MEMORANDUM

Date: August 17, 2016

To: Board of Directors

From: Darlene Thiel Gillum, General Manager

Subject: Request to Extend 1995 SHF/M&R Reimbursement Agreement

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RECOMMENDED ACTION

Move to deny the request to extend the 1995 Reimbursement Agreement with SHF Acquisition Corporation and allow the agreement to expire according to its terms on September 20, 2016.

BACKGROUND

In the early 1990s, developer SHF Acquisition Corporation constructed houses in a Rancho Murieta subdivision known as Unit 6 or the Fairways. As part of that subdivision, the developer paid for and installed certain water, sewer and storm drainage improvements. Some of the improvements were sized to benefit and serve lands other than the Unit 6 subdivision. Consequently, in 1995, the District entered into a Reimbursement Agreement with SHF concerning the reimbursement of a portion of the costs of the improvements from defined benefited properties. In September 2015, the Board authorized a one-year extension of the 1995 agreement. The agreement now expires on September 20, 2016.

M&R Investment One Company, Inc. claims it is the successor to SHF. In several letters to the District, M&R representatives have requested an extension of the agreement for nineteen additional years. M&R's representatives state that, if the District does not grant an extension, M&R will sue the District and seek a court-ordered extension, money damages and attorney fees.

District staff have evaluated M&R's request and recommend that the Board deny it for the reasons discussed below.

DISCUSSION

The District's lawyers have reviewed the Reimbursement Agreement and met with M&R's attorneys. They have confirmed that the District has no legal obligation to extend the Reimbursement Agreement.

As a potential compromise with M&R, District staff and M&R discussed the possibility of recommending to you a five-year extension. M&R's representatives have nevertheless stated M&R will only accept a nineteen-year extension.

In letters and meetings, M&R's representatives made two types of arguments for an extension. First, an extension is fair under the circumstances. Second, it is in the District's interest to extend the Reimbursement Agreement, because extending the Reimbursement Agreement has

no direct cost to the District while litigation with M&R would be very expensive. The following sections discuss these arguments.

A. M&R's Arguments Based on Fairness

1. M&R's Argument that Another Developer Received a 20-Year Extension Does Not Support an Extension in this Instance

In discussions with M&R representatives, M&R has argued that it is entitled to a 20-year extension of the SHF agreement because in 1999 the District extended a reimbursement obligation involving different developers for 20 years. District staff have compared the two situations and determined that the circumstances are very different and not comparable.

First, the two agreements are dissimilar. The 1999 extension involved a 1991 Reimbursement and Shortfall Agreement between the District and two developers. In 1991, the District formed Mello-Roos CFD No. 1 and issued bonds to finance water, sewer and other infrastructure to serve the development of lands in the south Rancho Murieta area. In arranging the bond financing, the District determined that there would be an estimated $6.6 million shortfall in the funding necessary to pay for the needed infrastructure. The District and developers then negotiated and approved the Reimbursement and Shortfall Agreement. The agreement obligated the developers to fund the infrastructure to the extent not covered by the District bond financing. The agreement provided for this funding obligation to be secured by letters of credit. The agreement provided for the developers to post additional security in the event the actual costs exceeded the estimated costs. Finally, the agreement provided for payment of reimbursement from other benefited properties that did not participate in the infrastructure financing and funding. The 1991 agreement provided that the developers' rights to reimbursement would expire after 20 years.

In contrast, the SHF agreement is solely a reimbursement agreement providing for the possible reimbursement over time for improvements installed by SHF. It lacks a related infrastructure financing component.

Second, the 1999 extension of the 1991 Reimbursement and Shortfall Agreement obligation involved a broader transaction with the developers concerning the ongoing infrastructure development and construction. By 1999, much of the needed infrastructure, and significantly including the needed water treatment plant expansion, had not yet been constructed. Also, by 1999, one of the letters of credit had expired.

Therefore, in 1999, the district and developers wanted to firm up the financing plan for the remaining infrastructure. In May 1999, the developers agreed to and did provide a new firm $3.6 million letter of credit to secure the south area's infrastructure funding obligation, including its one-third share of the water treatment plant expansion. Additionally, in May 1999, two prominent developer individuals, John Reynen and Christo Bardis, agreed to and did provide a personal guarantee that unconditionally and irrevocably guaranteed the obligations under the Reimbursement and Shortfall Agreement. In exchange for the new will serve letter and personal guarantee, the District in May 1999 agreed to provide a 20-year extension of the reimbursement obligation.

This extended Reimbursement and Shortfall Agreement financing arrangement has continued to the present with the District relying on the 1991 funding obligation, as modified and extended in 1999, to facilitate the construction of the water treatment plant expansion in 2014-16. The south area developers, through the Reimbursement and Shortfall Agreement and related letters of credit, funded a one-third share of the District's recent plant expansion construction costs.

In contrast to the developer obligations supporting the 1999 extension of the 1991 Reimbursement and Shortfall Agreement, M&R is not offering or proposing any additional obligation or consideration that would support or justify the requested extension of the 1995 SHF reimbursement agreement. Instead, M&R seems to argue for and demand an extension of the agreement simply because it did not receive reimbursement during the agreement's 20-year term.

Third, in early 1999, the District, together with other affected parties, was evaluating a project to rehabilitate a small bridge crossing the Cosumnes River and connecting the south area with the golf course and other facilities north of the river. In discussions between the District and Mr. Bardis, he indicated that he would support a proportionate share of funding for the bridge rehabilitation project, but he requested an extension of the reimbursement obligation in exchange.

Fourth, the 1999 extension decision was made by the District Board of Directors at that time based on the then-prevailing conditions and circumstances. Today is a different time and place and there are different directors on the Board. Simply because one District Board made a particular decision 17 years ago should not bind or obligate this Board to make the same decision.

2. M&R Is Incorrect that an Extension Is Necessary for M&R to Obtain the Benefit of Its Bargain with the District

M&R argues that, because SHF and M&R have collected no reimbursements since 1995, an extension is necessary so M&R can receive the benefits it bargained for in the Reimbursement Agreement.

M&R's argument is incorrect. The bargain between the District and SHF provides for a reimbursement right from future development, but that right expressly expires after 20 years. Nothing in the Reimbursement Agreement suggests the parties bargained that SHF and M&R would be entitled to an extension if they had not been fully reimbursed within 20 years. Rather, the Reimbursement Agreement expressly states the District makes no warranty that SHF will receive any reimbursement during the term of the agreement. In 1995, M&R's predecessor (SHF) bargained for the payment of reimbursement from the development of lands within a defined area of benefit over a 20-year term and, in doing so, it assumed the risk that there may be insufficient or no development within that area to fund reimbursement.

The 20-year term provided in the Reimbursement Agreement was fair and is typical for California facilities reimbursement agreements. In some situations, these types of agreements are limited to even shorter terms. (See Pub. Contract. Code, § 20610 [limiting reimbursement agreements for county waterworks districts to ten-year terms].) The District and SHF agreed to a 20-year term without providing for any extension if SHF was not fully reimbursed.

M&R also argues an extension is necessary because it was deprived of the benefits of the Reimbursement Agreement while the District was subject to a cease and desist order from the Central Valley Regional Water Quality Control Board from 2006-2008. However, it is speculative to argue that the regional board's order actually caused the lack of development in Rancho Murieta during that time period, especially in light of the global economic recession that began in late 2007 and the recession's significant impacts in the Sacramento area. Furthermore, SHF did receive a one-year extension of the agreement.

B. M&R's Is Incorrect that an Extension Is in the District's Interest

1. M&R Has Provided No Support for Its Claims that the District Failed to Perform Its Obligations Under the Reimbursement Agreement

M&R's representatives have argued that the District should extend the Reimbursement Agreement because a court will hold the District liable for failing to perform its obligations under the agreement. Specifically M&R's representatives have argued the District failed to use its best efforts to ensure M&R received reimbursement under the agreement.

This argument is incorrect. M&R's right to reimbursement is triggered by development of property that benefitted from the improvements SHF constructed. Since 1995, no development has occurred on the relevant properties, so there has been no reimbursement for the District to collect on behalf of SHF and M&R. Nor have M&R's representatives produced examples of any instance where the District failed to use its best efforts to ensure SHF and M&R received reimbursement to which they were entitled.

2. Granting M&R's Request Could Be an Unlawful Gift of Public Funds

An amendment to a contract is a contract. The District lawyers explain to me that in order to approve a binding contract, the contract must be supported by some price, benefit, interest or other consideration. M&R's request for an extension lacks consideration.

Related to this factor, the State Constitution prohibits the District from making a gift of public funds. In order to avoid the gift prohibition, an agreement to pay money to third party must promote a valid and substantial public purpose of the District. An agreement to extend the reimbursement term would obligate the District to collect development fees and pay them over to M&R for an ongoing period of time; however, without any consideration, such an agreement would not further or support any District public purpose.

Sometimes, the fair settlement of a good faith dispute with a private party may be an appropriate use of public funds because the waiver of a reasonable legal claim in return for settlement funds paid by the District accomplishes a valid public purpose. However, the settlement and compromise of an invalid claim is inadequate consideration to support a contract and probably would be an unlawful gift of public funds. District staff has determined that M&R has no right or entitlement to a reimbursement extension and no consideration is being proposed to support the extension. Therefore, even though M&R has threatened litigation, District staff are not aware of any valid legal claim that would support the extension/settlement.

3. Granting M&R's Request Would Create Additional Disputes When Future Development Occurs Over the Next Nineteen Years

The Reimbursement Agreement assumed a certain density of future development would occur within the District between 1995 and 2015. This assumption controlled the amounts of reimbursement that were assigned to specific properties within the District. Future development within the District is now expected to occur at lower densities than was anticipated in the Reimbursement Agreement. As a result, the amounts assigned to specific properties in the Reimbursement Agreement probably exceed the amounts the District could legally charge to future, less-dense development within the District. Consequently, it is likely that, if the District agrees to extend the Reimbursement Agreement, there will be additional disputes between M&R, the District and future development about how much reimbursement is properly charged to new development.

CONCLUSION

For these reasons, District staff recommends the District Board deny the request to extend the 1995 Reimbursement Agreement with SHF Acquisition Corporation and allow the agreement to expire according to its terms on September 20, 2016.