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Bonds 101: A Municipal Bond Primer

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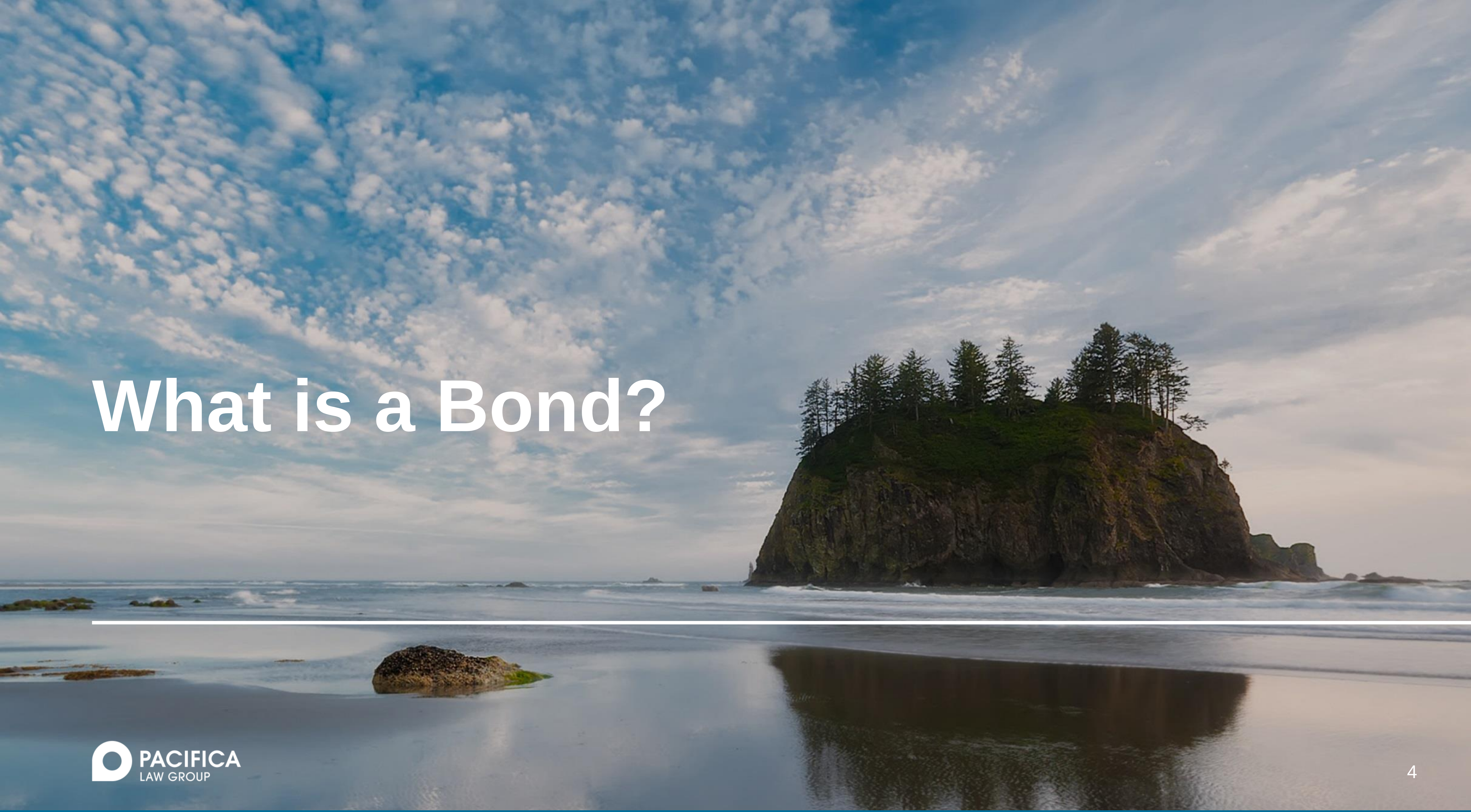
Overview of Session

Bonds 101

- What is a Bond?
- Legal Framework
  - State Law
  - Application of Federal Tax Law
  - Application of Federal Securities Law
- Deal Process
  - Roles and Responsibilities
  - Key Documents
  - Putting the Pieces Together
- Practice Tips, Resources

Questions?



What is a Bond?

What is a Bond?

A Bond evidences an obligation to pay (e.g., a loan). For example, defined in Washington as follows:

RCW 39.44.200(1); RCW 39.46.020(1)

- “Bond” means any agreement, which may or may not be represented by a physical instrument, including notes, warrants, or certificates of indebtedness, that evidences an indebtedness of the state or a local government or a fund thereof, where the state or local government agrees to pay a specified amount of money, with or without interest, at a designated time or times.

RCW 39.44.200(3)

- “Type of bond” includes: (a) General obligation bonds, including councilmanic and voter-approved bonds; (b) revenue bonds; (c) local improvement district bonds; (d) special assessment bonds such as those issued by irrigation districts and diking districts; and (e) other classes of bonds.

RCW 39.46.020(4)

- “Obligation” means an agreement that evidences an indebtedness of the state or a local government or a fund thereof, other than a bond, and includes, but is not limited to, conditional sales contracts, lease obligations, and promissory notes.

What is a Bond?

Must be authorized by State law

- Issuers (*e.g.* city, county, public utility district, university, fire district, school district, conduit issuer) have unique debt authority and limits under state law
- Requires governing board approval
- Final approval of bond sale may be delegated within certain parameters

Benefit of bond financing

- Receive project funding up front
- Intergenerational equity
- Time value of cash

What is a Bond?

Governmental Bonds

- Issuer issues bonds to finance governmental projects directly
- Payable from and secured by governmental revenue
  - Voted and non-voted general obligation bonds
  - Revenue bonds (payable from an enterprise fund (*e.g.* water, sewer, storm, solid waste, electric utility systems), general revenues of issuer)
  - Assessment bonds

Common Types of Governmental Bonds (Washington)

Unlimited Tax General Obligation (UTGO)	Limited Tax General Obligation (LTGO)
▪ Consumes UTGO debt capacity ▪ Only for capital purposes, not the replacement of equipment ▪ Supermajority (60%) voter approval ▪ Validation requirement ▪ Paid from excess property tax levy ▪ Outside of statutory or constitutional limits on regular property taxes ▪ Levy set at rate required to pay debt service	▪ Councilmanic, non-voter approved ▪ Consumes LTGO debt capacity ▪ Any municipal purpose (generally) ▪ Pledge to levy regular (nonvoted) taxes as necessary to pay debt service within legal limits: • Statutory rate per thousand (e.g., \$3.60/\$1,000 AV for cities) • Aggregate rate limit (\$5.90/\$1,000 AV – subject to prorationing) • 101% limit on increases in levy amount ▪ Paid from general fund or other legally available revenues

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Common Types of Governmental Bonds (Washington)

Revenue Bonds	Assessment Bonds
▪ Payable from generating assets (e.g., user fees, rates, connection charges) ▪ **Not** subject to constitutional or statutory debt limitations ("special fund doctrine") ▪ Capacity to issue additional bonds secured by enterprise revenues is typically limited by covenants established in the bond resolution ▪ Additional bonds test (ABT) requires an issuer to demonstrate a minimum level of debt service coverage (e.g., 1.25x or 1.50x), including the proposed new debt ▪ May require a debt service reserve fund	▪ Infrastructure (e.g., road or utility improvements) with special benefit to property owners ▪ Payable from charges imposed against properties in a designated local improvement district (LID) or utility LID in respect of special benefits received by those properties from the construction of nearby or adjacent public improvements, separate and apart from the general benefit accruing to the public at large ▪ Special assessments are determined according to the value of the benefit received – value capture financing ▪ Process for creating district, setting the assessment roll, finalizing the assessment roll, and issuing debt payable from assessment is highly statutory

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What is a Bond?

Conduit Bonds

- Issuer issues bonds and loans proceeds to a third party borrower for an authorized purpose
- Payable from and secured by revenues of borrower, typically derived from a loan, lease or installment sale payments
  - — Exempt facilities, including multi-family and single-family housing revenue bonds
  - — Nonprofit facility bonds (nonprofit primary schools, museums, YMCAs, social service providers, private universities; private hospitals)
  - — Industrial development bonds (small issue bonds for manufacturing)
- Nonrecourse obligation of the issuer, unless otherwise agreed to

What is a Bond?

May be issued as tax-exempt (for federal income tax purposes, and for state income tax purposes in states with income taxes)

- Interest paid to investor holding tax-exempt municipal bonds is excludable from income taxation
- Subject to ongoing federal tax law requirements

Subject to securities laws

Common financing methods

- Sale on public market via underwriter (negotiated or competitive sale)
- Bank financing (private placement)
- Seller/vendor/equipment financing
- State loan programs to local governments
  - Local Option Capital Asset Lending ("LOCAL") State borrowing program
  - Public Works Trust Fund, State Revolving Fund, Clean Renewable Energy Bond
- Federal loan programs to local governments
  - USDA Rural Development
  - US EPA (Water Infrastructure Finance and Innovation Act (WIFIA)) loans
  - US DOT (Transportation Infrastructure Finance & Innovation Act (TIFIA)) loans

Legal Framework

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Legal Framework – State Law

Legal authority to issue bonds derives from state law (varies from state to state)

- Specific statutory authority
- Issuer's charter or code may contain additional requirements

Decision-making tree:

- Does the issuer have constitutional and statutory authority to issue debt of the type proposed?
- Does the debt first require voter approval?
- Does the issuer have legal debt capacity to issue the debt?
- What is the statutory process for issuing the debt? (e.g., formation of LID/ULID and confirmation of assessment roll)
- Are any third party approvals, guarantees or notices needed?
- Does the issuer/borrower have the legal authority to pledge the identified revenues?
- Does the issuer/borrower have the legal authority to undertake the project to be financed?
- What is the issuer's/borrower's approval process for the authorizing legislation? (e.g., resolution or ordinance approving the bonds or delegating authority to approve bonds within specified parameters)

Legal Framework – Federal Tax Law

Internal Revenue Code and regulations govern:

- How tax-exempt bond proceeds can be spent
- Use of financed facility/assets
  - Limits the ability of the issuer to sell, lease or otherwise allow private use of the bond financed facility
- The investment and arbitrage of bond proceeds
- Records retention

Set expectations at closing with key documents

- Tax certificate(s)
- Form 8038-G (governmental bonds) and Form 8038 (qualified private activity bonds)

Monitor for changes

- Post-issuance compliance policy
- Private activity and use tracking

Legal Framework – Federal Tax Law

When planning the development of a new facility, consider:

- When does the issuer/borrower expect to *spend* the proceeds?
- Which expenditures *can be* financed with tax-exempt bonds?
- Which expenditures *should be* financed with taxable bonds or cash (equity)?
- What are the issuer’s/borrower’s *reasonable expectations* at closing with respect to use of the facility over the term of the bonds?
- How much *flexibility* is desired over the term of the financing?

Use of Governmental Bond Financed Facility – Limit on Private Activity

Nonqualified "Private Activity Bond" = TAXABLE

Two ways to have a private activity bond:

1. Private Loans
   - 5% test
2. Private business use plus private payments or security
   - 10% test
   - $15 million limitation

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Private Business Users

Generally, “private business use” means:

- Use (directly or indirectly)
- Of a financed facility
- In a “trade or business”
- Carried on by any nongovernmental person
  - — Corporations, partnerships or any other entity engaged in business
  - — Federal government and federal government agencies
  - — Natural persons engaged in a trade or business
  - — Nonprofit organizations

Common examples of “private business use”

- Private ownership of the financed facility
- Lease of the facility to a private business user
- Nonqualified management contract (e.g. food service contracts; parking contracts)
- Nonqualified output contract
- Special legal entitlement

Common Exceptions to Private Business Use

General Public Use

- Use by a member of the general public (natural persons not engaged in trade or business) is not private use

Incidental Use

- Examples: kiosks, vending machines, pay phones
- Use is non-possessory and the non-possessory uses do not exceed 2.5% of the financed facility

Short Term Use

- Example: facility rental
- Less than 50 days of use under a single lease or use agreement
- Payments must be fair market value

Agents

Use incidental to financing arrangements

Temporary use by developers

Qualified Private Activity Bonds ("PABs")

Nonqualified private activity bonds are taxable, but qualified PABs are available to help private parties finance various types of projects that are designated as eligible for tax-exempt financing under the Code

- Exempt facilities (airports; docks and wharves; mass commuting facilities; qualified residential rental projects; qualified green building and sustainable design projects; certain water, sewage, and solid waste facilities; and others); qualified mortgage bonds; qualified small issue bonds; qualified 501(c)(3) bonds; and others

Often issued as a conduit bond

- Proceeds loaned to conduit borrower to finance a qualified capital project or other authorized expenses

Generally 95% or more of net bond proceeds must be used for one or more qualified purposes

Public hearing and approval requirement

May have volume cap requirement

Legal Framework – Federal Securities Laws

Although municipal bond issuers are exempt from the SEC's registration and filing requirements that apply to corporate issuers, *all* issuers are subject to the antifraud requirements that apply when issuers speak to the market

- Antifraud requirements
  - — Rule 10(b)(5)
  - — Section 17
- Primary disclosure
  - — Preliminary and final Official Statements
- Secondary market disclosure
  - — Ongoing disclosure (i.e., required annual filings and event filings)
  - — Voluntary disclosure (e.g., on EMMA, issuer-investor relations webpage, etc.)

Antifraud Laws

Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934, prohibits fraud in connection with the purchase and sale of securities. Makes unlawful:

- any untrue statement of a material fact or
- omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,
- in connection with the purchase or sale of any security.

Section 17(a) of the Securities Act of 1933 prohibits fraud in the offer and sale of securities.

- Negligence sufficient to establish a Sec. 17(a) violation.
- No finding of scienter (intent) required.
  - "knew or should have known" standard for establishing negligence
  - i.e., failure by an actor to conform conduct to the standard of a reasonable person

Materially Accurate and Complete

Whether a statement or omission can give rise to a securities law violation depends on whether the statement or omission is *material*.

The definition of “material” has been established by case law

- There is a substantial likelihood
- That a reasonable bond investor
- Would consider it important in making an investment decision
  - There must be a substantial likelihood that a fact *“would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.”*

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Speaking to the Market: Primary Disclosure

The antifraud provisions apply any time an issuer speaks to the market. Primary disclosure includes the preliminary official statement and final official statement prepared in connection with the sale of bonds.

Preliminary Official Statement (POS)

- Deemed final by the issuer (includes all material info and materially accurate)
- Excludes pricing information

Final Official Statement (OS)

- Updates POS to include pricing information
- Stickers/amendments (if necessary)

Speaking to the Market: Secondary Market Disclosure – Filings on Electronic Municipal Market Access (“EMMA”)

Secondary market disclosure includes required EMMA filings and voluntary disclosure.

The SEC has settled alleged antifraud violations for secondary market disclosure under Rule 10(b)5 and based on a *willful or recklessness* standard.

- SEC Rule 15(c)(2)-12
  - Underwriter must confirm the issuer has entered into a written undertaking to provide annual information and notice of listed events

- Contractual obligation of the issuer and/or obligated party to provide:
  - Annual financial statements
  - Annual operating or other information, as stated in the undertaking
  - Notice of certain events within *10 business days* of the notice of the occurrence of the event (such as rating change, incurrence of a material financial obligation)

SEC Staff Legal Bulletin (Feb. 7, 2020)

A caution regarding the scope of the antifraud requirements

The SEC Office of Municipal Security (OMS) released a legal bulletin summarizing existing law regarding the application of the antifraud requirements to public statements by issuers and borrowers.

- Rule 10b-5 under Section 10(b) of the Securities Exchange Act
  - Applies to secondary market disclosures as well as primary disclosures
  - Prohibits making any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading
- *Any public statement* (at least by officials who may be viewed as having knowledge regarding the financial condition and operation of an issuer) may be *reasonably expected to reach investors* and therefore be subject to the antifraud requirements.

Deal Process

Deal Process – The Finance Team

Issuer team members:

- Key personnel:
  - Executive, Administrator or Manager
  - Finance Director/Officer
  - Issuer attorney/general counsel
  - Public works/project management staff
- Bond counsel (represents the Issuer)
- Disclosure counsel, if any (may be bond counsel; represents the Issuer)
- Municipal advisor (fiduciary responsibility to Issuer)

Other team members may include:

- Borrower (for conduit bonds)
- Counsel to borrower
- Lender or underwriter
- Counsel to lender or underwriter
- Third party guarantors
- Trustee/paying agent (e.g., State fiscal agent)
- Verification agent/escrow agent (if a refunding)
- Rating agency (for rated bonds)
- Bond insurer (for insured bonds)
- Verification agent (if a refunding)
- The Depository Trust Company (“DTC”) (for uncertificated bonds)
- Others

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Deal Process – Putting the Pieces Together

Key milestones

- Project development
- Obtain voter approval, if needed
- Assemble the financing team and hold scoping/kick off meeting
  - Any necessary RFP or procurement process
- Develop and adopt authorizing legislation (resolution or ordinance), financing documents (indenture and loan agreement, if applicable)
- Credit rating process
- Due diligence call
- Develop and release to potential investors the preliminary official statement
- Bond sale or pricing
- Develop and release final official statement
- Closing documents (including tax certificate) distributed for signature
- Closing
  - Receipt of funds
  - Opinions delivered
- Post-Issuance compliance period

Deal Process – Key Documents

Election ordinance or resolution, if voted bond

- Description of bond-finance project(s)
- Ballot language

Authorizing ordinance or resolution; indenture

- Description of the bonds' terms
- Security for the bonds
- Summary of how the bond proceeds will be used
- Covenants between the issuer and bondholder(s)
- Delegated authority

Preliminary and final official statements

- Issuer helps prepare and reviews for accuracy and completeness
- Issuer responsible for the contents no matter who prepares it

Deal Process – Key Documents

Bond purchase agreement

- Signed at pricing
- Agreement between issuer and underwriter that sets forth the negotiated agreement for the underwriter to purchase all of the bonds at closing
- Provides list of deliverables for closing to occur

Post Issuance Compliance Policies and Procedures

- Written procedures for compliance with securities and federal tax law requirements
- Risk management
- Identifies responsible individuals, prompts periodic trainings, identifies red flags and process for any corrective action
- Federal tax law
  - Track spending and investment of bond proceeds
  - Track use of bond financed facilities, and any private use
- Federal securities law
  - Compliance with ongoing disclosure undertaking
  - Reviewing communications to investors for potential anti-fraud violations

Wrap Up

Questions?

Comments?

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