Government Bonds: An Introduction for Issuing State and Local Government Attorneys

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A Practice Note introducing municipal bonds to attorneys representing state or local governments that issue bonds. This Note introduces bond transactions, covers the role and obligations of the issuing counsel, introduces obligations related to federal taxes, and offers key components of compliance policies and procedures.

An attorney representing a state or local government may be asked to assist in the issuance of municipal bonds. The matters that the state or local government attorney should consider in representing a client during a municipal bond issue include:

- The opinion that the attorney will be required to deliver at closing.
- The type of bond to be issued.
- The method that the bonds will be sold, whether publicly offered or privately placed.
- If the bonds are to be publicly offered:
  - the existing disclosure by the issuer;
  - the additional disclosure required for the issue; and
  - the continuing disclosure required after the issue.
- The issuer's compliance with the federal laws governing tax exemption, particularly regarding rebate reporting and private use.

The role of the issuer's counsel in a government bond transaction is limited but vital, particularly following the closing of the bond issue. At the beginning of a bond transaction, the issuer's counsel should determine the scope of the opinion required at closing (see Counsel Opinions). During the transaction, the issuer's counsel should ensure that all matters necessary to render that opinion have been duly addressed and evaluated. Following the transaction, the issuer's counsel should have in place procedures that ensure the issuer's compliance with the tax and disclosure rules (see Federal Tax Issues and Disclosure Issues). Adopting formal post-issuance policies and procedures is a highly useful way to minimize the possibility of noncompliance (see Compliance Policies and Procedures).

This Note is designed for the attorney representing a state or local government as the issuer's counsel (rather than as the bond counsel) in a municipal bond transaction. This Note assumes that a separate attorney or firm is acting as the bond counsel, and that this attorney or firm is responsible for more specialized functions that are beyond the scope of this Note. The attorney seeking guidance as the bond counsel should seek more detailed guidance elsewhere.

This Note uses the term "municipal bonds" to refer to bonds issued by state and local governments.

For an overview of the legal issues in local government finance, including budgetary and spending issues, see Practice Note, Legal Issues in Municipal Finance (w-001-5064).

BASIC STRUCTURE OF A BOND DEAL

The basic structure of a conventional bond deal is straightforward. Rather than borrowing money through a loan agreement, the state or local government issues municipal bonds. In a loan transaction, the government would be called the borrower but, in this context, the government is generally called the "issuer." The municipal bonds represent the issuer's promise to repay the stated principal amount, together with interest. The counterparty to the transaction buys the bonds, in effect loaning the proceeds to the issuer. Again, in a loan transaction, the counterparty is called the lender but, in this context, the counterparty is generally called the "purchaser."

In the simplest transaction, a single purchaser buys a single bond from the issuer, with a fixed rate of interest. Complexities quickly arise, however. For example, in lease-purchase financing the government enters into a capital lease to acquire equipment or property from a vendor, with the initial acquisition costs being provided by a financial institution. In this case, the government is generally called the "lessee" and the financial institution being called the "lessor." This form of arrangement, and other similar variations, are explored throughout this Note.

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COUNSEL OPINIONS

A municipal bond transaction implicates two main attorney-client relationships:

- **The bond counsel.** The bond counsel occupies a specialized role that specifically relates to the issuance of municipal bonds. The role of the bond counsel arose following the issuance by many state and local governments of bonds in the late nineteenth century to finance large-scale projects like railroads, state-chartered banks, and canals. A significant portion of those projects failed and, given the size of the borrowings involved, led to defaults on the accompanying municipal bond issues. Thereafter, many of these municipal bond issues were either repudiated or declared illegal, and the dealers and purchasers and of the bonds suffered massive losses. As a result, the dealers and purchasers of municipal bonds began to require that expert counsel render a legal opinion that the bonds were legal and enforceable obligations of the issuing government.
- **The issuer's counsel.** The primary counsel to the state or local government will also serve a specific role in a municipal bond transaction. The role and duties of the counsel to the state or local government, referred to in this note as the "issuer's counsel," are the main subject of this Note.

The transaction by which municipal bonds are issued may be complex, and may involve a host of additional participants (and attorneys) with different roles and interests (see Transaction Participants).

In any event, at the closing of a municipal bond transaction, at least two major opinions will be delivered, the opinion of the bond counsel (see Bond Counsel Opinion) and the opinion of the issuer's counsel (see Issuer's Counsel Opinion).

BOND COUNSEL OPINION

The bond counsel's opinion will provide that, at a minimum:

- The bonds have been duly authorized and executed by the government.
- The bonds are valid and binding obligations of the government.
- Interest on the bonds is excludable from gross income for federal income tax purposes.

The bond counsel's opinion may cover additional items, for example that ad valorem taxes may be levied to pay debt service on the bonds (for general obligation bonds) or that revenues of the system have been pledged for payment of the bonds (for revenue bonds). In general, however, the bond counsel's opinion is short and explicitly relies on conclusions given in the issuer's counsel opinion.

ISSUER'S COUNSEL OPINION

The opinion of the issuer's counsel will cover specifically local or internal items that are necessary for the bond counsel to render its opinion. The bond counsel may require the issuer's counsel to opine, and will rely on the issuer's counsel's opinion, whether:

- The meetings at which the government approved the municipal bonds were duly noticed and called.
- The issuer complied with applicable sunshine or freedom of information laws in approving the transaction.
- If the property or equipment purchased with bond proceeds is part of the security for the borrowing, the issuer complied with applicable procurement laws in acquiring the property or equipment.
- The person signing the bonds and bond documents was authorized to do so.
- The execution and delivery of the bonds does not conflict with any other agreements or local laws by which the issuer is bound.
- The issuer is not in default under any existing bond issues or contracts.
- No litigation is pending or threatened against the issuer that challenges the issuance of bonds or that could materially affect the issuer's ability to repay the bonds.
- The portions of the disclosure documents (if any) that specifically relate to the issuer do not:
  - contain any untrue statements; and
  - omit any material facts that are necessary to make the statements that are contained in the disclosure not misleading (the 10b-5 statement).

Therefore, the role of the issuer's counsel in a municipal bond transaction will largely be defined by the content of the issuer's counsel opinion required to be delivered at closing. Although the issuer's counsel will surely have other responsibilities in a municipal bond transaction, at a minimum the issuer's counsel must be prepared to opine on the matters specified above. The issuer's counsel should determine as quickly as possible the scope of the opinion expected at closing. The form of that opinion will not only define the role of the issuer's counsel, but will also provide the context for most of the questions that the issuer's counsel should ask.

TYPE OF BONDS

The responsibilities and duties of the issuer's counsel depend on the type of bond being issued. In addition, the type of bonds being issued influences the complexity of the transaction. In every state, the major classification to be made is between:

- General obligation bonds (see General Obligation Bonds).
- Revenue bonds (see Revenue Bonds).

GENERAL OBLIGATION BONDS

General obligation bonds are secured by the full taxing power of the issuer, and are therefore commonly described as involving a pledge of the full faith and credit of the government. In other words, the issuer might be forced to increase taxes without limit to retire the debt. The issuer may, subject to applicable state law, use sources of revenue other than taxes to retire the debt. The point is that if the sources of revenue are inadequate to service the debt, the bondholder can require the issuer to use its taxing power to raise additional revenue.

State law imposes significant restrictions on the issuance of general obligations bonds because they implicate the unrestricted taxing power of the issuer. The issuance of general obligation bonds is usually subject to either or both:

- A stated debt limit.
- Voter approval requirements.

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Furthermore, general obligation bonds, because they implicate the taxing power, are the most restricted, in terms of:

- Purpose.
- Amount.
- Term to maturity.
- Public approval process.
- Method of sale.

REVENUE BONDS

All municipal bonds, aside from general obligation bonds, are technically revenue bonds. However, municipal-revenue bonds can assume a variety of different forms. Common examples of the variety of revenue bonds include:

- **Utility revenue bonds.** Utility revenue bonds are secured by revenues of a revenue-generating utility system or systems, and are not subject to a legal debt limit, but do contain coverage requirements in the issuing instrument. Common requirements include both:
  - an earnings test, where net revenues must exceed expenses and debt service by a certain amount (usually 110-125%); and
  - an additional bonds test, where the issuer cannot issue additional bonds unless net revenues are projected to exceed expenses plus debt service (including the proposed new issue) by a certain amount (usually 120-150%).

  Although traditional utilities like electricity, water, and sewer are the most common security, this type of bond may (subject to state law) be supported by any revenue-generating enterprise, such as parking, tolls, or admission fees.
- **Certain lease-purchase agreements.** Lease-purchase agreements take the form of a lease under which lease payments include a principal and interest component. At the end of the lease, the lessee owns the asset or can purchase it for a nominal amount. This is effectively a financing lease, and the most common purpose to use this structure is either to streamline the acquisition of movable equipment or to evade the debt limit. The lease should contain a nonappropriation clause, which allows the lessee to fail to budget the lease payments, thereby forfeiting the collateral. This feature is ordinarily interpreted to mean that the lease is not debt for constitutional purposes. Some states modify this interpretation by statute.
- **Other types of revenue bonds.** Other revenue bonds may, to the extent permitted by state law, allow the securitization of revenue streams other than utility revenues, for example:
  - hospitality or accommodations fees;
  - special assessments;
  - tax increment payments; and
  - certain types of sales tax payments.

  The common aspect of these bonds is that the underlying revenue stream is not a generally applicable tax that would implicate the full faith and credit of the issuer.
- **Special source revenue bonds.** Special source revenue bonds are secured by payments or fees instead of taxes, for industrial projects that meet the state requirements for granting fee-in-lieu-of-tax (FILOT or PILOT) treatment to a project.
- **Bond anticipation notes.** Bond anticipation notes are secured by the promise to issue a takeout bond in the future. These bonds are generally short-term obligations that serve as bridge financing until the permanent financing is put in place.
- **Tax anticipation notes.** Tax anticipation notes are secured by the receipt of future taxes. Municipalities with cash flow challenges can use these notes to fund operations pending the receipt of taxes. For example, if tax receipts arrive in February for an entity using a June 30 fiscal year, a tax anticipation note can cover budgeted expenses during the period before February.
- **Grant anticipation notes.** Grant anticipation notes are secured by the proceeds of a future grant and, as with bond anticipation notes, can serve as bridge financing before a permanent financing solution is implemented.
- **Conduit bonds.** Conduit bonds are less commonly used by municipalities (instead being commonly used by States, agencies, and counties), and are generally secured by a loan agreement with a third party that ultimately receives and makes use of the bond proceeds. For example, an economic development authority would issue bonds to the market, loan the proceeds to an industry, and pledge the revenues under that loan agreement to the payment of the bonds. These bonds allow the government to serve as a conduit to raise financing for another entity.

METHODS OF SALE

PRIVATE SALE

The simplest municipal bond transaction involves a state or local government selling bonds directly to a financial institution. These types of transactions may involve as few as two participants, the issuer and the purchaser. The purchaser in this instance directly acquires the municipal bonds, either for its own portfolio or for resale or assignment to a collateralized pool. The main advantage of a private placement is its simplicity. The purchaser is essentially making a loan directly to the issuer, and usually compensation to the purchaser comes in the form of interest payments on the municipal bonds. This arrangement requires almost no disclosure, minimizes the number of additional required participants, and is relatively cheap in terms of transaction costs.

A common misconception is to use the term "bank-qualified" to mean a bond that is placed with a bank. The term "bank-qualified" is a tax concept that allows favorable interest treatment to the bank for certain types of issues or issuers. A bond may not be bank-qualified and may still be sold to a bank.

PUBLIC SALE

Private placement with a financial institution is not always an option, because of the size, term to maturity, or complexity of the municipal bonds. In this case the municipal bonds may be sold to the public capital markets. This form of transaction requires the involvement of an underwriter, which purchases the municipal bonds directly from the issuer and then resells the bonds to the investing public

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(usually in denominations of $5,000). Selling an issue to the public capital markets raises disclosure issues, increases the relative cost of issuance, and requires greater effort by the issuer. The public capital markets generally offer more competitive interest rates.

TRANSACTION PARTICIPANTS

The participants in a privately placed municipal bond transaction might include only the issuer and the purchaser. In virtually every case, however, the purchaser will require that the issuer retain and compensate the bond counsel, on whose opinion the purchaser will heavily rely. Furthermore, most of the time the issuer will choose or be required to retain issuer's counsel. In addition, the purchasing entity may (and often does) retain its own counsel.

More participants will necessarily be involved in a publicly sold municipal bond transaction. The most common participants, in addition to the issuer, bond counsel, and issuer's counsel, are:

- **The underwriter.** For issues sold to the public capital markets the underwriter is the entity that purchases the bonds from the issuer and then resells them to the public.
- **The underwriter's counsel.** A separate legal counsel representing the underwriter. The primary duties of the underwriter's counsel are to draft the Bond Purchase Agreement between the underwriter and the issuer and to coordinate the preparation of, and possibly opine on, the disclosure documents.
- **The disclosure counsel.** The disclosure counsel may assist the issuer in preparing, and may opine on, the primary disclosure. Either the underwriter's counsel or separate disclosure counsel will have primary responsibility for preparing and opining over the disclosure. Sometimes, the person or firm serving as the bond counsel may also serve as disclosure counsel. The important point for the issuer's counsel is to know which person or entity is serving as the disclosure counsel, for the reasons described further below under the heading Primary Disclosure.
- **The trustee.** An entity serving in the interest of the bondholders to, for example:
  - receive payments from the issuer;
  - make payments to the bondholders; and
  - enforce rights under the bond documents.

  The trustee is deemed to represent the interests of the bondholders as a whole. For example, if the issuer is in danger of defaulting on the municipal bond issue, the trustee is expected to step in and enforce the rights of the bondholders against the issuer.
- **The trustee's counsel.** A separate legal counsel representing the trustee. The primary duty of the trustee's counsel is to ensure that the trustee is not subject to liability for receiving, investing, and receiving payments regarding the bonds and for monitoring the rights of the bondholders.
- **The financial advisor.** An independent firm that assists and advises the issuer in, for example:
  - structuring the bonds;
  - selecting an underwriter;
  - securing ratings; and
  - acquiring credit enhancement.
- **The credit enhancer.** An entity that enhances the rating of the bonds by, either:
  - insuring their payment; or
  - supporting them with a letter of credit.

AUTHORIZATION AND COMPLIANCE ISSUES

Either the bond counsel or the issuer's counsel (or some combination of both) will opine that the municipal bonds have been duly authorized, executed, and delivered, and constitute valid and enforceable obligations of the issuer (see Counsel Opinions). Rendering this opinion requires counsel to understand and analyze applicable law, especially that law which applies to the government's authority to act and make the issue.

CONSTITUTIONAL AND STATUTORY AUTHORIZATION FOR THE ISSUE

At the state level, municipal bonds must be permitted by both the state constitution and statutes. At the local level, municipal bonds in all events must comply with the state constitution, but whether and to what extent the bonds must comply with state statutes depends on the jurisdiction. For example, many states require a referendum before the issuance of at least some types of municipal bonds. In the absence of clear tradition and precedent, the best practice for local government is to carefully comply with state statutes in issuing municipal bonds.

Local laws may also apply to a local government's ability to issue bonds. For example, local law may require a public hearing before certain types of actions, or may require that ordinances or resolutions be signed in a certain way.

Ordinarily the bond counsel will opine as to whether the municipal bond issue is permitted by state constitutional and statutory law (see Bond Counsel Opinion). Nevertheless, the issuer's counsel should be aware of the constitutional and statutory law applicable to the issue. Moreover, the issuer's counsel will ordinarily opine on applicable local law (see Issuer's Counsel Opinion). The issuer's counsel should, therefore, be familiar with the local law and ensure that the municipal bond issue complies with any applicable local law.

Home Rule and Authorization for Issue

Most states follow at least some form of Home Rule regarding at least some local governments. In theory, Home Rule means that local governments have self-governing authority within legislative spheres that have not been preempted by the state. At least some Home Rule states (for example, Illinois) allow certain local governments to issue municipal bonds in accordance with local authorizing procedures. Most states, however, require even Home Rule jurisdictions to comply with state statutes for municipal bond issues.

Dillon's Rule and Authorization for Issue

Under Dillon's Rule, local governments only have powers that are:

- Explicitly granted to them by the state government.
- Necessarily, or fairly implied, by expressly granted powers.

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- Essential to the declared objects and purposes of the local government.

As with Home Rule (see Home Rule and Authorization for Issue), most states follow at least some form of Dillon's Rule regarding at least some local governments. A local government subject to Dillon's Rule must comply with state statutes, construed narrowly, to issue municipal bonds.

Overlap Between Home and Dillon's Rule and Authorization for Issue

The overlap between Home Rule and Dillon's Rule jurisdictions is attributable to two facts. First, some states apply Home Rule to some local governments and Dillon's Rule to others. Second, Home Rule and Dillon's Rule are distinct legal concepts and are not mutually exclusive in practice. Home Rule addresses the delegation relationship between the state legislature and local governments, while Dillon's Rule addresses the method by which the state judicial branch will construe the powers that have been delegated or withheld. In short, virtually every state is unique in its local application of Home Rule and Dillon's Rule.

FEDERAL TAX ISSUES

The federal tax laws and regulations applicable to municipal bonds are complex. Most of the complexity arises in the structuring and initial closing of the bonds, for which the bond counsel is primarily responsible. This Note only briefly summarizes the issues for which the bond counsel has primary responsibility. For the local government lawyer, the two main issues that remain relevant after the closing are:

- The private activity rules (see Governmental Bonds and Private Activity Bonds).
- The arbitrage rules (see Federal Taxes and Arbitrage).

Before the closing, however, municipal bond's tax exempt status implicates the costs associated with borrowing and issuance (see Tax Exemption).

TAX EXEMPTION

Under Section 103(a) of the 1986 Internal Revenue Code, "gross income does not include interest on any State or local bond" (26 U.S.C. § 103). The net effect of this exclusion is lower borrowing cost to the issuer. The purchaser can get an equivalent net yield from a tax-exempt obligation bearing interest at a lower rate and a taxable obligation bearing interest at a higher rate, because the purchaser need not include the interest in gross income.

Therefore, the issuer's initial decision of whether to issue a taxable or a tax-exempt bond is entirely a financial one. Does the interest rate benefit of issuing a tax-exempt bond justify the costs and restrictions of complying with the federal tax rules? In virtually every case, the answer is yes.

Rules Generally Applicable to Tax-Exempt Bonds

A host of technical rules apply to the issuance of tax-exempt bonds. For example:

- The municipal bond must be a valid exercise of the issuer's borrowing power (see Constitutional and Statutory Authorization for the Issue).
- The issuer must be:
  - a state;
  - an Indian tribal government;
  - a US Possession;
  - the District of Columbia;
  - a political subdivision of one of the previously mentioned entities; or
  - an issuer "on behalf of" these entities.
- The municipal bonds must "registered," as opposed to bearer-bonds.
- The municipal bonds, with certain significant exceptions, must not be federally guaranteed.
- The issuer must file information about the municipal bonds with the Internal Revenue Service (IRS), which obligation requires the issuer, within a certain time after the issuance, to submit to the IRS a Form 8038, 8038-G, or 8038-GC.
- The issuer may not use the proceeds of the municipal bonds to reimburse itself for expenses incurred more than 60 days before it declares official intent to reimburse itself.

Other rules apply, and the complexity of the above-listed rules is considerable. This Note assumes, however, that the bond counsel is responsible for complying with these rules and that the issuer's counsel need only be aware of these rules. The remaining two rules, private use (see Governmental Bonds and Private Activity Bonds) and arbitrage (see Federal Taxes and Arbitrage), are of more significance to the issuer's counsel.

GOVERNMENTAL BONDS AND PRIVATE ACTIVITY BONDS

In general, federal tax exemption is allowed only for governmental bonds (see Governmental Bonds). All other bonds are considered private activity bonds (see Practical Applications of Private Activity Rules). Certain private activity bonds, however, are defined to be "qualified bonds" and therefore remain entitled to federal tax exemption (see Qualified Bonds).

Governmental Bonds

A municipal bond will be considered a governmental bond unless more than 10% of both:

- The proceeds of the issue are to be used for any private business use.
- The debt payments on the municipal bonds will be, either:
  - derived from payments regarding private business property; or
  - secured by private business property.

The first test above is called the "private use test" and the second test is called the "private payment test." The federal tax exemption is denied only if both tests are met. Therefore, the issuer might apply the entire proceeds of a tax-exempt municipal bond issue to finance a privately used facility, if the issuer received no private payments regarding the facility.

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In rendering its opinion that interest on the bonds is excludable from gross income for federal income tax purposes (see Bond Counsel Opinion), the bond counsel will implicitly conclude that the municipal bonds do not meet these two tests or, perhaps, that the municipal bonds are qualified bonds rather than governmental bonds. The question for the issuer's counsel, then, is what happens after the municipal bonds are issued.

For example, assume that the issuer finances a new courthouse with tax-exempt bonds. At the time of the closing, the issuer expects to use all the available space in the courthouse for governmental purposes. On that expectation, the bond counsel opines that interest on the bonds is excludable from gross income for federal income tax purposes. Several years after the issuance of the bonds, the issuer proposes to lease 25% of the space in the courthouse to a private business. At that point, the bonds may become private activity bonds. Issuer's counsel should therefore be alert to proposed changes in the use of bond-financed infrastructure.

Qualified Bonds

The IRS Code lists several uses that would otherwise be private uses but that, as preferred uses, can be "qualified" for tax-exemption. The qualified uses include:

- Under Section 142, bonds for certain exempt facilities, such as:
  - airports;
  - docks and wharves;
  - mass commuting facilities;
  - facilities for the furnishing of water;
  - sewage facilities;
  - solid waste disposal facilities;
  - qualified residential rental projects;
  - facilities for the furnishing of local electric energy or gas;
  - local district heating or cooling facilities;
  - qualified hazardous waste facilities;
  - high-speed intercity rail facilities;
  - environmental enhancements of hydro-electric generating facilities;
  - qualified public educational facilities;
  - qualified green building and sustainable design projects; and
  - qualified highway or surface freight transfer facilities.
- Under Section 143, qualified mortgages and qualified veterans' mortgages.
- Under Section 144, qualified small issue manufacturing facilities, qualified small-issue farm property, qualified student loans, and qualified redevelopment projects.
- Under Section 1394, qualified enterprise zone and empowerment zone facilities.
- Under Section 145, qualified 501(c)(3) bonds.

The bond counsel will be responsible for the initial determination that a municipal bond is a qualified private activity bond. As with governmental bonds, however, changes in use after the issuance of the municipal bonds may change their tax-exempt status.

Practical Applications of Private Activity Rules

Although the issuer's counsel does not need to master all the complexities of the private activity rules, the issuer's counsel should consider the following practical applications:

- Understand the basis on which the bond counsel has determined that interest on the municipal bonds is exempt from federal income tax, in particular whether the bonds are governmental bonds or qualified private activity bonds, and if they are qualified private activity bonds, the statutory basis for this qualification.
- Understand (and keep a record of) which facilities have been financed with the proceeds of tax-exempt bonds so that the issuer's counsel knows which proposed changes in use might affect a prior bond issue.
- Ensure that the issuer has a system in place to notify counsel (either the bond counsel or issuer's counsel) whenever it considers an action that could change the use of a bond-financed facility.

FEDERAL TAXES AND ARBITRAGE

State and local governments can issue tax-exempt bonds for most purposes, subject to private activity restrictions (see Governmental Bonds and Private Activity Bonds). State and local governments are themselves exempt from federal income taxes and can, therefore, invest in taxable obligations. State and local governments might therefore "arbitrage" their borrowing power by issuing tax-exempt bonds and investing the proceeds in taxable obligations, because of the normal disparity between tax-exempt interest rates and taxable rates. For example, a local government might issue 20-year tax-exempt bonds at a 4% interest rate, invest the proceeds in a 20-year taxable obligation bearing interest at 6%, and enjoy the virtually risk-free 2% arbitrage disparity.

As of this writing, and for the last many years, the interest-rate market has been such that arbitrage is a remote possibility. Taxable investments that both comply with investment limitations on local governments and that pay more interest than a tax-exempt bond of comparable term are simply not available. For more information on investment limitations placed on local governments, see Practice Note, Legal Issues in Municipal Finance (w-001-5064).

Before the late 1990s, however, the interest-rate market did allow arbitrage, and many local governments sought to take advantage of the opportunity. As a result, Congress (in the 1986 Code) and the IRS (in the 1989 Regulations) significantly restricted the ability of local governments to exploit the disparity between tax-exempt and taxable bonds. The law and regulations existing before the Code and Regulations did seek to limit arbitrage, but were relatively permissive and open to abuse. The new rules were much more restrictive.

There are two main components to the arbitrage rules:

- Yield restriction requirements (see Yield Restriction Requirements).
- Rebate Requirements (see Rebate Requirements).

The arbitrage rules that apply at the closing of the bond issue are extremely complex and compliance with the rules is the responsibility of the bond counsel. To discharge that responsibility, the bond counsel will require that the issuer sign a document called an arbitrage and tax compliance certificate (or some similar name). This certificate will

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describe and justify the issuer's reasonable expectations regarding interest earnings on the proceeds of the bonds.

Yield Restriction Requirements

Section 148(a)(2) of the Code contains the yield-restriction requirement (26 U.S.C. § 148(a)(2)). Under this rule, the issuer may not invest the gross proceeds of a bond issue, directly or indirectly, at a yield "materially higher" than the yield of the bond issue. The standard for "materially higher" is strict. If, on the issue date, the issuer "reasonably expected" that the proceeds of the bond issue would be invested at a materially higher yield, then the bonds are considered "arbitrage bonds" and will not be entitled to tax exemption. Other than municipal bonds issued for projects that are expected to require more than three years to complete, municipal bonds issued to finance capital expenditures are entitled to earn excess interest during a "three-year temporary investment period." If the proceeds (and earnings thereon) are not spent within the three-year period, the issuer must either invest the balance at a rate lower than the yield on the municipal bonds or make yield reduction payments to the IRS. In any event, despite this exception, the issuer must rebate the excess earnings.

Rebate Requirements

Section 148(f) of the Code requires that the issuer rebate excess interest earnings to the US Department of the Treasury. The rule applies only to "nonpurpose investments," which are investments other than those made to carry out the governmental purpose of the issue. (26 U.S.C. § 148(f).) For example, if the purpose of the bond issue is to loan the proceeds to another governmental entity, the resulting loan is a "purpose investment." If the issuer fails to rebate these excess earnings, the bonds are considered arbitrage bonds.

To calculate rebate liability, the issuer must determine:

- The yield on the municipal bonds.
- The total earnings on all nonpurpose investments of bond proceeds.
- The total earnings that would be permitted for nonpurpose investments if the yield on the investments were equal to the yield on the municipal bonds.
- The future value, as of the relevant computation date, of the difference between total earnings:
  - on all nonpurpose investments of bond proceeds; and
  - that would be permitted for nonpurpose investments if the yield on the investments were equal to the yield on the municipal bonds.

Except in extraordinary circumstances, the issuer's counsel should not perform the calculation. Instead, the role of the issuer's counsel is to ensure that an appropriate person or entity performs the calculation on behalf of the issuer. Multiple entities provide rebate consultation services, and can be retained to ensure compliance throughout the term of the bonds.

The primary responsibility of the issuer's counsel, then, is to ensure compliance with the rebate rules after closing. The rebate rules require that the issuer "rebate" interest earnings in excess of the yield on the municipal bonds to the IRS.

There are several exceptions to the rebate requirement:

- **Small issuer exception.** A rebate exception applies if the issuer expected, at the time municipal bonds were issued, to issue $5 million or less of tax-exempt bonds in the current calendar year.
- **6-Month exception.** A rebate exception applies if all the bond proceeds are spent within six months after the municipal bonds were issued.
- **18-Month exception.** A rebate exception applies if the bond proceeds are spent as follows: 15% within six months, 60% within one year, and 100% within 18 months, all measured from the date the bonds were issued.
- **2-Year exception.** A rebate exception applies if at least 75% of the bond proceeds are spent for construction projects and the bond proceeds are spent as follows: 10% within six months, 45% within one year, 75% within 18 months and 100% within two years, all measured from the date the bonds were issued. This exception applies only to governmental bonds, qualified 501(c)(3) bonds, and private activity bonds in which the financed property is owned by the government.

If none of these exceptions applies, the issuer is required to perform a rebate calculation at least every five years after issuance (a Rebate Installment Computation Date) and on the final redemption or maturity of the bonds (the Final Rebate Computation Date).

Practical Applications of Arbitrage Rules

Although the issuer's counsel need not master all the complexities of the arbitrage rules, the issuer's counsel should consider the following practical applications:

- Understand the general concept that the issuer may not invest the proceeds of the municipal bonds at a materially higher rate than the yield on the bonds.
- Be aware of this limitation in advising the issuer about investment decisions.
- Ensure that the issuer is timely performing rebate calculations and timely rebating amounts owing to the IRS.
- Advise the issuer that, if financial circumstances permit, the safest course is to retain a rebate consultant for the duration of the term of the municipal bonds.

DISCLOSURE ISSUES

Disclosure requirement are an important aspect of municipal bond transactions but not every transaction implicates formal disclosure. Municipal bonds may be privately placed with a financial institution. In these cases, the formal disclosure rules do not apply. The financial institution itself may require certain disclosures, both at the time of issuance and thereafter. For example, the financial institution may require the issuer to deliver three to five years of audited financial statements before closing and to provide annual, audited financial statements each year that the bonds are outstanding.

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FORMAL DISCLOSURE REQUIREMENTS

The Securities and Exchange Commission (SEC) has only limited jurisdiction over the issuers of municipal bonds. Municipal bond issuers are subject to both:

- The SEC's Rule 10b-5.
- The antifraud provision.

Municipal bond issuers are not subject to the remaining general laws and regulations applicable to publicly traded securities.

Regarding broader regulation of disclosure, therefore, the SEC regulates municipal bonds by promulgating rules that apply to broker-dealers acting as underwriters, placement agents, and remarketing agents for municipal bonds. The primary rule applicable to these broker-dealers, as it relates to municipal securities, is Rule 15c2-12.

Rule 15c2-12 contains two core requirements:

- Regarding primary disclosure, the underwriters must review the primary disclosure document (usually called an official statement) applicable to a municipal bond issue and file that document with the MSRB (see Primary Disclosure).
- Regarding continuing disclosure, the broker-dealers must ensure that the issuers of municipal bonds comply with the mandated continuing disclosure requirement. The requirements generally require annual reports (see Annual Reports) and event notices (see Event Notices).

PRIMARY DISCLOSURE

Rule 15c2-12 requires the broker-dealers that participate in a new offering of municipal bonds to obtain, review, and distribute an "official statement." This requirement does not apply to offerings of $1 million or less, and does not apply to municipal bonds in denominations of $100,000 or more that either:

- Are sold to no more than 35 persons, who:
  - have sufficient knowledge and experience to evaluate the risks of investing in the municipal bonds; and
  - are not purchasing for more than one account or with the view to redistribution.
- Have a maturity of nine months or less.

If the primary disclosure rules do apply, the information required to be disclosed is relatively standardized within the market. In a publicly sold issue of municipal bonds at least one person or firm is ultimately responsible for opining on the primary disclosure (see Transaction Participants). That person or firm might be the bond counsel, the underwriter's counsel, or separate disclosure counsel.

Regardless of the professional responsibilities, the issuer is ultimately responsible for the disclosure. If the disclosure contains materially misleading information, or omits information that makes the provided information materially misleading, the issuer can and will be held liable. The role of the professional is to assist the issuer in avoiding that liability.

Moreover, it is likely that the issuer's counsel will be responsible for opining on at least some sections of the official statement. The official statement will contain information that is uniquely "local" to the issuer; for example, the official statement will usually include information about the issuer's:

- Elected officials.
- Senior staff members.
- Organizational structure.
- Financial plans.

In many cases, the issuer's counsel will be in the best position to provide and verify this information, and may be expected to opine on the information.

Practical Applications of Primary Disclosures

Although the issuer's counsel need not master all the complexities of the primary disclosure rules, the issuer's counsel should:

- Identify the attorney primarily responsible for opining on the official statement.
- Determine, as early in the transaction as possible, which sections (if any) of the official statement for which he is responsible.
- Be certain that the issuer understands its responsibility for the disclosure. Retaining professionals to assist in preparing and to opine on the disclosure does not change the essential fact that it is the issuer's disclosure.
- Read the entire official statement and use reasonable efforts to confirm that it contains no information that would subject the issuer to liability under Rule 10b-5.
- Ensure that the issuer reads the entire official statement and applies that same standard.

In many cases, the role of the issuer's counsel in preparing the primary disclosure is a simple matter of common sense. Regarding each item in the primary disclosure, the issuer's counsel should ask:

- Is this item correct?
- How can this item be verified?
- Has the appropriate inquiry been made about each item?

ANNUAL REPORTS

Regarding annual reports, Rule 15c2-12 requires that each obligated person file annual financial information comparable to the quantitative financial information and operating data contained in the final official statement, including (when and if available) audited financial statements. The content of the annual filing will vary from issue to issue. At a minimum, the annual filing will include the issuer's audited annual financial statements. In addition, the annual filing should update any identified information in the official statement that is not included in the audited annual financial statements. The exact material required to be filed will be determined in a continuing disclosure certificate delivered at closing.

In prior years, there was little consequence to failing to file annual reports. The only formal remedy for a failure to file was to require that the issuer submit delinquent reports. Since the market crash in 2008, however, both the MSRB and the broker-dealer community have become much more serious about enforcing compliance with the annual reporting requirement. In 2010, Rule 15c2-12 was amended. The most important part of the amendment appears in the interpretive guidance, which states that broker-dealers

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are obligated to have a "reasonable basis" for recommending an investment, and that the reasonable basis should include a review of the disclosure document and of the issuer's past compliance with its disclosure documents. As a result, broker-dealers are now auditing an issuer's past compliance with continuing disclosure requirements. Sometimes issuers that have been delinquent in the past have been delayed in, or even foreclosed from, issuing new municipal bonds in the public markets.

Practical Applications for Annual Reports

The issuer's counsel should consider the following practical applications regarding annual filings:

- Ensure that the issuer is timely filing the annual reports.
- Be aware of the information required by the continuing disclosure certificate.
- If possible, simplify the annual filing process by directing the issuer to include all information required by the continuing disclosure certificate in the supplemental information contained in the annual audit.
- If the annual audited financial statements are not available when due, advise the issuer to file a notice of failure to file, together with the required information as may then be available.

EVENT NOTICES

The issuer of bonds must provide notice of the following events in a timely manner not more than ten business days after the occurrence of the event:

- Principal and interest payment delinquencies.
- Non-payment related defaults, if material.
- Unscheduled draws on debt service reserves reflecting financial difficulties.
- Unscheduled draws on credit enhancements reflecting financial difficulties.
- Substitution of credit or liquidity providers, or their failure to perform.
- Adverse tax opinions, the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations regarding the tax status of the security, or other material events affecting the tax status of the security.
- Modifications to rights of security holders, if material.
- Bond calls, if material, and tender offers.
- Defeasances.
- Release, substitution, or sale of property securing repayment of the securities, if material.
- Rating changes.
- Bankruptcy, insolvency, receivership, or similar event of the obligated person.
- The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake any of these actions or the termination of a definitive agreement relating to these actions, other than under its terms, if material.
- Appointment of a successor or additional trustee or the change of name of a trustee, if material.

The risk to compliance with the event notice requirements is that the issuer is unaware that a given event triggers the requirement. The issuer's counsel should, therefore, make every effort to ensure that the issuer has policies and procedures that remind the issuer to file an event notice when required.

COMPLIANCE POLICIES AND PROCEDURES

In recent years, the IRS increasingly has encouraged municipal bond issuers to adopt post-issuance tax compliance procedures. The IRS has not expressly required issuers to adopt these procedures, but issuers would be better protected by doing so. Moreover, the adoption of post-issuance tax compliance procedures would significantly assist the issuer's counsel in fulfilling its role.

The National Association of Bond Lawyers (NABL) and the Government Finance Officers' Association (GFOA) have prepared a white paper called "Considerations for Developing Post-Issuance Tax Compliance Procedures" (the "Post-Compliance White Paper"). This white paper is a useful resource for both issuers and for persons or entities acting as the issuer's counsel.

Particular areas of compliance that counsel should evaluate, include:

- **Arbitrage and rebate.** The issuer should adopt procedures that identify the investments made with bond proceeds, the return on those investments, and the timing and nature of expenditures of bond proceeds.
- **Use of bond proceeds and of bond-financed facilities.** The issuer should adopt procedures that both:
  - track the expenditure of all bond proceeds; and
  - identify all bond-financed facilities.

  The procedures should create an approval path for decisions that would change the use of any bond-financed facility.

CORE ELEMENTS OF AN EFFECTIVE PROCEDURE

The bond counsel can likely provide the form of useful post-issuance tax compliance procedures. Such procedures should, at a minimum:

- Identify the persons or entities responsible for each required compliance activity. For smaller organizations, a single staff member may assume this responsibility. In a larger organization, certain responsibilities may be assigned to specific departments, for example:
  - finance;
  - public works; and
  - the city attorney.
- Schedule periodic, regular due diligence meetings among the stakeholders. The stakeholders should include all parties with compliance activity responsibility. The diligence meetings should occur no less often than once a year.
- Provide for training of the responsible persons.
- Establish a record maintenance and retention schedule.

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- Identify areas of potential problems and ensure that those areas receive regular review.
- Provide a method to address non-compliance, if and when detected.

Disclosure Matters

Issuers may find it useful to expand post-issuance compliance matters to include not only tax matters, but also disclosure matters. In many cases the same departments will be involved in tax and in disclosure requirements, and it is usually more efficient to combine the diligence and meeting requirements into a single function.

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08-17

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