value of the tax credits purchased by the investor estimated at $12,700,000 and such additional funds as would make the investor "whole" for any investor loss caused by the City's bad acts. The specific events that can cause tax credit recapture are: (1) the CDE ceases to be a qualified CDE; (2) the QEI made by the investor into the CDE is redeemed; or (3) substantially-all of the proceeds of the QEI are not invested as either a loan or equity in a QALICB. The first two events would not be triggered by the QALICB and accordingly would not create liability for the City to indemnify the investor.

The third recapture event occurs if less than 85% or "substantially-all" of the QEI remains invested as either debt or equity by the CDEs in the QALICB throughout the seven-year compliance period. Failure to meet the "substantially-all" requirement could only occur if the QALICB did not remain a qualifying business throughout the compliance period, or the CDEs received a return of the investment prior to the end of the seven years. Examples of a non-qualifying business include: conducting any trade or business consisting predominantly of the development or holding of intangibles for sale or license, to operate a golf course, country club, massage parlor, hot tub or suntan facility, racetrack or other gambling facility, a liquor store, or a farming operation. Because the EIC will primarily consist of a Habitat for Humanity ReStore, a Clean Tech Demonstration Center, conference space for environmental workshops and job training programs, and a permanent Household Hazardous Waste drop-off facility, the EIC QALICB should remain a qualifying business throughout the seven-year compliance period.

The CDEs and the investor will seek an indemnification from the City to protect them from any claims arising out of environmental contamination on site. This is of low concern as staff anticipates that the City will have control over the use of the site. The City should, however, also include an indemnification clause in its subleases for potential environmental contamination caused by its tenants' activities. The subleases would also include limitations on the tenants' use and handling of hazardous materials.

## EVALUATION AND FOLLOW-UP

Staff will report on an analysis of the term sheet and possible modification of the recommendation. Staff will return to Council in early August 2011 with a recommendation to approve in substantially final form the Investment Fund Loan Agreement, Ground Lease, Master Lease, Development Agreement, New Markets Tax Credit Indemnification, Completion Guaranty, Environmental Indemnification, Put/Call Agreement, and authorize the City Manager, or other authorized designee, to execute and deliver these documents and other related documents as necessary in connection with the closing of the New Markets Tax Credit financing transaction.

## PUBLIC OUTREACH

- ☐ **Criterion 1:** Requires Council action on the use of public funds equal to $1 million or greater.
- ☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City.
- ☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach.

This recommendation does not meet any of the criteria listed above. This memorandum will be posted on the City's Internet website for the June 21, 2011, Council Agenda.

## COORDINATION

This memorandum has been coordinated with the Office of the City Attorney, City Manager's Budget Office, Office of Economic Development, and the Department of Public Works and Finance.

## COST SUMMARY/IMPLICATIONS

A deposit of $40,000 has been made to Chase in consideration for undertaking the process to prepare a term sheet and evaluate the proposed transaction for the EIC. This deposit was made from the Integrated Waste Management Fund's Non-Personal/Equipment appropriation and offset by late fee, AB939 fee, and utility rate payer revenue. This deposit would be refunded to the Integrated Waste Management Fund when the NMTC transaction closes.

Staff anticipates the need to make additional deposits to the CDEs not to exceed $50,000 in consideration for their engagement of legal counsel. Staff also anticipates to incur costs associated with obtaining an appraisal, environmental reports, and title reports required by Chase and the CDEs. These costs would not exceed $20,000. Additionally, the City may purchase additional insurance for the QALICB such as general commercial liability and directors and officers insurance for which the City would be reimbursed.

Once the term sheet is executed, additional legal and negotiation fees are expected be total $190,000. Therefore, staff does not anticipate exceeding a total of $300,000 to execute a term sheet and arrive at substantially completed closing documents.

If the NMTC transaction failed to close, execution of the term sheet would obligate the City to assume the costs incurred by Chase, CDEs, and any other third parties engaged during the preparation and negotiation process of such term sheet. If needed, the difference between the deposits and the remaining closing costs would be paid from the Integrated Waste Management Fund's 2011-2012 Non-Personal/Equipment appropriation and offset by late fees and other unrestricted revenues, AB939 Fees, and ratepayer funds in the amount of approximately $63,000 from each of these revenue sources

## CEQA

A CEQA Negative Declaration for the renovation of the EIC was adopted on December 1, 2009 (PP09-138).

/s/
JOHN STUFFLEBEAN
Director, Environmental Services

For questions please contact Jo Zientek, Deputy Director, Integrated Waste Management Division, at 408-535-8557.