INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION



Work Session II: Public Finance 101: Debt, Elections, Securities, and Taxation

Bonds in a Nutshell

by
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Speeches and Publications
"Special Utility Districts"
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Presentations to the Institute for Local Government Studies of the Center for American and International Law, Dallas and Plano, Texas 2002-2004
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Practice focuses on public finance, municipal and real estate matters as a part of serving on the firm's Corporate Finance and Real Estate Team, and the Public Finance Team.

Relevant Experience

- Represented technology and other corporate clients, and their employees, in the legal areas of corporate, partnerships, trusts and estates, real estate and collections
- Represents an array of local governments in land planning, regulatory issues, and inter-local agreements
- Represents local governments in the organization and administration of special districts for infrastructure development, emergency services, and land use opportunities
- Represents clients in economic development plans and tax incentive plans.
- Represents clients in zoning and land use issues as they relate to growth, development and re-development.

Elected and Appointed Positions

Richardson, Texas

- City Council 1995-Present
- City Plan Commissioner 1991-1995
- Richardson Independent School District Board of Trustees 1987-1991 (President 1991)

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Co-head of Public Finance Section. Practice focuses on municipal finance with related work in local government, securities, health care, tax and corporate trust law. Representation as bond counsel, special disclosure counsel and counsel to state and local government issuers, underwriters, hospitals, colleges and trustees. Experience in structuring and issuing tax exempt debt of all types, including higher education and health care, and drafting disclosure documents. Substantial experience in representing colleges and universities, hospitals and retirement facilities.

Relevant Experience

- Bond Counsel for more than $1.8 billion in bonds for hospitals and retirement communities.
- Special counsel to a state wide issuer for more than $450 million in bonds for acquisition of existing hospital facilities.
- Special disclosure counsel to California airport in rewriting disclosure documents for its airport revenue bonds.
- Author, “Making Good Disclosure: The Role and Responsibilities of State and Local Officials under the Federal Securities Laws,” published in 2001 by the Government Finance Officers Association.
- Special disclosure counsel for general obligation financings for a major state government, including continuing disclosure agreements.
- Expert witness in securities laws litigation growing out of Orange County, California default.
- Special counsel to state-wide issuer in negotiating of IRS closing agreements preserving tax exemption for more than $350 million in outstanding revenue bonds.

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Speaker, “Regulatory Issues,” Annual Meeting of Florida Government Finance Officers Association, 1999
Panelist, “Bond Communications and Disclosure Issues,” American Bankers Association Capital Market Forum, February 2001
Panelist, “Plain English Disclosure,” National Association of Bond Lawyers Washington Seminar, May 2000

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Panelist, "Legal Issues and Hospital Continuing Disclosure," National Federation of Municipal Analysts and Municipal Securities Rulemaking Board Forum, New York and San Francisco, March 2000

Speaker, "Recent Developments in Securities Law," Annual Bond Attorneys' Workshop (Chicago), 1996, 1997, 1998, 1999 and 2000

- Served on Municipal Securities Rulemaking Board, 1996–99; Vice Chairman, 1998–99.
- Advised major teaching hospital on corporate restructuring and served as bond counsel for issues both before and after restructuring.
- Represented international investment banking firm as underwriters' counsel for more than $626 million in bonds (10 series) for major state university.
- Co-author, "Rule 15c2-12 Handbook" and "Disclosure Roles of Counsel in State and Local Government Securities Offerings".
- Lecturer in Law, University of Virginia.

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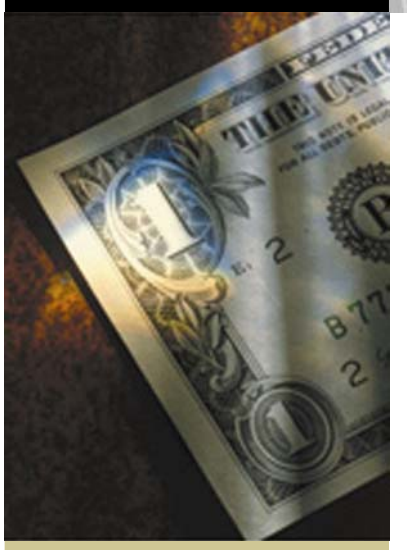

PUBLIC FINANCE

Public Finance

Hunton & Williams' public finance practice reflects experience in addressing virtually every significant legal issue that affects both governmental financing and tax-exempt financing for private entities. Our lawyers have served as bond counsel, special disclosure counsel and counsel to issuers, underwriters, trustees, credit enhancers and institutional investors in transactions throughout the United States. Our financings have covered all types of government obligations, including general obligation and revenue bonds for states and political subdivisions, as well as bonds for housing, airports, transportation, education and health care. We also have served as bond counsel, borrower's counsel and underwriter's counsel for tax-exempt financings for private colleges, hospitals and retirement facilities as well as the full range of tax-exempt borrowings available to private corporations.

In recent years we have devoted substantial resources to the challenges of public-private partnerships, including financings for privatized tolls roads, tax-increment financings and the development of community development districts. We have addressed all of the significant legal issues, including the federal tax regulations restricting "private use" in bond financed facilities and the state constitutional and statutory restrictions on governmental assistance to private entities. We have assisted in the development of financing techniques that allow the public sector to leverage private investment in much needed public infrastructure. These techniques also encourage accelerated private investment in stadiums, arenas, shopping malls, hotel/conference centers and other facilities promoting public purposes.

Our lawyers are well-versed in the federal tax law issues related to tax-exempt financing. Our specialists in this area devote substantial time to exploring tax questions raised by new financing techniques as well as constantly reviewing IRS regulations and rulings. Our ability to help our clients is enhanced by regular contact with both the IRS and Treasury Staff and the national tax-exempt bond bar. Our lawyers routinely serve as special tax-counsel for "tax intensive" financings, and the breadth of their knowledge is reflected in

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testimony before Congressional and IRS hearings as well as extensive writing and teaching activities. We have developed a special team to assist public finance clients undergoing IRS audit, and we have negotiated closing agreements with the IRS to preserve the tax-exempt status of bonds.

Hunton & Williams has taken a leading role in responding to the emerging standards in the application of the federal securities law to the sale of governmental bonds. We have participated in the industry-wide responses to SEC and other regulatory activities as well as the development of national "good practices" initiatives in municipal disclosure. In our representation of issuers and underwriters we have addressed the widest range of securities law issues affecting both governmental and private borrowers.

The firm's reputation is further evidenced by the leadership positions our lawyers have held both in the public finance bar and in organizations serving the national public finance industry. Two of them are former Presidents of the National Association of Bond Lawyers and one is a former Vice Chairman of the Municipal Securities Rulemaking Board.

Hunton & Williams takes particular pride in the ability of its public finance lawyers to find creative, soundly based legal structures for the ever-changing financing techniques that drive the world of public finance and tax-exempt borrowing.

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BONDS IN A NUTSHELL

The Basic Principles — State Bond Law, Federal Tax Law and Securities Law Considerations

By Robert Dean Pope

This outline sets forth the basic legal rules and restrictions that govern local governments, districts, special authorities and other public bodies when they issue bonds and utilize bond proceeds to finance public purposes. State law varies widely. Even within the same state, vastly different rules apply to different kinds of public bodies. The federal regulations governing the tax-exempt status of such bonds are especially complicated. **This outline is intended solely to assist in identifying issues that you may need to address. You will need sound and particularized legal advice in addressing your own financing plans**.

STATE PUBLIC FINANCE LAW

The ability of a local government, district, special authority or other public body to issue bonds is governed by state law. This law includes both constitutional and statutory restrictions.

Constitutional Limits

Every state constitution imposes restrictions on the incurrence of debt, usually both on the state itself and on its political subdivisions. These limitations often restrict the total amount of general obligation debt a local government can have outstanding at any one time, sometimes require voter approval of certain types of debt and frequently limit public borrowings to those that promote "public purposes" rather than "private purposes." This last requirement takes a variety of forms in state constitutions and currently is the subject of debate and litigation in terms of what kind of bond issues are permitted that may result in benefits to private businesses.

Statutory Limits

- Generally, any public body must find within an applicable statute a specific authorization to incur debt. The power to incur debt cannot be assumed.
- Statutory provisions customarily impose procedures for the incurrence of debt and limit the terms of the bonds and use of bond proceeds. In some states, such as Texas, public bodies may find that the authority to issue debt exists under multiple statutes and may have a choice of statutory provisions. In many states, however, a public body's ability to incur debt is governed exclusively by a single statute.
- Statutes frequently limit the use of bond proceeds to capital projects and related working capital, funded interest and issuance costs.

The Concept of Ultra Vires

Debt by public bodies is significantly distinguishable from corporate debt by the fact that debt invalidly issued by a public body is "ultra vires," i.e., outside the authority of governmental body — and therefore unenforceable by creditors. The concept of ultra vires no longer has application to debt of private corporations. It continues, however, to apply to debt of states and their political subdivisions. Indeed, the principal reason why the role of bond counsel came to exist was to provide investors protection against invalid bonds.

- The purpose of the bond counsel opinion is to give investors assurance (but not a guarantee) that the bonds are validly issued.
- If bonds are not validly issued, the governmental borrower generally will not be required to pay the



debt. Furthermore, in many states, the governmental borrower cannot even *choose* to pay invalidly issued debt.

- The concept of ultra vires is alive and well in the United States. Most spectacularly it resulted in the largest governmental bond default in history. In 1983, the infamous "WPPSS" default, i.e., default in the payment of more than $2 billion of debt by the Washington Public Power Supply System, resulted from state court opinions holding that the obligations of local governments within the system to make payments on the bonds were invalid.
- Increasingly taxpayers are challenging bond issues that they believe either go beyond the power of the locality to issue debt or have a constitutional or statutory defect. In particular, taxpayers are bringing litigation against bond issues that are perceived to aid improperly private parties who directly or indirectly benefit from the issuance of the bonds. Many of these suits are brought by businesses whose competitors are beneficiaries of the bond issue. **Every public body should assume that among its local citizenry will be individuals who are ready, willing and able to challenge controversial or legally suspect bond issues.**

Home Rule vs. Dillon's Rule

In some states public bodies, particularly cities and counties, are assumed to have broad "home rule" powers, much as private corporations in their corporate charters have broad powers. In many states, however, local governments and other political subdivisions are subject to Dillon's Rule. This principle of statutory interpretation holds that public bodies have only the powers that are specifically granted to them under the clear language of a statute.[1] Thus, in a Dillon's Rule state, the issuer and its bond counsel need to satisfy themselves that an applicable statute specifically authorizes the incurrence of debt for the purposes and on the terms undertaken.

Non-Debt Debt

Local governments increasingly raise money through bond offerings where the locality does not technically incur debt. These financings utilize such terms as municipal leases, certificates of participation and subject-to-appropriation financings. The principal distinction between these financings and traditional bonds is that the locality is legally obligated to pay the debt only if its governing body each year appropriates the debt service payments for that year. This form of financing may permit a locality to avoid debt limits, referendum requirements and other restrictions. Such financings usually require higher interest rates because of the risk of non-appropriation.

Federal Tax Exemption

Most, but not all, bonds issued by state and local governments qualify for exemption under federal income taxation, i.e., interest paid on the bonds is excludable from the gross income of bondholders for the purpose of federal income tax. The benefits of this are obvious and substantial. Investors are willing to accept lower rates on bonds that are tax exempt, thus reducing substantially the interest costs paid by the governmental borrower. Local governments and other public bodies, however, generally also can issue bonds that are valid under state law but do not qualify for the federal tax exemption. Obviously, taxable bonds will bear a higher interest rate, reflecting the taxable rather than the tax-exempt interest rate that the market determines is applicable for the particular credit being sold.

The Federal Tax Exemption is a Creature of the United States Congress

- For many decades state and local governments believed that the tax exemption of their bonds was required by the U.S. Constitution. In 1988, the United States Supreme Court rejected this view, holding that the federal tax exemption for governmental bonds is entirely at the discretion of the federal government.
- There appears to be little risk that Congress will eliminate the basic exemption applicable to governmental bonds, especially for traditional bonds for public improvements owned and operated by the government. Congress, however, has imposed many

[1] Dillon's Rule provides that municipal corporations have only those powers expressly granted to them, those necessarily or fairly implied from an express grant and those essential (and not merely convenient) to accomplish their public purposes. Under the Rule, any doubt as to the authority of a municipal corporation is resolved by concluding that it does not have the power in question.



restrictions on the issuance of such bonds, even by traditional governmental bodies, and is free in the future to impose additional restrictions.

The General Restrictions

The regulations under the Internal Revenue Code relating to the tax exemption of state and local government bonds are arcane, complicated and confusing, even by the standards of the Internal Revenue Code. The rules frequently are counterintuitive, and the regulations reflect generally a desire by the Internal Revenue Service to restrict the issuance of tax-exempt bonds as much as possible consistent with the Internal Revenue Code.

- *Public Use*. Tax regulations generally are designed to permit tax-exempt bonds issued by a public body for a public purpose and not primarily for the benefit of or use by private companies or individuals in their own business. These general principles result in restrictions on the use of tax-exempt bonds in many areas, including the following:
  - Public/private partnerships.
  - Facilities with use by both governmental and private entities.
  - Public facilities operated or managed by private companies.
  - Facilities that produce special benefit for private entities.
- *Useful Life*. Federal tax regulations restrict the term of a bond issue. Generally the average life of the bonds cannot exceed 120% of the useful life of the facilities financed. Thus, you cannot issue 30-year bonds exclusively to finance equipment with a useful life of five years. You can, however, include such equipment in a 30-year bond issue if the average useful life of everything financed permits compliance with the 120% test.
- *Arbitrage and Rebate*
  - The arbitrage regulations generally restrict the ability of a governmental entity to borrow on a tax-exempt basis and then invest the bond proceeds at higher, taxable rates. These complicated regulations affect the ability of localities to invest bond proceeds that are (i) held in construction funds prior to their expenditure or (ii) held in reserve funds securing the payment of the bonds. They also treat as bond proceeds subject to arbitrage restrictions certain other governmental funds that are not directly the proceeds of bonds but are deemed to be proceeds under the tax regulations. For example, if a governmental body establishes a special sinking fund for payment of bonds and holds money in such fund for a number of months prior to using the money to pay debt service on the bonds, such money may be subject to the arbitrage restrictions.
  - In 1986, Congress applied to local governmental entities the concept of arbitrage rebate. The rebate requirement is simple in concept. If a public body borrows on a tax-exempt basis, then any investment earnings on bond proceeds at taxable interest rates in excess of the interest rate paid by the governmental body to investors must be "rebated" or paid to the federal government. If, e.g., a local government borrows money at 4% and then, prior to expenditure, invests the proceeds of the bonds at 5%, it must pay the 1% differential to the federal government.
  - The process of calculating rebate can be cumbersome and expensive, even if the calculation ultimately shows that the issuer in fact does not have to pay any rebate.
  - The tax regulations create certain exceptions from the requirement to calculate and pay rebate. These exceptions generally require that bond proceeds be spent promptly pursuant to certain benchmarks. For example, under one of the exceptions, the requirement to calculate and pay rebate will be avoided if 10% of the proceeds of the bonds is spent within six months of issuance, 45% within 12 months of issuance, 75% within 18 months of issuance, and 100% within 24 months of issuance. It is always desirable to try to qualify for an arbitrage rebate exception.
  - Generally an issuer can issue tax-exempt bonds only if it reasonably expects to spend substantially all of the proceeds of the bonds within three years of issuance.
  - There are limits on the ability of an issuer to use bond proceeds to reimburse itself for project costs incurred prior to the issuance of



the bonds. The issuer can preserve its right to reimburse itself for such costs (and therefore permit the issuance of bonds after the undertaking of a project) by passing a qualified "reimbursement resolution" expressing intent to use bond proceeds for the permanent financing of the project.

- The arbitrage regulations severely limit the ability to borrow for working capital.

Compliance and Audits

- Local governments and other tax-exempt borrowers need to monitor the expenditure of bond proceeds to promote and evidence compliance with arbitrage and other applicable tax regulations. Bond counsel customarily requires at closing representations by the issuer as to its "reasonable expectations" as to the uses of bond proceeds and the schedule of expenditures. Issuers need to take all reasonable steps to ensure that proceeds are spent as originally projected. The regulations recognize that circumstances can alter expenditures and their timing, but any significant departure may create risks that are best dealt with by a memorandum to the file or other documentation evidencing the reason why the original expectations were not met.
- These practices are especially important in light of the new compliance program of the IRS, which includes both random and targeted audits of issuers. Any IRS audit should be taken seriously, and written evidence of an issuer's compliance can provide important protection to an issuer if it is audited.

Federal Securities Laws

General Application of the Federal Securities Laws

The federal securities laws, primarily the Securities Act of 1933 and the Securities Exchange Act of 1934, govern the sale of securities to investors. Most significant for state and local government issuers are the "antifraud provisions." The general principle of these laws is to require "full disclosure" to investors of all of the risks of buying the bonds.

The Federal Securities Laws Apply to Local Government Entities

Twenty years ago many public officials did not believe that the federal securities laws applied to the issuance and sale of bonds by state and local governments. While such bonds are not subject to requirements applicable to many private businesses to register the offering with the Securities and Exchange Commission, it is now clear that the antifraud provisions do apply to local government bodies — and their officials.

- In the last decade, the Securities and Exchange Commission has brought enforcement proceedings against both local governments and their officials. These include Orange County, California, Maricopa County, Arizona, the City of Syracuse, New York, and the City of Miami, Florida.
- The Securities and Exchange Commission can bring securities laws actions against governmental bodies even if they have not defaulted on their bond payments.
- Subject to limitations, private investors also can bring securities fraud suits against local government entities and their officials.

The Two-Prong Standard of Full Disclosure

SEC Rule 10b-5 sets forth the basic standard for full disclosure. It requires that in any sale of securities, the issuer must produce disclosure that (1) does not contain any misstatement of a material fact and (2) does not contain a "material omission." Generally a fact is "material" if any reasonable investor might consider it significant in making a decision to buy the bonds.[2]

Practical Applications of the Antifraud Provisions

The practical result of these requirements is that in any public sale of any of its bonds, a public body must produce an official statement or other offering document that contains "full disclosure." Full

2 Rule 10b-5 provides that it is unlawful for any person (which may be a public body), directly or indirectly, in connection with the purchase or sale of any security, "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading."



disclosure consists of (1) providing the information necessary for the investor to make a reasonable decision, (2) not making any "material misstatements" and (3) most challenging, avoiding any "material omissions."[3]

- Public bodies cannot delegate to third parties, such as underwriters and financial advisors, complete responsibility for the accuracy and adequacy of their disclosure. At the end of the day, the governmental issuer is responsible for its own bond offering document.[4]
- The most common disclosure problem traditional local governments face is describing financial developments subsequent to the most recently completed audit. If a county, for example, is issuing general obligation bonds in November, and its last audit covers the year ended the previous December 31, it must consider what, if any, disclosure is necessary on financial and other developments affecting its credit worthiness over the ten-month period subsequent to the last audit.

Public Offerings vs. Private Placements

An issuer may reduce, but not eliminate, its risks under the federal securities laws by selling its bonds to institutional investors in "private placements" rather than public offerings. Private placements are customarily made to institutional investors with the bonds sold in large denominations. Securities law risks remain, however, even in a private placement, and there is some confusion in the public finance world as to exactly what constitutes a private placement.

Continuing Disclosure

Local government entities now are required to supplement the disclosure made in their official statement with additional disclosure, to be provided to investors, either directly or through nationally recognized municipal securities information repositories ("NRMSIRs").

- SEC Rule 15c2-12 with some exceptions requires issuers to produce certain limited continuing disclosure. This includes the filing of annual financial information and operating statistics and notice of certain specified events, such as bond defaults, modification of security provisions, defeasances and rating changes.
- For certain types of bonds, investors are increasingly requiring the filing of quarterly financial information.
- The continuing disclosure information that an issuer files constitutes "speaking to the market" under the federal securities laws and therefore must be reviewed for accuracy and adequacy.

Conduit Bonds

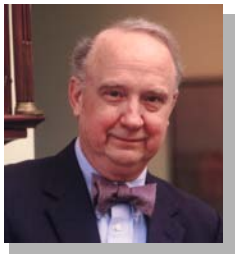
Both state public finance law and federal tax law permit the issuance of "conduit bonds." This term applies to bonds issued by a local government or special authority for the benefit of a private entity and payable exclusively from revenues received from the private entity. The result is usually a private financing through a public body with no tax dollars or other public funds pledged to bond payment.

- Most states permit conduit bonds to be issued for a variety of projects such as hospitals, colleges, museums and various manufacturing and commercial enterprises.
- Federal tax law severely restricts the use of tax-exempt financings for such bonds. Subject to a complex body of restrictions, exceptions and limitations, tax-exempt bonds can be issued for (1) projects for charitable tax-exempt "501(c)(3)" organizations, (2) low-income housing projects, (3) manufacturing facilities and (4) certain "exempt facilities" such as solid waste and sewage facilities, airports and dock facilities. ■

3 The following example conveys the concept of material omission. A county issues general obligation bonds on November 1. Its disclosure consists primarily of its audited financial statements and related financial statistics for the fiscal year ended the previous June 30. That information includes a list of the county's five largest taxpayers, which collectively accounted for 60% of tax revenues. All of the statements made by the county are accurate. The failure, however, to disclose in the offering document that in the last four months, three of the largest taxpayers have declared bankruptcy and discontinued their operations within the county almost certainly would be a material omission.

4 See Robert Dean Pope, **Making Good Disclosure: The Role and Responsibilities of State and Local Officials Under the Federal Securities Laws** (Government Finance Officers Association, 2001).





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Mr. Pope is a graduate of Princeton and the Yale Law School. He also holds a Diploma in Historical Studies from Cambridge University and a Ph.D. in history from Yale.

Public Finance at Hunton & Williams

Hunton & Williams has one of the largest and most diverse public finance practices in the United States. Our lawyers serve as bond counsel, underwriter's counsel and special disclosure counsel and also represent governmental entities, conduit borrowers, trustees and credit enhancers in the financing of schools, public utilities, airports, hospitals, retirement facilities, housing projects, toll roads, universities and museums. Our lawyers advise states, local governments, housing agencies and special authorities on virtually every kind of borrowing available to public bodies, including variable rate, credit enhanced and short-term transactions.

Our lawyers also are active in legislative matters affecting public finance and have extensive experience in workouts and other matters related to defaulted and troubled bond issues.

Please visit www.hunton.com for more information about Public Finance at Hunton & Williams or to contact our Public Finance Lawyers.

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