THE BOND BUYER
Thursday, May 5, 2016 | as of 12:00 PM ET

Taxation

Colo. Court Case Puts Spotlight on Special Districts That Issue Munis

By Lynn Hume
April 29, 2016

WASHINGTON – A broad ruling by the Colorado Court of Appeals in a case of a developer's egregious fraud has sent lawyers to the state's General Assembly for legislation to protect existing special districts that issue tax-exempt bonds.

The case could have been the poster child for English Comedian John Oliver's recent television segment skewering special districts and is an example of everything the Treasury Department is concerned about with such districts.

But lawyers in Colorado say it shouldn't be used to taint other special districts that have been properly set up and followed the law.

The case involves a high-profile developer, Zachary Davidson, who used sham contracts to make him and five associates organizers or "eligible electors" who formed a special metropolitan district in Greenwood Village, Colo. that issued almost $35 million of bonds now in default. Davidson included nearby condominium purchasers in the district and obligated them to pay taxes to help pay off the bonds, even though the condo owners were unaware they were in the district or that bonds had been issued.

Davidson stole millions of dollars of bond proceeds for his personal use and was eventually indicted on 20 felony counts by an Arapahoe County, Colo. grand jury. He eluded law enforcement for months and ultimately committed suicide by hanging himself from a tree in Withlacoochee State Forest in Florida at age 46.

After several years of litigation, the Colorado Court of Appeals issued a ruling on April 21 favoring the condo owners' Landmark Towers Association, Inc., ruling in part that Davidson used sham contracts to give him and his associates control of the special district and the bond issue.

Muni market participants in Colorado fear the case will be used to try to undo previously existing special districts and their taxing powers.

"This case has exceptionally unique and bad facts," said Dee Wisor, a lawyer with Butler Snow in Denver. The appeals court's ruling "was broadly written" and "not limited to the facts" of the case, he said.

"The risk here is that lawyers will go out and recruit taxpayers in special districts to invalidate elections that happened many years ago to avoid paying taxes," said Wisor. "We're trying to get the General Assembly to adopt legislation to validate other special district elections that have been previously held and which are not the subject of previous disputes," he said.

"It's common for the General Assembly to weigh in on legislative intent," said Mary Kay Hogan, director of government affairs for R&R Partners. Special districts are governed by state laws.

There's a lot at stake for special districts in Colorado, which were responsible for 240 general obligation bond deals totaling $2.9 billion in the six years from 2009 through 2014, according to the Special District Association of Colorado.

That group and the Colorado Municipal Bond Dealers Association, Inc. each filed friend-of-the-court briefs in the case, asking the appeals court to reverse certain findings of the district court. The two groups warned that the findings, if left standing, would hurt the muni bond market in Colorado.

Beyond Colorado

But the case may have national implications as well.

It comes as the Treasury and Internal Revenue Service have proposed controversial new rules for political subdivisions because of concerns that some special districts, or community development districts as they are called in Florida, are controlled by developers and their associates rather than taxpayers. Treasury and the IRS contend that developer-controlled districts should not be able to issue tax-exempt bonds.

Muni market participants argue that historically, many developers have set up special districts to issue bonds to pay for infrastructure improvements for projects such as retirement communities or business parks until homeowners or businesses can move in and begin to pay assessments or taxes to pay for the bonds.

For years, the test under the federal law for whether a district is a political subdivision that can issue tax-exempt bonds has been based on whether an entity has been delegated a substantial amount of at least one of three sovereign powers: eminent domain, taxation, and policing.

The Treasury and IRS are now proposing rules to expand that test to add two new requirements. Under rules they proposed February, a political subdivision that can issue tax-exempt bonds, would also have to serve a governmental purpose and be governmentally controlled "with no more than an incidental private benefit."

The proposed rules have met with a firestorm of criticism from muni lawyers who have warned they would threaten existing special districts and potentially millions of dollars of bonds.

But this case epitomizes the concerns of Treasury and the IRS. Davidson, through 7677 East Berry Avenue Associates, L.P. where he was managing partner, built two high-rise residential condominium towers in Greenwood, Colo., called Landmark and Meridian, from 2005 through 2007, according to court documents.

He did not create a special district for the project and instead entered into agreements with Greenwood Village in 2005 to build the towers and to receive a rebate of 50% of city sales taxes collected by commercial activities conducted on the project site for 20 years. Sales and use taxes on the building and construction materials as well as building permit fees were waived.

The towers were to be completed in 2007 and 2008. By the end of 2006, Davidson's company had 130 buyers for the condos under contract. The buyers paid $35,000 to $100,000 in nonrefundable deposits and agreed to pay pro-rated taxes for the year at closing, according to court documents.

That same year, Davidson, through Everest Marin, L.P., where he was also managing partner, bought 11.1 acres adjacent to the towers to develop a residential community to be called European Village that was to include manor homes, brownstones and infrastructure.

Davidson decided to create a special district, called the Marin Metropolitan District, to issue up to $35 million of general obligation bonds to finance the project. But he found the village property would not provide a sufficient tax base to support the GO bonds. So, acting on behalf of both his 7677 East Berry and Everest companies, Davidson decided to include the Landmark and Meridian Towers in the special district, without telling the condo buyers, documents show.

Contracts

Davidson entered into option contracts with five associates to qualify them and him as "eligible electors" who then elected to form the district and issue the bonds. The option contracts were for the purchase of an undivided 1/20th interest in a 10 foot by 10 foot parcel. These six individuals were the only ones who received notices of elections and votes and the only ones who voted on anything.

The six "electors" of the district submitted a service plan to Greenwood Village stating the district would provide public infrastructure improvements to all property within the district and would finance them with bond proceeds.

The Marin Metropolitan District hired Piper Jaffray to assist it in issuing the bonds. In June 2008, nearly $30.49 million of district GO bonds were underwritten by Piper Jaffary and sold to Colorado Bondshares, a tax-exempt mutual fund. The bonds had an interest rate of 7.75% and a maturity of 20 years, according to bond documents. UMB Bank, N.A. was trustee. About $13 million of the bonds were redeemed after that. The bonds went into default last year, according to bond documents. Davidson, who as a managing partner of Everest and an "elector" of the district had unsupervised access to the bond funds, was hurting for cash. He withdrew about $8 million of the bond proceeds, using much of it for his personal benefit.

The Landmark condo owners would never receive any benefits from the use of those bond proceeds and yet all of a sudden, they were on the hook for paying back the bonds.

In 2011, the Landmark Towers Association began to uncover the fraud and filed a complaint in a Colorado district court against the Marin Metropolitan District, Colorado Bondshares and UMB Bank to enjoin them from the future levying of taxes under the state's Taxpayers Bill of Rights (TABOR).

Landmark claimed the bond and tax election was illegally conducted because

the option contracts of the district's organizations were a sham and Landmark buyers had not been allowed to participate. It claimed the district had improperly disbursed bond funds for the benefit of Davidson. It also charged the district had set the property tax levy for debt service higher than allowed by law. Landmark said taxing the condo owners violated their constitutional right to due process because the bond-financed improvements would not benefit them.

The district court ruled in favor of Landmark on most of its claims and ordered the Marin district to refund to the condo owners the portion of the misused bond proceeds they had paid. The court also ordered the district to refund some of the property taxes collected and enjoined it from imposing further taxes on the condo owners.

But the court ruled that, even though district's organizers never made down payments for "director's parcels" or paid any taxes on the land, the option contracts were not a sham and were a legitimate way to create "eligible electors" of the district.

The defendants, including Colorado Bondshares, appealed the ruling, arguing in part that Landmark's challenge was untimely and that neither the taxes levied nor the misuse of bond funds violated TABOR. Landmark cross appealed disputing the court's findings that its challenge to the bond and tax election was time-barred. It also challenged the court's alternative determination that the election complied with TABOR and applicable statutes.

The appeals court affirmed parts of the district court's ruling, reversed other parts, and remanded the case back to the lower court.

Particularly important was that the appeals court disagreed with the district court's conclusion that the contracts were sufficient to make the organizers of the district eligible electors. It concluded instead that the organizers' contracts were sham agreements because of seven factors, including that none of the organizers (electors) made down payments or paid taxes, and that the parcel of land was too small to have any beneficial use.

"The purpose of requiring a district to gain approval from persons who own property within a district before it imposes a new tax is to allow the people who will have to pay the tax to decide whether the tax should be levied," the appeals court judges said in their ruling.

Wisor and other lawyers say they are trying to get the Colorado General

Assembly to pass legislation before the session ends on May 11 validating existing special districts that have followed the law.
