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FINANCE AND ECONOMIC DEVELOPMENT 101

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I. Classification and Characteristics of State and Municipal Bonds

- Full faith and credit or tax-supported debt – tax-payers at risk – *Flushing National Bank v. MAC*
- Revenue bonds – issued by state or municipality and paid from enterprise revenues
- Industrial development bonds – paid from project revenues by for-profit entity
  - Appropriation-backed debt – mimics full faith and credit debt but payment subject to annual appropriation
  - Hybrid bonds – *e.g.*, tax-increment financing – mimics full faith and credit debt for economic development projects
  - All municipal bonds are debt – never equity – and have an issuer, face amount. interest rate, maturity date, dated date, may be redeemable before maturity, may be payable as to principal annually as serial bonds, or may be payable as to principal at maturity as term bonds from a sinking fund

II. Origins, Nature and Limitations of Power to Borrow

- Monopoly to provide service demanded or used by everyone
- Recognition of the political subdivision under state law and federal tax law
- Early concepts of "public purpose"
- Borrowing authorized by legislative enactments and state constitutions only until imposition of federal income taxation and regulation of securities markets
- How debt paid for:
  - Through taxes – taxpayers at risk
  - Through benefit assessments – taxpayers may be at risk
  - Through non-tax revenues – investors at risk
- Unrestrained state/local borrowing and perceived abuses
- Weakness in the banking 19th century banking system and lack of federal oversight
- State law reaction to borrowing excesses:
  - Debt limits, voter approval
  - Dillon's Rule

III. Origins and Development of Public Authorities

- State-wide and regional public facilities required expansion of borrowing powers
- Debt limit requirements hindered financing through direct state and local debt
- Early public authority debt was financed through user revenues, not taxes, as true public enterprises
    - Port Authority of NY and NJ – bridges and transit terminals
    - Highway authorities
    - Parking authorities
- Borrowing authorized by legislative enactments
- Debt of public authorities (and New York City) led to federal regulation of underwriters selling and reoffering of municipal bond
    - The breakdown of intergovernmental immunity
    - The unique system of voluntary disclosure and state sovereignty
- Debt of public authorities became a popular tool for avoidance until the tax reform acts of 1982 and 1986:
    - The legacy of bearer bonds and the *South Carolina v. Baker* case
    - Federal tax law curtails public purpose financing – *e.g.,* sports stadiums

IV. Origins of Economic Development/Industrial Revenue Bonds

- Domestic economic expansion after World War II – tax-exempt financing reconsidered - particularly in the South in response to defaults after Civil War
- Growth of public sector financial assistance for housing and urban renewal purposes coupled with federal grant assistance
- Economic development as a public purpose – increasing or sustaining construction or permanent jobs
- The anomaly of "public purpose" under IRC §103(a) for lending to private parties for public benefit while avoiding the pledge of taxes or public revenues to secure debt
- Inflation of the late 1970s-early 1980s stimulated tax-exempt economic development financing and IRS attempts to curtail the "federal subsidy" to states and locals
- 1986 IRC; TEFRA; and the development of "private activity bonds" and "exempt facilities"
- The use of NFP corporations in context of economic development
    - Development of local development corporations
    - Use of qualified tax-exempt §501(c)(3) bonds

V. Origins of Appropriation-Backed Debt

- Development of tax-exempt leasing in the 1980s
- Development of state public authority revenue bonds secured by legislative appropriations absent enterprise revenue: *Lonegan v. New Jersey, LGAC v. STARC*
    - Constitutional issues – looks like full faith and credit debt but no vote, etc.
    - Deficit financing as a public purpose for appropriation backed debt
- Development of securitization of revenue streams through appropriation-backed debt – *McGreevy v. New Jersey*
- Rethinking the concept of "public purpose" in public finance – guidance from *Kelo v. New London* – deference to the legislative body

VI. Origins of Tax Increment Financing (TIF)

- Follows urban renewal financing concepts
- Carves out incremental increases in real property tax resulting from increased assessed value through economic development of blighted or underused property
- Proceeds limited to traditional public purpose infrastructure
- Compare TIF bonds to use of PILOTS in economic development financing

VII. How Bonds are Authorized

- Tax-supported debt authorized under strict state constitutional and statutory rules because the taxpayers are at risk – no legislative discretion
  - Requirement of voter approval
  - Requirement of hearing with due notice
  - Requirement of preliminary proceedings
  - Requirement of debt caps and limits
  - Authorization in compliance with IRC and securities law requirements
  - Delegation of authority to issuing officer
  - Failure to comply with authorization requirements – 19th century view
- Non-tax supported debt authorized by state enabling legislation and special act of issuing entity – limited legislative discretion
  - No requirement of voter approval
  - No requirement of debt caps and limits
  - Authorization in compliance with IRC and securities law requirements
  - Failure to comply with authorization requirements – modern view
- "On behave of" and other NFP corporation debt authorized by general state enabling law - wide legislative discretion
  - No requirement of voter approval
  - No requirement of debt caps and limits
  - Authorization in compliance with IRC and securities law requirements
  - Failure to comply with authorization requirements – corporate law view

VIII. How Bonds are Issued

- Tax-supported debt often sold through competitive sale to ensure fairness and transparency in interest rate and price for bonds – requirement may be statutory
  - Sealed bids, notice of sale
  - Limited disclosure for smaller transactions and short-term bonds/notes
  - Selection of paying agent or use of DTC or similar entity with "book-entry-only"
  - Estoppel or validation protection against claim of invalidity for failure to substantially comply with authorization or issuance procedures
  - Need to distribute an official statement (OS) – in a competitive bid sale the OS is generally considered the issuer's document as to content
  - The impact of SEC Rule 15c2-12 on primary and secondary disclosure

- Non-tax supported debt usually sold through negotiation under broad delegation of power for finance officer to set terms of the bonds
  - Issuer selects a financial advisor
  - Issuer selects an underwriter and sells bonds through a negotiated bond purchase agreement
  - Issuer selects a financial institution to act as trustee and paying agent or issues "book-entry-only"
- The use of bond insurance and letters of credit to secure payment of bonds

IX. How Interest on Municipal Bonds Becomes Tax-Exempt

- For interest on municipal bonds to be exempt from federal income taxation, several requirements of the IRC must be met to be a governmental bond or a qualified private activity bond
  - Issuer must be a political subdivision; the instrument must be debt
  - Interest on the bonds must be separately set forth
  - Payment of bonds cannot be guaranteed by the federal government
  - Bonds must be issued in registered form (not payable to bearer)
  - Bonds must not be "arbitrage bonds"
  - Arbitrage earnings must be "rebated" to the IRS
  - Current refunding bonds
  - Advance refunding bonds – comparing "yields" on refunded and refunding bonds; call for redemption prior to maturity
- Industrial development bonds payable by a non-governmental entity are private activity bonds (PAB) and their interest is taxable unless an exemption applies
  - TEFRA proceedings; private business use test
  - Private payment or security test – both tests must be satisfied
  - State-by-state volume cap on PABS – except qualified §501(c)(3) bonds
  - 5% "bad money" test - use of proceeds
  - 2% costs of issuance from proceeds test – "taxable tail"
  - Exempt facility PAB; qualified §501(c)(3) bonds
  - Qualified "small issue" bonds for manufacturing facilities

X. Impact of Federal Securities Law on Municipal Bonds

- Federal government may not regulate the states under the 10th Amendment of U.S. Constitution
  - Exempt from registration of bond issues under Securities Act of 1933 – but definition of "person" includes a government or political subdivision
  - 1975 Tower Amendment created MSRB to regulate underwriters which deal in municipal securities – indirect regulation of state and municipal bond issues
  - Anti-fraud provisions of §10(b) of Securities Exchange Act of 1934 applies to disclosure by states and municipalities in offerings of municipal securities
- MSRB establishes rules for underwriters and financial institutions in underwriting and selling municipal securities

- Rule 15c2-12 establishes standards for providing disclosure (but not disclosure content) for underwriters and financial institutions dealing in municipal securities
  - Primary disclosure
  - Secondary market disclosure – the 1995 amendments
  - The impact of a "material events" filing with a NRMSIR
- Standard for liability for violating federal securities laws in municipal securities offerings is "scienter" - *Ernst & Ernst v. Hochfelder*
  - A state of mind to deceive, manipulate or defraud
  - Negligence standard not sufficient to prove liability for fraud