Raising Revenues, Making Expenditures, and Borrowing Money: Legal Issues in Municipal Finance

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Section 1: Raising Revenues

Section 2: Making Expenditures

Section 3: Borrowing Money

Section 4: Questions and Applications

Section 1: Raising Revenues

All sources of revenue should be conceptually classified as *taxes* or *fees*.

1

Taxes

"Taxes … are compulsory payments that do not necessarily bear any direct relationship to the benefits of government goods and services received."

2

Fees

Fees are imposed on specific persons, activities, or properties that receive a service or benefit (user fees), or that cause negative externalities that burden the rest of the population. (regulatory fees)

Why does it matter?

1

Taxpayer Protection

Laws may require uniformity, supermajority vote or referendum, assessment or property value limitations, millage cap limitations, and statutory authority.

2

Application of Fees

Generally fees (a) may not exceed the cost of value of the service being provided, and (b) may not be used for other purposes.

3

Constitutional Issues

Generally, taxes are (or at least may be) more restricted by constitutional provisions. More on this later.

4

Borrowing

The nature of borrowing will be very different depending on whether it is secured by taxes or fees.

How do I tell the difference?

A general example, under *Brown v. Horry County*, 308 S.C. 180; 417 S.E.2d 565 (1992):

- a tax is an enforced contribution to provide for the support of government, whereas a fee is a charge for a particular service;
- a service charge is imposed on the theory that the portion of the community which is required to pay it receives some special benefit as a result of the improvement made with the proceeds of the charge;
- the revenues generated by a fee should be used only to provide the benefit, and not paid into the general fund of the government to defray customary governmental expenditures; and
- fees must be uniform.

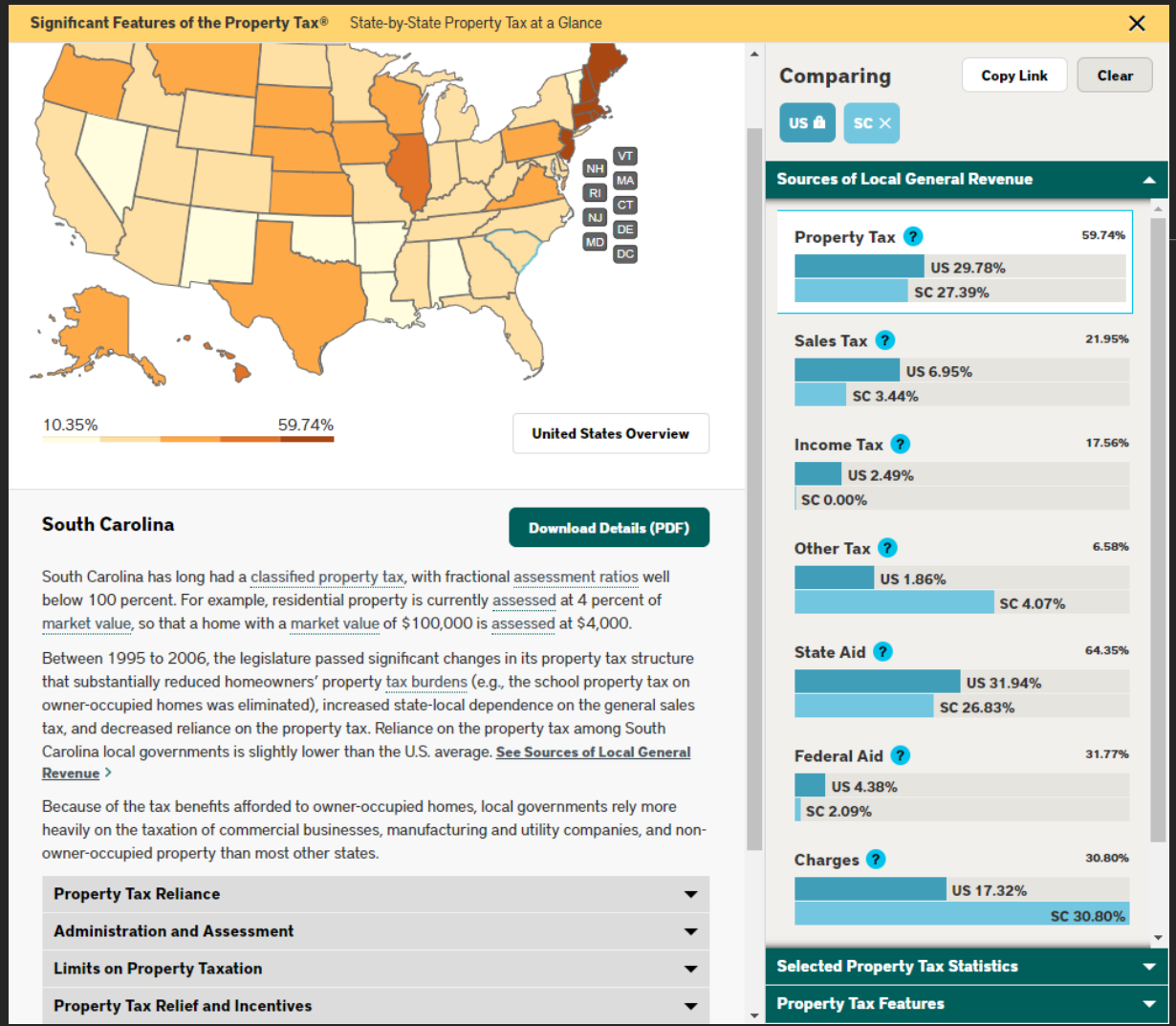
Main Types of Taxes

Property taxes are the main source of tax for local governments in most states, so that's what I'll focus on.



Local governments also have access to sales taxes in many cases. There are likely many optional "add-ons" that must be approved at referendum.

Most cities don't have income taxes, but many states and some cities do. I won't discuss them today.



http://datatoolkits.lincolninst.edu/subcenters/significant-features-property-tax/state-by-state-property-tax-at-a-glance#

SC Limits on Property Taxes

1

Reassessment Caps

No more than 15% in 5 years, with a limited point of sale exemption.

2

Millage Caps

Millage may not increase more than a factor determined by combining population growth and increase in CPI.

3

Rollback

In a reassessment year, millage rate must be reduced to generate the same amount of taxes as the prior millage did.

General/Enterprise Funds

1

General Fund

Taxes and generally applicable fees.

2

Enterprise Fund

Money-making ventures like water, sewer, electricity, natural gas.

3

Transfers

Municipalities can "transfer" money out of enterprise funds by (a) direct unrelated expenditures, (b) indirect cost recovery, and (c) discretionary transfers.

Section 2:
Making Expenditures

First, budgeting.

- **Every municipality will have some formal budgeting process.**
  - Be aware of advertising and public hearing requirements.
  - Be aware of balanced budget requirements.
  - Be aware of how changes are made. Can the executive reallocate within lines? Within categories?
- **The executive function.**
  - Be aware of the person of office in your form of government who has the authority to prepare and present the budget. It won't matter until it does.



Other technical limitations

1

Procurement

The purchase of goods and services is almost always subject to public bidding requirements. Know the applicable rules.

2

Funds on Hand

State law will restrict the ability of the municipality to invest funds on hand. Often "loans" are considered investments and must therefore be analyzed under this heading.

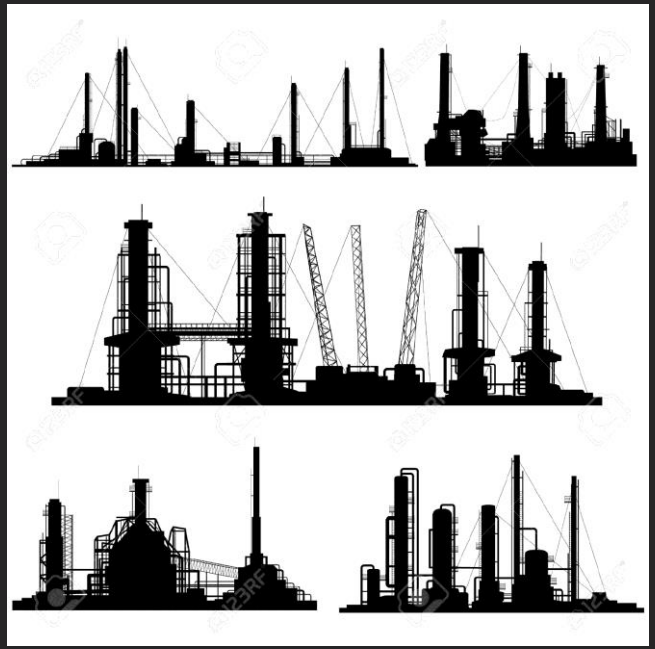
3

Statutory Restrictions

Of course, as noted above, fees must be applied to specific purposes. This restriction may be organic or statutory. And other statutory limits may apply. For example, tourism.

Major Issue: Public Purpose

- **At least 46 states have some form of "anti-gift" constitutional protections. The most common is public purpose.**
  - All expenditures (and all borrowing) must serve a "public purpose."
  - "A public purpose has for its objective the promotion of the public health, morals, general welfare, security, prosperity and contentment of all the inhabitants or residents within a given political division."
  - Public purpose is "evolving."
  - Does it include industrial development? Commercial development? Support to residential redevelopers?



Example: The South Carolina Test

The Court should *first* determine the ultimate goal or benefit to the public intended by the project.

Second, the Court should analyze whether public or private parties will be the primary beneficiaries.

Third, the speculative nature of the project must be considered.

Fourth, the Court must analyze and balance the probability that the public interest will be ultimately served and to what degree.

Major Issue: Lending of the Public Credit

- **Another major "anti-gift" provision is referred to as the probation on lending of the public credit.**
  - In South Carolina: "The credit of neither the State nor of any of its political subdivisions shall be pledged or loaned for the benefit of any individual, company, association, corporation, or any religious or other private education institution."
  - Can this be applied literally?
  - Does it mean more than just public purpose?



SC: Lending of the Public Credit

1

Full Faith and Credit

The prohibition does not apply to pledges of "fees" or to revenues other than taxes. It applies only when the pledge implicates the full faith and credit of the government.

2

Limited Exception?

A case from the 1980s seemed to suggest that the prohibition would not be violated if the government financed a major asset and retained reversionary rights in the asset.

3

Public Purpose Plus?

In the early 1990s, the South Carolina Supreme Court had the chance to read lending of the public credit as "public purpose plus," meaning that taxes require a higher standard. It dodged the question.

Lending of the Public Credit: Other Theories

1

Public Purpose Only

Some states have read this provision as essentially equivalent to the public purpose requirement; if the public is the "major" beneficiary, no violation.

2

Public Purpose Plus

Other states conclude that when taxes are involved, the public benefit must be higher or more direct.

3

Deals with Investments

The most logical approach (Maryland, Maine, others) is that the prohibition is on investments and lending. "Cash is not credit." The purpose is to avoid speculative ventures.

Other Limitations to Consider



Constitutional (Equal Protection, Takings)



Long-Term Capital Planning



Political (Voter Support?)



Your own conscience?



Corporate Purpose (for a Municipality)

Section 3: Borrowing Money

Types of Bond Issues

1

General Obligation

Involve a pledge of the "full faith and credit" of the municipality, which means the municipality could be forced to levy taxes to retire the debt. Debt limit, perhaps voter approval.

2

Revenue Bonds

Secured by revenues of a "system" or "systems." Not subject to a legal debt limit but contains coverage requirements in the issuing instrument.

3

Lease-Purchase

A lease under which payments include a principal and interest component. At the end of the lease, the lessee owns the asset. Includes a non-appropriation clause.

4

Other

Special source revenue bonds, bond anticipation notes, tax anticipation notes, grant anticipation notes, conduit bonds….

Methods of Sale

1

Public

Public sale raises disclosure issues, increases costs of issuance, and requires greater effort by the issuer. Public markets generally offer more competitive interest rates.

2

Private

Sold directly to a bank to hold in its portfolio or to assign or re-sell. Less costly, less complex, generally higher interest rates. Also banks generally have size and term limitations (For example, $10mm and 10 years).

Market Participants

Issuer. The public entity issuing the bond or, as we would normally say, borrowing the money.

Underwriters. In issues sold to public markets, the entity that "purchases" the bonds from the issuer and then resells them to the public.

Financial Advisor. An independent firm that assists and advises the issuer in structuring the bonds, selecting an underwriter, securing ratings, acquiring credit enhancement, etc.

Credit Enhancer. An entity that "enhances" the rating of the bonds, either by insuring their payment or by supporting them with a letter of credit.

Trustee. Serves the interest of bondholders to receive payments from the issuer, make payments to the bondholders, enforce rights under the bond documents, etc.

Bond Counsel. Opines that the bonds are legal, valid, binding, enforceable, payable from the pledged source of funds, and exempt from federal and state income taxation. Usually drafts the documents.

Issuer's Counsel or **Local Counsel**. Most likely, you. In any event, the lawyer or law firm that represents the issuer.

Underwriter's Counsel. Separate legal counsel representing the underwriter.

Local Counsel Opinion: What is it?

- The local counsel opinion will vary according to the complexity of the deal, the firm serving as bond counsel, whether the issue is sold to the public or to a bank, and so on.
- Therefore, local counsel should ask early and often about the expected content of his or her opinion at closing.

First: Upon What Did You Rely?

- The opinion will list the sources upon which the opinion writer relies or has consulted.
- Generally, these sources will be the Federal and State Constitutions; applicable laws; local proceedings such as ordinances, resolutions, or even minutes; and documents specific to the deal.
- If you DIDN'T review something, or cannot speak to its reliability, then disclaim it.

Sample Conclusions, pt. 1

1

Existence and Power

The type of entity issuing the bonds; whether it exists and is in good standing; whether it has the power to do what it is purporting to do.

2

Authorization and Execution

Whether the issuing entity has lawfully authorized all parts of the deal; whether the right person has executed (and perhaps attested) the documents.

3

Valid and Binding

Whether the documents, even if properly authorized and executed, are binding and valid.

Sample Conclusions, pt. 2

4

No Conflict

Whether entering into the documents or transaction will conflict with other applicable provisions; for example, a covenant against additional borrowing.

5

No Default

Qualify by your knowledge, perhaps after appropriate inquiry; rely on certificates.

6

Consents and Approvals

Whether all other consents and approvals have been obtained.

Sample Conclusions, pt. 3

7

No Litigation

Whether there is litigation pending (or, in some cases, threatened) that would jeopardize the transaction or the security.

8

Disclosure

The disclosure does not contain any "untrue statement of material fact" and does not "omit any material fact necessary to make the statements contained therein not misleading."

LIMIT THE SCOPE!

9

Procurement

For deals in which the security depends on collateral, whether the issuing entity complied with its procurement procedures.

Continuing Disclosure: Overview

- For the initial disclosure issues, you'll have the assistance of bond counsel, underwriter, and underwriter's counsel. So I have only two notes here.
- First, you should read the disclosure. All of it. And you should, to the limits of your ability and influence, make yourself comfortable and confident that it is correct.
- Second, you should determine for which portions of the disclosure (if any) you will be required to opine. With respect to those sections, you need to be more than comfortable and confident.

Disclosure AFTER the Closing

1

SEC Rule 15c2-12

Prohibits underwriters from offering bonds that don't have required continuing disclosure filings.

2

Annual Reports

Each year while the bonds are outstanding, file an annual report with audited financial statements and certain additional data.

3

Material Events

Also, the agreement will require timely filing when certain "material events" occur.

Annual Reports

- First, make sure that they are filed on time.
- If they cannot be filed on time (e.g., the audit is not finished), then file what you do have, tell the market what you don't have, and tell them when you expect to file. Then, file what you didn't have as soon as you do have it.
- Second, make sure that what you file is correct. After all, these are just as much market disclosures as the original Official Statement. In theory, people make secondary trades on the contents of the annual filings.

Material Events

1. Principal and interest payment delinquencies;
2. Non-payment related defaults, if material;
3. Unscheduled draws on debt service reserves reflecting financial difficulties;
4. Unscheduled draws on credit enhancements reflecting financing difficulties;
5. Adverse tax opinions or other material notices or determinations with respect to the tax status of the security;
6. Modifications to rights of security holders, if material;
7. Bond calls, if material, and tender offers;
8. Defeasances;
9. Release, substitution, or sale of property securing repayment of the securities, if material;
10. Rating changes;
11. Bankruptcy, insolvency, receivership, or similar event of the obligated person;
12. Merger, consolidation, or acquisition or the sale of all or substantially all of the assets of the obligated person; or
13. Appointment of a successor or additional trustee or the change of name of a trustee, if material.

Advice, FWIW

- One of your responsibilities, then, is to create (or make sure that someone within your municipality creates) a system that "reminds" the municipality to file if any of these things occurs. It's easy to overlook the need to file unless (a) your bond counsel happens to ask, or (b) you have a reliable system in place to make it happen.
- Also, in a new Official Statement, you must describe your compliance with your prior continuing disclosure agreements.
- So, if your municipality was late in filing an annual report, or didn't file a material event notice, or otherwise breached the prior continuing disclosure agreements, you have to say that in the new Official Statement.
- As a bond lawyer, I used to be pretty casual about continuing disclosure. But the SEC and the MSRB are getting very, very concerned about this matter, and we can't afford to be casual anymore.

The Basics of Tax Exemption

Why Does It Matter?

- Interest payments on most municipal bonds are exempt from federal income tax.
- Purchasers of municipal bonds will therefore require a lower rate of interest on a tax-exempt bond than they would for a taxable bond.
- In short, tax exemption saves you money.

Private Use

- A bond-financed facility that has "private use" is not eligible for tax exemption.
- Sometimes private use is easy. If you issue bonds to build a new car dealership, and then lease it to your good friend the car dealer, that's private use.
- But what about a bank that sponsors your athletic field and gets naming rights? What about a private company that caters every event in your auditorium?

Arbitrage

- The issuer cannot earn a materially higher rate of return on the investment of bond proceeds than it is paying on the bonds.
- In this interest rate market that is a theoretical rather than a real limitation, but you still have to follow the rules.

After Closing….

- The bond lawyer handles these questions when the bonds are issued.
- But after the bonds are issued, local counsel may become the central player.
- Assume your municipality issues general obligation bonds to build a new public services complex. You are planning for future growth, so you build the complex larger than it needs to be. Initially, the only occupant of the complex is your municipality. But a few years down the road, growth is slower than expected, and your City Manager gets a request to lease the unused space in the complex to a local insurance firm. The unused space is 25% of the total square footage of the building.
- What do you think the IRS would say about this proposal?
- How do you keep the tax issues in mind?

Procedures for Tax Compliance

It's certainly wise to have a system that tracks or requires:

- The investment and expenditure of the bond proceeds;
- The nature, location, and use of all facilities or parts of facilities financed by the bonds;
- Periodic review of compliance with the legal requirements necessary to preserve the tax advantages of the bond;
- Hiring professionals or consultants as necessary to comply with the legal requirements applicable to the bonds, including, without limitation, the requirement to compute and pay rebate;
- Consultation with bond counsel prior to engaging in post-issuance credit enhancement transactions;
- Consultation with bond counsel before modifying the interest rate, maturity date, or other material terms of any outstanding bonds;
- Retention of records relating to the bonds for the period required by law, which is currently the term of the bonds plus 3 years.

Section 4:
Questions and Applications

Thank You!

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