

Staff Report

for the Board of Directors' Meeting of May 23, 2018

TO: Board of Directors
FROM: Chip Close, Water Operations Manager
Shannon Wood, Business Services Technician
DATE: May 15, 2018
SUBJECT: District Financing - Due on Sale Clause

OPERATIONS

RECOMMENDATION:

Review and discuss the benefits and burdens to the Due on Sale Clause within the District's financing agreements and leaving the program unchanged, as recommended by the Administrative Practices Committee.

BACKGROUND:

As part of the District Financed Waterline Extension (DFWLE) Agreement and Term Payment Agreement, property owners must pay the balance of their loan with the District upon the sale of the property for which the agreement was set up. Recently, the Board requested staff review the potential removal of the Due on Sale portion of the agreement thereby assigning the loan to future owners. Staff has completed the review and listed the potential benefits and burdens below.

Benefits

The benefits of eliminating the Due on Sale Clause seem to only assist the current property owner and include:

- Full Collection of Home Value Upon Sale - Eliminating the Due on Sale Clause will allow property owners utilizing District financing to collect the full home value at the time of sale by passing the remaining loan balance to the new owner. This may promote utilization of District Financing; however, this approach may lead to the personal profit of the current property owner while the District extends the financing to future owners.

Burdens

The potential burdens and risks of eliminating the Due on Sale Clause include:

- Collection of Delinquent Accounts - The District sends out multiple reminders for late and overdue billings to DFWLE and Term Payment Agreement participants. Eventually, if payment is not collected, the District can place a lien on the property and collect delinquent funds through the County tax roll. Recently, Nevada County challenged the District's ability to collect on parcels that have changed ownership in the previous year. The County claims that

the fees were a result of a decision made by the previous property owner thus the delinquency cannot be transferred to the new owner. In support of this position, the County has cited to the following code provision that is in the Irrigation District Law that governs NID:

(a) In case any charges for water and other services or either remain unpaid, the amount of the unpaid charges may, in the discretion of the district:

(1) If unpaid at the time specified for delivery of the assessment book to the collector, be added to and become a part of the annual assessment levied upon the real property upon which the water for which the charges are unpaid was used and upon the real property subject to the charges for any other district services and shall constitute a lien on that real property. However, if, during the year preceding the date on which the first installment of real property taxes which evidence the charges appears on the roll, any real property to which the lien would attach has been transferred or conveyed to a bona fide purchaser for value, or if a lien of a bona fide encumbrancer for value has been created and attaches thereon, then the lien which would otherwise be imposed by this subdivision shall not be added to and become part of the annual assessment nor shall it attach to the real property.

(Water Code § 25806, subd. (a).)

- Land Covenant - DFWLE and Term Payment Agreements are classified as a covenants that run with the land; however, it may be challenged in court that the decision to partake in the program is a voluntary decision made by the previous owner that does not succeed to a new owner. A decision in favor of non-covenant would jeopardize collection for all DFWLE and Term Payment agreements.
- Bankruptcy/Natural Disaster - As the District extends lending to multiple owners the risk for a discharge of the loan in a bankruptcy proceeding increases. To date water charges in a bankruptcy proceedings have been forgiven. For this reason, the DFWLE agreement classifies the loan as capacity and connection charges as a protection from discharge. This protection has not been tested in the court and the outcome is unknown. The total risk to the District of discharge in a bankruptcy is small given it is unlikely that all or a substantial majority of owners could declare bankruptcy at the same time. However, relatedly, in the event of a wildfire or other natural disaster that affects the entire neighborhood like recently experienced

in Rough and Ready and Santa Rosa, the District maybe left working with insurance companies that would have a financial incentive to reduce or eliminate the payment obligation to the District.

- Longer Payback of DFWLE Loaned Funds - The intent of the DFWLE program was to front the initial costs of water line extension projects with an anticipation that reimbursement from the loans would support additional Community Investment Programs for future projects. Many properties will change hands or be refinanced over the course of 30 years, meaning that the District in many cases will be reimbursed before the 30-year term elapses. Eliminating the Due on Sale Clause will likely extend the payoff on these loans to the full 30 years and reduce the rate of District reinvestment for future projects.
- Likelihood of Future Changes in the Law Affecting District Remedies – In the event of default, the District’s remedies include placing the delinquency on the tax roll (limitations discussed above), discontinuing water service, and/or filing an action for breach of contract. In 2012, the state passed Water Code § 106.3 establishing a “human right to water”. The new law has and will continue to influence state policy and laws in the future. As one example, SB 998 (Dodd) is a pending bill in the legislature that would prohibit the District from terminating water service in the event of nonpayment under certain circumstances. Given the trend in state law, staff believes that it will become more difficult to collect delinquencies by discontinuing service. This leaves fewer remedies available to the District in the event of default. The Due on Sale Clause is a way to counteract this potential and protect the District from financial loss.

As a potential alternative, staff could work with legal counsel to develop a Transfer Agreement that would require participation from both the current owner and the new purchaser. The District would require execution of the agreement prior to transferring any loan balances. This would provide additional supporting documentation in the event of a loan default.

However, developing a new Transfer Agreement comes with its own set of burdens and risks including:

- Transfer Agreement & Escrow Challenges – Requiring a Transfer Agreement inserts the District into a time sensitive escrow process. Should the new owners refuse to sign the new agreement, or the District encounter delays, it could hold up a real-estate transaction. Similarly, if the former owner is delinquent, it may be difficult or perhaps impermissible to collect the delinquency from the new owner.
- Transfer Agreement Setup Costs - As properties change hands, District staff will be required to renew or establish new agreements with the new owners. This will include recording and subordination to the new mortgage company. This process involves staff time that is not reimbursed through the current DFWLE program. Because of this, it may be difficult to defend under

Proposition 218 or may require the District to justify the expense through utilization of non-fee revenue.

- Challenges with Previous Assignments of Loan Documents - Staff has experienced instances where District loans have been assigned to new owners and it has come with challenges. The new owners challenged the District's project charges and documentation in an attempt to reduce or forgive the loan. This led to a time consuming and costly process for staff to revisit the archives to satisfy the new owner's apprehensions. Staff remains concerned that a release of the Due on Sale Clause or the establishment of a Transfer Agreement will lead to an increase of these types of inquiries.

Based on the information gathered from this review, Staff is recommending the Due on Sale Clause remain in effect. The current policy provides the District with the best protection for program financing and supports the continued success of the DFWLE program.

BUDGETARY IMPACT:

None at this time

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