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Municipal Lawyer

THE JOURNAL OF LOCAL GOVERNMENT LAW

MAR APR 2025 VOL.66 NO.02



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CONTENTS

MARCH / APRIL 2025

FEDERAL IMMIGRATION LAW AND LOCAL AUTHORITY—WHERE IS THE LINE?

By: Amanda Karras, IMLA Executive Director and General Counsel, Rockville, Maryland

The new Administration seeks increased action by local governments regarding undocumented aliens, including communicating their whereabouts and detaining them for apprehension by federal authorities. These policies test the line between federal prerogative and the Tenth Amendment, permissible detainers and the Fourth Amendment, and much more.

PAGE 6

LOCAL GOVERNMENT'S GROWING ROLE IN HOUSING AFFORDABILITY

By: Kevin Ramakrishna, Shareholder, and Joseph Shumow, Shareholder, Reinhart, Boerner, Van Deuren, S.C., Madison, Wisconsin

As housing becomes unaffordable for an ever-increasing number of constituents, municipalities are called upon to do more. Alongside zoning, density changes, and similar local mechanisms, Federal programs--including tax credits and other incentives--can be part of the solution for local governments.

PAGE 12

UNDERSTANDING AND USING ARTIFICIAL INTELLIGENCE FOR MUNICIPAL ATTORNEYS

By: James E. "Jeb" Brown, Senior Counsel, Liebert Cassidy Whitmore, Los Angeles, California. and John G. Peters, Jr., Ph.D. John G. Peters, Jr. & Associates, Henderson, Nevada

Initially perceived by many of us as a vehicle amassing the world's greatest repository of data and content to derive instant answers and more creative writing, AI's transformative potential is now becoming evident. Municipal lawyering will clearly be affected, and IMLA members need to be prepared.

PAGE 18



DEPARTMENTS

22 INSIDE CANADA
Deferral Denied, Housing By-Law Upheld, Trails Protected, and More
By: Monica Ciriello, Director of Municipal Law and Licensing Compliance, City of Hamilton, Ontario
Recent Canadian cases of interest.

26 DAY IN THE LIFE
From BigLaw to MediumLaw to Fulfillment in Local Government Law
By: Avery Morris, IMLA Editorial Staff
Interview with Sofia Hernandez, Deputy City Attorney, Durham, North Carolina

29 SCHOLARSHIPS
Thompson Local Government Law Scholarship Winners
Selected from an outstanding group of future municipal attorneys

32 PRACTICE TIPS
Effective Communication: Pointers for Consulting with a Local Government Client
By: Galen Gatten, Assistant City Attorney – Municipal Law Section Head, City Attorney's Office, City of Arlington, Texas
The fine points of hearing and being heard.

34 MUNICIPAL FINANCE
Bond Basics
By: Debra D. Rosman, Assistant Director of Law, City of Cleveland, Ohio
A fundamental vehicle for local government funding, explained.

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MUNICIPAL FINANCE

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Bond Basics

INTRODUCTION

If you work for a municipal government, your employer has likely issued municipal bonds. This article will provide an overview of municipal bonds, why cities issue them, the various types of municipal bonds, the persons who work on the issuance of the bonds, and some of the common documents utilized in their issuance. Along the way, there will be practical pointers that municipal attorneys should be aware of regardless of whether or not their own practice directly involves working with municipal bonds.

Bonds in General

First, what is a municipal bond? Basically, a bond is an obligation of a municipality promising to pay the original value loaned to the municipality to the holder of the bond at a date fixed in the future, with interest payments made to the holder periodically. It is an I.O.U., with interest payments. Using bonds allows a government to finance various projects, and in most cases, to finance the projects at a cost below current interest rates for similar borrowing. In addition, by issuing bonds, a city can avoid repeatedly going to a bank for loans of tens or hundreds of thousands of dollars to finance stadiums, airports, roads, bridges, buildings, parks, and other municipal projects—and in some states, financing court judgments. As may sometimes occur, not all items that a city intends to fund with bond funds actually come to fruition. New projects may be substituted for projects that had been originally intended, but the new projects must fit within what was delineated in the city's legislation authorizing the bonds, and must be of at least a useful life that fits within the calculation of average useful lives for the issue by bond counsel.

Members of a Bond Working Group

Most bond issuances involve a number of individuals working together over a period of months. Although your employer will have hired a nationally-recognized bond counsel, you should be aware that bond counsel's allegiance is to the bondholders first, and although the bondholders' and the municipality's interests are usually aligned, it is advisable to have a representative to advocate on the part of the municipality, keeping bond counsel apprised of specific laws of the municipality of which they may not be aware since they perform bond counsel services for many other issuers.

Besides bond counsel, other members of the group working on bond issuance may include: municipal finance personnel, underwriters to sell the bonds, underwriters' counsel, the city's financial advisor, the bond trustee to hold the bond funds and to enforce promises made by the city to the bondholders, disclosure counsel to advise and to prepare public communication regarding the bonds, engineers to provide feasibility reports in some cases, and an escrow agent in the case of bond refundings, discussed below. With the exception of in-house municipal staff, all other working group members are paid, usually from bond proceeds, so a potential bond issuer should evaluate whether the bond deal is large enough to justify paying the bond professionals or whether the cost of the projects should be paid out of other revenue sources instead.

Common Types of Municipal Bonds

1. General Obligation Bonds. The General Obligation Bond (also known as "a G.O. bond") is usually issued to pay the costs of permanent improvements. G.O. bonds are the most secure type of municipal bond because the government's full faith and credit is pledged to pay the interest and principal on the bonds. In the context of bonds, pledging

the full faith and credit means that the government is promising to use its full taxing power to support the bonds, as well as any other revenues available to it, to pay the principal and interest on the G.O. bonds. State law typically puts a cap on the amount of general obligation debt that a municipality can legally pledge, so as not to encumber too large a percentage of tax funds. The pledge of full faith and credit leads to lower interest rates to be paid by the municipality since G.O. bonds are considered very secure.

2. Revenue Bonds. Revenue bonds are secured by a net revenue stream from ownership or operation of an enterprise or from a specific project. Unlike G.O. bonds, revenue bonds are not secured by taxes. Examples of revenue bonds include bonds for airport improvements, which may be secured by landing fees; bonds for a utility, such as a water department or electric department, secured by revenue generated from the sale of water or electricity, respectively; bonds for parking facilities, secured by parking fees; and the like. To issue revenue bonds, a municipality may be required to pledge to charge rates that will bring in enough funds to pay off debt service (which is defined as principal and interest) on the bonds. Frequently, the municipality will hire an expert to perform a rate study to assure the working group (and later, the bondholders) that rates charged will be sufficient to pay debt service on the bonds.

3. Mortgage Revenue Bonds. These bonds are exactly like the Revenue Bonds described above, with a lien placed on the enterprise or project to further secure payment of debt service on the bonds.

4. Tax-Exempt Bonds. Each of the bonds listed above may be issued on a tax-exempt basis. This means that the interest the bondholder receives periodically from the municipality will not be taxed by the federal government. Because there is no money owed on the interest by the bondholder, tax-exempt bonds are sold at a lower interest rate, making them less costly for a city to issue. There are some constraints, however, on use of assets constructed with tax-exempt bonds that include restrictions on use by private parties either through leasing, sale, or managing the asset. Running afoul of the Internal Revenue Service's restriction on use of and payments for tax-exempt bond-financed property by private persons could cause the bonds to lose their tax-exempt status retroactively to the day they were issued. For this reason, contracts involving the use of such assets must be monitored.

5. Taxable Bonds. Each of the bonds listed in Numbers 1 through 3 above may also be issued on a taxable basis. Despite having to pay higher interest for taxable bonds, a city might prefer to issue taxable bonds if it intends to have the bond-financed property used by private parties through either lease, sale, or management. Taxable bonds are also used for financing economic development projects since the ultimate goal of those types of projects is to benefit private businesses.

6. Certificates of Participation. A Certificate of Participation (COP) is a bond substitute where an investor purchases a fractional interest in a lease of real property, and investors are paid lease revenues instead of interest. The COP is secured by the property being financed, and if the holders are not paid, then their only recourse is for the trustee to foreclose on the asset being financed. In the case of COP's, the municipality will appropriate the funds to pay the debt service annually, so the largest amount of money that investors could recover in a default is the current annual appropriation of debt service. A COP arrangement may be preferable to issuing bonds when a city has reached its state-mandated limits on general obligation bonds but still needs to construct a project, such as a building or a stadium, although the cost of issuing COP's is higher than the cost of issuing bonds given that investors will need to be paid a higher rate of return because this method of financing leaves them less secure. COP's can be issued on a tax-exempt or taxable basis.

7. Bond Anticipation Notes. If financing is needed on a short-term basis, and bonds are anticipated to be issued during the next year or two, then a city can issue short-term notes that will be paid off when the bonds are issued. Notes are subject to the same rules and follow the same procedures as actual bonds, with the difference being the length of time the notes are outstanding. Bond anticipation notes can be secured by tax dollars as a general obligation of the City or by a revenue stream, depending upon the type of bond that will replace the notes.

Continued on page 36



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8. **Refunding Bonds.** Any of the bonds listed in Numbers 1 through 3 may be refinanced to achieve savings on interest rates. In a refunding, an escrow agent holds the proceeds of the new refunding bonds (which have been issued at a lower interest rate); when the original bonds become due, the proceeds of the new refunding bonds are used to pay off the original bonds. The refunding bonds are considered a new bond issuance, and a working group convenes to perform the same functions as in any other bond issuance. Because of the costs involving bond professionals for the new refunding bonds, interest rates on the refunding bonds should render sufficient interest payment savings to justify the time and expense involved in a new bond issuance.

Bond Documents

The first official document in any bond deal is the legislation authorizing the bond issuance. The legislation will state the parameters under which the bonds will be issued and specify the types of projects to be financed. It will be prepared by bond counsel, who will ascertain whether the proposed projects are bond-eligible. As part of the official bond documents, the City clerk will opine that the legislation is valid and in effect at the time of the bond issuance.

Necessary bond documents will include a trust indenture setting forth the terms under which the bond trustee will hold the bonds and by which the city will make certain promises or pledges that the bond trustee will be charged with enforcing, if necessary. Oftentimes, the bond trustee is also the bond registrar and paying agent, so those duties may be delineated in the trust indenture as well. If a separate entity is the registrar and paying agent, then there will be a separate registrar and paying agent agreement to ensure that bondholders receive interest at the appropriate times. If there is a mortgage taken in the case of revenue bonds, the terms and conditions of the mortgage will also be set forth in the trust agreement.

The bonds are sold through distribution of a preliminary offering statement that is prepared and vetted by the working group, and signed by the city, and distributed by the underwriter. The official statement provides, among other things, information on the city itself, its finances, the plan of finance for the bonds in question, the security for the bonds and the sources of payment of debt service, information about the proposed projects to be funded, a list of other material city financial undertakings, risk factors, litigation matters, tax matters, and any other matters that are considered relevant to discuss in connection with the sale of the bonds. Upon the sale of the bonds, the preliminary offering statement is updated and released as an official statement.

The bond professionals also provide official opinions concerning the validity of the sale of the bonds. Opinions are typically issued by the municipality's chief legal officer, bond counsel, underwriter's counsel and disclosure counsel. In addition, various certificates are issued by the parties attesting to certain facts relevant to the bond issuance. If there was an expert report, it will be included in the bond documents as well.

In addition, the city will execute an agreement containing a duty to disclose material adverse events that arise while the bonds are outstanding. The Securities and Exchange Commission has specified what types of events must be disclosed, and at a minimum the disclosure agreement must require the listed events to be disclosed if they occur. In addition, the disclosure agreement will provide for disclosure of routine financial information about the city on an annual basis as set forth in the disclosure agreement. The required disclosure will be made on a website set up by the Municipal Securities Rulemaking Board and will be available for public viewing.

CONCLUSION

This article has summarized some basic concepts involving municipal bonds. Bonds are an important source of obtaining funds for financing municipal projects, but to use bonds effectively, a city must balance the costs of the bonds and restrictions on spending proceeds of bonds when using this source of funds.

NOTES

1. For each of the types of bonds and other financings listed in this article, interest payments may be either fixed rate or a variable rate.
2. Typically, one underwriting firm will take the role as "lead underwriter" for a group of underwriters and will be the sole underwriter to participate in the working group.
3. In some working groups, the underwriter's counsel or bond counsel perform the job of disclosure counsel in addition to their customary duties.
4. Pledging tax money means that pledged tax revenues received by the municipality must first be used to pay interest and dividends on bonds before paying for any other municipal expenses.
5. Proposals to eliminate tax-exempt bonds are regularly floated. Even if tax-exempt bonds were eliminated going forward, already-issued tax-exempt bonds would continue to be outstanding for years to come, and the rules relating to use of tax-exempt bonds would presumably continue to apply to those outstanding bonds.