



POPE FLYNN  
GROUP

# Tax-Exempt Bond Fundamentals

April 29, 2024

## What this Presentation will Cover:

- Overview/Background
  - What is a Tax-Exempt Bond?
  - Evolution of Public Finance
  - Public Purpose
  - Powers/Control of Government
- Types of Borrowing
  - Understanding Municipal Credits
  - Tax-Pledges
  - Revenue-Pledges
  - Non-Appropriation Borrowings
  - Other Municipal Debt

## What We Will Cover in this Presentation

- Understanding the Players
  - Issuers
  - Legal Counsel
  - Municipal Advisors
  - Bankers/Underwriters
- Transactional Building Blocks
  - Loans vs. Securities
  - Tax-Exemption
  - Disclosure
  - Other Legal Considerations for a Borrowing

## Background

- What is a Tax-Exempt Bond?
- Evolution of Public Finance
- Public Purpose
- Powers/Control of Government

## What is a Tax-Exempt Bond?

- Status
  - Government
  - Qualified Private Entity
- Conduct
  - Private Business Use Considerations
  - Private Payment and Private Security Considerations
  - Use of Proceeds Considerations

## Evolution of Public Finance

- Generally
- Manifest Destiny
- Defaults
- Dillon's Rule v. Home Rule
- Legislative Restraint
- Role of Bond Counsel

### Public Purpose

- Limitations on lending of Public Credit
- Failure of the Union Pacific Railway to market bonds for the second transcontinental railroad and associated bank failure contributed to the Panic of 1873 and led to the failure of many railroads, which had been supported by state and local governments



## Public Purpose

- Widespread defaults and litigation lead to severe limits on the ability of government to joint venture with private enterprise, lend the public credit, and undertake financings secured by taxing power



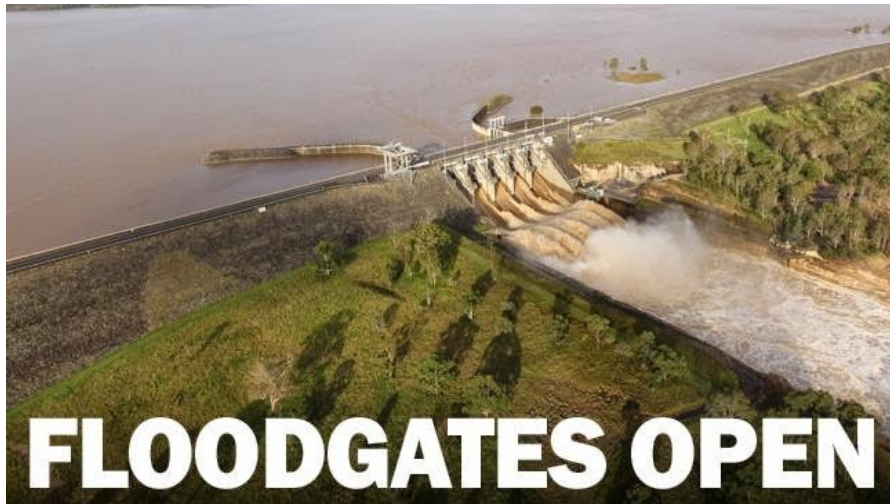


## Public Purpose

- Bondholders experienced significantly varying outcomes in litigation relating to municipal bonds, leading the market to question representations by local governments and their local counsel
- In response, bondholders demanded that underwriters obtain an objective opinion regarding the bonds, typically from a Wall Street firm
- Bond issues with “nationally recognized bond counsel” sold more readily and the practice became standard in the industry

## Public Purpose

- Limitations on lending of Public Credit
- Constantly evolving; can be unclear
- Pushing the permissible limits
- “Economic Development” blessed as a public purpose in the 1980’s by the South Carolina Supreme Court opened the floodgates



### Public Purpose

- That is all to say that the willingness and ability for governments to find ways to entice industry to locate in its area has a long and colorful history, and continues full tilt



## Power to Borrow

- Governments generally cannot “sign a note” at a local bank

(2) The political subdivisions of the State shall have the power to incur bonded indebtedness in such manner and upon such terms and conditions as the General Assembly shall prescribe by general law within the limitations set forth in this section and Section 12 of this article.

Such political subdivisions shall have the power to incur indebtedness in the following categories and in no others:

- (a) General obligation debt; and
- (b) Indebtedness payable only from a revenue-producing project or from a special source as provided in subsection (10) of this section.

- Restrictions under State law – determining the validity of the borrowing; pre-emption and Constitutional approvals
- Restrictions under Federal law – tax-exemption, registration, reporting
- General Fund v. Proprietary/Enterprises Funds
- Governmental Clearing Houses: SFAA, JEDA, County Councils

## Types of Borrowings

- Understanding Governmental Credits
- General Obligation Debt
- Revenue Debt
- Non-Appropriation Borrowings

## General Obligation Bonds

- General Obligation Bonds
  - Must be for “public” and “corporate” purpose
  - Full Faith, credit, and general taxing power
  - “Unlimited” pledge
  - Can be accompanied by a limited (capped millage authorization) pledge of a specific area (County special taxing districts)
  - Determining borrowing capacity
  - Voter approval?

### Revenue Bonds

- Revenue Bonds
  - Payable solely from revenues from a specific source or pooled revenues from various sources

(10) Indebtedness payable solely from a revenue-producing project or from a special source, which source does not involve revenues from any tax or license, may be issued upon such terms and conditions as the General Assembly may prescribe by general law;

### Revenue Pledges

- Revenue Bonds may be:
  - Project Based (water, sewer, solid waste, gas, electric charges)
  - Fee based (tourism fees, hotel taxes, parking, FILOT)
  - Special Source and TIF Borrowings
- Typically not subject to debt limitations
- Authorization:
  - Constitution
  - Local: Indenture, Ordinance, Resolution....



### Revenue Bond Covenants

- Limited Pledge
- “Waterfall” of funds
- Borrowing documents will specify whether debt service on bonds will come before O&M expenses (gross pledge) or after (net pledge)
- Covenants
  - Reserve funds
  - Insurance
  - Rates
  - Asset ownership/sales
  - Surplus funds
  - Efficient operation
  - No free service

### Revenue Bond Covenants

- Coverage Ratios:
  - Rate Covenant – requires that utility rates be maintained at a certain level (a multiple of O&M and debt service)
  - Additional Bonds Test – requires certain coverage before the issuance of new debt
- Additional Bonds:
  - Parity bonds enjoy the same lien status as the prior bonds, and must meet the additional bonds test
  - Junior lien bonds may be issued at any time
  - Special projects, lease/purchase exceptions in bond documents

## Subject-to-Appropriation Borrowings

- Lease-Purchase
  - Limited by State law (amount, asset-type, term, etc.)
  - No pledge of revenues; payment obligation is subject to appropriation
  - Premise of Lease exception is that since a lessee is obligated for rent only to the extent of use of the property, the ability to walk away constitutes an exception to the State law debt limitations
  - Lessee is only obliged on an annual basis and not over a long term
  - Tax requirements provide that lease payments be separated into principal and interest components
  - Asset will pass to issue free and clear upon conclusion of lease term
  - Be mindful of problematic contract terms (non-substitution, indemnification, additional insured)

## Subject-to-Appropriation Obligations

- Installment purchase
  - Like Lease-Purchase, this is a class of non-debt debt
  - Subject to appropriation
  - Essentiality is important - Look to asset financed (City Hall v. Public Park)
  - Authorization may be limited by State law
  - Tax requirements provide that lease payments be separated into principal and interest components
  - Title passes at end of term
  - Reasons:
    - There is a project that the municipality wants to undertake but does not have sufficient debt limit to finance the project;
    - The municipality has available debt limit for the project but does not want to exhaust all of its available debt limit for this project; or
    - The municipality plans to issue a revenue bond but the coverage requirements or repayment sources present challenges.

## Other Borrowings

- Double Barrel Bonds
- Anticipation Borrowings
  - Bond Anticipation Notes
  - Grant, Revenue, Tax Anticipation Notes
- Special Assessment Bonds
- Tax Increment Financing

# Understanding the Players

- Issuers (Direct v. Conduit)
- Legal Counsel
  - *Bond Counsel*: Required to deliver validity opinion for borrowing
  - *Local Counsel*: Know day to day operations; required to deliver an opinion as to underlying documents and litigation
- Municipal Advisors
  - Evolving role, far more involved in transactions; Should have discussions with Counsel or existing FA about role in transactions or on-going operations
- Bankers/Underwriters
  - *Underwriter*: Only for public market deals
  - *Other Counsel*: Represent Trustee, Underwriter, Issuers (i.e. Disclosure or Special Tax matters)

## Legal Counsel

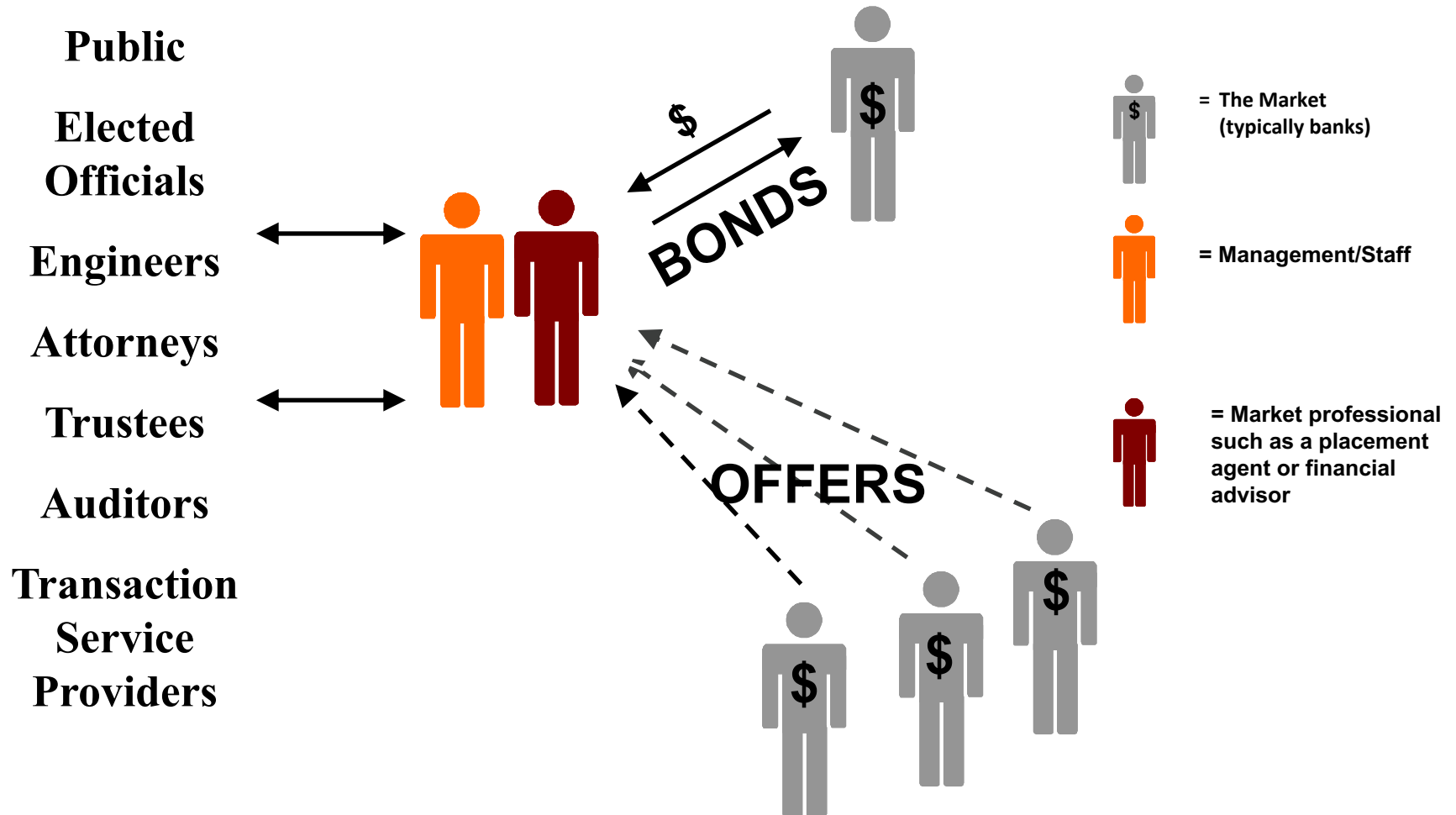
- Bond Counsel
- Borrower's Counsel
- Underwriter's Counsel
- Trustee's Counsel

# Municipal Advisors

- Background:
  - Regulations in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, passed after the Great Recession, established that anyone providing financial advice to issuers of bonds would be regulated
  - Responsibility was left to the Securities and Exchange Commission to define what a municipal advisor is and is not
- What or who is a municipal advisor?
  - A firm and its associated persons that provides “advice,” with or without compensation, to “municipal entities” and “obligated person” on the issuance of “municipal securities” or “municipal financial products”
- What are the implications of being a Municipal Advisor?
  - Required to register with the MSRB
  - Statutory Fiduciary Duty: includes a duty of loyalty and duty of care
  - Subject to the MSRB rules

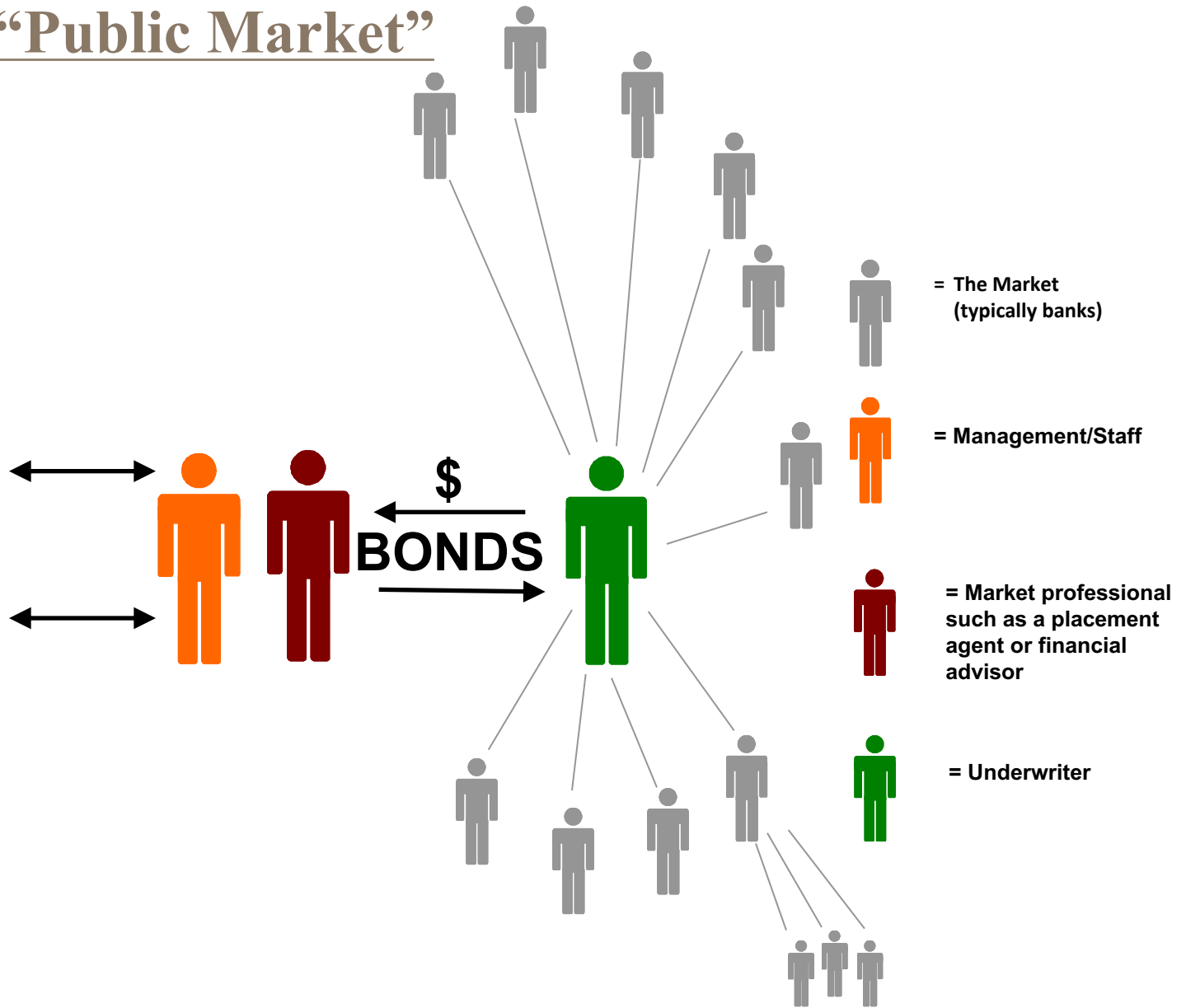


# “Bank Loans”



“Public Market”

- Public**
- Elected Officials**
- Engineers**
- Attorneys**
- Trustees**
- Auditors**
- Rating Agencies**
- Transaction Service Providers**



## Transactional Building Blocks

- Loan vs. Security
- Tax-Exemption
- Disclosure
- Other Legal Considerations for a Borrowing

## Loan vs. Security

- Purina Test: *SEC v. Ralston Purina Co.*
- Reves Test: *Reves v. Ernst & Young*. – A note is presumed to be a security unless it is of a type specifically identified as a non-security
- MSRB Guidance
- Expanded Scope of Continuing Disclosure requirements

## Tax-Exemption

- With tax-exemption comes agreement to abide by certain rules and regulations regarding use and payment sources
- Set forth in IRS rules and regulations
- Section 103 – Substantially overhauled in 1986
- Bank-qualification (Section 265) – Applicable to Qualified Small Issuers

## 2017 Tax Reform

- Tax Exemption Preserved
- Elimination of Advance Refundings
- Elimination of Certain Tax Credit Bonds
- Retention of Private Activity Bonds
- Maintains authorizations for arenas and stadium
- Reduction of Corporate Tax Rate
  - 35% to 21%
  - Banks, Insurers
  - Effected Tax Gross-Up provisions in docs
- Repeal of corporate AMT

## Disclosure

- 1933 Securities Act
  - Section 17(a): Antifraud
- 1934 Exchange Act
  - Tower Amendment
  - Section 10b-5: Antifraud
  - Rule 15c2-12
- Continuing Disclosure
  - Rule 15c2-12 (1975; 1994)
  - MSRB; EMMA
  - Municipalities Continuing Disclosure Cooperation initiative

## Other Legal Considerations for a Borrowing

- Other Legal Considerations for a Borrowing
  - FOIA
  - Arbitrage and rebate
  - Spend down requirements
  - Tax Covenants (Ownership, use, disposition)
  - Economic Development/Public Purpose
  - Policies & Procedures
  - Capital planning





\*\*\*DISCLAIMER\*\*\*

This presentation does not create an attorney-client relationship. All material contained in this presentation is presented for educational purposes only and does not and may not be construed as legal advice to any person. Prior to relying on any statement contained herein, any reader of these materials should consult with counsel and obtain independent legal advice.