

# Rapport Meyers Whitbeck Shaw & Rodenhausen LLP

## ***Borrowing Money: Ten Things You Should Know About Municipal Finance in New York***

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The issuance of bonds by municipalities is governed by the New York State Local Finance Law as well as federal tax and securities laws. This article is intended to provide an introduction to several basic procedures and concepts applicable to the issuance of municipal obligations, and to identify current topics which may affect a financing.

### **Who are the players and whom do they represent?**

Local participants in municipal bond offerings often do not have a clear understanding as to what roles various parties play in the transaction. Because consultants and attorneys come with a price tag, and because the structure of the deal will affect your costs, it is important to understand who these parties are and what their role is. In a typical small Local Finance Law transaction which is privately placed, the parties involved might include the municipal issuer, bond counsel and a local bank. In a publicly offered transaction, or a larger transaction sold on a negotiated basis, other parties involved might include a financial advisor, underwriters, underwriter's counsel, auditors, rating agencies and bond insurers.

*A bond counsel firm* is a law firm listed in the Bond Buyer's Municipal Marketplace or "Red Book", which is engaged to render an "unconditional" opinion as to the validity and tax-exempt status of the bonds. In a Local Finance Law transaction, bond counsel is engaged and paid by the municipal issuer.

Because they must pass on all procedural matters affecting the bonds, the bond counsel firm generally prepares bond resolutions, referendum proceedings, legal publications, notices of sale and closing documentation. They provide assistance in structur-

ing the obligation and the use of proceeds to comply with the Local Finance Law and federal tax requirements.

It has been a common practice in New York for local attorneys who are not nationally recognized bond counsel firms to give opinions on BAN proceedings for very small note offerings purchased by local banks. Issuers need to be able to borrow at the least cost, and often prevail upon their local counsel to accommodate them. Problems can arise, however, when there is a failure to comply with any of the numerous specific requirements of the Local Finance Law.

If proper procedures are not followed, it may not be possible to later issue long-term serial bonds to pay off short term notes. For example, a failure to comply with the requirement to make principal payments in compliance with the 50% rule could mean that bond counsel is unable to render the opinion required by the public bond market. In addition, federal tax law requirements change frequently and impose requirements on even the smallest note issues. For example, failure to issue obligations within the time period required by the reimbursement regulations could leave a municipality with no alternative but to issue taxable bonds at significantly higher cost to the municipality.

*Financial advisors*, sometimes known as fiscal advisors, are independent consultants engaged by the municipal issuer. They assist the issuer in structuring the terms of the bonds and determining the most cost-effective method of sale, work with rating agencies to obtain a rating, assist with the preparation of disclosure documents, take bids for services such as printing official statements and bond insurance and work with all parties in scheduling and coordinating the tasks required.

Financial advisors act as an agent of the issuer; they do not purchase the bonds. They should not be confused with underwriters (although underwriting firms may act as financial advisors in transactions where they are not participating as an underwriter). Financial advisors are engaged to represent the interests of the issuer and should not represent other parties without full disclosure to and consent of the issuer.

*Local banks* often purchase notes on a negotiated basis. Even for small unrated issues, municipalities should always consider shopping for rates from more than one bank to ensure they are paying the lowest possible cost for debt service.

After 1986, banks were no longer permitted to deduct interest incurred on indebtedness incurred to purchase tax-exempt bonds. Section 265(b)(3) of the Internal Revenue Code provides an exception for municipalities which issue less than \$10,000,000 of bonds in a given year. For this reason, local banks are usually interested in purchasing bonds or notes only from issuers which fall under this \$10,000,000 threshold.

*Underwriters* are firms that purchase bonds from the issuer in an initial public offering. Typically, they market the bonds to prospective purchasers in advance of the pricing and will settle with their purchasers at or about the same time as the bond closing. Their compensation typically comes in the form of the difference between the price paid to the issuer and the price paid by the ultimate investors. If an underwriter's counsel is involved, their fee as well as other underwriting expenses may be paid by the issuer or the underwriter; this is a matter of negotiation in each transaction; for example, it is typically used in an advance refunding.

In a competitive offering, underwriters bid for the issue at a competitive sale. In a negotiated sale, underwriters work with an issuer in advance to structure the offering. A negotiated sale may be considered cost-effective for novel or complex structures. In either case, the underwriter may be a single firm or a group of firms acting together as part of a syndicate.

In a negotiated transaction, the underwriter engages its own counsel to assist the underwriter in performing its "due diligence" with respect to the bond issue. Due diligence includes looking behind the statements of the issuer to confirm financial information and legal requirements which may affect payment of the bonds. Traditionally, underwriter's counsel has prepared the official statement for larger negotiated offerings, meeting with representatives of the issuer and bond counsel to collect the necessary information. Recently, more issuers are engaging their own counsel to prepare the disclosure documents on their behalf. The underwriter would still be obligated to do its own diligence and would need counsel to review documents on its behalf.

A municipality's auditor is often involved in larger public offerings because prior years' audits are included in the disclosure documents. As a part of the underwriter's due diligence, the auditor may be asked in some cases to provide an update as to changes in the financial status of the issuer since the date of the last audit. In these cases the audi-

tor may be asked to perform a variety of “agreed-upon procedures”. Auditors typically charge fees for involvement in a bond issue in addition to the fee they charge for the audit itself.

*Rating Agencies* such as Moody’s Investors Service, Standard & Poor’s Ratings Group and Fitch Investors Service, Inc. all provide ratings on municipal bonds which are to be sold publicly. For smaller issues, only one rating is usually obtained. The issuer must pay a fee for the rating process. The reason an issuer seeks a rating is to make the bonds more attractive to investors; some purchasers such as investment funds can purchase only those bonds which are in the highest rating categories. A broader market for bonds is usually considered to result in lower interest rates. It does not always follow, however, that every incremental increase in rating category will result in better interest rates. The decision as to what ratings to seek should be made with the assistance of the issuer’s financial advisor and bond counsel.

Once an issue is rated, the rating agencies will request additional financial information on an ongoing basis in order to maintain the rating. Recently, some rating agencies have attempted to charge issuers an annual fee in this regard, although this has not yet become common.

*Bond insurers* such as MBIA, FGIC, AMBAC and others provide an insurance policy for bondholders insuring the prompt payment of principal and interest on the bonds. As with a rating, the purpose of the insurance policy is to make the bonds more attractive to investors and secure a better interest rate. Paying agents are banks engaged by the issuer to provide a service to the issuer to ensure bonds are transferred and paid on a timely basis. They were a necessary party when bearer bonds were the norm, but have become less common with the use of registered and DTC-only obligations.

*Rebate analysts* are engaged by the issuer after the bonds are issued to compute rebate liability on the bonds, discussed below. For issues subject to rebate, it is important for the issuer to maintain good records with respect to investments made with the proceeds of the bonds.

### **What are BANs and Bonds and when are they issued?**

All obligations issued by municipalities under the Local Finance Law are general obli-

gations of the municipality, secured by the full faith and credit of the municipality. Municipalities can issue tax anticipation notes, revenue anticipation notes and budget notes under specified conditions for short-term operating funds, which are beyond the scope of this article. Capital projects are financed with Bonds, BANs, or a combination of both.

BANs are bond anticipation notes issued for a period of not exceeding two years, and renewable annually, to finance a project after a bond resolution is adopted. The original purpose for issuing BANs was to permit an issuer to finance project expenses for a short period of time until the project was complete and the final cost was known, and then to issue a single long-term bond obligation. BANs normally must be rolled into serial bonds within five years, but BANs issued for assessable improvements may continue to be renewed.

When short-term rates are substantially lower than long-term rates, many issuers will continue to issue BANs each year rather than issuing long-term serial bonds or statutory installment bonds, notwithstanding the additional issuance costs involved for each issuance. Issuers should take into account the risk of interest rate changes over time in evaluating the relative costs of staying in BANs versus issuing Bonds.

### **What is a PPU anyway?**

Under the New York State Local Finance Law, a project must have a “period of probable usefulness,” or “PPU,” in order to be financed with bonds or capital notes. This requirement was adopted as part of the original Local Finance Law to collect in one statutory location a list of all of the types of projects for which debt may be issued. This provision is intended to ensure that a municipality does not finance a project for a period longer than its useful life. The drafters believed that those who benefit from a project are the ones who should be taxed to pay for it, and they also wished to encourage municipalities to retire debt quickly to save on interest costs. There are currently over 90 PPU’s, some of which are roughly based on useful life and some of which appear to be entirely arbitrary.

As an example, sewer systems generally have a PPU of 40 years for new projects, with 30 years for replacements, and 10 years for replacement of furnishings. Injection sealing has a PPU of 15 years. Water systems have a PPU of 40 years, with 15 years for replacement of furnishings.

The PPU for judgements or settlements of litigation is generally five years, but can be increased to ten years if the judgement exceeds one percent of average assessed valuation, or fifteen years if it exceeds two percent.

The PPU is one of the items which must be specified in the bond resolution. Bond counsel will determine the appropriate PPU based on factual information and representations of the issuer and, in some cases, its engineers, accountants or other consultants.

The PPU is important to the municipality in planning for annual debt service because it determines the maximum term over which the bonds can be amortized. The last maturity date of the bonds cannot exceed the PPU, which is measured from the date of first issuance of BANs. This will directly affect the annual cost of the project.

Another major factor in the annual debt service payments is the principal maturity schedule, determined according to the old “50% rule” or the newer level or declining debt service rule. Under the old 50% rule, no payment of principal can exceed by more than 50% any prior principal payment. Under the level debt rule, the issuer can elect to structure the principal payments so that the total principal and interest payments in each year are substantially equal or decline over the life of the issue. If BANs are renewed for longer than two years, payments must be made to retire principal annually in compliance with one of these rules. Problems can arise if an issuer makes too small a payment toward retiring principal before a BAN renewal, and it becomes impossible to comply with the statutory requirements for a later serial bond issue.

### **Should municipal obligations be sold publicly or privately?**

In general, BANs can be sold either publicly or privately, and bonds over \$1,000,000 must be sold publicly (i.e. by competitive bidding). An exception which allows negotiated sales (i.e. the price is determined by negotiation directly with an underwriter) for variable rate bonds or with the New York State Comptroller’s consent. For a small issue, a private financing with a local bank may be most cost effective, depending on the borrower’s size and borrowing history. For these very small issues, the additional costs of a public offering may not be cost effective in comparison to the potential difference in interest rates over the life of the issue.

## **The chicken or the egg?**

Several timing factors are critical in a bond or BAN issuance. The Local Finance Law requires that a bond resolution be adopted before an encumbrance is made. Thus, if a municipality is planning to temporarily finance a purchase of equipment from another source and replace it at a later date with bond proceeds, it is necessary to adopt the bond resolution before the equipment is purchased. In addition, federal tax laws require that an issuer indicate its intent to finance an expenditure with an issue of bonds before costs, other than certain preliminary costs, are incurred. Bonds or BANs must be issued within a specified period following the completion of the project in order to be tax-exempt. It is important to contact bond counsel early in the process of planning for a project to ensure that the proper procedures are followed. Another timing consideration is deciding when to authorize or issue obligations and when to bid contracts. If a referendum is required, it is necessary to plan the structure of the issue, including making a preliminary calculation of debt capacity, in order to ensure the amount of the authorization is sufficient. Most officials do not want to present a referendum which is larger than absolutely necessary, but actual costs can sometimes vary considerably from engineering estimates. Some municipalities compromise by taking bids, then holding the referendum, and then awarding the contract, issuing BANs and commencing the project. This type of schedule can become more complicated if a bid contest arises. Each municipality should discuss these timing issues with its project manager and engineer or architect and bond counsel and ensure all parties to the transaction are kept apprised of any changes in project cost and schedule.

## **What do I need to know about disclosure?**

The Securities Exchange Commission (SEC) has issued significant regulations affecting disclosure in connection with the initial issuance of bonds and imposing continuing disclosure requirements for the life of the bond issue. The SEC has also increased its enforcement activities in the municipal arena. Municipal officials should be aware of this focus and understand its impact on their issues.

The municipal securities market is exempt from the securities registration requirements applicable to corporate debt offerings. Over the last 20 years or so, there have been increasing efforts to subject municipal offerings to the same standards as corporate offerings.

In 1993, the SEC used its general anti-fraud authority to promulgate Rule 15c2-12 under the Securities Exchange Act, which makes it unlawful for an underwriter to participate in an offering subject to the rule unless the underwriter reviews a “deemed final” official statement in advance. In 1994, the rule was amended to require that an underwriter determine that the issuer or other obligor has undertaken in a written agreement to provide continuing disclosure of annual financial and operating data and annual audits. These changes were intended to improve disclosure in the municipal marketplace. Exemptions are provided for obligations under \$1,000,000, for certain short-term notes and private placements, and for small issuers with less than \$10,000,000 in outstanding obligations.

For issues subject to Rule 15c2-12 (generally issues over \$1,000,000), if an audit is prepared, it must now be provided as a part of continuing disclosure. In addition, if the issuer’s financial statements are not prepared in accordance with generally accepted accounting principles (“GAAP”), the issuer must explain in what respects its statements differ from GAAP.

A “NRMSIR”, or nationally recognized municipal securities information repository, is a private information service supported by user subscriptions, and officially recognized by the SEC for purposes of the reporting requirements of Rule 15c2-12. Three repositories are currently recognized by the SEC. Documents are to be provided by issuers to the NRMSIRs by fax, and subscribers can access data. Both the NRMSIRs and the Municipal Securities Rulemaking Board (MSRB) are working on a method for filing and accessing information electronically.

Some changes in these disclosure requirements have probably occurred in part because of the growth of investment funds, with larger resources and more clout to demand proper information from municipal issuers. It is unclear whether the changes have, in the short run, resulted in better availability of information. Some investment funds have complained that issuers which formerly provided any and all information when asked now provide only the information specifically required by the rule, out of fear that they will be liable for providing partial information which is misleading when read outside the context of a full disclosure document. SEC representatives have indicated informally that they believe that under the general securities anti-fraud rules, issuers have an obligation to disclose material information at any time.

One primary focus for the SEC's enforcement activities has been "pay-to-play"-- allegations have been made that certain underwriters and other municipal participants have made contributions to municipal officials who select those participants for a transaction. To discourage this practice, the Municipal Securities Rulemaking Board has adopted Rule G-37, which prohibits an underwriter from doing business with a municipality for two years if certain contributions are made to officials of the municipality. In addition, the SEC has commenced investigations and filed federal criminal and civil fraud charges in cases where they believe pay-to-play practices have occurred.

The SEC's enforcement focus has fallen on issuer officials as well as other market participants. A number of municipalities have been the subject of recent SEC investigation, in cases where the SEC believes the issuer did not adequately disclose all material facts in connection with an offering. Several municipal groups, including the National League of Cities and the Government Finance Officers Association, have published a pocket guide to disclosure. It contains questions which the groups believe should be asked by members of an issuer's board in connection with any municipal offering. The questions tend to focus on whether the issuer has procedures in place to ensure compliance with the disclosure requirements, and on the allocation of responsibilities among participants.

### **When do I have to make "rebate" payments to the IRS?**

Since 1986, municipal obligations for governmental projects have been subject to rebate requirements. Municipal issuers are required to rebate to the federal government investment earnings on bond proceeds which are in excess of the yield on the bonds.

Municipalities which issue less than \$5 million in a calendar year are eligible for an exemption from rebate. Exceptions are also provided for issuers which expend funds within certain time periods. In order to take advantage of these exceptions and avoid having to pay rebate, the issuer has an incentive to delay issuance of the bonds until proceeds are actually needed. This, of course, was precisely the reason for the adoption of the rebate requirements.

Briefly, there is a six month exception, an eighteen-month exception and a two-year

exception to the rebate requirements. The first exception permits an issuer to avoid rebate if all proceeds, including investment earnings, are expended within six months of the date of issuance. The second is applicable if at least 15% of the proceeds are spent within six months of the issue date, 60% within twelve months, and all of the proceeds within eighteen months. The two-year rule is applicable only for the portion of an issue used for construction purposes, as opposed to acquisition of land, materials or equipment. At least 10% of the construction proceeds must be spent within six months, at least 45% within one year, at least 75% within eighteen months, and all of the proceeds within two years. Special rules are provided for construction retainages under both the eighteen month and two-year rules.

Lest you set out to outwit the IRS by investing bond proceeds with your local bank at an artificially low rate below the bond yield, the arbitrage rebate rules assume fair market value investments. The IRS has particularly focused on “yield burning” in the context of refundings, where it believes that some issuers may have purchased treasury securities from underwriters at prices other than fair market value.

There are a number of strategies available to minimize the payment of rebate. One is to temporarily fund preliminary costs of projects with internal funds and issue bonds only after the project is certain to be completed within the relevant time period. Another is to issue BANs in small amounts over the course of the construction period so that each BAN can be expended within the requisite time period, and then issue serial bonds to take out the BANs upon completion of the project. Your financial advisor and bond counsel can help determine the best strategy for your issue. In any event, it will be important for the issuer to maintain good records regarding its investments and expenditure of proceeds both for purposes of documenting exceptions to rebate and providing information for any necessary rebate calculation.

### **What is a permitted management or operating agreement for governmental bonds?**

In order to finance a project on a tax-exempt basis, it must not be a “private activity bond,” or it must meet one of several specific exceptions which impose additional requirements on such “private activity bonds.” Ownership or leasing of property by a non-governmental party is “bad use” which can cause bonds to be considered private activity bonds, but in addition a management or operating agreement can also result in “bad use”.

In 1997, the IRS published final federal tax rules governing private activity bonds. These rules define private use, private payment and private loans, and provide for modified change in use rules. Under a new revenue procedure issued concurrently with these final rules, management or operating agreements with private parties may be entered into with any of the following types of compensation arrangements without causing the bonds to be private activity bonds. These arrangements are therefore permitted under the federal tax code for governmental projects:

- i) 95% of annual compensation is based on a periodic fixed fee and the term does not exceed 15 years or 80% of useful life;
- ii) 80% of annual compensation is based on a periodic fixed fee and the term does not exceed 10 years or 80% of useful life;
- iii) in the case of public utility property, the term can be as long as 20 years in i) or ii);
- iv) 50% of the annual compensation is based on a periodic fixed fee or all of the compensation is based on a fee per-person or a combination of fee per-person and periodic fixed fee, with a term not exceeding 5 years, terminable after 3 years;
- v) all of the annual compensation is based on a per-unit fee or a combination per-unit and periodic fixed fee with a term not exceeding 3 years, terminable after 2 years;  
or
- vi) for services to third parties or for start-up periods only, all of the compensation is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee, with a term not exceeding 2 years, terminable after 1 year.

The terms of the permitted agreements are substantially longer than those allowed under prior rulings, particularly for sewer and water projects. This reflects a recognition by the IRS that municipalities need additional flexibility to implement privatization initiatives.

## **What is sewage?**

You might think you know it when you see it, and for a long time the IRS said essentially just that. However, the IRS recently spent several years attempting to define sewage. For municipalities which own and operate their own plants, or hire an operator under an agreement which meets the management contract rules described above, this is not an issue. If the facility does not meet these requirements, they must fit into one of the categories of exempt facilities, such as sewage facilities. Until 1986, pollution control facilities were also permitted private activity bonds as a category of exempt facilities. It was therefore less important to distinguish sewage treatment from pollution control or pre-treatment. After 1986, the IRS undertook to define sewage to indicate which projects could continue to take advantage of the sewage facilities exception. A full discussion of the regulations is beyond the scope of this article, but in general the regulations define a sewage facility as one which is used for the secondary treatment of wastewater. If the average daily raw wasteload concentration of biochemical oxygen demand (“BOD”) exceeds a limit of 350 milligrams per liter as oxygen, the exemption is available only to the extent treatment is for wastewater having an average daily raw wasteload concentration of BOD that does not exceed that limit.

Exceptions are permitted for waste which exceeds the BOD limit as a result of a federal state or local water conservation program, primary and tertiary treatment used in connection with secondary treatment, sewage sludge, and septage. Pretreatment is not included.

## **What is DTC?**

Depository Trust Company (“DTC”) has been around for awhile now, but it doesn’t come up in everyday conversation. In 1983, Congress decided that all bonds should be in registered form rather than in bearer form, chiefly to combat money laundering. Once all bonds were required to be registered, it was a short step to deciding that bonds could be owned through a “book-entry” system.

DTC was created as a cooperative company owned by municipal brokerage firms. Their customers could then purchase bonds, and the customers’ ownership positions could be recorded by computer entry rather than the customer literally having to get the bonds out of the vault (or out from under the mattress), bring them down to a bank for

a signature guaranty for transfer, and physically register a new bond. Bondholders of book-entry only bonds receive a computer-generated confirmation of their trade, and never see the physical bond certificate. One bond certificate per maturity is held by DTC as nominal owner.

Almost all public bond issues are now book-entry only. This results in some savings for the issuer, because there is no need to print bonds. The issuer can generally act as its own paying agent, because a single payment is made to DTC on each payment date. Another important impact is the substantial decrease in turnaround time for transfers of securities.

One thing which is immediately apparent from a review of the foregoing is that information systems and automation have had a huge impact on the municipal bond market. It is also clear that issuers must be good consumers and responsible participants in this often confusing area.

This article cannot cover all of the matters which will arise in connection with a bond issue, and the discussion is necessarily simplified in some cases. Issuers should discuss financing options with their financial advisor and bond counsel to create the most advantageous financing.

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