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CALIFORNIA DEBT FINANCING GUIDE

THE CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

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California Debt and Investment Advisory Commission

The California Debt and Investment Advisory Commission (CDIAC) provides information, education, and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals. CDIAC was created to serve as the state's clearinghouse for public debt issuance information and to assist state and local agencies with the monitoring, issuance, and management of public debt.

Additional information concerning this guide or CDIAC programs may be obtained by contacting CDIAC directly via phone (916) 653-3269, fax (916) 654-7440, e-mail (cdiac@treasurer.ca.gov) or by visiting CDIAC's website: www.treasurer.ca.gov/cdiac.

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Preface

The California Debt and Investment Advisory Commission (CDIAC) was created in 1981 with the passage of Chapter 1088, Statutes of 1981 (AB 1192, Costa). This legislation established CDIAC as the State's clearinghouse for public debt issuance information and required it to assist state and local agencies with the monitoring, issuance, and management of public financings. To meet its statutory responsibilities, CDIAC divides its functions into four units: Data Collection and Analysis, Policy Research, Education and Outreach, and Administration.

Since 1984, CDIAC has provided information, education, and technical assistance on debt issuance and public funds investing to state and local public agency officials and other public finance professionals. As a cornerstone of its educational program, CDIAC commissioned Orrick, Herrington & Sutcliffe LLP to write an introduction to California public debt. Orrick worked with CDIAC to develop the *California Debt Issuance Primer* (*Primer*), which has served as the go-to reference guide for public finance professionals, policy makers, and students on California debt since 1988.

The Primer has undergone subsequent revisions, including those done by Orrick in 1990 and 1998 and by CDIAC staff in 2006. But these updates have failed to keep pace with transformations in the market and the needs of a new generation of public finance professionals. To address these concerns CDIAC, again in partnership with Orrick, Herrington & Sutcliffe LLP, has created the *California Debt Financing Guide* (*Guide*)—a completely new educational tool and reference for California public agencies and service providers.

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The *Guide* offers a new approach to understanding the responsibilities and obligations of issuers and the elected and appointed officials who are ultimately accountable for the use of debt financing by their agency. It also provides a comprehensive discussion of the legal and statutory requirements for debt issuance while employing a framework that supports the deliberative process issuers undertake before, during, and after issuing debt.

WHAT INFORMATION DOES THE GUIDE INCLUDE?

Public agencies have a number of options when financing capital improvements and managing their cash flow, including relying on existing resources or operational surpluses. In some cases and under certain conditions, debt financing is both the most economical and sensible means of financing both short-term and long-term purposes. But there are business, economic, legal, and practical concerns to be affirmatively considered and addressed in any decision to use debt financing.

The Introduction addresses the five principal responsibilities of public agencies choosing debt financing: **i.1 Understand Your Public Agency**; **i.2 Decide Whether Debt Financing Is Appropriate For Your Agency**; **i.3 Apply the Appropriate Analysis to the Decision to Use Debt Financing**; **i.4 Lead the Process of Issuing Your Debt**; **i.5 Manage Your Debt After It Is Issued**. The discussion of each of these points serves as an introduction to the process of debt financing. The Introduction, as a result, is the starting point for those unfamiliar with debt financing by public agencies as well as those seeking to better understand the scope of the process and obligations that fall on public agencies using debt financing. If you are an elected or appointed official, public agency staff new to debt financing, or member of the public seeking to understand how public agencies finance projects or how and why your agency has taken a particular approach to financing a project with debt, you are encouraged to start with the Introduction before moving on to the remainder of the *Guide*.

The *Guide* provides readers an understanding of the "legal and regulatory" requirements of debt financing in California. It begins in Chapter 1 with a discussion of the Constitutional and statutory authority given to public agencies to issue debt and to receive revenues needed to repay the debt and restrictions of that authority. Chapter 2 addresses the structural features of debt, including the source of revenues for repayment, security, and the term and interest rate mode. Chapter 3 provides a new approach to identifying

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debt "types" by categorizing them according to the security and source of repayment, interest rate mode (fixed- or variable-rate), and tax treatment. Chapter 4 covers the federal tax law requirements for issuing tax-exempt debt. Chapter 5 discusses the process of selling public debt to investors. Chapter 6 focuses on federal securities laws administered by the Securities and Exchange Commission as well as rulemaking by the Municipal Securities Rulemaking Board. Chapter 7 covers the additional requirements issuers of public debt must meet, including reports to CDIAC and the California Environmental Quality Act. Chapter 8 explains the on-going administrative responsibilities of issuers to investors, regulators, and the public. Chapter 9 introduces the options public agencies have to invest bond proceeds and the limitations they must adhere to when investing these funds.

The *Guide* also includes six appendices. Appendix A is a listing of state laws pertaining to the use of debt by California public agencies. Appendix B takes an in-depth look at one financing common to the California bond market: K-12 school financing. Appendix C is a listing of additional resources and reference materials. Appendix D is a discussion of the process public agencies must take when seeking bankruptcy protection under the Chapter 9 of the U.S. Bankruptcy Code. Appendix E is a glossary of terms. Appendix F is a subject index.

HOW TO USE THE GUIDE?

For those seeking an introduction to debt financing or an overview of the obligations of public agencies, the Introduction is required reading. Chapters 1 through 9 can be read in their entirety or used to research specific questions readers might have. The *Guide* is published as an "electronic book" to improve access to the materials and the reader's management of the information. Readers may pursue additional study using the Appendices and following links to materials outside of the *Guide*.

ACKNOWLEDGEMENTS

The *Guide* was produced in collaboration with Orrick, Herrington & Sutcliffe LLP. The Orrick team of attorneys was led by Steve Spitz.

The vision and, therefore, the responsibility for the outcome of the *Guide* was CDIAC's, led by Mark B. Campbell, Executive Director. He was supported in

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this by CDIAC's excellent staff, including Angel Hernandez, Research Manager, and researchers Joel Tokimitsu, Tara Dunn, and Nova Edwards.

No amount of recognition would provide fair compensation for the support, guidance, and direct contribution of materials and text provided by an advisory committee of public finance professionals. This group included David Brodsly, Managing Director, KNN Public Finance LLC; Dan Deaton, Partner, Nixon Peabody LLP; Steve Heaney, Managing Director, Stifel, Nicolaus & Company, Incorporated; Lakshmi Kommi, Debt Management Director, City of San Diego; and Megan Reilly, Chief Business Officer, Santa Clara Office of Education. Additional support was provided by Heather White, Counsel, Nixon Peabody, LLP. The quality of the materials and the format are the direct result of their insights and thoughtful consideration of this project and process.

The *Guide* was reviewed by Mark Paxson, Chief Counsel, Office of the California State Treasurer and Tim Schaefer, Deputy State Treasurer, Office of the California State Treasurer. It was edited by Coral Cavanagh, Curalium Consulting.

The *Guide* was formatted and published under the direction of CDIAC's graphic designer, Megan Batty.

Nothing in the *Guide* should be construed or relied upon as legal or financial advice. The *Guide* is rather intended to serve as a general introduction to the subjects discussed herein.

NOTE TO OUR READERS

The *Guide* has been published as an "e-book" to improve the reader's access to the materials. Because it exists in an electronic form it is a "living" document that can be easily maintained and expanded. To help do so CDIAC is asking readers to identify changes and improvements that will further CDIAC's goal to educate and inform. Please contact CDIAC with your suggestions at CDIAC@treasurer.ca.gov.

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Introduction

In general, public agencies turn to the capital markets to finance capital improvements and on occasion, working capital needs. When this financing is achieved through the sale or "issuance" of debt, that debt may be issued as a municipal security. "Debt" in a broad legal sense means an obligation one person is bound to pay, provide, or perform for another. In the context of a public agency, "debt" generally refers to a state or local government's obligation to make payments with respect to borrowed money. Defined in this way, debt has a **principal** amount (the amount of money to be repaid) and a **maturity date** (the date on or by which principal must be repaid) and it bears **interest** on the principal amount until the debt is fully paid. The interest portion compensates the lender for the financial and economic costs and risks that it assumes when entering into the transaction. The repayment generally consists of a portion representing the principal amount of the debt and a portion representing interest paid on the principal.

The **Municipal Securities Rulemaking Board (MSRB)**, a self-regulatory organization that is subject to oversight by the Securities and Exchange Commission (SEC), provides the following definition for "municipal securities:"

> A general term referring to a bond, note, warrant, **certificate of participation** or other obligation issued by a state or local government or their agencies or authorities (such as cities, towns, villages, counties or special districts or authorities). A prime feature of most municipal securities is that interest or other investment earnings on them are generally excluded from gross income of the bondholder for federal income tax purposes. Some mu-

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> nicipal securities are subject to federal income tax, although the **issuers** or bondholders may receive other federal tax advantages for certain types of taxable municipal securities. Some examples include Build America Bonds, municipal fund securities and direct pay subsidy bonds.[1]

Public agencies may also borrow funds through other arrangements that do not constitute the issuance of a security. These transactions are usually structured as leases, loans, or lines of credit and are based upon contractual agreements between the public agency (as the borrower) and the lender (usually a financial institution like a bank or other governmental entity). Debt that are not municipal securities may also include public-private partnerships and build-lease agreements.

The California Code of Regulations Title 4, Division 9.6, Section 6000 defines debt to mean "a contractual agreement through which a Creditor or Creditors transfers assets or moneys of an agreed value or amount, or rights to beneficial use of assets, to an Issuer in exchange for one or more non-cancelable payments, inclusive of an interest component no matter whether it is paid, accrued, or imputed, over a specified period of time, the total present value of which is approximately equal to the value of the assets or rights on or about the time the transfer occurred."[2]

A public agency's debt may be payable from its "general" revenues or "general fund" or it may be payable from a specific source of **revenues** such as the **proceeds** of a specific tax or assessment, revenues of a municipal enterprise, or payments made by another agency, which includes leases.

This Introduction of the *California Debt Financing Guide* (*Guide*) provides a framework for public agencies using debt financing to understand their responsibilities to their constituents and to those who have invested in specific public projects. The focus of the Introduction is on debt financing for capital projects, that is, physical improvements including buildings and fixed assets required to provide governmental services such as libraries, schools, and water or wastewater management facilities. Although considered to a lesser degree, the Introduction also applies to debt issued for operating capital such as lines of credit or pension obligation bonds.

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1 Municipal Securities Rulemaking Board. www.msrb.org/glossary/definition/municipal-securities.aspx.

2 These regulations, applicable to the California Debt and Investment Advisory Commission, became effective on April 1, 2017. They are available at www.treasurer.ca.gov/cdiac/regulations/approved-text-regulations.pdf.

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The Introduction is organized around five recommendations the California Debt and Investment Advisory Commission (CDIAC) makes to all public agencies using debt financing:

1. **Understand your public agency.** (Section i.1)
2. **Decide whether debt financing is appropriate for your agency.** (Section i.2)
3. **Apply the appropriate analysis to the decision to use debt financing.** (Section i.3)
4. **Lead the process of issuing your debt.** (Section i.4)
5. **Manage your debt after it is issued.** (Section i.5)

For each of these recommendations the Introduction provides materials that will help readers—including elected officials, the public, students of public finance, and experienced public finance professionals—understand the scope of a public agency's responsibilities before, during, and after issuing debt. Within the Introduction readers will find specific references to additional materials contained in the *Guide*. Chapters 1-9 of the *Guide* provide the **legal and regulatory context** for the use of debt financing by public agencies in California. It is designed to answer questions public agency staff and consultants may have regarding a project or a financing that a public agency may be undertaking.

i.1 UNDERSTAND YOUR PUBLIC AGENCY

The purpose, authority, and structure of state and local agencies are uniquely designed to serve a specific constituency in order to promote its welfare.[3] One way agencies do this is by financing, constructing, and maintaining capital facilities. Cities provide public facilities, roads, and water, fire, and police services. School districts provide educational programs at schools and colleges. Flood control districts protect homes and property during flood events and prepare for these through the development and maintenance of flood management systems.

Before diving into a public project, every public agency must address **whether the project is an appropriate use of its authority**. That means answering ques-

[3] Among the purposes of government identified in the Preamble to the United States Constitution is "to promote the general welfare."

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tions such as, "Does the law allow the agency to build it, finance it, and operate it?" Sometimes public agencies get confused about their responsibilities or mission. In their effort to be effective, agencies add on, expand, and diversify their programs and services, and consequently, the types of facilities they operate. This is known as "mission creep." Imagine a school district that believes it can enhance operations by building a sports stadium and charging gate or rental fees for its use. With the best of intentions, the district may find that the challenge of staffing, maintaining, and operating the stadium begins to compromise its ability to meet its core mission of educating students. In an effort to be more effective, the district may have undertaken a project based on a distorted sense of mission. Mission creep such as this can over time make the agency less effective and cause it to compromise its core mission.

Public officials are very likely to find themselves pressured to expand their agency's mission. Some proposals may offer long-term benefits to the agency's constituents and may deserve consideration. Other proposals introduce risks and systemic challenges. The agency must take the time to understand the difference by considering four questions.

i.1.1 Who Are You and What Do You Want To Be?

Public agencies differ in the degree to which they administer the legal and permissive authorities provided by the State of California (State) Constitution. Some agencies are "full-service" providers, directly or indirectly administering their police, tax, and land use powers, while others are "special districts" or single-purpose agencies. Regardless of their roles, agencies are likely to undertake some form of planning to define their missions and the means by which they will achieve them. Review of their authorities, their capacities and resources, and their constituents' needs is essential to defining this strategy.

i.1.2 What Is Mission Failure for Your Agency?

Because each agency has a mission, each is able to identify what constitutes "mission failure." For some agencies mission failure is quantitative. For others it is qualitative. Understanding the nature of mission failure allows an agency to determine the causes and remedies and the effect financing, operating, and maintaining facilities has upon the agency's success.

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i.1.3 What Is the Agency's Tolerance for Risk?

Risk tolerance for an investor is the degree to which that investor can absorb volatility, or more specifically, a decline in asset value. It applies equally to investments made by public agencies in new programs, services, or facilities. For a public agency, risk tolerance represents how much the agency and its elected or appointed leaders are willing to risk NOT fully or effectively delivering programs, services, or facilities.

i.1.4 Do Projects Conform to the Agency's Mission and Risk Tolerance?

Before proceeding with any project, the agency must determine whether the project conforms to its mission, that is, whether it has the authority to finance, operate, and maintain the facility. If it pursues that project, the agency must assess whether it assumes any risks that will threaten its ability to meet its mission. Because each agency is unique, the process by which agencies make these determinations will differ. At a minimum, however, the process should include (1) developing a strategic vision, (2) identifying the capital projects that are needed to meet that vision, and (3) deciding how to finance and fund those capital projects.

i.1.4.1 STRATEGIC PLANNING

Most public agencies answer questions about their mission or vision through planning. The agency may call this a general plan or a strategic plan or something different. Capital projects that carry out the plan are identified in a capital improvement plan (CIP) or a facilities plan.[4] A CIP or facilities plan may lack the broad scope of a strategic plan or be limited to a span of time that may be more tactical than strategic.

i.1.4.2 CAPITAL IMPROVEMENT PLANNING AND CAPITAL IMPROVEMENT BUDGETING

CIPs include projects needed to maintain, replace, refurbish, enhance, and expand a public agency's capital facilities. Capital improvement budgets (CIBs) are

[4] This Guide does not consider the capital improvement planning or capital improvement budgeting processes in detail. Extensive resources for developing both are available to public agencies at the Government Finance Officers Association (GFOA) website. www.gfoa.org/materials/master-plans-and-capital-improvement-planning. See Appendix C - Additional Sources of Information.

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systematic assessments of the improvements in a CIP that should be funded in light of the resources available to the public agency. A CIP should contain the projects necessary to achieve the agency's strategic vision and to maintain and improve the agency's existing facilities. Decisions regarding what appears in the CIP should include assessments of useful life, life cycle costs,[5] and estimated replacement costs (both in nominal dollars and inflated dollars). This decision-making is decidedly different from simply estimating replacement costs of the public agency's fixed assets in isolation.[6] For example, in 2010, the Government Finance Officers Association (GFOA) adopted a "Best Practice" that recommends public agencies adopt "a policy to require a complete inventory and periodic measurement of the physical condition of all existing capital assets. The assessment should document the established methods of condition assessment, including any that are used to evaluate below-ground infrastructure. This physical condition inventory and measures used should be kept current, with facility condition ratings updated every one to two years."[7]

CIPs are based on policy decisions: which components or systems of infrastructure the public agency needs over the short-, medium-, and long-term planning period and which of those components or systems have priorities over others. A public agency should be able to review its CIP and get a clear sense about the condition of its capital assets, how long that condition should last, and what the public agency needs to do, both in terms of capital projects and cost, to maintain or improve the condition of its facilities.

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[5] The term "life cycle costs" can be thought of as a methodical approach to assessing the total cost of ownership of the capital asset. It takes into account all costs of acquiring, owning, and disposing of the asset over the planned life of that asset. This approach is especially useful when alternative projects are being considered and the alternatives will meet the public agency's objectives equally well, but with a different configuration or specific asset. The alternatives may have different initial or operating costs. In order to establish the "best" alternative, the analysts will measure whether higher initial costs will produce comparable results, but at lower operating or maintenance costs. Life cycle costs analyses are often the most straightforward and easy-to-interpret measure of economic evaluation, as opposed to "internal rate of return" or "cost/benefit" analysis.

[6] References to capital assets and capital facilities or improvement are intended be synonymous and refer in most cases to physical improvements or real property. Accounts require that a capital facility be completed and providing benefit before being defined as an asset.

[7] Excerpt from GFOA Best Practice - *Asset Maintenance and Replacement*, adopted by GFOA Board, March 2010.

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The CIP process is incomplete, however, if it does not address what can be the most challenging question in assessing the funding needs of the public agency: what can the public agency afford and what, therefore, should it fund? A public agency rarely has the resources to do all that a CIP contemplates. That means that there is likely to be a gap between what the agency can fund and what it will have to finance. This introduces the distinction between funding and financing.

i.1.4.3 UNDERSTAND THE DIFFERENCE BETWEEN FUNDING AND FINANCING

Financing decisions are different than funding decisions. "Funding" refers to the stream of public agency revenue that pays for or offsets the cost of an asset or service or supports repayment of debt that finances the asset. In contrast, "financing" refers to the method of paying for an asset or service, including debt financing. For example, a public agency may borrow money (the financing) to pay the cost of an asset and repay that loan from a recurring tax (the funding). The tax or source of repayment is referred to as the security for the borrowing.

A CIB should systematically identify potential funding sources and financing options and match those resources to the capital needs identified in the CIP. It should also make the difficult decisions regarding which capital needs the public agency will fund, when it will fund them, and from what resource. By its nature, the CIB may cover a shorter time horizon than the CIP and may specifically omit or ignore funding sources, financing sources, or both for certain projects that are embodied in the CIP.

i.2 DECIDE WHETHER DEBT FINANCING IS APPROPRIATE FOR YOUR AGENCY

A decision to issue debt to finance capital facilities should be part of a process that ensures that the type of debt issued aligns with the agency's program and financial goals. This process entails three decisions:

1. **What is the right source of funding?** (Section i.2.1)
2. **What is the right source of financing?** (Section i.2.2)
3. **Can the municipal market help the public agency meet its capital financing needs?** (Section i.2.3)

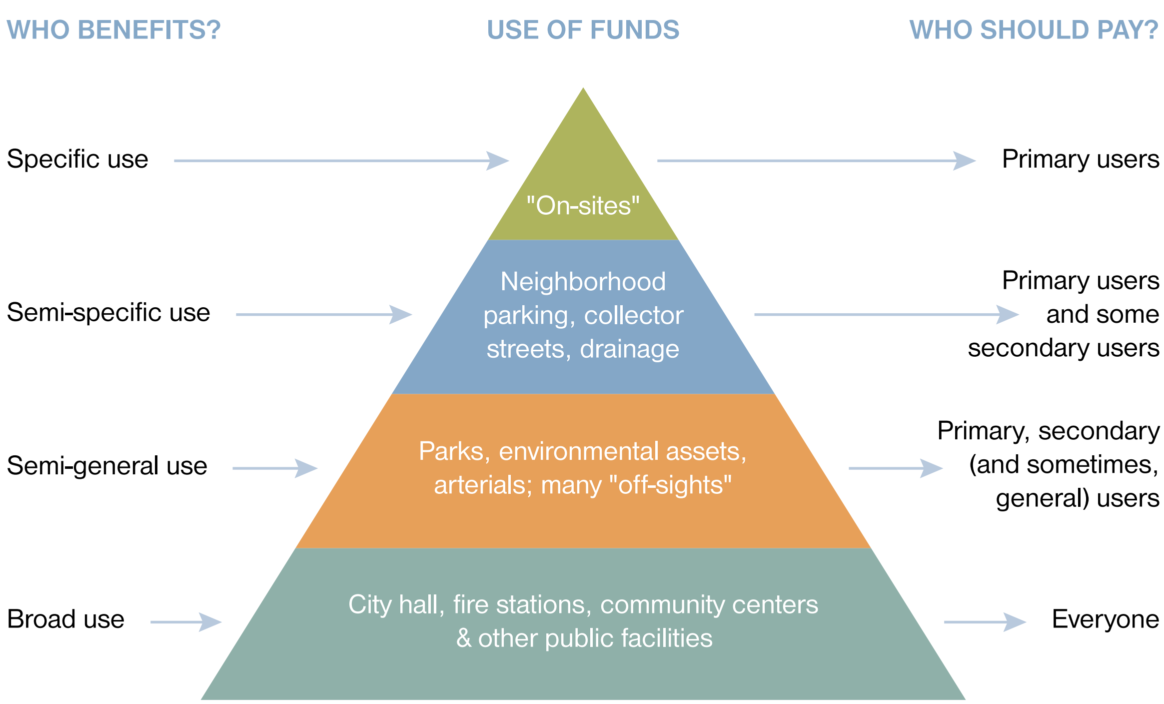
i.2.1 Decision #1 - What is the right source of funding?

When considering how to fund a capital project, the agency must consider whether the primary users of a capital asset should pay the cost of construction or improvement or whether other stakeholders should contribute. This raises the question of "taxpayer equity."

Figure i-1 illustrates how various types of projects align with possible sources of payment and benefits to taxpayers. The concept of equity comes from the balance between who pays for and who benefits from a project. The improvements at the bottom of the pyramid are generally viewed to be of broad use, providing broad benefit to users regardless of the level or frequency of use. It may be appropriate, depending upon the project, to assign the repayment obligation to "everyone." By contrast, the improvements at the top of the pyramid are much narrower in their use and it is both easier and more logical to have the primary users that directly benefit from the improvements pay for their costs.

Figure i-1

TAXPAYER EQUITY



Another important consideration in deciding who pays is timing. For a facility with an extended useful life, such as a school building, the agency must

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decide how to allocate the repayment obligation over time. Assigning some repayment obligation to future generations creates what is known as "intergenerational equity."

The public agency must decide, within the scope of its authority, who should pay for capital projects to produce taxpayer equity and intergenerational equity.

i.2.2 Decision #2 – What is the right source of financing?

Once the public agency has developed a CIP listing essential capital projects, it must determine how to finance them in the CIB. Paying for a capital improvement as the financial resources are available is called "pay-as-you-go" funding (PAYGO). If the agency lacks the financial resources to use this approach it may consider borrowing the funds needed to construct the capital improvement and repay those funds over time. This is called "pay-as-you-use" funding, or debt financing.[8]

The decision to use PAYGO or debt financing is a function of many factors including those described below.

- **How quickly is the project or facility needed?**

  The construction or acquisition timeline is essential in deciding whether to use PAYGO or debt. If the facility is needed immediately and the agency lacks sufficient resources to construct or acquire it, debt is the most reasonable alternative. Some projects may be driven by legal or regulatory mandates or court judgements; these are likely to move sooner than other discretionary projects.

- **Will the public agency have enough funds on hand when it needs them to pay for a capital improvement on a PAYGO basis?**

  Is paying for a capital improvement on a PAYGO basis feasible? The public agency must consider when it will need funds to construct or acquire the capital improvement as set forth in the CIP and whether the needed funds will be available at that time. Special care should be taken to avoid unrealistic assumption about growth in revenue and interest earnings.

[8] Public agencies may finance operations with debt, but without voter approval, the State Constitution requires many public agencies to repay such debt from current year revenues. (See Section 1.2.4.1)

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- **Does the public agency have access to the capital markets to fund a capital improvement using debt?**

  In order to pay for a capital improvement using debt, an agency must be able to raise sufficient money from investors to pay for the capital asset and provide reasonable assurances to these investors that the debt will be repaid as promised.[9] This typically depends on sound financial operations and effective reporting.

- **Does the public agency have enough ongoing funding to pay debt service without jeopardizing services?**

  In order to pay for a capital improvement using debt, an agency must provide reasonable assurances to investors that borrowed money can be repaid as promised. Similarly, the agency must assure its stakeholders that it can continue to deliver promised services and still allocate necessary resources to debt repayment in the foreseeable future, even during economic downturns.

- **Given the nature of the asset, will available funding cover the total cost of ownership?**

  Every capital improvement has a life cycle cost. This is better understood as the "total cost of ownership," which includes periodic costs such as maintenance, major renovation, or replacement of component parts of the financed improvement during the life of the asset, especially during the term of the indebtedness. If the agency is using most of its available funding to repay the debt used to finance a capital improvement, there is a risk that the agency will be unable to maintain or operate the improvement over time.

- **Does funding for the project pose any intergenerational equity implications?**

  Intergenerational equity attempts to align the useful life of the capital improvement with the period during which those benefiting from the improvement are paying for it. How much should one generation pay for public services and facilities as opposed to future generations?

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9 Debt financing may result in the issuance of a municipal security that is purchased by investors or it may involve a loan between the public agency and a lender. Where the discussion applies to both forms of financing, we use the term investor to include both. When we use only one term the discussion is not intended to apply to the other.

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i.2.2.1 WHEN SHOULD A PUBLIC AGENCY CONSIDER PAYGO?

Notwithstanding intergenerational equity, PAYGO has its advantages. It is often less expensive and can be the simplest method of funding capital improvements.

But PAYGO also has its drawbacks:

- It may not be financially feasible.
- The public agency may find a mismatch between when it receives revenues and when it needs to pay for the facilities that generate them; for example, this could occur for public utilities that generate the revenues to pay the cost of facilities over time.
- PAYGO can deplete reserves to a level that affects the agency's credit and financial stability.
- Even if debt is more expensive, the agency's stakeholders may value the services that the asset offers now rather than forego services while they wait for sufficient funds to accumulate to construct the project.
- And, of course, intergenerational equity. PAYGO can place an excessive burden on current stakeholders.

If a public agency is going to consider using PAYGO for major projects, then each of the following should be true:

- **The public agency has accumulated sufficient financial resources to fully address the need.**

  The public agency needs to be able to not only pay for the capital improvement but also provide for its other capital and operating needs. The amount that the public agency has on hand needs to be sufficient and readily available (or reasonably certain to be received in time) and not committed to some other purpose or vulnerable to diversion or attrition.

- **The CIP identifies the capital improvement as a priority.**

  Using PAYGO runs the risk of using financial resources on capital improvements of lower priority simply because the project is "ready to go" at the time the public agency has the resources to pay for the need. This places the public agency at risk of deferring more critical (or costly) improvements.

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- **The public agency is not concerned that funding the capital improvement on a PAYGO basis will create intergenerational inequity.**

  Using PAYGO calls on current taxpayers or ratepayers to pay the full cost of major capital replacements that may benefit future generations. This runs the risk that all of the cost for the capital improvement will be unfairly borne by current stakeholders.

Accordingly, public agencies tend to use PAYGO to fund capital improvements for the following situations:

- Capital improvements that are smaller or have shorter useful or economic lives (such as equipment purchases of police cars or photocopiers) and do not create intergenerational inequities.
- Larger capital improvements for new or growing communities when development impact fees are measurable and available, and the use of those funds does not inappropriately burden a stakeholder.
- When reserves or set-aside funds are sufficient to fund a capital improvement without jeopardizing the service-level solvency of the agency.

i.2.2.2 WHEN SHOULD A PUBLIC AGENCY CONSIDER DEBT?

Local agencies use debt to pay for capital improvements in the following circumstances:

- The asset being acquired has a long useful and economic life and the public agency wants to allocate or distribute the cost of the asset among both current and future users.
- The asset is too expensive to be reasonably constructed or acquired with currently available resources.
- The local agency intends to undertake deferred maintenance on an existing asset that has not been provided for in the past.
- The availability of significant, incremental and, typically discretionary, revenues for the replacement of capital assets is limited or restricted.
- Borrowing rates compare favorably to the expected rate of acquisition cost inflation and investment earnings.
- The asset fills an urgent need.

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i.2.3 Decision #3 - Can the municipal market help the public agency meet its capital financing needs?

The final decision for public agencies in this process is to assess whether the municipal market can help finance its capital needs. To this end, publicly-offered debt exhibits distinct strengths and weaknesses.

STRENGTHS OF PUBLICLY-OFFERED DEBT

- Debt can potentially finance 100% of the cost of the project.

  Public agencies are routinely able to finance all of the cost of a particular capital project or acquisition through debt financing. This allows a public agency to maintain cash reserves to deal with contingencies.

- Publicly-offered debt is often the cheapest source of funds, especially when interest payments to the lender are exempt from income taxation.

  For most public projects, debt financing can be done on a tax-exempt basis, which means that there is no income tax paid by the bondholder on the interest income received on the bond. The benefit to some investors is significant and results in a lower cost of financing for the public agency.

- **Fixed-rates** over a long period are readily available.

  Unlike many other areas of the capital markets and banking sectors, public agencies frequently issue debt at a fixed-rate for 30 years or even longer. This allows a public agency to establish a stable source of financing that can extend over a long planning period without exposure to **interest rate** fluctuation. It also allows an agency to better match the repayment period to the lifespan of the facility itself.

WEAKNESSES OF PUBLICLY-OFFERED DEBT

- Complicated Process

  The process of debt financing can be lengthy and difficult and requires the assistance of outside parties, attorneys, consultants, and financial firms. The public agency needs to lead the process as well as assume significant ongoing obligations to investors.

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- Compliance with Securities Laws

  Debt that constitutes a municipal security carries substantial obligations under federal securities laws, including the preparation of offering documents that explain to investors the terms and conditions of the bonds, risks associated with the investment, the finances and operations of the public agency, and any other information that would be important to investors in deciding to purchase the bonds. In addition, an offering of municipal securities requires the public agency to maintain policies and procedures for ensuring that any **disclosure** to the market is made on a timely basis and is correct and complete, both at the time of the initial transaction and throughout the life of the borrowing.

- Transaction Costs

  Debt financing usually requires the involvement of consultants, including lawyers, financial advisors, underwriters, trustees, and paying agents, who assist the public agency in the process. For smaller transactions these costs may render bond financing uneconomical.

- Market Prefers "Standardized" Structures

  Although this is not always the case, the municipal market tends to require debt issued as a municipal security to conform to certain standardized norms. This may force the public agency to adjust its practices. For example, interest payments on long-term bonds are typically scheduled at 6-month intervals, and principal is repaid once per year. Long-term bond issues generally require a detailed security **pledge** and operating and financial **covenants** designed to protect bondholders. These covenants likely will bind an issuer for the length of time the bonds are **outstanding**.

- Requires Ongoing Monitoring of Legal and Financial Commitments

  Debt issued as a municipal security requires public agencies to perform certain ongoing activities to ensure compliance with tax laws and bond covenants.

- Debt Capacity

  The total amount of debt a public agency may incur may be subject to legal limitations and is subject to practical limitations. Overreliance on debt can be a sign of financial weakness.

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i.3 APPLY THE APPROPRIATE ANALYSIS TO THE DECISION TO USE DEBT FINANCING

i.3.1 Understanding the Work Each Public Agency Must Commit to When Using Debt Financing

Public agencies that choose to debt finance a capital project with debt that is issued as a municipal security assume legal and financial responsibilities imposed by state and federal laws and regulations meant to protect the interests of market participants and the public.[10] Public agencies that issue debt in the private market, including bank loans, are likewise subject to legal and financial requirements imposed by the lender. Regardless of the type of debt, it is imperative that the public agency, BEFORE undertaking a debt financing, understand what these responsibilities are and what it takes to administer them.

Failure to adhere to the terms of a financial obligation may constitute a financial, market, or legal **default**, resulting in substantial adverse consequences. These may include rescheduling of payment obligations or escalating interest rates, denied access to capital or the imposition of extraordinary restrictions on future borrowing, or any costs associated with defending against civil actions brought by investors or other interested parties.

i.3.2 Legal Responsibilities of Issuers of Municipal Securities

COMPLIANCE WITH SECURITIES LAWS - ANTI-FRAUD - In 2012, the SEC issued a report on the state of the public securities market recognizing its lack of transparency.[11] The report highlighted the need for additional effort on the part of issuers to comply with existing securities laws to protect investors and the public. To ensure compliance, the SEC beginning in 2013 increased its surveillance of the market through the newly established Public Finance Abuse Unit.

The *Securities Act of 1933 Act* (1933 Act) requires most issuers to register securities with the SEC and to submit to a pre-issuance review of their offering

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[10] When choosing to debt finance a capital project, some public agencies have access to financing from both the municipal market and private lenders. Depending upon the agency there may be advantages to each option. Our focus here is on debt issued as a municipal security in the municipal market.

[11] SEC, Report on the Municipal Securities Market, July 31, 2012, www.sec.gov/news/studies/2012/munireport073112.pdf.

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document.[12] Public agencies are generally exempt from the registration and reporting requirements to which corporate securities must adhere; however, they are subject to the anti-fraud provisions contained in securities laws. Specifically, municipal issuers and officials (as well as other market participants) are subject to the federal anti-fraud provisions contained in **SEC Rule 10b-5** as adopted by the SEC under Section 10(b) of the *Securities Exchange Act of 1934* (1934 Act) and Section 17(a)(1) of the 1933 Act.[13] In addition, they are subject to the anti-fraud and anti-negligence provisions of Section 17(a)(2) and (3). Furthermore, the *Securities Acts Amendments of 1975* (1975 Amendment) defines "person" as used in the 1934 Act to include government entities, thereby giving the SEC the affirmative authority to pursue state and local governments and their officials. See Chapter 6 - Securities Laws Pertaining to Municipal Debt.

i.3.2.1 COMPLIANCE WITH MUNICIPAL SECURITIES LAWS - DISCLOSURE

Public agencies subject to the anti-fraud provisions must protect against making untrue statements of material facts or omissions of material facts in both primary offering materials and when providing additional information after the debt has been issued. SEC Rule 10b-5 applies to issuers when they are "speaking to the market," which includes publication of offering documents (Official Statements [OSs]), **annual reports** and material events notices required under **SEC Rule 15c2-12** and any voluntary disclosures, including financial information posted to the agency's website or to an investor relations website. The SEC, however, provides no definition of "materiality" in any rule or statute. As a result, issuers must determine whether there is a "substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest."[14]

SEC Rule 15c2-12 applies directly to underwriters who act as "market makers" to purchase the municipal securities issued by the agency and resell them to other investors. However, through an agreement between the underwriter and the issuers, SEC Rule 15c2-12 indirectly imposes requirements on issuers. Specifically, SEC Rule 15c2-12 requires that underwriters of municipal securities, before bidding, purchasing, or selling a municipal security in the

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12 www.sec.gov/answers/about-lawsshtml.html.

13 Ibid.

14 As quoted in Supreme Court decision in Basic Inc. v. Levinson (1988), 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194 - Supreme Court (1988).

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primary market, must obtain and review the issuer's preliminary and final OSs and reasonably determine that the issuer has committed to provide **continuing disclosures** to investors, including annual financial statements and notices of specified material events.[15]

i.3.2.2 LEGAL RESPONSIBILITIES UNDER THE INTERNAL REVENUE CODE

State and local governments receive direct and indirect benefits under Section 103 of the Internal Revenue Code of 1986 as amended (Tax Code) by being able to issue debt that is tax-exempt. See Chapter 4 - Federal and State Tax Law Requirements. This means that purchasers of the debt generally do not pay taxes on the income received in the form of interest payments. California also exempts income earned on California state and local bonds from state tax obligations. Because investors do not pay taxes on the interest income from holding municipal debt they are willing to accept a lower interest rate. A lower interest rate results in lower cost of funds for the public agency. In compensation for state and federal governments relinquishing some amount of tax revenues by providing public debt this tax advantage, the Tax Code imposes requirements on issuers. These include the requirements imposed by the Internal Revenue Service (IRS) on the issuance of debt, the investment of proceeds from the sale of debt, the time period during which the debt may be outstanding and the proceeds unspent, and the use of property and facilities paid for with the debt. State and local governments that issue tax-exempt debt must create procedures to monitor compliance with these requirements throughout the life of the bonds.

State and local agencies may issue debt and direct part or all of the proceeds to benefit a nongovernmental entity. Debt issued for this purpose is termed a "**private activity**" bond and is subject to additional requirements. Issuers must determine whether their debt is a private activity bond both at the time of issuance and through the full term of the debt obligation. The determination, which is discussed in more detail in Chapter 4 - Federal and State Tax Law Requirements, is based on several tests concerning the nongovernmental entity's benefit received from the activities or facilities financed with the proceeds of the debt.

Issuers who fail to comply with the Tax Code requirements may be subject to an adverse ruling revoking the tax exemption of the bonds if examined by the IRS. Barring the issuer's ability to negotiate a settlement with the IRS that reinstates

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[15] A full list of material events notices is provided at www.msrb.org/msrb1/pdfs/SECRule15c2-12.pdf.

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or maintains the debt's tax-exempt status, revoking the tax exemption will likely incite investors to sue the issuer for damages suffered.[16]

i.3.2.3 RESPONSIBILITIES OF ELECTED AND APPOINTED OFFICIALS

It is generally understood that elected officials have an ethical duty to the people they serve. This duty arises whether the official is elected, appointed, or a member of a governmental agency's staff. This ethical duty has been refined by court rulings with respect to elected officials to include the concept of **fiduciary** duty and loyalty. In Noble v. City of Palo Alto the court ruled that an official is "bound to exercise the powers conferred upon him with disinterested skill, zeal and diligence and primarily for the benefit of the public."[17] The court's wording conforms very closely to the concept of a fiduciary as expressed in rules adopted by the SEC. See, for example, MSRB Rule G-42 addressing the responsibilities of a municipal advisor providing advice to a municipal client who "is subject to a fiduciary duty that includes a duty of loyalty and a duty of care."[18, 19] Elsewhere, the court has characterized the duties of a fiduciary as an "affirmative duty of utmost good faith and full and fair disclosure of all material facts" as well as an affirmative obligation "to employ reasonable care to avoid misleading."[20]

The anti-fraud provisions and prohibitions against making untrue statements or omissions contained in the 1933 Act and the 1934 Act apply to elected and appointed officials as much as to the governmental agency they represent. As discussed above, the SEC's attention to municipal securities has resulted in 16 enforcement actions against individuals between 2013 and 2016.[21] Many of these have involved fines or prohibitions against officials participating in municipal

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16 Issuers may wish to review the IRS's publications 4079 and 4078 for a basic understanding of these requirements.

17 Noble v. City of Palo Alto, 89 Cal. App. 47, 51 (1928).

18 The MSRB was established by Congress in the 1975 Amendment under the 1934 Act. The MSRB is a self-regulatory organization charged by Congress with regulating the activities of securities dealers that buy, sell, or trade municipal securities. Rules created by the MSRB must be adopted by the SEC to become effective.

19 MSRB Rule G-42, Duties of Non-Solicitor Municipal Advisors, effective June 23, 2016.

20 SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

21 Robert Doty, *Expanding Municipal Securities Enforcement: Profound Changes for Issuers and Officials*. International Municipal Lawyers Association, 2016, P. 20.

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transactions. In the City of Harvey, Illinois, for example, the SEC acted against a sitting mayor with allegations that the mayor was a control person and that he signed disclosure materials and bond closing certificates that misrepresented to bondholders the actual use of the bond proceeds. The mayor was fined $10,000 and barred from participating in future bond sales. As a result of this ruling, public agency officials holding leadership positions may be expected to prove their "good faith" and lack of "direct or indirect" inducement of actions of others that violate securities laws.[22] The SEC action against the Westlands Water District and two of its managers focused on the misrepresentations and omissions of data in its marketing materials for the sale of **refunding** bonds in 2012. The OS provided misleading information on the district's debt service coverage in prior years. It was misleading because the district failed to disclose that it had performed some "extraordinary accounting transactions" to achieve the coverage it had promised to maintain in prior bond offerings. The SEC issued a cease and desist order against the district, the district's general manager, and its assistant general manager from committing or causing any future violations of Section 17(a) of the 1933 Act. In addition the SEC fined the district $125,000, the general manager $50,000, and the assistant general manager $20,000.[23]

i.3.3 Financial Responsibilities

HOW DOES DEBT FINANCING AFFECT THE AGENCY AND ITS MISSION? - Debt financings attach specific obligations to the public agency to ensure that the debt will be used for the intended purposes and will be repaid as promised. The agency must generate sufficient funds to make scheduled payments to investors. While debt service may represent only a small percentage of the agency's budget it is a fixed obligation that cannot be ignored without substantial penalty. This on-going commitment reduces operational flexibility that constrains the agency and may force it to postpone delivery of services or facilities when available funds decline.

FINANCIAL MANAGEMENT RESPONSIBILITIES - Due in part to the challenges California public agencies face in generating revenues, each agency should adopt a long-term financial plan to align financial capacities with the long-

[22] Doty, ibid. P. 119.

[23] SEC, *Securities Act of 1933*, Release No. 10053, March 9, 2016 (www.sec.gov/litigation/admin/2016/33-10053.pdf).

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term service objectives. An agency's long-term financial plan should include a projection of its financial condition at the end of the period; projections of revenues and expenditures; proposed changes in programming or capital financing; an assessment of economic conditions, service objectives, and financial challenges; and financial policies regarding liquidity, debt capacity, or reserve requirements. A well-developed long-term financial plan can help the agency respond to long-term challenges and opportunities. This means integrating financial considerations into the agency's organizational and capital planning, or "big picture" thinking.

i.3.4 Organizational Responsibilities

MAKE PRUDENT DECISIONS - For public agencies, the costs of making a bad decision with regard to the use of debt financing are significant. As a result, the agency and its elected and appointed officials must make prudent business decisions when debt financing. A prudent decision is one that a prudent person would make when considering the costs of the decision to the agency's constituents, including employees, customers, and financial partners. In other words, when seen in hindsight, a prudent person would make the same decision given the same set of facts and circumstances.

To make prudent decisions the agency must develop and administer an analytical process to:

- Identify the agency's program and financing goal(s).
- Gather the information required to make a prudent decision.
- Identify alternative decisions taking into account program and budgetary outcomes.
- Select the alternative that achieves the agency's goals. Review the decision and establish outcome measures to track success or re-evaluate alternatives in the future.

ADOPT THE RIGHT ORGANIZATIONAL APPROACH - Unfortunately, most public agencies operate within the discrete silos created by the organization's design. This limits the open exchange of ideas and analyses. To avoid this, particularly when making debt financing decisions, public agencies must develop an organizational approach that intends to break down siloed thinking. Forming work

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groups composed of multidisciplinary teams to develop goals, gather information, and identify alternatives is one way to do this. When making debt financing decisions, the agency should build that team with representatives from legal, financial, and facilities operations and engineering units.

LEARN ABOUT DEBT FINANCING - Elected and appointed public officials are subject to securities law and are held to a fiduciary standard when acting in an official capacity. Both of these requirements impose a standard of care and expertise that can only be achieved through a deliberate, ongoing effort to analyze, understand, and evaluate alternative courses of action. Concerning the use of debt financing, this implies that elected and appointed officials will seek to educate themselves, and when necessary, obtain the best, objective guidance in order to make decisions that legally and fairly implement the mission of the public agency. Before issuing debt, therefore, elected and appointed officials should understand the agency's financing needs, its alternative financing strategies, the implication of each on the agency's mission and its financial well-being, and the agency's capacity to meet its long-term financial and administrative responsibilities if debt is the chosen alternative.

Appendix C of the Guide provides a comprehensive list of educational and informational resources for elected and appointed officials.

i.4 LEAD THE PROCESS OF ISSUING YOUR DEBT

i.4.1 Financing Team

UNDERSTAND YOUR RESPONSIBILITIES AND THOSE OF YOUR FINANCING TEAM - Once a public agency has determined that debt financing in the municipal market is the right path, it must decide on the appropriate form of debt. This will depend upon factors internal to the agency, including its financing needs, the purpose of the financing, and its authority to both debt finance and to collect revenues for debt repayment. The form of the debt also depends upon factors external to the agency, including investor interest. Finding the path often requires specialized knowledge and participation of professionals outside the agency.

Regardless of who is involved and in what capacity, however, the SEC has made it clear that the issuer is "primarily responsible for the content of their disclosure documents and may be held liable under securities laws for misleading

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disclosure."[24] The reliance on work done by consultants, including those responsible for the development of the offering document, does not exempt the issuer of its responsibility. That being said, some consultants (attorneys, for example), are subject to both professional standards and regulations that define their level of service and obligations to the issuer. See Chapter 6 - Securities Law Pertaining to Municipal Debt.

SELECT AND PROCURE TEAM MEMBERS - Public agencies often select members of the financing team using a competitive solicitation process. In most cases, the agency defines the scope and terms of service in a request for proposals and then evaluates the proposals received before making a selection.

i.4.1.1 PRE-ISSUANCE PHASE

During this pre-issuance phase the public agency must make basic business decisions regarding the project—its scope, cost, and the approach to financing. Issuers should carefully consider their own policies and long-range objectives at this early stage so that during the actual process of preparing, selling, and closing the debt transaction, the goals of the agency are given weight. Consultants that may support the agency's pre-issuance work include the following:

- MUNICIPAL ADVISORS - The public agency may engage a professional to provide financial and program advice on the debt type, purpose, and structure. Pursuant to regulations emerging from the *Dodd-Frank Act*, "**municipal advisors**" are fiduciaries to the public agency and must put the issuer's interests first. Pursuant to the rules adopted by the SEC, municipal advisors are fiduciaries and they have a duty of care and a duty of loyalty to their client (See Section 6.2.1, Municipal Advisors and Underwriters). The municipal advisor may assist the issuer in filling out the team with other professionals. The advisor may work with the issuer to develop a plan of finance and financing schedule and may assess alternative financing strategies. The advisor may advise on the sale method and may conduct the bidding if the issuer chooses to use a competitive process. The advisor may also prepare preliminary cash flows and analyze opportunities to refund outstanding debt.

- LEGAL COUNSEL - The industry identifies different legal roles in a debt transaction, including **bond counsel**, disclosure counsel, tax counsel, and underwriter counsel. In cases involving one or more of these roles, the work may be per-

[24] SEC Rel. No. 34-26985 n. 84, 54 F.R. 28799, 28811 n. 84 (July 10, 1989).

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formed by different individuals and sometimes different firms. In at least the case of underwriter counsel, the client is not the issuer but the underwriting firm. Legal counsel may assist the issuer in complying with any administrative tasks, including receiving the approval of the agency's governing body to issue debt. Legal counsel may also interpret tax law, contracts, or outstanding litigation on behalf of the issuer. Underwriter counsel is typically responsible for drafting a purchase agreement and undertaking any due diligence required.

- BANKER OR UNDERWRITER - Municipal securities may be purchased by a middleman who ultimately redistributes them to end-market investors. This financial intermediary is an underwriter responsible for buying part or all of the initial debt. In a **negotiated deal** the underwriter may work with the borrower to develop a finance plan and structure the debt. The underwriter may work on developing a marketing memorandum or offering documents and may solicit pricing from other members of the underwriting team. In a **competitive sale**, the underwriter prepares a price bid and submits it to the issuer.

- CREDIT RATING AGENCIES - Issuers of municipal securities may seek to improve the marketability of their debt and thus lower their borrowing cost by having the debt rated by a nationally recognized, independent rating agency. Ratings agencies apply a set of criteria, sometimes unique to the agency, to assess the borrower's organization and financial composition to project the probability that it will meet its repayment obligations over the term of the debt.

- FEASIBILITY AND MARKET ANALYSTS - In most types of debt, particularly debt supported by special revenues or taxes, the issuer may benefit from engaging feasibility or market analysts to support the financing plan. Their analysis may evaluate the financial and economic viability of the plan, particularly the adequacy of the revenues to repay the debt.

i.4.1.2 ISSUANCE PHASE

During the issuance phase, a public agency may wish to retain the following municipal market professionals as they ready their debt for the market:

- MUNICIPAL ADVISORS - During the sale of the debt a municipal advisor may help to evaluate the bids provided by underwriters, analyze **cash flow** calculations, and manage the bond closing process. Immediately following the sale of the debt the municipal advisor may monitor how the debt is trading in the

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market to determine whether the bond was accurately priced in the initial sale to underwriters.

- UNDERWRITER - During the sales process the underwriter executes the bond purchase agreement to sell the debt and settle the transaction.

- LEGAL COUNSEL – Legal counsel generally prepares the indenture, **loan agreement**, or other documents providing for the issuance or repayment of the debt and works with the issuer to prepare appropriate disclosure documents. In the case of tax-exempt debt, legal counsel may draft a tax certificate that confirms the issuer's expectations and affirms the issuer's intent to use the proceeds of the debt in compliance with federal and state tax laws. Legal counsel may also submit other required reports, including a report to CDIAC on the sale of the debt.

- TRUSTEE - With many forms of debt, there is a need for a third party to receive and distribute the proceeds of the debt sale and payments of principal and interest to end-market investors. This role is performed by a trustee. The trustee acts a fiduciary in the investors' interests to enforce the terms of the agreements. The trustee may also hold and invest funds associated with the debt, including reserves and unspent debt proceeds. The trustee also maintains records to identify current investors. In some circumstances, these third parties may be called fiscal agents or paying agents when they are performing similar but more limited duties, particularly with regard to the investment of funds.

- CREDIT ENHANCERS - In the case of lower-rated debt offerings, the interests of end-market investors are secured against loss or default by credit enhancers. This is a form of credit insurance that intends to (a) make principal and interest payments in the event the issuer cannot and (b) lower the issuer's borrowing costs.

- VERIFICATION AGENT AND ESCROW AGENT - In a refunding, the issuer replaces an outstanding debt with a new issue of debt. A verification agent validates that cash flows from the new debt will be sufficient to repay the old debt. The escrow agent serves as a custodian of funds and holds the old debt that supports repayment of the new debt.

i.4.1.3 POST-ISSUANCE PHASE

During the post-issuance phase, a public agency may wish to retain the following municipal market professionals:

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- PUBLIC AGENCY DEBT ADMINISTRATION - Issuers of public debt are responsible for performing several administrative tasks, including tracking, monitoring, and reporting on the proceeds of bond sales. Some of these tasks may be supported by or performed by consultants. The public agency staff administers the agency's funds to ensure compliance with financial and administrative policies and procedures. This work involves projecting revenues and expenditures, establishing budgetary authority, and monitoring budgetary activities; procuring and administering contracts; accounting for the financial activities of the agency; and developing and administering internal control systems.

- THIRD-PARTY ADMINISTRATORS AND CONSULTANTS - Many public agencies contract with service providers to administer revenue collections, arbitrage and tax reporting, auditing, and financial reporting. Issuers may rely on tax consultants to interpret U.S. Treasury rules and their compliance with these while allocating debt proceeds.

- DISSEMINATION AGENTS - Issuers may on their own prepare and disseminate the disclosures or engage third-party providers to act in their behalf to submit information required under their continuing disclosure agreement or in compliance with their SEC Rule 15c2-12 undertakings. The work of a dissemination agency may be performed by a trustee or municipal advisor as well.

- INVESTMENT ADVISORS - Issuers typically invest the proceeds of a bond sale to increase project funding and to take advantage of economic opportunities in the market. Issuers may rely on investment advisors to make recommendations that achieve these goals and to purchase securities. If these recommendations include the investment of bond proceeds, then the investment advisor is acting as a municipal advisor and must meet the requirements of the *Municipal Advisor Rule*. This includes registering with the SEC and MSRB and passing the Municipal Advisor Representative Qualification Exam.[25] Issuers should consider the advice offered by investment advisors as one of many options and evaluate potential advisors to identify those that meet the issuer's goals and policies.

- REMARKETING AGENTS AND SWAPS DEALERS - In order to obtain lower interest rates on their debt, some issuers may choose to issue **variable-rate** bonds that may be reissued on a regular schedule. This "reissuing" achieves short-

[25] Rule G-3, Professional Qualifications Requirements, MSRB, www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-3.aspx.

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term borrowing rates even though the debt may be outstanding for many years. Issuers engage a service provider called a remarketing agent to conduct the rate setting and remarketing process. Alternatively, issuers of long-term, fixed-rate bonds may swap the interest component to a variable-rate. They do so by entering into an agreement with an intermediary or counterparty, to receive a fixed-rate of interest while paying a variable-rate.

- MUNICIPAL ADVISOR - Municipal advisors may assist issuers with ongoing obligation under securities law to provide annual financial reports and to make event notifications. A municipal advisor may evaluate opportunities to refund outstanding debt to lower the cost of borrowing, to benefit from an alternative debt structure, or to address restrictions imposed on the issuer by covenants or others terms contained in the outstanding obligation. As noted above, municipal advisors must register with the SEC and MSRB and comply with the requirements of MSRB Rule G-3.

- LEGAL COUNSEL - Legal counsel advises the issuer with respect to the obligations it has undertaken; specifically, tax covenants and continuing disclosure.

i.4.2 Key Decisions Public Agencies Must Make when Selecting the Appropriate Debt Option

When selecting an appropriate debt option, public agencies must make many decisions, including those described in the sections below. These decisions focus on the resources (or lack thereof) of the public agency, as well as the risks a public agency may or may not be comfortable assuming. This list of decisions is not intended to be prescriptive and the order is not always sequential. In fact, certain decisions may overlap or be interdependent with other decisions.

i.4.2.1 DECISION #1 - CHOOSE THE FUNDING SOURCE

Depending upon their authorities, some public agencies have multiple revenue sources from which they can repay borrowed money. See Chapter 1 - Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues. Most cities, for example, can choose to fund debt service from general taxes (which typically include sales taxes and property taxes), revenue sources like enterprise systems (such as a water system), or special taxes or **assessments**. Determining which funding source should be used to pay debt service generally hinges on two questions:

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1. Is there a funding source that is most fair and appropriate given the need that is being financed?
2. Is the funding source vulnerable to interruption or adverse changes that would unduly endanger the public agency's ability to meet its service mission if it is committed to repayment of debt?

A city seeking to finance the construction of a parking facility, for example, may consider funding its debt service from its general fund or from the revenues of the parking facility. On one hand, the parking revenues could be the best choice because the debt will finance the construction of the parking facility, while using general fund revenues could jeopardize the use of those revenues for more important priorities. On the other hand, the city may conclude that the parking revenues are insufficient or are not reliable enough to pay debt service.

i.4.2.2 DECISION #2 - CHOOSE A SECURITY PACKAGE

Usually, the revenues that will serve as the funding source for debt service will also serve as the revenues that will secure the debt. Sometimes, however, the source of revenue used to fund debt service is different from the source of revenue used to secure the debt. In the example of the city-financed parking facility, the city may decide that it will use the parking revenues to repay the debt but may still opt to use general fund revenues to secure the debt.

This decision hinges on the answers to three questions:

1. What sources of revenues are sufficiently creditworthy to serve as security for the debt?
2. What sources of revenues are legally permissible to serve as security for the debt?
3. What risks to the mission of the public agency or to the funding of higher-priority needs are implicated by using a source of revenue as security for the debt?

i.4.2.3 DECISION #3 - SELECT A TERM

The public agency also must decide the term of its debt, that is the length of time the debt may be owed. The term may be short, medium, or long. This decision hinges on the answers to three questions:

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1. How much debt service is the agency able to pay without limiting other programs or services?
2. Over what period does the public agency plan to repay the debt?
3. How does the term of the debt align with the useful life of the asset being financed?

i.4.2.4 DECISION #4 - SELECT AN INTEREST RATE TYPE

The public agency must also choose an interest rate type. For municipal debt obligations there are two principal interest rate modes: fixed and variable. See Chapter 2 - Debt Structures - What Factors Drive Structuring Decisions? Most public debt is issued as fixed-rate debt. Some public agencies, particularly those with large cash reserves, may benefit from issuing variable-rate debt.

The interest payment on a fixed-rate obligation is calculated using a single rate set at the time the debt is negotiated. The rate in a variable-rate obligation is set based on market demand at the time the debt is repriced or rolled over.

Variable-rate debt products tend to have lower initial interest rates than fixed-rate debt products. The market expresses this relationship of costs over time through a "**yield curve**," which is a representation of interest rates at different moments in time. Generally, the farther one goes out on the yield curve (i.e., the longer the maturity of the debt), the higher the interest rate. This reflects the exchange of risk between the issuer of debt and the investor: the longer the maturity, the more the public agency has transferred to the investor the risk that interest rates will increase and purchasing power will be eroded, and for tax-exempt debt, the risk that tax laws will change. Figure i-2 offers an example of a yield curve.

The decision to use a fixed or variable-rate hinges on two basic questions:

1. Do the potential interest rate savings of variable-interest-rate products outweigh the financial burden that substantially increased interest rates would impose on the public agency?
2. Can the public agency bear the interest rate and market risk associated with variable-rate debt?

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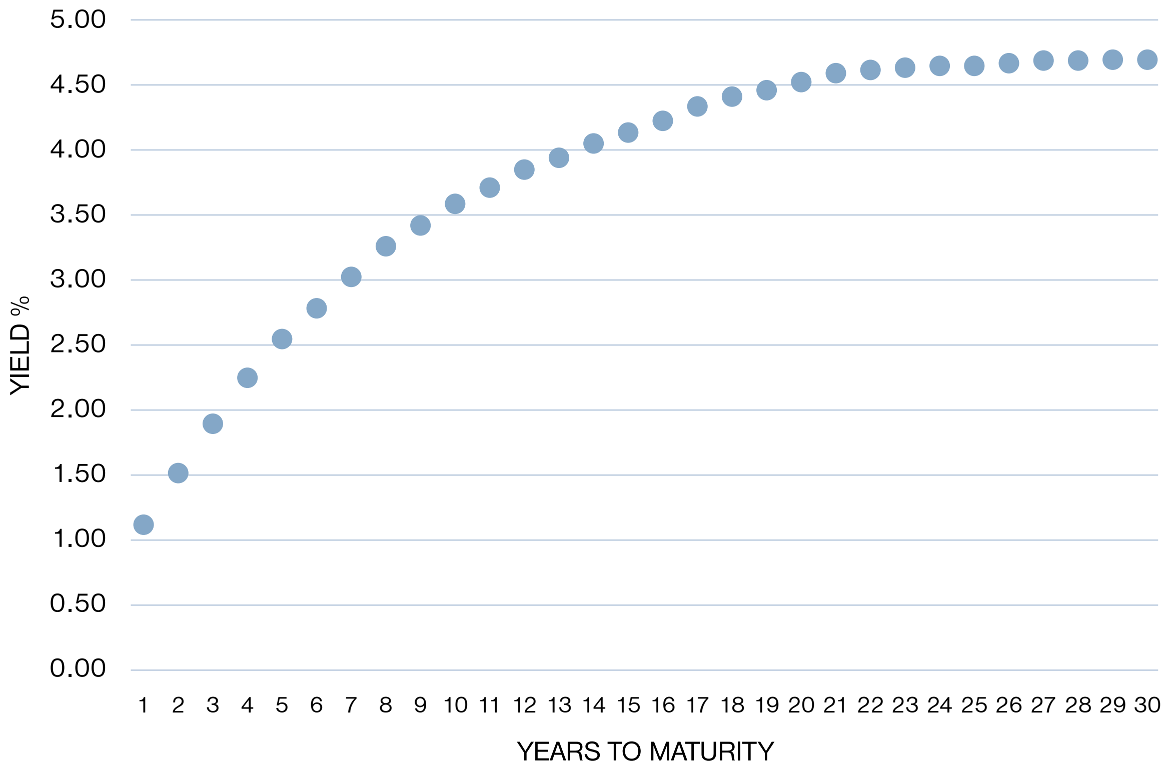
Figure i-2

SAMPLE YIELD CURVE, AAA ISSUES



Variable-rate options may provide advantages over current fixed-rates, but they bear certain risks, namely, volatility risk. If interest rates increase substantially, then the overall interest cost on the debt product can become a significant burden to the public agency.

i.4.2.5 DECISION #5 - UNDERSTAND WHAT THE AGENCY COMMITS TO DO IN THE FUTURE

As a part of the contractual agreement between the public agency and the investor, the agency agrees to perform certain tasks and maintain certain conditions that intend to ensure repayment of the debt. These commitments are typically contained in bond or debt covenants. Among them are commitments on the issuer's part to procure insurance, ensure the priority of the debt against other obligations, set rates or levy taxes to pay debt service or maintain coverage (if legally permitted),[26] and provide financial information to investors and lenders. Failure

[26] Coverage is typically understood as a ratio of revenues to debt service, but may be expressed in different ways depending on the form of debt issued.

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to comply with some of these covenants may trigger a default. Penalties that may result from a default include an increase in interest rates, an acceleration of the debt, or cross-defaults to other debt.

i.4.2.6 DECISION #6 - DECIDE WHETHER THE DEBT WILL BE TAX-EXEMPT

Public agencies that issue debt on a tax-exempt basis generally enjoy lower interest rates than they would if they issued taxable debt. The interest rate difference between taxable and tax-exempt debt will vary depending on market conditions and other particulars, but it can be significant to the total cost of the financing. The federal tax exemption is conditioned on the satisfaction of certain requirements and limitations for the life of the debt. In addition to the federal tax exemption, interest on debt of California public agencies is exempt from California personal income taxes. California tax exemption only requires that the debt be issued by a California political subdivision.

When a public agency issues debt on a tax-exempt basis, the public agency must comply with certain limitations and requirements on the use of the financed facilities and on the investment of the proceeds of the debt. Issuers must continue to monitor the use of bond financed properties and the investment of bond funds throughout the life of the bonds. The public agency must evaluate whether these limitations and requirements pose operational constraints that are untenable or problematic. See **Chapter 4 - Federal and State Tax Law Requirements** and **Chapter 8 - Post-Issuance Debt Management Requirements Including Tax Compliance and Ongoing Disclosure Obligations**.

i.4.2.7 DECISION #7 - EVALUATE MUNICIPAL MARKET OPPORTUNITIES TO USE DEBT FINANCING

Debt products customarily issued in the municipal market tend to be structured to meet the investment preference of particular investors. The market for debt products sold by state and local governments is highly stratified and is arranged around three factors: (1) the term of the debt obligation, (2) the inherent credit strength of its source of repayment, and (3) the strength of the debt covenants. Debt products range from those with very short maturities (such as **commercial paper** that can be issued with very short maturities—as short as 1 day) to relatively long maturities (such as long-term, fixed-rate bonds that can be generally issued with up to 30-year maturities or longer). Some debt products inherently require support from a commercial

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bank (such as variable-rate demand bonds, which require a **line of credit** from a commercial bank to cover bonds that investors tender, or essentially sell back to the public agency), while some debt products have no support from commercial banks (such as fixed-rate bonds). Some debt products have very few or no financial and operating covenants (other than very basic covenants) while other debt products contain extensive and complex financial and operating covenants that restrict the issuer.

The principal concern of all investors is whether or not the issuer will pay back the debt but they may also seek out specific characteristics, including the following:

- FIXED-RATE OR VARIABLE-RATE - Some investors look for fixed-rate debt products. Retail investors, for example, want to purchase debt products that will produce a predictable stream of income and that they can place in their investment portfolio for an intermediate-to-long term. Other investors look for variable-rate debt products that may meet specific limitations imposed by policy or financial goals, including liquidity or hedges against a fixed-rate position.

- LONG-TERM, MEDIUM-TERM, OR SHORT-TERM PRODUCTS - Some investors look for long-term debt products that will likely remain outstanding for a long period. Many bond funds generally fall into this category. Retail investors seek medium-term investments. Still other investors look for short-term debt products. These include bond funds that concentrate on short-term variable-rate debt.

- REDEMPTION PROVISIONS - If investors are looking for a long-term, fixed-rate debt product, they tend to care about when and at what price the bonds can be redeemed. If investors are looking for short-term variable-rate debt, they tend not to care about whether the issuer can redeem the debt product because they are less interested in how long the debt product is outstanding.

- FINANCIAL COVENANT PACKAGE - Investors of all types consider the financial covenants that may address the issuer's right to issue additional debt or to maintain a debt service reserve.

i.4.3 Steps Public Agencies Must Take to Use Debt Financing

THE AUTHORITY TO ISSUE DEBT - As a general rule, public agencies only have the powers that are expressly granted to them, are fairly implied from the

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powers expressly granted, or essential to the declared objectives and purposes of the governmental entity.[27] This means that for a public agency to issue debt or generate revenues, state law must expressly authorize the public agency to do so.

As described in Chapter 1 - Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues, most public agencies must look to state statute for authorization to borrow or to generate revenues to repay debt. Under the California Constitution, charter cities must look to their city charters for this authorization. Charter cities are also subject to general state laws, and all public agencies are subject to the California Constitution. In general, when a state statute authorizes a public agency to incur debt and that statute prescribes a method by which the public agency may take the action, the agency may not take the action using a different method. This fact is sometimes expressed as "the mode is the measure of the power." For example, the courts have ruled that if a statute authorizes a public agency to incur debt and then provides that the public agency is to sell that debt through competitive bidding, the public agency is required to follow that approach.

The California Constitution sets limitations on the debt certain types of public agencies can incur in any given year. Article XVI, Section 18 of the California Constitution prohibits cities, counties, and school districts from entering into indebtedness or liability in any year if it exceeds their income and revenue for that year unless the local agency first obtains two-thirds voter approval for the obligation. This is commonly referred to as the **debt limit**. School districts have the option to seek authority for indebtedness that requires only a 55% voter approval for the construction or rehabilitation of school facilities (including furnishings and equipment).

There are three main exceptions to the debt limit: (1) the Lease Exception, (2) the Special Fund Exception, and (3) the Obligations Imposed by Law Exception. California local agencies subject to the debt limit rely on these three exceptions to issue the majority of their debt, with the Lease Exception being the most commonly used exception. See Chapter 1 - Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues.

[27] This is referred to as Dillon's Rule (named for Judge John F. Dillon of Iowa, who articulated the rule in the late 1800s).

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LEASE EXCEPTION - The Lease Exception provides that a long-term lease obligation entered into by a city, county, or school district as **lessee** will not be considered an "indebtedness or liability" under the debt limit if the lease meets the following criteria:

- The obligation to pay rent for any rental period is contingent upon the public agency lessee having beneficial use and occupancy of the leased premises for that rental period.
- If use and occupancy by the public agency is not available, there is abatement of rent during the period the use and occupancy is not available.
- If the public agency lessee fails to pay rent when due, there can be no acceleration of future rent due.
- The rent in each year does not exceed the fair rental value of the premises.

A city, county, or school district that is constrained by the debt limit from issuing general obligation debt may choose to enter into a lease-based financing, such as lease revenue bonds or certificates of participation in order to avoid the time, expense, and political risk of seeking voter approval of the debt; however, lease-based financing are paid out of the agency's general revenues and, thus, directly affect operating budgets.

SPECIAL FUND EXCEPTION - The Special Fund Exception permits long-term indebtedness or liabilities to be incurred without an election if the indebtedness or liability is payable from a "special fund" and not the public agency's general revenues. Special funds are used to finance an activity related to the source of revenues. Case law has affirmed that when debt is paid from revenues related to the enterprise financed with the indebtedness, the indebtedness or liability is not the public agency's but is instead an indebtedness or liability of the special fund and thus is not subject to the debt limit. There must be a connection between the project financed with the indebtedness and the special fund. For instance, parking revenues deposited in a special fund cannot be used to finance sewer repairs, because there is no relation between the use of proceeds and the special fund.

OBLIGATIONS IMPOSED BY LAW EXCEPTION - The Obligations Imposed by Law Exception is not frequently used, but has been used to support pension obligation

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bonds, borrowings used to satisfy legal judgments, and Teeter Plan[28] financings to advance delinquent property taxes. An indebtedness to finance an obligation imposed on the public agency by law (e.g., a court order to make a payment that is required by state law) is not subject to the debt limit. This debt limit exception is based on the notion that the obligation is not discretionary, and thus it does not make sense to request voter approval.

i.4.4 Additional Legal Requirements - Internal Boards, Reporting to CDIAC, and Voter Approval

Even if the public agency has legal authority to issue the debt and the issuance will not violate the debt limit, there are other steps that the public agency must take in order to legally issue the debt. A short checklist of these steps includes the following:

- OBTAIN VOTER APPROVAL TO ISSUE DEBT (IF REQUIRED).
- PURSUE A VALIDATION ACTION. Although not a typical part of the issuance process, a public agency may pursue a validation action to obtain judicial approval before the bonds are issued, particularly if a bond transaction relies on a legal conclusion for which there is no clear precedence in case law. A validation action will establish that a court has deemed the bonds "valid." Public agencies may use the validation process to preempt challenges as to the validity of the bonds that may be brought by other parties.
- ADOPT A GOVERNING BOARD RESOLUTION OR ORDINANCE APPROVING THE DEBT AND LEGAL DOCUMENTS. The governing board adopts a resolution or ordinance authorizing the issuance of debt and the execution of legal documents. Specific requirements, such as the timing of the approval, may be established by state or local law.
- EXECUTE LEGAL DOCUMENTS. Once the governing board has authorized its officers to execute the legal documents that will govern the transaction, the financing team finalizes them.

[28] The Teeter Plan is a voluntary program administered by the county that redistributes tax collections in order to guarantee member taxing agencies annually receive 100% of their levied taxes. (See **Section 3.3.5**)

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- PROVIDE NOTICE TO CDIAC. State law requires public agencies to provide notice to CDIAC of any proposed debt issuance 30 days before sale and a report of final sale within 21 days after the sale.

i.4.5 Issuing Tax-Exempt Debt

The federal government through the Tax Code and related U.S. Treasury regulations imposes rules that must be satisfied for interest on municipal debt to be tax-exempt. See Chapter 4 - Federal and State Tax Law Requirements. These rules include (1) a requirement that the debt be issued by a qualified issuer, (2) limitations on the uses of the financed facilities, (3) limitations on a public agency's ability to take advantage of the "arbitrage" opportunities available given the lower interest rates associated with tax-exempt bonds, and (4) administrative and procedural requirements. These are described below.

i.4.5.1 REQUIREMENT #1 - THE DEBT MUST BE ISSUED BY A QUALIFIED ISSUER

The Tax Code and related regulations permit tax-exempt debt to be issued only by a state or political subdivisions of the state. In limited cases where the recipients of the subsidy are broader than state or local governments, such as an exempt private activity (e.g., a nonprofit hospital), the Tax Code nonetheless generally requires the debt to be issued by a state or local government. A state or local government includes states, territories, the District of Columbia, and any "political subdivision" thereof. A political subdivision is any public agency that can independently exercise one or more of the three substantial sovereign powers (taxing power, police power, and eminent domain). Many public agencies are clearly political subdivisions (e.g., cities, counties, and school and other districts) because they clearly possess the requisite sovereign powers, but others (e.g., joint powers authorities) require a detailed analysis.

Tax-exempt bonds may also be issued "on behalf of" a state or local government by entities that are themselves not political subdivisions. For example, constituted authorities formed by a state, such as the California Educational Facilities Authority, qualify as "on behalf of" issuers. In addition, "on behalf of" entities include nonprofits that are formed and controlled by a state or local government. Thus, obligations issued by a nonprofit corporation formed under the general nonprofit corporation law for the purpose of stimulating industrial development within a political subdivision of a state are also considered issued "on behalf of" the political subdivision, provided they meet certain requirements.

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i.4.5.2 REQUIREMENT #2 - THE DEBT MUST FINANCE A QUALIFYING PROJECT AND SATISFY ONGOING REQUIREMENTS AND LIMITATIONS REGARDING THE USE OF THE PROJECT

The Tax Code requires the application of complex rules regarding **private use**. Determining if there is to be any private use of the facility must be completed before issuance and continuously monitored until the bonds are fully paid. "Private use" generally means the use of a financed project in the trade or business of any person other than a state or local government which differs from the use of the project by the general public. Loans of bond proceeds to nongovernmental persons ("private loans") also will generally prevent debt from qualifying for tax exemption. *De minimis* amounts of "private use" or "private loans" are permitted but the application of complex rules is required to measure the amount of private use or private loans. Thus, a project that is or will be subject to leases, contracts, or other special arrangements regarding its use must be carefully analyzed to determine whether it is eligible for tax-exempt financing. Projects eligible to be financed on a tax-exempt basis generally include projects for governmental or general public use (such as government buildings, roads, schools, libraries, and parks). However, some projects the federal government seeks to encourage but that are used by private persons may still be eligible to be financed on a tax-exempt basis, such as airports, docks, and wharves, subject to a significant number of special rules applicable to bonds issued for such projects. To analyze whether the project a public agency might finance is a qualifying project, here are the key questions to ask:

- Will any portion of the project be owned by a nongovernmental person?
- Will any portion of the project be leased or licensed to a nongovernmental person?
- Will any portion of the project be subject to a management, service, or other contract relating to the project (such as a food concession or naming rights contract)? Contract arrangements that are purely incidental to the primary governmental function of the project, such as a janitorial contract, generally do not cause private use.
- Will any portion of the project be subject to and used in connection with corporate, nongovernmental, or federally sponsored research?
- Will any portion of the proceeds of bonds be used to make "private loans?"
- Will any portion of the project be used by the federal government?

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If the answer to any of the above questions is yes, more analysis is required to determine whether the debt can be issued on a tax-exempt basis.

On the date of issuance, the public agency must reasonably expect to not exceed the *de minimis* limits for private use and private loans for the entire period over which the debt will remain outstanding. Following issuance, the public agency is responsible for ensuring that the limits are in fact not exceeded for the life of the debt. If the limits are exceeded after issuance and before full repayment of the debt, the debt could be determined to fail to qualify for tax exemption, retroactively to the date of issuance. The IRS has been strongly encouraging public agency issuers to adopt formal policies and procedures to ensure that the rules and limits are and remain satisfied for the life of the debt, including compiling and maintaining records of the specific assets financed, identifying persons with primary responsibility for monitoring the use and disposition of the assets, and requiring periodic checks to confirm compliance. See Chapter 8 - Post-Issuance Debt Management Requirements, Including Tax Compliance and Ongoing Disclosure Obligations.

i.4.5.3 REQUIREMENT #3 - MANAGE THE ARBITRAGE RULES

The ability to issue tax-exempt debt and invest proceeds in the taxable market is called earning "arbitrage." If investments of bond proceeds earn *more* interest income than the interest costs of the tax-exempt debt, there is "positive arbitrage;" however, if interest income is less than the interest costs of the tax-exempt debt, there is "negative arbitrage." See Chapter 4 - Federal and State Tax Law Requirements. The arbitrage provisions of the Tax Code are designed to ensure that tax-exempt bonds are not issued too early, are not issued for an amount more than is reasonably necessary, and are not outstanding too long.

In addition, the Tax Code also places strict limits on the funding of, and investment of monies held in, debt service reserve funds. A debt service reserve fund is a common feature of bonds issued by public agencies. The thrust of the IRS regulatory regime is to reduce or eliminate the opportunity for a public agency to "borrow low" and "invest high."

In order to prevent tax-exempt bonds from being outstanding too long, the Tax Code requires that bonds be issued to finance capital expenditures for which the average time of bond repayment matches up with, or is not much longer than, the average time over which the financed assets are to be enjoyed. In limited

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circumstances, tax-exempt obligations may be used to finance working capital, generally with limits on the term over which the bonds can remain outstanding.

Like the requirements and limitations relating to the use of the financed project, the arbitrage requirements and limitations must be satisfied for the life of the debt or the debt could fail to qualify for tax exemption, retroactive to the date of issuance. As noted, the IRS encourages formal policies and procedures to ensure ongoing compliance.

i.4.5.4 REQUIREMENT #4 – ADHERE TO PROCEDURAL AND OTHER RULES

Special tax law rules, requirements, and limitations may apply to financings in specific contexts, such as financings for working capital or refunding transactions. The ability to finance working capital with tax-exempt debt is very limited and is subject to special rules. The most common working capital financings used by public agencies are tax and revenue anticipation notes (TRANs). To qualify for tax exemption, TRANs generally must be issued in an amount more than the amount of the cash flow deficit anticipated by the public agency within 6 months following the issue date.

Refunding bonds are issued by public agencies to replace outstanding bonds either to achieve costs savings, to restructure the debt repayment, or to change specific bond covenants. Refunding bonds are either **advance refundings**, that is the refunding bonds are issued more than 90 days before the outstanding bonds are redeemed, or **current refundings**, i.e. within the 90 day window. The Tax Cut and Jobs Act (P.L. 115-97) eliminated the tax exemption for advance refunding bonds issued after December 31, 2017.

Qualification for tax exemption is also dependent upon satisfaction of certain procedural rules, most notably the timely filing of IRS Form 8038: a form intended to notify the IRS of each tax-exempt debt issue. IRS Form 8038 provides the IRS certain information regarding the debt, such as amount, issue date, expected application of the proceeds, and contact information.

i.4.6 What Financing Options are Available?

The list below (and Chapter 3 - Types of Debt Obligations Issued by Public Agencies) identifies the most common types of debt obligations that public agencies may use to finance capital improvements and operating capital (marked with an asterisk).

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The list is organized by three essential characteristics of debt: (1) type of security and source of repayment, (2) interest rate and payment term of the obligation, and (3) tax status. This approach recognizes actual differences in the authority, security or source of repayment that account for the risk and cost of different types of debt. It also avoids creating artificial differences based on nomenclature.

DEBT TYPES BY SECURITY OR SOURCE OF REPAYMENT

- Local General Obligation Bonds (Section 3.3.1)
- General Fund Obligations
  1. Lease Revenue Bonds and Certificates of Participation (Section 3.3.2.1)
  2. Pension Obligation Bonds* (Section 3.3.2.2)
  3. Tax and Revenue Anticipation Notes (TRANs) and Revenue Anticipation Notes (RANs)* (Section 3.3.4)
  4. Teeter Bonds* (Section 3.3.5)
- Enterprise Fund Debt Obligations (Section 3.3.6)
- Special Assessments, Special Taxes, and Tax Increments
  1. Special Assessment Bonds (Section 3.3.7.1)
  2. Mello-Roos Bonds (Community Facility Bonds) (Section 3.3.7.2)
  3. Redevelopment Agency Debt (Section 3.3.7.3)
  4. Sales Tax Revenue Bonds (Section 3.3.3)
  5. Enhanced Infrastructure Financing District Bonds and Infrastructure Financing Bonds (Section 3.3.7.4)
- Single-Family Mortgage Revenue Bonds (Section 3.3.8)
- Conduit Revenue Bonds
  1. Exempt Facilities Revenue Bonds (Section 3.3.9.1)
  2. Small-Issue Industrial Development Bonds (Section 3.3.9.2)
  3. Health Care Conduit Bonds (Section 3.3.9.3)
  4. Education Conduit Bonds (Section 3.3.9.4)

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5. Multifamily Housing Conduit Bonds

- State General Obligation Bonds

DEBT TYPES BY INTEREST RATE AND PAYMENT TERMS

- Long-Term, Fixed-Rate Bonds
- Long-Term, Variable-Rate Bonds
- Commercial Paper

DEBT TYPES BY TAX TREATMENT

- Taxable Bonds
- Alternative Minimum Tax (AMT) Bond
- Non-AMT Tax-Exempt Bonds

UNIQUE PUBLIC AGENCY FINANCINGS TO ADDRESS LEGAL CONSTRAINTS

- Financing Leases
- Installment Sales Agreements
- Certificates of Participation (typically used to securitize financing leases and installment sales agreements)
- Joint Powers Authority Bonds (typically used to securitize financing leases and installment sales agreements)

OTHER TYPES OF FINANCINGS

- Direct Loans
- Direct Leases
- Bond Anticipation Notes (BANs) and Grant Anticipation Notes (GANs)
- Other Tax and Fee Secured Debt
- Asset Securitization

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- Refunding Bonds
- **Pool Bonds**

i.5 MANAGE YOUR DEBT AFTER IT IS ISSUED

Public agencies that issue debt are likely to benefit from good management practices, including efforts to establish and maintain policies and procedures that produce accountability and transparency. Issuers that have developed strong administrative systems to manage their debts are more likely to comply with their securities and tax obligations and avoid the cost of having to make reparations to investors, regulators, and the public if they fail to comply with these obligations.

Apart from the financial rewards, however, public agencies and the elected officials that lead them, should understand that debt financing is NOT a source of unrestricted funds. The use of debt financing imparts a tremendous legal, financial, and administrative burden and must be used wisely, with a complete understanding of the responsibilities assumed.

i.5.1 Managing Your Agency's Debt Financings

Securities laws are intended to provide a fair and efficient market that ensures access to capital for borrowers and the ability for investors to properly price risk. The tax exemption that provides public agencies a lower cost of financing for essential services and capital improvements also requires issuers to demonstrate public benefit and compliance with rules on the use of proceeds. The public agency, under the direction of its elected and administrative leadership, should develop and follow procedures and policies that ensure compliance with all legal and administrative requirements and guard against the negative consequences of regulatory actions taken by the SEC and IRS or civil actions brought by investors, taxpayers, or others. The procedures should include certain key components, among them the following:

- Clear delegation of duties and roles
- Staff training and technical support to designated officials
- Due diligence reviews at regular intervals
- Centralized recordkeeping and retention policies

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- Procedures reasonably expected to identify noncompliance promptly
- Procedures ensuring that the issuer will take steps to correct noncompliance promptly

The agency's policies should define both the direction and outcome of the procedures, that is, the work conducted by staff and service providers to meet legal and regulatory requirements. Often times, policies and procedures are combined in a single document. The most common policies adopted by public agencies to administer their debt are (1) debt management policies, (2) disclosure policies, and (3) investor relations policies.

i.5.1.1 DEBT MANAGEMENT POLICIES

Public agencies develop and apply policies to ensure that debt is issued and managed prudently. This practice is advocated by the GFOA, which published and subsequently updated Best Practice guidelines for debt management policies in 1995, 2003, and 2012.[29] The GFOA endorsed the use of a **debt management policy** to improve the quality of decisions, articulate policy goals, provide guidelines for the structure of debt issuance, and demonstrate a commitment to long-term capital and financial planning.

A local agency's debt management policy can assist its debt managers in making decisions and supporting efforts to identify conflicts, inconsistencies, and gaps in a local agency's approach to project finance and debt management. A debt policy can also be instrumental in setting a proper balance between limits on the use of debt financing and providing sufficient flexibility to respond to unforeseen circumstances and opportunities. Potential benefits of a formal debt policy include the following:

- Supporting financial decisions that are transparent and consistent
- Establishing standard operating procedures to guide daily financial activities
- Providing performance measures and limits based on predetermined levels and benchmarks
- Providing justification for decisions
- Providing an interface between capital planning, long-term financing objectives, and daily operations

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[29] GFOA Best Practice - *Debt Management Policies*, www.gfoa.org/materials/debt-management-policy.

- Focusing on the overall financial plan in contrast to individual issues
- Proactively safeguarding public agencies from making unsuitable debt-related decisions
- Providing consistency and instruction to new and transitioning staff
- Establishing an effective management mechanism for post-issuance compliance

Lacking a formal set of well-understood and well-communicated policies, issuers may run into problems in both the issuance and administration of debt. In the absence of policies, issuers may fail to control the type, structure, and maturity of debt being issued. They may enter into service contracts that are not well understood and potentially harmful, and they may fail to meet federal disclosure and tax compliance obligations. Failures such as these may result in adverse outcomes for public agencies and their officials. To the extent that a lack of policies leads to the injudicious use of debt, poorly structured debt or repayment schedules, or the failure to meet disclosure or tax obligations, the issuer may be penalized by regulators, downgraded by ratings agencies or, at minimum, lose investor and taxpayer confidence.

Equally painful are the implications of a poorly managed debt portfolio to the agency's fiscal conditions. Potential implications include cash shortfalls, missed debt service payments, or the inability to call or refund debt to take advantage of changing market conditions. Well-constructed and well-communicated policies protect the interests of the public as well as the public servants who, acting in good faith, seek to meet the needs of their constituents.

TOPICS ALL PUBLIC AGENCIES SHOULD ADDRESS IN THEIR DEBT MANAGEMENT POLICIES

Assignment of Responsibilities - Issuers may depend upon professionals to provide various services associated with debt issuance and administration. But in the end, it is the issuer's full responsibility to perform these tasks. Issuers are accountable for the information contained in the Official Statement through which the debt securities are sold and in all subsequent disclosures and financial reports and are responsible to pay principal and interest in full when due. Issuers are responsible to use the proceeds for the purposes represented to the investors and to tax- and fee-payers. Issuers commit to comply with all laws and regulations regarding the administration of the bonds in the contract they execute with the securities dealers. But who is responsible to track whether they have complied with these promises and obligations?

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An issuer's debt policies should assign responsibility for specific administrative tasks to specific roles within the organization. The match between assignment and task should make organizational sense. That means the person with the role should have the authority to execute the responsibilities of the task, the knowledge and resources to do so, and the supervision necessary to make the role accountable. These assignments should be reviewed intermittently and changed when either personnel within the agency change or the scope of responsibilities changes. The agency should adopt procedures to monitor its performance, questioning both whether tasks were performed as required and within an acceptable timeframe. Monitoring can be built into the agency's internal control program as discussed below.

Public agencies differ in size and staffing. When they lack sufficient expertise or resources, they may contract with service providers to perform administrative tasks related to debt. The agency must continue to dedicate resources to monitoring contract performance and to ensuring compliance.

Identification of Refunding Opportunities - Issuers of fixed-rate debt may benefit by refunding outstanding bond issues when interest rates fall. As with a home mortgage, refunding debt allows the borrower to save money. Some state laws authorizing California public agencies to issue refunding bonds include a requirement that the interest rate on the new debt result in debt service savings. The agency's debt policies should identify who is responsible for making the decision and under what circumstances it is appropriate to refund.

Tax Compliance - In order to maintain the tax-exempt qualification, issuers must ensure that the requirements of Section 103 of the Tax Code are met through the life of the bonds:

- Filing of certain information at the time of issuance
- Proper use of bond-financed property
- Limitations on investment earnings and how the bond proceeds may be invested
- Calculation and rebate of any positive arbitrage

When circumstances arise unexpectedly and cause issuers to fail in their tax compliance, U.S. Treasury regulations provide "self-help" remedies that issuers can employ to maintain the tax exemption of the debt. For example, if due to changed circumstances a public agency desires to sell a portion of the property

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acquired with the debt proceeds, the public agency could redeem or defease the portion of the debt allocated to the property being sold.

Keeping Up with Bond Covenants - Issuers promise investors that certain conditions or practices regarding the bonds will remain in place for the life of the bonds. These may consider the use of the facility by a private business, the issuance of additional bonds in the future, insurance coverage on the financed facility or system, maintenance of credit agreements or maximum tax rates of taxpayers. Each of these, as conditions of issuance, are memorialized in one of the key financing agreements, such as an indenture, lease, or installment purchase agreement. Once agreed to, however, these conditions obligate the issuer to create administrative procedures to test, monitor, and respond to deviations from the agreed-upon conditions.

Investing Debt Proceeds - Because an issuer's debt policies address the issuance and administration of its debt program and compliance with any legal, contractual, or regulatory obligations under it, its investment policies must address the investment of bond proceeds. See Chapter 9 - Investment of Bond Funds. Government Code Section 53601 sets forth the allowable investments a public agency may use when investing surplus funds. However, this section does provide that bond proceeds may be invested differently if invested in accordance with the bond documents. Issuers use this authority to maximize their investment earning, subject to the Tax Code, to potentially increase the funds available for projects or to reduce the size of their debt issuance.

i.5.1.2 DISCLOSURE POLICIES

Disclosure policies should provide specific guidance on who, how, and when the issuer will provide ongoing disclosures as required by SEC Rule 15c2-12.[30] These disclosures fall into two groups: (1) updates, additions, and amendments to information originally presented in the OS and subject to the issuer's continuing disclosure agreement and (2) material event notices.

Disclosure policies are designed to ensure the accuracy of the issuer's disclosures and its compliance with all applicable federal and state securities laws, and to

[30] Issuers are required to use the MSRB Electronic Municipal Marketplace Access (EMMA) system to post required disclosures, including offering documents, annual financial reports, and material event disclosures.

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promote best practices regarding disclosures. Disclosure policies and procedures should address who, what, when, and how information is to be released to the market with the intent to:

- Identify the information that must be disclosed on a continuing basis.
- Create a schedule for disclosures.
- Establish a full list of events that must be reported.
- Create procedures to gather the information, validate the information, and approve its release.
- Designate roles and responsibilities that control the release of information.

The policies may also address the development and review of the policies, a timeline for the review of the policies, a training program to inform key staff of the procedures and their responsibilities under the policy, and measures to retain and track documents.[31]

i.5.1.3 INVESTOR RELATIONS POLICIES

In addition to making required disclosure in compliance with SEC Rule 15c2-12, an issuer is likely to have intermittent communications with investors, the market, and the community about its debt. Policies that guide these communications can help to ensure that valid and consistent information is shared. The policies should identify the roles responsible for communicating, the procedures for the review and approval of communications, and a system to track such communications. Staff responsible for these communications should be trained annually, if not more often, on securities laws as they relate to public communications.

The MSRB Electronic Munipal Marketplace Access (EMMA) System offers issuers the opportunity to set up an investor website. The GFOA maintains that an investor website can make "disclosure information more accessible" and help to "improve the efficiency of the municipal market" and "possibly lower borrowing costs by improving access to information relevant to determining the credit quality of an issuer's bonds."[32]

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[31] Additional information on primary and continuing disclosure is available through CDIAC, the GFOA, and the National Federation of Municipal Analysts.

[32] GFOA Best Practice - *Using Technology for Disclosure*, www.gfoa.org/materials/using-technology-for-disclosure.

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An investor website has several advantages, including offering:

- An efficient and low-cost means of distribution
- The simultaneous, controlled release of information
- Lower costs and broader reach as compared to traditional investor relations programs used by most issuers to respond to investor inquiries.

The use of an investor website poses risks to issuers who fail to develop it properly or keep it current. Disclosures that are incomplete, late, stale, or incorrect may constitute violations of securities laws or commitments made to bondholders. The GFOA has published its Best Practice recommendations to help issuers avoid these pitfalls.[33]

i.5.2 California Review and Reporting Requirements on Debt

i.5.2.1 PROPOSITION 39 GENERAL OBLIGATION BONDS

School districts may issue general obligation bonds with 55% voter approval if they meet certain requirements with regard to expenditures, tax rates, and oversight of the bonds.[34] Districts that issue these bonds must establish an oversight committee "to inform the public concerning the expenditure of bond revenues." The committee's duties will be to "actively review and report on the proper expenditure of taxpayers' money for school construction."[35] Education Code also requires school districts to conduct oversight and identifies penalties to be assessed against school or community college districts that do not appoint an oversight committee. Districts that avail themselves of the authority to issue these bonds must also complete an annual independent financial and performance audit and provide this to the oversight committee.[36]

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33 Ibid, GFOA.

34 Article XIIIA, Section 1 of the California Constitution.

35 California Education Code, Section 15278(b).

36 Subparagraphs (C) and (D) of paragraph (3) of subdivision (b) of Section 1 of Article XIII A of the California Constitution.

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i.5.2.2 MARKS- AND MELLO-ROOS BONDS

Local agencies issuing bonds using the authority of the *Marks-Roos Local Bond Pooling Act* (California Government Code Section 6584 et seq.) or the *Mello-Roos Community Facilities Act of 1982* (California Government Code Section 53313 et seq.) must submit to CDIAC an annual report on the debt they have issued. These reports capture, among other points of data, the outstanding principal balance on the debt and the amount of funds in their reserve accounts.

i.5.2.3 CONDUIT ISSUER REPORTING

Conduit financing providers, defined as public agencies that are authorized to issue conduit revenue bonds, must disclose certain information related to their affairs (Government Code 5870). They must make available agendas and notices of meetings, minutes of meetings, staff and audit reports, and annual financial transaction reports on a website. In any audit of the provider's financial records required by law, the audit must include, for the period considered, a review of fees imposed, disclosure of expenditures related to those fees, disclosure of the amount of bonds issued, and a disclosure of the amount of bonds authorized but unissued, among other things.

i.5.2.4 GRAND JURIES

California Penal Code Section 888, et seq. provides counties the authority to empanel a civil grand jury composed of volunteer citizens charged with the task of investigating public offenses or, more commonly, public processes with the intent of recommending improvements. A grand jury, by the nature of this authority, may direct attention to a public agency's use of debt financing.

i.5.2.5 REPORTS TO THE CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

Government Code Section 8855 requires California public agencies that issue debt to provide certain reports to CDIAC. These include the following:

REPORT OF PROPOSED DEBT ISSUANCE - Issuers must notify CDIAC of their intent to issue debt at least 30 days before the sale of the debt, including a certification by the issuer that it has adopted local debt policies which shall include the following information:

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- The purposes for which the debt proceeds may be used
- The types of debt that may be issued
- The relationship of the debt to, and integration with, the issuer's CIP or CIB, if applicable
- Policy goals related to the issuer's planning goals and objectives
- The internal control procedures that the issuer has implemented, or will implement, to ensure that the proceeds of the proposed debt issuance will be directed to the intended use

REPORT OF FINAL SALE OF DEBT - No later than 21 days after the sale of the debt, issuers must report to CDIAC and include the pricing on the bonds (in addition to the information provided in the *Report of Proposed Debt Issuance*).

ANNUAL DEBT TRANSPARENCY REPORT - Issuers who submit a report of final sale to CDIAC on or after January 21, 2017, must provide an **annual report** to CDIAC until the debt has been repaid and the proceeds have been fully spent. The report captures for the reporting period beginning and end balances on principal outstanding, authority remaining, and the use of bond proceeds. The reporting period is July 1 through June 30.

Data compiled from each of these reports is available on the CDIAC website at www.treasurer.ca.gov/cdiac.

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Chapter 1. Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues

Local public agencies[1] in California, like those in other states, have only the powers given to them by state law. The powers held by California public agencies vary. The scope of these powers affects whether and how a particular public agency can borrow, and on what terms, and the revenue sources available to it. This chapter provides an overview of the statutory and legal framework within which California local public agencies may incur debt and obtain the funds needed to repay it, including legal sources of authority to borrow (See Section 1.1), state constitutional limits on that authority (See Section 1.2), exceptions to the state constitutional debt and revenue limits (See Section 1.3), revenue sources available to public agencies (See Section 1.4), the limits on those sources, and related matters.

The objective of this chapter is not to provide an exhaustive list of all the laws that apply to a particular public agency and its issuance of debt or to provide all of the details of applicable state law. Rather, the chapter is designed to provide sufficient understanding of these laws to allow public agency officials to consult with legal counsel and other advisors. Different provisions affect public agency issuers in varying ways, depending in part upon the type of entity from a constitutional perspec-

[1] The terms "public agency" and "local public agency," and "local government" are used synonymously to mean any city, county, city and county, public district, public corporation, authority, agency, board, commission, or other public entity or any improvement district or zone thereof. These terms as used herein do not include departments or agencies of the State itself.

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tive (such as a city, county, district or other agency or authority) and upon the revenue source to be used for debt repayment (e.g., taxes vs. enterprise revenues).[2]

1.1 A PUBLIC AGENCY'S AUTHORITY TO BORROW

All public agencies are subject to the California Constitution, and as a general rule, they have only the powers that are expressly granted to them, are fairly implied from the powers expressly granted, or are essential to the declared objectives and purposes of the governmental entity.[3] This means that for a public agency to issue debt or generate revenues, state law must expressly authorize the public agency to do so. This authority may be contained in the statutes that form the agency ("organic statutes") (See **Section 1.1.1**) or they may be contained in statutes that broadly apply to public agencies ("general bond statutes") (See **Section 1.1.2**). Charter cities are provided the authority to borrow under their charters. (See **Section 1.1.3**)

1.1.1 Statutory Authority to Borrow

California public agencies are formed by, or pursuant to, state statute. Sometimes these statutes apply to only a single entity, while others apply to a category of entities (such as counties and school districts). In many cases, public agencies derive their power to borrow from these organic statutes.

Whenever state statute authorizes a public agency to incur **debt** and prescribes how the public agency may take the action, the agency must use that method. This fact is sometimes expressed as "the mode is the measure of the power." For example, if a statute authorizes a public agency to incur debt and then says that the public agency is to sell that debt through competitive bidding, the public agency must follow that approach.[4]

As a general rule, public agencies cannot borrow outside of the powers provided by these statutes.

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[2] Appendix A, Legal References contains the full text of the California Constitution provisions and citations to statutes discussed in this chapter.

[3] This is referred to as Dillon's Rule (named for Judge John F. Dillon of Iowa, who articulated the rule in the late 1800s).

[4] Reams v. Cooley, 171 Cal. 150 (1915).

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1.1.2 General Bond Statutes

Numerous statutes spread across several California codes give public agencies the power to borrow. As practices in the municipal bond market have evolved over time, some of the provisions in these statutes have become outdated and have made it difficult for public agencies to issue and sell bonds. Rather than amending each individual statute, the State Legislature has addressed some of the problems that have arisen through the adoption of statutes that apply to all public agencies (and are sometimes referred to as the "general bond statutes"). For example, after federal tax law was modified in the early 1980s to require that bonds must be issued in registered form in order for the interest on the bonds to be excluded from income for federal income tax purposes, the State Legislature passed the *Registered Public Obligations Act of California* (California Government Code Section 5050 et seq.) providing all public agencies in California the ability to establish a system of registration and to issue **registered bonds**.

Over time, state general bond statutes have covered numerous aspects of the issuance of debt, ranging from issuance of **refunding** bonds, registration of bonds, execution of bonds, **pledges** of security for bonds, interest payment dates, and issuance of bonds using an indenture or trust agreement or another instrument.

1.1.3 Borrowing Authority of Charter Cities

A California city can be a "charter city," with a voter-approved city charter, or a "general law" city. Approximately one-quarter of the cities in California are charter cities. The balance are general law cities.[5]

Article XI, Section 5 of the California Constitution provides that charter cities (but not general law cities) may operate under separate charters that govern the city with respect to all **municipal affairs**, subject only to the limitations in their charters and the Constitution. Charter cities in California must look to their city charters for the authorization to borrow. Charter cities are also subject to state laws addressing issues of "statewide concern," and like all public agencies, are subject to the California Constitution. The scope of charter city powers related to debt financing is discussed in Section 1.5, Charter Cities.

[5] The League of California Cities reports that there are 121 charter cities out of the 482 cities in the State. See www.cacities.org/Resources/Learn-About-Cities.

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1.2 CONSTITUTIONAL DEBT LIMIT

The California Constitution places limits on the ability of certain public agencies to incur debt, referred to as the **debt limit**. Case law has provided judicially recognized exceptions to the debt limit. While attention to the debt limit is important and imposes real constraints on municipal debt offerings, nearly all public finance transactions are either not subject to the debt limit or can be fit within one of the exceptions to the debt limit.

1.2.1 Debt Limit

The debt limit provisions in the California Constitution require two-thirds voter approval of certain forms of "indebtedness" and "liabilities" of certain public agencies so as to limit their ability to incur unfunded, long-term obligations. Article XVI, Section 18 of the California Constitution reads as follows:

> No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose.

The limitations of Article XVI, Section 18 cannot be overridden by statute. Furthermore, these provisions are a limit on the exercise of power and do not allow a public agency to incur obligations without independent constitutional or statutory authority.

1.2.2 Purpose of Debt Limit

The purpose of the constitutional debt limit as described in an early California Supreme Court case,[6] was to prevent "municipal extravagance" involving long-term financial commitments that exceed the current means of the public agency to repay. Each year's income and revenue must pay each year's indebtedness and liability," the court said, and "no indebtedness or liability incurred in any one year shall be paid out of the income or revenue of any future year." The debt limit provisions also serve as indirect limits on tax increases (by preventing obligations

[6] San Francisco Gas Company v. Brickwedel, 62 Cal. 641 (1882).

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that would require them) and curb intergenerational transfers (current residents enjoying benefits paid for by future years' taxpayers).

Determining whether a proposed issuance violates the constitutional debt limit based on the purpose of the issuance has had limited impact, and subsequent judicial determinations regarding "debt" and its compliance with Article XVI, Section 18 have relied on both the form and the substance of the transaction.

1.2.3 Scope of Debt Limit - When Does the Debt Limit Apply?

THE DEBT LIMIT APPLIES ONLY TO SPECIFIED PUBLIC AGENCIES. Article XVI, Section 18 of the California Constitution applies to cities (including charter cities), counties, and school districts (including community college districts). It does not apply to other local agencies such as joint exercise of powers agencies (JPAs), or special districts, although special district statutes may include their own limitations. A similar constitutional provision, Article XVI, Section 1, applies to the State of California. Courts have viewed the governing principles of the local agency and state debt limitations as the same, so cases interpreting one are authority for the interpretation of the other.

THE DEBT LIMIT APPLIES TO SOME ARRANGEMENTS NOT ORDINARILY THOUGHT OF AS DEBT. The actual terms used in Article XVI, Section 18, "indebtedness" and "liability," are quite broad and include many things not ordinarily thought of as debt: employment, service, and construction contracts; purchase agreements; performance guarantees; and **letter of credit** reimbursement obligations. In practice, therefore, the avoidance of debt limit constraints has been based primarily on judicial determinations that under certain conditions the debt limit does not apply (commonly, if not always accurately, referred to as "exceptions" or "judicially created exceptions").

PUBLIC AGENCIES MUST DETERMINE WHETHER THE CONSTITUTIONAL DEBT LIMIT APPLIES. To determine whether the debt financing arrangement under consideration might pose a problem under the debt limit for the public agency involved in the transaction, ask the following:

1. Is the public agency subject to the debt limit?

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2. If so, does or may the transaction obligate the public agency to make payments out of the revenues of a future fiscal year?

3. If so, does the transaction fit into one of the "debt limit exceptions" described below?

1.2.4 Exceptions to the Debt Limit

California courts recognize several exceptions to the constitutional debt limit. The principal debt limit "exceptions" are the following:

1. Current Fiscal Year Exception
2. Annual Appropriation Exception
3. Lease Exception (Offner-Dean Lease Exception)
4. **Special Fund** Exception
5. Contingent Obligation Exception
6. Obligations Imposed by Law Exception

The sections below describe each of these exceptions. Some exceptions are well-established and their application to specific debt structures is clearly established by case law. For other exceptions, however, the exception's applicability to a particular transaction may not be clear and it may be necessary to pursue a **validation** judgment.[7] Validation is most likely to be necessary for transactions under the Contingent Obligation Exception and the Obligations Imposed by Law Exception, which are less well defined than some of the other exceptions.

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[7] California Code of Civil Procedures Section 860 et seq. permits a public agency to seek a Superior Court judgment that particular contracts or debt instruments are valid. To do so, the public entity files a validation action in court, in effect requiring those who would contest the validity of the documents or instruments in question to come forward. If the complaint is not answered, the Superior Court may enter a judgment as to the validity of the documents before it; the judgment may not be subsequently challenged. If the complaint is answered, the public agency must either litigate the issues to decision or drop the case and pursue an alternative financing approach. See additionally the California Debt and Investment Advisory Commission Off Print "Validation Actions and Public Finance," July 2000 at www.treasurer.ca.gov/cdiac/debtpubs/2000/72000validation.pdf.

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1.2.4.1 CURRENT FISCAL YEAR EXCEPTION

PREMISE - A debt obligation may be eligible for this exception if the public agency can pay the debt with funds it already has or will receive during the current fiscal year.

LEGAL REQUIREMENTS - A debt obligation must be payable solely from (1) amounts currently available to be appropriated in the public agency's current year budget, or (2) revenues and income to be received in or for the fiscal year in which the obligation is incurred.

CAVEATS AND QUALIFICATIONS - The terms of the obligation should be clear that if the public agency's income and revenues in the current fiscal year prove to be insufficient, the lender or debt holder has no further legal recourse.

COMMON APPLICATIONS IN THE PUBLIC FINANCE CONTEXT - This exception is commonly applied to tax and revenue anticipation notes (TRANs) and revenue anticipation notes (RANs). See **Section 3.3.4, TRANs and RANs**.

1.2.4.2 ANNUAL APPROPRIATION EXCEPTION

PREMISE - The premise of the Annual Appropriation Exception is similar to the Current Fiscal Year Exception (See **Section 1.2.4.1** above). A debt obligation qualifies for this exception if the source of repayment is an annual appropriation made by the public agency.

LEGAL REQUIREMENTS - The public agency's payment obligation in each fiscal year must be limited to income or revenues that the public agency elects in that fiscal year to appropriate for that purpose, or the public agency must have the ability, in each fiscal year, to terminate the agreement without further payment.

CAVEATS AND QUALIFICATIONS - If there is no legal consequence to the public agency of a failure to appropriate, lenders or debt holders must rely on a public agency's "moral obligation" (expressed or implied) to appropriate or on the public agency having a strong desire to preserve its reputation in the public capital markets by making its payments. As a result, annual appropriate financings are generally structured as leases with the public agency losing possession of the facility if it fails to appropriate. Investors generally require the leased asset be an "essential facility" that the public agency (the **lessee**) would find difficult to replace if possession were given up and for which the lessee would therefore be

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inclined to appropriate rental payments. If, however, the consequences are so severe that the public agency is essentially compelled to appropriate (e.g., loss of the use of property, or other rights worth far more than the amount owed, or some other "forfeiture"), the arguments justifying the use of this debt limit exception may not hold.[8]

COMMON APPLICATION IN THE PUBLIC FINANCE CONTEXT - Although used frequently outside of California, credit issues and the availability of the Contingent Obligation Exception and the "Offner-Dean" Lease Exception described below make reliance on the Annual Appropriation Exception in California infrequent.

1.2.4.3 LEASE EXCEPTION (THE "OFFNER-DEAN LEASE EXCEPTION")

PREMISE - A debt obligation may be eligible for this exception if it is structured as a lease financing and the public agency has to make payments only if it has use of the leased facility that year.

LEGAL REQUIREMENTS - The Lease Exception is a well-defined subset of the more general Contingent Obligation Exception (See **Section 1.2.4.5**). It is often referred to as the "Offner-Dean" (or "Offner-Dean-Rider") Lease Exception, referencing the leading cases.[9] The requirements for an Offner-Dean lease are modeled on the characteristics of transactions approved by courts. The foundational principle is that the lessee's obligation to pay rent from the revenues of each fiscal year is contingent upon the public agency having "beneficial use and occupancy" of the leased premises during that fiscal year. The essential requirements flowing from this are as follows:

1. The property subject to the lease must be a leasable asset (e.g., a building, plant, or equipment, not window panes or paint).

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[8] See Garrett v. Swanton, 216 Cal. 220 (1932), in which the public agency had made a significant initial payment and therefore was under a practical compulsion to protect its investment by making further payments from its general fund.

[9] In City of Los Angeles v. Offner, 19 Cal. 2d 483 (1942), the rental payments made by the city were determined to be lease payments for use during the respective fiscal years in which they were required to be made; they were not installment payments on a purchase price. In Dean v. Kuchel, 35 Cal. 2d 444 (1950), the vesting of title in the state at the end of the lease was not a logical difference from the city's purchase option in Offner. In Rider v. City of San Diego, 18 Cal. 4th 1035 (1998), the JPA created by the city to act as lessor was a legal entity separate from the city so it could enter into the lease with the city.

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2. Rent in each fiscal year must not exceed the "fair rental value" of the leased premises.
3. If the lessee fails to pay rent when due, there can be no **acceleration** of future rent.
4. If effective use and occupancy is not available (e.g., because construction has not been completed or because of a casualty loss), rent must be "abated" (not legally required to be paid) to the extent and during the period use and occupancy is not available.

CAVEATS AND QUALIFICATIONS - A lease agreement that does not meet the Offner-Dean requirements may be a "debt" even if it takes the form of a lease. Further, matching "fair rental value" with lease payments based on variable interest rates may be particularly challenging for certain types of facilities or lessees.

COMMON APPLICATION IN THE PUBLIC FINANCE CONTEXT - This exception is used for long-term financing of governmental facilities to be paid for out of a public agency's general revenues, often involving certificates of participation or JPA lease revenue bonds. See **Section 3.6.1**, **Financing Leases**.

1.2.4.4 SPECIAL FUND EXCEPTION

PREMISE - A debt obligation may be eligible for this exception to the constitutional debt limit if **debt service** is payable solely from a special fund (including future fiscal year revenues) without the need to spend the public agency's general fund or general revenues.

LEGAL REQUIREMENTS - The debt obligation must be payable out of a special fund established by the public agency and there must be a "nexus" between the purpose for the debt and the special fund from which the limited obligation is payable. For example, debt incurred to finance water system improvements, payable solely from the revenues of the water utility enterprise, would meet the "nexus" requirement. In contrast, debt incurred to finance general city capital improvements or power system improvements payable from water utility enterprise revenues would not. It is not necessary, however, for the source of repayment to be limited to revenues generated by the financed facilities; all revenues of an enterprise may be dedicated to the repayment of debt incurred for the benefit of the enterprise. The public agency cannot be obligated to make any payments from future fiscal year general fund income or revenues, and the exception may not apply if the special fund includes

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traditional general fund revenues (e.g., tax revenues) or if a newly established special fund redirects revenues that would otherwise have flowed to the general fund.

CAVEATS AND QUALIFICATIONS - "Nexus" determinations are often challenging. Further, if the enterprise is not self-sustaining such that any amounts paid from the special fund would be back-filled from the general fund, an obligation payable from the revenues of the enterprise may not qualify for treatment as a "special fund."[10]

COMMON APPLICATIONS IN THE PUBLIC FINANCE CONTEXT - The Special Fund Exception is available for revenue bonds payable out of the revenues of a municipal enterprise. See Section 3.3.6, Enterprise Fund Debt Obligations. The exception is also available for **project financings** (financings where debt service is payable solely from the revenues generated by financed facilities) and provides the constitutional debt limit exception applicable to conduit revenue bond issues. (See Section 3.3.9, Conduit Revenue Bonds)

1.2.4.5 CONTINGENT OBLIGATION EXCEPTION

PREMISE - An obligation such as a service contract or debt-related financial product may be eligible for the exception if the public agency's obligation to make payments from the income and revenue of a future fiscal year is contingent upon the public agency's benefitting from the service or product during that fiscal year.

LEGAL REQUIREMENTS - The public agency must have no payment obligation in any fiscal year unless in that fiscal year the other party is providing benefits (e.g., services, use of property) or is at least able to perform required services or make required payments. For example, one leading case found that a multiyear sewage

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[10] Leading cases include City of Oxnard v. Dale, 45 Cal. 2d 729 (1945) (revenue bonds to finance sewer system improvements that were to be payable from "revenues of the entire sewer system" were held to qualify for the Special Fund Exception); Palm Springs v. Ringwald, 52 Cal. 2d 620 (1959) (bonds to provide parking improvements that would be payable from parking revenues and sales and use tax revenues did not qualify for the exception because sales and use taxes constituted general funds of the city); and City of Redondo Beach v. Taxpayers, Property Owners, et al., 54 Cal. 2d 126 (1960) (harbor revenues and dedicated tidelands trust revenues were special fund revenues, but sales, use, and license tax revenues "attributable to the construction of the harbor project" did not qualify for the exception because sales, use, and license tax revenues are ordinarily general revenues of a city the assertion of a nexus between the harbor improvements sought to be financed and the general sales, use, and license tax revenues to be pledged was too speculative).

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disposal service contract with a private company fell within the exception because the obligation to make payments in future years did not arise until the service was provided to the city in those future years.[11] The payment obligation in any fiscal year may exceed the amount of the actual benefit received in that year.

CAVEAT AND QUALIFICATIONS - Because the case law is not well developed, Contingent Obligation Exception structures generally require a validation proceeding if the financing requires an unqualified opinion to proceed.

COMMON APPLICATIONS IN THE PUBLIC FINANCE CONTEXT - The Contingent Obligation Exception is commonly applied to service contracts, interest rate swaps (See Section 2.3.3, Interest Rate Swaps and Synthetic Structures) and financial products.

1.2.4.6 OBLIGATIONS IMPOSED BY LAW EXCEPTION

PREMISE - The constitutional debt limit is designed to address only discretionary actions and is not applicable to a public agency's legal obligations. That is, voter approval is not required for actions that a public agency is required by law to take.

LEGAL REQUIREMENTS - For this exception to apply, a payment of a liability must be imposed or mandated by law. Examples that courts found to fall within the exception include an obligation to pay the salary of a public officer whose office was created and whose salary was fixed by state statute[12] and the obligation to pay a tort judgment.[13]

CAVEATS AND QUALIFICATIONS - Because the case law is not well developed, this exception generally requires a validation proceeding.

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[11] McBean v. City of Fresno, 112 Cal. 159 (1896) (A multiyear sewage disposal service contract with a private company did not create a present liability; rather, an obligation payable from the revenues each future fiscal year did not arise until service was provided to the city in such fiscal year); City and County of San Francisco v. Boyd, 17 Cal 2d 606 (1941) (It was a fair presumption at the outset of the contract that performance under a multiyear consulting contract would be carried out in the future).

[12] Lewis v. Widber, 99 Cal. 2d 412 (1893) (City was obligated to pay the salary of a public officer whose office was created and whose salary was fixed by state statute).

[13] City of Long Beach v. Lisenby, 180 Cal. 2d 52 (1919) (A major tort judgment against the city did not create a prohibited debt even though sufficient funds were not available in the current fiscal year to pay it).

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COMMON APPLICATIONS IN THE PUBLIC FINANCE CONTEXT - The Obligations Imposed by Law Exception is commonly applied to judgment bonds and pension obligation bonds. See Section 3.3.2.2, Pension Obligation Bonds.

1.3 COMMON STRATEGIES FOR AVOIDING THE DEBT LIMIT

Public agencies may consider various legally permitted financing strategies for issuing debt obligations that do not cause the agency to violate the constitutional debt limit. The following discussion identifies a few of these and is presented only to illustrate how the market has responded to the constraints imposed by the state law to meet the financing needs of public agencies. A more detailed discussion of debt instruments used in California is presented in Chapter 3, Types of Debt Obligations Issued by Public Agencies.

1.3.1 Lease Revenue Bonds and Certificates of Participation

In lease revenue bond or certificates of participation (COPs) financing, a public agency enters into a lease with a third party (which may be a government, a nonprofit entity, or a for-profit entity). The public agency leases a building or other asset from the third party and the rent paid by the public agency is used to pay debt service on the bonds or certificates issued by that third party and sold to investors. The transactions are structured so that the rent is sufficient to pay debt service and so that the transactions fall within the Lease Exception to the constitutional debt limit. Lease revenue bonds and COPs are discussed in greater detail in Section 3.3.2.1, Lease Revenue Bonds and Certificates of Participation.

1.3.2 Joint Powers Authorities

A joint exercise of powers agency or authority (JPA) is a separate governmental entity formed by two or more governmental entities. A JPA is created by an agreement (generally called a "Joint Exercise of Powers Agreement" and referred to as a "JPA agreement") among the governmental entities forming the JPA (generally referred to as "JPA members"). Once established, the JPA is an independent governmental entity separate from the JPA members. JPAs are not subject to the constitutional debt limit. JPAs are frequently used as

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the issuer of bonds in lease revenue bond transactions or as the issuer of other bonds secured by local agency obligations. Although the JPA bonds are not subject to the constitutional debt limit, a local agency obligation securing the JPA bonds may be. For example, in a JPA lease revenue bond transaction for a city, the lease between the JPA and the city must satisfy the requirements of the Lease Exception to the debt limit. See **Section 3.6.4, Joint Powers Agency or Authority (JPA) Bonds and Other Issuances** and **Section 3.8, Joint Exercise of Powers Agencies** discusses JPAs in greater detail.

1.3.3 Revenue Bonds

Public agencies—particularly those with separate revenue streams such as airports, water systems, sewer systems, and electricity systems—issue revenue bonds. Cities frequently issue water revenue or sewer revenue bonds that are supported by the revenues of the enterprise, allowing them to issue bonds for those purposes that fall into the Special Fund Exception to the constitutional debt limit.

1.4 LOCAL GOVERNMENT REVENUE SOURCES - SECURITY FOR AND REPAYMENT OF DEBT

Public agencies may structure their debt with a security or repayment pledge from a variety of taxes, **assessments**, fees, and charges (i.e., local government revenue sources). Broadly speaking, debt may be payable from income and taxes and/or from other, often limited, revenue sources.

Amendments to the California Constitution over the last several decades have imposed substantive limitations and procedural requirements for the tax levies, assessments, fees, and charges that comprise local government revenue. This in turn has affected the ability of local governments to generate revenues to pay debt service and has influenced the shape of the financing vehicles employed by public agencies. These limitations, and relief from certain of these limitations, have been enacted primarily through the people's exercise of the initiative power. See **Section 1.6, The Initiative and Referendum Powers**.

Public agency revenue sources fall, for purposes of the California Constitution, into one of the categories described in Figure 1-1 and the sections below.

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Figure 1-1

PUBLIC AGENCY REVENUE SOURCES BY CATEGORY

HISTORICAL TAXES

AD VALOREM REAL PROPERTY TAXES	General tax levy on assessed value (AV) for general purposes, limited to 1% of AV. Generally limited to taxes that existed upon passage of Proposition 13 in 1978.[14] May be used as a source of repayment for tax and revenue anticipation notes (TRANs) and leases, including certificates of participation (COPs). See Section 1.4.3, *Ad Valorem* Real Property Taxes.

TAXES REQUIRING APPROVAL OF VOTERS

AD VALOREM REAL PROPERTY TAXES SECURING DEBT OBLIGATIONS	Tax levy on AV to repay voter-approved debt above the 1% limit established by Proposition 13.[15] For public agencies, except school/community college districts (school districts), levies require approval by two-thirds of voters. General obligation debt issued by school districts for facilities may be authorized with 55% voter approval. See Section 1.4.4, *Ad Valorem* Real Property Taxes Securing Voter-Approved Obligations.
GENERAL TAXES	Tax levy levied by a city or county for a general purpose. New, extended or increased general taxes require approval by a two-thirds vote of the taxing entity's governing board members and a majority of voters. May be used as a source of repayment for general fund obligations such as TRANs and leases. See Section 1.4.5, General Taxes.
SPECIAL TAXES	Special tax levy (including parcel tax) for a specific purpose or by special districts. Levies generally require approval by a majority of the taxing entity's governing board and two-thirds of voters. Typically used as a source of repayment for **Mello-Roos bonds** or sales tax revenue bonds. See Section 1.4.6, Special Taxes.

CHARGES REQUIRING APPROVAL UNDER PROCEDURAL REQUIREMENTS

ASSESSMENTS	Levy of charges on real property assessed in proportion to a special benefit, with burden of proof on the levying public agency. Procedural requirements for assessments include public hearings and approval by majority vote of governing board members and property owners. Typically used as a source of repayment for assessment bonds. See Section 1.4.7, Assessments.
FEES AND CHARGES	Typically used as a source of repayment for enterprise revenue bonds, including water, wastewater and solid waste utility revenue bonds. Can be a source of general fund revenue. "Property-related fees and charges" are subject to additional requirements. See Section 1.4.8, Fees and Charges.

[14] Proposition 13 (officially named the *People's Initiative to Limit Property Taxation*) added Article XIIIA to the California Constitution, limiting *ad valorem* property taxes to 1% of full cash value (with exceptions to protect existing obligations) and required two-thirds voter approval for "special taxes."

[15] Op cit.

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1.4.1 Determining the Category of Revenues

Different restrictions apply to "taxes," "assessments," and "fees and charges" under the California Constitution; therefore, it is important to understand how the different categories are defined. To determine the applicable category of a local government revenue source, ask the following series of questions:

- Is the revenue source a "levy, charge, or exaction of any kind?" This is intended to include virtually every type of revenue.
- If so, is the levy, charge, or exaction a "tax?" For these purposes, "tax" is defined by exclusion: all levies, charges, and exactions are taxes unless an exception applies. See What Is a Tax? (Section 1.4.2) below.
- If so, is the tax an ***ad valorem*** real property tax; that is, is the amount of the tax a percentage of the assessed valuation of real property?
- If the levy, charge, or exaction is a tax, but is not an *ad valorem* real property tax, is the tax a general tax or a special tax; that is, is the tax imposed by a general-purpose governmental entity for general revenue purposes or is it imposed for a specific purpose or purposes or by a limited-purpose governmental entity?
- If the levy, charge, or exaction is not a tax, is it an "assessment" or is it a "fee or charge"?
- If the levy, charge, or exaction is a fee or charge, is it a "property-related fee or charge"?

1.4.2 What Is a Tax?

For purposes of Article XIIIC of the California Constitution, "any levy, charge, or exaction of any kind imposed by a local government" is a **tax**, except the following:

a) "A charge imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of conferring the benefit or granting the privilege." Examples include neighborhood parking permits and parade permits.

b) "A charge imposed for a specific government service or product directly to the payor that is not provided to those not charged, and which does not exceed the local government's reasonable cost of service to the fee payor." Examples

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include municipal utility charges for water, sewer, and electricity service, ambulance transportation fees, and public records copying fees.

c) "A charge imposed for the reasonable regulatory costs to a local government for issuing licenses and permits; performing investigations, inspections, and audits; enforcing agricultural orders, and the administrative enforcement and adjudication thereof." Examples include permitting and inspection of regulated businesses, enforcement activities, and pet licenses.

d) "A charge imposed for entrance to or use of local government property or the purchase, rental, or lease of local government property." Examples include zoo and museum admissions, golf course green fees, athletic field and equipment rentals, and metered parking.

e) "A fine, penalty, or other monetary charge imposed by the judicial branch of government or a local government, as a result of a violation of law." Examples include parking tickets and late payment fees.

f) "A charge imposed as a condition of property development." Examples include building permit fees, development impact fees, and environmental mitigation cost recovery.

g) "Assessments and property-related fees imposed in accordance with [California Constitution] Article XIIID." These are discussed in Section 1.4.7, Assessments and Section 1.4.9, Property-Related Fees and Charges.

Article XIIIC further provides, "The local government bears the burden of proving by a preponderance of evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bears a fair and reasonable relationship to the payor's burdens on, or benefits received from, the government activity." Cost and benefit determinations, therefore, need to be made and documented. These may be challenging and a study by an independent expert is often advisable.

1.4.3 *Ad Valorem* Real Property Taxes

Ad valorem real property taxes are taxes levied on real property as a percentage of the assessed valuation of that property. *Ad valorem* taxes are collected by counties

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and are allocated to the county and to cities, special districts, and school districts within the county.

CONSTITUTIONAL LIMITATION[16] - Subject to the exceptions described below, *ad valorem* taxes assessed against a particular property may not exceed 1% of "full cash value." The full cash value of a property is, in turn, the full cash value of the property in Fiscal Year 1975–76, increased by the lesser of 2% annually or the rate of inflation as evidenced by the consumer price index. Full cash value may, however, be redetermined in connection with improvements to the property (with some exceptions) or damage to or contamination of the property. Of greater significance, full cash value may also be redetermined upon a "change of ownership" of the property, which is defined to exclude a limited subset of transfers. In addition, property owners may transfer the full cash value assessment on an existing property to a new property under certain conditions.

EXCEPTIONS - *Ad valorem* real property taxes levied to pay obligations approved by voters before July1978 and general obligation bonds approved by voters in accordance with Proposition 46 or Proposition 39 are excepted from the 1% of full cash value limitation. See **Section 1.4.4, Ad Valorem Real Property Taxes Securing Voter-Approved Obligations**.

DEBT FINANCING IMPACT - For governmental entities receiving *ad valorem* real property tax revenue before the passage of Proposition 13, *ad valorem* real property tax revenues not securing voter-approved obligations ("general property tax revenues") are a revenue source available for general purposes, including general fund obligations such as leases and TRANs. Because general property tax revenues are a source for the payment of operation and maintenance expenses as well, the greater the share of *ad valorem* revenues committed to repay debt the less is available for operations. Since the amount of general property tax revenues is a function of the aggregate full cost value of taxable property in the jurisdiction and not the tax rate, a governmental entity receiving general real property tax revenues has no control over the amount of *ad valorem* real property tax revenues.

[16] See California Constitution, Articles XIII and XIIIA.

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1.4.4 *Ad Valorem* Real Property Taxes Securing Voter-Approved Obligations

Ad valorem taxes assessed against property may exceed the 1% limitation described above if the proceeds of the taxes are to be used to pay the following:

- Obligations approved by voters before July 1, 1978 (Pre-Proposition 13 Obligations, see Section 1.4.4.1);
- General obligation bonds approved in accordance with the provisions of California Constitution Article XIIIA, Section 1(b)(2) (See Section 1.4.4.2, Proposition 46 General Obligation Bonds); or
- General obligation bonds approved in accordance with the provisions of California Constitution, Article XIIIA, Section 1(b)(3) (See Section 1.4.4.3, Proposition 39 General Obligation Bonds).[17]

Voter-approved general obligation bonds are paid from a revenue source (unlimited *ad valorem* real property taxes in excess of 1% of full cash value limit) that is not otherwise available to the issuer. Although property tax obligations increase the overall burden on the issuer's constituents, general obligation bond debt service payment obligations do not increase the amount payable from the issuer's general revenues.

1.4.4.1 PRE-PROPOSITION 13 OBLIGATIONS

Pre-Proposition 13 obligations consist principally of voter-approved bonds, but can include obligations other than bonds, such as pension commitments. Voter approval can be through adoption of a voter-approved city charter or charter amendments or through bond elections. The analysis of Pre-Proposition 13 obligations is fact-specific and requires case-by-case analysis.

1.4.4.2 PROPOSITION 46 GENERAL OBLIGATION BONDS

Local governments may issue general obligation bonds with two-thirds voter approval.

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[17] See California Constitution Article XIIIA.

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ELIGIBLE ISSUERS - Any local governmental entity with statutory authority and the power to tax real property

ELIGIBLE PURPOSES - Acquisition or improvement of real property

GOVERNING BOARD APPROVAL REQUIREMENT - Varies: two-thirds vote for cities, and majority vote for counties and school districts

VOTER-APPROVAL REQUIREMENT - Two-thirds

1.4.4.3 PROPOSITION 39 GENERAL OBLIGATION BONDS

School districts and community college districts may issue general obligation bonds with 55% voter approval, subject to accountability requirements.

ELIGIBLE ISSUERS - School districts and community college districts

ELIGIBLE PURPOSES - Construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities

GOVERNING BOARD APPROVAL REQUIREMENT - Majority vote

VOTER APPROVAL REQUIREMENT - 55%

Section 3.3.1, Local Agency General Obligation Bonds discusses Proposition 46 General Obligation Bonds and Proposition 39 General Obligation Bonds in detail.

1.4.5 General Taxes

General taxes are taxes levied by local governmental entities for general revenue purposes. Although it may be possible for an advisory measure to indicate voter desires with respect to how tax proceeds should be spent, a "general tax" may not be imposed for a specific purpose or specific purposes. Only general-purpose governmental entities (i.e., cities and counties) may levy general taxes and California Constitution, Article XIIIA precludes the imposition of new *ad valorem* real property taxes as "general taxes." General taxes are addressed in Article XIIIC of the California Constitution. Common types of general taxes include the following:

- Utility user taxes

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- Transient occupancy taxes
- Add-on sales taxes (See Section 3.3.3, Sales Tax Revenue Bonds)
- Business license taxes (including a "soda tax" and rental car taxes)
- Admissions or event entrance taxes

APPROVAL REQUIREMENTS FOR NEW, EXTENDED OR INCREASED GENERAL TAXES - The imposition, extension, or increase of any general tax must be approved by the governing board of the taxing entity or placed on the ballot by an initiative petition and must be approved by voters. A general tax is not "increased" if imposed at a rate not higher than previously approved.

CITY COUNCIL OR COUNTY BOARD OF SUPERVISORS APPROVAL REQUIREMENT - Two-thirds vote

VOTER APPROVAL REQUIREMENT - Majority

DEBT FINANCING IMPACT - Like a local governmental entity's share of general property tax revenues, general taxes are a source of revenue available for general purposes and are a source of payment for general fund obligations such as leases and TRANs.

1.4.6 Special Taxes

Special taxes are taxes levied by local governmental entities for special purposes or are taxes levied by local governmental entities that are not general-purpose governmental entities (e.g., school districts and special districts). A tax levied for a special purpose is a special tax even if tax proceeds are deposited in the governmental entity's general fund and special taxes may not be *ad valorem* real property taxes. The proceeds of special taxes may be used solely for the voter-approved purpose or service for which the tax was imposed. Common types of special taxes include the following:

- Parcel taxes
- Mello-Roos taxes for services
- Public library service taxes

Taxes that would be general taxes may be special taxes if the **proceeds** are to be used for a specific purpose or specific purposes (e.g., a sales tax to be used solely to finance transportation projects).

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APPROVAL REQUIREMENTS FOR NEW, EXTENDED OR INCREASED SPECIAL TAXES - Special taxes must be approved by the governing body of the taxing entity or placed on the ballot by an initiative petition and must be approved by voters. A special tax is not "increased" if it is imposed at a rate not higher than previously approved.

GOVERNING BOARD APPROVAL REQUIREMENT - Majority vote (two-thirds vote for add-on sales taxes)

VOTER APPROVAL REQUIREMENT - Two-thirds. A recent California Supreme Court decision suggests that approval may be by majority vote in the case of a special tax proposed by initiative.[18] Certain Mello-Roos taxes may be approved by a landowner vote.

DEBT FINANCING IMPACT - Special taxes are pledged to secure debt and used to pay debt service on bonds issued for the purpose for which the special tax is imposed. See Section 3.3.7.2, Mello-Roos Bonds (Community Facilities Districts).

1.4.7 Assessments

Article XIIID of the California Constitution restricts the ability of public agencies to levy assessments, which are defined to include "any levy or charge upon real property by [any local government] for a special benefit conferred upon the real property." Article XIIID further defines "assessment" to include special assessments, benefit assessments and maintenance assessments and special tax assessments and requires that "standby charges" be treated as assessments.[19] Assessments are levied against benefitted property and are secured by a lien on the property, with the lien, as a matter of law, having a priority higher than deeds of trust or mortgages imposed by private contract. Assessments are "non-recourse" in that their payment is not an obligation of the property owner; if the property owner does not pay, the local government may not seek a judgment for payment against the property owner and its remedy is limited to foreclosing on the assessed property.

SUBSTANTIVE CONSTITUTIONAL LIMITATIONS - Assessments must comply with constitutional requirements:

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[18] City & County of San Francisco v. All Persons Interested in the Matter of Proposition C, Dkt. A158645 (Cal. App., June 30, 2020) California Cannabis Coalition v. City of Upland, 3 Cal. 5th 1047 (2017)

[19] California Tax Data defines a standby charge as "an assessment that is charged to unimproved properties to ensure that adequate water or sewer services will be available for that parcel when needed." www.californiataxdata.com/pdf/standby.pdf

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- Assessments may be levied only for a special benefit conferred upon the assessed property. A "special benefit" is a particular and distinct benefit over and above general benefits conferred on real property within the assessment area or to the public at large. General enhancement of property value does not constitute a "special benefit."[20]
- Assessments may not be levied for general benefits conferred on real property in the assessed area or to the public at large, and the local government must separate general benefits from special benefits.
- The assessment imposed on any particular parcel may not exceed the reasonable cost of the proportional special benefit conferred on that parcel, determined with reference to the cost of the capital cost or operation and maintenance expense or the cost of the property-related service to be financed with the assessment.
- Governmentally owned parcels may not be exempt from assessment unless the parcels receive no special benefit.
- Benefit determinations must be supported by a detailed engineer's report.

CONSTITUTIONAL PROCEDURAL REQUIREMENTS - In addition to satisfying statutory requirements, the process for levying assessments must include notification of the owners of the affected parcels, a public hearing, and balloting the owners of the parcels. If more ballots oppose the assessment than are in favor, with ballots weighted proportionally to the financial obligation of the affected property, then the assessment may not be imposed.

DEBT FINANCING IMPACT - Assessment bonds (bonds on which the debt service is payable from assessments and which are secured by assessment liens) are a major source of financing for public improvements, especially infrastructure improvements necessary for new development. For built-out communities, the constitutional requirements for assessments can be challenging to satisfy, but the requirements are less difficult to meet if assessments are imposed while the subject property is held by a limited number of owners (e.g., before the property is developed and homes or lots are sold).

Section 3.3.7.1, Assessment Bonds discusses assessment bonds in detail.

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[20] Silicon Valley Taxpayers Association, Inc. v. Santa Clara County Open Space Authority, 44 Cal. 4th 431 (2008), requires that courts determine special benefits independently; they may not simply rely on a local agency's determination.

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1.4.8 Fees and Charges

Fees and charges, for purposes of the California Constitution, are local government charges or exactions that are not "taxes" or "assessments." The first key question is whether a particular fee or charge fits into one of the exceptions to the definition of a tax. See Section 1.4.2, What Is a Tax? for the list of exceptions. To do so, the local government must undertake a two-part analysis. First, it must prove that the charge does not exceed its reasonable costs to provide the benefit, privilege, or service and that the costs allocated to a particular payor bear a fair and reasonable relationship to the burden on the local government entity or the benefit that the payor receives from the government entity (i.e., that charges in the aggregate do not exceed reasonable costs and are fair and reasonably allocated). To meet this burden, public agencies often rely on independent cost-of-service and benefit studies. Second, the local government must determine whether a fee or charge is a "property-related fee or charge" subject to Article XIIID of the California Constitution. Property-related fees and charges must satisfy the additional requirements described in Section 1.4.9, Property-Related Fees and Charges.

DEBT FINANCING IMPACT - The requirement that imposed fees and charges not exceed the cost of service does allow some flexibility in recovering general overhead or other indirect costs (e.g., the cost of city attorney time allocable to service provided to a municipal utility), but effectively precludes the use of fees and charges to support general local government operations. Further, the requirement that the fees and charges be fairly and reasonably allocated may affect the ability to offer "lifeline" rates or provide conservation incentives to particular categories of payors. The validity of a local government's rates and charges schedule is essential to making budgetary decisions, particularly when these charges are a source of debt repayment.

1.4.9 Property-Related Fees and Charges

A property-related fee or charge is a fee or charge "imposed upon a parcel or person as an incident of property ownership." Article XIIID of the California Constitution specifically excludes fees for the provision of electrical or gas service or imposed "as a condition of property development," from the scope of its limitations on property-related fees and charges. This has been interpreted by the courts to include connection and other charges imposed as a condition to connecting a property to a municipal water system. Case law interpreting the phrase

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"as an incident of property ownership" continues to evolve. Fees or charges payable whether or not the property is used are imposed "as an incident of property ownership." Furthermore, fees and charges that cannot be avoided because they are based on actions essential to the reasonable use of property (e.g., the consumption of water) are also imposed "as an incident of property ownership." In contrast, fees or charges that could be avoided by use of the property for another reasonable use (e.g., using the property for something other than residential rental property) are not imposed as an incident of property ownership.[21]

SUBSTANTIVE CONSTITUTIONAL LIMITATIONS - Property-related fees and charges may not be extended, imposed or increased unless the following are true:

- Revenues derived from the fee or charge do not exceed the funds required to provide the property-related service and are used for no purpose other than that for which the fee or charge was imposed.

- The amount of the fee or charge imposed upon any parcel or person does not exceed the proportional cost of the service attributable to the parcel.

- The service is actually used by or immediately available to the property owner (no fees or charges for potential or future use).

- The fee or charge is not imposed for general governmental service where the service is available to the public at large in substantially the same manner as it is to property owners.

The local government agency bears the burden of demonstrating compliance and determinations of revenue needs and estimations of revenue to be derived from a fee or charge include large elements of uncertainty. Judgments with respect to

[21] In Apartment Association of Los Angeles County, Inc. v. City of Los Angeles, 24 Cal. 4th 830 (2001), the California Supreme Court determined that an inspection fee imposed on owners of residential rental property is not a "levy … as an incident of property ownership" subject to Article XIIID because it would not be payable if the owner used the property for another purpose. In Richmond v. Shasta Community Services District, 32 Cal. 4th 409 (2004), the California Supreme Court determined that a capacity charge and fire suppression fee imposed as a condition for making a new connection to a water system are neither "assessments" nor "property-related fees and charges" for purposes of Article XIIID. In Bighorn–Desert View Water Agency v. Verjil, 39 Cal. 4th 205 (2006), the California Supreme Court determined that because the use of water was essential to the use of property, consumption-based water charges are "fees and charges" for purposes of Articles XIIIC and XIIID.

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"proportional costs" across properties can be particularly difficult. At what point, for example, does increased water usage in a water utility's service area necessitate seeking additional costly supply, and how should that cost be allocated between homeowners who are using more water than their neighbors and homeowners whose properties are newly connected to the system? Demonstrating the appropriateness of the allocation of general costs of a general-purpose entity like a city to its utilities (to be borne by ratepayers) can be particularly difficult and open to criticism. Courts have not required mathematical certainty or fine distinctions, but it is important that assumptions and categorizations be well-considered. It is therefore common for public agencies to base their conclusions on studies done by independent experts projecting revenue needs and costs of providing service to various customer classes.

CONSTITUTIONAL PROCEDURAL REQUIREMENTS - Unless an exception applies, property-related fees and charges must be approved by a majority vote of the owners of the property subject to the fee or charge or by a two-thirds vote of the electorate in the covered area. The exceptions to this voter requirement, including fees and charges for sewer, water and refuse collection services, cover most but not all property-related fees and charges. Stormwater drainage fees, for example, which were determined to be neither "water" nor "sewer" related, are not excepted.[22] For the imposition or increase of a fee or charge in the excepted categories, the local government agency must mail notice to the owners of the property to be charged, hold a public hearing, and consider protests. The fee or charge may not be imposed if the local government agency receives written protests from a majority of owners of the affected parcels.[23]

DEBT FINANCING IMPACT - Property-related fee and charge limitations are most relevant in wastewater and solid waste enterprise revenue financings. The constraints on the ability to impose service charges can make compliance with rate **covenants** associated with a debt financing more challenging. A greater concern is that in an area where interpretation is still developing, an imposed fee or charge or the process of its imposition may subsequently be found to be invalid, resulting in reduced revenues and vulnerability to refund claims.

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22 Howard Jarvis Taxpayers Assn. v. City of Salinas, 98 Cal. App. 4th 1351 (2002).

23 Unlike the assessment context, where affirmative favorable votes must at least equal negative votes, for purposes of the imposition of property-related fees a "majority protest" requires a majority of all property owners (i.e., failure to protest counts as approval). Consequently, a "majority protest" is highly unlikely outside of small, highly engaged communities.

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1.5 CHARTER CITIES

A California city can be a "charter city," with a voter-approved city charter, or a "general law" city. City charters may be extensive, with complex governance structures and processes and comprehensive local legislation, or may simply avail a city of the powers available to charter cities under the California Constitution. Roughly 25% of California cities are charter cities and larger and older cities are more likely to be charter cities than smaller and newer cities.

1.5.1 Charter City Powers - Municipal Affairs vs. Statewide Concerns

California is what is known as a **Home Rule** state. Article XI, Section 5 of the California Constitution provides that charter cities "may make and enforce all ordinances and regulations in respect to municipal affairs, subject only to restrictions and limitations provided in their several charters and in respect to other matters they [are] subject to general laws [of the state]." Charter city power may also be limited by other provisions of the California Constitution. In contrast, general law cities, like other local government agencies, have the limited powers granted to them by state statute. A city charter does not grant powers, it "accepts the privilege granted by the Constitution of complete and autonomous rule with respect to municipal affairs."[24] To determine what limitations apply to city-adopted legislation, the key question is whether the issue addressed is a "municipal affair" or the term courts use for its opposite, a "statewide concern."

As a general proposition, a "municipal affair" is local in nature, does not affect persons or property outside the jurisdiction of the city, and does not interfere with a statewide regulatory scheme established by the Legislature. Article XI, Section 5 of the California Constitution enumerates a few specific "municipal affairs:"

1. Constitution, regulation, and government of the city police force
2. Sub-government in all or part of the city
3. Conduct of city elections

[24] See West Coast Advertising Company v. City and County of San Francisco, 14 Cal. 2d 516 (1939)

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4. Provision for the election, appointment, and compensation of municipal officers and employees

The above list is not exhaustive. Other general areas that courts have determined to concern "municipal affairs" include the following:

- Taxation for local purposes (apart from taxation of banks and insurance companies and other areas for which the state has developed a comprehensive taxation scheme). For example, see Weekes v. City of Oakland, 21 Cal. 3d 386 (1978), where the California Supreme Court determined that the levy by a city of a tax on employee "gross receipts" for services performed in the city was a municipal affair.
- Formation of assessment districts and assessment procedures (subject to constitutional limitations)
- Land use and zoning (with certain exceptions)
- Budgeting and expenditure of tax receipts
- Public contracting requirements (with certain exceptions)

The concept of "municipal affair" is fluid as well as indefinite, as municipal and state interests change over time. "Municipal affair" questions are particularly challenging when addressing matters for which both a charter city and the State have taken action. Although there is no concept of "preemption" of local ordinances by state law in the manner that federal law preempts state law, and the Legislature is not empowered to determine what is and what is not a "municipal affair," courts will take into account a manifest intent and purpose that a general state law "occupy the field" to the exclusion of municipal regulation.[25] .

For determining whether a charter city ordinance controls over a general state statute in a particular case, the California Supreme Court has developed a four-pronged test:

1. Does the matter implicate a "municipal affair?"
2. If so, is there a genuine conflict between the municipal ordinance and state law?
3. If so, is there a "statewide concern" (a dimension demonstrably transcending identifiable municipal interests)?

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25 Bishop v. City of San Jose, 1 Cal. 3d 56 (1969)

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4. If so, is the statute "both reasonably related to the resolution of [the statewide] concern and 'narrowly tailored' to limit incursion into legitimate municipal interests?"

Although "municipal affair" and "statewide concern" are mutually exclusive ultimate conclusions, court cases[26] use the terms in a pragmatic balancing between municipal and state interests.

1.5.2 Charter City Financing

The municipal affairs power of charter cities can affect charter city debt financing in a number of ways:

- *Ability to issue debt in the absence of statutory authority*. "Charter city financings" in the historical, narrow sense referred to debt financings that could be done by charter cities but not by general law cities, especially in the **conduit financing** arena. These situations have become rarer as state legislation has become more comprehensive, but there can be areas in which statutory authority is limited or the authority has expired and not been reinstated.

- *Control over the debt-approval process.* City charters may provide for alternate procedures for the formation of assessment districts and as long as they are consistent with constitutional requirements, assessment procedures, and may impose different standards and requirements for the approval of revenue bonds and other obligations.

- *Greater revenue generation authority*. The authority to levy taxes and impose charges for local purposes may create additional revenues to secure debt obligations and/or allow the issuance of new debt obligations secured by the revenues.

- *Greater financial control.* A charter city may have additional budgeting and expenditure flexibility and may be able to avoid certain state contracting requirements.

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[26] See California Savings and Loan Association v. City of Los Angeles, 54 Cal 3d 1 (1991), where the California Supreme Court determined that the taxation of financial corporations is a "statewide concern." In Johnson v. Bradley, 4 Cal. 4th 389 (1992), the California Supreme Court determined that a State proposition precluding public funding of campaigns was not reasonably related to the legitimate statewide concern of preserving the integrity of the electoral process. Under State Building Construction Trades Council of California, AFL-CIO v. City of Vista, 54 Cal. 4th 547 (2012), a city is not required to comply with state prevailing wage laws in the construction of public projects.

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- *Charter-imposed limitations.* City charters often impose substantive limitations on debt and on spending that are more restrictive than those of general law cities. City charters may also impose approval requirements that are more stringent than those applicable to general law city debt obligations.

Charter city debt financings require a multistep analytical approach:

1. Examine the general state statutes, the charter city's authority to incur the debt, and charter-imposed substantive and procedural requirements.
2. If the proposed financing involves the exercise of substantive or procedural powers beyond the statutory powers of general law cities, determine whether the exercise constitutes a "municipal affair".
3. Consider state constitutional limitations such as those described above in Section 1.4, Local Government Revenue Sources - Security for and Repayment of Debt.

1.6 THE INITIATIVE AND REFERENDUM POWERS

Article II, Sections 8 and 9 of the California Constitution reserve the right of the people to effect changes to the State Constitution or statutes through initiative or to reject legislative actions through referendum. These powers are available to the electorate of local agencies as well as to the state as a whole. City charters may also reserve these powers.

1.6.1 Initiative Power and its Impact on Debt

Under the initiative power, the electorate in California may propose amendments to the Constitution, statutes, and other legislation. Qualifying initiative proposals, also called propositions, are frequently placed on the ballot for enactment or rejection by voters. Initiatives generally become effective upon adoption.

The impact of the initiative power on debt issuance can be major. Through constitutional amendments, for example, the electorate may authorize or prohibit particular types of debt or alter the procedures for approving debt. Further, the electorate by initiative may impose substantive and procedural limitations on the ability of governmental agencies to levy, charge, and collect the taxes, fees, and charges, and assessments required to pay debt service.

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California Constitution, Article XIIIC, Section 3 provides that "the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment fee, or charge." This provision has the potential for a significant impact on both a public agency's credit generally and the security for particular obligations. It is, however, subject to two important limitations:

- The initiative power is an exercise—by the electorate rather than the governing board—of a municipal entity's legislative power. The electorate's initiative power should not extend beyond the legislative power of the governing board. Where statutes provide that legislative action cannot reduce or eliminate the security for debt lawfully issued, such as assessment bonds, general obligation bonds, Mello-Roos Bonds, and certain revenue bonds, the security (pledge of repayment) may not be reduced through an initiative.

- The Contracts Clause in Article I, Section 10, of the United States Constitution, which prohibits states and local governments from impairing contractual obligations through legislative acts, offers a degree of protection. Because Contract Clause impairment analysis is a balancing test, an initiative may adversely affect a public agency's revenue-raising capacity and weaken the security for its debt obligations. The initiative power cannot, however, be used to impair a public agency's payment obligation or deprive debt holders of fundamental security.[27]

1.6.2 Referendum Power and its Impact on Debt

Under the referendum power, the electorate in California may reject and nullify a legislative act. If a petition with the requisite number of signatures is submitted to the legislative body within 30 days of the legislative act, the legislative body may either repeal the legislation or submit the legislation to the electorate for ratification. Legislative acts for which a qualifying referendum petition has been submitted do not become effective until ratified.

[27] In United States Trust Co. v. New Jersey, 431 U.S. 1 (1977), the States of New York and New Jersey repealed statutory covenants that were an important security provision protecting holders of Port Authority of New York and New Jersey revenue bonds. The United States Supreme Court determined that such repeal was an impairment of contract prohibited by the United States Constitution.

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The referendum power may be applied to actions approving the issuance and sale of debt, and the referendum power must be kept in mind in scheduling the consummation of transactions for which a referendum petition is a realistic concern. Referenda on actions approving debt issuances are, however, rare.

1.7 HISTORICAL OVERVIEW OF VOTER-APPROVED LIMITATIONS ON LOCAL GOVERNMENT REVENUES

Commencing in the 1970s, California voters approved a series of state-level initiatives directed at the fiscal affairs of California state and local government. These initiatives, described below in Sections 1.7.1–1.7.7, have dramatically limited fiscal flexibility.

1.7.1 Proposition 13 (1978), Jarvis-Gann Initiative

PURPOSE OF INITIATIVE - Officially named the *People's Initiative to Limit Property Taxation*, Proposition 13 addressed the perceived problems of high property taxes resulting from escalating property values. It also addressed the potential to offset reduced property taxes through increases in other taxes.

PRINCIPAL PROVISIONS - Proposition 13 added Article XIIIA to the California Constitution, limiting *ad valorem* property taxes to 1% of full cash value (with exceptions to protect existing obligations). The proposition required two-thirds voter approval for "special taxes." Subsequent court rulings excluded from "special taxes" taxes levied by entities without property taxing power, taxes for general governmental purposes, assessments, user fees and charges, and regulatory charges.

PRINCIPAL IMPACT - In lieu of lost revenues at the local government levels, the State assumed greater responsibility for certain public services, especially public school funding. Proposition 13 stopped the financing of public improvements through general obligation bonds by eliminating the ability to impose new property taxes, giving rise to increase in financing through assessments, landowner-voted special taxes, special district sales taxes, revenue-supported debt, and lease financing. The passage of Proposition 13 by California voters has been the catalyst for the creation of many financing techniques discussed in this Guide.

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1.7.2 Proposition 4 (1979), Gann Limit Initiative

PURPOSE OF INITIATIVE - Sometimes referred to as the "Spirit of 13 Initiative," Proposition 4 addressed the perceived problem of increasing levels of government spending.

PRINCIPAL PROVISIONS - Proposition 4 added Article XIIIB to the California Constitution, establishing an "appropriations limit" for each governmental unit, limiting expenditures from "proceeds of taxes." Appropriation limits may be raised because of cost-of-living and population increases or with voter approval.

PRINCIPAL IMPACT – Proposition 4 led to greater use of user fees and charges, fines, and assessments to fund improvements and services.

1.7.3 Proposition 46 (1986)

PURPOSE OF INITIATIVE - By allowing increases to local taxes for bond repayment, Proposition 46 addressed the perceived problem caused by Proposition 13's effective preclusion of new property tax-supported debt.

PRINCIPAL PROVISIONS - Proposition 46 allowed, with two-thirds voter approval, the issuance of general obligation bonds to finance the acquisition of and improvements to real property.

PRINCIPAL IMPACT - Proposition 46 restored general obligation bonds as a financing vehicle, especially for school districts.

1.7.4 Proposition 62 (1986), *Voter Approval of Taxes Act*

PURPOSE OF INITIATIVE - Proposition 62 addressed the perceived problem caused by court decisions that narrowed the scope of Proposition 13's limitations.

PRINCIPAL PROVISIONS - New general taxes must be approved by a two-thirds vote of the governing body of the taxing entity before they are put on the ballot. In the event taxes are imposed in violation of Proposition 62, a mechanism requires a dollar-for-dollar reduction in *ad valorem* property taxes as a "remedy" for illegal taxation. Proposition 62 also included various provisions that were invalidated by subsequent court decisions.

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PRINCIPAL IMPACT - Proposition 62 set the stage for Proposition 218. Many Proposition 62 provisions are now embodied in Article XIIIC of the California Constitution.

1.7.5 Proposition 218 (1996), *Right to Vote on Taxes Act*

PURPOSE OF INITIATIVE - Proposition 218 addressed the perceived problem caused by user fees, charges, and assessments (so called "disguised taxes") charged and levied without voter approval and by limitations on the exercise of initiative power in local fiscal matters.

PRINCIPAL PROVISIONS - Proposition 218 added Article XIIIC and Article XIIID to the California Constitution, requiring majority voter approval of "general taxes" and expanding the scope of "special taxes" requiring two-thirds voter approval. The added articles also impose substantive and procedural limitations on assessments and "property-related fees and charges" other than charges for electricity and gas services and fees imposed as a condition of property development. In addition, Proposition 218 extended the local agency initiative power to taxes, assessments, fees and charges.

PRINCIPAL IMPACTS - Increased documentation and procedural requirements have resulted in significant cost to local government agencies. New or increased maintenance assessments and standby service charges have been effectively precluded. Pursuit of policy goals (e.g., water conservation) beyond recovery of the cost of providing service has been more challenging. Voter approval requirements have made tax increases more difficult.

1.7.6 Proposition 39 (2000), *School Facilities Local Vote Act of 2000*

PURPOSE OF INITIATIVE - Proposition 39 addressed the perceived problem of limits on the issuance of general obligation bonds for school facilities resulting from the two-thirds voter approval requirement.

PRINCIPAL PROVISIONS - The proposition amended Article XIIIA, Section 1 and Article XVI, Section 18 of the California Constitution to reduce the voter approval requirement for school district and community college district general obligation bonds to 55%, subject to accountability requirements.

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PRINCIPAL IMPACT - Proposition 39 increased the ability of school districts and community college districts to finance school facilities through the issuance of general obligation bonds.

1.7.7 Proposition 26 (2010) *Supermajority Vote To Pass New Taxes And Fees Act Or The Stop Hidden Taxes Initiative*

PURPOSE OF INITIATIVE - Proposition 26 addressed the perceived problem caused by the levy of "taxes" hidden as regulatory fees and assessed without voter approval.

PRINCIPAL PROVISIONS - The proposition amended Article XIIIC to define "tax" as "any levy, charge, or exaction of any kind imposed by a local government" not falling within one of the enumerated exceptions provided by Proposition 26. It also limited the ability of public agencies to use electricity and gas fees to recover the cost of providing service.

PRINCIPAL IMPACT - Proposition 26 restricted the ability of local governments to make up for the differences between recoverable costs and the full social and environmental costs of providing municipal services.

Chapter 2. Debt Structures: What Factors Drive Structuring Decisions?

Once a public agency has identified a project or financing need, undertaken a rigorous assessment of its options to fund that need through available resources, and determined that debt financing is the best alternative, the public agency must decide how to structure the proposed debt obligation to best achieve project or financing goals, taking into consideration cost and other critical policy matters. This chapter provides a framework for exploring the different structural choices available to public agencies choosing debt financing, including how the debt will be repaid and secured and how it will attract investors and address market conditions.

2.1 OVERVIEW

Debt represents an obligation to pay a stated amount (the **principal**), at a given time (the **maturity**) with **interest** at a stated rate (the **interest rate**), where interest is the borrower's cost of renting the principal from the lender for a period of time. This basic structure is enhanced by additional conditions. These conditions may modify or fine tune the means by which the debt will be repaid or by which the lender (i.e., debt holder or investor) will be secured against different types of risks. These conditions may also prescribe terms and conditions that the borrower undertakes to meet for the benefit of investors.

The **issuer** and its financing team typically make decisions about which structural elements to include iteratively, as they consider a number of different factors,

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beginning with the nature and scope of the project or financing objectives. Decisions are often dictated by conditions such as the financial or market position of the public agency or its authority to **issue** debt.

As the issuer and its financing team define the nature and scope of the project, the source of repayment, current market activity, and investor interests in more detail they begin to address preliminary questions that will help determine which structure is the best fit:

- What is the source of revenue and security for repayment of the debt?
- Does the project to be financed allow the agency to spread repayment over a short or long period?
- Should the interest rate be fixed through that **term** or vary in some determined way?

A funding source is often linked to the purpose of the public agency or the project that needs to be financed. It is also linked to the statutory authority that the public agency is using to issue the debt, which may include constitutional limitations related to **debt limit** and revenue sources. The appropriate term and interest rate method (basic structure) of debt are affected by the useful life of the capital asset being financed and its **cash flow** requirements.

With respect to structural factors that address the underlying credit, including the financial operations of the issuer or the form of the debt, the public agency may ask the following:

- Which structural factors are determined by or should be determined by the source of the revenues from which the debt will be repaid or by which it will be secured?
- Are there project-specific requirements or considerations that may affect the debt structure or investor interests?
- What are the general market conventions that affect investor preferences, such as credit enhancements or provisions relating to redemptions?

The debt may be structured to mitigate bondholder risk. Investors may look at the general credit strength of the issuer, the resiliency of the source of the funds committed to debt repayment in the face of changes in financial markets (including interest rates) or in the political environment, the reliability of income

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streams, and the **tax** treatment of interest on the debt. From the investor's perspective, a project's essentiality is often a critical factor in the assessment of its risks of nonpayment (credit risk). The more that the project is seen as supporting a critical function of the issuer, the less likely, investors believe, the issuer will **default** on the financing. Investors may demand additional security features or higher **yields** for projects that are perceived as less essential.

Other structural factors of interest to investors are the tax status of the bonds (i.e., taxable vs. tax-exempt), the credit quality of the bond (**credit rating**), its term to maturity, the risk of **redemption**, and its potential for sale in the **secondary market**. An issuer may rely upon members of its financing team to provide advice on how to structure a debt obligation or make a recommendation on the type of debt to issue, but, ultimately, it is the issuer's responsibility to make these decisions.

The sections below provide additional detail regarding decisions about sources of revenue and security (See Section 2.2.1) and terms and interest rates (See Section 2.2.2).

2.2 STRUCTURAL FEATURES ADDRESSING HOW DEBT WILL BE REPAID

2.2.1 Sources of Revenue and Security for Repayment

A public agency using debt to fund a project or financing must decide how the debt should be repaid. Expressed differently, who, among the public agency's residents, businesses, property owners, and customers should bear the burden of debt repayment? Although shaped in detail by legal constraints, structural characteristics, and market conventions, the first general operating principle applied by public agencies is that the payment of municipal debt should be linked to the purpose for which the debt has been incurred.

> *First General Operating Principle of Municipal Debt—The funds to pay debt should be derived from taxes,* ***assessments****, fees, and charges paid by those who benefit from the financed facilities or services.*

As there is a broad range of purposes for which municipal debt may be incurred, there is likewise a wide variety of repayment sources. Debt used to fund an **enterprise** such as wastewater treatment may be paid off from fees and charges assessed upon the users of this service. Many governmental services, projects and programs, however, provide general community benefits and do not generate revenues.

In determining the best type of debt obligation to issue, a public agency must consider the revenue source and a means to secure those revenues (i.e., **security pledge**) to repay the debt. Determining which funding source should be used to pay debt service generally hinges on four questions:

1. What sources of revenues are legally permissible to serve as security and source of payment for the debt?

2. Is there a funding source that is most fair and appropriate given the need that is being financed?

3. Is the funding source sufficiently creditworthy to serve as security for the debt? Is it vulnerable to interruption or adverse changes? Must the public agency secure the debt in other ways?

4. Would the public agency be locked into a commitment that may affect its ability to meet its service mission if it is pledged to repay debt? Is there a risk that a draw on financial resources to meet its debt obligation will force cuts to other services?

As an example, a city that wants to finance the construction of a parking facility must decide whether its source of revenues for repayment will come from its general fund or from the parking facility revenues. Using parking revenues makes sense because those who benefit from the project would be responsible for funding it. Investors may not, however, be willing to bear the risk that parking revenues will be insufficient to meet debt service in a given year. The city, in this case, may decide to agree to use general fund revenues as security for the debt, but to reimburse the general fund from the parking facility revenues for any debt service payments made from the general fund.

2.2.2 Term and Interest Rate Mode

Issuers must make decisions about the term of the debt (the period of time between issuance and the final payment) and the interest rate mode (a fixed interest through the term of the obligation or a **variable-rate**, based on the market, tax-law, and credit factors that may change over time). Although primarily driven by

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cash flow requirements and financial policies, the term and interest rate method may also be limited by the state laws authorizing the debt issuance or by federal tax law considerations. See Chapter 3, Types of Debt Obligations Issued by Public Agencies and Chapter 4, Federal and State Tax Law Requirements.

With regard to term of the debt, public agencies apply a second general operating principle:

> *Second General Operating Principle of Municipal Debt—Financed facilities should be paid for over a substantial portion of the useful life of the facilities (intergenerational equity).*[1]

Municipal debt obligations are generally structured to be payable over a term corresponding to the purpose for which the debt is incurred. Long-term debt is used to finance capital items with long useful lives and short-term debt is used to finance capital items with short lives or for cash flow management. Long-term assets are, however, occasionally financed on an interim basis, with the expectation of securing and committing to provide "long-term, take-out financing."[2] Matching the term of the debt to the useful life of the asset does not necessarily imply a chronological matching. For example, the useful life of many public buildings is 50 years or more, while the debt issued to finance the construction of the building is usually 30 years.

The choice of whether to use a fixed-rate or variable-rate approach may be more difficult to make. Except under highly unusual market conditions, short-term interest rates are lower than long-term rates. Although variable-rate and interim financing can increase flexibility and reduce borrowing costs they come with significant additional risks, are difficult to forecast, and do not mesh well or at all with some sources of payment and security. This makes them impractical alternatives for many local government borrowers.

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[1] Consider an example of the two general principles working together: Group X (which may include the entire community) is benefitting from a financed facility in Year Y. Debt service payable in Year Y is paid from revenue generated from the membership of Group X (which may be all community residents) in Year Y, and that corresponds to the benefits received by the membership of Group X in Year Y. Put another way, "You get what you pay for and you pay for what you get."

[2] Many capital projects use this approach often because the project has not yet been completed and the amount of financing needed cannot be determined.

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2.2.2.1 LONG-TERM, FIXED-RATE DEBT

Most municipal debt is issued as long-term, fixed-rate debt.[3] Long-term debt is typically structured so that issuers can spread the cost of the project over time. Principal is generally payable over 25 or 30 years, although bonds maturing over longer periods have been issued. Long-term, fixed-rate bonds are generally sold in **denominations** of $5,000 or integral multiples thereof and contain provisions allowing the issuer to redeem the bonds before maturity (see Section 2.3.1, Redemption or Prepayment).

Long-term, fixed-rate bonds generally pay interest twice per year and the issuer is required to make either twice-yearly or annual principal payments. **Debt service** payments are scheduled to provide payment of all principal and interest on the bond issue over the term of the issue. If the amount of debt service (principal and interest) payable is to be relatively the same each year (level debt service), the amount of interest payable each year will decline, and the amount of principal payable will increase. If the amount of principal paid each year is the same (level principal), debt service will decline over time. If revenues are subject to significant uncertainty, all principal can be scheduled to **mature** at a later date with revenues required to be applied to pay principal (through the redemption of bonds) when available.

Long-term, fixed-rate bond issues typically include both serial bonds and **term bonds**. The principal of a serial bond is payable on a specific date. Serial bonds generally mature in a "series," with a separate bond maturing on each consecutive annual or twice-yearly principal payment date. Purchasers of bonds that mature during the first 10 to 15 years after the issuance date, which tend to be **retail investors**, usually value having a specific date on which the principal will be paid.

A term bond is a bond on which principal is payable by redemption through "mandatory **sinking fund** payments" on consecutive principal payment dates leading up to and including the term bond's maturity date. The principal amounts of term bonds of a particular maturity to be redeemed are selected by lot. The investors in bonds maturing 15, 20, or 30 years after the issuance date, which tend to be **institutional investors**, purchase bonds in large pieces that are more easily resold when the institutions need cash (i.e., they are more liquid). As a result, the secondary market demand for long-dated term bonds more than offsets any ben-

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[3] The term "bonds" in this section refers to bonds, notes, or certificates of participation.

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efit from a specific date of principal payment. A bond issue that includes a range of maturities spread across the **yield curve** appeals to investors with varied needs and thus tends to result in a lower overall interest cost than selling a long-term, fixed-rate bond issue as a single bond maturity.

With a long-term, fixed-rate bond issue, the issuer pays a fixed-rate of interest on a particular bond for the life of the bond. The market value of a particular fixed-rate bond, however, changes over time, depending on a variety of factors, including the credit of the issuer or its credit provider, the likelihood that the bond will be redeemed before maturity, income tax rates, and the tax law treatment of municipal debt. The most significant factors affecting the value of a fixed-rate bond, however, are the rate of interest payable on the bond and the time remaining to the bond's maturity or, if the bond is likely to be redeemed early, to the first date on which the bond can be redeemed. If market interest rates fall, the value of a fixed-rate bond generally rises and if market interest rates rise, the value of a fixed-rate bond generally falls. Bonds not maturing or expected to be redeemed for many years may fluctuate significantly in value.

PAR, DISCOUNT, AND PREMIUM BONDS - When a fixed-rate bond is initially offered, it may be sold at par (a price equal to 100% of its principal amount), at a **discount** (a price lower than its principal amount) or at a **premium** (a price higher than its principal amount). The expected yield to the investor on par bonds matches the interest coupon (i.e., the stated rate), the expected yield on a discount bond is higher than the interest coupon and the expected yield on a premium bond is lower than the interest coupon. The expected yield on premium bonds is generally calculated with reference to the date on which the bond can first be redeemed instead of or as well as with respect to its maturity date (such bonds are referred to as "yield to call bonds").

CAPITAL APPRECIATION BONDS - **Capital appreciation bonds** (CABs) are long-term, fixed-rate bonds on which the interest is **compounded** on each interest payment date rather than paid to bondholders. CABs are, from an economic standpoint, the equivalent of bonds with a 0% interest rate sold at a deep discount. They are sometimes referred to as **zero coupon bonds** for this reason. All interest is paid when the principal on the bond is paid at maturity or prepaid. Because they have an established reinvestment rate (compounded interest is in essence reinvested at the yield on the bond), CABs fluctuate in value more than conventional bonds of the same maturity. Moreover, because interest and principal on CABs are only paid at maturity, the amount of debt service due in any

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particular year is more easily manipulated and public agencies can use CABs to defer the payment of debt service.

2.2.2.2 SHORT-TERM DEBT

"Short-term debt" generally refers to either obligations maturing within 1 year of issuance or obligations payable from the fiscal year revenues of the current fiscal year, although the term is also often applied to debt maturing in the 1 to 5 year range. Short-term debt is generally issued in the form of notes, which may bear interest at a **fixed-rate** or at variable-rates. Interest is generally paid at note maturity, although if the note term is greater than 1 year, an intermediate interest payment date may be included. Short-term debt issues are primarily for the following:

1. Cash flow borrowing
2. Financing for capital assets with short useful lives (e.g., equipment with a useful life of 1 to 5 years)
3. Interim financing for capital assets with long useful lives (e.g., a building with a useful life of 40 years)

Cash flow borrowings (e.g., tax and revenue anticipation notes) are useful if public agency revenues or expenses are uneven over the course of its fiscal year. See Section 3.3.4, TRANs and RANs. A local government entity may receive substantial **property tax** revenue twice per year, state or federal funding dates may be uneven, water or power sales may be highly seasonal, or expenses may need to be incurred in advance of the receipt of corresponding revenues. To better manage cash flow variation over the course of a single fiscal year, the **proceeds** from the sale of short-term debt can be applied to pay current expenses, with revenues received later in the year applied to repay the debt. To provide noteholders security, a mechanism is generally established to set aside revenues for the debt payment as available revenues are received.

Financing for short-term capital assets, such as vehicles, should match the useful life of the asset. In many cases this means a term of 1 to 5 years. "Interim financing" with respect to long-lived capital assets, generally refers to debt obligations with a significantly shorter term than the useful life of the asset. Interim debt is not expected to be paid (and quite often could not be paid) from current revenues when due, either at maturity or by reason of a mandatory tender. Rather, the expected sources for the repayment of interim debt can include the anticipated receipt of a grant

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from another governmental entity (interim financing notes are usually referred to as grant anticipation notes (GANs)), a gift, or proceeds from the sale of assets. (See Section 3.7.3, Grant Anticipation Notes and Bond Anticipation Notes).

Issuers using interim financing anticipate paying off the debt in whole or in large part with new long-term debt. Long-term notes issued for this purpose are usually referred to as bond anticipation notes (BANs). The cost of a new building project may be divided into "construction phase" and "permanent" financing, allowing the issuer to reduce costs during capital project construction and achieve greater flexibility with respect to the amount and term of long-term financing. This may be valuable if the total construction cost is uncertain. When construction or other short-term risk is significant, interim financing can be provided by lenders familiar with the risks and the long-term financing can be done when that risk has passed.

Interim debt can bear interest at a fixed-rate or at variable-rates and interest may be paid at maturity or on intermediate dates. Principal is not generally **amortized**. Interim financing is commonly refunded or paid upon completion of the financed project's construction. Interim financing allows a capital project to commence in advance of receipt of the funds that are the ultimate source of funding and is less costly than debt payable over a longer term than is expected to be necessary.

The principal concern for the purchasers of interim debt is the timing and receipt of the funds expected for use as payment and/or the ability of the issuer to refinance the debt. So the "credit" for interim debt is related less to the issuer's ability to pay the debt from current revenues and assets and more to the issuer's "market access" to refinance it to avoid a default. The issuer must access the market even if long-term interest rates or **liquidity** and/or credit support costs are higher than expected.

2.2.2.3 VARIABLE-RATE DEBT

The interest rate on variable-rate debt is periodically reset in accordance with the terms under which the debt has been issued, and the rate of interest payable on the **outstanding** debt will rise and fall over the term of the issue with the rise and fall of interest rates generally. Variable-rate municipal debt is generally sold to institutional investors in minimum denominations of $100,000 or more and interest is payable more frequently than with fixed-rate debt, usually monthly. There is generally no benefit providing for **serial bonds**, and variable-rate debt

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is generally issued as a single maturity with monthly, twice per year, or annual mandatory sinking fund payments. Most variable-rate debt structures require additional support in the form of liquidity providers or credit enhancements. See Section 2.3.2, Credit Enhancement and Liquidity Support.

VARIABLE-RATE DEBT VS. FIXED-RATE DEBT - ADVANTAGES - The principal advantages of variable-rate debt are as follows:

- *Lower rates*. Unless interest rates increase significantly, the interest payable on variable-rate debt over the life of the issue (even including credit, liquidity, and **remarketing** costs) will be less than the interest payable on fixed-rate debt.[4]

- *Lower initial underwriting costs*. Variable-rate debt is sold into the short-term debt market and the "take down" (sales compensation to the underwriter) is significantly lower for short-term debt than for long-term debt.

- *Redemption flexibility*. Because the value of variable-rate debt is rarely more than par (and with VRDOs [variable-rate demand obligations] the interest rate is set to establish the value of the debt at par) investors do not require any or much **call protection** and the issuer may have much greater flexibility to prepay or refinance the debt. See Chapter 3, Types of Debt Obligations Issued by Public Agencies.

VARIABLE-RATE DEBT VS. FIXED-RATE DEBT DISADVANTAGES - The principal disadvantages with variable-rate debt are the additional risks described below:

- *Interest rate risk*. An increase in the interest rate on variable-rate debt can arise from these factors:
    - General increase in market interest rates
    - Changes affecting the value of tax-exempt debt versus taxable debt, including changes in income tax rates
    - Changes in the tax characterization of the particular variable-rate obligation, such as a questioning of the tax-exempt status of interest on that or similar obligations
    - Changes in the credit of either the issuer or of the provider of liquidity support or credit enhancement for the obligations

[4] The fact that short-term rates are generally lower than long-term rates more than offsets any rise in interest rate or credit, liquidity, or remarketing costs.

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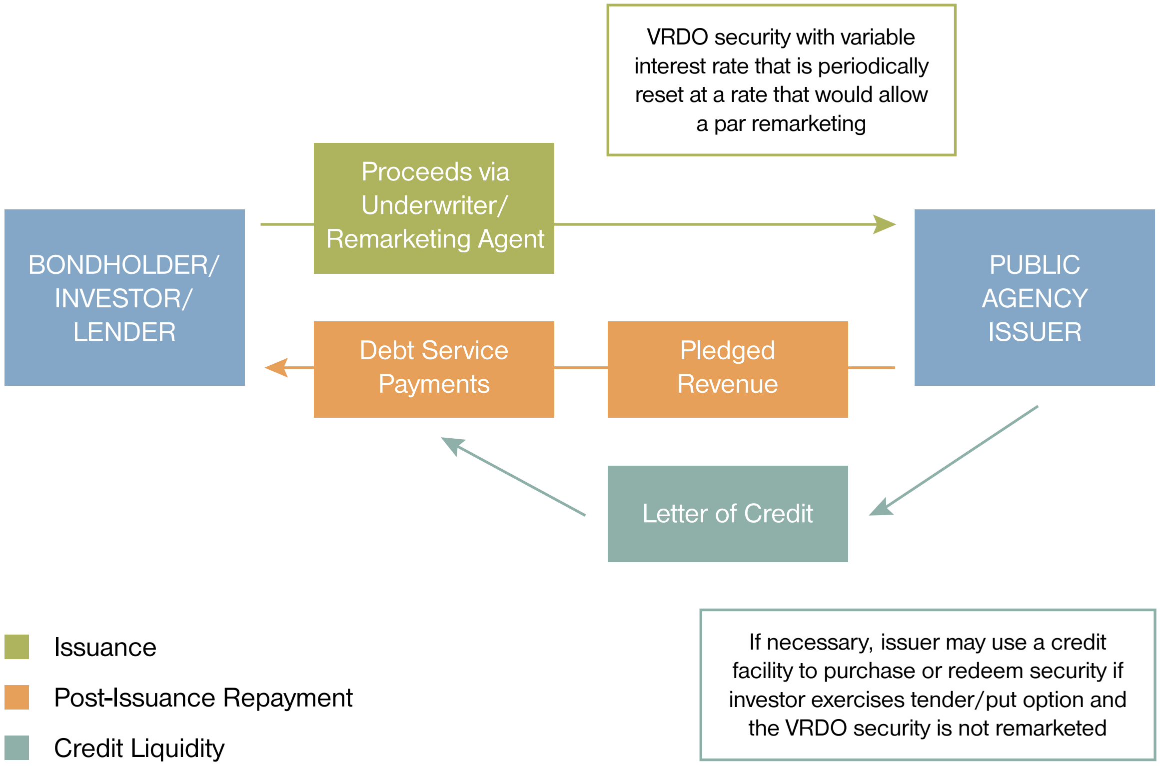
Figure 2-1

BASIC CASH FLOW FOR A VARIABLE-RATE DEMAND OBLIGATION OR "VRDO"



- *Renewal risk*. Liquidity support and, apart from bond insurance, credit enhancement is generally not available for the entire term of the obligations and must be periodically extended or replaced. At the time of renewal, liquidity support or credit enhancement may not be available or may be significantly more expensive, either because of changes in the liquidity support/credit enhancement market or because of changes to the issuer's credit.

- *Default/**acceleration** risk*. Liquidity support and **credit enhancement providers** generally require the ability to require a tender of variable-rate obligations for purchase upon the occurrence of a "default" with a lower threshold than for a default that would trigger the acceleration of fixed-rate debt. See Section 2.4.8, Events of Default and Remedies.

The risks associated with variable-rate debt may be mitigated somewhat if an issuer's variable-rate debt is a limited portion of the issuer's debt or if the issuer has a large investment portfolio, with the short-term investment of assets providing a natural hedge to a variable-rate cost of debt.

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LIMITATIONS BASED ON PAYMENT SOURCE - Variable-rate debt is not generally a practical alternative if an issuer has limited flexibility with respect to the revenues to be used to repay the debt, such as with general obligation bonds, assessment bonds, or **tax allocation bonds**. Although lease financings can be done as variable-rate obligations, the "fair rental value" requirement of the Lease Exception to the constitutional debt limit can add significant complexity. See Section 3.4, Interest Rate and Payment Terms.

2.3 STRUCTURAL FACTORS ADDRESSING RISK AND INVESTOR INTERESTS

Publicly issued, long-term debt comes in a variety of forms. The basic documentation includes an **indenture** (between the public agency issuer and a **trustee**) or another indenture-like document such as a trust agreement, a **bond resolution** (adopted by public agency issuer), and a **paying agent** agreement (between public agency issuer and paying agent). Bonds generally mature more than 1 year from the **date of issuance**. The issuer typically makes debt service payments to a trustee or paying agent who in turn makes payments to bondholders.

Bonds are structured to meet the needs of not only the issuer but also the investors. "Market conventions" are provisions embedded in the structure of the bonds to make a bond issue more acceptable to the market. Knowing the common market conventions helps issuers determine the type of provisions that they may need to include in the structure to reach specific investors or the market in general.

2.3.1 Redemption or Prepayment

"Redemption" refers to the payment of all or a portion of the principal amount of a bond before the bond's nominal maturity date. Early principal payment of obligations other than bonds, such as **notes** or an obligation to make lease or installment purchase payments, is referred to as "prepayment." The two achieve the same functional outcome. In addition, the bond redemption is referred to as a "bond call" or a **call**. The issuer's right to cause a redemption is referred to as the issuer's "call right," bonds subject to redemption are "callable," bonds not subject to redemption are "noncallable," and the amount of time between the issuance of a bond and the first date on which the bond can be redeemed is referred to as "call protection." For example, if the bonds have "10-year call

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protection," they cannot be called for 10 years after their issue. Redemption can be scheduled for a date or occasioned by an event outside of the issuer's discretion (mandatory redemption) or can be done at the issuer's option (optional redemption). The possibility that a bondholder may have its long-term, fixed-rate bond redeemed very early because of a redemption may affect the issue's **pricing**.

Bond indentures generally require that bondholders be given notice of redemption at least 20 days in advance of the redemption date. The indenture may also allow a redemption notice to be cancelled or provide that redemption is conditioned upon the satisfaction of certain conditions, such as the bond trustee having received funds sufficient to pay the redemption price. If the notice is made conditional, the issuer can avoid a payment default if funds are not available. This may provide the issuer additional flexibility and allow it to avoid having a period during which a large amount of funds (such as the proceeds from a **refunding**) are uninvested. When an issuer redeems a bond, interest on the bond stops accruing and the holder has no further rights apart from the right to receive the redemption price.

2.3.1.1 MANDATORY REDEMPTION

Mandatory redemption events are generally one of the following types:

1. Mandatory sinking fund redemption of term bonds
2. Redemption from unexpended bond proceeds
3. Redemption required by a fundamental change in situation adverse or potentially adverse to bondholders

Mandatory sinking fund redemption is the payment of scheduled principal in the form of redemption payments on term bonds rather than as maturity payments.

An unexpended bond proceeds redemption may be necessary if the issuer was unable to use bond proceeds to acquire or construct assets.

2.3.1.2 EXTRAORDINARY REDEMPTION

If bondholders believe a mandatory redemption (generally forcing the issuer to refinance to avoid the redemption turning into a payment default)

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is preferable to leaving debt outstanding, they may require an extraordinary redemption. Although rare, extraordinary redemption circumstances include the following:

- Loss by an eminent domain action taking property subject to a lease or critical to generating revenue or an issuer decision to not repair or replace that type of property following damage or destruction
- A dissolution of the issuer, a merger of the issuer with another governmental entity, or a significant change in the issuer's operations or service area beyond the issuer's control (generally, issuers will covenant to not take or allow such actions if under its control)
- A change in the tax status of the bonds (e.g., interest on the bonds becomes taxable)

2.3.1.3 OPTIONAL REDEMPTION

The issuer's ability to pay debt before its scheduled maturity can be valuable for purposes including the following:

- Debt reduction
- Relief from **covenants** and release of assets (revenues, property, or reserve funds) securing debt
- Debt restructuring
- Debt service savings

The issuer's ability to reduce balance sheet debt is useful if unexpected or excess funds are available, if the repayment of debt may release the issuer from a pledge of assets needed for other purposes or the issuer seeks to relieve itself of financial or operating covenants that are unduly burdensome. Debt restructuring can consist of a change in interest rate mode (e.g., fixed-rate to variable-rate or variable-rate to fixed-rate) or a rescheduling of principal (e.g., deferring principal payment to later dates to reduce short-term debt service or moving principal payment dates to level out annual debt service). Each of these goals can be achieved through a legal **defeasance** of the debt to its maturity date. See Section 3.7.6, Refunding Bonds. The cost of a legal defeasance to maturity can, however, be significant.

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Debt service savings on fixed-rate debt can be achieved by issuing new debt to prepay outstanding debt if the interest cost of the new debt is sufficiently lower than the cost of the outstanding debt. This may be because of improved issuer credit, selling on the shorter end of the yield curve or, most often, because of lower prevailing market interest rates. This savings must offset the cost of a defeasance and the cost of issuing and selling the new debt. A right of optional redemption, with the optional redemption available early, enhances savings prospects. See Section 3.7.6, Refunding Bonds.

From an investor's perspective, the redemption of a bond for a price less than what the bond's value would have been had it been "noncallable" (required to be left outstanding and bear interest to maturity) is an economic loss against which the investor may demand compensation. For variable interest rate bonds, on any date on which the interest rate on the bond is reset to the rate that allows the bond to be marketed at par (or for VRDOs with a "daily" or "weekly" rate adjusting the value to par at short intervals), the bond will not be worth more than its principal amount plus accrued and unpaid interest. In that case, the loss to an investor through a par redemption is minimal and issuers generally have wide optional call flexibility. With respect to fixed-rate debt and variable-rate debt for which the interest rate will not be reset for some time, however, a decline in market interest rates could make a bond worth considerably more than its principal amount plus accrued and unpaid interest. In that case, investors desire protection against and/or compensation for an optional redemption.

Investor protection or compensation may come in the form of "call protection" and/or a "redemption premium." A redemption premium can be expressed as a percentage of the principal amount of the bond redeemed, generally declining to par over time. Call protection precludes an optional redemption of a bond before a particular date and a redemption premium is an amount that must be paid to the bondholder to redeem a bond in addition to principal plus accrued and unpaid interest. As a general matter, the shorter the call protection and the lower the redemption premium, the higher the interest rate will be demanded by the investor. The optimal optional redemption provisions vary from transaction to transaction, depending upon the issuer's need for flexibility and general market conditions. A "10-year par call" (optional redemption with no premium allowed from the date 10 years after issuance) is sometimes referred to as a "standard call provision" for long-term, fixed-rate debt.

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EXAMPLE OF A PAR CALL

First 10 years after bond issuance - Bond not subject to optional redemption

More than 10 years after bond issuance - Bond subject to optional redemption at a price of 100% of the principal amount thereof (plus accrued interest)

EXAMPLE OF A PREMIUM CALL

First 10 years after bond issuance - Bond not subject to optional redemption

10–11 years after bond issuance - Bond subject to optional redemption at a price of 102% of the principal amount thereof (plus accrued interest)

11–12 years after bond issuance - Bond subject to optional redemption at a price of 101% of the principal amount thereof (plus accrued interest)

More than 12 years after bond issuance - Bond subject to optional redemption at a price of 100% of the principal amount thereof (plus accrued interest)

A redemption premium can also be a "make-whole" premium calculated according to a formula. A make-whole premium is designed to pay the bondholder the market value of its bond (if greater than the outstanding principal). Any make-whole redemption calculation formula will be an imperfect measure of value, and the formulas investors generally require tend to overvalue the bonds redeemed. Tax-exempt bond issues rarely have make-whole redemption provisions. Taxable bond issues may have either make-whole redemption provisions or redemption provisions similar to those in tax-exempt bond issues. Often, taxable bonds will provide for make-whole redemptions before the optional call date.

2.3.2 Credit Enhancement and Liquidity Support

Credit enhancement involves the provision of additional security for debt through a credit facility that provides for the timely payment of debt service to investors whether or not the amounts are paid by the issuer. With credit enhancement, investors can look for payment to come from either the basic source of payment for the debt or from the credit enhancement provider. The credit enhancement

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provider assumes the credit risk on the debt and steps into essentially the same position as investors with respect to the need for covenants and remedies to protect its interests. The most common types of credit enhancement are letters of credit (for variable-rate debt) and bond insurance (the fixed-rate debt).

Credit enhancement can be helpful in the sale of "story bonds" (bonds with unusual or complex credit characteristics), as the story may be more easily told to or understood by a credit enhancement provider than to an investor. In a pool financing, where the debt is secured by the obligations of a diverse mix of borrowers, credit enhancement can "unify" or "homogenize" the credit in the minds of investors. Further, credit providers may sometimes require security provisions and issuer covenants that are less burdensome than would be required to sell the debt without credit enhancement.

Credit enhancement can be used to allow debt that would not be investment grade to achieve a higher rating or to allow good credits that are "un-ratable" (e.g., based on the value of real property assets) to be rated. On rare occasions, credit enhancement can be used to enhance debt that is not of investment-grade quality, although in these cases the security provisions and covenants may be much more stringent than if the debt were sold as unrated debt.

Issuers primarily use credit enhancement to achieve debt service savings. With credit enhancement, an issuer's debt can be rated based upon the credit rating of the credit enhancement provider. For fixed-rate debt, although the underlying credit of the issuer is still of interest to investors, credit-enhanced debt is more secure and more highly rated and can therefore be sold to investors with a lower interest rate. If, on a present-value basis, the interest cost saved with credit enhancement is greater than the cost of obtaining the credit enhancement, the issuer enjoys a debt service savings.

Liquidity support involves an obligation by a liquidity support provider to provide amounts for the purchase of variable-rate debt obligations that are tendered for purchase and are not remarketed. With liquidity support, investors can rely on the credit of the liquidity support provider for payment of the purchase price. Because liquidity support would otherwise become credit support, a provider of liquidity but not credit support is allowed to terminate its purchase obligation upon the occurrence of an issuer bankruptcy, a payment default, or certain other major adverse credit events. The most common type of liquidity support are letters of credit, lines of credit, and standby bond-purchase agreements.

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Although certain issuers may be able to issue variable-rate debt without credit enhancement or liquidity support, liquidity support for variable-rate debt is still the norm. Investors holding variable-rate debt require a high degree of certainty (a highly rated "put") and even issuers with large cash balances available to purchase non-remarketed bonds rarely try to comply with the cash management restrictions necessary to avoid the need for liquidity support.

Reference: California Government Code Section 5922(c) provides: "In connection with, or incidental to, the issuance or carrying of bonds, … the state or a local government may enter into credit enhancement or liquidity agreements, with payment, interest rate, currency, security, default, remedy, and other terms and conditions as the state or the local government determines."

This Code section provides public agencies broad statutory authority to enter into credit enhancement and liquidity agreements but does not relieve the issuer from complying with constitutional limitations. Public agency payment obligations for credit enhancement and liquidity agreements must be structured in a manner that does not violate state constitutional debt limits. See Section 1.2, Constitutional Debt Limit.

2.3.2.1 BOND INSURANCE

With bond insurance, an insurance company approved to insure municipal bonds issues a policy insuring timely payment of principal and interest on the debt. The bond insurer pays scheduled principal and interest on the debt in the event payments are not made by the issuer (or are recovered from holders by a bankruptcy trustee). Following any such payment, the bond insurer steps into the shoes of the debtholder with respect to rights to receive payments of principal and interest on the obligation by the issuer. Bond insurance is not a **liquidity facility**. It does not secure payment of the purchase price of variable-rate debt upon tender by holders.

To obtain a bond insurance policy, an issuer must pay a premium generally based upon total debt service on the issue and determined in large measure by the underlying credit rating, the bond insurer's own analysis of the issuer's credit, and the security for the debt. Bond insurance premiums are paid when the insured obligations are issued and are generally not refundable, even if the debt is refunded or otherwise prepaid. Because bond insurance can be obtained to cover the full term to maturity of the debt, bond insurance is the usual form of credit enhancement for fixed-rate issues.

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2.3.2.2 DEBT SERVICE RESERVE FUND SURETY BONDS

In place of a **reserve account** funded from bond proceeds and invested in permitted securities, an issuer may obtain a debt service reserve fund surety bond to provide additional security for one or more series of debt obligations. A debt service reserve fund surety bond, generally issued by a bond insurance company and usually available only if the bond insurance company is insuring at least a substantial portion of the related debt, provides funds to pay debt service if the bond trustee would otherwise use amounts on deposit in a reserve fund. The total amount available under the surety bond is equal to the amount that otherwise would be deposited in the reserve fund (e.g., maximum annual debt service). See Section 2.4.4, Debt Service Reserve Fund.

Any draws on a debt service reserve fund surety bond must be repaid with interest and the issuer must enter into a reimbursement agreement providing for the repayment. Reimbursements are generally required to be made from the same source of funds and with the same payment priority as an obligation to provide funds to restore a cash-funded debt service reserve fund following a draw (i.e., from funds available after making ongoing debt service payments).

An issuer's decision whether or not to use a surety bond in place of a cash-funded reserve fund will depend on several factors:

- The cost of incurring additional debt to fund a reserve fund and the impact of the additional debt on debt service **coverage** or debt capacity.
- The reinvestment environment (can cash in the debt service reserve fund be invested at a yield equal to or even exceeding the interest cost of the debt?).
- The surety bond premium (including the fact that surety bond premiums, like bond insurance premiums, are not refundable even if the debt is refunded).
- The risk that the surety will have a reduced value or be of no value if the surety provider's credit standing falls.

2.3.2.3 LETTERS OF CREDIT

Letters of credit are issued by most banks, but only highly rated banks are used to secure municipal debt. Some highly rated financial institutions may issue facilities that, although not "letters of credit," operate like letters of credit and are referred to generally as "credit facilities." A **letter of credit** can be a standby letter of credit or

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a direct-pay letter of credit. With a standby letter of credit, the trustee for the debt draws under the letter of credit only if the issuer fails to make a payment or files for bankruptcy. With a direct-pay letter of credit, the trustee draws under the letter of credit to make all payments on the debt, with amounts paid by the issuer as debt service being used to reimburse the bank for those draws. Letters of credit can also provide liquidity support to pay the purchase price of variable-rate bonds tendered but not **remarketed**. Because they better address bankruptcy concerns, direct-pay letters of credit are more common than standby letters of credit. Letters of credit are often referred to as "LOCs," but because "LOC" is also an acronym for "**line of credit**," "LOC" should be used for "letter of credit" only when the context is clear.

A draw on a letter of credit to pay debt service is treated as an advance from the bank to the issuer. If the advance by the bank is not immediately reimbursed, the issuer must pay interest to the bank at an agreed rate (e.g., prime plus 2%) that is usually higher than the interest rate on the debt. The issuer must enter into a reimbursement agreement with the bank providing for the issuance of the letter of credit and for the reimbursement. Reimbursement agreements also include representations, warranties, covenants, and default and remedy and other provisions common to credit agreements. Unlike bond insurance, issuers pay letter of credit fees only partially up front and pay most fees over the term of the letter of credit. Letters of credit are usually available only for a limited initial term, often 2 or 3 years and rarely more than 5 years.

2.3.2.4 LINES OF CREDIT AND STANDBY BOND PURCHASE AGREEMENTS

For public agencies with a strong credit, an alternative is a line of credit or standby bond purchase agreement, for which a liquidity provider advances funds to purchase bonds tendered but not remarketed but does not provide funds to cover payment defaults. Lines of credit are typically provided by commercial banks, while standby bond purchase agreements are offered by other financial institutions. The circumstances under which the liquidity provider can suspend or terminate its obligation to purchase or advance funds (i.e., the provisions distinguishing liquidity support from credit support) are key provisions in liquidity agreements and are given close scrutiny by investors and rating agencies as well as by issuers. With a line of credit, the bonds are purchased or paid with proceeds loaned to the issuer. The liquidity provider is repaid in a manner similar to the reimbursement for a draw under a letter of credit. With a standby bond purchase agreement, the bonds are purchased by the liquidity provider. The liquidity

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provider is paid as a bondholder, but bonds held by the liquidity provider pay interest at a higher "bank" interest rate and principal may be required to be paid more quickly. Credit agreements and standby bond purchase agreements contain representations, warranties, covenants, and default provisions similar to those in reimbursement agreements.

2.3.3 Interest Rate Swaps and Synthetic Structures

An **interest rate swap** is not a debt obligation but can be used to change the substantive financial terms of a debt from a fixed-rate obligation to a variable-rate obligation or from a variable-rate obligation to a fixed-rate obligation or to create a "synthetic fixed-rate obligation."[5] An interest rate swap is a contractual agreement between two parties who agree to exchange (or swap) certain cash flows for a defined period of time. In the case of a municipal swap, the two parties are a governmental entity and a broker-dealer or financial institution as "counterparty." Generally, the cash flows to be swapped relate to interest to be paid or received with respect to some asset or liability. If a public agency issues variable-rate debt and enters into a swap where what it pays the counterparty is based on a fixed-rate and what it receives from the counterparty is based on a variable-rate, the obligation of the public agency under the debt and swap together is the synthetic fixed-rate. Accordingly, the swap is designed to generate a net change in the interest rate cash flow related to that asset or liability (typically investment securities or bond indebtedness, respectively), but the swap neither affects the principal of that asset or liability nor results in the creation of any new principal. As a result, the "size" of a swap, for purposes of describing the computational base on which the swapped payments are calculated, is referred to as the notional amount.

As part of any swap, both parties agree to the following:

- The notional amount.
- The rate or formula each party will use to compute the amounts to be paid to the other on that notional amount.
- The dates on which cash flows will be exchanged.
- The term of the swap.

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5 If a public agency issues variable-rate debt and enters into a swap where what it pays is based on a fixed-rate and what it receives if based on a variable-rate the obligation of the public agency under the debt and swap together is a "synthetic fixed-rate" obligation.

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Interest rate swaps typically do not generate new funding like a loan or bond sale, although there are swap variations that are structured to achieve altogether different financing goals, such as generating an up-front cash payment.

Public agencies can use interest rate swaps to achieve the following:

- *Provide better asset/liability matching*. If a public agency has cash balances invested in short-term obligations (variable-rate assets) and fixed-rate debt, a swap in which the public agency pays at a variable-rate and receives at a fixed-rate "hedges" the public agency's balance sheet.
- *Lock in the benefit of current interest rates.* If a public agency has fixed-rate debt that cannot be refunded for several years, a forward-starting swap where the public agency pays at a fixed-rate set at current rates and receives at a variable-rate hedges against future rate increases that would reduce the savings from the refunding.
- *Cap exposure.* An interest rate "cap," a swap structured to become effective only if and when interest rates are significantly higher, can limit the interest rate risk of variable-rate debt.
- *Generate cash.* A swap can be structured so that the public agency receives an upfront payment from the counterparty and pays at a higher rate (effectively, a loan embedded in a swap).
- *Reduce net interest costs*. Variable-rate debt combined with a swap where the public agency pays a fixed-rate and receives a variable-rate designed to correspond to the rate expected to be paid on the variable-rate debt can result in a "synthetic fixed-rate" expected to be lower than the interest cost on fixed-rate bonds.

INTEREST RATE SWAP RISKS - Interest rate swap transactions pose significant risks, including the following:

- *Counterparty credit risk.* At any point a swap has a positive value to the public agency, the public agency is extending credit to the counterparty.
- *Termination risk.* If a swap terminates early and the swap has a negative value to the public agency, the public agency could be required to make a significant payment, even if the termination payment obligation results from a default by the counterparty.

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- *Collateralization risk.* Frequently, an issuer is required under an interest rate swap agreement to post collateral in the form of cash or cash equivalents if the negative value of the interest rate swap increases above a negotiated threshold.

- *Basis risk.* The variable-rate on the swap may not match the actual variable-rate on the hedged obligation (the interest rate payable by the public agency may be higher than the variable-rate it receives on the swap). A change in federal tax law is one example of an event that could create a mismatch.

- *Amortization risk.* If the principal amount of the **hedged bonds** no longer matches the notional amount of the swap (perhaps because of an early redemption of bonds), the swap is no longer an effective hedge.

Events that occurred during the financial crisis of 2008, including the Lehman Brothers bankruptcy, the loss of "AAA" ratings by bond insurers on variable-rate debt that had been associated with swaps, and the collapse of the auction-rate securities market, underscored the reality of these risks. Because swaps generally terminate at market value, these types of event risks could not be managed. As a consequence, municipal interest rate swaps are less common and new synthetic fixed-rate transactions are rare.

California Government Code Sections 5922(a)(i) and 53534 provide clear statutory authority for swaps applicable to all state or local governments.[6] However,

[6] Government Code Section 5922(a)(i) states "In connection with, or incidental to, the issuance or carrying of bonds, or acquisition or carrying of any investment or program of investment, any state or local government may enter into any contracts which the state or local government determines to be necessary or appropriate to place the obligations or investment of the state or local government, as represented by the bonds, investment, or program of investment and the contract or contracts, in whole or in part, on the interest rate, currency, cash flow, or other basis desired by the state or local government, including, without limitation, contracts commonly known as interest rate swap agreements, currency swap agreements, forward payment conversion agreements, futures, or contracts providing for payments based on levels of, or changes in, interest rates, currency exchange rates, stock or other indices, or contracts to exchange cash flows or a series of payments, or contracts, including, without limitation, interest rate floors or caps, options, puts or calls to hedge payment, currency, rate, spread, or similar exposure. These contracts or arrangements also may be entered into by state or local governments in connection with, or incidental to, entering into or maintaining any agreement that secures bonds, including bonds issued by private entities. These contracts and arrangements shall be entered into with the parties, selected by the means, and contain the payment, security, default, remedy, and other terms and conditions, determined by the state or local government, after giving due consideration for the creditworthiness of the counterparties, where applicable, including any rating by a nationally recognized rating agency or any other criteria as may be appropriate."

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the state, a city, a county, or a school district may not enter into a swap if the swap constitutes an "indebtedness" or "liability" within the meaning of California Constitution Article XVI, Section 1 (applicable to the State), or Section 18 (applicable to cities, counties, and school districts). There is little case law in California or other states analyzing how swaps are to be treated for such purposes; however, counsel can generally render a qualified opinion to the effect that the swap would/should not constitute an indebtedness or liability for purposes of these constitutional debt limitations.

2.4 OTHER COMMON DOCUMENT PROVISIONS

Legal documents formalize the structure of a bond, providing the rights and obligations of the involved parties for each financing. Chapter 3, Types of Debt Obligations Issued by Public Agencies identifies the common forms of debt and their associated legal documentation, such as resolutions, indentures, trust agreements, leases, **installment sale agreements**, and other agreements. These documents provide for the issuance or incurrence and the payment and security of public agency debt (generally referred to as "bond documents," even if the debt does not take the form of bonds) and are agreements entered into between public agencies and other parties. Even if not a party to the bond documents, investors are the intended beneficiaries of the agreements. The particular bond documents used differ from transaction to transaction, and the contractual terms contained in bond documents also vary considerably, depending upon the type of financing obligation and the debt payment terms. Bond documents generally contain most, if not all, the standard provisions that in addition to term, interest rate, and redemption features define the basic terms of the issue.

2.4.1 Application of Proceeds

Bond documents generally provide for the application of the proceeds of the sale of the bonds or other debt securities. Proceeds may be held by the bond trustee and deposited in accounts established by the bond documents, transferred to the public agency or, in the case of a refunding, transferred to the trustee for the refunded obligations. Amounts to be held in a reserve fund are almost always held by the bond trustee. The amounts to be used to pay project costs or issuance costs are usually held by the trustee and disbursed upon a requisition by the public agency. Sometimes, however, those amounts are transferred to the public agency borrower and held by the public agency pending expenditure.

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2.4.2 Source of Payment; Pledge

Unless the debt is payable from all of the public agency's general fund assets and revenues, the bond documents generally specify the sources of funds available for the payment of the debt. This will vary with the type of financing obligation. If the public agency's payment obligation is limited to a particular source, such as revenues on an enterprise, assessments levied against particular properties, payments received from a conduit borrower or revenues of the current fiscal year, specificity as to what is available is essential. Of even greater importance is a limitation on the public agency's payment obligation to make payment from such sources. The bond documents may also provide for the pledge of revenues (such as enterprise revenues or conduit borrower payments) or assets (such as funds held by the trustee) to secure the debt.

2.4.3 Funds and Accounts; Flow of Funds

The bond documents generally provide for the establishment of various funds and accounts to hold monies related to the debt. Funds and accounts may be held by the public agency or the trustee or sometimes by another party. Funds and accounts may include the following:

- *Project fund.* A project fund holds debt proceeds before expenditure. This can be held by the public agency or the trustee and can include a separate account for payment of issuance costs.
- *Revenue funds.* This fund captures and retains the revenues to be used for the payment of the debt, subject to use for permitted purposes.
- ***Debt service funds***. These including interest, principal, and redemption accounts, held by the trustee or paying agent pending application to pay debt service.
- *Reserve funds*. Reserve funds are held by the trustee to provide security for the timely payment of debt service.

Bond documents may also provide for a **flow of funds** establishing the priority of the allocation of revenues. This is essential if other uses are allowed, such as the payment of operation and maintenance expenses, or if different types of debt are payable at different levels of priority (e.g., "senior lien" debt and "subordinate"

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debt). Flow of funds provisions are also important in **project financings**, where funds must be prioritized between debt service retirement and project maintenance, and in asset-backed debt providing for the application of principal recoveries and other "excess revenues" to the prepayment of debt.

2.4.4 Debt Service Reserve Fund

A **debt service reserve fund** is an economic tool used by issuers when structuring their bonds. Depending on considerations related to general creditworthiness, the type of issuer and/or the type of debt, a debt service reserve fund may be advantageous or in some circumstances, required. Issuers may establish a debt service reserve fund to achieve a particular rating or rating category by a rating agency or to target specific investors.[7] With a debt service reserve fund, the bond trustee may draw upon the debt service reserve fund if other funds are not available to pay debt service. The amount required to be deposited in the debt service reserve fund (reserve fund requirement) is set with reference to credit needs and federal tax law limitations. See Section 4.8, Arbitrage Yield Restriction. The reserve fund requirement may generally be recalculated if debt service requirements are reduced, for example if a refunding of some of the secured debt occurs. If the amount on deposit in the debt service reserve fund is less than the reserve fund requirement, because the debt service reserve fund was drawn upon or because of a change in the market value of debt service reserve fund investments, the issuer is generally obligated to "replenish" the debt service reserve fund from amounts available after the payment of debt service.

When bond documents provide for the issuance of multiple series of bonds over time, a debt service reserve fund may secure all of the bonds (a "common reserve fund") or a separate debt service reserve fund may secure each series. If there is a common reserve fund, the reserve fund requirement is calculated with reference to all outstanding bonds. In connection with each new issuance, the amount held in the reserve fund must be increased if necessary to meet the new reserve fund requirement. A common reserve fund generally results in a smaller overall reserve fund because, with multiple series of bonds, maximum annual debt service on all of the bonds is generally less than the sum of maximum annual debt on each series. Separate reserve funds, however, provide the issuer the flexibility to have different reserve fund sizes for different series. An alternative is to allow the issuer to elect, upon the issuance of each new series, whether that series will be secured by the com-

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7 These market preferences may change.

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mon reserve fund or a separate reserve fund. Bond documents may also allow a reserve fund requirement to be satisfied through the delivery of a debt service reserve fund surety bond. See Section 2.3.2.2, Debt Service Reserve Fund Surety Bonds.

2.4.5 Covenants

A **covenant** is a promise or agreement made by a party for the benefit of another. Covenants include "affirmative covenants," agreements to take specified actions, and "negative covenants," agreements to not take specified actions or allow those actions to occur. Most covenants are made by the public agency borrower for the benefit of the debt holders or creditor liquidity facility providers. Issuer covenants in bond documents fall into four broad categories:

1. Debt covenants relating specifically to the debt obligation
2. General financial covenants relating to the issuer's general financial management
3. Property covenants relating to specific property securing or generating revenues necessary to pay the debt
4. System covenants relating to the finances and operations of the issuer's enterprise system

2.4.5.1 DEBT COVENANTS

Debt covenants are included to some degree in all bond documents. These may include covenants to do the following:

- Pay all debt service punctually and not extend the time for payment.
- Budget and appropriate funds for the payment of debt service.
- Levy and collect the taxes, fees, or assessments from which debt service is to be paid.
- Comply with the terms of all of the bond documents, including any continuing **disclosure** undertaking.
- Take actions necessary to preserve, and not take actions that will adversely affect, the tax exemption of interest on the debt.

Bond documents also generally include a covenant of "further assurances," an agreement to adopt, deliver, execute, and make any and all further assurances, in-

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struments, and resolutions as may be reasonably necessary or proper to carry out the intention or to facilitate the performance of the issuer of its obligations under the bond documents and assuring and confirming to the bondholders the rights and benefits provided to them in the bond documents. There is also the implied covenant of good faith and fair dealing in every California contract.[8]

2.4.5.2 GENERAL FINANCIAL COVENANTS

General financial covenants are included unless the debt is payable from a specific source. These may include covenants to do the following:

- Adopt budgets.
- Keep and maintain books and records and prepare financial statements in accordance with applicable accounting standards.
- Comply with applicable laws and material contractual requirements.

2.4.5.3 PROPERTY COVENANTS

Property covenants are important in lease financings (where the public agency's payment obligation is contingent upon having use and occupancy of the leased property) and project finance transactions. These may include covenants to do the following:

- Not sell or encumber the property.
- Maintain the property in good condition.
- Reconstruct, repair or replace the property in the event of damage or destruction.
- Maintain casualty and other property-related insurance.

2.4.5.4 SYSTEM COVENANTS

Covenants relating to the management of an issuer enterprise system are important in revenue bond financings. See Section 3.3.6, Enterprise Fund Debt Obligations. These may include covenants to do the following:

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8 See Comunale v. Traders and General Insurance Company, 50 Cal. 2d 654 (1958) (There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything that will injure the right of the other to receive the benefits of the agreement).

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- Charge and collect for services provided.
- Set rates at levels sufficient to produce **net revenues** with a minimum specified ratio to debt service (e.g., Net revenues must equal at least 1.25 times debt service). This is known as a "rate covenant."
- Not allow competing facilities.
- Keep system facilities in good working order and free of liens and pay operating expenses.
- Not sell property essential to the operation of the system.
- Maintain customary insurance coverage.

2.4.6 Additional Debt

Additional debt tests (often referred to as the **additional bonds test** or "ABT") balance investors' interest in not having revenues and assets securing the debt they hold be used to pay other debt and the public agency's need to be able to borrow on favorable terms to meet future needs. These ABTs are to provide sufficient investor protection to allow the present issue to be sold on favorable terms without compromising the issuer's ability to incur future debt on favorable terms.

2.4.6.1 ADDITIONAL DEBT ISSUED UNDER EXISTING BOND DOCUMENTS

An additional debt test in a set of bond documents may impose conditions upon the issuance of additional obligations under the bond documents (e.g., another series of bonds or certificates of participation secured by a common debt service reserve fund or lease payments with respect to a specific property or portfolio of properties). The bond documents may, in that case, require that all debt secured thereby pay interest and principal on the same dates and require that additional assets (reserve fund deposits or properties) be added when new debt is issued.

2.4.6.2 ADDITIONAL DEBT PAYABLE FROM THE SAME SOURCE

As an alternative or in addition to the above, bond documents may limit the public agency's ability to incur additional debt payable from a stream of tax, enterprise, or other revenues. The public agency must generally confirm that it is

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not in default on outstanding debt, and must satisfy various financial tests, apart from limited circumstances such as refundings for savings or debt required to complete a revenue-producing facility. Additional debt requirements generally vary with the relative payment priority (senior, subordinate, or **parity**) of the proposed new debt, with the public agency allowed significantly greater flexibility if the new debt will be subordinate to the existing debt.

2.4.6.3 ADDITIONAL DEBT TEST CALCULATIONS

Additional debt tests may be based entirely on historical results but are generally expressed in terms of projected future performance (e.g., an ability to meet the issuer's rate covenant over the following 5 fiscal years). For example, an issuer may consider an additional debt test calculation based on net revenues over a 12-consecutive-month period, current enacted rates, and the new project and related costs. A key element in any forward-looking test is the scope allowed to the public agency in making assumptions, as follows:

- May planned but not adopted rate increases be included?
- Must collection expectations with respect to highly variable revenue sources (such as revenues derived from new development) be "discounted"?
- What interest costs must be assumed with respect to variable-rate debt?
- May **bullet** principal maturities be assumed to be refunded?
- Must calculations reflect the terms of credit and liquidity support facilities that are not expected to, but may, be drawn upon?
- Must the reasonableness of assumptions be supported by a report from an independent consultant?

As is the case with redemption provisions and covenants, the optimal approach with respect to additional debt test provisions will vary from public agency to public agency and must be carefully considered.

2.4.7 Investments

The **investment of proceeds** and other monies relating to a debt issue is typically governed by state law and by the indenture, trust agreement, or bond resolution. The documents may prescribe the types of investments that may be acquired and the maximum maturity of investments of certain funds. As a guiding principle,

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bond-related funds may not be invested with a maturity date later than the date on which funds are expected to be needed. Even funds that are not expected to be used on any particular date, such as funds held in a debt service reserve fund, may be limited in term to avoid a risk of significant loss in market value if the investment is liquidated. **Investment agreements** with highly rated providers that allow for funds to be withdrawn at par when needed for bond purposes may allow access to longer-term yields. Chapter 9, Investment of Bond Funds discusses the investment of debt-related funds more fully.

2.4.8 Events of Default and Remedies

Events of Default in bond documents are events that allow bondholders to take action to protect their interests or, more often, allow or require the bond trustee to take action to protect bondholders' interests. "Remedies" refers to the actions that may be taken in addition to the general rights exercisable against governmental entities for breach of contract.

2.4.8.1 EVENTS OF DEFAULT

"Events of Default" may include the following:

- *Payment default.* A failure by the public agency to make a scheduled debt service payment
- *Covenant default.* A failure by the public agency to comply with its covenants, other than a payment default. The failure may be required to be **material** and the public agency is generally allowed a period of time (e.g., 30 days) to cure or remedy a default before it becomes an Event of Default.
- *Bankruptcy, insolvency, or other general financial failure by the public agency.*

"Events of Default" may also include events that do not reflect "fault" on the part of the public agency but for which it is important to bondholders to be able to exercise remedies. These can include defaults by conduit borrowers, failures of credit or liquidity providers (unless replaced), credit-changing events that are "events of default" under credit agreements, changes in law, and changes in organization. These events are often called "Mandatory Redemption Events." Under the terms of a lease, an abatement or non-appropriation of funds to pay the lease may not be a legal default but would likely be considered a "default" by the investor.

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2.4.8.2 REMEDIES

Remedies include the right to sue for payment, to pursue contractual damage claims, and to seek performance by the public agency of its obligations through judicial or administrative action. A key question is whether remedies include a right of acceleration: the right to declare all principal (including principal not scheduled to be paid until a future date) to be immediately due and payable. Acceleration is not a permitted remedy under leases relying on the Lease Exception to the constitutional debt limit. See Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception"). For bonds such as general obligation bonds secured by annual property tax levies, assessment bonds and sales tax bonds acceleration may not be of practical value.

The impact of acceleration when available is to place all bondholders on the same footing (bondholders whose principal is due currently do not have a claim greater than those of bondholders whose bonds mature later). Because accelerated obligations are effectively moved ahead of nonaccelerated obligations payable from the same security (e.g., senior lien or enterprise revenues), if any parity or co-secured obligations are subject to acceleration, all debt holders will want a right to accelerate.

Remedies are generally exercised by the bond trustee on behalf of bondholders, although bond documents generally allow the holders of a majority or supermajority of the principal amount of the bonds to direct the trustee's actions. When there is credit enhancement, the credit enhancement provider is generally allowed to control the exercise of remedies and bond insurers require the ability to prevent acceleration.

2.4.9 Fiduciary Rights and Duties

The fiduciaries in public agency debt transactions are independent parties such as trustees, paying agents, tender agents, and remarketing agents, with duties running to the public agency and/or debt holders. The fiduciary provisions in bond documents set forth the qualification requirements for fiduciaries and the terms of their appointment.

Bond trustees are generally required to have trust powers and minimum amounts of capitalization. They are generally appointed by the public agency issuer and can be removed by the issuer as long as no event of default has occurred. The ef-

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fectiveness of any removal or resignation may be conditioned upon acceptance by a new trustee. A bond trustee's duties are generally as follows:

- *Before* an event of default occurs, the trustee is required to perform the express duties set forth in the bond documents. These generally relate to (1) the receipt, holding, and disbursement of funds; (2) the investment of trustee-held funds (usually as directed by the issuer); and (3) the evaluation and approval, if warranted, of requested consents and amendments.

- *After* an event of default occurs, the trustee is generally required to act to protect the interests of bondholders under a prudent person standard of care.

Bond trustees are only responsible for their own negligence or willful misconduct, are indemnified by the issuer or borrower, and are not required to risk their own funds. Trustees are also generally entitled to rely on the advice of counsel and on factual certifications made by the issuer.

Paying agents, tender agents and remarketing agents are required to perform specified duties in accordance with professional standards.

2.4.10 Discharge and Defeasance

Discharge provisions spell out the requirements for the release of the security granted by the bond documents and the termination of the public agency's obligation to pay debt service, which generally include a requirement that all debt obligations issued under the bond documents have been paid or defeased. **Defeasance** provisions allow for the public agency's payment obligation with respect to particular debt securities to be discharged through an irrevocable deposit with the bond trustee of cash or securities of a permitted type (defeasance securities) that, together with the interest to be earned thereon, will be sufficient to pay principal and any redemption premium on the defeased securities at maturity or upon prior redemption and to pay interest on the defeased securities through that date. Upon defeasance, the securities are payable solely from amounts held for that purpose by the bond trustee.

Defeasance securities must be noncallable and of sufficient credit quality to provide debtholders reasonable assurance of payment notwithstanding the discharge of the public agency's payment obligation. Direct, "full faith and credit" obligations of the United States of America (U.S. Treasury securities) are always permitted. Beyond that, bond documents vary.

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2.4.11 Amendments

Amendment provisions establish the prerequisites for amendments to bond documents and related debt security documents. Amendments fall into three broad categories:

1. Amendments not requiring the consent of debt holders
2. Amendments requiring the consent of the holders of a percentage of the aggregate principal amount of the debt
3. Amendments requiring the consent of each affected debt holder

If the debt is credit enhanced, most amendments also require the consent of the credit enhancement provider. Bond documents also often require an opinion of **bond counsel** to the effect that the proposed amendments are permitted by the bond documents and will not adversely affect the tax exemption of interest on the debt.

2.4.11.1 AMENDMENTS NOT REQUIRING DEBT HOLDER CONSENT

The bond documents may generally be amended without debt holder consent for the following purposes:

- To add agreements and covenants required to be performed by the issuer or to surrender any right or power reserved to or conferred on the issuer
- For the purpose of curing any ambiguity or of correcting, curing, or supplementing any defective provision in the bond documents or in regard to questions arising under the bond documents that the issuer deems necessary or desirable and not inconsistent with the bond documents
- To add agreements and covenants as may be necessary to qualify the bond documents under the *Trust Indenture Act of 1939*
- To provide for the terms of additional debt obligations authorized by the bond documents
- To make amendments effective only on a date on which all outstanding debt obligations have been paid or have been subject to mandatory tender.

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Bond documents may also allow, without debt holder consent, amendments that will not materially, adversely affect the interests of the debt holders.

2.4.11.2 AMENDMENTS REQUIRING DEBT HOLDER CONSENT

Amendments not permitted to be made without debt holder consent, and not requiring the consent of each affected debt holder, may be made with the consent of a percentage of the holders of debt, where the percentage is related to the percentage of principal still outstanding, sometimes a simple majority, sometimes 60%, and sometimes two-thirds. Examples of such amendments include:

- Amendments to add additional authorized investments for bond funds (See Section 9.3, Investment Authority and Controlling Documents)
- Amendments to definitions to "modernize" provisions to address matters like the treatment of tax subsidy bonds (treating Build America Bond subsidy payments as an offset to debt service rather than as revenues)
- Amendments to reduce reserve fund amount requirements to reflect current practices and security needs or to allow the use of surety bonds
- Amendments to remove a requirement to set aside moneys for debt service on a monthly basis when debt service is payable semiannually

2.4.11.3 AMENDMENTS REQUIRING THE CONSENT OF EACH AFFECTED DEBT HOLDER

Amendments that change the essential terms of the debt require the consent of each affected debt holder. Examples of such amendments include:

- Change in the interest rate on a bond
- Extending the maturity of a bond
- Adding a right to redeem a bond that is not callable
- Fundamental changes to the security for a bond (e.g., releasing security in a way that turns secured debt into unsecured debt)

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Chapter 3. Types of Debt Obligations Issued by Public Agencies

This chapter of the *California Debt Financing Guide* is focused on the principal types of financing obligations issued by California public agencies, including the State of California, with a more detailed look at the most common.

3.1 INTRODUCTION: WHAT CONSTITUTES A "TYPE" OF DEBT OBLIGATION

The types of debt obligation discussed in this chapter take their form and substance from several core features: the security and source of payment, the **interest** and payment characteristics, and the **tax** treatment. Debt obligations can exhibit multiple features. A sales tax revenue bond, for example, may also be a tax-exempt, long-term, fixed-rate bond. In addition, some unique California debt obligations have been structured specifically to address restrictions imposed by California statutes.

The descriptions in this chapter include appropriate cross-references to Chapter 1, Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues, Chapter 2, Debt Structures: What Factors Drive Structuring Decisions?, and Chapter 4, Federal And State Tax Law Requirements.

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3.1.1 Security and Source of Payment

The most fundamental, critical features distinguishing debt obligations in the municipal securities market is the source of funds that pay the debt obligations and the security backing that source.

- The strengths, weaknesses, and security of the sources of payment may differ significantly and are critical to **investors** in the municipal securities market.
- The security and source of payment determine which population will be responsible for paying debt service on the debt obligation, which is critical to **issuers**.
- The security and source of payment often drive the structure of the debt obligations, which is critical from a legal standpoint.

As a result, the first critical difference between debt obligations is the security and source of payment.

3.1.2 Payment Term and Interest Rate

The second major distinction comprises the payment term and **interest rate**. Debt can be short term (maturing within 1 to 5 years of issuance) or long term, with long term divided from investor's perspective between "intermediate" (6 to 15 years) and "long dated" (maturities or a serial **issue** and term bonds typically having maturities of more than 15 years from issuance). The accompanying interest rates are either fixed or variable. Examples include long-term, fixed-rate debt obligations and variable-rate **demand bonds**.

3.1.3 Tax Treatment

Municipal securities market participants also differentiate among debt obligations by tax treatment. In the municipal securities market, the most obvious distinction is between tax-exempt and taxable obligations. In addition, interest on tax-exempt debt obligations may or may not be subject to the federal **alternative minimum tax (AMT)**. Debt obligations are commonly referred to as "tax-exempt" or "taxable" and "AMT" or "non-AMT."

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3.1.4 Unique Public Agency Financings that Address Legal Constraints or Public Policy Issues

California public finance professionals have structured some types of debt to address special legal constraints. These include lease revenue bonds and certificates of participation (COPs), both of which are structured to allow public agencies to use debt financing without violating state constitutional **debt limits** or to address a lack of statutory authorization to issue debt obligations.

3.1.5 Purposes for Which Debt is Incurred

Public agencies may incur **debt** for a variety of purposes including the following:

- Long-term financing of governmental facilities
- Long-term financing of **enterprise** facilities
- Interim financing of capital improvements
- **Cash flow** and working capital financing
- Development financing
- Program financing
- Financing for private parties (**conduit financing**)
- **Refunding** of existing debt

In addition, some types of debt obligations do not fit into one or more of these categories because of how the debt is issued, among other factors.

3.1.6 Types of Debt Instruments

Further, debt instruments may take a variety of forms.

BONDS - Bonds are debt instruments issued directly by the public agency issuer (for example, a city). The basic documentation includes an **indenture** or trust agreement (between the public agency issuer and a **trustee**) or a **bond resolution** (adopted by public agency issuer) and a paying agent agreement (between the public agency issuer and the **paying agent**). Bonds generally **mature** more than 1 year after the **date of issuance**. The issuer makes debt service payments to a trustee or paying agent who makes payments to bondholders.

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NOTES - Like bonds, notes are debt instruments executed and delivered by a public agency. The basic documents include a trust agreement (between the public agency and a trustee) or a note resolution (adopted by the public agency) and a paying agent agreement (between the public agency and a paying agent). Notes generally have a shorter term than bonds, often maturing in less than 1 year. The public agency makes payments directly to the trustee or paying agent who makes payments to noteholders.

DIRECT LEASES - Simple examples of **direct leases** are equipment leases. The public agency leases the property from the lender, which may be the vendor of the property, a leasing company, or a bank. Lease payments made by the lessee cover **principal** and interest. The lessor may transfer the lease to another party. See Section 3.7.2, Direct Leases.

COPs - **Certificates of Participation** are financial instruments that provide a means to allow the rights to receive revenues under a lease or other agreement to be sold to multiple investors. See Section 3.6.3, Certificates of Participation.

3.2 DIAGRAMS OF BASIC DEBT OBLIGATIONS

The cash flows for three fundamental debt structures help to explain difference between debt types based upon the security and source of payments. These diagrams do not account for all the parties involved in the financing. In particular, these diagrams omit the role of the **underwriter**, who acts as an intermediary between the issuer and the investor to create a market for the agency's debt, and bond insurer or credit enhancer, who provides security against payment **defaults**. While these roles are essential, the diagrams are intended to represent only the **flow of funds** between the public agency and the investor, lender, or purchaser of the debt.[1]

3.2.1 Direct Debt Obligation

In a direct debt obligation the issuer is both the recipient of the **proceeds** and the source of repayment. Direct debt obligations (Figures 3-1 and 3-2) encompass

1 Depending on the audience and the purpose of the diagram, the relationships between parties to debt transactions can be drawn in many ways. The diagram may focus on cash flows, controlling documents, or roles and responsibilities of the participating members of the system. For each type of debt it is possible to imagine several variations based on minor and, often inconsequential, differences in how cash flows, controlling documents, and participating parties are named or administered.

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most forms of bonds and **notes** as well as the more traditional, privately offered and held, direct loan. The bondholder may be an investor in municipal securities, it may be leasing agent, or it may be a bank or non-bank financial institution. The proceeds are transferred to the public agency (debt issuer), who is obligated by a note or **loan agreement** to repay the debt. In the case of a municipal bond or note, the public agency issuing the debt or taking on the loan makes a **debt service** payment to a trustee, paying agent, or other independent administrator. The trustee, paying agent or administrator makes principal and interest payments (P&I) to the bondholders, investors, or lenders. The trustee function may be performed by the

Figure 3-1

PUBLIC OFFERING

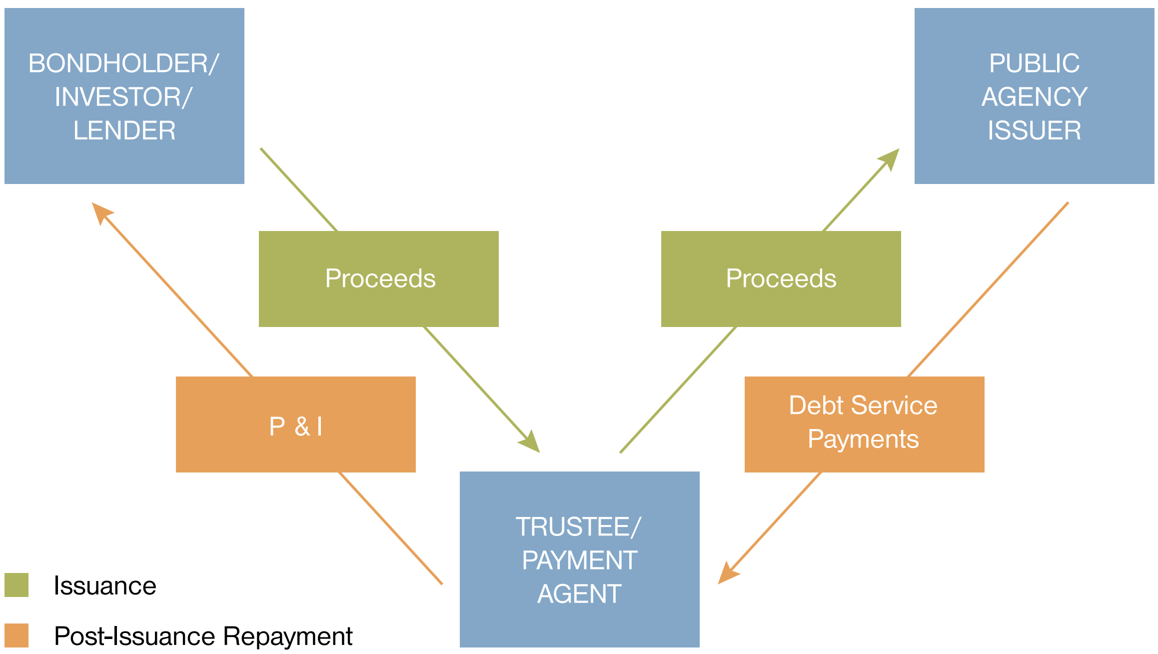
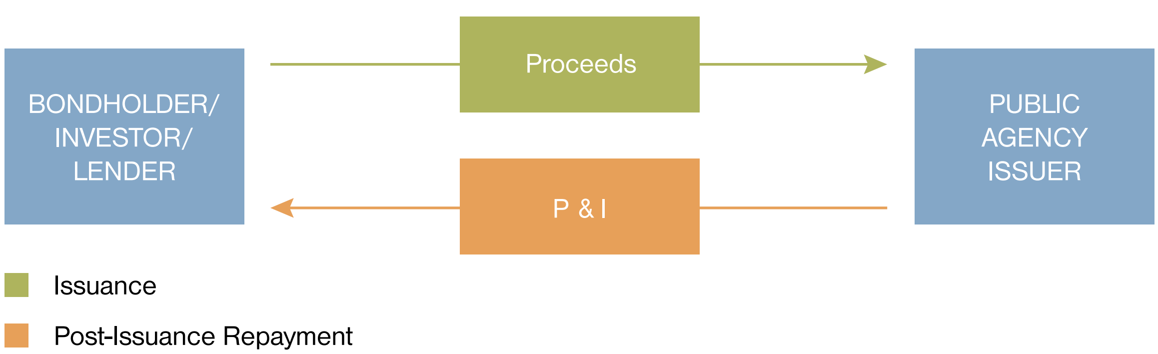


Figure 3-2

PRIVATE PLACEMENT (DIRECT LEASE/LOAN)



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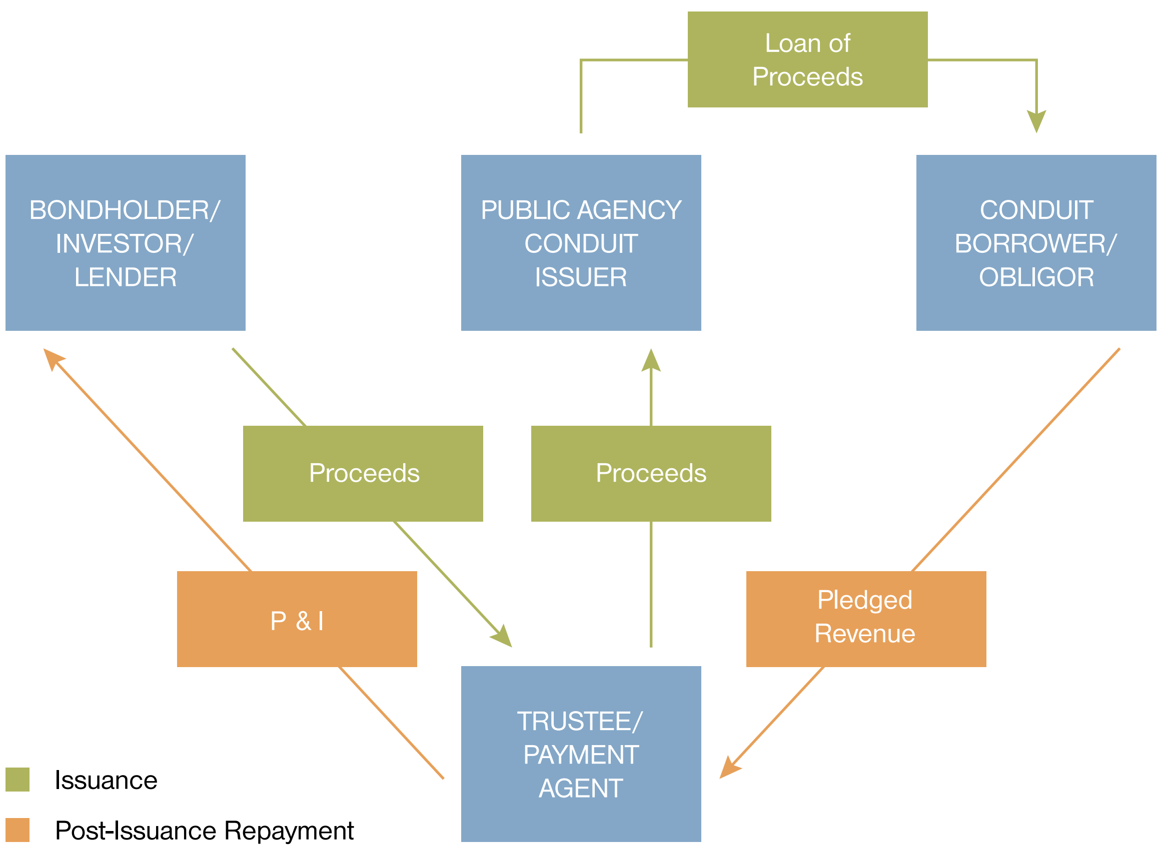
treasury services of the public agency. With a direct bank loan (Figure 3-2) the debt service payment is made directly to the lender or financing institution holding the debt. There is no third-party trustee involved in direct bank loans.

3.2.2 Debt Obligations Issued on behalf of a Borrower

With debt issued on behalf of another borrower, the issuer is neither the recipient of the proceeds nor, in most cases, the source of repayment. Debt issued on behalf of another entity (Figure 3-3) includes debt issued by a public agency for the benefit of a borrower, typically another public agency or an entity providing public benefit, such as a nonprofit hospital. The debt may be sold in the form of bonds, loans, or COPs. The proceeds are transferred to the borrower, who is obligated under a loan or lease agreement to repay the debt. Borrowers are likely to repay the debt with revenue earned from their activities. As a result, this structure is common to public enterprises such as water and wastewater utilities. **Private activity bonds** and exempt-facilities bonds use this structure as well.

Figure 3-3

DEBT OBLIGATIONS ISSUED ON BEHALF OF A BORROWER



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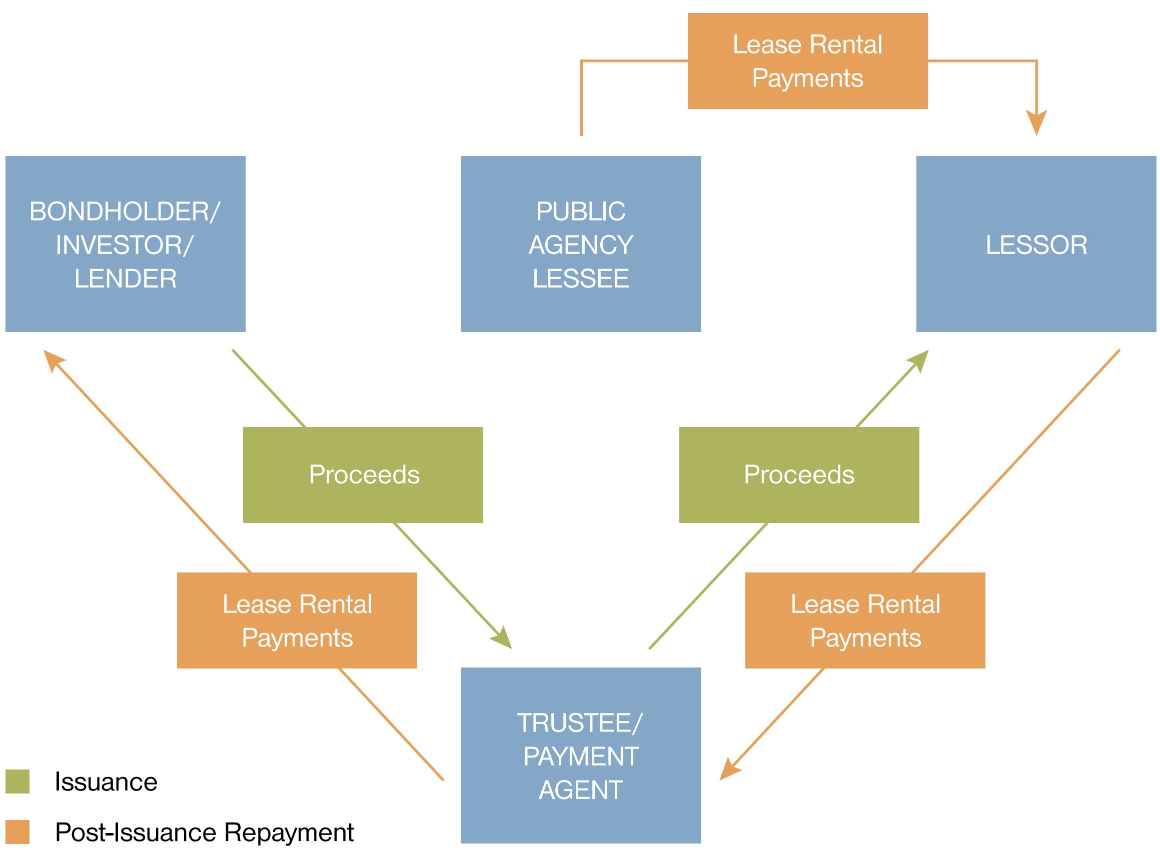
3.2.3 Lease-Supported Debt

Lease-supported debt (Figure 3-4) represents a blend of direct debt and debt issued on behalf of another entity. With lease-supported debt there is an issuer as the lessee, the source of repayment, and a **lessor** as a third-party to the transaction. The proceeds of the debt flow to the lessor who builds (or pays the lessee to build) the facility. This structure constitutes the basis of the Lease Exception. (See Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception")). The lessor may be a joint powers authority (JPA) or another financing authority within the public agency issuing the debt. Lease financing includes a structure known as a lease-leaseback financing. In this arrangement the public agency leases a facility to a lessor who leases it back to the public agency. The lease payments made by the public agency **lessee** provide the source of funds to repay the debt. The debt may be issued as a lease revenue bond or COPs promising investors a share in the lease payments.

Figure 3-4

LEASE-SUPPORTED DEBT



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3.3 TYPES OF DEBT OBLIGATIONS ORGANIZED BY SECURITY AND SOURCE OF PAYMENT

As noted above, the security and source of payment are distinguishing factors among debt obligations, and the types of debt obligations are frequently organized around them. For example, sales tax revenue bonds do not denote long- or short-term obligations or even how the bonds are structured but simply denote the security and source of payment for the obligation. The following is a listing of common debt obligations with reference to security and source of payment.

3.3.1 Local Agency General Obligation Bonds

General obligation bonds (GO bonds) issued by California local government entities are payable from unlimited ***ad valorem*** taxes on real property within the public agency's jurisdiction, the payment of which is secured by liens on the taxed properties. Tax rates are established annually at levels necessary to generate amounts sufficient to pay debt service and are collected with general property tax. Because they are secured by the issuer's taxing power, GO bonds are considered to be low-risk obligations and are consequently a source of low-cost, long-term, fixed-rate financing. GO bonds may be aimed to satisfy the requirements of Article XIIIA, Section 1(b)(2) of the California Constitution (Proposition 46 General Obligation Bonds) or the requirements of Article XIIIA, Section 1(b)(3) of the California Constitution (Proposition 39 General Obligation Bonds). See **Section 1.4.4, Ad Valorem Real Property Taxes Securing Voter-Approved Obligations**.

The principal challenge with GO bonds is obtaining the voter approval required by the California Constitution. Election scheduling requires planning and foresight and obtaining the requisite vote—two-thirds for Proposition 46 GO bonds and 55% for Proposition 39 GO bonds—requires broad-based public support, especially because public funds may not be expended to promote passage of a bond measure.

PRINCIPAL USES - Proposition 46 GO bonds may be issued only to finance "the acquisition or improvement of real property." This phrase is subject to interpretation but as a general matter includes rehabilitation, acquisition, installation of fixtures, and the payment of financing and other soft costs directly connected to real property acquisition and improvement and excludes routine maintenance costs and the acquisition of equipment. Proposition 46 GO

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bonds are most commonly used to finance buildings for general governmental use but are also issued to acquire property for open space or future public use. The property acquired or improved is usually owned by the issuer of the bonds but may be owned by others if in furtherance of public purposes (e.g., a GO, bond-financed program to promote the development of affordable housing or seismic safety improvements). The proceeds of Proposition 39 GO bonds may be used to finance the construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities, but may not be used for salaries or other operating expenses.

PRINCIPAL ISSUERS - GO bonds may be issued only by public agencies with taxing power. Proposition 46 GO bonds may be issued by cities, counties, and some special districts. Proposition 39 GO bonds may be issued only by school districts and community college districts. Proposition 39 GO bonds are the principal financing tool for school districts and community college districts. School districts may form school facility improvement districts to issue bonds payable from taxes levied on property in an area constituting less than the entire jurisdiction of the district.

LEGAL AUTHORITY - GO bond issuance authority must generally be derived from statute, as follows:

- *Cities* - California Government Code Section 43600 et seq. Charter city authority may also be derived from the city charter.
- *Counties* - California Government Code Section 29900 et seq.
- *School Districts and Community College Districts* - California Education Code Section 15100 et seq.

Most special districts created before the passage of Proposition 13 in 1978 are authorized in their respective governing statutes to issue GO bonds. In addition, local agencies may issue GO bonds in accordance with the provisions of California Government Code Section 53506 et seq.

APPROVAL PROCESS - An election to approve GO bonds must generally be called by the issuer's governing board. Statutes vary:

- The calling of a GO bond election by a general law city requires a two-thirds vote of the city council (see California Government Code Section 43608).

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- The calling of a GO bond election by a county requires a majority vote of the board of supervisors (see California Government Code Section 29901).

- A GO bond for a school district may be called by a majority vote of the school board (see California Education Code Sections 15100 and 5304) or by a voter petition (see California Education Code Sections 15100 and 5321).

The bond election must be called a specified number of days in advance of the election date and voters must be provided a statement of the estimated tax rate required to pay debt service on the bonds. A Proposition 46 GO bond election may be held on any Tuesday. A Proposition 39 GO bond election may be held only on a statewide election date or the date of a regularly scheduled election for the governing board of the issuer or of another governmental entity with a jurisdiction completely overlapping that of the issuer. If approved by voters, GO bonds may be issued in multiple series over time, so long as the total principal amount issued does not exceed the amount authorized and bonding capacity limits and if tax rates are under statutory tax rate limits.

Issuance of refunding bonds that result in debt service savings does not require additional voter approval.

STRUCTURE AND DOCUMENTATION - GO bonds are generally issued as long-term, fixed-rate bonds. **Capital appreciation bonds** can be used to defer debt service, but generally at a higher interest cost, and school districts must comply with the additional requirements of California Education Code Sections 15144.1, 15144.2, and 15146.

OTHER CONSIDERATIONS - Bond proceeds may be spent only for projects approved in the bond election, so care must be taken to ensure that the approved projects are described neither too loosely nor too specifically. Further, in seeking voter approval for the issuance of GO bonds, a public agency is asking for approval of an increase in *ad valorem* real property taxes. Establishing the amount for which approval will be sought ("**sizing the bond measure**") requires making assumptions about assessed valuation growth, having awareness of the extent of public support for the acquisition and construction of the improvements on the project list, and anticipating the degree to which voters are willing to pay for the projects through increased taxes.

POST-CLOSING ADMINISTRATION AND OVERSIGHT - GO bond issues must establish procedures to ensure that bond proceeds are spent only for the specific purposes approved in the bond measure. For Proposition 39 GO bonds, annual

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independent performance and financial audits must be conducted by a citizen's oversight committee. See Appendix B, Section B.1.3.1, Local General Obligation Bonds – Proposition 39.

3.3.2 General Fund Obligations

The vast majority of debt obligations that are backed by a public agency's general fund are issued by cities, counties, or school districts. Most of the debt obligations issued by other public agencies are connected to a specific revenue stream. A public agency general fund is the agency's basic operating fund and is used to account for all revenues and expenditures necessary to carry out basic governmental activities of the agency that are not accounted for through other funds. Typically, general fund revenues include (but are not limited to) property taxes sales and use taxes, license fees, permit fees, and charges for services. The general fund can be used to support large infrastructure projects or to manage daily cash flow for operations.

3.3.2.1 LEASE REVENUE BONDS AND CERTIFICATES OF PARTICIPATION

Some long-term general fund obligations of cities, counties, and school districts may be structured as leases in order to take advantage of the Lease Exception to the debt limit in the California Constitution. See Section 3.6.1, Financing Leases and Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception"). A lease can be the source of repayment for revenue bonds issued by joint exercise of powers agencies or authorities (See Section 3.6.4, Joint Powers Agency or Authority (JPA) Bonds and Other Issuances) or interests in a lease can be sold as COPs (See Section 3.6.3, Certificates of Participation). A lease may also be used to acquire equipment from a vendor (See Section 3.7.2, Direct Leases).

3.3.2.2 PENSION OBLIGATION BONDS

While other public agencies can issue pension obligation bonds (POBs), most POBs are obligations issued by and payable from the general fund of a city or a county. Public agencies issue POBs to make a payment to the public agency's retirement system (a self-managed system, a group system, the California Public Employees' Retirement System (CalPERS) or the California State Teachers' Retirement System (CalSTRS) to satisfy an obligation to make payment to the system. The pension obligation funded can be the public agency's required payments for the current fiscal year (its "normal annual contribution"), the public agency's

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unfunded accrued actuarial liability (UAAL) or both. Financing the normal annual contribution in effect defers payment and provides the public agency cash flow relief in the current fiscal year. Financing the UAAL replaces a multi-year pension funding obligation with a multi-year debt service payment obligation. Although a variety of policy considerations are involved, from a pure payment obligation standpoint, the public agency as a general matter will come out ahead if the retirement system invests the proceeds of the POB and earns more than the cost (debt service and issuance costs) of the POBs and will come out behind if it does not. The retirement system can invest in a broad range of investments, including equity securities.

Pension obligation financings are generally structured with an issuance by the public agency of a note payable to the retirement system. The note is then refunded with POBs issued under a refunding bond law statute. See **Section 3.7.6, Refunding Bonds**. Pension obligation bonds can qualify for the Obligations Imposed by Law Exception to the constitutional debt limit. However, a **validation** action under California Code of Civil Procedure Section 860 et seq. is generally required. See **Section 1.2.4.6, Obligations Imposed by Law Exception**.

POBs are generally payable from the same source as the financed pension obligations (e.g., the public agency's general fund) and can be issued as either fixed-rate or variable-rate obligations. There is generally no **debt service reserve fund**. Because of limitations on the ability to fund working capital, POBs are generally issued as taxable debt for federal income tax purposes. See **Section 4.5, Cash Flow Borrowings**.

Public agencies have also explored ways of financing their other post-employment benefit (OPEB) obligations. Because of complexities in the calculation of these obligations and because public agency responsibilities with respect to OPEB obligations are less clearly defined than they are with respect to pension obligations, financing OPEB obligations is challenging.

3.3.3 Sales Tax Revenue Bonds

Sales tax revenue bonds are bonds that are payable from and secured by revenues from the imposition of a sales and use tax, or a transaction and use tax, on retail transactions within the issuer's boundaries. These revenues are collected by the California State Board of Equalization and remitted to the issuer. The principal challenge with sales tax revenue bonds is obtaining the voter approval required for the imposition of the tax. Sales and use taxes are paid by all retail buyers

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within the issuer's jurisdiction and obtaining the required vote requires broad-based public support.

PRINCIPAL USES - While sales tax revenue bonds may be used for general purposes, depending on the nature of the tax and public agency collecting them, sales tax revenue bonds are particularly useful for financing projects that will not generate revenues sufficient to cover the project's operating costs and debt service. Sales tax revenue bonds are often used to finance transportation facilities, especially highways and mass transit facilities.

PRINCIPAL ISSUERS - Only public agencies with the authority to impose a sales tax may issue sales tax revenue bonds. Although cities and counties do issue sales tax revenue bonds, most sales tax revenue bonds are issued by local transportation authorities.

LEGAL AUTHORITY - A public agency's authority to impose a sales tax is derived from its governing statute and is subject to limitations imposed by that statute. Sales tax imposition is also subject to the requirements and limitations of the "Transactions and Use Tax Law" (California Government Code Sections 7251–7279.6), including limitations on the combined sales tax rate that can be imposed in any county, and must comply with the requirements of Article XIIIC of the California Constitution. Sales and use taxes imposed by cities and counties that are not imposed for a specific purpose or purposes are **general taxes**, while sales and use taxes imposed for a specific purpose or purposes or by a local government entity that is not a general governmental entity (e.g., a transit district or a transportation authority) are **special taxes**. See Section 1.4.6, Special Taxes.

Bond issuance authority may be derived from a public agency's governing statute. California Public Utilities Code Section 180250 et seq., for example, provides for the issuance of "limited tax bonds" payable from the proceeds of a retail transaction and use taxes imposed by local transportation authorities created or designated under the *Local Transportation Authority and Improvement Act* (California Public Utilities Code Section 180000 et seq.). If the bonds are secured by fare box or other revenues as well as sales tax revenues, bond issuance authority may also be derived from the *Revenue Bond Law of 1941* (California Government Code Section 54300 et seq.) known as the "1941 Act."

APPROVAL PROCESS - The imposition of general taxes and special taxes must comply with the respective procedural requirements of California Constitution

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Article XIIIC (i.e., two-thirds vote of the governing body, majority voter approval for general taxes, and two-thirds voter approval for special taxes). Bond issuance must be approved by the issuer's governing board, generally by ordinance, and voter approval is also often required. Authorizing statutes may allow the tax and bond approval measures to be combined.

STRUCTURE AND DOCUMENTATION - Sales tax revenue bonds are generally issued as long-term, fixed-rate bonds. Once a tax rate is established, sales and use tax revenue will, over time, vary with the level of transactional activity; revenue levels are beyond the issuer's control. Debt service "coverage," the amount or multiple by which annual tax revenues exceed annual debt service, provides protection against fluctuations or declines in the amount of tax revenue. The provisions respecting the issuance of additional bonds secured by a particular stream of tax revenues are therefore a key structuring concern.

OTHER CONSIDERATIONS - The proceeds of bonds payable from special taxes may be expended only for the purposes approved by voters, so care must be taken in developing bond and tax measures. Local transportation authority bonds are generally issued to finance capital items in the applicable county transportation expenditure plan. Because the operating revenues of transportation agencies rarely cover the agency's operating costs there is little likelihood that these revenues will be used to pay debt service on the bonds. Bond-financed projects may, as a result, have significant "private use" without creating private activity bonds. See Section 4.6, Governmental Bonds/Private Activity Bonds.

POST-CLOSING ADMINISTRATION AND OVERSIGHT - As with GO bonds, it is essential to establish procedures to ensure that bond proceeds are expended for approved purposes.

3.3.4 TRANs and RANs

Public agencies use the proceeds of tax and revenue anticipation notes (TRANs) and revenue anticipation notes (RANs) to finance their current fiscal year expenses. Although the notes may mature in the following fiscal year, they are payable solely from revenue received or accrued during the fiscal year in which they are issued. TRANs and RANs are secured by a **pledge** of and lien on the revenues of the fiscal year of their issuance; should the revenues prove insufficient, however, the issuer is not obligated to pay debt service on the notes from any other source. TRANs and RANs are generally issued early in the issuer's fiscal year.

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PRINCIPAL USES - The proceeds of TRANs and RANs may be expended for any purpose for which the issuer may use and expend money, including for working capital. TRANs and RANs are used primarily as a cash management tool and are of particular value if the public agency's revenues and/or expenditures are uneven over the course of a fiscal year, as is often the case for public agencies that derive revenues from property taxes.[2] Expenses incurred early in the fiscal year can be paid from note proceeds, and revenues received later in the fiscal year can be used to pay the notes.

PRINCIPAL USERS - School districts and many general government agencies use TRANs and RANs.

LEGAL AUTHORITY - TRANs and RANs are generally issued under the provisions of California Government Code Sections 53850–53858. These provisions authorize notes to be issued in an amount up to 85% of the issuer's estimated taxes to be collected, income, revenue, cash receipts, and other moneys available for making note payments. These provisions allow the notes to mature up to 15 months from the date of issuance (as long as they are payable solely from revenue received or accrued during the current fiscal year). TRANs and RANs issued under the California Government Code provisions satisfy the requirements of the Current Fiscal Year Exception to the constitutional debt limit. See **Section 1.2.4.1, Current Fiscal Year Exception**.

APPROVAL PROCESS - The issuer's governing board generally approve TRANs and RANs by adopting a resolution. Notes of a school district or community college district that has not been accorded fiscal accountability status by the California Education Code may be issued in the name of the school district or community college district by the board of supervisors of the applicable county.

STRUCTURE AND DOCUMENTATION - TRANs and RANs may be issued as fixed-rate or as variable-rate obligations and may be made subject to optional prepayment, although they are generally issued as non-callable, fixed-rate debt. If the notes are issued with a term of 12 months or less, interest is generally paid at **maturity**; if the notes have a longer term, an interim interest payment date is generally established. To ensure that current fiscal year revenues needed to pay the notes remain unspent and available, the issuer is generally required to set aside revenues in specified amounts for payment of the notes during the second half of the fiscal year.

[2] Property taxes are typically paid annually and due twice a year in December and April.

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TRANs and RANs are generally issued under a note resolution adopted by the issuer. To enhance noteholder security, a trustee or **fiscal agent** may be engaged to receive and hold revenues set aside for note payment, in which case a trust agreement or similar agreement may also be required. To spread financing costs and enhance marketability, TRANs and RANs of multiple issuers are often combined in a pooled financing. See **Section 3.7.7, Pool Bonds**.

OTHER CONSIDERATIONS - Depending upon market conditions, it may be possible to invest the proceeds of a TRAN or RAN issue before expenditure, at **yields** higher than the yield on the notes. The extent to which TRANs and RANs can be issued on a tax-exempt basis and the ability to retain "positive arbitrage" depend upon satisfaction of the requirements of the Internal Revenue Code of 1986, as amended, and applicable regulations. See **Section 4.5, Cash Flow Borrowings**.

POST-CLOSING ADMINISTRATION AND OVERSIGHT - The issuer must manage its annual cash flow to ensure that it will have revenues available to make required set-asides for the payment of the notes at the times and in the amounts required and must, upon the turn of a fiscal year, separate required revenues of the prior fiscal year from revenues of the new fiscal year.

3.3.5 Teeter Bonds

A "Teeter Plan" is an alternative method for the distribution of secured property taxes. Upon adoption and implementation of this method by a county board of supervisors, local agencies for which the county acts as "bank" (including the county) and certain other public agencies in the county receive annually the full amount of their share of property taxes on the secured rolls regardless of the amount of tax collection. Because a Teeter Plan creates a timing gap between the county's advance of funds and its collection of delinquent taxes the county bears the risk of delinquencies and losses and in return receives any interest and delinquency penalties it collects. See California Revenue and Taxation Code Sections 4701–4717.

Most counties finance the distributions of "Teetered" delinquencies through loans from their treasurers' investment pools. These loans may run as long as 9 years and are likely to run, on average, 3 to 3.5 years. As an alternative, a county may finance distributions through the issuance of "Teeter bonds" (which may take the form of **commercial paper** or other notes) under California Government Code Sections 54773–54783. Teeter bonds may be issued in the amount of the current fiscal year's delinquencies and may have a maturity of up to 7 years. Teeter

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bonds are secured by a pledge of the delinquent property tax receivables and are generally also payable from the county's general fund. To be issued on a federally tax-exempt basis, the bond issue must satisfy the requirements for a long-term working capital borrowing. See **Section 4.5, Cash Flow Borrowings**.

Because Teeter bonds are multi-year obligations payable from tax revenues and general county funds, an exception to the constitutional debt limit is necessary. Teeter bond issuers generally rely upon the Obligations Imposed by Law Exception on the theory that once a county has established a Teeter Plan it is obligated by law to make advances to the entities receiving tax revenues. See **Section 1.2.4.6, Obligations Imposed by Law Exception**. Teeter bonds generally require a validation action.

3.3.6 Enterprise Fund Debt Obligations

Debt payable from and secured by enterprise revenues is the primary financing option used for local government entities with "proprietary" enterprises that generate revenues sufficient to cover capital costs and operating expenses (to the extent required to be paid from revenues as opposed to tax proceeds). The public agency may be a department of a general-purpose governmental entity accounted for separately from "general fund" activities, such as a city water utility, or it may be a special district, such as an irrigation district. A particular public agency may have multiple enterprises (e.g., a water enterprise and a power enterprise).

An enterprise may consist of an entire utility system such as a wastewater system, a portion of a utility system such as a specified service area within the public agency's jurisdiction, or even a single revenue-generating facility such as a parking garage or power generation facility. The security for revenue-secured debt is generally limited to a pledge of enterprise revenues; debt holders have no security interest in any physical assets. Because the debt is issued to finance facilities for an enterprise and is payable solely from the revenues of the enterprise, public agencies subject to the constitutional debt limit can rely on the **Special Fund** Exception. See **Section 1.2.4.4, Special Fund Exception**.

3.3.6.1 PUBLIC ENTERPRISE REVENUE BONDS

Public enterprise revenue bonds are issued directly by the public agency borrower. Revenue bonds are the preferred financing vehicle for enterprise revenue debt when revenue bonds can be issued without voter approval.

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PRINCIPAL USES - Public agencies use public enterprise revenue bonds to finance facilities for revenue-generating municipal utility systems, including power, water, wastewater and solid waste systems, proprietary operations such as airports and parking, and other revenue-generating enterprises. These bonds are also used for financing stand-alone, revenue-generating projects such as power generation facilities and toll roads and bridges. The use of public enterprise revenue bonds can be challenging for enterprises such as hospital systems that do not generate positive cash flow. These bonds are also often a vehicle for refunding revenue-secured debt.

PRINCIPAL ISSUERS - The principal issuers of public enterprise revenue bonds are charter cities and special districts with the authority to issue revenue bonds without voter approval and public agencies refunding revenue-secured debt.

LEGAL AUTHORITY - The issuance of revenue bonds requires city charter or statutory authority. The governing statutes of public agencies operating municipal enterprises generally authorize the issuance of revenue bonds, often expressed as an authorization to issue revenue bonds in accordance with the *Revenue Bond Act of 1941*. Local government agencies may issue revenue bonds under the local agency revenue bond refunding law (California Government Code Section 53570 et seq.) to refund indebtedness payable from enterprise revenues, including installment sale payments payable from enterprise revenues. California Government Code Sections 5450–5451 provide statutory authority for public agencies to pledge revenues to secure debt and to give a perfected security interest in pledged revenues.

APPROVAL PROCESS - The public agency's governing board must approve the bonds and the financing documents by resolution or, if required, by ordinance. If voter approval is required, revenue bond statutes generally require a simple majority.

STRUCTURE AND DOCUMENTATION - Revenue bonds are issued using a bond structure. Because the amount of revenue can generally be controlled to a significant extent through the public agency issuer's ability to set rates, revenue bonds can be either fixed-rate debt or variable-rate debt. Because decisions made in structuring a revenue bond issue will affect the public agency's flexibility in managing the enterprise and will generally also apply to subsequent issues of **parity** bonds, careful consideration must be given to the key documentation decisions.

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SCOPE OF THE "ENTERPRISE" - Although enterprise revenues are pledged and available to pay debt service, enterprise expenses are paid from the revenues, and debt service **coverage** is a function of net revenues of the enterprise and the debt service payable from the revenues, the public agency has flexibility in defining the enterprise. Agencies must decide whether the enterprise is an entire utility system, a portion of a utility system (a specific service area or customer class), or only the specific project financed. The following factors shape the decision:

1. Credit considerations. Should, for example, a stronger component and a weaker component be combined, so that they support each other, or be defined as separate enterprises? Combining the two could make revenue-secured financing easier for the weaker enterprise but more difficult for the stronger enterprise.

2. Legal limitations on revenue generation. Enterprises may need to be defined by their unique revenue authority. For example, it may be difficult to combine a water utility and a power utility within on enterprise because water charges must be for water service and power charges must be for power.

3. Accounting considerations. What, for example, are the accounting challenges of maintaining separate revenue statements for separate services provided by a single utility? Revenue bond documents generally do allow for a public agency to exclude from the enterprise for revenue bond purposes financings for "special facilities"—a financing to construct particular facilities with revenues used to pay debt service derived solely from those facilities.

REVENUES, O&M, AND DEBT SERVICE - Three important terms associated with enterprises are revenues, operation and maintenance (O&M) expenses, and debt service. These terms are used to establish the source of repayment for revenue debt (revenues less O&M) and the rate covenants and additional debt tests such as debt service coverage (revenues less O&M divided by debt service). The definitions are based on generally accepted accounting principles (GAAP), but are consistent with the reality that debt service must be paid in cash when due, GAAP definitions are modified to exclude non-cash items.

- *Revenues.* Revenues of an enterprise consist principally of the income from rates and charges, connection fees and standby or availability charges and may include investment earnings (if not used for construction). Revenues do not generally include debt proceeds or amounts collected for dedicated purposes, such as property taxes for GO bonds, **assessments** for assessment bonds,

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grants, and contributions in aid of construction or refundable deposits. Further, although changes in the value of investments can create gains and losses under GAAP, distortion can occur if asset values change and are included in revenues before the value change is realized.

- *Operation and Maintenance Expenses*. Generally, O&M expenses comprise the ongoing costs of running an enterprise (other than non-cash items). These include purchased power or water; repair costs; salaries and independent contractor costs; administrative expenses allocable to the enterprise; insurance premiums and debt carrying costs such as trustee, legal, and accounting fees. O&M expenses exclude depreciation, replacement or obsolescence charges and amortization of intangibles, premiums, and discounts. O&M expenses can also exclude expenses paid from sources other than revenues (e.g., taxes).

  Certain obligations may be O&M expenses under GAAP, but the obligations require large payments over time like debt (e.g., "take or pay" contracts). Because these types of obligations are paid before debt service, there may in some cases be a perceived risk to debt security. An approach to this concern is to require, before these obligations can be treated as O&M, a determination by the public agency that entering into the obligation will be beneficial to the enterprise and will not adversely affect the public agency's ability to comply with its rate covenant (the contractual agreement to establish rates and charges at levels that will generate revenues sufficient to achieve a stated minimum ratio of **net revenues** to debt service).

- *Debt Service*. Debt service consists primarily of principal and interest payable on debt, broadly defined to include revenue bonds, **installment sale agreements**, and similar obligations (without regard to whether the obligations are publicly offered or privately held or whether the obligations are "debt" within the meaning of constitutional or statutory restrictions). Debt service, however, generally excludes interest that has been capitalized and debt not payable from revenues, such as GO bonds, assessments, and conduit debt obligations paid by private borrowers. Debt service may have multiple levels of payment priority (e.g., senior lien debt and subordinate lien debt).

  Because projecting debt service is necessary to set rates at levels sufficient to meet a rate covenant and satisfy additional debt tests, it is critical to establish appropriate assumptions about variable-rate debt and principal expected to be refinanced. Variable-rate debt is generally assumed to bear interest at either

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current or recent **variable-rates**, at the current index rate, or at an assumed **fixed-rate**. **Bullet** maturities can often be assumed to be refinanced over a longer term. Some public agencies will also find it important to specify the treatment of interest rate swap revenues, obligations, and termination payments.

FLOW OF FUNDS, PLEDGE - The flow of funds for revenue bonds, and the timing and priority of application of revenues to expenditures and deposits, follows a basic pattern, although some flexibility is possible. Generally, enterprise revenue is deposited in a "revenue fund." Revenues are used first to pay O&M when due and second to pay debt service and related costs. Revenues are then applied to make required reserve fund deposits and to pay subordinate obligations. Any remaining amounts are deposited in a fund separate from the revenue fund and may be either expended for other purposes or retained. In the ordinary course, revenues should be sufficient to fund all requirements. When an issuer's source of payment is limited to revenues, however, the flow of funds becomes critical if revenues are insufficient to pay all obligations.

Revenue bonds may be secured by a pledge of **gross revenues**, with the public agency nevertheless allowed to apply revenues to pay O&M, or by a pledge of net revenues (revenues remaining after the payment of O&M). A pledge of gross revenues provides greater clarity in the event of the public agency's bankruptcy and is therefore preferable. But because payment of O&M is essential to the continued generation of revenues, the practical difference between a pledge of gross revenues and a pledge of net revenues is minimal.

RATE COVENANT - Because successful enterprise operation is essential to generate revenue, revenue bond issuers must make a variety of system **covenants**. See Section 2.4.5, Covenants. The most central of these is a rate covenant in which the issuer agrees to set rates and charges at levels that will produce enough revenue to pay all amounts payable from revenues and result in net revenues each year at least equal to a specified percentage of the debt service for that year (e.g., net revenues at least equal to 120% of debt service). A rate stabilization fund, which allows the public agency to use deposits from excess debt service coverage to supplement coverage in later years, can allow a public agency the flexibility to address debt service coverage requirements over a multi-year period while maintaining a smooth rate increase trajectory. The rate covenant reflects, of course, only the contractual minimum amount of debt service coverage. Public agencies seeking strong **credit ratings** may select higher levels of savings.

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ADDITIONAL BONDS TEST - The ability to incur future debt payable from revenues at the same priority level as existing debt is important to revenue bond issuers. Additional debt tests generally require projected satisfaction of the issuer's rate covenant in future years. See Section 2.4.6, Additional Debt.

OTHER CONSIDERATIONS - A particular enterprise may be the operations of a single facility or a utility serving a large area and a variety of customer classes. Enterprises also vary in the degree to which revenues can be controlled by the public agency borrower through its status as a monopoly service provider versus revenues that are dictated by competitive market forces. An understanding of the credit is essential to the development of a successful approach to a revenue bond financing. Investors must take into account how revenues, O&M, debt service, and the rate covenant are defined as well as the assumptions used to project future revenues, O&M, and debt service.

POST-CLOSING ADMINISTRATION AND OVERSIGHT - Public agencies that operate enterprises tend to be regular borrowers. The issuer should have a long-term financial plan that is used to anticipate and structure rate increases and meet debt service coverage targets.

3.3.6.2 PUBLIC ENTERPRISE REVENUE INSTALLMENT SALE AGREEMENTS

Public revenue enterprise obligations may also be in the form of installment sales agreements. See Section 3.6.2, Installment Sale Agreements. Installment sale agreements are used by public agencies to that do not have the authority to issue revenue bonds without voter approval.

3.3.7 Special Assessments, Special Taxes, and Tax Increments

Aside from general fund revenues or enterprise fund revenues, a public agency has other options to secure debt obligations. To finance projects in specific areas, a public agency can look to secure debt obligations with revenue streams such as special assessments and special taxes with the approval of property owners or voters that will benefit from the financed project. In addition, tax increment-supported debt obligations generated by increased property values in designated areas can be considered as well.

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3.3.7.1 ASSESSMENT BONDS

Local governmental entities issue assessment bonds to pay for public infrastructure that confers a special benefit upon real property and are payable from assessments imposed on the real property. Assessments are imposed through the formation of an assessment district and constitute a lien upon the assessed property. Should a property owner fail to pay an assessment, the local governmental entity may (and will typically be required to) foreclose upon the real property to collect the assessment. Because assessment districts must be formed before assessment bonds may be issued, the process for issuing assessment bonds often takes 6 months or more.

PRINCIPAL USES - Assessment bond proceeds may be used for a variety of public works or improvements, typically streets, parks, water infrastructure, and sewer infrastructure. Assessments (but not the proceeds of bonds) may also be used to finance specified maintenance and services.

PRINCIPAL USERS - Many local governments use assessment districts and assessment bonds to finance public infrastructure facilities.

LEGAL AUTHORITY - The vast majority of assessment bonds are issued under the *Improvement Bond Act of 1915* (California Streets and Highways Code Section 8500 et seq.), referred to as the "1915 Act." 1915 Act bonds are most often secured by assessments imposed under either the *Improvement Bond Act of 1911* (California Streets and Highways Code Section 5000 et seq.), referred to as the "1911 Act," or the *Municipal Improvement Act of 1913* (California Streets and Highways Code Section 10000 et seq.), referred to as the "1913 Act." Article XIIID of the California Constitution (added by Proposition 218) and the Proposition 218 *Omnibus Implementation Act* (Government Code Section 53750 et seq.) outline the legal framework for conducting assessment proceedings. See Section 1.4.7, Assessments.

APPROVAL PROCESS - Although there are slight variations between the provisions of the 1913 Act and the 1911 Act with respect to formation proceedings, the following sequence applies generally to both types of assessment districts:

The local government entity forms an assessment district by adopting a resolution stating its intention to form an assessment district, specifying the proposed improvements, the boundaries of the district, and the intent to levy an assess-

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ment, and providing for the issuance of bonds. The issuer then records the map of the proposed boundaries of the assessment district and a report prepared by an assessment engineer that describes the special benefit of the improvement to be financed by the assessment. If the engineer's report is preliminarily approved by the issuer, a public hearing date is set and noticed, and ballots are delivered to the property owners. If, following the hearing, there is no majority protest, the local government entity moves forward with the assessment ballot proceedings. In accordance with California Constitution Article XIIID, ballots are weighted according to the proportional financial obligation of the affected parcel. If a majority of the ballots, as weighted, is in favor of imposing the assessments and forming the assessment district, the public agency may then approve the engineer's report and impose the assessments. An assessment diagram and notice of assessment is then recorded against the property subject to the assessment.

Once the assessment district is formed and the assessment proceedings are completed, the public agency may approve the bonds and the financing documents by resolution adopted by its governing board.

STRUCTURE AND DOCUMENTATION - Bonds are issued in a principal amount equal to the full cost of unpaid assessment on the property. Generally, the bonds are issued as fixed-rate bonds to avoid fluctuations in the assessments due by property owners in each year. The structure of 1915 Act bonds is very rigid and set by statute, including interest payment dates of March 2 and September 2 in each year, and matures only on September 2, a term of not greater than 39 years, and a **redemption** premium of not less than 3%. The 1915 Act also outlines specific provisions for the redemption of bonds in connection with prepayments of the assessments by property owners. Typically, bonds are structured with a reserve fund because any assessment delinquencies will result in a shortfall in amounts available to pay debt service.

OTHER CONSIDERATIONS

- *Special Benefit*. An assessment may only be imposed if there is a "special benefit" to the property that is over and above the benefits conferred upon the general public at large. General enhancement of property value, by itself, does not constitute a special benefit. Any assessment must be proportional to the benefit actually received by a parcel and the assessment may not exceed the proportional benefit. As an example, property within a community may be assessed to finance a roadway that services more than one community, but the assessment

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must be limited to the community's share of the benefit received. This may make it difficult to finance capital improvements in full from assessments. As interpreted by the California Supreme Court, "a special benefit must affect the assessed property in a way that is particular and distinct from its effect on other parcels and that real property in general and the public at large do not share."[3]

- *Standard of Review for Legal Challenge*. Since the passage of Proposition 218, the validity of assessments has become a constitutional question, subject to an independent judgment standard of review by the courts. The burden is on the public agency imposing the assessment to prove that the assessment was imposed in accordance with Proposition 218.[4]

POST-CLOSING ADMINISTRATION AND OVERSIGHT - The assessment engineer or the local agency's engineer must set the assessment levy annually in the amount of the unpaid assessment plus an annual administrative add-on equal to the costs of administering the assessment district. Typically, the assessment is collected with the property taxes by the county and disbursed by the county together with other property tax collections. The local government entity must keep careful records of the amounts allocable to any assessment district and must not comingle amounts. Some counties include assessment districts in a Teeter Plan, which results in the local government entity receiving 100% of the assessments in each year regardless of whether the assessments are paid by the property owners. The local government entity must be aware of whether the county employs the Teeter Plan and, if so, whether it applies to assessment districts. If the county does not apply the Teeter Plan to assessment districts, the local government entity will be responsible for conducting **foreclosure** proceedings in accordance with the foreclosure covenant in the bond documents, typically within a certain period after the tax installments are due. See Section 3.3.5, Teeter Bonds.

3.3.7.2 MELLO-ROOS BONDS (COMMUNITY FACILITIES DISTRICTS)

Mello-Roos bonds are payable from special taxes imposed on real property. The types of improvements that may be financed through Mello-Roos are broader than

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3 Silicon Valley Taxpayers' Association v. Santa Clara Open Space Authority, 44 Cal. 4th 431 (2008).

4 See CDIAC "Opportunities to Use Assessment Districts to Finance Facilities and Services in California Today," CDIAC No. 15-07, http://www.treasurer.ca.gov/cdiac/publications/opportunities.pdf.

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those that may be financed using assessment districts. The bonds are secured by a pledge of the special taxes imposed according to the formation of a community facilities district (CFD). The special tax is a lien upon the real property. Should a property owner fail to pay the special tax, the local governmental entity may (and will typically be required to) foreclose upon the real property to collect the special tax. Because CFDs must be formed before community facilities bonds may be issued, the process for issuing Mello-Roos bonds often take 6 months or more.

PRINCIPAL USES - Proceeds from Mello-Roos bonds may be used for a variety of public works or improvements as specified in the *Mello-Roos Community Facilities Act of 1982* (Mello-Roos Act) (Government Code Section 53311 et. seq.). Generally, bonds may be issued to finance real or other tangible property with an estimated useful life of 5 years or longer and the financed property need not lie physically within the CFD. Property and facilities that may be financed include (but are not limited to) parks, schools, libraries, child care facilities, wet and dry utilities, undergrounding of utilities, hazardous substance remediation, and seismic remediation. Under the Mello-Roos Act, CFDs may be formed to collect a special tax for certain public services and maintenance as well, including fire and police services and maintenance of facilities. Bonds may not be issued to finance services, but the special tax collected for services may be pledged to the payment of debt service on bonds. The Mello-Roos Act may also be used to finance public facilities and services provided by multiple local agencies if those agencies enter into a joint community facilities agreement or a joint exercise of powers agreement for this purpose.

PRINCIPAL USERS - A number of local government entities, including cities, counties, and special districts, use Mello-Roos bond financing.

LEGAL AUTHORITY - The Mello-Roos Act authorizes the formation of CFDs to finance the community facilities described above and authorizes the collection of special taxes within those districts. The special taxes may be used to either finance the facilities directly or to pay debt service on bonds issued to finance the facilities.

APPROVAL PROCESS - The formation process and authority to issue bonds involves several steps that begins with the adoption of local goals and policies. These goals and policies include certain provisions and limitations on the type of public facilities, credit quality for issuance of bonds, notice to subsequent owners of property, method for determining equity of **tax allocation** formulas, and for school districts, priority attendance to students residing in a CFD.

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Once a local government entity has adopted local goals and policies, it may commence formation proceedings. The first step of formation proceedings may also be forced upon a local government entity if it receives a written request signed by two members of the legislative body or a petition of 10% of the registered voters or owners of 10% or more of the area of land proposed to be included within the proposed CFD. The local government entity must then adopt a resolution stating its intention to form a CFD, specifying the proposed improvements, the boundaries of the district, and the intent to levy a special tax. The resolution should also set an appropriations limit and direct preparation of a hearing report and a resolution of necessity to incur debt. Included in the resolution of intention is approval of the rate and method of apportionment, which must provide the detail to each landowner or resident within the proposed district to estimate the maximum amount of their respective special tax obligations. Either a special tax consultant or a civil engineer prepares the rate and method of apportionment. Following adoption of the resolution of intention, the local government entity records a map showing the proposed boundaries of the CFD.

A facilities report must then be prepared and filed with the legislative body of the local government entity describing the facilities and services and the costs of providing them. Typically, a special tax consultant or civil engineer prepares this report. After a hearing on the report, which must be conducted at least 30 days after adoption of the resolution of intention, if there is no majority protest (as described in the Mello-Roos Act), the local government entity may adopt a resolution forming the CFD and a resolution to incur bonded indebtedness.

Thereafter, the local government entity must conduct an election by the qualified electors. Qualified electors are either landowners (if fewer than 12 persons were registered to vote for each of the 90 days preceding the close of the public hearing or if no special tax will be imposed on residential property) or the registered voters in the proposed district. Time limits, forms of election materials, notice, and ballot procedures are outlined in detail in the Mello-Roos Act and the California Elections Code. In an uninhabited district where landowners make up the qualified electors, waivers and consent are often obtained to waive the form and timing of the election proceedings. In a landowner vote, votes are weighted by the number of acres owned within the proposed CFD. In each case, the special tax and the issuance of bonds is subject to two-thirds voter approval. A notice of special tax lien must then be recorded and an ordinance levying the special tax enacted for the special tax lien to attach to the property in the district.

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Once the CFD is formed and the election completed favorably, the public agency's governing board may approve the bonds and the financing documents by resolution.

STRUCTURE AND DOCUMENTATION - Generally, Mello-Roos bonds are structured as fixed-rate bonds with debt service that escalates by approximately 2% annually to take advantage of the ability to increase the special tax by the same amount (if so specified in the rate and method of apportionment). The Mello-Roos Act describes in detail the structure of bonds, including interest payment dates of March 1 and September 1 in each year, with principal payable on September 1 in each year. The rate and method of apportionment may establish certain provisions for prepayment of the special tax by property owners.

OTHER CONSIDERATIONS

- *Special Benefit*. The rate and method for the levy of special taxes may be based on the benefit received or "some other reasonable basis as determined by the legislative body." The criteria are not as rigid as for assessments described above. However, in a landowner vote, the special tax may only be imposed to mitigate the effects of the new development. Specifically, a Mello-Roos special tax may only finance services "to the extent they are in addition to those provided within the area of the district before the district was created," and the "additional services may not supplant services already available within that territory when the district was created." A local agency may only conduct a landowner vote if it determines "that any facilities financed by the district are necessary to meet increased demands placed on local agencies as the result of development or rehabilitation occurring in the district."

- *Risk of Repeal of Tax*. A special tax is generally subject to reduction or repeal using the local initiative power; however, federal contract impairment issues may preclude the exercise of the local initiative power where the special tax is pledged to pay debt service on bonds.

- *Landowner Voting Concerns*. A public agency's ability to the number of qualified voters may be limited. In City of San Diego v. Shapiro, 228 Cal. App. 4th 256 (2014), a California appellate court struck down a CFD-like creation by the City of San Diego. The city had, by ordinance, created a convention center facilities district based in large part on the Mello-Roos Act, which allowed the city to impose a special tax on hotel property. The qualified electors for the convention center facilities district consisted only of the owners of real property on which a hotel stood and the lessees of the hotel property. Although the appellate court made it clear that it was not deciding the validity of landowner voting under the city's charter and ordinances, nor the Mello-Roos Act, the court concluded that "[t]here is nothing in either the text or the constitutional history of Proposition 13 that suggests that voters intended for local governments to be able to exclude large numbers of registered voters from voting in a special tax election by limiting who would be deemed 'qualified electors' for purposes of the election." Thus, though the Mello-Roos Act permits a landowner vote when there are fewer than 12 persons registered to vote for each of the 90 days preceding the close of the public hearing, most recent CFDs have been formed in areas of undeveloped land with no registered voters.

POST-CLOSING ADMINISTRATION AND OVERSIGHT - The special tax consultant or the local agency's civil engineer must set the special tax levy on an annual basis in the amount specified in the rate and method of apportionment. Typically, the special tax is collected with the property taxes by the county and disbursed by the county together with other property tax collections. It is important for the local governmental entity to keep careful records of the amounts allocable to any CFD and not to comingle amounts. Some counties that participate in the Teeter Plan include CFDs therein. See Section 3.3.7.1, Assessment Bonds.

3.3.7.3 REDEVELOPMENT AGENCIES

Created to assist in the redevelopment of blighted areas, redevelopment agencies were dissolved in 2012. The remaining successor agencies are charged with winding down the administration of the redevelopment agencies, which in some cases includes issuance of refunding bonds. Legal authority for the refunding of bonds previously issued by a redevelopment agency is set forth in California Health and Safety Code Sections 34161 et seq. and 34170 et seq. and Assembly Bill X1 26 (Chapter 5, Statutes of 2011); Assembly Bill No. 1484 (Chapter 25 Statutes of 2012); and Senate Bill 107 (Chapter 325, Statutes of 2015), together, the "Dissolution Act." Bonds and refunding bonds issued by redevelopment agencies and their successors are paid from tax increment, as calculated under the Dissolution Act.

The Dissolution Act sets forth a detailed and complex mechanism for approval of refunding bonds. Typically, the successor agency's oversight board directs the successor agency to undertake the refunding, which allows for all consultants to be paid from tax increment should the refunding fail to be approved. Once

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a pro forma set of numbers reflecting savings is prepared, the successor agency may adopt a resolution to approve the financing and all associated documents (including an indenture, purchase agreement, **official statement**, and continuing disclosure agreement), and the oversight board may adopt a resolution approving those actions of the successor agency and authorizing the refunding. Thereafter, the California Department of Finance reviews the action of the oversight board and approves the refunding. The Department of Finance has 5 days to request a review and then may take 40 days from the date of that request to approve or to return to the oversight board for reconsideration.

Many entities may have an interest in a former redevelopment agency's tax increment. The successor agency must annually prepare a statement of its obligation payment schedule for approval by the Department of Finance before it may pay those obligations from tax increment. In structuring refunding bonds, it is important to review the recognized obligations payment schedule and determine any necessary subordinations.

3.3.7.4 ENHANCED INFRASTRUCTURE FINANCING DISTRICTS

Approved by Senate Bill 628 (Chapter 785, Statutes of 2014) and modified by Assembly Bill 313 (Chapter 320, Statutes of 2015), the "EIFD Act," California Government Code Section 53398.50 et seq., enhanced infrastructure financing districts (EIFDs) build upon the existing infrastructure finance district law. Traditional public works such as transportation, transit, parks and libraries, water and sewer facilities, solid waste disposal, and flood control and drainage may be financed by EIFDs. The EIFDs may also be used for environmental mitigation, low-income housing, transit priority projects, and projects intended to "implement a sustainable community's strategy." Establishing a district begins with adoption of a resolution of intention by the legislative body of a city or county describing boundaries (which need not be contiguous), the type of facilities and development to be financed, the need for and goals of the district, the incremental property tax from the city or county, and some or all affected taxing entities in the district (if approved by resolution), and fixing the date and time for a hearing.

The initial step in forming the district is for the preparation of an infrastructure plan by the city or county engineer or another appropriate official. The plan must describe boundaries, projects, financial assistance, and the maximum portion of incremental tax of the city or county and each affected taxing entity proposed to be committed to the district each year and propose a plan of finance. Copies are

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to be sent to each landowner, to each affected taxing entity (together with any California Environmental Quality Act reports), and to the planning commission. After a public hearing, a resolution approving the plan must be adopted by the governing body of each affected taxing entity (a portion of the tax increment of which is to be allocated to the district), which must not include any school district, county board of education, or community college district. The plan can be amended to exclude any affected taxing entity that does not approve the plan. No city or county that formed a redevelopment agency can participate until the redevelopment agency has completed its winding up, either by receipt of a finding of completion from the Department of Finance or after certain enumerated steps have been taken. Bonds may be payable from tax increment but must be approved by a vote of 55% of the electors.

The new EIFD is governed by a "public financing authority" consisting of members of the legislative bodies of the participating taxing entities (comprising a majority) plus at least two members of the public chosen by their legislative bodies.

3.3.8 Single-Family Mortgage Revenue Bonds

Public agencies issue single-family mortgage revenue bonds to assist homeownership. Local agency single-family mortgage revenue bonds are issued by cities, counties, and JPAs under California Health and Safety Code Section 52000 et seq. Bond proceeds are used to make mortgage loans to first-time homebuyers who satisfy income requirements (generally family income of up of 100% of area median income for one- and two-person families and 115% of area median income for families of three or more) for the purchase of homes that satisfy purchase limit requirements (generally 90% of the "average area purchase price"). In federally designated targeted areas there is no first-time homebuyer requirement and income and purchase price limits are higher.

Bond-financed mortgage loans are either pledged to secure the bonds or are used to create Ginnie Mae, Fannie Mae, and/or Freddie Mac mortgage-backed securities that are pledged to secure the bonds. The public agency may also collect participation fees from lenders, servicers, and developers. Because the bonds bear interest at tax-exempt rates, the interest rate paid by participating home buyers can be below rates available in the conventional market. As an alternative, a portion of the bonds can be sold at a **premium** with the premium used to provide down payment assistance.

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The timing of the receipt of revenue from a pool of mortgage loans is unpredictable because homeowners may prepay home mortgage loans at any time and generally must prepay a mortgage loan if they sell the home. Single-family mortgage bonds must be structured and have redemption features that allow an adequate matching of revenues and debt service under a variety of loan prepayment scenarios. Because bond credit requires a "spread" between the interest rates payable on the bonds and the interest rate on the bond-financed loans and program effectiveness requires a spread between the interest rate on the bond-financed loans and "market" rates, single-family mortgage revenue bonds are uncommon in low interest rate environments.

3.3.9 Conduit Revenue Bonds

"Conduit financings" involve bonds issued by governmental entities to finance projects for **nongovernmental borrowers**. Federal tax exemption requires issuance of the bonds by a state or a political subdivision of a state. Bonds must satisfy the requirements in the Internal Revenue Code for tax-exempt "private activity bonds." Although a number of local governmental entities may provide conduit financing, most conduit revenue bonds are issued by JPAs or by State financing authorities.

Conduit revenue bonds are issued primarily to finance the following:

- Infrastructure qualifying as **exempt facilities**
- Small manufacturing facilities
- Hospitals and other nonprofit health care facilities
- Educational facilities
- Multifamily housing developments serving low-income tenants

Conduit financing is also provided for cultural, recreational, and other nonprofit organizations. The specifics of what can be financed with conduit revenue bonds and much of the process are dictated by the federal tax law requirements. See Section 4.7, Qualified Private Activity Bonds. The benefits of conduit financing are generally more pronounced in higher interest rate environments, where the interest rate difference between taxable and tax-exempt debt is greater.

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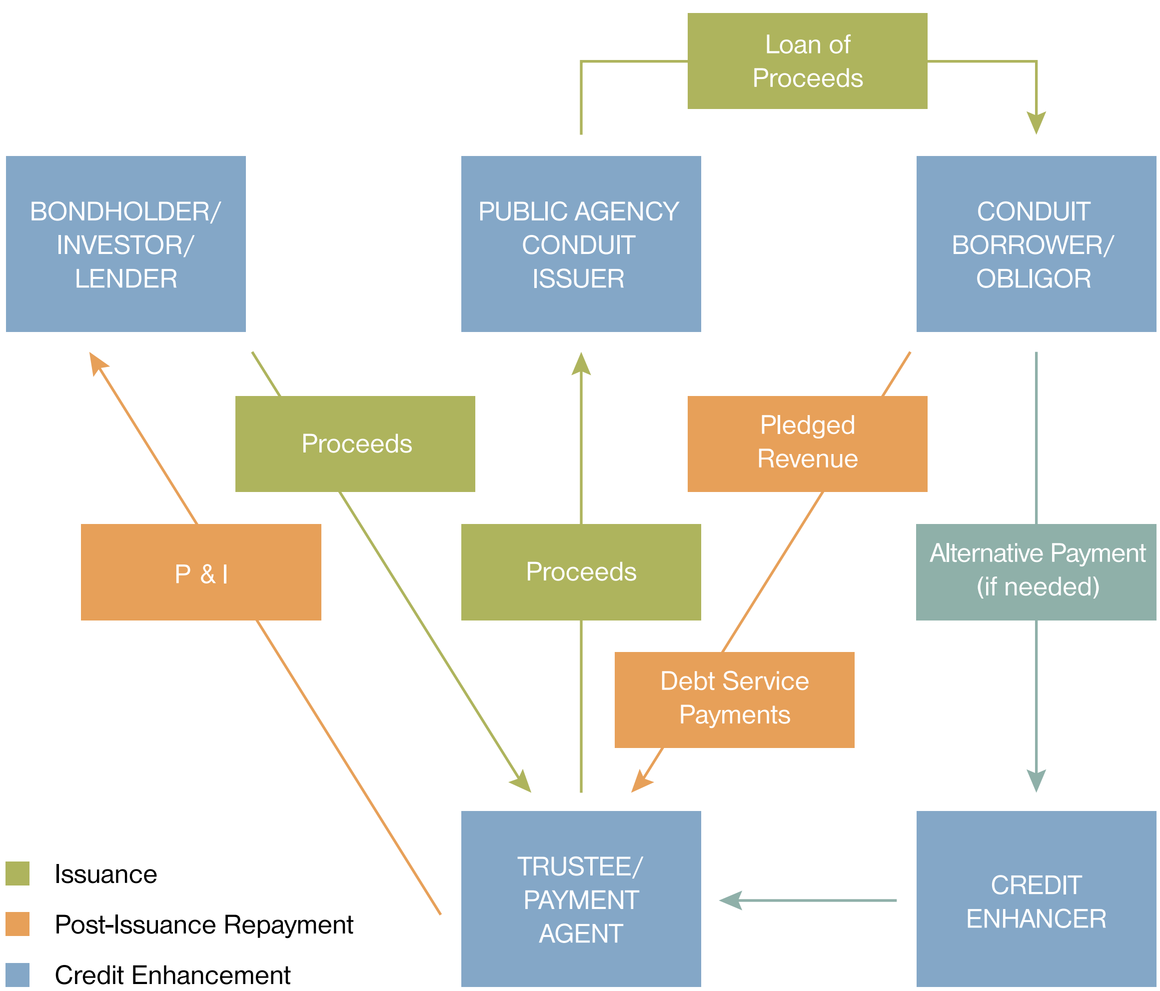
Conduit revenue bonds are generally issued by a public agency under an indenture or trust agreement between the issuer and a trustee and the bond proceeds are loaned to a private borrower. The private borrower makes loan repayments that match the debt service on the bonds. The loan repayments constitute the "revenues" securing the bonds and the public agency is obligated to pay debt service on the bonds only to the extent it receives the payments. In theory, the private entity makes loan payments to the public agency, which in turn makes payments on the bonds to the trustee who makes payments to bondholders. In practice, the private entity borrower makes payments directly to the trustee. Figure 3-5 diagrams the flow of funds in a typical Conduit Revenue Bond.

Figure 3-5

CONDUIT REVENUE BOND



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3.3.9.1 EXEMPT FACILITIES

Exempt financed facilities generally fall into one of three broad categories:

- Transportation facilities, such as airport, port, mass commuting, and intercity rail facilities
- "Utility" facilities, such as facilities for water supply, sewage, solid waste disposal, and under limited circumstances, electricity and gas
- Multifamily housing bonds (discussed below)

Many private conduit borrowers are providing services to the public that are often provided directly by governmental entities.

ISSUERS - Exempt-facility bonds may be issued by some public agencies. Most, however, are issued either by a joint exercise of powers agency (JPA) with a statewide geographic scope or by a state agency such as the California Pollution Control Financing Agency.

3.3.9.2 SMALL MANUFACTURING FACILITIES

TYPES OF FACILITIES FINANCED - Small-issue industrial development bonds ("qualified small-issue bonds" under the Internal Revenue Code) may be issued to finance manufacturing facilities and directly related and ancillary facilities. California statutes may authorize the issuance of bonds to finance commercial facilities, but federally tax-exempt bonds may no longer be issued for this purpose.

ISSUERS - Small-issue industrial development bonds may be issued by charter cities, industrial development authorities established by a city or a county, JPAs with statewide geographic scope, or a state agency such as the California Pollution Control Financing Authority.

SPECIAL CONSIDERATIONS - Qualified small-issue bonds may be issued in an aggregate face amount of not more than $1 million. The limitation on issue size may be increased to $10 million if the sum of the following items do not exceed $10 million during the 6-year period beginning 3 years before the date of bond issuance: (1) All capital expenditures made by the nongovernmental borrower or any related person for any facilities within the same political jurisdiction as the project, any other principal user of the facility being financed or any person (whether nor

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not a principal user) to benefit from the bond-financed facility, plus (2) the face amount of the bonds to be issued, plus (3) the remaining principal amount of all prior **outstanding** qualified small-issue bonds issued to finance facilities in the same incorporated municipality (or in the same county but not in any incorporated municipality) as the project being financed, in which the nongovernmental borrower for the project being financed is the owner or a principal user.

Further, a nongovernmental borrower may not be the beneficiary of a qualified small-issue bond financing if the total amount of all private activity bonds allocated to that nongovernmental borrower, plus the amount of the proposed issue, will exceed $40 million.

Small-issue industrial development bonds are generally either privately placed or sold with credit enhancement.

3.3.9.3 HEALTH CARE

TYPES OF FACILITIES FINANCED - Facilities for private hospitals and other health care facilities may be financed with tax-exempt **qualified 501(c)(3) bonds** if the borrower is an organization exempt from taxation under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (a "501(c)(3) organization"), and if the financed facilities are owned by the 501(c)(3) organization and used for its exempt purposes, not for an unrelated trade or business activity.

ISSUERS - Health care conduit financing issuers include charter cities, JPAs, and the California Health Facilities Financing Authority.

SPECIAL CONSIDERATIONS - Conduit financings for private health care facilities present issues distinct from those presented by debt issuances for health care facilities owned and operated by a governmental enterprise such as a hospital district (payable from operating or tax revenues) or health care facilities owned and operated by a general-purpose government entity (like a county hospital payable out of the general revenues of the government entity).

3.3.9.4 EDUCATION

TYPES OF FACILITIES FINANCED - Educational facilities for 501(c)(3) organizations may be financed with **qualified 501(c)(3) bonds**. Conduit borrowers include private colleges and universities, private secondary schools, and charter schools.

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ISSUERS - Education conduit financing issuers include JPAs, the California Educational Facilities Authority (for private colleges and universities), and the California School Finance Authority (for charter schools).

SPECIAL CONSIDERATIONS - The First Amendment to the United States Constitution and Article I, Section 4 and Article XVI, Section 5 of the California Constitution preclude public agencies from issuing bonds to finance facilities that will be used for religious purposes.

3.3.9.5 MULTIFAMILY HOUSING

TYPES OF FACILITIES FINANCED - The construction and the acquisition and rehabilitation of residential rental properties (multifamily housing) may be financed with tax-exempt "exempt facility" bonds if, among other things, 20% of the units may be rented only to tenants with family income of 50% or less of area median income or 40% of the units may be rented to only tenants with family income of 60% or less of area median income. The acquisition, construction and/or rehabilitation of multifamily housing projects by 501(c)(3) organizations may be financed with qualified 501(c)(3) bonds.

ISSUERS - Multifamily housing conduit financing issuers include cities, counties, housing authorities, JPAs, and the California Housing Finance Agency.

SPECIAL CONSIDERATIONS - Apart from certain financings for projects in high-cost, urban areas, multifamily housing bonds are generally issued to finance projects that receive low-income housing tax credits, with the effect that all units are rented to tenants with family income of 60% or less of area median income. Most multifamily housing bonds are privately placed, and transactions are often structured without a trustee and/or as "drawdown bonds"—obligations for which principal is advanced by the lender/bondholder as funds are needed. In some cases, the party extending credit is characterized as a lender to the public agency rather than as a purchaser of its bonds.

3.4 INTEREST RATE AND PAYMENT TERMS

The second major category of debt obligations is organized around the interest rate and payment terms of the debt obligations.

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3.4.1 Long-Term, Fixed-Rate Debt

Most municipal debt is issued as long-term, fixed-rate debt. Principal and interest are generally payable over 25 or 30 years. Publicly offered long-term, fixed-rate bonds are generally sold in **denominations** of $5,000 or integral multiples thereof and contain provisions allowing the issuer to redeem the bonds before maturity. They may be issued as **serial bonds** or as **term bonds**. Serial bonds involve the issuance of multiple bonds in a bond issue with the individual serial bonds maturing in consecutive years. Structuring the bonds in this way allows the issuer to extend the repayment period over time and to better match it with the expected life of the asset financed or the source of revenues. Serial bonds represent individual securities and are sold as such even though they may be parts of a single issue. Term bonds have a single maturity date. A bond issue may include both serial and term bonds. If so, the term bond typically matures after the final maturity of the serial bonds. See Section 2.2.2.1, Long-Term, Fixed-Rate Debt.

3.4.2 Long-Term, Variable-Rate Debt

Variable-rate debt is a popular and important tool for many local public agency issuers in providing additional flexibility to better manage their long-term debt programs. Long-term, variable-rate bonds generally come in the form of indexed bonds, variable-rate debt obligations (VRDO), and floating-rate notes. See Section 2.2.2.3, Variable-Rate Debt.

The interest rate on variable-rate debt is periodically reset in accordance with the terms under which the debt has been issued, and the rate of interest payable on the outstanding debt will generally change over the term of the issue with change in interest rates. Variable-rate municipal debt is generally sold to **institutional investors** in minimum denominations of $100,000 or more and interest is payable more frequently than with fixed-rate debt, usually monthly. Variable-rate debt is generally issued with a single maturity and with monthly, twice per year, or annual mandatory **sinking fund payments**. There are four main types of long-term, variable-rate debt:

- **Index debt**
- Tender or demand obligations
- Floating-rate notes

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- **Auction-rate securities**

Figure 2-1 provides an illustration of cash flows in a variable-rate debt structure.

3.4.2.1 INDEX DEBT

The interest rate payable on index debt is adjusted periodically in accordance with a published formula modified to reflect the tax treatment of the interest on the debt and the credit of the issuer. Longer-term index debt may bear a higher interest rate than shorter-term index debt because the longer the term of the transaction, the less precisely the benchmark index will "fit" relative to the intended performance, and debt holders are exposed to greater credit risk. Common indices include the following:

- U.S. Treasury obligation indices of various types
- The **Secured Overnight Financing Rate (SOFR)**, an index based on U.S. Treasury repurchase agreement transactions.
- The **London Interbank Offered Rate (LIBOR)**, a short-term taxable debt index[5]
- The **Securities Industry and Financial Markets Association (SIFMA)** Municipal Swap Index, a short-term tax-exempt debt index (formerly, the Bond Market Association/PSA Municipal Swap Index)

If the holder of index debt is a bank, either because the bank acquires debt directly in a **private placement** or because of a draw on a liquidity or credit facility, the index used is often the bank's "prime" or "reference" rate. The interest rate formula may be subject to adjustment if the tax character of the debt changes (if the debt is no long "tax-exempt") or less frequently, if the issuer's creditworthiness declines.

3.4.2.2 TENDER OR DEMAND OBLIGATIONS

Tender or demand obligations (referred to as "variable-rate demand obligations" or "VRDOs") are long-term obligations that achieve short-term interest rates

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[5] The Financial Conduct Authority, regulator for the United Kingdom's financial sector, has announced that LIBOR will be discontinued 2021. Alternative indices have been identified by the Alternative Reference Rates Committee formed by the Federal Reserve Board and the Federal Reserve Bank of New York. See CDIAC Issue Brief – *Preparing for the End of LIBOR: A Look at LIBOR and the USD LIBOR Alternative*, October 2018, https://www.treasurer.ca.gov/cdiac/issuebriefs/201810.pdf

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by offering a "tender" or "put" feature. Bonds may be tendered (delivered to the issuer or its agent for purchase) or may be subject to a mandatory tender when certain events occur before maturity. The intervals at which the holder can tender bonds for purchase can vary (daily, quarterly, or twice per year) but a right of a holder to tender on any business day upon providing 7 days' notice (obligations known as "weekly floaters") is the most common variable interest rate "mode." A tender can be occasioned by the following:

- An optional tender by the holder and demand for purchase by the issuer
- An election by the issuer (such as an interest rate mode conversion)
- The occurrence of a specified event (such as the expiration of a credit support or **liquidity facility** or a tender resulting from an issuer default under a credit agreement)
- A specified date or at specified intervals

The interest rate following the tender of obligations tendered in whole is generally the rate at which the securities can be **remarketed** **at par**. The interest rate on obligations subject to optional tender is generally the interest rate that the **remarketing agent**, in its professional judgment, determines to be the rate at which the securities could be remarketed at par, even if no obligations have been tendered. The interest rate on obligations subject to tender by the holders on 7 days' notice is generally reset weekly. Issuers of tender bonds must engage a broker-dealer firm to act as the remarketing agent for purposes of establishing the interest rate and remarketing tendered bonds and because the purchasers of variable-rate demand obligations require a high degree of certainty that purchase obligations upon tender will be honored, issuers that do not have very strong credit must obtain **liquidity** support for the purchase of obligations tendered and not remarketed and credit support for the debt. See Section 2.3.2, Credit Enhancement and Liquidity Support.

REMARKETING AND PURCHASE - Tendered bonds are remarketed by the remarketing agent at the interest rate (subject up to a maximum rate) that enables the remarketing agent to sell the bonds to new investors at par. If all the bonds of a series are remarketed, the remarketing may be "underwritten," meaning that the remarketing agent agrees to purchase the bonds whether or not it has identified new purchasers. Generally, however, and always in the case of VRDOs tendered by the holders, the remarketing agent's obligation to remarket the bonds is a "best efforts" undertaking.

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If the remarketing agent is unable to remarket tendered bonds, the bonds are generally purchased by the issuer's liquidity provider or are purchased for the account of the issuer with the proceeds of a draw on a line of credit or letter of credit, in which case the issuer has a payment or reimbursement obligation to the purchaser. Bonds held by a liquidity provider, or reimbursement obligations resulting from draws on liquidity facilities, generally bear interest at relatively high rates and the issuer may be obligated to pay principal more rapidly than the scheduled principal on the purchased bonds. When conditions allow, tendered bonds that are not remarketed and purchased by the liquidity provider or credit provider may be remarketed to new investors in the future. See Section 2.3.2, Credit Enhancement and Liquidity Support.

FLOATING-RATE NOTES - **Floating-rate notes** are obligations (which can be bonds) that bear interest at an index rate but are subject to mandatory tender for purchase on a future date, generally between 2 and 4 years from the offering date. The notes are usually also subject to tender at the option of the issuer for a 6-month window before the mandatory tender date. Because payment of the purchase price on the tender date is dependent upon the issuer's ability to refund or remarket the notes (including remarketing for a new **floating-rate** note period), floating-rate notes may only be issued by public agencies with strong credit ratings and reasonably assured market access.

AUCTION-RATE SECURITIES - With auction-rate securities (ARS), debt holders may offer to sell their holdings on periodically scheduled auction dates at interest rates they specify to prospective purchasers, who offer to buy the securities at interest rates they specify. The interest rate from that auction date to the next auction date is the rate that "clears the market," that is, the rate at which the aggregate dollar amount of sell orders matches the aggregate dollar amount of buy orders. The issuer of the debt has no obligation to purchase bonds offered for sale, so no liquidity support is needed. Auction-rate securities were common in the municipal market until the auction market failed to function during the financial crisis of 2008.

INTEREST RATE MODE CONVERSION - Debt documents generally allow an issuer of variable-rate debt to elect to convert the tender and interest rate period from one mode to another (e.g., from weekly to twice per year, or from daily to weekly) or to fix the rate interest on the debt to its maturity. An interest rate mode conversion may be more efficient than a refunding and may be possible even if a change in law would make a refunding impractical, either because of a change in tax law or new state

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law limitations. The debt securities are generally subject to mandatory tender for purchase on the mode conversion date and then to be remarketed in the new mode.

DOCUMENTATION - The indentures, trust agreements, and leases providing for variable-rate debt must address interest rate determination methods, tender rights and requirements, and the remarketing of tendered bonds and are therefore more complex than fixed-rate debt documents. Further documentation is also required if a liquidity or credit support facility is needed. See Section 2.3.2, Credit Enhancement and Liquidity Support. A remarketing agreement between the issuer and a remarketing agent is necessary to specify the rights, duties, and compensation of the broker-dealer engaged to determine interest rates and remarket tendered bonds.

3.4.3 Commercial Paper

A commercial paper program is a program for the issuance and marketing of short-term notes. Commercial paper consists of notes of varying, short-term maturities (no more than 270 days and generally 1 to 90 days) that are generally rolled over (paid off with the proceeds of new notes) as they mature. Commercial paper can be used as an alternative to variable-rate debt by issuing the full authorized principal amount at the start of the program. More often, however, commercial paper is used as a **line of credit**: money is borrowed (notes are issued) when funds are needed and is repaid (notes are paid and not "rolled") when funds for this purpose are available.

Tax-exempt commercial paper is a useful financing vehicle for interim financing for the construction of capital facilities eligible to be financed on a tax-exempt basis. Commercial paper notes are issued as construction costs are incurred and the notes are refunded with long-term debt when construction has been completed. Taxable commercial paper can be used as interim financing for capital facilities for which tax-exempt financing is not available, or for working capital. Some issuers actively engage in selecting the maturity dates of individual commercial paper notes and some issuers rely on their commercial paper dealers to manage the program to minimize interest expense.

A commercial paper program may be supported by a liquidity facility in the form of a line of credit or standby **bond purchase agreement**, a credit facility in the form of a **letter of credit**, or neither. See Section 2.3.2, Credit Enhancement and Liquidity Support. Purchasers of commercial paper require

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that the notes be highly rated. Only issuers with significant cash available to pay notes that cannot be "rolled" (replaced by newly issued paper) can avoid the need for a liquidity facility. Issuers with very strong credit can maintain a commercial paper program with liquidity support only. Those without very strong credit must rely on both liquidity support and credit support. Extendable commercial paper is a specialized structure where notes that cannot be rolled are extended to a 270-day maturity that is used only by a few issuers with very strong credits.

A commercial paper program also requires scale (a minimum program size of $50 million or more) and active program management. As a consequence, commercial paper programs are generally established and maintained only by large governmental entities.

3.5 TAX TREATMENT OF MUNICIPAL BONDS

A bondholder's "after tax" return on a bond depends in part upon how interest on the bond is treated in calculating the bondholder's income for federal and state income tax purposes. If interest is not taxed, a lower interest rate paid by the public agency issuer will result in the same after-tax yield to the holder as interest at a higher rate that is taxed. All other things being equal, a bond for which the interest has more favorable tax treatment can be sold bearing interest at a lower rate than the interest rate paid on another bond with less favorable tax treatment.

The federal income tax treatment of interest on bonds (commonly referred to as the bond's "tax status") issued by public agencies generally falls into one of three major categories:

1. Interest is included in the gross income of the holder (Taxable Bonds).

2. Interest is not included in the gross income of the holder but is treated as a "specific preference item" in calculating the holder's alternative minimum tax (AMT) liability (if any). That is, it is added to income for AMT purposes and effectively taxed at the AMT rate for holders subject to the AMT (AMT Bonds).

3. Interest is not included in the gross income of the holder and is not a "specific preference item" for purposes of the AMT (Non-AMT Bonds).

Most bonds issued by public agencies are Non-AMT Bonds.

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The tax status of a particular bond may depend on a number of factors, including the **date of issuance** of the bond or any bond refunded by the bond. For example:

- Bonds that fail to meet the requirements for federal income tax exemption described in Chapter 4, Federal and State Tax Law Requirements are taxable bonds.

- Tax-exempt private activity bonds (including the private activity bond portion of airport and port bonds) other than single-family mortgage revenue bonds, multifamily housing bonds, and qualified 501(c)(3) bonds are AMT Bonds. See Section 4.7, Qualified Private Activity Bonds.

- Tax-exempt **governmental bonds**, single-family mortgage revenue bonds, multifamily housing bonds, and qualified 501(c)(3) bonds are Non-AMT Bonds. See Section 4.6, Governmental Bonds/Private Activity Bonds.

Bonds issued by California public agencies are also exempt from State of California personal income taxes regardless of the federal income tax treatment. See Section 4.1, California Tax Exemption. The benefit of California tax exemption to California investors generally allows the federally tax-exempt bonds of California public agencies to be sold at interest rates lower than the interest rate on comparable federally tax-exempt bonds issued by public agencies in other states. Most bonds issued by public agencies are Non-AMT Bonds.

Federal tax law may also affect the after-tax return to investors in other ways. Tax credit bonds, for example, provide a tax credit to bondholders and **bank qualified bonds** can be held by a bank without a reduction in the bank's deduction for interest cost. See Section 4.11, Bank Qualified Bonds. This benefit to bondholders allows public agency issuers to reduce borrowing costs by increasing investor demand.

3.6 UNIQUE PUBLIC AGENCY FINANCING TO ADDRESS LEGAL CONSTRAINTS

Certain debt obligations were created to address potential hurdles California public agencies may face in issuing debt. As discussed below, financing leases, installment sale agreements, COPs, and JPA bonds have the potential for use when a public agency lacks statutory ability to issue debt. These legal structures also enable public agencies to work within statutory and constitutional debt limitations.

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3.6.1 Financing Leases

Lease financing is the basic financing tool for "governmental" capital needs—acquisition of or improvements to real property or acquisition of personal property (e.g., equipment) for the payment of which no project, enterprise, or dedicated tax revenues are available. The public agency obtains financing by entering into a lease for which it makes rental payments from all lawfully available funds (i.e., from the lessee's general fund). The public agency may lease the property to be acquired or improved, with the lessor acquiring or improving the financed property for lease to the public agency. In an alternative financing structure, known as an "asset transfer" or "equity strip," the public agency leases out and leases back an existing unencumbered property. With an asset transfer, the lease out is for a lump sum rental payment that the public agency uses to pay the costs of capital improvements elsewhere. See **Figure 3.4 Lease-Supported Debt**.

With either approach, the public agency is generally permitted to substitute other property of comparable value for the leased property, and it is common for the public agency to substitute the new asset, upon its completion, for the initially leased asset. Public agencies may also be allowed to remove properties from a lease upon partial prepayment or if the remaining leased assets are of sufficient value. Although public agencies may select from a broad range of properties, lenders and investors generally prefer that the properties subject to a **financing lease** constitute "essential facilities": facilities the public agency will have a strong incentive to retain, maintain and, if necessary, repair.

When, as is generally the case, the obligation to make rental payments under a financing lease is a general fund obligation of a local government entity subject to the limitations on indebtedness in California Constitution Article XVI, Section 18. The lease must fit within one of the debt limit exceptions. See **Section 1.2, Constitutional Debt Limit**.

The Annual Appropriation Exception, where the lessee has an annual option to terminate the lease, is a possible approach, but is not used much in California except for vendor direct-lease equipment programs, such as equipment. The Offner-Dean Lease Exception exposes investors to less risk and is more common. The Special Fund Exception is also not often used when available, because revenue bond and installment sale agreements are preferable financing obligations. The discussion in this section, therefore, is focused on financing leases relying on the Offner-Dean Lease Exception (generally referred to as "abatement leases").

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Satisfaction of the requirements of this exception, in particular the requirement that the lessee's payment obligation be abated if the lessee does not have use and occupancy of the leased property, results in financing leases having a credit quality that is slightly below the public agency's general credit standing.

PRINCIPAL USES - Lease financing is principally used for financing of non-revenue-generating governmental facilities. Asset transfer leases may, in limited circumstances, be used to obtain funds for other purposes.

PRINCIPAL USERS - Local government entities subject to the constitutional debt limit (cities, counties and school districts) are the principal users of lease financing, except with respect to financings for municipal enterprises such as water, sewer, power, or solid waste.

LEGAL AUTHORITY - The general statutory and city charter authority of public agencies to lease property covers lease financing. The leased property must be a leasable asset, which generally means land and depreciable property. Unless part of a larger project (e.g., a building or a parking lot), paint, windows and asphalt do not satisfy this requirement; dedicated public thoroughfares (i.e., bridges, highways, and streets) are questionable. The transaction must, absent another exception, be structured and documented in a manner satisfying the requirements of the Lease Exception to the constitutional debt limit. See Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception").

APPROVAL PROCESS - The public agency's governing board must approve the lease and the financing documents by resolution or, if required, by ordinance. Voter approval is generally not required and the procedural requirements for the disposition of property need not generally be followed if the property is leased back by the public agency.

STRUCTURES AND DOCUMENTATION - Documentation depends upon the answer to three basic structural questions:

1. Will the leased property be the financed property, or will the transaction be an asset transfer?
2. Will the vendor or other private lender provide financing, or will securities be publicly offered?
3. If securities will be publicly offered, will the securities be lease COPs or JPA lease revenue bonds?

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The key documentation issues for financing leases are shaped by the constitutional requirements ensuring that the public agency's rental payment obligation in each fiscal year is in consideration for the "use and occupancy" of the leased property in that year. See **Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception")**.

FAIR RENTAL VALUE - Fair rental value may be determined at the time the public agency enters into the lease, and the rent need not be reduced if the fair rental value of the facility declines. Because governmental facilities are generally not the type that are leased in a commercial context, fair rental value must usually be determined indirectly by reference to the value of the property. If the leased property is newly acquired or constructed, acquisition and construction cost can provide a reasonable proxy for value. If the leased property is an existing facility, however, value must be determined by a certification made by the public agency or, in some cases, by an appraisal.

A practical consequence of the fair rental value requirement is that the amortization period of leases for real property and improvements cannot be very short. To be **amortized** quickly, the principal payments would likely be unreasonably large and, thus, not reflective of fair rental values. In addition, variable-rate leases pose two significant challenges to the fair rental requirement. First, either because market rates rise, or because tendered securities cannot be remarketed and are held by the credit or liquidity provider and bear interest at a "bank rate," interest rates can rise to levels which, if not limited, could cause rental payments for a fiscal year to exceed fair rental value. Second, the limits imposed by the fair rental value requirement may keep the public agency from being able to agree to immediately reimburse the credit or liquidity provider following a default, the inability to remarket a security, or the expiration of a credit or liquidity facility. Although these issues can be addressed (for example, with rent caps subject to carry-forward), they can cause complications in negotiations with credit and liquidity providers, particularly in high-interest-rate environments.

NO ACCELERATION - Because acceleration would require prepayment of rent (paying during the current fiscal year for use and occupancy in future years) a financing lease may not allow the lessor, as a default remedy, to declare future rental payments immediately due and payable.

ABATEMENT - A public agency lessee may not have use and occupancy of a leased property if construction of the leased property is not completed on schedule

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(construction risk), if the property is seized by eminent domain (takings risk), or if the property suffers a casualty loss (casualty risk). In such cases, the lessee would not be obligated to make lease payments under an abatement clause.

Construction risk can be addressed by capitalizing interest to a date (generally 6 months) past the expected completion date, and by performance bonds and insurance. Construction risk can be avoided entirely by using an asset transfer structure in which the asset leased is a built facility. Takings risk is not generally a significant issue, as eminent domain proceedings against public property are rare, and condemnation proceeds are a source to prepay lease obligations. Casualty risk can be addressed by insurance, including business interruption insurance, but earthquake insurance is expensive and is not generally required. "Self-insurance" in the sense of an independent and actuarially sound plan is generally permissible; "self-insurance" in the sense of absorbing the risk of being uninsured is not, because it undercuts the abatement requirement.

Debt service reserve funds address abatement as well as general lessee credit risk. Debt service reserves are therefore very common in publicly offered financing lease transactions and are more common in the financing lease context than for other municipal debt offerings with issuers of comparable credit standing.

Additional factors that may determine the structure of a financing lease include the following:

1. Will the trustee (acting on behalf of the bond or COP holders as assignee of the lessor) have as a default remedy the right to terminate the lease and take possession of the leased property? The alternative is to limit the trustee's remedy to bring suit for each year of unpaid rent. A termination right is an encouragement to the lessee to make every effort to pay the rent. Repossession may not, however, be practicable and the repossession claim may, depending upon the circumstances, not be enforced if enforcement would have an adverse impact on public health and safety. The "essentiality" of the facility, of course, affects both the value of a termination remedy if enforceable and, in contrast, the likelihood that it would be enforced.

2. What will the value of the leased property be in relation to the aggregate principal component of the rent? The value of the leased property must be sufficiently high to support the rent level, but should/may it be significantly higher (often referred to as "overcollateralization")? If lease termination is a remedy, overcol-

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lateralization provides lenders and investors greater security. Overcollateralizing the lease may alter the economics of the transaction in such a way as to compel the lessee to meet the terms of the lease. The risk is that this may undermine the debt limit exception provided to lease financings. Leasing more property than necessary also reduces the amount of unencumbered property available to the public agency for other asset transfer leases.

3. Will a master lease structure be used? Master leases allow the public agency to add, in later transactions, additional properties and additional rent obligations. A master lease structure offers the public agency greater flexibility but reduces the level of comfort lenders and investors may receive from knowing what the leased property is. Liberal property substitution provisions in a lease involve the same trade-off.

OTHER CONSIDERATIONS - When the lease itself is to be the tax-exempt obligation it must be "debt" (an installment payment obligation) for federal income tax purposes and must have a separately stated interest component.

POST-CLOSING ADMINISTRATION AND OVERSIGHT - A financing lease ties up property. Either lease restrictions or title or federal tax law considerations may limit to some extent the public agency's flexibility in using the leased property or to sublease it or allow encumbrances. The maintenance and use of the property must therefore be monitored for the full term of the lease.

3.6.2 Installment Sale Agreements

Installment sale agreement financings are based on a public agency's legal authority to purchase property, including property used by its enterprises and to appropriate annual funds to meet this obligation. To create a security marketable to investors, the public agency must employ a COP structure or a JPA bond structure, which are each more complex than a revenue bond structure. Installment sale agreements are the preferred financing vehicle for enterprise revenue debt when the issuance of revenue bonds requires voter approval.

PRINCIPAL USES - The principal uses of installment sale agreements are essentially the same as described above in Section 3.3.6.1, Public Enterprise Revenue Bonds.

PRINCIPAL USERS - The principal users of installment sale agreements are public agencies that may not issue enterprise revenue bonds without voter approval.

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LEGAL AUTHORITY - Virtually every public agency has the authority to purchase property, and voter approval is rarely required.

STRUCTURE AND DOCUMENTATION - Unless the debt is placed with a single lender, public agencies use either a COP structure or a JPA bond structure. Structure and documentation considerations are otherwise the same as described above in Section 3.3.6, Enterprise Fund Debt Obligations.

3.6.3 Certificates of Participation

In a lease COPs financing the governmental obligation is a lease entered into between the public agency as lessee and a financing entity as lessor. The financing entity may be a governmental entity (such as a JPA), a nonprofit corporation, or even a for-profit corporation. Public agencies often create a nonprofit corporation to play this role. Under the lease, the public agency lessee is obligated to make base rental payments, which are separated into principal and interest components. The right to receive base rental payments is assigned by the financing entity to the trustee of a trust established under a trust agreement. The basic documents are a lease (between the public agency and a lessor), an assignment agreement (between the lessor and a trustee), and a trust agreement (among the public agency, the lessor, and a trustee). The trustee executes and delivers COPs evidencing interests in the right to receive base rental payments and the COPs are sold to investors. The public agency lessee makes base rental payments to the trustee, who makes payments to COP holders.

In an installment sale agreement COPs financing the governmental obligation is an installment sale agreement entered into between the public agency as purchaser and a financing entity as seller. Under the installment sale agreement, the public agency purchaser is obligated to make installment sale payments and interest thereon and the right to receive the payments is assigned by the financing entity to the trustee under a trust agreement. The basic documents are an installment sale agreement (between the public agency and a seller), an assignment agreement (between the seller and a trustee), and a trust agreement (among the public agency, the seller, and a trustee). The trustee executes and delivers COPs evidencing interests in the right to receive installment sale payments and interest thereon and the COPs are sold to investors. The public agency purchaser makes installment sale and interest payments to the trustee who makes payments to COP holders. See Figure 3-4 for a cash flow diagram.

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The principal advantage offered by the COP structure is the flexibility it offers with respect to the identity of the financing entity. For governmental entities that are not able to establish a JPA with another governmental entity, the COP structure may be an attractive alternative. In most other cases, however, the disadvantages inherent in COP structures outweigh any advantages they have over JPA revenue bonds: public agencies that have or can easily form a financing JPA tend to structure transactions as JPA lease revenue bonds or JPA installment sale revenue bonds rather than as lease COPs or installment sale COPs.

Other reasons the JPA lease or installment sale structure may be preferred to a COP structure include:

- Although the lease or installment sale agreement, and consequently the security and source of payment for the debt holder, would be the same whether the transaction is structured as COPs or JPA bonds, publicized problems with COP transactions—even if entirely unrelated or in another state—sometimes make COPs less attractive to investors than bonds. This perception of problems may result in increased interest costs for COP transactions.

- COP structures are even more complex than JPA revenue bond structures and therefore are more difficult to document and explain to non-experts.

3.6.4 Joint Powers Agency or Authority (JPA) Bonds and Other Issuances

Due to the extensive bond issuance authority afforded JPAs under government code, JPAs are a common vehicle for issuing bonds that are backed by either a lease or installment sale agreement. JPA revenue bond structures (JPA bonds) are of two principal types: lease revenue bonds issued by a JPA and installment sale revenue bonds issued by a JPA. See Section 3.8, Joint Exercise of Powers Agencies. With a lease revenue bond issue, the JPA as lessor enters into a lease with the public agency as lessee and issues "revenue bonds." The base rental payments made by the public agency under the lease match the principal and interest on the bonds issued by the JPA and constitute the "revenues" securing the JPA bonds. The basic documents are a lease (between the public agency and the JPA) and a trust agreement and indenture (between the JPA and a trustee). In theory, the public agency makes base rental payments to the JPA, which in turn makes payments on the bonds to the trustee, who makes payments to bondholders. In practice, the public agency makes its payments directly to the trustee, who makes payments to bondholders.

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With an installment sale revenue bond issue, the JPA as seller enters into an installment sale agreement with the public agency as purchaser and issues "revenue bonds." The installment payments and the interest payable thereon under the installment sale agreement made by the public agency under the installment sale agreement match the principal and interest on the bonds issued by the JPA and constitute the "revenues" securing the JPA bonds. The basic documents are an installment sale agreement (between the public agency and a JPA) and a trust agreement or indenture (between the JPA and a trustee). In theory, the public agency makes installment sale and interest payments to the JPA, which in turn makes payments on the bonds to the trustee, who makes payments to bondholders. In practice, the public agency makes its payments directly to the trustee, who makes payments to bondholders.

Rather than by a JPA, a nonprofit corporation can issue the bonds on behalf of the public agency (referred to as "63-20 bonds" because of the applicable Internal Revenue Service Revenue Procedure). See **Section 4.2.3.2, 63-20 Corporations**. These 63-20 bond issues were once common but are now rare.

3.7 OTHER OBLIGATIONS

Municipal debt obligations do not always exhibit the typical features of debt, because their features result from factors such as the manner of the issuance of the debt, the kind of investor, or something else. Types of municipal debt not conforming to one of the other groupings include direct loans, direct leases, bond or grant anticipation notes, other tax and fee-secured debt, asset securitizations, refunding bonds, and pool bonds, discussed in the sections below.

3.7.1 Direct Loans

A direct loan is an extension of credit by a bank or other financial institution to a public agency borrower. The bank may advance all funds at closing or advance funds over time as needed by the borrower, with interest paid only on funds advanced (generally referred to as a "drawdown" loan). Direct loan documents, like credit facility reimbursement agreements (See **Section 2.3.2, Credit Enhancement and Liquidity Support**), include issuer representations, warranties, covenants, and default provisions more extensive than those in a **public offering** and tend to be negotiable.

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A public agency's borrowing authorization generally covers issuing bonds or notes rather than obtaining loans. To stay within the agency's authorization, a direct loan may be structured as a bond purchase issued by the public agency, or a loan repayment obligation may be evidenced by a note executed and delivered by a public agency. In this case, a separate agreement between the public agency and the bank, often referred to as a "continuing covenants agreement," may address additional bank requirements. A direct loan may also be structured as a direct lease or installment sale agreement.

3.7.2 Direct Leases

The direct lease (or lease-purchase) structure is most often used to finance the acquisition of equipment such as fire trucks. In the usual transaction, the public agency leases the property from the lender, which may be the vendor of the property, a leasing company, or a bank. Under the financing lease, title to the property is transferred to the public agency upon expiration of the lease term. A portion of each lease payment made by the public agency is designated as interest, which may qualify as tax-exempt income to the lender. The lender may then transfer its interest in the lease to another party. The basic document is a financing lease (between the lessor and the public agency), and rental payments are made by the public agency directly to the lessor or to a party to whom the lessor has assigned its right to receive the payments. An alternative to a direct lease is an installment sale agreement in which the lessor is instead a seller and the public agency lessee is a buyer, and the public agency makes installment payments rather than lease payments. See Figure 3-2 for a cash flow diagram of a direct lease (private placement).

3.7.3 Bond Anticipation Notes and Grant Anticipation Notes

Bond anticipation notes (BANs) are notes issued in advance, generally several years in advance, of the expected date of long-term financing for a project. All principal is payable at maturity and, although the notes may be payable from the issuer's general funds or from enterprise revenues, they are sold with the understanding that the issuer is unlikely to have funds sufficient to repay note principal on the stated maturity date; the expected source of payment is long-term debt issued to refund the notes. To avoid causing concern for other debt, bond anticipation notes are generally structured as obligations subordinate to the issuer's long-term debt. Grant anticipation notes (GANs) are similar to bond anticipation notes, with the source of payment being a grant (e.g., a federal or state grant

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funded only upon the project's completion) rather than the proceeds of long-term debt.

BANs and GANs need not be in the form of notes. They can be bonds or installment payment obligations, although fair rental value constraints generally preclude the use of lease financing. BANs and GANs may also be longer-term obligations subject to mandatory tender for purchase.

BANs and GANs are useful interim financing vehicles if investors can be given a high level of certainty that funds will be available for payment at maturity. For BANs, the key is issuer market access. The issuer must have solid credit and there can be no significant procedural obstacles, such as voter or third-party approval, to the issuance of the long-term debt. For GANs, the key is near certainty of the receipt of grant funding: grant amounts must have been (or are expected to be) budgeted, and funding conditions must be within the issuer's control.

3.7.4 Other Tax and Fee-Secured Debt

Public agency bonds and other debt obligations may also be secured by taxes and fees levied by the public agency, such as parcel taxes, fines, concession fees, admissions and event taxes, parking fees and taxes, utility user taxes, transient occupancy taxes, and license fees. Because investors are generally unwilling to assume significant risk that a key (or the sole) source for debt repayment may be subject to legal challenge, it is often necessary to obtain a judicial determination that the fee in question is not a "tax" or to have followed meticulously the requirements for approval of a special tax, as applicable. See **Section 1.4, Local Government Revenue Sources - Security for and Repayment of Debt**.

3.7.5 Asset Securitization

An asset securitization involves a public agency selling either assets expected to generate future revenues, such as tax or other receivables, or the right to receive a stream of payments, such as litigation settlement payments payable over time. The assets are sold to a special-purpose entity that issues debt payable from and secured by the assets and applies the proceeds of the debt to pay the purchase price of the assets to the public agency. Asset securitizations are rare and highly complex transactions.

3.7.6 Refunding Bonds

Refunding obligations are any municipal debt obligations used to pay principal, interest and premium on other municipal debt (referred to in this section as "refunded bonds"). Principal on refunded bonds may have become payable for any reason, including maturity, mandatory redemption, or default acceleration, but refunding bonds are generally issued to pay refunded bonds that have been called for optional redemption. Further, refunded bonds may be redeemed optionally for a number of purposes, including covenant relief, asset release, and debt restructuring, but refunding bonds are generally issued and refunded bonds redeemed to save money on the debt service. See **Section 2.3.1, Redemption or Prepayment**. If current interest rates are significantly lower than those payable on the refunded bonds, public agencies can reduce debt service costs by replacing the refunded bonds with new, lower-interest, cost-refunded bonds. Public agencies often refund only the portion of the refunded bonds on which significant savings can be achieved.

Retirement of the refunded bonds generally occurs (1) shortly after the refunding bonds' issue date, or (2) on the first date that the issuer may redeem the outstanding obligations. In a refunding transaction, the refunding bonds are issued to pay all or a portion of the interest and principal of the prior obligations, including redemption premium (if any). Bonds are **advance refunding** bonds if their proceeds are expended to pay principal, interest, or redemption premiums (if any) on the prior obligations more than 90 days after the refunding bonds' issue date. Bonds are **current refunding bonds** if their proceeds are expended to pay the principal or interest on the prior obligations within 90 days after the refunding bonds' issue date.

Since the *Tax Cuts and Jobs Act of 2017* ended tax-exemption for municipal advanced refundings, issuers' options regarding refundings of tax-exempt bonds are limited. Issuers seeking to refund tax-exempt debt may consider other options, with the assistance of their **municipal advisor**, including taxable refundings or other debt structuring techniques to facilitate benefits similar to an advanced refunding.

LEGAL AUTHORITY - Statutes providing for bond issuance generally provide for refunding bond issuance. In addition, several statutes (e.g., California Government Code Sections 53500 et seq. and 53570 et seq.) provide general authority to public agencies to refund outstanding debt, including installment payment obligations under installment sale agreements, with refunding revenue bonds.

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Issuing a refunding bond usually does not require voter approval, even if the issuance of the refunded bond did.

STRUCTURE AND DOCUMENTATION – Where an advance refunding is possible, the proceeds of the refunding bonds are generally used to purchase obligations (defeasance securities) of the type permitted by the terms of the outstanding debt to be used to "defease" the outstanding debt. See Section 2.4.10, Discharge and Defeasance. Defeasance securities generally are deposited in an escrow fund for the refunded bonds. The principal, interest, and redemption premium (if any) on the refunded bonds will then be paid from amounts derived from the defeasance securities on deposit in the escrow fund until the date on which the issuer may redeem the refunded bonds. Although the refunded bonds are still held by the bondholders until their call date and continue to be traded on the market, the indenture or bond resolution is legally defeased with respect to the refunded bonds, and the holders of the refunded bonds look to the escrow fund rather than the issuer's revenues or other collateral for payment.

In a current refunding transaction, the refunding bonds' proceeds are used to pay the principal of and interest on the refunded bonds on or shortly after the refunding bonds' issue date. The refunded bonds generally are legally defeased, and the holders of the refunded bonds generally look to the escrow fund for payment.

A refunding escrow is generally established under an escrow agreement between the issuer and the trustee for the refunded bonds or according to a letter of instructions from the issuer to the trustee. The escrow agreement or letter of instructions provides for the establishment of an escrow fund, the deposit of money with the trustee, the purchase of the defeasance securities by the trustee and the application of amounts received with respect to the defeasance securities and other amounts in the escrow fund to the payment of the refunded bonds.

Defeasance securities may consist of U.S. Treasury Notes and Bonds - State and Local Government Series (**SLGS**, pronounced "slugs"), a special series of U.S. Treasury obligations designed to be used for refunding tax-exempt debt or securities purchased on the open market (an "open market" escrow). In an "open market" escrow, if defeasance securities maturing on the precise dates on which amounts are needed to pay the refunded bonds are not available on the market, the escrow will be "inefficient." Inefficiency can be addressed through the substitution of more efficient securities for the defeasance securities in the escrow or through instructions to the trustee to reinvest in other qualifying securities (if then available) between the

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date the original defeasance securities' mature or pay interest and the date amounts are needed to pay the refunded bonds. For example, if the defeasance securities mature on May 15 and the refunded bonds are to be paid on July 1, the trustee can be instructed to reinvest proceeds of the defeasance securities received on May 15 in new qualifying securities maturing on or before July 1. Alternatively, the issuer's right to reinvest can be sold (for money up front) under an arrangement commonly known as a "forward supply contract."

OTHER CONSIDERATIONS - The *Tax Cut and Jobs Act of 2017* amended the Internal Revenue Code of 1986 to prohibit the issuance of tax-exempt advance refunding bonds. Issuing taxable advance refunding bonds may, however, still produce debt service savings. An issuer may issue current refunding bonds to refund either governmental bonds or private activity bonds. There is no limit on the amount of times a governmental bond issue or a private activity bond issue may be currently refunded. See Section 4.12, Refunding Bonds.

3.7.7 Pool Bonds

Pool bonds are payable from payments made by governmental entities (participants) on two or more debt obligations. The pool bond issuer purchases each of the participants' debt obligations (or enters into leases or installment sale agreements with the participants) and issues its own bonds secured by and paid from payments received on the participant obligations (referred to as "underlying obligations"). The bond pool issuer may be a JPA or an entity created or authorized to act in this role for other agencies.

This basic structure includes many different pool bond issue types. The principal distinguishing features of pool bonds are the following:

- Pool bond issuer
- Number of participants
- Types of participant obligations
- Parity debt flexibility
- Credit risk sharing

POOL BOND ISSUERS - Under the *Marks-Roos Local Bond Pooling Act of 1985* (the "Marks-Roos Act," California Government Code Section 6584 et seq.), JPAs

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have broad authority to issue bonds to finance public capital improvements and to acquire obligations of local government entities and to enter into leases and installment sale agreements with local government entities. A JPA can be established by the pool participants to issue pool bonds for the participants or can be an established JPA with a broad geographic scope operating a pool financing program. (See Figure 3-6) A "captive" JPA (a JPA created by a public agency and having the same governing board, for example a city and the city's financing authority) allows the participants greater control of the financing but tends to be impractical if there is more than one pool participant. (See Figure 3-7) State agencies also issue pool bonds in connection with financing programs for local government entities.

NUMBER OF PARTICIPANTS - Financing pools vary in size, from small to large. The underlying obligations may also be obligations of a single public agency payable from separate sources (e.g., one underlying obligation payable from the revenues of a city's water enterprise and another payable from the revenues of the city's wastewater enterprise).

TYPES OF PARTICIPANT OBLIGATIONS - Pool bonds are issued in connection with a large variety of underlying obligations. For a given pool bond issue, however, the underlying obligations are most commonly of the same type, such as TRANs issued by school districts or water or wastewater enterprise revenue obligations.

Figure 3-6

MARKS-ROOS LARGE SCALE POOL

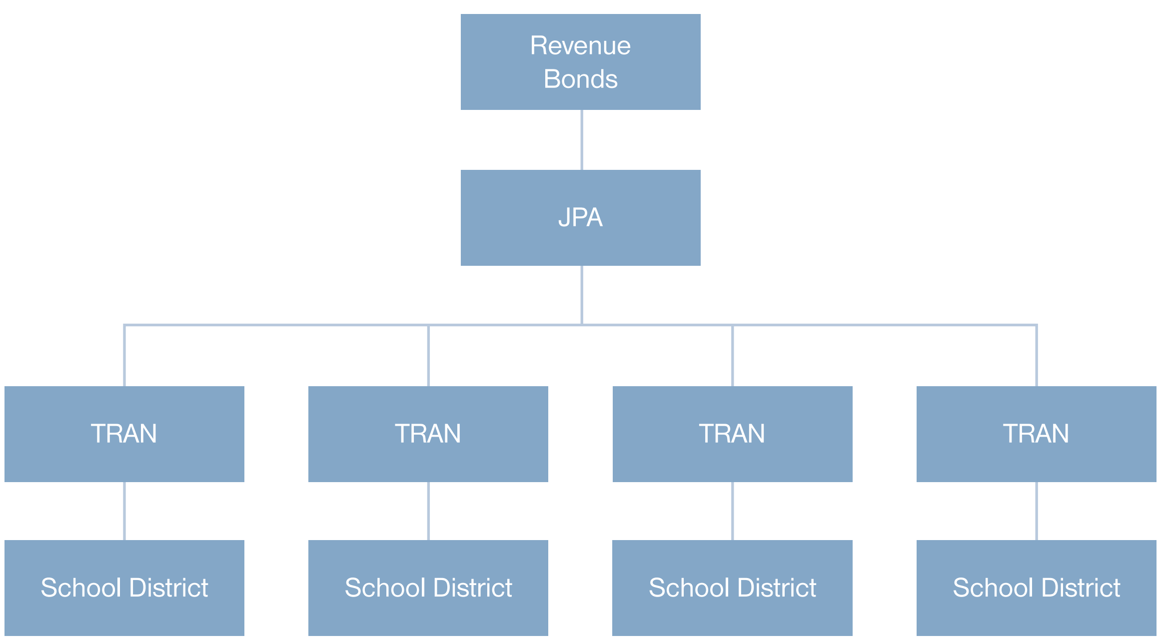

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Figure 3-7

MARKS-ROOS CAPTIVE POOL

PARITY DEBT FLEXIBILITY - Pool bonds may fund a "closed pool" or an "open pool." With a closed pool (also known as a "dedicated pool") all of the underlying obligations are set at the time the pool bonds are issued. With an open pool (also known as a "blind pool"), additional underlying obligations may be added, and **additional bonds** issued, with the initial and subsequent bonds both secured by the initial and subsequent underlying obligations. An open pool allows for the creation of large pools and the associated diversification can improve the security for the pool bonds. Because the ultimate source of payment of pool bonds secured by an open pool is not known when the initial bonds are sold, an open pool structure requires strict and well-articulated requirements for subsequent underlying obligations.

CREDIT RISK SHARING - A pool bond issue can be structured so that each underlying obligation is a completely stand-alone obligation, meaning that no participant is required to incur any increased cost or risk any benefit because of a default by another participant on another underlying obligation. The diversification of underlying obligations may provide investors protection against a significant loss on default where a payment default by any participant could result in a payment default on the pool bonds. Pool bond issuers generally attempt to address this

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"weakest link" concern by unifying the credit through **bond insurance** or other credit enhancement for the pool bonds.

A pool bond issue can also be structured so that the pool bond security is stronger than the sum of the underlying obligations. This generally requires a degree of credit risk sharing. If the pool bond issuer has "equity" to contribute or put at risk, the risk of loss from a participant default can be borne by the issuer.[6] An issuer contribution can take the form of a cash deposit, a pledge of a greater principal amount of loans as security than the principal amount of the pool bonds or, if the pool has been active for a while, the retention of excess in the pool bond indenture. Credit sharing may also be done across pool participants through "step-up" provisions that increase other participants' obligations by amounts sufficient to cover nonpayment by a participant or with a common reserve fund funded by all participants but available to be used in the event of a default on any underlying obligation.

ADVANTAGES - Possible advantages to a participant include the following:

- Marketing benefits in selling a large issue
- Spreading of issuance costs
- Access to the public market for smaller and/or less creditworthy public agencies

DISADVANTAGES - Possible disadvantages to a participant include the following:

- Loss of flexibility in timing, because the whole issue must move as one
- Loss of flexibility in debt structure because it is generally preferable for marketing purposes for the underlying obligations to have similar terms
- Loss of control over the selection of **bond counsel**, trustee, and underwriters
- Exposure to the credit of other participants if there is credit sharing at the participant level

In general, public agencies do not use pool bonds for debt issuances of sufficient creditworthiness to allow market access and of sufficient size to support the costs of issuance of a stand-alone issue. Pool bond programs may, however, be of great value to smaller public agencies with relatively small borrowing needs.

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[6] A public agency may have a funding source such as federal grant money or may elect to subsidize an activity from its own resources. These funds can often be used most effectively as "leverage," as a source of support for a large lending program.

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3.8 JOINT EXERCISE OF POWERS AGENCIES

A joint exercise of powers agency or authority (JPA) is a separate governmental entity formed by two or more governmental entities. A JPA is created by an agreement (generally called a "Joint Exercise of Powers Agreement" and referred to as a "JPA agreement") among the governmental entities forming the JPA (JPA members). Once established, the JPA is an independent governmental entity separate from the JPA members, with its own governing board, officers, bylaws, conflict of interest code, and treasury, although the governing board, officers, and staff of the JPA are usually representatives from the governing boards, officers, and staffs of one or more of the JPA members. California JPAs have two sources of powers: (1) those powers common to its members and assigned to the JPA, and (2) independent powers granted to JPAs such as the powers granted in the *Marks-Roos Local Bond Pooling Act of 1985* (the "Marks-Roos Act").

The laws governing JPAs are quite flexible and JPAs can be used for a variety of purposes. A single JPA can serve a variety of functions and can evolve over time. JPAs generally, however, are of one of three types: (1) a truly independent governmental entity, (2) a vehicle for joint action by JPA members, or (3) a financing vehicle.

An example of a truly independent JPA is one established to operate an enterprise serving a multi-jurisdictional area (e.g., a regional treatment facility). Such a JPA generally has its own staff and employees and can often borrow on its own credit (i.e., on the strength of the revenue-producing capability of the enterprise it operates).

An example of a JPA serving as a vehicle for joint action by JPA members is a JPA established to finance a project, the costs and benefits of which are to be shared by participating JPA members (e.g., a shared power-generation facility). In this case, the officers and staff of the various JPA members work in partnership to manage the affairs of the JPA. Joint venture JPAs often need to rely on JPA member payments to repay JPA debt. Financing can, in this case, be done by the members jointly, with "step-up" or other provisions obligating other JPA members to cover debt service if one JPA member cannot cover its share, or separately, with each JPA member borrowing on its own credit and making contributions or advances to the JPA.

The ability to use a JPA as a financing vehicle is derived largely from the Marks-Roos Act (California Government Code Section 6584 et seq.). Under the Marks-Roos Act, JPAs have a variety of powers designed to enable them to assist in the

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financing of "public capital improvements" (a broadly defined term). These powers include the power to buy, sell, and lease property, issue revenue bonds, and buy and sell local agency bonds and other debt obligations. Several financing JPAs with statewide scope have been established to assist borrowers by issuing bonds on a conduit basis. Financing JPAs are also often formed by a governmental entity to assist in its financings through a JPA agreement between it and a separate entity governed by its governing board, such as a JPA formed through a JPA agreement between a city and its housing authority. This is referred to as a "captive JPA."

One use of a financing JPA is to pool credits. If, for example, a governmental agency was issuing debt payable from separate enterprises, the debt could be sold to the JPA, which would issue bonds backed by an undivided interest in all of the debt. JPAs can also be used for pool financings for multiple governmental entities. See **Section 3.7.7, Pool Bonds**. A financing JPA can also issue lease or installment sale revenue bonds instead of COPs. The governmental entity could, for example, enter into a lease or installment sale agreement with the JPA, which would issue bonds backed by the entity's payments under the lease or installment sale agreement. See **Section 3.3.9, Conduit Revenue Bonds** and **Section 3.6.4, Joint Powers Agency or Authority (JPA) Bonds and Other Issuances**. Finally, a financing JPA can be used to avoid limitations in bond statutes. **Competitive sale** requirements, for example, can be avoided by selling bonds to the JPA for resale to the underwriters at a **negotiated sale**.

3.9 STATE FINANCINGS

The State of California uses a variety of financing vehicles. These have included financings as complex as warrant issuances and asset and tax revenue securitizations but the most commonly used tools are State GO bonds, lease revenue bonds issued by the State Public Works Board payable from lease payments made by state departments and agencies, and revenue anticipation notes. State enterprise departments generally finance facilities and programs through the issuance of obligations payable from enterprise and program revenues.

3.9.1 State General Obligation Bonds

State GO bonds are issued under a voter-approved bond act authorizing the issuance of bonds up to a stated amount for described purposes adopted in accordance with California Constitution Article XVI, Sections 1 and 2, the State

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General Obligation Bond Law (California Government Code Section 16720 et seq.), and a bond resolution. The timing of the bond sales is determined by the State Treasurer. Each bond act provides that the State will collect annually in the same manner and time that it collects other State revenue an amount sufficient to pay principal of and interest on the related series of GO bonds in that year.

Each bond act further provides that the bonds issued under it "shall be and constitute a valid and binding obligation of the State of California, and the full faith and credit of the State is hereby pledged for the punctual payment of the principal of, and interest on, the bonds as the principal and interest become due and payable." The pledge of the full faith and credit of the State does not create a lien on any particular moneys in the State General Fund or any other assets of the State but is an undertaking by the State to be irrevocably obligated in good faith to use its taxing powers as may be required for the full and prompt payment of the principal of and interest on all State GO bonds as they come due. Only California Constitution Article XVI, Section 8 (which says that the State will first set aside money to support the public school system and public institutions of higher education) creates a higher priority for any State fiscal obligation.

State GO bonds are issued for a wide variety of purposes and, because they are supported by the financial resources and taxing power of the State, provide low-cost, long-term, fixed-rate financing. State GO bonds differ from the local government GO bonds described above in **Section 3.3.1, Local Agency General Obligation Bonds**, in two critical respects: (1) State GO bonds are payable from State general funds, not *ad valorem* property tax revenues; and (2) unlike the authorization of an increase in *ad valorem* property tax rates inherent in voter approval of local agency GO bonds, the authorization of State GO bonds does not create an additional source of revenues. If the facilities or program financed with State GO bonds generates revenues, however, the revenues may be applied to the bond payments, making the State's GO credit more a guarantee than a primary source of payment.

3.9.2 State Public Works Board Lease Revenue Bonds

The California State Public Works Board issues lease revenue bonds under the *State Building and Construction Act of 1955* (California Government Code Section 15800 et seq.) to finance capital improvement projects for "state agencies," defined as state offices, officers, departments, divisions, bureaus, boards, commissions, or-

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ganizations, and agencies. State Public Works Board lease revenue bonds are payable from base rental payments made by the state agencies for whom the financings are done under leases of the financed facilities to the respective state agencies and are additionally secured by a master debt service reserve fund. State agencies make rental payments from funds authorized for that purpose in the state budget, so the ultimate source for the payment of State Public Works Board lease revenue bonds is the State's general fund. The leases are structured to satisfy the requirements of the Lease Exception to the constitutional debt limit, including rental abatement if the state agency does not have use and occupancy of the leased facilities. See Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception").

3.9.3 Revenue Anticipation Notes

The State issues revenue anticipation notes (RANs) to manage cash flow. The RANs provide funds for expenditures early in a fiscal year and are paid from tax and other revenues received by the State later in the fiscal year. RANs are issued under California Government Code Section 17300 et seq. and a resolution adopted by the State Treasurer, are approved by the State Controller and the State Director of Finance, and may be issued as either fixed-rate or variable-rate obligations. RANs must mature within 120 days of the end of the fiscal year and they satisfy the Current Fiscal Year Exception to the constitutional debt limit because the State's payment obligation is limited to unapplied money for the fiscal year in which the notes are issued. See Section 1.2.4.1, Current Fiscal Year Exception. "Unapplied money" means money in the State General Fund for which payment warrants have not been drawn, subject to a priority for amounts needed to support the State's school system and public institutions of higher education, to pay the principal of and interest on State GO bonds and notes and to reimburse internal borrowings for the General Fund from other State funds to the extent required by law.

3.9.4 Financings for State Enterprises

State enterprises such as the California Department of Water Resources, Housing Finance Agency, and Department of Veterans Affairs CalVet Home Loan Program issue bonds and notes payable from enterprise revenues. These obligations are not payable from the State's general funds and satisfy the requirements of the special fund debt limit exceptions. See Section 1.2.4.4, Special Fund Exception.

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Chapter 4. Federal and State Tax Law Requirements

Under the Internal Revenue Code of 1986 (Tax Code) and regulations adopted by the Internal Revenue Service (IRS) pursuant to the Tax Code (Regulations), the **interest** on bonds issued by a state or local government is generally excluded from gross income for federal income tax purposes. For purposes of the Tax Code (and as used in this chapter), the term "bond" means any evidence of indebtedness, including **notes** or **financing leases** (which are treated as **installment sale agreements** for federal income tax purposes). These bonds are often referred to as being "tax exempt" or as bearing tax-exempt interest, which generally means that **investors** in tax-exempt bonds will not pay federal income tax on the interest they receive as a bondholder.[1] As a result, investors will purchase the bonds at a lower interest rate than if interest on the bonds were taxable, reducing the cost of borrowing for state or local governmental issuers. Although the interest on the bonds is tax-exempt, the interest may be taken into account in determining other federal income tax consequences, such as the alternative minimum tax, interest expense deductions, and taxation of social security benefits. Further, bondholders may experience a taxable gain upon the sale or disposition of a bond.

The federal income tax exemption for bonds is an indirect federal subsidy to state and local governmental **issuers**. Federal subsidies of debt can take forms other than tax exemption. For example, "tax credit" bonds allow the bondholders to take

[1] Investors as discussed here include lenders who may finance tax-exempt loans or leases.

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credits against their other tax liabilities, and "direct subsidy bonds" provide for payment of an amount equal to a percentage of the interest cost of the bonds directly to the governmental issuer of these bonds (e.g., Build America Bonds). Although such programs require satisfaction of additional or alternative conditions, most of the requirements are similar to the requirements for tax-exempt bonds discussed in this chapter. New **issues** of tax credit and direct subsidy bonds were, however, eliminated by the *Tax Cuts and Jobs Act of 2017*[2] enacted in December 2017.

Although Section 103 of the Tax Code provides a general rule that interest on state or local bonds is excludable from gross income for federal tax purposes, there are numerous specific requirements that must be met in order for bonds issued by state or local governments to qualify as tax-exempt. These requirements tend to fall into three broad categories, characterized by the following questions:

1. What will the **proceeds** of the bonds finance, and how will that bond-financed project be used? Bonds that finance a capital project that will be owned, leased, or otherwise used by a private business will generally be **private activity bonds** that will not qualify as tax-exempt bonds, unless the project and the bonds meet the specific requirements for **qualified private activity bonds**.

2. How will the proceeds of the bonds be invested until spent on the project? The purpose of these restrictions is to prevent state and local governments from borrowing at a federally tax-exempt **interest rate** and investing the proceeds at a higher rate. There are several exceptions that allow proceeds to be freely invested for a period of time after issuance, but if the restrictions are not met, bonds will be classified as "arbitrage bonds" and will not be eligible for tax exemption.

3. Do the bonds meet the other substantive and procedural federal income **tax** requirements? Both the Tax Code and Regulations impose other requirements for bonds to be qualified as tax-exempt bonds, including that debt service on the bonds cannot be federally guaranteed and an information return (Form 8038 or 8038-G) must be filed for the bonds.

[2] Although originally introduced as the Tax Cuts and Jobs Act of 2017, that title was not included in the final enacted legislation but continues to be a colloquial reference. The official title of the tax reform legislation (Public Law 115-97) is *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*.

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This chapter follows the route to federal income tax exemption for purposes of covering the federal income tax requirements for issuance of tax-exempt bonds.

ROUTE TO FEDERAL INCOME TAX EXEMPTION

Bonds must be issued by a state or a political subdivision of a state. (See Section 4.2)

Bonds must be "debt" under general federal tax law principles. (See Section 4.3)

Bonds must finance capital expenditures or **cash flow** working capital borrowings. (See Sections 4.4 and 4.5)

Bonds must not be an issue of private activity bonds unless qualified private activity bonds. (See Sections 4.6 and 4.7)

Bonds must not be an issue of **arbitrage bonds**. (See Section 4.8)

Bonds must satisfy other Code requirements. (See Chapter 8, Post-Issuance Debt Management Requirements, Including Tax Compliance and Ongoing Disclosure Obligations and Chapter 9, Investment of Bond Funds)

Bond issuer must satisfy Code procedural requirements. (See Chapter 8, Post-Issuance Debt Management Requirements, Including Tax Compliance and Ongoing Disclosure Obligations and Chapter 9, Investment of Bond Funds)

4.1 CALIFORNIA TAX EXEMPTION

State statutes providing for the issuance of bonds generally provide for the exemption of interest on the bonds from State of California personal income taxes, regardless of the federal income tax status of the bonds. Article XIII, Section 26(b) of the California Constitution, moreover, expressly provides, "Interest on bonds issued by the State or a local government in the State is exempt from taxes on income." Although interest on bonds issued by California public agencies is exempt from State of California personal income taxes, it is not exempt from other taxes such as corporate taxes. In addition, bondholders may experience other tax consequences, such as a taxable gain upon the sale or disposition of a bond.

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4.2 OBLIGATIONS OF A STATE OR A POLITICAL SUBDIVISION

4.2.1 General

Generally, interest on obligations issued by a state (including the District of Columbia and any possession or territory of the United States) or political subdivision thereof (also referred to as a "state or local governmental unit") is excluded from gross income for federal income tax purposes subject to the satisfaction of certain requirements under the Tax Code and Regulations. In addition, tax-exempt obligations may be issued by certain other entities and will be treated as tax-exempt obligations issued "on behalf of" a state or local governmental unit.

4.2.2 Political Subdivision - Sovereign Powers Requirement

For purposes of the Tax Code, a political subdivision is any division of a state or local governmental unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit. The three generally recognized sovereign powers are power to tax, power of eminent domain, and police power. Although it is not necessary that all three sovereign powers be delegated, possession of only an insubstantial amount of any or all sovereign powers is not sufficient. When determining whether an entity is a division of a state or local government, all of the facts and circumstances are relevant, including the extent to which the entity is controlled by the state or local government and motivated by a wholly public purpose.

4.2.3 "On Behalf of" Issuers

An entity that is not itself a state or political subdivision may still issue tax-exempt obligations if it is deemed to be issuing such obligations "on behalf of" a state or local governmental unit. "On behalf of" issuers include constituted authorities, "63-20 corporations," and other issuers. The sections below described these "on behalf of" issuers.

4.2.3.1 CONSTITUTED AUTHORITIES

A constituted authority is an entity that is formed under state law and is specifically authorized by state law to issue bonds on behalf of a state or a political

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subdivision of a state to further public purposes. In general, for an entity to be treated as a constituted authority the following must be true:

1. The entity must have been formed with the approval of the state or political subdivision on behalf of which it is intending to issue bonds.

2. The governing board of the entity must be controlled by the governing body of the applicable state or political subdivision.

3. The entity must have the power to acquire, finance, lease, and sell property and to issue bonds in furtherance of its purposes.

4. **Debt service** on bonds must be payable from revenues of the entity and the applicable state or political subdivision must not be liable to bondholders for payments of debt service (although the entity's revenues may be entirely derived from payments made by the applicable state or political subdivision).

5. The entity is a nonprofit or state agency and earnings cannot benefit private persons.

6. Upon dissolution, title to all bond-financed property must revert to the applicable state or political subdivision.

4.2.3.2 63-20 CORPORATIONS

A 63-20 corporation is an entity formed under general state nonprofit corporation law. It is typically used when state law does not specifically authorize the formation of entities that would otherwise qualify as constituted authorities (as described in Revenue Ruling 63-20). For an entity to qualify as a 63-20 corporation, certain criteria must be satisfied, including the following:

1. The corporation must engage in activities that are essentially public in nature.

2. The corporation must be organized under the applicable state's general nonprofit corporation law.

3. The corporate income must not benefit any private person.

4. The state or political subdivision thereof must have a beneficial interest in the corporation while the debt is **outstanding**, which can be shown in various

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ways, including the state or political subdivision having exclusive possession and use of the property financed by the obligations.

5. Once the debt is retired, the state or political subdivision must obtain legal title to the property for which the indebtedness was incurred.

6. The state or political subdivision must approve both the corporation and the specific obligations to be issued by the corporation.

4.2.4 Other Issuers

Other entities that are authorized to issue tax-exempt bonds for certain purposes include Indian tribal governments, volunteer fire departments, and a corporation issuing qualified scholarship funding bonds.

4.3 WHAT IS AN ISSUE OF DEBT?

For interest on a bond to be tax-exempt, the bond must be debt under general federal tax law principles. **Debt** may take a variety of forms; generally, "debt" means an obligation to make payments on borrowed money. For federal tax law purposes, an obligation such as a lease may be treated as "debt." even though it is not a debt for purposes of the California Constitution. A separately stated interest component, however, is generally a minimum requirement. Conversely, an obligation in the form of debt (e.g., a subordinate note) may be treated for tax purposes as equity and not debt if there is not a reasonable expectation that the **principal** and interest on the debt instrument will be paid when scheduled.

In general, the various federal tax limitations and requirements apply in the aggregate to an "issue" of bonds rather than separately to individual bonds. In other words, to determine whether bonds meet the applicable federal income tax requirements, one must first determine which bonds are part of the same issue in order to evaluate the requirements for that issue. In general, bonds will be treated as part of the same issue if the bonds are sold at substantially the same time (i.e., less than 15 days apart), are reasonably expected to be paid from substantially the same source of funds, and are sold under the same plan of finance (which is based on various factors including the purposes for the bonds and the structure of the financing). These rules apply for federal income tax purposes and may result in bonds issued as separate series or even under separate **indentures** being treated as a single issue. A single issue can include bonds of different tax classifications.

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4.4 CAPITAL EXPENDITURE FINANCINGS

Proceeds of tax-exempt bonds are most commonly applied to finance capital costs associated with the acquisition, construction, or improvement of a capital project. For federal income tax purposes, except for cash flow borrowings (described below) and certain other limited situations, proceeds of tax-exempt bonds will only be treated as spent when used to finance or reimburse capital expenditures. The federal income tax analysis is based on whether the costs would be treated as capital expenditures (or would be treated as capital expenditures if a proper federal income tax election was made) under general federal income tax principles. In general, costs incurred to acquire, construct, or improve land, buildings, and equipment are capital expenditures. In certain cases, the federal income tax treatment of costs as capital expenditures may differ from the state law or financial accounting treatment of costs.

4.4.1 Issue Sizing and Term

OVERBURDENING RESTRICTIONS - The Tax Code and the Regulations prohibit the issuance of debt by public agencies that may "overburden" the tax-exempt bond market. Prohibited practices include issuing more bonds or issuing bonds earlier/allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds. When determining whether an action overburdens the tax-exempt bond market, an important factor is whether that action would reasonably be taken to accomplish the governmental purpose of the issue if interest on the issue were not tax-exempt. Factors evidencing an over-issuance of bonds include the issuance of bonds for which the proceeds are (1) reasonably expected to exceed (by more than a minor portion) the amount necessary to accomplish the governmental purposes of the issue or (2) in excess of the amount of **sale proceeds** allocated to expenditures for the governmental purposes of the issue. The fact that the bonds do not qualify for a "temporary period," as discussed in Section 4.8.4.1, Initial Temporary Period, may be evidence of an early issuance. Bonds with a **term** that exceeds 120% of the average reasonably expected economic life of the financed capital projects may be evidencing of the fact that the bonds may remain outstanding longer than necessary. These factors may be outweighed by other factors, however, such as bona fide cost underruns and long-term financial distress.

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HEDGE BOND RESTRICTIONS - In general, a bond is not tax-exempt if it is a **hedge bond**, which means any bond issued as part of an issue, unless the issuer reasonably expects both of the following:

- To spend at least 85% of the proceeds of the bonds on the governmental projects for which the bonds were issued within 3 years
- To invest no more than 50% of the proceeds in "non-purpose" investments (investment securities purchased with bond proceeds before expenditure of the proceeds on their ultimate use) with a substantially guaranteed **yield** for 4 years or more

In the case of a refunding transaction, the hedge bond analysis for the **refunding** bonds looks to the expectations at the time of issuance of the refunded bonds.

These expenditure requirements do not apply if 95% of the **net proceeds** of the bonds are invested in other tax-exempt bonds that are not subject to the AMT until such proceeds are expended. A hedge bond may still qualify as tax-exempt if the following are true:

1. At the time of issuance of the bonds, the issuer reasonably expects that:
    - 10% of the proceeds of the issue will be spent for the governmental purposes of the issue within 1 year from the date of issuance; and
    - 30% of the proceeds of the issue will be spent for the governmental purposes within 2 years; and
    - 60% of the proceeds of the issue will be spent for the governmental purposes within 3 years; and
    - 85% of the proceeds of the issue will be spent for such purposes within 5 years; and
2. At least 95% of the reasonably expected legal and underwriting costs of issuance are paid no later than 180 days following the **date of issuance**, and the payment of legal and underwriting costs are not contingent.

4.4.2 Costs of Issuance

Costs incurred in connection with issuing bonds, such as **underwriters' discounts** or fees, bond counsel and other legal fees, consultants' fees, **trustee's** fees, **rating**

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agency fees, and other similar fees and costs, may be financed with proceeds of the bonds. However, most qualified private activity bonds (as described further below) are subject to a restriction that no more than 2% of the proceeds may be used to pay costs of issuance. Tax-exempt bond proceeds may also be used to pay municipal **bond insurance** premiums, **letter of credit** fees, **liquidity** fees, and certain fees associated with interest rate swaps or similar hedging instruments.

4.4.3 Capitalized Interest

For new money transactions, the issuer may use bond proceeds to pay interest on the bonds starting on the issue date and ending on the later of 3 years from that date or 1 year after the date on which the project is placed in service. This is called **capitalizing interest** or interest costs. For qualified private activity bonds (described further below), however, only interest that accrues before the date the project is placed in service is treated as a qualifying cost for purposes of the bonds, which may limit the amount of interest that can be financed.

4.4.4 Reserves

Tax-exempt bond proceeds can also be used to fund a **debt service reserve fund** (DSRF) securing the payment of debt service on the bonds if it is a "reasonably required reserve or replacement fund." A DSRF amount will generally be considered to be a reasonably required reserve fund or replacement fund only if the amount is limited to the lesser of (1) maximum annual principal and interest requirements on the issue, (2) 10% of the principal amount of the issue, or (3) 125% of the average annual principal and interest requirements on the issue. Other reserves, such as an operating reserve, may be funded with bond proceeds in limited situations.

4.4.5 Reimbursement of Prior Expenditures

An issuer may often initially finance costs associated with a project out of its general fund or out of restricted funds in anticipation of being reimbursed from proceeds of a future bond issue. For the proceeds of the bonds to be used to reimburse costs paid before issuance of the bonds, (1) the issuer must adopt a declaration of "official intent" for the original expenditure no later than 60 days after payment of the original expenditure, (2) the original expenditure generally must be a capital expenditure (although certain other expenditures

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may be eligible for reimbursement), and (3) the reimbursement (i.e., issuance of the bonds and allocation of the proceeds to the initial costs) generally must be made not later than 18 months after the later of the date the original expenditure is paid, or the date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid. However, these timing requirements are modified such that (a) for certain small issuers, the reimbursement must be made no later than 3 years after the date the original expenditure is paid and (b) on projects for which both the issuer and a licensed architect or engineer certify that at least 5 years are necessary to complete construction, the issuer may reimburse expenditures for up to 5 years after the original expenditure is paid.

An "official intent" is an issuer's declaration of intent to reimburse an expenditure (initially made from its own funds) with the proceeds of a debt obligation. The official intent of an issuer to reimburse expenditures from bond proceeds may be made in any reasonable form, including (1) a resolution of the issuer, (2) action by an appropriate representative of the issuer (e.g., a person authorized or designated to declare official intent on behalf of the issuer), or (3) specific legislative authorization for the issuance of obligations for a particular project.

The official intent must generally describe the project for which the original expenditure was paid and must state the maximum principal amount of obligations expected to be issued for the project. A project includes any property, project, or program (e.g., highway capital improvement program, school building renovation, water facility capital improvement program, computer equipment acquisition, or treatment plant construction). Deviations between the project description in the official intent and the actual project financed with the reimbursement bonds will not invalidate the official intent to the extent that the actual project is reasonably related in function to the described project. On the date of declaration of official intent, the issuer must have a reasonable expectation that it will reimburse the original expenditure with proceeds of a bond issue. Official intent declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project (e.g., blanket declarations) are not reasonable. Similarly, a pattern of failure to reimburse actual original expenditures covered by an official intent is evidence of unreasonableness.

The official intent requirement and the reimbursement period requirement do not apply to costs of issuing any bond or to an amount up to the lesser of

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$100,000 or 5% of the proceeds of the bond issue. In addition, the requirements do not apply to preliminary expenditures of up to 20% of the aggregate issue price of the issue(s) that finance—or are reasonably expected by the issuer to finance—the project accounting for the preliminary expenditures. Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance costs, and similar costs that are incurred before commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incurred at the start of construction.

If an issuer satisfies the reimbursement guidelines described above, the bond proceeds will be deemed expended for tax purposes upon requisition by the issuer and the reimbursed funds will be no longer be treated as proceeds of the bonds, and instead will be treated as revenues (or restricted funds, as the case may be) of the issuer. If the reimbursement guidelines are not satisfied, bond proceeds disbursed to the issuer for prior expenditures will not be treated as spent for tax purposes and instead will still be treated as unspent proceeds, which may prevent the bonds from qualifying as tax-exempt bonds.

4.5 CASH FLOW BORROWINGS

"Cash flow" is the movement of monies "in" (revenues) and "out" (expenditures) of a fund. Public agencies may find themselves temporarily short of cash to finance operations and may need to address the shortfall with a short-term financing called a "cash flow borrowing."

In general, proceeds of tax-exempt bonds may not be used to finance working capital expenditures. Any cost that is not a capital expenditure is a working capital expenditure (e.g., current operating expenses). Proceeds of an issue of tax-exempt bonds may, however, be allocated to working capital expenditures (and therefore be deemed spent for tax purposes) as of any date that the issuer's working capital expenditures exceed its "available amounts." Available amounts mean any amount that is available to an issuer for working capital purposes of the type being financed by the bond issue. Available amounts may include cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by the issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be

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reimbursed. In general, an issuer will have no available amounts on a date on which it has a cash flow deficit.

Public agencies may generally issue tax and revenue anticipation notes (TRANs) or revenue anticipation notes (RANs) to finance working capital expenditures during periodic cash flow deficits. Deficits may result from a temporary mismatch of revenues and expenses within a fiscal period and the size of a TRAN or RAN borrowing is generally limited to the amount of the anticipated deficit over the course of the fiscal period. Issuers may keep any arbitrage earnings generated by the investment of the TRAN or RAN proceeds provided that the issue is sized so that all of the TRAN or RAN proceeds are reasonably expected to be expended on working capital expenditures within 13 months of the issue date. See **Section 3.3.4, TRANs and RANs**.

TRANs and RANs are generally short-term cash flow borrowings. Long-term working capital borrowings (long-term bonds issued to finance cash flow borrowings or judgments) are more challenging to finance, but long-term working capital financing may be available if the issuer's general fund is expected to have a persistent cash flow deficit.

4.6 GOVERNMENTAL BONDS/PRIVATE ACTIVITY BONDS

Public agencies commonly finance facilities owned, operated or used by them through the issuance of **governmental bonds**. In general, governmental bonds can finance any type of project—roads, schools, administrative buildings, water systems, power plants, and similar—as long as the bonds and the financed project *do not* satisfy the private activity bond tests described below (the "Private Activity Bond Tests"), either at the time of issuance of the bonds or at any time while the bonds are outstanding. Bonds that meet the Private Activity Bond Tests will be private activity bonds and will be taxable unless they meet the requirements for qualified private activity bonds, such as **qualified 501(c)(3) bonds** or exempt facility bonds. See **Section 4.7, Qualified Private Activity Bonds**. The private activity bond tests are intended to limit the situations in which tax-exempt bonds may be used to finance projects used in the trade or business of nongovernmental persons, which would result in transferring the benefits of tax-exempt financing to a nongovernmental person. Projects that are directly used by a state or local government (and not by a nongovernmental person), or by the public generally, are referred to as having "governmental use."

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Bonds will NOT meet the Private Activity Bond Tests and therefore will constitute governmental bonds if both of the following are true:

1. No more than 10% (or $15 million, if less) of the proceeds of the bond issue or the bond-financed property are used directly or indirectly in trades or businesses carried on by persons other than a state and local governmental unit (the "Private Business Use Test").

2. The amount of revenues derived (directly or indirectly) from the trade or business use and payments or property used in the trade or business that secure the bond issue total no more than 10% (or $15 million, if less) of the debt service on the bond issue (the "Private Security or Payment Security Test").

Together the two above tests are called the "Private Business Tests."

The Private Business Use Test threshold is reduced to 5% in the case of a private business use that is (1) unrelated to any governmental use also being financed with the issue, or (2) disproportionate to the related use being financed. Bonds will also be treated as private activity bonds if the lesser of 5% or $5 million of the proceeds of the issue are used to make loans to persons other than state or local governmental units (the "Private Loan Test").

Generally, the determination of whether an issue of bonds is an issue of private activity bonds is based upon the issuer's reasonable expectations as of the date the bonds are issued. With certain limited exceptions, it is important that issuers reasonably expect to own and use a bond-financed project for the shorter of the following periods:

- The entire **economic useful life** of the financed project
- The term of the bonds

Notwithstanding an issuer's reasonable expectations of governmental use, certain deliberate actions taken after issuance by an issuer or independent actions by third parties may cause the Private Business Use Tests or the Private Loan Test to be satisfied with respect to an issue. See **Section 8.3.3, Monitoring Use of Bond-Financed Property** and **Section 8.3.7, Changes in Use of Bond-Financed Property**. It is also important for the issuer to track and maintain records with respect to how bond proceeds have been spent or allocated. See **Section 8.3.2, Tracking and Allocating Bond Proceeds**.

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4.6.1 Private Business Use

Private business use is the direct or indirect use of bond proceeds or bond-financed property in the trade or business of a nongovernmental person. Private business use by a nongovernmental person may arise as a result of, among other things (1) ownership (determined in accordance with federal income tax principles), (2) actual or beneficial use of property under a lease (determined in accordance with federal income tax principles), (3) management or services contracts, (4) output contracts, or (5) research agreements.

In addition, other arrangements that convey similar special legal entitlements to a nongovernmental person for the beneficial use of bond proceeds or bond-financed property will result in private business use. For financed property that is not available for use by the general public, private business use may result from a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlement to use the property. In determining whether a special economic benefit exists, all of the facts and circumstances must be considered, including whether (1) the financed property is functionally related or physically near to the property used in the trade or business of a nongovernmental person, (2) only a small number of nongovernmental persons receive the actual benefit, and (3) the cost of the financed property is treated as depreciable by any nongovernmental person.

Use by an employee of the issuer or an individual who is not carrying on a trade or business is not private business use. Use of financed property as a member of the general public is not treated as private business use. Use by a nongovernmental person of financed property in its trade or business will be treated as general public use if the property is intended to be available and is in fact reasonably available for use on the same basis by natural persons not engaged in a trade or business. Arrangements that convey priority rights or other preferential benefits are not use on the same basis as the general public. An arrangement providing for use by the general public at no charge or at generally applicable and uniformly applied rates does not convey priority rights or other preferential benefits, even if different rates apply to different classes of users (such as volume purchasers) if such differences are customary and reasonable, or a special rate arrangement is negotiated, but only if the user is prohibited by federal law from paying the generally applicable rates, and the established rates are as comparable as reasonably possible to the generally applicable rates.

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By way of example, if a bond-financed water system provides water to residences and private businesses and both the residences and the private businesses are charged a uniform rate for water services, purchases of water by the residences and businesses will be viewed as use by members of the general public and therefore not private business use. Conversely, if an issuer provides water to private businesses through "take or pay contracts" or similar output-type contracts or on a basis other than the basis on which the service is provided to members of the general public under contracts fixing quantity and price, the use and the related payments will be private business use. A similar analysis would apply in the case in which an issuer is seeking to supply water through its bond-financed facility to several water wholesalers or retailers for distribution. If any of the wholesalers or retailers (or any of the entities that purchase water from them) are not state or local governmental units, the issuer must analyze the amount of private trade or business use as well as any related payments generated by the water sales.

4.6.1.1 *DE MINIMIS* PRIVATE BUSINESS USE EXCEPTIONS

Short-term arrangements for the use of bond-financed property by a nongovernmental user will not be considered private business use if the following requirements are satisfied:

- *100-Day Arrangements*. (1) The term of use under the arrangement (including all renewal options) is no longer than 100 days; (2) the arrangements would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable, uniformly applied rates are generally not available to those persons; and (3) the property is not financed for the principal purpose of providing that property for use by that nongovernmental person. This exception is available for facilities that are not available for general public use, such as short-term housing of federal prisoners in a bond-financed facility.

- *50-Day Arrangements*. (1) The term of use under the arrangement (including all renewal options) is no longer than 50 days; (2) the arrangement is a negotiated arm's-length transaction, with fair market value compensation; and (3) the property is not financed for the principal purpose of providing that property for use by that nongovernmental person. This exception allows for negotiation of specific arrangements for short-term use.

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Certain other types of use of bond proceeds or bond-financed property will not be considered private business use or will be disregarded, including the following:

- *Use by Agents*. Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person

- *Use Incidental to Financing Arrangements*. Use by a nongovernmental person that is solely incidental to a financing transaction or arrangement (e.g., bond trustees, loan services)

- *Temporary Use by Developers*. Temporary use during initial development by a developer of an improvement that carries out an essential governmental function, if (1) the issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and the benefited property, and to transfer the improvement to a governmental person; and (2) the improvement is in fact transferred promptly after the benefitted property is developed

- *Incidental Use*. Incidental use (e.g., pay telephones, vending machines, advertising displays, use for television cameras) up to 2.5% of the proceeds of a bond issue used to finance the facility will be disregarded if (1) except for vending machines, pay telephones, kiosks and similar uses, the use does not involve the transfer of possession and control of spaces that is separated from other areas of the facility by walls, partitions or other physical barriers; (2) the non-possessory use is not functionally related to any other use of the facility by the same nongovernmental person (other than a different non-possessory use); and (3) all non-possessory uses of the facility do not, in the aggregate, involve the use of more than 2.5% of the facility

- *Qualified Improvements*. This exception applies to proceeds used for improvements of existing governmentally owned buildings where the building already has some private business use. Proceeds used for improvements of governmentally owned buildings (including land functionally related and subordinate to the building) will not be treated as having private business use if (1) the building was placed in service more than 1 year before the construction or acquisition of the improvement is begun, (2) the improvement is not exclusively for any private business use, (3) no portion of the improved building or any payments in respect of the improved building are taken into account under the private security test, and (4) no more than 15% of the improved building is used for a private business use. For example, this exception would apply to proceeds spent

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on seismic improvements to existing governmental buildings, where the buildings might have some amount (less than 15%) of current private business use.

4.6.1.2 MEASUREMENT OF PRIVATE BUSINESS USE

The Regulations provide a complex method for measuring the amount of private business use of a bond-financed project. In general, however, the amount of private business use is based on the average amount of private business use during each 1-year period, averaged over the period beginning on the earlier of the bond issue date or the date the project was placed in service and ending on the earlier of the bond **maturity** date or the end of the expected economic life of the project. The maturity date of the bonds is subject to adjustment if either the issuer expects to refund the bonds with longer-term bonds or the issuer expects to redeem the bonds before their scheduled maturity date.

If private business use is reasonably expected to have a greater fair market value than the government use, the average amount of private business use must be determined according to the relative (according to the facts and circumstances) reasonably expected fair market values of use rather than another measure, such as average time of use. The amount of private business use of common areas within a bond-financed facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility, and neutral costs paid with bond proceeds (costs of issuance, investments in reserve or replacement fund, qualified guarantee, or qualified hedge fees), are allocated according to this method among the other purposes for which bond proceeds are used.

4.6.1.3 MANAGEMENT, OPERATING, AND SERVICE CONTRACTS

Private business use can also arise through contracts allowing private parties to earn fees through the management and operation of governmentally owned facilities. Whether or not a management contract results in private business use depends on all of the facts and circumstances, but the IRS has provided safe harbor guidance[3] for "qualified management contracts" that will not be treated as resulting in private business use.

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[3] The Municipal Securities Rulemaking Board – *Glossary of Municipal Securities Terms* defines "safe harbor" as a "provision of a rule or regulation that outlines certain steps that, if followed, will be viewed as compliant with the applicable portion of the rule or regulation." www.msrb.org/Glossary/Definition/SAFE-HARBOR.aspx

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A management contract will result in private use if compensation for services under the contract is based, in whole or in part, on a share of net profits from the operation of the facility or will result in the service provider being the **lessee** or owner of the bond-financed facility for federal income tax purposes. Under new safe harbor guidance provided by the IRS in March 2017, a management contract will not result in private business use if it complies with the following requirements:

REASONABLE COMPENSATION - The fee paid to the service provider is reasonable. Fees determined through a competitive process or fees within a normal range for such services generally will be reasonable.

NO NET PROFITS - Compensation to the service provider cannot be based, even in part, on the net profits of the financed project. This includes directly sharing net profits, as well as designing incentives that are based on a combination of **gross revenues** and expenses. Incentive compensation based on performance metrics like quality of services or productivity is not necessarily treated as a net profits incentive. Often, payments under management contracts are split between (1) reimbursement for actual service provider costs, subject to the approval of annual budgets by the project owner, and (2) a separate **management fee**. This type of structure can more easily qualify as a "qualified management contract" than an "all-in" compensation structure in which the service provider is paid a comprehensive fee and is entirely responsible for paying all operating costs out of that fee. Even in the context of all-in contracts, however, certain types of management fees (one or more of a capitation fee, a periodic fixed fee, a per-unit fee, or a fee based on certain performance metrics) are not considered to be net profits arrangements.

NO NET LOSSES - Compensation to the service provider cannot be based, even in part, on the net losses of the financed project. The most common example of a net losses problem is if the fee paid to the service provider is subordinate to the payment of debt service and if the fee would never be paid if there were insufficient funds at the time the fee is due. Subject primarily to some timing limitations, a solution can be for any unpaid fees to accrue with interest. A service provider whose compensation is reduced by a stated dollar amount for failure to keep the managed property's expenses below a specified target will not be treated as bearing a share of net losses as a result of this reduction. Like the net profits prohibition, all-in contracts raise significant concerns, the reimbursement of costs generally is ignored, and management fees that are capitation fees, periodic

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fixed fees, and per-unit fees are not considered to be net losses arrangements, even in all-in management contracts.

TERM LIMITATION - The term of the management contract may not be longer than the lesser of 30 years or 80% of the remaining useful life of the financed project. The useful life of a newly constructed project that consists primarily of building construction or improvements should support a 30-year management contract.

CONTROL - The owner of the financed project (generally the issuer, or for qualified private activity 501(c)(3) bonds described below, the 501(c)(3) owner) must exercise control over the project. This control requirement is met if the project owner approves (1) the annual operating budget, (2) any capital expenditures, (3) the disposition of property, (4) the rates charged for the use of the bond-financed facility, and (5) the general nature and type of use of the project. For management contracts with cost reimbursement plus a management fee, these control requirements should be satisfied under typical practices.

RISK OF LOSS - The service provider cannot be responsible for replacing the financed project if there is a catastrophic loss.

SERVICE PROVIDER TAX POSITION - The management contract must state that the service provider will not claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the project.

LIMITATION ON RIGHTS - Finally, the service provider must not have a role or relationship with the project owner, such as the chief executive officer of the service provider being in a similar position with the project owner that, as a practical matter, would limit the project owner's rights to take action under the management contract.

Certain types of agreements are generally not treated as management agreements that give rise to private business use, including (1) a contract for services solely incidental to the primary governmental functions of financed facility (for example, for janitorial services, office equipment repair, hospital billing services, or similar services); (2) the mere granting of admitting privileges by a hospital to a doctor (even if conditioned on providing de minimis services) if those privileges are available to all qualified physicians in the area consistent with the size and nature of the hospital; (3) contracts for the operation of facilities consisting predominately of public utility property if the only compensation is the reimbursement of actual and direct

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expenses and reasonable overhead expenses of the service provider; (4) contracts for services if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to third parties.

Under certain circumstances, a management contract may be more properly characterized a lease, particularly when considering (1) the degree of control over the property that is exercised by a nongovernmental person and (2) whether a nongovernmental person bears risk of loss of the financed property. A management contract that is characterized as a lease for tax purposes will not be eligible for the safe harbor for management contracts described above and would generally result in private business use.

4.6.1.4 OUTPUT FACILITIES

Output facilities, such as power generation or transmission facilities, raise complex private use issues, especially if output is sold to investor-owned utilities or other private users. "Private use" of such facilities is, moreover, limited to $15 million per project, even if the 10% test would allow greater private use. In general, output facilities that are used solely for a state or local governmental utility's retail load and that are provided to customers under standard rates and charges, will be treated as used for general public use and not for private business use.

4.6.2 Private Security or Payment Test

The Private Security or Payment Test is the second part of the Private Activity Bond Tests. Both the Private Business Use Test and Private Security or Payment Test must be satisfied for a bond to be a private activity bond. In other words, a bond can qualify as a tax-exempt governmental bond if the Private Business Use Test is met, or if the Private Security or Payment Test is met, but not if both tests are met. In certain bond structures, it is clear that one of the tests will be met, and the tax analysis for the bonds will focus on ensuring that the other test is not met. For example, as described below, tax assessment bonds will generally meet the Private Security or Payment Test, and as a result, it is necessary to ensure that these bonds do not meet the Private Business Use Test.

As its name implies, the Private Security or Payment Test looks at the source of the monies paid toward debt service (directly or indirectly) and the security provided for the bonds by nongovernmental persons. The Private Security or Payment Test is met if the aggregate present value of the private payments and pri-

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vate security exceeds 10% of the present value of the debt service on the bonds, with certain adjustments. Present values are computed using the yield on the bonds as a discount rate.

For purposes of the Private Payment or Security Test, the Regulations provide that generally applicable taxes imposed at a uniform rate and applied to all persons of the same classification in the jurisdiction are not taken into account. For example, ***ad valorem* property taxes** are generally applicable taxes, and will not be treated as private payments or private security. In addition, it is possible to structure certain arrangements with payments in lieu of taxes or "PILOTs", which will be treated as generally applicable taxes and therefore not as private payments or private security. However, in general, real property **assessments**, Mello-Roos special taxes, and other payments for a special privilege granted or service rendered are not generally applicable taxes and instead would be treated as private payments or private security. As a result, bonds secured by such assessments, taxes, or payments generally must be used for projects that do not meet the Private Business Use Test in order to be issued as tax-exempt bonds.

PRIVATE SECURITY - The Regulations provide only limited guidance in interpreting the private security provisions of the Private Payment or Security Test. In general, to the extent that property is **pledged** as security for the payment of debt service on the bonds, and that property is either (1) financed with proceeds of the bonds and used for any private business use, or (2) provided by a nongovernmental user of proceeds of the bonds (or assets financed by the bonds), the property will result in private security. For purposes of valuing the property to determine the amount of private security, property used by nongovernmental persons is to be valued at its fair market value (rather than its historical cost) as of the date when the property first secures the bonds.

PRIVATE PAYMENTS - In general, the Regulations consider all payments to the issuer or to any related entity by any nongovernmental person that uses the bond proceeds or bond-financed facilities as private payments, even if the payments are made by nongovernmental persons who use the property as members of the general public, to the extent the payments either (1) are to be used, directly or indirectly, to pay debt service on the bonds, or (2) are to be made for bond-financed facilities that are subject to private business use.

This is a broad definition of private payments. For example, if a bond-financed hospital is managed by a nongovernmental person according to a contract that

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results in private business use (i.e., it is not a qualified management contract that fits within the safe harbor from private business use), all payments made by the public with respect to use of that hospital will be treated as private payments. Because of this broad definition of private payments, the tax analysis for tax-exempt bonds often focuses primarily on ensuring that the Private Business Use Test is not met. There are some exclusions for amounts that might otherwise be treated as private payments. The amount of the private payments is decreased by the allocable operating and maintenance expenses paid by the issuer with respect to the financed facilities. In addition, the amount of private payments is limited by the amount of private business use of a project, such that a small amount of private business use within a larger bond-financed project might not require all revenues of that facility to be treated as private payments, but instead only the portion of the revenues allocable to that private business use.

4.6.3 Private Loan Test

The Private Loan Test is met if more than the lesser of 5% or $5 million of the proceeds of the issue is used to make or finance loans to nongovernmental persons. A loan is any transaction that is characterized as a loan under general federal income tax principles, and this tax analysis will be based on the substance of the transaction rather than the particular form. For example, a lease or a management contract might be considered a loan if federal tax ownership of the facility is transferred to the lessee or manager. Likewise, an output contract might be considered a loan if the agreement shifts significant burdens and benefits of ownership to the output purchaser.

Real property assessments and certain Mello-Roos special taxes may be treated for federal income tax purposes as loans to the property owners. However, such "tax assessment loans" will not be treated as loans for purposes of the Private Loan Test as long as the loans arise from the imposition of a mandatory tax or other assessment of general application, are imposed for the purpose of financing essential governmental functions, and are applied on an equal basis to owners of property benefitting from the financed improvements. While tax assessment loans will not be treated as loans for purposes of the Private Loan Test, the payments made by property owners may cause the bonds to meet the Private Security or Payment Test. As a result, most **special tax** and assessment bonds are limited to financing projects that do not meet the Private Business Use Test (e.g., public infrastructure) in order to qualify as tax-exempt.

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4.7 QUALIFIED PRIVATE ACTIVITY BONDS

4.7.1 Categories of Qualified Private Activity Bonds

Bonds that meet the Private Activity Bonds Tests will not be treated as governmental bonds, and instead will be private activity bonds. The interest on private activity bonds will not be tax-exempt unless the bonds meet the requirements to be issued as qualified private activity bonds. Each type of qualified private activity bonds is based on the specific type of facility to be financed or manner in which the proceeds of the bonds are used. The types of qualified private activity bonds include the following:

- Exempt facility bonds
- Qualified mortgage bonds (single-family mortgage revenue bonds)
- Qualified veterans mortgage bonds
- Qualified student loan bonds
- Qualified small-issue bonds
- Qualified redevelopment bonds
- Qualified 501(c)(3) bonds

4.7.1.1 EXEMPT FACILITY BONDS

Exempt facility bonds are bonds for which at least 95% of the net proceeds are to be used to finance capital costs of one of the following types of facilities:

- Airport facilities
- Docks and wharves
- Mass commuting facilities
- Facilities for the furnishing of water
- Sewage facilities
- Solid waste disposal facilities
- Qualified residential rental projects (i.e., multifamily housing)
- Facilities for the local furnishing of electric energy or gas

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- Local district heating or cooling facilities
- Qualified hazardous waste facilities
- High-speed intercity rail facilities
- Environmental enhancements of hydroelectric generating facilities
- Qualified public educational facilities (public schools owned by private entities in **public-private partnership** arrangements)
- Qualified green building and sustainable design products
- Qualified highway or surface freight transfer facilities
- Qualified broadband projects
- Qualified carbon dioxide capture facilities

Net proceeds comprise all proceeds of the bonds, less amounts in a DSRF and less **investment proceeds** earned after completion of the project. The Code and Regulations contain specific rules and definitions covering each of these exempt facility categories. In the case of the exempt facility bonds issued for airports, docks, and wharves, mass commuting facilities, and environmental enhancements for hydroelectric facilities, the facilities must be owned by a governmental unit.

4.7.1.2 MULTIFAMILY HOUSING BONDS

Exempt-facility qualified residential rental property bonds are bonds issued to finance affordable rental housing. Among other requirements, either 20% of the units in a financed facility must be made available for rental to families earning 50% or less of area median income or 40% of the units in the financed facility must be made available for rental to families earning 60% or less of area median income. See **Section 3.3.9.5, Multifamily Housing**.

4.7.1.3 SINGLE-FAMILY MORTGAGE REVENUE BONDS

Single-family mortgage revenue bonds are bonds, the proceeds of which are loaned to homebuyers as acquisition financing for an owner-occupied personal residence. Except for homes in federally designated "targeted areas," the homebuyers must be first-time homebuyers. Borrower family income and the purchase price of the home must satisfy the requirements of the Code. Single-family housing bonds are also subject to special arbitrage restrictions. See **Section 3.3.8, Single-Family Mortgage Revenue Bonds**. The Code also treats certain bonds that are issued by a state to provide home mortgage financing for veterans to be treated as qualified private activity bonds.

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4.7.1.4 STUDENT LOAN BONDS

Student loan bonds are bonds for which at least 90% of the proceeds are used to make loans to students for educational purposes. Detailed federal tax limitations apply to student loan bonds.

4.7.1.5 QUALIFIED SMALL-ISSUE BONDS

Qualified small-issue bonds are also known as industrial development bonds (IDBs). These are bonds issued in the aggregate face amount of $1 million or less and at least 95% of the net proceeds are used to finance a manufacturing operation and at least 75% of the net proceeds are used to acquire, construct, or improve land or depreciable property or to redeem bonds previously used for such purposes and provide the actual production facilities of the manufacturing operation, as opposed to office and warehouse structures and equipment. The $1 million limitation on issue size may be increased to $10 million if certain requirements are met. To qualify for the $10 million limit, the sum of the following items may not exceed $10 million during the 6-year period beginning 3 years before the date of issuance of the bonds and ending 3 years after the date of issuance:

- All expenditures made by the following:
  - The **nongovernmental borrower** or any related person for any facilities within the political jurisdiction in which the project is to be sited
  - Any other principal user of the facility being financed
  - Any person (whether or not a principal user) to benefit from the bondfinanced facility
- The face amount of the bonds to be issued
- The remaining principal amount of all prior outstanding qualified small-issue bonds issued to finance facilities in the same incorporated municipality (or in the same county but not in any incorporated municipality) as the project being financed, a principal user of which is the nongovernmental borrower for the project being financed

If this capital expenditure limitation of $10 million is exceeded, the bonds will lose their taxexempt status from the date the limit is exceeded. See Section 3.3.9.2, Small Manufacturing Facilities.

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4.7.1.6 QUALIFIED REDEVELOPMENT BONDS

Qualified redevelopment bonds are bonds issued to finance certain costs of acquisition or rehabilitations (but not construction) of land or properties in blighted areas.

4.7.1.7 QUALIFIED 501(C)(3) BONDS

Qualified 501(c)(3) bonds are bonds the proceeds of which are used to finance facilities owned by an exempt organization described in Section 501(c)(3) of the Tax Code. The most common use of these bonds is to finance health care and higher education facilities. Qualified 501(c)(3) bonds also are used to finance low-income housing projects and various other charitable facilities. The primary requirements for qualified 501(c)(3) bonds are that any financed facilities must be owned by a public agency or a 501(c)(3) organization and the Private Business Tests must not be satisfied. The following apply for purposes of the Private Business Tests in connection with 501(c)(3) bonds:

- 501(c)(3) organizations are treated as governmental units to the extent their use of the financed facilities is not an "unrelated trade or business" activity.
- The allowable amount of private business use or private payments or security is limited to 5% rather than 10%.

See **Section 3.3.9.3, Health Care** and **Section 3.3.9.4, Education**.

4.7.2 Additional Requirements Applicable to Qualified Private Activity Bonds

The following sections describe miscellaneous restrictions that apply to some or all of the qualified private activity bond categories.

4.7.2.1 VOLUME CAP

In order to limit the amount of tax-exempt qualified private activity bonds that can be issued, each state is allocated a "**volume cap**" for each year, which must be allocated to the issuance of certain types of qualified private activity bonds. In order to issue such tax-exempt qualified private activity bonds in California, every issuer must apply to the California Debt Limit Allocation Committee to be assigned the necessary amount of volume cap.

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The following types of qualified private activity bonds do not require a volume cap:

- Any qualified veteran's mortgage bond
- Any qualified 501(c)(3) bond
- Bonds used for airports, docks and wharves, environmental enhancements to hydroelectric generation facilities, and qualified educational facilities
- 100% of any high-speed intercity rail facility bonds, but only if owned by a governmental unit (75% of any high-speed intercity rail facility bonds, if not owned by a governmental unit)
- Any bond used for governmentally owned solid waste disposal facilities
- 100% of any qualified broadband project bonds, but only if owned by a governmental unit (75% of any qualified braodband project bonds, if not owned by a government unit)
- 100% of any qualified carbon capture facility bonds, but only if owned by a governmental unit (75% of any qualified carbon capture facility bonds, if not owned by a governmental unit

4.7.2.2 TEFRA PUBLIC REQUIREMENTS

Before the issuance of any qualified private activity bond, a public hearing must be held by or on behalf of an applicable elected public official or elected legislative body of the issuer and, if the project is outside the geographic jurisdiction of the issuer, a governmental body with geographic jurisdiction over the project. Reasonable public notice must be given in advance, containing certain basic information regarding the nongovernmental borrower, the projects to be financed (such as purpose and location), and the amount of bonds to be issued for each project. For **TEFRA** (*Tax Equity and Fiscal Responsibility Act of 1982*) approvals on or after April 1, 2019, the notice is presumed reasonable published in a newspaper of general circulation in the locality of the project or, upon satisfaction of certain requirements, posted on the issuer's website, at least 7 days before the scheduled hearing. After the hearing, the "applicable elected representative" must formally approve the bond issue. For local agencies, the elected legislative body (city council or board or supervisors) typically gives the approval. A TEFRA hearing and governmental approval are not necessary for an issue of **current refunding** bonds unless the average maturity date of the refunding issue is later than the average maturity date of the bonds being refunded.

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4.7.2.3 USEFUL LIFE LIMITATIONS

The average maturity of an issue of qualified private activity bonds may not exceed 120% of the average reasonably expected economic life of the facilities being financed with such an issue. Note that, as described above, there is a similar 120% test applied for purposes of determining whether the bonds (including governmental bonds) are outstanding longer than necessary.

4.7.2.4 LAND AND USED PROPERTY LIMITS

No more than 25% of the net proceeds of qualified private activity bonds may be used directly or indirectly for the acquisition of land or any interest therein. This restriction does not apply to qualified 501(c)(3) bonds, or to certain acquisitions of land by a governmental unit in connection with an airport, dock, or wharf, mass commuting facility, or high-speed intercity rail facility. No part of the net proceeds of qualified private activity bonds may be used for the acquisition of previously used property or any interest therein. This restriction does not apply, however, with respect to any building (and equipment) if rehabilitation expenditures with respect to the building (and equipment) are at least equal to 15% of the cost of acquiring the building (and equipment) financed with the net proceeds of the issue.

4.7.2.5 COST OF ISSUANCE LIMIT

No more than 2% of the proceeds of any qualified private activity bond issue may be used to finance the **costs of issuance** associated with the bonds (no more than 3.5% with respect to qualified mortgage bonds or qualified veterans mortgage bonds if the proceeds do not exceed $20 million). Certain costs, such as letter of credit fees or bond insurance premiums, are not treated as costs of issuance for purposes of this limitation. This limitation is particularly important in the case of smaller issues because the actual costs of issuance may often exceed the 2% threshold. In these cases, the issuer or conduit borrower will have to pay the excess amount out of cash or a separate taxable borrowing.

4.7.2.6 CERTAIN PROHIBITED FACILITIES

None of the proceeds of qualified private activity bonds may be used to provide any of the following:

- Airplanes

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- Skyboxes or other private luxury boxes
- Health club facilities
- Facilities primarily used for gambling
- Stores with the principal business of selling alcoholic beverages for consumption off premises

The prohibition against financing health club facilities does not apply to qualified 501(c)(3) bonds.

4.7.2.7 SUBSTANTIAL USER RESTRICTION

Any private activity bond (other than a qualified 501(c)(3) bond) will cease to be a qualified private activity bond and will lose its tax-exempt status during any period in which the bond is owned by a "substantial user" of the financed facility or by a "related person" of such substantial user. A substantial user includes an owner or lessee of the financed facility.

4.8 ARBITRAGE YIELD RESTRICTION

4.8.1 General

The Tax Code provides that any bond will be a taxable "arbitrage bond" if the issuer reasonably expects to use the proceeds of the bond, directly or indirectly, either (1) to acquire securities or obligations with a yield materially higher than the yield on the bond, or (2) to replace funds used to acquire higher yielding securities or obligations. Thus, the Tax Code restricts the rate of return on investments made with bond proceeds to a yield that is not materially higher than the yield on those bonds. However, the Tax Code provides exceptions to **yield restriction** for the portion of the bond proceeds held in a reasonably required reserve fund during the life of the bond issue and for other proceeds of the bonds deposited during a "temporary period." Key for purposes of arbitrage analysis are determining what funds constitute "bond proceeds" and the "yield" on the bonds and on investments of bond proceeds.

Compliance with **arbitrage yield restrictions** is an important post-issuance compliance requirement. See Section 8.3.4, Monitoring Investment Income and Arbitrage Compliance.

4.8.2 Bond Proceeds

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For tax purposes, different arbitrage rules apply to different categories of bond proceeds. In general, the **investment of proceeds** must be tracked until the proceeds are spent for tax purposes, which may include a proper allocation to reimburse prior expenditures, as described in Section 4.4.5, Reimbursement of Prior Expenditures. In addition, under certain circumstances, unspent proceeds may be reallocated from one bond issue to another (for example, through a refunding), or may be deallocated from a bond issue under specific tax rules based on the amount of bonds outstanding.

4.8.2.1 CATEGORIES OF PROCEEDS

For tax purposes, bonds proceeds are categorized as follows:

SALE PROCEEDS - The amounts actually or constructively received by the issuer from the sale of the bonds, including amounts used to pay **underwriter's discount** or other compensation and **accrued interest**, if any (other than pre-issuance accrued interest, which was common historically, but has become much less common).

INVESTMENT PROCEEDS - The amounts actually or constructively received from investing the proceeds of a bond issue.

TRANSFERRED PROCEEDS - When the proceeds of a refunding issue are used to make payments of principal on refunded bonds, any unspent proceeds of the refunded bonds "transfer over" to the refunding issue based on a formula set forth in the Regulations, and the unspent proceeds become transferred proceeds of the refunding issue.

REPLACEMENT PROCEEDS - Includes money held by the issuer or a "substantial beneficiary" of the bonds if the amounts have a sufficiently direct relationship to the bond issue or a governmental purpose of a bond issue and the amount invested would be used for a governmental purpose. For example, amounts held in a sinking fund or **pledged** fund for the bonds would generally be treated as replacement proceeds of the bonds.

GROSS PROCEEDS - All proceeds (sale proceeds, investment proceeds, replacement proceeds, and transferred proceeds) plus amounts that are reasonably expected to be used to repay the bonds, such as revenues deposited in a debt service fund (DSF) and amounts that are pledged as security for the repayment of the bonds (**Gross Proceeds**).

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DISPOSITION PROCEEDS - Amounts received from the sale of all or a portion of a bond-financed facility, while the bonds are still outstanding. For arbitrage purposes, disposition proceeds are treated as gross proceeds of the applicable bonds.

NET PROCEEDS - The proceeds (sale proceeds, investment proceeds, and transferred proceeds) of the bonds less the amount of a reasonably required reserve or replacement fund.

4.8.2.2 EXPENDITURE OF GROSS PROCEEDS

Understanding whether funds remain "proceeds" at any given time requires an understanding of when funds related to a bond issue will be treated as spent. The following concepts are important to an understanding of expenditures:

EXPENDITURES RELATED TO PURPOSE OF ISSUE - Generally, proceeds may be spent only on capital costs of facilities and costs of issuing the bonds. Once proceeds are actually allocated to a qualified expenditure for a facility, that facility will be treated as financed with proceeds of the bonds. The proceeds will then need to be tracked for purposes of ensuring that the bonds meet the private activity bond or qualified private activity bond requirements, as applicable to the particular type of bonds. If the purpose of the bonds is to finance working capital expenditures, the Regulations provide that proceeds are spent only at times in which the issuer has no "available amounts" on hand available to cover those working capital expenses.

INVESTMENTS - Gross proceeds are considered not spent if they are used to acquire non-purpose investment securities (investments purchased before expenditure of the proceeds on their ultimate use). They are simply allocated to those investments temporarily and return to the issuer for ultimate use or reinvestment as the investment securities **mature** or are sold. During the time gross proceeds are allocated to investment securities, they are tracked for arbitrage purposes, as well as to determine the amounts of investment proceeds that have accumulated.

PAYMENT OF DEBT SERVICE - Generally, gross proceeds that are not sale, investment, or transferred proceeds are spent when they are used to pay debt service on the bonds.

REIMBURSEMENTS - Issuers and conduit borrowers often wish to use bond proceeds to reimburse themselves for costs paid before the issuance of the

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bonds. Bond proceeds allocated to "reimbursement costs" will be treated as "spent" only if certain requirements are satisfied. See **Section 4.4.5, Reimbursement of Prior Expenditures**. If these requirements are not satisfied, any bond proceeds that the issuer or conduit borrower attempts to allocate to the reimbursement costs will not be treated as spent and will continue to be subject to the arbitrage yield restriction rules and the rebate requirement discussed in more detail below.

4.8.3 Yield

The yield on a bond issue is the discount rate or interest rate that allows all of the payments of principal and interest on the bonds (net of payments or receipts from certain interest rate hedging transactions such as swap agreements), plus any payments for credit enhancement (such as letter of credit fees or bond insurance premiums), to equal the aggregate issue price of the bonds, on a present value basis and as of the date the bonds are issued. The issue price of bonds is measured on a maturity-by-maturity basis (or by **CUSIP**[4] number if there are bonds of a split maturity) and is generally the first price at which at least 10% of each maturity (or CUSIP number) of bonds are sold to persons who are not underwriters. An underwriter's discount or fee does not affect the issue price of the bonds and, therefore, does not affect the calculation of yield on the bonds. In other words, although from the issuer's perspective the payment of an underwriter's discount increases borrowing costs, it does not increase the yield on the bonds.

4.8.3.1 FAIR MARKET VALUE RULES

One fundamental requirement of all of the yield-related limitations (e.g., the arbitrage yield restriction, the **rebate requirement**) is that non-purpose investments must be purchased by issuers at a fair market value price. Without this fair market value requirement, issuers could simply direct prohibited investment profits, or profits that would otherwise be paid to the federal government, to entities other than the United States. The process of purchasing investments at an inflated price, known as "yield burning," has received significant attention and enforcement efforts from federal authorities. Issuers must be careful to comply with the fair market value requirement. Reliance on a fair market value certificate of the seller of securities, in circumstances where the seller will profit from an inflated

[4] Committee on Uniform Security Identification Procedures.

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price and the issuer will not be harmed, is inherently suspect. The Regulations provide a safe harbor for determining the fair market value of certain acquisitions of investments, which generally requires a bidding process and at least three bids from qualified providers of the investment securities.

The federal government has established a special program through the Bureau of Public Debt in which issuers can purchase special U.S. Treasury obligations—State and Local Government Series (SLGS)—at or below market yields in order to comply with the arbitrage yield restriction. Purchase of **SLGS** is deemed to have been at fair market value.

4.8.3.2 GUARANTEED INVESTMENT CONTRACTS

Proceeds of bonds may be invested under **investment agreements** commonly known as **guaranteed investment contracts** (GICs), where the issuer is guaranteed a certain rate of return on the amount of bond proceeds being invested with an investment provider. GICs usually involve the portion of bond proceeds used to finance capital improvements or held as a reasonably required reserve fund. A GIC should permit an issuer enough flexibility to spend the money invested so that all tax requirements of the Code are met, such as the timing requirements of the hedge bond rules. Fees paid to the GIC broker are permitted to be used to increase the yield on the bonds to the extent permitted by the Regulations. However, certain bidding requirements and certifications are required in order to take such payments into consideration. For GICs that are expected to be entered into at the same time as the issuance of the bonds, **bond counsel** should be involved early in the bidding or negotiation process because the GICs may have collateral effects on the tax or bond analysis.

4.8.4 Arbitrage Yield Restriction Exceptions

As discussed above, the general rule is that proceeds of the bonds may not be invested at a yield that is materially higher than the yield on the bonds. However, there are several important exceptions to this yield restriction rule, and almost all bond issues take advantage of one or more of these exceptions. For example, as a result of the initial temporary period exception, the bona fide DSF exception and the reasonably required reserve or replacement fund exception, none of the proceeds of a typical "new money" governmental financing will be subject, at least initially, to arbitrage yield restriction.

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4.8.4.1 INITIAL TEMPORARY PERIOD

For bonds issued to finance capital expenditures, an issuer may invest the proceeds of an issue at an unrestricted yield for up to a 3-year period (an "initial temporary period") provided the issuer reasonably expects that as of the issue date of the bonds the following requirements will be satisfied:

1. At least 85% of the proceeds of the bonds will be spent on capital projects by the end of the 3-year period.

2. Within 6 months of the issue date, the issuer expects to spend or expects to incur a binding obligation to a third party to expend at least 5% of the proceeds of the issue on capital projects.

3. The completion of the capital projects and the allocation of the proceeds of the issue to expenditures will proceed with due diligence.

In the case of bonds issued to finance construction expenditures, the proceeds may be eligible for a 5-year initial temporary period if the issuer reasonably expects to satisfy the above-described expenditure, binding contract, and due diligence tests and both the issuer and a licensed architect or engineer certifies that a longer construction period is necessary to complete the project.

4.8.4.2 BONA FIDE DEBT SERVICE FUNDS

An issuer may have up to a 13-month temporary period for amounts deposited in a bona fide DSF. A bona fide DSF is a fund used primarily to achieve a proper matching of revenues and debt service each bond year by depositing revenues in the fund until they are needed to pay debt service on a bond issue. The fund must be depleted each year except for an amount not to exceed the greater of (1) the earnings on the fund for the immediately preceding bond year, or (2) one-twelfth of the principal and interest payments on the bond issue for the immediately preceding bond year.

4.8.4.3 RESERVE FUNDS

A DSRF is eligible to be invested at an unrestricted yield (i.e., invested without regard to yield) if the funds are considered "reasonably required." The amount of a reasonably required reserve fund is limited to the least of (1)

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maximum annual debt service on the bonds, (2) 10% of the proceeds of the bonds, or (3) 125% of average annual debt service on the bonds. In general, a reserve fund for general obligation bonds may not be able to qualify as a reasonably required DSRF.

4.8.4.4 OTHER EXCEPTIONS

Investment earnings on proceeds generally qualify for a 1-year temporary period beginning on the date the proceeds are received.

The exceptions to arbitrage yield restrictions only apply to "non-purpose investments," which are investment securities purchased with bond proceeds before expenditure of the proceeds on their ultimate use. In contrast, "purpose investments" are investments acquired in order to carry out the governmental purpose of the bond issue, such as the acquisition of a conduit loan. Purpose investments are allowed to have a yield of either 1/8% or 1.5% higher than the yield on the bonds depending on certain factors. Furthermore, purpose investments are not subject to the rebate requirements, so that issuers may retain any excess investment return derived from the allowable 1/8% or 1.5% spread.

Regardless of the availability of any of the arbitrage yield restriction exceptions described here, gross proceeds generally may be invested in other tax-exempt bonds without regard to the yield on the tax-exempt investments.

4.8.5 Yield Restriction; Yield Reduction Payments

To the extent that bond proceeds of an issue remain unexpended at the end of the respective **temporary periods**, such unexpended proceeds may generally not be invested at a yield in excess of 1/8 of 1% above the yield of the issue. Alternatively, in certain circumstances an issuer may be eligible to make "yield reduction payments" to the U.S. Treasury Department. By making yield reduction payments, an issuer may continue to invest the proceeds of the bonds above the yield on the issue after the expiration of the temporary period as long as any earnings on the proceeds before expenditure in excess of the bond yield are paid as yield reduction payments to the U.S. Treasury Department at the same time and in the same manner as under the general rebate requirement.

4.9 ARBITRAGE REBATE

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Since enactment of the *Tax Reform Act of 1986*, most bond financings have been subject to the arbitrage rebate requirement. To the extent that proceeds of bonds are allowed to be invested at a yield in excess of the bond yield and actually are invested at a higher yield, the Code requires that the excess (generally referred to as "arbitrage earnings") must be rebated to the federal government. Thus, even though certain exceptions to the yield restriction requirements permit bond proceeds to be invested at an unrestricted yield during certain temporary periods, the rebate requirement generally requires that any arbitrage earnings be paid to the federal government. Issuers may, however, qualify for certain exceptions from arbitrage rebate liability as described below. In addition to bond proceeds held pending expenditure for the acquisition or construction of the project financed, the rebate requirement applies to arbitrage earnings on investments held in reasonably required reserve or replacement funds. However, earnings on bona fide DSFs for governmental bonds are exempt from the rebate requirement if the gross earnings on the DSF for a bond year are less than $100,000 or if the bonds have a fixed interest rate and an average maturity of at least 5 years.

The amount of an issuer's arbitrage rebate liability, and the availability of applicable exceptions to that liability, are based on actual expenditures, not on the issuer's expectations. Compliance with arbitrage rebate requirements is an important post-issuance compliance requirement. See **Section 8.3.5, Arbitrage Rebate**. Public agency issuers generally engage an expert to provide arbitrage rebate calculation services.

4.9.1 Rebate Exceptions

There are four important exceptions to the rebate requirement that the issuer and bond counsel should carefully consider when structuring a bond issue. The sections below describe these exceptions.

4.9.1.1 SMALL ISSUER EXCEPTION

The small issuer exception allows a public agency to retain all arbitrage earnings realized from the investment of the gross proceeds of certain bond issues that are not qualified private activity bonds. The small issuer exception is available only to issuers that possess general taxing powers (even if those powers may only be exercised after voter approval of the tax). The exception may be applied

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to a bond issue if the amount of the issue, together with the amount of any other bonds issued or expected to be issued by the issuer by the issuer and all closely related public agencies during the same calendar year, does not exceed $5 million. Additionally, the issuer must expect to spend at least 95% of the net proceeds of the bonds for the governmental purpose for which the bonds are issued. A recent amendment to the tax code raised the $5 million limit to $10 million to the extent the additional bonds are issued to finance construction of public school facilities.

4.9.1.2 6-MONTH EXPENDITURE EXCEPTION

Under the 6-month expenditure exception, proceeds are not subject to the rebate requirement if the issuer actually spends all proceeds of the issue within 6 months of the date the bonds are issued. The 6-month exception is based on actual expenditures. Solely for purposes of determining compliance with the 6-month expenditure exception, amounts held in a qualifying reserve fund are not treated as proceeds. Therefore, the amounts held in the reserve fund are subject to the normal rebate requirement. The 6-month expenditure exception is most likely to apply to acquisition financing (where the project is being acquired rather than constructed), TRAN and RAN financing, reimbursement financings, and current refundings.

4.9.1.3 18-MONTH EXPENDITURE EXCEPTION

As with the 6-month exception, proceeds of an issue that are not in a reserve fund are not subject to the rebate requirement if all of the proceeds (including investment proceeds) are spent within 18 months from the issue date, provided all of the following occur:

- At least 15% of the proceeds are spent within 6 months.
- At least 60% of the proceeds are spent within 12 months.
- At least 100% of the proceeds are spent within 18 months.

Compliance with the 18-month exception, like compliance with the 6-month exception, is based on actual expenditures, although the 15% and 60% expenditure requirements are measured based on the sale proceeds plus the aggregate investment proceeds expected to be earned during the 18-month period, in accordance with the issuer's reasonable estimate of investment

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earnings at closing. Additionally, as with the 6-month exception, amounts held in a reserve fund are not treated as proceeds for purposes of satisfying the expenditure requirements. The 18-month expenditure exception does not apply to refundings.

4.9.1.4 2-YEAR EXPENDITURE EXCEPTION

Under the 2-year rule, an issue is not subject to the rebate requirement if all proceeds (including investment proceeds) except for amounts held in a reserve fund are expended within 2 years from the issue date, provided that all of the following occur:

- At least 10% of such proceeds are spent within 6 months.
- At least 45% are spent within 12 months.
- At least 75% are spent within 18 months.
- At least 100% are spent within 24 months.

Compliance with the 2-year exception, like compliance with the 6-month exception, is based on actual expenditures, although the 10%, 45%, and 75% expenditure requirements are measured based on the sale proceeds plus the aggregate investment proceeds expected to be earned during the 2-year period. Additionally, as with the other expenditure exceptions, amounts held in a reserve fund are not treated as bond proceeds for purposes of satisfying the expenditure requirements. The 2-year expenditure exception does not apply to refundings.

In order to qualify for the 2-year expenditure exception, at least 75% of the proceeds of the bond issue must be expected to be expended for construction costs, as opposed to acquisition or refinancing costs. If the 75% construction cost requirement is not expected to be met by the bond issue as a whole, the tax code allows the issuer to treat the bond issue as two separate issues. If one of such issues, the construction portion, meets 75% construction cost requirement, then the construction portion is eligible for the 2-year expenditure exception. The 6-month expenditure exception (but not the 18-month expenditure exception) or the normal rebate requirements would apply to the remaining portion. Special rules apply to pooled financings.

4.9.2 Penalty in Lieu of Rebate

The Tax Code also allows an issuer to pay a penalty in lieu of a rebate, if the issuer

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so elects at the time its bonds are issued (i.e., at closing). The penalty is 1.5% of the amount of proceeds of the bond issue that, as of the close of each 6-month period described above in Section 4.9.1, Rebate Exceptions, are not spent in accordance with the 2-year expenditure schedule. The election to pay a penalty in lieu of rebate should only be contemplated by an issuer if the bond proceeds are expected to be invested substantially above the yield on the bonds; otherwise, an issuer may find itself paying a penalty even though the issuer is not realizing any significant arbitrage earnings.

4.10 ADDITIONAL FEDERAL TAX LAW REQUIREMENTS

4.10.1 Registration

An obligation must be issued in registered form to be tax-exempt unless the bond (1) is an obligation not of a type offered to the public, to be determined based on whether similar obligations are in fact publicly offered or traded, or (2) has a maturity (at the time of issuance) of not more than 1 year. An obligation may be registered in either a certificate system or a book-entry system.

Under a certificate system, the obligation is registered with the issuer or its agent as to both principal and stated interest, the holder is issued a physical certificate evidencing its rights to the amounts, and transfer of the obligation to a new holder occurs by surrender of the old certificate and either the reissuance by the issuer of the surrendered certificate or the issuance of a new certificate. Under a book-entry system, the ownership interest in an obligation is reflected in a book-entry record maintained by the issuer or its agent, and generally physical certificates are not delivered to individual holders. Any transfers of ownership are made through a book-entry. The issuer may elect to change from a certificate system to a book-entry system, or vice versa. Generally, tax-exempt bond issues are registered through the book-entry system maintained by The Depository Trust Company.

4.10.2 No Federal Guarantee

A bond will not be tax-exempt if the bond is federally guaranteed. A bond is federally guaranteed if (1) the payment of the principal of and interest on the bond is guaranteed in whole or in part by the United States or an agency or instrumentality thereof; (2) the bond is part of an issue of bonds of which 5% or more of the proceeds are to be (a) used to make loans, the payment of the principal of

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or interest on is to be guaranteed in whole or in part by the United States or an agency or instrumentality thereof or (b) invested directly or indirectly in federally insured deposit accounts; or (3) the payment of principal of or interest on the bond is otherwise indirectly guaranteed in whole or in part by the United States or an agency or instrumentality thereof. There is a broad exception for proceeds invested during a permitted initial temporary period, such as during the first 3 years following issuance of a new money bond issue (that meet the requirements for the 3-year temporary period described in Section 4.8.4.1, Initial Temporary Period). Other exceptions include certain insurance programs (e.g., a guarantee by the Veterans Administration), guarantees of student loans, investments in a bona fide reserve fund or a reasonably required reserve or replacement fund; and investments in obligations issued by the U.S. Treasury.

4.10.3 Information Reporting Requirements

The issuer is required to file with the IRS not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which a bond is issued a statement containing certain specified information regarding a bond issuance. For governmental bonds, the issuer files a Form 8038-G and for qualified private activity bonds, including 501(c)(3) bonds, the issuer files a Form 8038. See Chapter 8 - Post-Issuance Debt Management Requirements, Including Tax Compliance and Ongoing Disclosure Obligations.

4.10.4 Limitations on Pooled Financing Loans

In a pooled financing, a state or local government issues bonds and subsequently loans the proceeds to multiple borrowers.[5] A pooled financing bond is a bond for which more than $5 million of the proceeds are reasonably expected to be used (or are intentionally used) directly or indirectly to make or finance loans to two or more ultimate borrowers. Pooled financing bonds do not include qualified private activity bonds that are subject to the volume cap requirements. A pooled financing bond will not be tax exempt unless the issuer and the borrower satisfy certain requirements that are generally intended to limit issuance of pooled financing bonds before the time that the ultimate borrowers are known.

[5] This may be facilitated by the issuer purchasing the bonds of the borrowers.

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4.11 BANK QUALIFIED BONDS

Generally, a bank may not deduct any of the carrying cost of tax-exempt bonds, effectively eliminating the benefit of investing in tax-exempt bonds. A bank may, however, deduct a portion of the interest on a "qualified tax-exempt obligation" (generally referred to as "bank qualified bonds"). Thus, bank qualified bonds are attractive investments for banks and can generally be sold with lower interest rates than similar bonds that are not **bank qualified** bonds.

For a bond to be a bank qualified bond, the issuer cannot reasonably anticipate, when the bond is issued, to issue more than $10 million in tax-exempt bonds in that calendar year (excluding certain refunding bonds), the bond cannot be a private activity bond (other than a qualified 501(c)(3) bond), and the issuer must designate the bond as a bank qualified bond (which is generally done in the **disclosure** document and in the **tax certificate** relating to the bond).

4.12 REFUNDING BONDS

The proceeds of refunding bonds are used to pay principal, interest, or **redemption** price on another prior issue of bonds. For federal tax purposes, there are two important categories of refunding bonds:

- ADVANCE REFUNDING BONDS - **Refunding** bonds issued more than 90 days before the bonds being refunded will be retired
- CURRENT REFUNDING BONDS - **Refunding** bonds issued within 90 days of the date the bonds being refunded will be retired

The issuance of refunding bonds often raises complex federal tax issues. Tax analysis, for example, requires review of the expenditure of the proceeds of the refunded bonds. Further, the *Tax Cuts and Jobs Act of 2017* enacted in December 2017 prohibits the issuance of tax-exempt bonds to advance refund other tax-exempt bonds.

4.13 TAX RISK

As described above, for bonds to be and remain tax-exempt, some complex issues must be addressed. If the IRS determines and successfully demonstrates that an is-

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sue of bonds is "taxable" the issuer would likely be subjected to a suit for damages by unhappy investors unless the issuer enters into a "settlement agreement" with the IRS in which the IRS agrees to allow the bonds to continue to be tax-exempt in exchange for a substantial payment by the issuer. If taxability results from an act or omission of the issuer it generally constitutes an event of **default** on the debt.

Even if a bond issue is not declared taxable, if an issue becomes subject to a "tax cloud," either because of something relating directly to the issue or because similar transactions unrelated to the issue or the issuer are called into question, the issuer may experience trouble marketing future debt. If a "tax cloud" appears on variable-rate tender debt, the debt may all be tendered, and **remarketing** of the debt may not be possible or may require very high interest rates.

Because of the potential losses involved, it is incumbent upon public agencies issuing tax-exempt debt to assure that the debt in fact is and remains tax exempt. Public agencies can minimize tax risk by selecting highly competent and careful bond counsel and other financing professionals and by exercising prudence in deciding how to structure each transaction.

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Bond counsel oversees all aspects of the transaction relating to tax exemption, advises the issuer and other financing participants of the impact of various structural alternatives on tax-exemption, and renders an opinion that interest on the debt is tax exempt (generally stated, "excluded from gross income for federal income tax purposes").

Chapter 5. Sale of Municipal Debt

The sale of municipal debt by a public agency **issuer** is often the culmination of years of capital and financial planning. A fundamental decision for the public agency and its financing team is how the bonds will be offered to the market, referred to as the "method of sale." Municipal debt securities can be sold to **investors** in a **public offering** or a **private placement** transaction. The method of sale can be directed by statute or public policy or simply by cost. This chapter describes the method of sale options available to public agency issuers and the factors to be considered when selecting the method of sale, including costs of issuance, **credit ratings**, and marketing considerations.

5.1 WHAT IS A PUBLIC OFFERING?

A public offering is the sale of municipal debt securities (referred to in this chapter as "bonds"), generally through an **underwriter**, to the general public or a limited sector of the general public. The offer is usually accompanied by an **Official Statement** (OS) in which the terms of the financing and its structure,

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sources of repayment security, and other important information are set forth. The OS provides the information needed by investors to make an informed investment decision. See Section 6.3, The Official Statement and Section 8.4, Continuing Disclosure. A public offering may be either a **negotiated sale** or a **competitive sale**.

5.1.1 Sale Methods - Competitive or Negotiated Sale

In the absence of any legal or policy requirement to conduct a bond sale using a specific method, issuers will need to decide which method of sale—competitive or negotiated—best suits their objectives. Although the majority of municipal bonds today are sold through a negotiated method, competition inspires notions of fairness and transparency. The truth, however, is that each method offers advantages and disadvantages and the issuer must consider them and its political, financial, and legal goals in choosing one or the other.[1] The appropriate sale method should be determined on a case-by-case basis after evaluating factors related to the proposed financing, the issuer, and the bond market.

The challenge for public issuers is to properly identify how the relevant decision factors apply to their proposed bond **issues** and whether one type of sale is preferable. The Government Finance Officers Association (GFOA) encourages issuers that do not possess in-house expertise[2] to engage a municipal advisor in the analysis and evaluation of the appropriate method of sale.

The GFOA recognizes that the following factors may warrant the use of a competitive sale method.[3]

- The **rating** of the bonds, either credit-enhanced or unenhanced, is at least in

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[1] The Government Finance Officers Association (GFOA) recommends that when state or local laws do not prescribe a sale method, the issuer decide based on a "thorough analysis of the rating, security, structure, and other factors pertaining to the proposed bond issue." GFOA Best Practice - Advisory, *Selecting and Managing the Method of Sale of Bonds*, www.gfoa.org/materials/selecting-and-managing-the-method-of-sale-of-bonds.

[2] GFOA describes "in-house" expertise to be "dedicated debt management staff whose responsibilities include daily management of a debt portfolio." See GFOA Best Practice - *Selecting and Managing Underwriters for Negotiated Bond Sales*, www.gfoa.org/materials/selecting-and-managing-underwriters-for-negotiated.

[3] Ibid.

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the single-A category.

- The bonds are general obligation bonds or full faith and credit obligations of the issuer, or they are secured by a strong, known, and long-standing revenue stream.
- The structure of the bonds does not include innovative or new financing features that require extensive explanation to the bond market.
- The issuer is well known and is frequently in the market.

Factors that may warrant the use of a negotiated sale include:

- The rating of the bonds, either credit-enhanced or unenhanced, is lower than single-A category.
- Bond insurance or other **credit enhancement** is unavailable or is not cost-effective.
- The bond structure has features such as a pooled bond program, variable-rate debt, **deferred interest bonds**, or other bonds that may be better suited to negotiation.
- The issuer desires to target underwriting participation to include disadvantaged business enterprises (DBEs) or local firms.

These are only a few of the factors that drive decision making in this area; others are discussed below.

5.2 COMPETITIVE SALES

A competitive sale is a public offering that prices a debt issuance through a bidding process. Statutes often refer to competitive sales as **public sales**. In a competitive sale, a public agency sells its bonds to the underwriter or group of underwriters offering the best bid while meeting the terms of the sale. The issuer, typically with the assistance of **bond counsel** and a **municipal advisor**, conducts all the tasks necessary to prepare the bonds for sale. These tasks include structuring the **maturity** schedule, preparing the **Preliminary Official Statement (POS)**, verifying legal documents, obtaining a rating, securing any credit enhancement, and timing the sale.

California Government Code Section 53692 requires that the issuer of bonds to be sold through a competitive sale publish a notice of its intention to sell the bonds. The notice must be in a financial publication generally circulated

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throughout the state or reasonably expected to be disseminated among prospective bidders for the bonds. The notice must appear at least 15 days before the public sale of any bonds having a **principal** amount of $1 million–$10 million and at least 5 days before the public sale of any bonds having a principal amount that exceeds $10 million. The notice must include the date, time, and place of the intended sale and the amount of the bonds to be sold.

The issuer advertises the sale of the bonds in advance of the specified sale date through a **Notice of Sale** (NOS). The NOS contains relevant information (including a schedule for submittal of bids, distribution of a POS, etc.) on the proposed issue, and the criteria by which the bonds will be awarded. At the specified date, time, and venue, the issuer receives bids. The issuer reviews them and awards the right to purchase the bonds to the underwriter or group of underwriters with the best bid.

Identification of the best bid is based on the criteria specified in the NOS—generally the lowest **true interest cost**, a metric that accounts for the **interest rate** to be paid on the bonds by the public agency, as well as other one-time **premiums** and **discounts** paid by or to the public agency in connection with the initial sale of the bonds. Bids can be required to be delivered in person or by facsimile, although most competitive sales are conducted through an electronic bidding platform. The bonds are sold to the winning bidder, which may be a single underwriting firm or a **syndicate** of firms, generally on an "all or none" basis. (The NOS can specify that awards will be made on a maturity-by-maturity basis, but this is usually only for very large TRAN offerings.)

Although the underwriters purchase the bonds from the public agency and resell them to investors, they do not play an active role in structuring the transaction. The underwriters are generally compensated by bidding **interest** coupons on the bonds, allowing the underwriters to resell the bonds to investors for more than the price they paid for the bonds or receive an **underwriter's discount** from the public agency, or some combination thereof. Additionally, issuers may require bidders to provide a **good faith deposit** in an escrow or other type of account as a minimum qualification to participate in the competitive offering.

5.2.1 Advantages of a Competitive Sale

The issuer's ultimate goal in a financing is to protect the public's interest by obtaining the lowest possible overall borrowing cost. The main advantage of a com-

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petitive sale is competitive **pricing** of the bonds among underwriters. Because the public agency will sell the bonds upon the terms of the best qualifying bid (i.e., the bid that offers the lowest overall debt service cost to the public agency, in addition to any other specified factors), bidders have an incentive to offer the lowest cost bid.

5.2.2 Disadvantages of a Competitive Sale

Because underwriters bidding on a competitive sale have no guarantee of being awarded the bonds, they cannot be expected to conduct the same level of pre-sale marketing (canvassing prospective investors before the sale) as in a negotiated sale. To compensate for uncertainty about market demand, underwriters may include a hedge or a risk premium in their bids, which can show up either in the spread or the **reoffering** scale.

Additionally, public agency issuers may have limited flexibility with respect to the timing of the sale and changes to the proposed financing's debt structure, because an issuer's ability to make last-minute changes is limited by the competitive sale process. While an NOS can be structured to allow for postponement of a competitive sale and subsequent reoffering, legal notice requirements restrict the issuer's ability to move the sale date forward.

Furthermore, the competitive sale restricts the issuer's ability to adjust major structural features, such as final maturity and call provisions, to match the demand realized in the actual sale process. Again, while a properly structured NOS can increase the flexibility of a competitive sale by allowing for changes to bid terms before the bid and for modification of the size of the issue (within certain parameters) and principal maturity amounts, after bids are received, a negotiated sale still offers more flexibility in structuring.

With a competitive sale, the issuer relies on a competitive bidding method for underwriter selection and bond distribution. The issuer sells the bonds to the underwriter that submitted the best bid, based on the NOS criteria. Because of this the issuer is unable to ensure that its preferences will be met with regard to the type, size, or location of the firm(s) selected.

5.2.3 Documentation for a Competitive Sale

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Issuers of bonds in a competitive sale provide a notice of intention to sell the bonds. The notice of intention states when the sale is scheduled and how potential bidders may obtain a copy of the NOS. In addition, the NOS is generally distributed to likely bidders. The NOS describes the requirements of the financing, including the following:

- The method of delivering bids and the date, time, and place of the bid opening or, if an electronic bidding platform is used, the requirements for participation.
- The rights of the public agency to amend the NOS, delay the sale, or reject bids
- The terms of the bonds and the security for them
- Maximum and minimum offering prices
- Any requirements with respect to bond terms (e.g., ascending interest rates) that must be reflected in bids
- The basis for determining the winning bid
- The ability of the public agency to adjust principal amounts following the receipt of bids
- The good faith deposit or **surety** required to secure the underwriters' obligation to take delivery of and pay for the bonds
- An enumeration of the documents, certificates, and opinions that must be delivered concurrently with the delivery of the bonds (which are of more limited scope than for a negotiated public offering)

Bidders are generally allowed to specify that principal amounts maturing on sequential dates be consolidated into **term bonds** and the public agency is often authorized to increase or decrease the amount of principal maturities within specified limits (e.g., to achieve level **debt service** or the desired amount of **proceeds**). The NOS, together with the winning bid and the public agency's acceptance of the bid, form the agreement for the purchase and sale of the bonds between the public agency and the underwriter submitting the winning bid.

As it would in a bond pricing for a negotiated sale, a public agency selling bonds through a competitive sale may turn to its municipal advisors to develop an understanding of prevailing market conditions, evaluate key economic and financial indicators, and assess how these indicators may affect the proposed pricing in the

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competitive offering. Additionally, because bonds sold in a competitive sale are awarded to the lowest bid, issuers and their advisors must be prepared to verify the accuracy of the bid's proposed interest cost relative to the terms of the bid document and structure of the debt issuance.

5.3 NEGOTIATED PUBLIC OFFERINGS

In a negotiated public offering, the public agency selects one or more underwriters with whom to negotiate the purchase of the bonds (for ultimate resale to investors). Statutes often refer to negotiated offerings as "private sales," even though the bonds may be widely offered. Underwriter selection may be determined through a competitive request for qualifications (RFQ) or **request for proposal** (RFP) procurement process although the selection may be based upon other factors, such as an existing business relationship with an underwriter. The GFOA identifies five key components that should be included in each public agency RFP:[4]

1. A clear and concise description of the contemplated bond sale transaction or financing program

2. A statement noting whether firms may submit joint proposals and stating whether the issuer reserves the right to select more than one underwriter for a single transaction

3. A description of the objective evaluation and selection criteria and an explanation of how proposals will be evaluated

4. A requirement that all underwriter compensation structures be presented in a standard format (typically as a cost for $1,000 in bonds, either on average or on a maturity-by-maturity basis), indicating which fees are proposed on a not-to-exceed basis, describing any conditions, and explicitly stating which costs are included in the fee proposal and which costs are to be reimbursed

5. A requirement that the proposer provide at least three references from other

[4] GFOA Best Practice - *Selecting and Managing Underwriters for Negotiated Bond Sales*, www.gfoa.org/materials/selecting-and-managing-underwriters-for-negotiated. See also Municipal Securities Rulemaking Board, *Issuer Considerations for Selecting the Underwriting Team and Understanding the Pre-Marketing Process*, 2016, www.msrb.org/msrb1/pdfs/selecting-Underwriting-Team.pdf.

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public-sector clients, preferably clients to whom the firm provided underwriting services similar to those proposed in the RFP

The selection of the underwriter or underwriters in a negotiated sale may target certain types of underwriting firms (including firms that may help an agency meet targeted business enterprise [TBE] participation goals) and establish goals for the distribution of bonds among prospective investors. The underwriting team may consist of a sole senior underwriter or a group of two or more underwriters (including a senior manager, co-managers, and other dealers) called a syndicate, which shares in the underwriting risk associated with the debt issuance. Issuers trying to reach certain market sectors or types of investors may be able to negotiate with the underwriter to allocate bonds accordingly.

During the issuance process, the public agency works with the underwriters, bond counsel, and the public agency's financial advisor to structure the transaction. See Chapter 2, Debt Structures: What Factors Drive Structuring Decisions? On the date set for pricing of the bonds, after the pricing process further described below, (see Section 5.3.4, Pricing of a Negotiated Public Offering), the public agency enters into a **bond purchase contract** with the underwriters in which the underwriters agree to accept delivery of and pay for the bonds on a specified date in the near future on the terms and conditions contained in the contract, including interest rates and underwriter's compensation. See Section 5.3.3, Documentation for a Negotiated Public Offering. Before entering into the purchase contract, the underwriters have generally obtained commitments from investors for the purchase of most or all of the bonds. In a negotiated public offering, the underwriters generally buy the bonds at a discount from the price at which the underwriters expect to resell the bonds to investors (or are paid an underwriting fee) and this "underwriters' discount" or "spread" is the principal form of compensation derived by the underwriters for their underwriting services.

5.3.1 Advantages of a Negotiated Public Offering

The advantages to a public agency of a negotiated public offering may include structuring assistance, pre-sale marketing, and additional flexibility in the transaction structure and timeline. Involving an underwriter early in a transaction can help the public agency craft its financings because the underwriter may be familiar with innovative techniques employed by similar issuers in recent financings. In addition, because the underwriter in a negotiated sale knows it will be able to

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purchase the public agency's bonds, it may conduct effective pre-sale marketing with potential investors to provide information on market demand and otherwise generate interest in, and feedback on, the offering before the offering date. Pre-sale marketing is of particular value if the transaction is complex or the public agency's credit is weak or difficult to understand.

The underwriter can also obtain commitments from investors to purchase the bonds before determining the **yields** on the bonds, which may reduce an underwriter's inventory risk and result in a lower risk premium in the pricing for the public agency. Additionally, a negotiated sale makes last-minute adjustments to debt structure or sale timing easier, giving the public agency additional flexibility to respond to investor feedback and short-term market fluctuations. Flexibility is of particular value in volatile markets, for unusual financings, and for financings involving independent variables (e.g., the need to structure a **current refunding** to optimize total savings or a general obligation [GO] bond to respond to tax rate targets). Finally, a negotiated sales approach may enable an issuer to achieve other goals, such as hiring firms that employ disabled veterans.

5.3.2 Disadvantages of a Negotiated Public Offering

In a negotiated sale, the process of setting a price for the bonds is less subject to the rigors of competition because the underwriter obtains the exclusive right to purchase the bonds in advance of the pricing. The decision to use a negotiated sale rather than a competitive sale may generate concern among the issuer's taxpayers or fee payers that the costs were not subject to competition. That is not to say that there is not an opportunity or incentive to lower the issuer's borrowing costs through competition. First, underwriters are subject to **Municipal Securities Rulemaking Board** (MSRB) Rule G 17 ("fair dealing") and, second, they are aware that delivering the lowest borrowing cost to the agency may lead to future business opportunities. They may also be able to generate competition by marketing to potential investors. Nonetheless, issuers should remain vigilant and obtain market information on comparable transactions at the time of the pricing. A municipal advisor can help the issuer obtain the information, as well as monitor investor interest and underwriter performance.

Underwriters in a negotiated sale can provide an array of financial services in ad-

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dition to the actual underwriting of the bonds; however, these services come at a price. Because these services will be paid for as part of the underwriting spread (versus a flat fee), issuers should fully understand the services provided and the compensation proposed and disclosed by underwriters, in compliance with applicable MSRB rules.

5.3.3 Documentation for a Negotiated Public Offering

UNDERWRITING DOCUMENTS - If there is more than one underwriter, there may also be an "Agreement Among Underwriters" (AAU) allocating rights and obligations among the underwriters. A **selling group** agreement may also be used if bonds will be sold through broker-dealers who are not underwriters and party to the bond purchase contract. The GFOA recommends that the issuer be aware of its important role in evaluating an AAU and other agreements between underwriters or selling groups.[5] The agreements may include consideration of the rules of a transaction and should reflect a tone consistent with the issuer's underwriting, legal, administrative, and financial policies.

BOND PURCHASE AGREEMENT - In a negotiated public offering, the agreement for the purchase and sale of the bonds is formalized in a purchase agreement between the underwriter(s) and the public agency. The bond purchase agreement, which covers the timeframe beginning on the date of sale and ending on the financing's **closing date** generally specifies the following:

- Purchase price of the securities to be paid by the underwriters, which considers the underwriter's compensation and reimbursements.
- Interest rates, maturity dates, and principal amounts of each maturity of the bonds.
- Time, date, and place of the closing of the financing.
- The public agency's representations and warranties to the underwriters, including representations respecting authorization of the transaction and the completeness and accuracy of disclosure.
- Any agreements required to allow the underwriters to meet their obligations

5 Op cit.

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under U.S. Securities and Exchange Commission **(SEC) Rule 15c2-12** (including requiring the execution and delivery of a continuing disclosure agreement or similar document) See Section 8.4, Continuing Disclosure.

- A list of market disruption events that allow the underwriters to terminate the contract.
- An enumeration of the documents, certificates, and opinions that must be delivered concurrently with the delivery of the bonds.
- The identification of **eligible costs** (see Section5.4.2, Underwriting Fees and Expenses) to be borne by the issuer and expenses (including regulatory fees)[6] incurred in connection with the financing that are the responsibility of the underwriters.
- Liquidated damages (often secured by a good faith deposit) in the event the underwriters fail to take delivery of and pay for the bonds as required.
- The rights, if any, the underwriters and the public agency have to indemnification from each other.

5.3.4 Pricing of a Negotiated Public Offering

Unlike a competitive sale, a negotiated public offering allows a public agency selling bonds to actively negotiate the price of the bonds. The borrowing cost of a negotiated public offering is established through a formal pricing process conducted by the underwriter that determines the interest rates and reoffering prices at which bonds of particular maturities will be offered to investors. The public agency issuer should be prepared to evaluate the proposed pricing scale relative to applicable benchmarks and negotiate changes to the pricing (the price of tax-exempt bonds may be evaluated relative to indices, such as the Thomson Reuters Municipal Market Data index [MMD], where appropriate).

The underwriter's spread, including **takedown**, expenses and any **management**

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[6] In general, regulatory fees and other related expenses for a debt issuance cannot be passed through to the issuer and should be paid by the underwriter. Examples include SIFMA, MSRB, CalPSA, and GASB fees and computer run charges or bond model fees. Further, commuting costs to and from the underwriter's office by underwriter's staff should not be borne by the issuer.

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fee, are also subject to negotiation. While an issuer may retain a pricing consultant or municipal advisor to assist with bond pricing, issuers should fundamentally understand how its debt should be expected to perform in the marketplace. The GFOA recommends that issuers develop an understanding of prevailing market conditions, evaluate key economic and financial indicators, and assess how these indicators likely will affect the timing and outcome of the pricing.[7] To assist with this difficult responsibility, issuers may turn to financial advisors or others with pricing expertise to evaluate the pricing book received from the underwriter or the municipal advisor, including the following:

- "Comparable" recent sales
- Information on the interest rates and current market yields of recently priced and **outstanding** bonds with similar characteristics
- Interest rates and interest rate indices for bonds with similar characteristics provided by independent services that track pricing performance
- Historic benchmark index data for the bonds of the type being sold

Generally, the underwriters will have mailed or electronically distributed a POS to potential investors and to other underwriters about a week before the pricing date to announce the debt issuance to the market and to provide the information needed by prospective investors to make an informed investment decision. Federal securities laws generally require that if a POS is used to market an issue, it must fully disclose all facts that would be **material** to a potential buyer other than matters dependent on pricing. See Section 6.3, The Official Statement. The day before the date of pricing, the underwriter generally proposes and confers with the public agency issuer and its municipal advisor with respect to a debt structure and pre-marketing pricing scale. The terms must be agreeable to the issuer.

On the pricing date, the underwriters offer the bonds to investors on the agreed terms, generally through a "pricing wire," and they solicit orders. Electronic systems now allow the issuer and its municipal advisor to monitor the flow of orders for bonds in real time. If an appropriate number of orders are received, the issuer and the underwriters enter into a bond purchase contract on those terms. If not enough orders are received, or if orders for one or more maturities exceed the amount of bonds available (and the maturity would be "oversubscribed,") the issue may be re-

[7] GFOA Best Practice - *Pricing Bonds in a Negotiated Sale*, www.gfoa.org/materials/pricing-bonds-in-a-negotiated-sale.

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priced to be more attractive to investors or to give a better rate to the issuer. At the end of the pricing period, the issuer will agree to the final pricing through a "verbal award," with the information provided to the underwriter's counsel for preparation of the final bond purchase agreement incorporating the terms of the sale. Typically, the bond purchase agreement is executed on the same day as the verbal award.

5.4 COSTS OF ISSUANCE

The costs of issuance (COI) are the expenses paid by or on behalf of the issuer in connection with the sale and issuance of publicly offered bonds. For some types of bonds, the COI can be paid from the proceeds. For other types of securities (e.g., **qualified private activity bonds**) the COI, including the underwriter's discount, borrowed as part of the issue are limited to 2% of the proceeds.

5.4.1 Direct Costs of Issuance

An issuer's COI are typically paid from a COI fund or account established by an **indenture** or **bond resolution** and may be held by a bond trustee, a **paying agent**, or the issuer. In general, authorized COI should be paid after the receipt of invoices and within 120 days after the closing date of a debt issuance. COI are in addition to any internal costs incurred by the public agency for staff work directly related to the debt issuance or applicable fees to other government departments. The internal control and practices used to authorize COI should be consistent with procedural requirements specified in bond documents and applicable public agency administrative policies. Direct COI may include the following:

- Municipal advisor fees
- Legal counsel (bond counsel, issuer counsel, **disclosure counsel**) fees
- Bond trustee fees
- Credit rating fees
- Printing/distribution costs
- **Bond insurance** premium
- Auditor fees
- Fees payable to conduit issuers

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Refunding transactions may also include the following:

- **Escrow agent** fees
- Escrow securities bidding costs
- Pricing/escrow verification agent fees

5.4.2 Underwriting Fees and Expenses

In both negotiated and competitive sales, underwriting fees and expenses (the "underwriter's discount", **underwriter's gross spread**, or **spread**) are paid indirectly by the issuer to the underwriter of the bonds. The underwriting fees cover costs incurred by the underwriter and services related to selling the bonds to investors and managing elements of the transaction. The fees also include the underwriter's commission (or "takedown").

Components of the underwriter's discount include the following:

- TAKEDOWN - Normally the largest component of the spread, similar to a commission, which represents the compensation derived by the selling broker or dealer from the sale of the bonds

- UNDERWRITER EXPENSES - Any advertising and printing costs to the underwriter, fees and expenses of underwriter's counsel, Blue Sky fees and expenses,[8] external data services fees, investor road show expenses, out-of-pocket travel expenses, CDIAC, Committee on Uniform Security Identification Procedures (**CUSIP**), and The Depository Trust Company (DTC) fees and other similar expenses

- RISK PREMIUM - The amount of compensation for risks incurred by the underwriter in underwriting the bond issue, relating to the difficulty of marketing the issue, bond market conditions, and the amount of bonds remaining to be resold after the execution of the bond purchase agreement. It is rare for there to be any risk component in a negotiated sale.

- MANAGEMENT FEE - Sometimes a fee paid to the **managing underwriter** for handling the affairs of the syndicate, including, in the case of a negotiated

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[8] Generally the cost of determining the requirements of state securities laws and paying required fees. (See **Section 6.5.2**)

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sale, structuring the issue with the issuer

These costs are primarily allocated to the difference between the price an underwriter pays the issuer for the bonds and the price at which the underwriter expects to resell the bonds to investors. Underwriter's discount is typically reflected in the purchase price of the bonds paid by the underwriters at closing. In some cases, however, issuers must pay these fees from either bond proceeds or, if no proceeds are available because the offering price of **refunding** bonds cannot exceed the **redemption** price of refunded bonds, the public agency issuer's own funds.

Underwriting spreads have tended to decline in recent years due to competition, market factors, and technology. It is difficult to state a rule of thumb for what an underwriting spread should be or what the components should be relative to each other, because of the variables, which can include the type of financing, the credit quality of the debt, the scope of services to be provided by the underwriter, and other factors. Well before the final pricing of the bonds, the public agency issuer should request pricing book information from the underwriter detailing the elements of the expected spread and data on comparable spreads from other recent pricings. Issuers should remember that in a negotiated sale all of the elements of a spread are negotiable. If a financial advisor is involved in the transaction, the advisor should be prepared to analyze the proposed spread and ensure that it is reasonable under all of the circumstances.

Issuers also should be aware that certain costs are embedded within the bids received from underwriters in a competitive sale. These costs and fees are usually not specified in a competitive bid and are outside of the issuer's control, although the amount of underwriter's fee is reflected in True Interest Cost (TIC) and is factored into the determination of the winning bid.

The GFOA advises issuers to work with their financial advisors to understand all costs and fees, so that they can be controlled and managed throughout the financing process.[9] In addition, a thorough discussion with the issuer's municipal advisor and other professionals involved in the transaction should be expected. These discussions should occur at the time that compensation is being deter-

9 GFOA Best Practice - *Debt Issuance Transactions Costs*, www.gfoa.org/materials/debt-issuance-transaction-costs.

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mined for key members of the financing team, including the financial advisor, bond counsel, and other service providers. As always, cost must be balanced with quality, because it is critical that the issuer receives high-quality services and work products from all parties. Furthermore, it may be useful to see what other public agencies in California paid when issuing debt. Historical issuance costs can be found on the California State Treasurer's ***DebtWatch* database**.

5.5 PRIVATE PLACEMENTS

Private placements are sale transactions in which the issuer sells the entire issue of debt to a single or to a limited number of investors. The terms of the issue are generally negotiated directly between the issuer and the investor. Sometimes, an investment banker (or other advisor) will act as **placement agent**, bringing the parties together and acting as an intermediary in the negotiations. Instead of an OS, an offering circular, offering memorandum, or **private placement memorandum** may be prepared. The principal characteristics of a private placement are described below.

NO "SEC RULE 10B-5-COMPLIANT" OFFERING DOCUMENT - There may be a private placement memorandum or other offering material for soliciting investor interest, but there is no OS purporting to disclose all a prospective investor needs to know in order to make an informed investment decision. Issuers should be aware that while a private placement may not require a "SEC Rule 10b-5-compliant" offering document, applicable anti-fraud provisions of securities laws still apply to the issuer in private offering (i.e., issuers cannot fail to disclose material information). See **Section 6.3, The Official Statement**.

INVESTOR ACCESS TO RELEVANT INFORMATION - In the absence of a SEC Rule 10b-5-compliant offering document, prospective investors are provided sufficient access to information (which may include direct conversations with issuer officials) to enable them to evaluate the debt and the likelihood of repayment.

SOPHISTICATED INVESTORS - To ensure that investors are capable of making an adequate investigation, initial sales and subsequent transfers are limited to sophisticated investors, generally either "Qualified Institutional Buyers" (as defined in Rule 144A promulgated under the *Securities Act of 1933*) or "Accredited Investors" (as defined in Regulation D promulgated under the *Securities Act of 1933*).[10]

[10] Private placement purchasers may include municipal bond funds, in which case the ultimate investors are the holders of interests in the respective funds. The investment decision,

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Accredited Investors may be further limited to accredited investors that are not natural persons. The transfer restrictions may be removed later if, for example, the debt receives an "A" rating or an "investment-grade" rating.

LARGE MINIMUM DENOMINATIONS - The minimum authorized **denominations** for privately placed debt are usually $100,000 or $250,000, which are higher than the principal amounts in which municipal bonds are typically held by **retail investors**.

INVESTOR LETTER - Private placement purchasers are generally required to deliver an investor letter (described below) upon purchase of the bonds in an initial offering. Subsequent purchasers are sometimes required to deliver an investor letter as a condition to transfer of the bonds, in which case the transaction is said to require a "traveling letter."

Private placement offerings take a variety of forms, including the following:

- Sale by the issuer to an underwriter for resale to one or a limited number of investors. From a regulatory perspective, this is an underwriting that may be referred to as a limited public offering. In general, a limited public offering is sold in authorized denominations of $100,000 to a limited number of investors (no more than 35 persons) that meet certain established "sophisticated investor" standards for qualifying as a purchaser of the securities. This form of offering is exempt from the provisions of SEC Rule 15c2-12
- Sale by the issuer directly to one or a limited number of investors "brought to the table" by a placement agent
- Sale by the issuer directly to an investor without the engagement of either an underwriter or a placement agent, of which a "direct loan" (discussed below) is a variant

As a result of limits on the amount of credit a financial institution can extend to a particular borrower and the efficiency (in terms of issuance cost per dollar borrowed) of large public offerings, private placements tend to be limited in size. Further, because privately placed debt is often of lesser credit quality, security is often of a type that cannot be analyzed through standard rating criteria (e.g., real property), and obtaining ratings is an avoidable expense, privately placed debt is

however, is made by the sophisticated managers of the funds.

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generally unrated.

Private placements are common in **conduit financings** (See Section 3.3.9, Conduit Revenue Bonds), in which event investigative activities and credit negotiations are handled by the conduit borrower who acknowledges and agrees that the conduit issuer has no responsibility for the completeness or accuracy of the information provided or for payment of the debt.

5.5.1 Documentation Used in Private Placement Transactions

Apart from "direct loans," private placement bond documents are similar to the bond documents in a public offering, except that with the investor "at the table," issuer representations and **covenants** and security provisions tend to be negotiated. If there is an underwriter or a placement agent, there is generally a bond purchase contract or a placement agent agreement. Placement agent agreements are similar to bond purchase contracts, except that the placement agent agrees to use its best efforts to "place" the bonds with investors, rather than agreeing to purchase the bonds for resale.

Investor letters, delivered by the purchasers of the bonds, are key documents in private placements. In its investor letter, the purchaser does the following:

- Certifies that it satisfies the requirement for purchasing the bonds (e.g., that it is a Qualified Institutional Buyer or an Accredited Investor)
- Acknowledges that it has had an opportunity to obtain information with respect to the issuer and the bonds, and has made inquiries as it has deemed necessary
- Acknowledges, as appropriate, that investment in the bonds involves a high degree of risk
- Affirms that it is acquiring the bonds for investment and has no present intention to dispose of any or all of the bonds
- Acknowledges the restrictions on transfer of the bonds

5.5.2 Direct Loans

A direct loan or bank loan is a form of alternative financing for public agency issuers and represents a form of **debt** directly between an issuer and a lender and

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may be a type of a private placement. Often a direct loan is an extension of credit by a bank or other financial institution to a public agency borrower. The MSRB defines a direct loan "as a loan to a municipal issuer from a banking institution or another lender." Direct loan "obligations may constitute municipal securities."[11]

The bank may advance all funds at closing or advance funds over time as needed by the borrower, with interest paid only on funds advanced (generally referred to as a "drawdown" loan). Direct loan documents, like credit facility reimbursement agreements (e.g. Letters of Credit) (See Section 2.3.2, Credit Enhancement and Liquidity Support), include issuer representations, warranties, covenants, and default provisions more extensive than those in a public offering and tend to be heavily negotiated.

Because a public agency's borrowing authorization is generally to issue bonds or **notes** rather than to obtain loans, a direct loan may be structured as a purchase of a bond issued by the public agency, or the loan repayment obligation may be evidenced by a note executed and delivered by a public agency. In this case, additional bank requirements may be addressed in a separate agreement between the public agency and the bank, often referred to as a "continuing covenants agreement." A direct loan may also be structured as a **direct lease** or **installment sale agreement**. See Section 3.6.1, Financing Leases.

5.5.3 Alternative Financing Considerations

Standard & Poor's Global Ratings (S&P) groups direct lending under the term "alternative financing." They define it as "[D]ebt other than traditional long-term fixed-rate debt, notes, variable-rate **demand bonds**, and **commercial paper** commonly sold in the U.S. municipal market. Alternative financing typically includes bank loans, direct-purchase bonds, and other types of privately placed debt."[12] The emergence of the alternative lending market undoubtedly provides benefits to issuers by offering diversification and, often times, new sources of capital. Issuers should recognize, however, that the structural character of these loans may differ from the traditional forms of borrowing they have used in the past. Specifi-

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11 MSRB, Glossary of Municipal Securities Terms, Direct Loan, www.msrb.org/Glossary/Definition/DIRECT-LOAN.aspx.

12 Standard & Poor's Ratings Services, RatingsDirect: How Standard & Poor's Considers U.S. Public Finance Alternative Financing in its Rating Process, March 26, 2014.

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cally, many of these loans contain covenants that lead to **acceleration**,[13] create demands on **liquidity**, or contain cross-default provisions for other outstanding debt of the borrower. These claims may subordinate the claims of other lenders even if those lenders negotiated terms with the borrower before the latter borrowing in the alternative market. Issuers must understand that these provisions may trigger a disclosure obligation, requiring them to recognize the implications of the covenants in their direct loans on other outstanding debt. CDIAC addresses some of the risks associated with alternative financings as well as **disclosure** and reporting considerations when using direct loans.[14]

Private placements and alternative financings are reportable forms of debt to CDIAC under California Government Code Section 8855.

5.6 CREDIT RATINGS

Publicly offered municipal debt securities are generally assigned a credit rating by one or more credit rating agencies. Credit ratings reflect the opinion of the credit rating agency as to the probability that interest or principal payments on a security will not be paid in full and on time. Credit ratings provide an independent assessment of an issuer's credit risk derived from a systemic, uniform guide to creditworthiness. Investors may use ratings to supplement their evaluation of how much return they expect in terms of a bond's value, relative to an estimated probability that the issuer or obligor may **default** on paying its obligations. A bond with a strong credit rating would be assessed to have a lower likelihood of a payment default than a bond with a lower rating. The sections below provide more detail on rating systems.

Because different obligations payable by a particular obligor with a particular priority from a particular source present the same credit risk, reference is often made to an issuer's "rating." In California, this term usually refers to the agency's general obligation bond rating, whether or not they have actually issued such bonds. A public agency may, however, have bonds with differing ratings. Obligations pay-

[13] Acceleration provisions require full payment of the debt on default and give private lenders priority in default and repayment.

[14] CDIAC, Alternative Financing in the Municipal Market: Financial and Policy Considerations for Municipal Borrowers, CDIAC No. 15-04, 2015, www.treasurer.ca.gov/cdiac/issuebriefs/201507.pdf.

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able from a city's general fund, for example, may be rated A+, while obligations payable from the revenues of the city's water utility and secured by a senior lien on those revenues are rated AA and obligations payable from the revenues of the city's water utility and secured by a subordinate lien on the revenues are rated A.

While bonds and other debt obligations are generally not legally required to be rated, in most cases issuers find it to their advantage to obtain credit ratings. Ratings are, in most cases, directly associated with interest costs. Issuers should expect to pay investors higher interest rates on lower-rated debt, and it is often difficult and cost prohibitive to sell unrated debt.[15]

The use of credit ratings may also help an issuer to achieve a broader reception for its debt in the municipal market than for unrated debt. Some **institutional investors**, for example, including mutual funds, investment trusts and managers of public funds, are restricted by law or by the terms of their controlling legal documents and governance policies to buying securities at or above specified credit rating levels, so the use of credit ratings may help ensure that an issuer's debt is eligible for institutional investor consideration. Many other investors may apply credit criteria and strategies informally. The general acceptance and uniformity of credit ratings as stable and reliable assessments of credit risk levels may help conduit issuers to establish a minimum level of credit risk exposure (risk tolerance) for prospective investors by applying credit rating requirements for conduit borrowers/ debt issuances. For example, as a matter of policy, California's Educational Facilities Authority and Health Facilities Financing Authority require a minimum "A" rating—either through credit enhancement or on a "stand-alone" basis, although on a case-by-case basis they will permit a "BBB" or "Baa" rating if additional collateral (such as a deed of trust) is posted.

Ratings are also important to the **secondary market**, where investors can sell their bonds.[16] The additional liquidity provided to investors in rated securities translates into lower initial interest rates for the issuer.

5.6.1 What Credit Ratings Mean

[15] One important exception is land-secured financings, such as assessment or Mello-Roos Bonds, for districts where development has not been substantially completed at the time of the issuance of the bonds, which are commonly issued as unrated bonds.

[16] The MSRB has agreed to post on its EMMA website the ratings for municipal securities assigned by a rating agency that has agreed to provide this rating information.

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Municipal debt ratings are opinions of the rating agencies about the investment quality of issuers and debt obligations in the municipal and tax-exempt markets. The municipal bond market uses different rating criteria from the corporate debt market because of the unique characteristics inherent in municipal debt. Municipal debt ratings are viewed in relation to the state and national economy, debt levels and mix, revenue and expense **cash flows**, repayment source, and the issuer's management strategies. While historical and operating experience and collateral may factor into the analysis of an issuer's creditworthiness, credit ratings, which are based on a rating agency's proprietary analytical models, assumptions, and expectations, are simply a prediction of how an issuer will perform in the future with respect to credit risk.[17]

A credit rating agency is required to register as a **Nationally Recognized Statistical Rating Organization** (NRSRO) with the SEC. In 2010, the adoption of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Pub.L. 111-203, H.R. 4173) (Dodd-Frank Act) mandated the creation of the Office of Credit Ratings (OCR), which was established within the SEC in June 2012 and is responsible for regulatory oversight and examination of credit rating agencies registered as NRSROs. Substantively, the Dodd-Frank Act enhanced the regulation and oversight of NRSROs with new reporting, disclosure, and examination requirements, resulting in the adoption of new SEC rules and amendments concerning NRSRO internal control structures, credit rating methods, conflicts of interest relating to sales and marketing activities, look-back reviews, disclosure forms and certifications to accompany each credit rating, public disclosures of NRSRO credit rating performance statistics and credit rating histories, asset-backed securities, third-party **due diligence** providers, and NRSRO standards of training, experience, and competence.

The four most commonly used NRSROs in the municipal debt market are Moody's Investor Service (Moody's) Investor Service, S&P Global Ratings Inc. (formerly Standard & Poor's), Fitch Ratings, and Kroll Bond Rating Agency (KBRA). Credit ratings assigned by these major credit rating agencies are represented by various alphabetical designations that may include numeric or symbolic (plus or minus signs) modifiers that give relative indications of long-term and short-term bond and note creditworthiness.

Each major credit rating agency maintains separate rating scales for long-term debt

[17] A credit rating does not reflect other types of risk, such as market or liquidity risks, which may affect the value of a debt obligation.

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(generally debt with a maturity of greater than 1 year) and short-term debt (generally debt with a maturity of less than 1 year). Although long-term and short-term credit prospects are related, it is possible for an issuer's short-term rating to be of a different category than its long-term rating. Figure 5-1 describes the various credit ratings for Moody's, Standard & Poor's, Fitch and KBRA. A comprehensive list of credit rating scales is also available in Appendix C, Additional Sources of Information.

Figure 5-1

CREDIT RATING SCALES

		MOODY'S	STANDARD & POOR'S	FITCH	KBRA	THE RATINGS MAP*
LONG-TERM RATINGS	INVESTMENT GRADE	Aaa	AAA	AAA	AAA	High Grade
		Aa1	AA+	AA+	AA+	
		Aa2	AA	AA	AA	
		Aa3	AA-	AA-	AA-	
		A1	A+	A+	A+	Upper Medium Grade
		A2	A	A	A	
		A3	A-	A-	A-	
		Baa1	BBB+	BBB+	BBB+	Lower Medium Grade
		Baa2	BBB	BBB	BBB	
		Baa3	BBB-	BBB-	BBB-	
	NON-INVESTMENT GRADE	Ba1	BB+	BB+	BB+	Speculative
		Ba2	BB	BB	BB	
		Ba3	BB-	BB-	BB-	
		B1	B+	B+	B+	Highly Speculative
		B2	B	B	B	
		B3	B-	B-	B-	
		Caa1	CCC+	CCC	CCC+	Substantial Risks
		Caa2	CCC		CCC	Extremely Speculative
		Caa3	CCC-		CCC-	Default
		Ca	CC		CC	
					C	
			D	DDD	D	
				DD		
				D		

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SHORT-TERM RATINGS					
	P-1	A-1	F1	K1+/ K-1	Highest/Very Strong Short-Term Credit Quality
	P-2	A-2	F2	K2	Good Short-Term Credit Quality
	P-3	A-3	F3	K3	Fair Short-Term Credit Quality
		B	B	B	Speculative/Questionable
		C	C	C	High Short-Term Default Risk
			RD		Restricted Default-Entity has defaulted on one
		D	D	D	Default

* The rating definitions in this table reflect a general description of the rating categories. Precise credit rating definitions and rating methodologies are provided by each credit rating agency respectively, on their website.

5.6.2 The Credit Rating Process

The issuer is responsible for selecting members of its financing team during the early steps of the debt issuance process, including consideration (with advice from the financial advisor or underwriter) of which credit agency or agencies should be used to independently rate the creditworthiness of the proposed debt obligation. Before engagement, an issuer may find it helpful to meet with representatives of each credit rating agency or participate in conference calls to discuss and understand the credit ratings criteria, process, ratings application, and terms of agreement and anticipated fees in connection with the expected financing.

Another important consideration is the market creditability of the rating agency. Issuers should be familiar or seek assistance from municipal advisors familiar with each agency's area of specialization because ratings for particular types of debt may be more respected at a particular agency, which can result in increased marketability and added value. Following the adoption of its first set of rules for NRSROs in 2007, the SEC began granting **registrations** to credit rating agencies (listed in Figure 5-2) each with a specialization of one or more of the following classes of credit rating sectors: (1) financial institutions, brokers, or dealers (Financial Institutions); (2) Insurance Companies; (3) Corporate Issuers; (4) issuers of asset-backed securities (ABS); and (5) issuers of government securities, municipal securities or securities issued by a foreign government (Government Securities).

In general, the ratings process begins when a credit rating agency formally accepts an application from an issuer requesting a rating. Each rating agency has

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its own application process. Normally, once the financing structure is designed, and the controlling legal documents are close to final form, the financial advisor or underwriter will provide all of the necessary documents to the rating agency or agencies and will provide any other additional information (such as cash flow data or other financial calculations) requested by the rating agency. Rating agency representatives will discuss the financing directly with the issuer. [18] Representatives of the rating agency also may visit the issuer or the project being financed. A financial advisor or underwriter may also recommend that representatives of

Figure 5-2

CREDIT RATING AGENCIES REGISTERED AS NRSROs WITH THE SEC[19]

NRSRO'S PROVIDING MUNICIPAL AND CORPORATE DEBT RATINGS

Fitch Ratings, Inc.	Financial Institutions, Insurance Companies, Corporate Issuers, ABS Issuers and Government Securities
Kroll Bond Rating Agency (KBRA)	Financial Institutions, Insurance Companies, Corporate Issuers, ABS Issuers and Government Securities
Moody's Investor Service, Inc.	Financial Institutions, Insurance Companies, Corporate Issuers, ABS Issuers and Government Securities
S&P Global Ratings (S&P)	Financial Institutions, Insurance Companies, Corporate Issuers, ABS Issuers and Government Securities

NRSRO'S PROVIDING CORPORATE/BUSINESS RATINGS

A.M. Best Company, Inc.	Insurance Companies
DBRS, Inc.	Corporate Issuers
Egan-Jones Ratings Company	Corporate Issuers
Morningstar Credit Ratings, LLC	Financial Institutions, Corporate Issuers, and ABS Issuers

the issuer and other members of the financing team meet with rating agencies in their offices in San Francisco or New York to present details of the financing or provide a presentation via conference calls.

When a decision on a credit rating has been made, a representative of the credit

[18] In general, the credit rating agency identifies a lead analyst, typically with particular sector expertise to perform the credit analysis on the issuer and expected debt obligation. Once the lead analyst formulates an opinion, a recommendation on a proposed rating is given to a ratings committee, which determines the credit rating.

[19] The HR Ratings de México, S.A. de C.V., and Japan Credit Rating Agency, Ltd are also registered NRSROs with the SEC; however, these credit rating agencies primarily cover securities issued in foreign markets.

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rating agency informs the issuer on the credit rating decision and may provide a draft copy of the written credit action before public dissemination. With the exception of those credit ratings that are clearly identified as point-in-time ratings, once a credit rating has been published, the credit rating agency will periodically review the credit rating, whether or not requested by the issuer. A review may result in the up- or downgrading of an existing rating. To perform their reviews, credit rating agreements typically require issuers to provide periodic financial and other reports relating to the issuer, the source of debt repayment, and the status of the bond issue.[20] If the issuers do not provide these reports, the rating agency may suspend the rating of an issue. Although ratings are generally assigned only in response to a request from the issuer, the rating agencies reserve the right to assign a rating without such a request. More detailed descriptions of the credit rating categories and ratings methods for each major rating agency are available on each firm's website. Information about the OCR and registered NRSROs may be found on the SEC's website.

5.7 HOW BONDS ARE MARKETED TO INVESTORS

In an effort to achieve the financing objectives of the issuer, including the lowest interest costs, a public agency issuer may seek to market a debt issuance to investors in a particular market (i.e., "target" investors). The issuer should consider how a debt issuance should be marketed to investors as soon as an underwriter and other financial team members are selected. In a negotiated sale, the senior managing underwriter should develop a marketing plan before the sale date of the debt issuance. A marketing plan should identify the target investors and propose a marketing strategy, which may include a retail order period, to market bonds to those investors. Issuers should assess how the marketing plan meets their goals with regard to distribution of the bonds.

5.7.1 Marketing Strategy

One of the advantages of selling bonds in a negotiated sale is the opportunity to pre-market the debt issuance to investors, including those identified as target

[20] In general, a representative of the credit rating agency contacts the issuer, financial advisor, and other sources and requests updated financial information about the outstanding debt, issuer, and financed project. Issuers should plan ahead with respect to annual surveillance requests from credit rating agencies to ensure a timely and accurate response.

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investors in an offering's marketing plan. The marketing plan should include a marketing strategy that describes the methods the underwriters will use to reach the target investors. Typically, these methods may consist of notices published in print and electronic media with financial or local publications, advertisements on broadcast media, investor conference calls, and internal sales correspondence. The senior managing underwriter, issuer, and other financial team members may also conduct an investor "road show" for the anticipated bond sale, typically a webinar-style presentation made available online to investors, sometimes accompanied by a recorded presentation.

During this pre-sale marketing period, the underwriters also assess feedback from prospective investors, which helps to gauge investor demand and provide information that may be used to adjust the debt amortization structure of the bond issue. It is important for the issuer and senior managing underwriter to recognize these market nuances when pricing and marketing the bond issue. It is also important for issuers to recognize that marketing a debt issuance to investors involves speaking to the market. As a consequence, marketing must be conducted in strict compliance with the anti-fraud provisions of securities laws pertaining to municipal debt, specifically those pertaining to selective disclosure. See Section 6.3, The Official Statement.

5.7.2 Targeting Investors

The target investors identified in a marketing plan will likely be different for each range of maturity.[21] Accordingly, structuring a debt issue should involve identification and selection of market conventions preferred by target investors that will best enable the issuer to minimize interest costs. The types of investors an issuer targets in an offering are often determined by the purpose and structure of the debt financing. Also, while the senior managing underwriter may offer a marketing strategy that identifies which investors are likely to be interested in the debt issuance, the recommendation should reflect the issuer's goals and objectives for the offering. For example, if an objective of an issuer is to increase participation of local investors in the debt issuance, the marketing plan's list of target investors should include local retail investors as a target group.

If the issuer's goal is to promote retail investor participation and help ensure that individual investors have an opportunity to purchase bonds in a public offering

[21] Municipal Securities Rulemaking Board, Issuer Considerations for Selecting the Underwriting Team and Understanding the Pre-Marketing Process, p. 3, 2016.

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in advance of orders placed by institutional investors, issuers may require underwriters to conduct a retail order period. An issuer may give preference to retail investors under the established "syndicate rules," which lay out the priority under which orders will be filled and how underwriter compensation will be distributed if there is more than one underwriter. According to the MSRB, giving priority to retail orders may allow issuers to maintain access to different types of investors, make bonds available to target investors in their communities, set the tone for pricing in the institutional period, support fair pricing for retail investors, and overall, achieve favorable pricing of the debt issue. [22] Issuers may define retail investors in one or more categories, including individual investors, professional retail investors (often placed by institutions that separately manage accounts for wealthy individuals), or non-institutional investors.

To ensure that a prospective investment security is suitable for an investor, securities laws require underwriters and broker-dealers to match up the sophistication, risk tolerance, and economic situation of a potential investor with the structural features, liquidity, and credit quality of the bonds being offered. It is important for issuers to know which suitability considerations an underwriter or broker-dealer will use in selling the issuer's debt to target investors, including sources of repayment and **pledges** of security. An investor often considers the essentiality of the project financed by a municipal debt security to be a critical factor in an assessment of credit risk and, therefore, investment suitability. Issuers should recognize how the purpose of the project and use of proceeds can help to market a debt offering to target investors. The more a project is seen as supporting a critical function of the issuer, the less an issuer is likely to default on the financing, which should be particularly attractive to retail and institutional investors alike. Additionally, public agencies seeking to finance projects related to the management of natural resources or environmental protection may have opportunities to market debt offerings to target investors with socially responsible investment and policy goals, i.e. Green Bonds.[23]

5.8 IMPROVING TRANSPARENCY AND INVESTOR ACCESS TO THE MUNICIPAL MARKET

[22] Op cit.

[23] See CDIAC Issue Brief: Green Bonds, 14.09, www.treasurer.ca.gov/cdiac/publications/1409.pdf

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Individual investors are among the largest holders of municipal bonds, either through direct ownership or indirectly, through mutual funds, money market funds, and other investment vehicles. Compared to the market for equities, the municipal debt market is relatively illiquid and less transparent with respect to pricing, which in theory, may discourage investors (particularly retail investors) from participating in an offering and lead to higher cost of funds for issuers. Consequently, public agency issuers should have an interest in promoting technological resources that broaden retail investor participation in a debt issuance and minimize basic transactional barriers to investing. These activities may include investor relations and outreach websites and adoption of internet and other technology-based platforms that afford investors greater access to debt offerings and provide transparency on the pricing of municipal securities.

5.8.1 Investor Relations and Outreach

Issuers are required to post certain disclosures, including their annual financial reports and event notifications, on the MSRB **Electronic Municipal Market Access** (EMMA) website. See **Chapter 6, Securities Laws Pertaining to Municipal Debt**. In addition, issuers may choose to communicate with interested parties, including investors and the public, about its debt issuance and the projects financed using the proceeds of these transactions. In doing so, issuers must be aware that such communications may be deemed to "speak to the market" and as such are subject to the anti-fraud provisions of securities law. Notwithstanding this, the GFOA recommends that governmental issuers use their websites to disseminate information to the municipal securities market regarding their debt, financial condition, and other investor relations-related information.[24] The internet, in general, and issuers' websites in particular, provide a powerful tool for improving transparency by communicating with and disclosing information to investors as well as credit analysts, underwriters, and other market participants.

[24] GFOA Best Practice- *Using Technology for Disclosure,* www.gfoa.org/materials/using-technology-for-disclosure.

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Chapter 6. Securities Laws Pertaining to Municipal Debt

Municipal bonds, **notes**, **certificates of participation**, and similar obligations sold to **investors** ("municipal securities") are generally subject to federal and state securities laws.[1] While generally exempt from the **registration** requirements of the federal *Securities Act of 1933* (the "1933 Act") and the California Corporations Code, they are subject to securities law disclosure rules, commonly referred to as "anti-fraud rules." Public agencies issuing municipal securities must ensure that prospective investors are provided the information they need to make an informed investment decision. A municipal issuer may rely upon the assistance of professionals to prepare **disclosure** documents and perform the underlying analyses that support statements made in these documents. The primary responsibility, however, for the accuracy of the information provided to investors is the public agency's. As the U.S. Securities and Exchange Commission (SEC) made clear in its action against the City of Miami in 2003, the public agency "does not discharge this obligation by the employment of [professionals]. Municipal issuers have an affirmative obligation to know the contents of their securities disclosure documents, including their financial statements."[2] Governing board members, officers, and staff can be held personally accountable for violation of the SEC anti-fraud rules.

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1 Direct purchase transactions can be structured as "loans" that are not "securities." See Section 5.5.2, Direct Loans.

2 SEC, In the Matter of The City of Miami, Florida. Admin. Proc. File No. 3-10022, www.sec.gov/litigation/opinions/33-8213.htm.

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Other participants in municipal debt offerings are also subject to securities law requirements. See Section 6.2, Roles and Responsibilities of Other Financing Participants. These requirements may condition an **issuer's** access to the public capital markets on the underwriters' ability to comply, thereby indirectly regulating public agency borrowers. **Underwriters** of municipal debt, for example, are required to obtain from "**obligated persons**" a commitment to provide continuing disclosure to the market. See Section 6.1.3, Secondary Market Disclosure.

The SEC has in recent years, moreover, taken an increasing interest in the municipal securities market and the activities of municipal issuers, advisors, and dealers. As a result, public agencies and their officials are at risk of sanctions, including monetary fines, for violations of securities laws. See Section 6.1.4, SEC Enforcement Actions.

In a **public offering**, the disclosure vehicle is generally an Official Statement (OS). The OS describes the terms of the debt, provides information on the public agency borrower and its financial condition, discloses other risks, and includes other information likely to be of interest to investors. The OS is generally delivered to prospective investors in preliminary form as a **Preliminary Official Statement** (POS) in advance of the formal offering.

STANDARDS OF PERFORMANCE FOR PROFESSIONAL SERVICE PROVIDERS - The relationship between the issuer and members of the financing team, including underwriters, municipal advisors, and attorneys, is subject to various legal and administrative standards. The **Municipal Securities Rulemaking Board** (MSRB) regulates both underwriters and municipal advisors that bring municipal securities to the market. MSRB Rule G-17, known as the "fair dealing" rule, sets out specific requirements the underwriter must comply with when communicating and working with municipal issuers. Rule G-17 requires underwriters to deal fairly with municipal issuers and investors at all times.[3] However, the underwriter maintains an "arm's-length" relationship with the issuer (See Section 6.2.1, Municipal Advisors and Underwriters). This means that they are on opposite sides of the transaction and the underwriter may make decisions that are in the underwriter's best interests rather than the issuer's.

[3] As a part of this responsibility, underwriters must inform the issuer of all potential conflicts of interest and provide all the information required to enable the issuer to make accurate, truthful, and complete disclosures to the investor before sale of securities.

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As of June 23, 2016, municipal advisors are required to follow the standards of conduct in MSRB Rule G-42 on Duties of Non-Solicitor Municipal Advisors. Subject to MSRB Rule G-42, the municipal advisor is a fiduciary and owes the public agency a duty of care and a duty of loyalty. As a consequence, the municipal advisor must place the interests of the issuer above its own.

Attorneys, subject to the professional responsibility standards of their license, must pursue the best interests of their clients—in the case of municipal securities, the public agency—within the limits of the law and the attorneys must disclose conflicts of interest or causes that would keep them from doing so.

6.1 FEDERAL SECURITIES LAWS

Section 3(a)(2) of the 1933 Act exempts from the registration requirements of the 1933 Act "Any security issued or guaranteed by... any State of the United States, or by any political subdivision of a State...or by any public instrumentality of one or more States." Separate exemptions are generally available for instruments securing municipal securities. A **letter of credit** issued by a bank, for example, is exempt under Section 3(a)(2), and a **bond insurance** policy is exempt under Section 3(a)(8). Further, the loan payment obligation of a conduit borrower is not generally a "separate security" requiring its own obligation.

The registration exemption, however, does not exempt the issuers of municipal securities from federal "anti-fraud" rules and the corresponding obligation to provide accurate and complete information to potential investors or, at times, to securities markets generally. Thus, the primary securities law focus in the municipal securities context is on disclosure; in the working group for a particular municipal securities offering the focus is on the OS.

6.1.1 Anti-fraud Rules

Statements by municipal issuers to investors, or potential investors, and even statements to the public generally, if likely to be heard and relied upon by the securities market, are subject to regulation under two key anti-fraud provisions of federal law: Section 17(a) of the 1933 Act and SEC Rule 10b-5 promulgated by the SEC under Section 10(b) of the *Securities Exchange Act of 1934* (the "1934 Act"). These two anti-fraud provisions, referred to simply as Section 17(a) and SEC Rule 10b-5, are presented below.

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SECTION 17(a)

It shall be unlawful for any person in the offer or sale of any securities by the use of any means . . . of . . . communication in interstate commerce or by the use of the mail, directly or indirectly

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a **material fact** or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

SEC RULE 10B-5

[It is] unlawful for any person, directly or indirectly, by the use of any means . . . of interstate commerce, or of the mails . . .

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit 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, or

(c) to engage in any act practice or course of business, act, practice, which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 17(a) and SEC Rule 10b-5 require that there are no untrue statements of material facts in the POS and OS. Further, the regulations require that the material facts are not presented in a misleading manner in light of the circumstances. The POS and OS must include appropriate information to make sure the material facts are not misleading. “Materiality” is a context-dependent concept and is not specifically defined by any SEC rule. Statements in court decisions and SEC enforcement actions about what “materiality” means, however, include the following:

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> A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor.
>
> There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the "total mix" of information made available.
>
> Materiality will depend at any given time upon a balancing of the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of [the affected entity's] activity.

Because the SEC has consistently refused to provide any guidance on exactly what constitutes material misstatements or omissions, materiality ends up being decided only in hindsight, which puts a great deal of pressure on parties to a transaction to make an appropriate decision when deciding on a disclosure issue. Further, if an item of information is material to investors, the fact that it is confidential, or politically embarrassing, is not a defense to leaving it out of the document, nor is it possible to claim the information is subject to attorney-client privilege.

To prove a violation of SEC Rule 10b-5, the SEC must prove, among other elements, that in connection with the purchase or sale of securities, the issuer[4] intended to mislead or defraud investors or was reckless in not assuring that there was no misleading or fraudulent action in the securities disclosure (i.e., the issuer knew or should have known the correct facts). To find a Section 17(a) violation, however, the SEC only has to find that the issuer was negligent (i.e., acted with a lack of ordinary care). Either the SEC or private plaintiffs can file a claim of violation of SEC Rule 10b-5, but private plaintiffs must show not only that an issuer made a material misstatement or omission but also that they in fact purchased or sold the securities in reliance on that statement or omission and suffered damages as a result of that reliance.[5] Private actions are not allowed under the more lenient negligence standard of Section 17(a).

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[4] As used in this chapter, "issuer" means the entity having financial responsibility for repayment of the debt, whose information is therefore of material interest to investors. This may be a governmental entity or a nonprofit or for-profit borrower acting through a "conduit" government issuer of debt.

[5] Because the price of a fixed-income security is affected by many factors including prevailing interest rates, it can be difficult to prove a direct connection between a securities law violation and loss of value of a bond. Hence, there are few private actions in the municipal bond market and almost all cases are brought by the SEC.

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The issuer is primarily liable for any material misstatements or omissions regarding the issuer and its debt made in the documents used to offer and sell the issuer's securities. The issuer may not transfer this primary liability to its underwriters, **municipal advisor**, public agency counsel, **bond counsel**, **disclosure counsel** or any of the other parties involved in the financing. Those parties may have obligations of their own, but any liability of those parties will not absolve the issuer of its primary liability.

Municipal securities issuers and their directors, governing board members, officers, and staff may rely on the advice of professionals, including attorneys, municipal advisors, engineers, **feasibility consultants**, or accountants, in determining what information to disclose. Reliance on professionals must, however, be reasonable, and issuers and their boards must exercise independent judgment in approving securities disclosure. Further, reliance on the advice of professionals will not help deflect all potential claims. Consequently, the issuer and its staff must make every effort to ensure that its offering documents are accurate and complete.

Inadequate disclosure practices can lead to outcomes or consequences such as the following:

- Investigation by the SEC
- Investigation by a local district attorney or the U.S. Justice Department
- Investigation or hearings by state or local legislative bodies
- Requirement to enter into an order to cease and desist from future violations of securities laws
- Imposition of fines or penalties, both on the issuer and any public official deemed culpable for the issuer's violation of securities laws
- Requirement to hire outside consultants to implement and/or supervise securities law procedures
- Order barring a public official found culpable for securities violations from taking part in future securities transactions for some period of time
- Substantial out-of-pocket costs to defend against government or private investigations or suits
- Harm to the issuer's reputation, investor confidence, or to political careers

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- Inability to obtain timely audit reports and lack of access to public securities markets
- Rating agency downgrades

Liability for false, misleading, incomplete, or fraudulent statements under the anti-fraud laws attaches to the directors, governing board members, officers, and staff of issuers. Individual officials or members of the staff found to have violated the law may be subjected to penalties, fines, injunctions or, in extreme cases, incarceration, and there is no official immunity from these consequences.

6.1.2 Governing Board Responsibilities

The SEC has made clear its view that public agency governing board members are responsible for ensuring that there is adequate disclosure in connection with the offering of municipal securities:

> A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts.[6]

For a governing board member to participate personally in all aspects of the disclosure process is neither practical nor necessary. There are, however, important things governing boards and governing board members can do:

- PROMOTE A CULTURE OF TRANSPARENCY. A governing board member can help establish a culture and "Tone at the Top" in which forthright and honest discussion of failures and difficulties is acceptable and covering over problems is not.

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[6] Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 36761 (January 24, 1996).

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- ENSURE A GOOD DISCLOSURE PREPARATION PROCESS. A governing board should make disclosure the responsibility of a high-level officer of the public agency and empower that officer to command the participation of the entire organization in the disclosure preparation process. Each disclosure matter should receive the input of the particular individuals within the organization with the best information and insight. The board should make sure that the organization has written policies and procedures for preparing disclosure documents, that those procedures are followed, and that staff and the board receive regular training on securities law requirements and procedures.

- ENGAGE EXPERIENCED AND KNOWLEDGEABLE PROFESSIONALS. A governing board should ensure that the public agency is assisted by experienced professionals who have an understanding of the public agency and the municipal market and who are knowledgeable about securities law requirements.

- UNDERSTAND THE TRANSACTION. A governing board member should understand the terms of the proposed transaction, the obligations undertaken by the public agency, and how the financing affects the public agency's financial position and fits into its overall strategy.

- DON'T JUST MOVE THINGS ALONG. A governing board member should satisfy himself or herself that the disclosure document accurately describes the proposed transaction and the operations and financial position of the public agency. Special focus should be given to areas where the governing board member has particular insight and information. Questions should be asked, and responsive answers received before a transaction is approved.

6.1.3 Secondary Market Disclosure

Following issuance, municipal securities trade in the **secondary market**. To support the needs of investors in this market, state and federal laws, including **SEC Rule 15c2-12**, have influenced the nature and extent of disclosures. A public agency may provide information to the municipal marketplace because it has a legal obligation to do so (e.g., in connection with an offering of municipal securities), because it has a contractual obligation to provide specified information (often an obligation compelled by regulation as a condition of participation in the public capital markets), or because the public agency has voluntarily chosen to make statements intended or likely to be relied upon by the market (e.g., speaking at a securities conference or investor meeting).

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Secondary market disclosure requires care, in all cases, because information provided to the market must meet the **SEC Rule 10b-5 standard**. That is, it must not contain untrue statements of material facts or omit to state material facts necessary to make information provided not misleading under the circumstances. Outside a formal municipal securities offering, context determinations may be challenging. Further, when public officials speak freely, the distinctions between what should and should not be taken as a statement of fact, or as a statement intended for the securities markets, are not always clear. Continuing disclosure is discussed in detail in Section 8.4, Continuing Disclosure and Section 8.5, Other Disclosures to the Market.

6.1.4 SEC Enforcement Actions

While enforcement activity by the SEC has occurred for many years, a marked increase in SEC focus on the municipal market has occurred since 2010. In that year, the SEC Enforcement Division reorganized into certain subject matter units, one of which was formed to focus on municipal securities and public pensions. The new Public Finance Abuse Unit includes attorneys, accountants, and investigators, many of whom are former prosecutors. The consequences of an SEC investigation are very expensive, can be politically harmful, and can potentially damage an agency or individual's reputation, even if no charges are ever brought.

6.1.4.1 RECENT SEC ENFORCEMENT FOCUS

Although SEC enforcement activity has covered a broad and expanding range of perceived securities law violations, recent activity has been focused in particular on the following.

INADEQUATE PENSION DISCLOSURES - The SEC brought actions against the City of San Diego (2006), the State of New Jersey (2010), the State of Illinois (2013) and the State of Kansas (2014), all of which were settled. In the case of San Diego, however, the SEC also levied fines on certain individual officials. These actions generally focused on failure to adequately disclose funding shortfalls in pension systems, and the potential for future budget difficulties as pension contributions would have to be increased. One common theme of all these actions was inadequacy of internal procedures and training to ensure accurate disclosure in securities offering documents.

MISLEADING OR INCOMPLETE FINANCIAL DISCLOSURES AND UNUSUAL ACCOUNTING ACTIONS - Clear financial presentation is, of course, critical to disclo-

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sure, and enforcement activity has been directed against issuer's efforts to hide or obscure financial difficulties.

1. *City of Miami, Florida (2013)*. The SEC alleged that the city had hidden shortfalls in its General Fund by temporarily transferring moneys from other funds into the General Fund just before the fiscal year end, and then transferring the funds out again. The city and its budget director took the case to trial, where a jury found in favor of the SEC. The city then settled the case and agreed to pay a fine of $1 million.

2. *City of Allen Park, Michigan (2014)*. The city failed to reveal a budget gap, which was supposed to be closed by private investment from a movie studio development. The movie studio plan fell apart, but the city did not reveal the impact of that event on the budget gap. The city and two of its officials settled charges; the two officials were barred from taking part in future municipal securities offerings and one official paid a penalty of $10,000.

3. *Westlands Water District, California (2016)*. In 2010, during a drought that reduced water usage (and hence revenue), the district took an unusual accounting action to transfer money from certain reserves to add to its "revenues" in order to maintain minimum "**coverage**" requirements under its bond **indentures**, an action that was approved by its accountants. In a later bond offering that showed prior years' coverage, the district failed to disclose that it only met the coverage in 2010 by use of the one-time accounting transfer. The SEC charged that not pointing this out was a securities law violation. The district settled and paid a fine of $125,000; its general manager and assistant general manager were also charged and paid fines of $50,000 and $20,000, respectively.

4. *Town of Ramapo, New York (2016)*. The town, its local development corporation, and various officials were charged with deliberately keeping misleading books that hid financial deficits and budget strains. According to the SEC, the problems arose from declining **tax** revenues and the failure of a minor league baseball park project. In addition to the SEC charges, the Department of Justice brought criminal charges for securities fraud against a town attorney and the town supervisor. The town supervisor was found guilty by a jury and was sentenced to 2.5 years in prison and a $75,000 fine. The town attorney pled guilty and was sentenced to 18 months of supervised release and a $20,000 fine.

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FAILED ECONOMIC DEVELOPMENT PROJECTS - Failed development projects often lead to municipal security defaults, in which disclosure is subject to scrutiny with the benefit of hindsight.

1. *Greater Wenatchee Regional Events Center, Washington (2013)*. Short-term construction notes for a regional event center were coming due and had to be refinanced by new notes at the height of the financial crisis. The OS for the new notes failed to disclose a less favorable consultant report than the one used in the document. The events center did not, in fact, meet revenue estimates and the new notes **defaulted**. The issuer settled and paid a fine of $20,000.

2. *City of Harvey, Illinois (2014)*. This case involved a failed hotel development and diversion of bond funds for unauthorized purposes by the city controller. The city settled the SEC charges, which included a requirement to hire outside securities counsel and consultants. The controller was fined and had to disgorge moneys received totaling over $200,000.

3. *Rhode Island Economic Development Corporation (2016)*. A state authority issued bonds, guaranteed by the state itself, to subsidize the move of a start-up software firm from Massachusetts to Rhode Island. The OS indicated that the bonds would only cover part of the startup costs needed to produce the planned software game but failed to disclose that the remaining funding was never obtained, and the company went bankrupt. Charges were brought against the state authority, several officials, the underwriter and the lead banker at that firm. The state authority and two officials settled charges and the two officials paid fines of $25,000 each.

FAILURE TO DISCLOSE RISKS - Although this element may have occurred in some of the cases already noted, the cases below focused on failures to disclose known risks that the SEC asserted would have been material to investors.

1. *City of South Miami, Florida (2013)*. The city borrowed money from a statewide pool and used it to build a parking garage. Contrary to its tax agreement, the city leased portions of the garage to a private developer, likely making the bonds taxable. On a second bond issue, it failed to disclose this tax risk. The city settled the case.

2. *UNO Charter School, Illinois (2014)*. A nonprofit charter school used bond proceeds for construction but failed to disclose in the OS that its senior man-

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agement had engaged with the school in certain transactions that violated prohibitions under state law against conflicts of interest. These conflicts could have led to withdrawal of state grants, which were critical to the school's finances. The school settled SEC charges and the founder of the school paid a fine of $10,000.

3. *Port Authority of New York and New Jersey (2017)*. In selling bonds for several years for a variety of projects, the port authority did not disclose that its internal counsel had raised significant legal concerns about use of bond proceeds to fund certain road improvements in New Jersey. Although the road projects were ultimately funded with other moneys, the SEC alleged securities law violations for failing to disclose the legal risk. The Port Authority settled but had to admit wrongdoing and agree to a fine of $400,000, to improve internal procedures for board of directors' approvals of bond sales, and to hire an outside consultant.

FAILURE OF CONTINUING DISCLOSURE - The SEC has also brought actions based on issuers' failures to comply with continuing disclosure obligations.

1. *City of Harrisburg, Pennsylvania (2013)*. The city was under severe financial strain and did not produce and file annual audits and financial reports as required by its continuing disclosure agreements (CDAs). Nonetheless, the city and its officials made public statements concerning its financial condition, including budget reports. The SEC sued on the grounds that these public statements and budget reports omitted material information about the city's dire financial condition, asserting that in the absence of the required continuing disclosure reports, investors had no choice but to rely on the other statements for current information on which to make investment decisions.

2. *West Clark Community Schools, Indiana and City Securities Corporation (2013)*. The school district affirmatively stated in an OS that it had not failed to comply in all material respects with any prior disclosure undertakings when it had, in fact, never filed any annual financial reports as required by its existing CDA. The school district settled the case. The underwriter of the bonds was also sanctioned for failing to adequately perform **due diligence** on the school district's statement for CDA compliance and paid a substantial fine.

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6.1.4.2 LESSONS FROM SEC CASES

Many important lessons can be learned from recent SEC enforcement activity:

- The SEC will bring cases even when there is no evident financial loss to investors, including cases where there was no default on the bonds or any loss of **ratings**. The law does not require the SEC, unlike a private plaintiff, to prove any monetary damages, or even that any investors relied on the allegedly mistaken or misleading disclosures; the SEC can and will bring cases based on its assessment of a violation of securities laws in the abstract.

- Municipal issuers and underwriters are now subject to a wider range of sanctions. Civil fines are common, and in many cases, parties will be required to engage specialized consultants or legal counsel to help them implement new disclosure policies. Parties may no longer be given the option to "neither admit nor deny" the SEC charges, which has significant reputational impact. Parties subject to regulation by the SEC (e.g., dealers and municipal advisors) may be "censured."

- The level of civil fines has steadily ratcheted upward, with recent fines in excess of $100,000 for issuers.

- Individual public officials are at risk of SEC sanctions. The SEC now routinely includes culpable individuals in its cases. These individuals will have to consent to a cease and desist order, may have to pay substantial civil fines, and may be barred from future involvement in municipal financings. Furthermore, the SEC is casting a wider net for culpable public officials, using concepts such as "controlling person" or "aiding and abetting" to sanction officials beyond the individual who signs a "SEC Rule 10b-5 certificate" for a bond issue.

- The SEC can take additional actions in unusual cases. In one case the SEC sought and obtained an injunction against an issuer to prevent an ongoing bond offering. In another case (not described above) the SEC referred information to the Justice Department, which brought a successful criminal indictment against officials of a city alleged to have falsified a city's financial records to hide budget shortfalls.

The most valuable lesson to be learned from the SEC enforcement activity, however, is the importance of accurate and comprehensive disclosure, the culture of transparency, a good disclosure preparation process, assistance from knowledge-

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able professionals, and the governing board attentiveness that lead to accurate and comprehensive disclosure.

6.2 ROLES AND RESPONSIBILITIES OF OTHER FINANCING PARTICIPANTS

Various professionals are involved in the municipal securities issuance and sale process, including municipal advisors, underwriters, bond counsel, disclosure counsel, and underwriters' counsel. These professionals have duties and obligations to various parties arising under securities and other laws and are also subject to independent professional responsibility standards. In working with financing professionals, municipal issuers must remain cognizant of these parties' responsibilities—issuers who impede professionals' ability to comply with their respective securities law obligations will likely be denied their services and possibly denied access to the market.

6.2.1 Municipal Advisors and Underwriters

Municipal advisors and underwriters are both required to register with the SEC and to comply with rules promulgated by the MSRB. In a negotiated public offering, the municipal advisor is engaged by the issuer and the underwriters are selected by the issuer, and the lead role in coordinating the financing process may be undertaken by either the municipal advisor or the lead underwriter.[7] Both municipal advisors and underwriters, moreover, may provide advice respecting the structure and timing of the transaction, rating agency and marketing strategy, disclosure and other questions. The roles and responsibilities of municipal advisors and underwriters in municipal securities offering, are, however, quite distinct.

A municipal security issuer's municipal advisor has a fiduciary relationship with the issuer. Municipal advisors are required to follow the standards of conduct contained in MSRB Rule G-42 on Duties of Non-Solicitor Municipal Advisors. Rule G-42(a)(2) states that "a municipal advisor to a municipal entity shall, in the conduct of activities for that client, be subject to a fiduciary duty that includes a duty of loyalty and a duty of care." Both MSRB Rule G-23 and California Government Code Section 53691, moreover, require that financial advi-

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7 In a competitive sale, by contrast, the underwriter is the firm making the winning bid and the separation of activities between municipal advisor and underwriter is clearer.

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sory relationships be evidenced promptly in writing that sets forth the basis of compensation for financial advisory services. The regulations generally prohibit firms from acting as both a municipal advisor and an underwriter with respect to a particular municipal securities offering.

A broker-dealer acting as an underwriter of municipal securities is obligated under MSRB Rule G-17 (Rule G-17) to "deal fairly with all persons," including the issuer, and "not engage in any deceptive, dishonest, or unfair practice" and MSRB Notice 2012-38, interpreting Rule G-17, requires, among other things, that underwriters disclose in writing various risks, including potential conflicts of interest, to issuers. As underwriters, broker-dealers do have a duty to treat issuers and investors fairly, but they do not have a fiduciary relationship with the issuer of municipal securities they underwrite. Because the underwriter maintains an "arm's-length" relationship with the issuer, the underwriter and the issuer are on opposite sides of the transaction and the underwriter may make decisions that are in the underwriter's best interests rather than the issuer's.

MSRB Rule G-23 prohibits a broker-dealer from acting as an underwriter on an issue for which it is acting as a municipal advisor and, as a result, will ensure that it cannot be characterized as a "municipal advisor" to the issuer. An underwriter may provide factual and general information to an issuer without providing advice. During the course of a transaction an underwriter will usually ask the issuer to acknowledge that the purchase and sale of the securities is "an arm's-length commercial transaction;" that the underwriter is acting as a principal and not as an agent or a fiduciary of the issuer; that the underwriter has not assumed an advisory or fiduciary responsibility in connection with the offering or any obligation other than as provided in the purchase contract for the securities; and that the issuer has consulted its own legal, financial, and other advisors to the extent it has deemed appropriate.

Communications outside the course of a transaction, however, including a suggestion that the issuer consider taking advantage of a financing opportunity, raise issues under Rule 15Ba-1 promulgated by the SEC under Section 15B of the 1934 Act (the "Municipal Advisor Rules") and MSRB Rule G-23.[8] Broker-deal-

[8] MSRB Rule G-23 prohibits a firm from changing its status with an issuer client from being a municipal advisor to being an underwriter; thus, firms that want to be underwriters must ensure that they do not inadvertently become municipal advisors by providing some kinds of advice before they are formally engaged to be an underwriter.

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ers, therefore, generally try to fit within one of the three main exceptions to the broad definition of "municipal advisor" in the Municipal Advisor Rules:

1. The exclusion for activities as an underwriter of a particular issue "within the scope of an underwriting of such issuance of municipal securities." For this exclusion to apply, the broker-dealer must have been selected to serve as the underwriter for the issue that is the subject of the communication.

2. The exclusion for responses to requests for proposals or qualifications. A broker-dealer may provide "advice" in the context of competing for the issuer's business.

3. The exclusion for participation by an independent registered municipal advisor (IRMA). This requires that the issuer have engaged an IRMA and that the IRMA be an active participant in consideration of the advice offered by the broker-dealer.

Underwriters, as sellers of municipal securities, may also face liability under SEC Rule 10b-5. Unlike issuers, however, underwriters have available a "due diligence" defense to a claim brought under SEC Rule 10b-5. "Due diligence" requires taking reasonable care to (a) avoid selling securities that have an offering document containing material misstatements or omissions, and (b) perform a reasonable investigation of the issuer and its financial position designed to ascertain relevant facts. "Diligence" efforts in municipal securities offerings generally include, in addition to obtaining representations as to the completeness and accuracy of disclosure, review of various documents and other information and questioning of key officials of the issuer.

The underwriters also generally require the receipt of so-called "SEC Rule 10b-5 letters" from bond counsel, disclosure counsel, and/or underwriters' counsel confirming that during the course of their participation in the financing no facts came to the attorneys' attention that caused them to believe (subject to certain exclusions) that the offering documents contained material misstatements or omissions.

In addition, SEC Rule 15c2-12, promulgated by the SEC under Section 15(c)(2) of the 1934 Act, requires underwriters to obtain, review, and provide to prospective investors OSs and to obtain from municipal issuers undertakings to make annual disclosure reports and report certain events. See Section 8.4, Continuing Disclosure. Underwriters of municipal securities are also obligated to ensure that offered municipal securities are suitable investments for their inves-

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tors, and underwriters' MSRB Rule G-17 obligations require that municipal securities be offered at fair prices.

6.2.2 Attorneys

The attorneys involved in the disclosure process for a municipal securities offering include, in addition to the issuer's counsel, bond counsel, and underwriters' counsel (in a **negotiated sale**). The issuer may also engage a separate disclosure counsel. All attorneys are subject to the professional responsibility standards of the legal profession, including a requirement to pursue the best interests of their client (e.g., the public agency) within the limits of the law and to disclose conflicts of interest that would prevent them from doing so.

Bond counsel plays a unique role in a municipal securities offering. Although bond counsel is generally engaged by—and has an attorney-client relationship with—the issuer, a key to a successful offering is the opinion delivered by bond counsel stating the following:

- That the bonds have been validly issued pursuant to state law
- That the bonds and the indenture or trust agreement with which the bonds are issued constitute valid and binding obligations of the issuer
- If applicable, that interest on the bonds is excluded from gross income for federal income tax purposes

This "bond counsel opinion" is addressed to the issuer but is intended to be relied upon by the holders of the bonds. A bond counsel opinion represents (and must represent if the bonds are to be marketed successfully) an objective judgment on the matters addressed rather than the partisan position of an advocate.

Bond counsel and disclosure counsel represent the issuer and assist the issuer in the preparation of the OS. Disclosure counsel, and sometimes bond counsel, may deliver a SEC Rule 10b-5 letter to the underwriters to assist the underwriters in their diligence efforts. See Section 6.2.1, Municipal Advisors and Underwriters. Disclosure counsel is at times asked to address a SEC Rule 10b-5 letter to its client, the issuer. Because no "due diligence" defense is available to securities issuers, however, a SEC Rule 10b-5 letter is of less value to an issuer than the assistance provided by the counsel in the preparation of disclosure.

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In the past, it was common for underwriters' counsel to assist the issuer in the preparation of the OS. It is more often the case now that the issuer will engage the firm serving as bond counsel or a different firm to act as the issuer's disclosure counsel. Underwriters' counsel does not, however, have an attorney-client relationship with the issuer and California Government Code Section 53593 in fact prohibits attorneys from serving as both bond counsel and underwriters' counsel for a given local agency municipal securities offering.

6.3 THE OFFICIAL STATEMENT

The offering document in a public offering of municipal securities is usually called the **Official Statement** (OS). If the securities are being offered on a limited basis, the offering document might be called an offering circular, an offering memorandum, a **private placement memorandum**, or a limited offering memorandum. The OS in a public offering of municipal securities is analogous to the prospectus in a corporate registered offering. The OS contains the issuer's "official" statements; that is, the statements about itself upon which it intends others to rely, including statements about its financial condition, the securities, the project or program to be financed with the securities, and the sources of repayment for the securities. Its purpose is to tell potential investors what they need to know in order to decide whether or not to buy the securities—all the "material" information needed for an investment decision.

The OS is the issuer's document, but in practice it is a joint product of the issuer's financing team. Coordination of OS preparation is generally undertaken by underwriters' counsel or the issuer's disclosure counsel in a negotiated sale and by the issuer's financial advisor or the issuer's disclosure counsel in a **competitive sale**. This party generally prepares a draft OS on the basis of information provided by the issuer (with respect to itself, its operations, and its financial condition) and bond counsel (with respect to descriptions of financing documents and tax law matters). All members of the financing team review and comment on OS drafts. Parties also conduct a "due diligence" investigation with respect to the OS. This due diligence involves inquiries of issuer officials and review of supporting documentation. A POS and an OS are generally not posted electronically or printed and distributed until all concerned parties are comfortable that the information included is accurate and complete.

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6.3.1 Role and Purpose of the Official Statement and the Preliminary Official Statement

The OS serves three basic functions:

1. It provides a description of the transaction - its purpose, use of the proceeds, and a description of the securities offered and their source of repayment.
2. It assists with marketing the securities.
3. It discloses material information associated with investment in the securities, including the risks related thereto.

Because in most transactions the OS cannot describe the securities completely until after they have been sold, a POS is made available and distributed in advance of the offering. SEC Rule 15c2-12 requires the POS to be “final” except for **pricing** and information dependent upon or determined as part of the pricing. The POS is used by the underwriters to solicit interest in the securities. Depending upon the complexity and novelty of the transaction, the POS is generally distributed, usually by electronic posting, from a few days to a couple of weeks before the expected sale date. If material developments occur or material information comes to light after the POS has been distributed, the POS must be supplemented before the sale date.

6.3.2 Contents of the Official Statement

The OS can assume that recipients have general knowledge, but unlike a private placement memorandum or term sheet provided to a purchaser actively engaged in the transaction, it must be complete in the sense that the investor should not be expected to conduct any investigation beyond reading the document and any publicly available materials incorporated by reference. The specific content varies, of course, based on the type of securities offered, but OSs generally follow a simple, basic format. The OS cover identifies information such as the amount, **maturities**, interest rates, and payment information for the securities being offered and a brief description of their source of repayment, their tax status, the expected delivery date, and ratings.

The body of the OS generally consists principally of the following:

- A brief overview of the purpose of the financing

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- A more detailed description of the terms of the securities (especially any mandatory or optional tender or **redemption** provisions and, if the securities are variable-rate securities, the manner in which interest rates are determined)
- A detailed description of security (pledges of revenues, tax receipts or assets, including limitations, reserve funds, and any credit enhancements and their providers)
- The sources and uses of funds for the financing
- The tax treatment of interest paid on the securities
- The terms of the underwriting
- Published ratings of the securities
- The presence or absence of litigation
- A summary of the issuer's undertaking to provide continuing disclosure

The body of the OS also, of course, describes the issuer and its financial condition, especially the financial and operating data relevant to the payment of the securities and any **parity**, senior, or subordinate obligations of the issuer. If the issuer's obligation is limited to a particular source, such as the revenues of a utility **enterprise** or the proceeds of a **special tax**, the discussion will focus on information related to that source.

The body of the OS may also include a separate "risk factors" section. These are more common with enterprise or revenue obligations than with tax-supported general obligations. This section can be used to highlight special risks unique to the securities or the industry, or to disclose risks for which a description cannot easily be worked into the general discussion. Because a "risk factors" section cannot address all risks and even described risks cannot be fully comprehended apart from context, an investor must read the entire OS for a full understanding of the risks associated with the offered security.

The OS generally includes, as appendices, various items that, while part of the OS, would interfere with the flow if included in the body of the OS. Typical appendices include the following:

- The issuer's audited financial statements
- Expert consultant reports or feasibility studies, if any, in whole or in summary form

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- Information of only indirect importance, such as general demographic and economic information
- Summaries of legal documents (to the extent they are not described in the body of the OS)
- A form of the continuing disclosure undertaking (CDU), specifying the form in which the issuer will make future disclosure in complying with its continuing disclosure obligation
- A description of The Depository Trust Company's book-entry procedures
- The form of the opinion to be delivered by bond counsel

The information in an OS should be primarily historical, verifiable information. Projections of future receipts, operating revenues, expenses, or **debt service** are, however, often important and are included particularly for revenue obligations. In such cases, it is essential to clearly identify the information as projected. The OS should state clearly the assumptions on which the projections are based, that forward–looking statements are about the future and are based on assumptions and qualified, and that the achievement of expected results is subject to uncertainties, including the occurrence (or nonoccurrence) of future events. Likewise, although it is preferable that the historical financial information included be audited data, unaudited financial data is often included.

6.3.3 Disclosure Standards and Guidance

There are no "standards" for what an OS must include apart from the requirements that it be sufficiently complete to allow a potential investor to make an investment decision without independent investigation and that it not contain material misstatements or omissions. Guidance as to what may be desirable to include in an OS is, however, available from a variety of sources. The Government Finance Officers Association (GFOA), for example, has produced comprehensive guidelines for disclosure in municipal offerings, titled *Disclosure Guidelines for State and Local Government Securities* (the "GFOA Guidelines"). The GFOA Guidelines are not legally binding, and even though they have not been updated since 1991, they still provide a useful standard for disclosure that can be referred to by issuers of municipal securities. The *Disclosure Handbook for Municipal Securities* published by the National Federation of Municipal Analysts (NFMA) contains specific disclosure recommendations for various types of **debt** financing techniques. The NFMA has published detailed guidelines for specific sectors of

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What should be included in an OS?

While they are helpful to provide readers with relevant and customary information in a format they are familiar with, templates, guidelines, and checklists cannot substitute for judgment. Each municipal offering has its own story, and a mere update to a model disclosure document without careful reflection about the current transaction does not suffice. The issuer and its financing professionals must carefully consider the issuer's current situation and the terms of the debt, security, and source of funds for its repayment and form an independent judgment as to what information must or should be included to assure that the OS contains the information needed for a potential investor to make an informed investment decision and does not contain material misstatements or omissions. A sense of balance and perspective is also essential.

the municipal market. The National Association of Bond Lawyers (NABL) has issued guidelines for developing and adopting disclosure policies.[9]

Attaining the standards set by NFMA and NABL and implementing the best practice recommendations of the GFOA requires issuers to administer a process to collect, interpret, and report on information necessary to investors. The goal in the end is to be comprehensive, yet concise—to present the requisite information in a manner that is clear and practicable for investors.

6.3.4 Transactions with Credit or Liquidity Support

If credit for the securities is enhanced by a bond insurance policy, a letter of credit, or another credit facility, or if a third party is providing liquidity support, a separate security is being offered, and the OS must include a description of the terms of that credit or liquidity support and disclosure regarding the credit or liquidity provider (See **Section 2.3.2, Credit Enhancement and Liquidity Support**). Liquidity providers ensure market execution by providing capital to an illiquid market. A form of any bond insurance policy or letter of credit securing the securities is generally included as an appendix to the OS.

For fixed-rate municipal securities secured by bond insurance or other credit support, the financial condition of the issuer is nonetheless material because, no matter the financial strength of the credit provider, an issuer's financial failure could lead to an early par redemption when interest rates would otherwise result in the securities being valued at a **premium**. The financial condition of the

[9] National Association of Bond Lawyers, Crafting Disclosure Policies, August 20, 2015, www.nfma.org/assets/documents/other.orgs/crafting_disclosure_policies.pdf.

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issuer is also material for variable-rate securities with liquidity but not credit support because the issuer's financial failure could excuse the liquidity provider from performance. In both of these cases, an OS with full disclosure of the issuer's financial position (plus disclosure concerning the credit or liquidity provider) is necessary.

There is a range of market-accepted approaches to disclosure for variable-rate debt with both credit and liquidity support (e.g., variable-rate **demand bonds** secured by a letter of credit or by a **standby purchase** commitment and bond insurance).[10] Sometimes full financial disclosure about the issuer or other obligor is included in the OS for variable-rate securities, and representatives of the SEC have expressed a preference for full financial disclosure, regardless of the credit or liquidity support provided. Sometimes, however, when there is a "full credit substitution" letter of credit, where investors are protected against financial consequences of a default by the issuer or obligor, virtually no financial information about the issuer is included, in which case the investor is explicitly instructed to make its investment decision on the basis of the credit and liquidity support provider and not based on the condition or circumstances of the issuer.

6.3.5 Conduit Offerings

In most conduit offerings of municipal securities, debt service on the securities is payable solely from amounts received by the governmental conduit issuer from the conduit borrower. Therefore, in such transactions, information on the financial condition of the conduit issuer is not necessary (and could be misleading) and should not be included in the OS. The OS should, moreover, make clear that the conduit issuer is assuming responsibility only for the limited material included in the OS that has been provided by it, which is generally only a brief description of the conduit issuer and a statement that there is no pending litigation against the conduit issuer challenging the financing or the issuance of the municipal securities. Rather, all of the typical disclosures that an issuer would have to make are done instead by the conduit borrower and full information on the conduit borrower, its guarantors, and/or its credit and **liquidity** provider is included.

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10 These different approaches exist because, as long as the credit and liquidity providers are financially sound, variable-rate obligations backed by credit and liquidity support will never be worth materially more or less than par and the holder can receive par, upon 7 days' or similar notice, even if the issuer fails.

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6.4 OTHER MARKETING ACTIVITIES AND OTHER PUBLIC STATEMENTS

In offering its securities, the issuer's discussion of matters relating to its credit is often not confined to the OS. Issuers also make formal presentations to rating agencies or prospective credit enhancers (generally before publication of the POS), and often make presentations to groups of prospective major investors (bond funds or other institutional purchasers). Issuers make these presentations during the period of time between the publication of the POS and the pricing of the securities, each of which must conform with the anti-fraud standards discussed in Section 6.1.1, Anti-fraud Rules. There are often "internet road show" slides prepared by the underwriters to assist in marketing. These communications, while important to a successful issuance, pose risk because they can form the basis for securities claims, yet the speakers often approach them with less formality than statements that have been made in OSs. Issuers should ensure that communications with rating agencies, credit enhancers, and potential investors are carefully prepared and reviewed in advance, and that any additional written materials available to investors, such as an internet road show, are entirely consistent with and only contain information that can be found in the POS.

Information provided to rating agencies and credit enhancers can go beyond that provided to investors by including greater detail, technical analysis, and conjectural or other soft information not appropriate for a disclosure document. In providing such information, though, the issuer should consider whether such information is consistent with the OS or should be included in the OS to avoid misleading investors, and whether such information is accurate and not misleading for the particular purposes for which it is being presented.

Public information offered by the issuer (including statements by officials and information posted on the issuer's website intended to or expected to reach and affect the market for municipal securities) can also be viewed as statements about the issuer's securities. Although offering public information cannot and should not be prevented, it is important that care be taken and that the accuracy and completeness of these types of statements be considered in the light of the circumstances under which they are being made.

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6.5 STATE SECURITIES LAWS

6.5.1 California State Securities Laws

Notes, bonds, and evidences of indebtedness issued by public agencies fall under the broad definition of "security" in California Corporations Code Section 25019. Such securities are exempt from the qualification requirements of the *Corporate Securities Law of 1968* pursuant to California Corporations Code Section 25100(a). California Corporations Code Section 25401 (Section 25401), however, states the following:

> It is unlawful for any person to offer or sell a security in [California], or to buy or offer to buy a security in [California], by means of any written or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements made, in light of the circumstances under which the statements were made, not misleading.

False or misleading disclosure may, in addition, lead to breach of contract claims. Securities offerings and sales in California are also subject to general statutory and common law rules prohibiting fraud. California Corporations Code Section 25540, moreover, provides for fines or imprisonment for any person who willfully violates Section 25401.

6.5.2 Securities Laws in Other States

Debt securities issued by California public agencies are often sold to investors in states outside of California. Like California, other states have enacted state securities laws (commonly referred to as **Blue Sky laws**). Before Congressional enactment of the *National Securities Market Improvement Act of 1996* (NSMIA), many states required securities offered in the state to meet creditworthiness standards (known as "merit regulation") or required additional disclosure in offering documents. The NSMIA expressly preempted such state regulation, with certain exceptions. One of the preemptions is the regulation of securities issued by municipal issuers located in that state. However, the NSMIA allowed states to continue to require specified notice filings and to continue to collect fees. As a result, the securities laws of states outside of California may require that filings be made, or fees paid, for certain types of securities issued by California public agencies to be offered or sold in that state.

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Chapter 7. Additional Requirements Imposed on Issuers of Municipal Debt

Earlier chapters of this Guide address the legal foundation under which a California public agency issues debt in the market and list the tax and securities laws applicable to all public agency debt. This chapter addresses some other prominent legal requirements of public agency issuers in California, including statutory reporting requirements, the constitutional prohibition of gifts of public funds, and applicable environmental laws.

7.1 REPORTING TO THE CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

All local and state public agency issuers are required by California statutes to provide periodic reporting on their debt issuance activities to CDIAC. From the initial Report of Proposed Debt Issuance to the Annual Debt Transparency Report, **issuers** are statutorily required to file debt issuance information with CDIAC for transparency purposes.

CDIAC was created in 1981 to, among other things, "collect, maintain, and provide comprehensive information on all state and local debt authorization and issuance, and serve as a statistical clearinghouse for all state and local debt issues." CDIAC's regulations, codified as Chapter 1 of Division 9.6 of Title 4 of the California Code of Regulation, defines **debt** as "a contractual agreement through which a Creditor or Creditors transfers assets or moneys of an agreed

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value or amount, or rights to beneficial use of assets, to an issuer in exchange for one or more non-cancelable payments, inclusive of an interest component no matter whether it is paid, accrued, or imputed, over a specified period of time, the total present value of which is approximately equal to the value of the assets or rights on or about the time the transfer occurred."[1] Debt includes, but is not limited to, bonds, notes, **loans**, warrants, **certificates of participation**, **commercial paper** notes, lines of credit, installment purchase agreements, and certain types of leases.

California Government Code Sections 8855(i)–(k) give CDIAC the authority and direction to collect information about public agency debt authorization and issuance. These Code sections give CDIAC significant discretion in regard to the specific debt information required of issuers and the method for collecting it, including the reports summarized in Figure 7-1.

Figure 7-1

REPORTS THAT DEBT ISSUERS MUST SUBMIT TO CDIAC

REPORTING AGENCY	DESCRIPTION	TIMING	APPLICABLE CODE SECTION
STATE AND LOCAL AGENCIES that propose to issue debt	Give written notice of the proposed sale and provide specified information.	At least 30 days before the sale	Government Code Section 8855(i)(1)
STATE AND LOCAL AGENCIES that issue debt	Submit a report of final sale including specified information about the transaction.	No later than 21 days after sale	Government Code Section 8855(j)
STATE AND LOCAL AGENCIES filing report of final sale on or after January 21, 2017	Submit an annual report on the status of that debt.	Seven months following the end of the reporting period or January 31 of each year.	Government Code Section 8855(k)

1 California Code of Regulations, Title 4, Division 9.6, Chapter 1, Article 1, Section 6000(k), https://govt.westlaw.com/calregs/Document/IC84C8DC6EECC4020AE0E223DAFD99172?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=(sc.Default).

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Figure 7-1

REPORTS THAT DEBT ISSUERS MUST SUBMIT TO CDIAC, CONTINUED

REPORTING AGENCY	DESCRIPTION	TIMING	APPLICABLE CODE SECTION
COMMUNITY FACILITIES DISTRICTS issuing bonds under the Mello-Roos Act	CFD Legislative body must submit the following: Specific events affecting the value of outstanding bonds, and annual status. Report of proposed debt issuance. Yearly fiscal status for debt issued on or after January 1, 1993. Default, draws on reserve	None specified. At least 30 days prior to the sale. Report annual debt status by October 30. Report defaults and draws on reserve within 10 days of occurrence	Government Code Section 53556.05 Government Code Section 53359(a) Government Code Section 53359.5(b) Government Code Section 53359 - (c)
LOCAL AGENCIES, including city, county, city, and county, school district, community college district or special district issuing general obligation bonds	Report cost of issuance of bonds	None specified but Government Code Section 8855(j) specifies no later than 21 days after sale.	Government Code Section 53509.5(b)
LOCAL AGENCIES issuing refunding bonds	Submit a written statement from the issuer explaining why the local agency decided to sell the bonds at a private sale or on a negotiated basis instead of via public sale.	Reason for Private Sale of Refunding/ Revenue Bonds due 2 weeks (14 days) after the sale date for sale of refunding/ revenue bonds	Government Code Section 53583(c)(2)(B)
CITIES, COUNTIES AND OTHER AGENCIES	Submit a written statement explaining the decision by legislative body to sell public enterprise revenue bonds at a private (negotiated) sale.	Due 2 weeks after the bonds are sold.	Government Code Section 54418
SCHOOL DISTRICT AND COMMUNITY COLLEGE DISTRICTS	Governing body report the issuance cost of bonds issued by a school district. Governing body report the sale or planned sale by a school district.	No later than 21 days after sale (issuance costs report with Report of Final Sale) 30 days prior to sale and 21 days after sale	Education Code Section 15146(d)(2) Education Code Section 15146(e)

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Figure 7-1

REPORTS THAT DEBT ISSUERS MUST SUBMIT TO CDIAC, CONTINUED

REPORTING AGENCY	DESCRIPTION	TIMING	APPLICABLE CODE SECTION
SCHOOL DISTRICTS AND COMMUNITY COLLEGE DISTRICTS (school improvement district)	To create a school improvement district, a district must get approval by the county board of supervisors which has jurisdiction over the district and location of project.	Timing not specified in statute	Education Code Section 15303(b)
JOINT POWERS AUTHORITY	Report the level of fees or charges imposed by a Joint Powers Authority for the issuance of bonds pursuant to the Joint Exercise of Powers Act.	Not later than 21 days after the sale	Government Code Section 6548.5
JOINT POWERS AUTHORITY AND LOCAL AGENCY BORROWERS	Give notice about the required public hearing, where the authority makes certain findings and takes actions with respect to financing improvements.	At least 5 days before the public hearing	Government Code Section 6586.5(a)(3)
JOINT POWERS AUTHORITY AND LOCAL AGENCY BORROWERS (with exemptions for certain types of issuers and projects)	Submit a copy of the resolution adopted by an authority authorizing bonds or the issuance of bonds or accepting the proceeds of bonds issued pursuant to Joint Exercise of Powers Act.	Not later than five days after adoption by the authority	Government Code Section 6586.7(a)
JOINT POWERS AUTHORITY acquiring local obligations	Written notice of proposed sale. Yearly fiscal status report for bonds issued on or after January 1, 1996. Default or draws on reserve	30 days prior to sale. No later than October 30 annually No later than 10 days after occurrence.	Government Code Section 6599.1(a) Government Code Section 6599.1(b) Government Code Section 6599.1(c)
JOINT POWERS AUTHORITY issuing rate reduction bonds	Submit a statement from the authority that it is issuing rate reduction bonds, state the source of repayment, and state the saving realized from the sale of the bonds.	Report issuing rate reduction bonds at least 30 days before the sale Report realized savings no later than 21 days after sale	Government Code Section 6588.7(e)(2)

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Figure 7-1

REPORTS THAT DEBT ISSUERS MUST SUBMIT TO CDIAC, CONTINUED

REPORTING AGENCY	DESCRIPTION	TIMING	APPLICABLE CODE SECTION
HARBOR AGENCY - JOINT POWERS AUTHORITY	Submit annual report(s) of receipts and expenditures from the infrastructure fund and financing activities	Annually – no date specified in statute	Harbor and Navigation Code Section 1706(b)
REDEVELOPMENT AGENCY	Submit a copy of the agency's resolution specifying the financial advantage of the agency purchasing its own bonds and a cover letter with other information specific to the bonds.	Report within 2 weeks following the purchase of bonds	Health and Safety Code Section 33664(d)
IRRIGATION DISTRICTS	Notice of proposed sale of any evidence of indebtedness issued to provide financing of any works of the district. Failure to five notice shall render the sale invalid. CDIAC may waive the 30 day notice upon application by the district.	30 days prior to the proposed sale.	Water Code Section 20560.2

Currently, the forms of reporting described below are submitted electronically through CDIAC's website, www.treasurer.ca.gov/cdiac/reporting.asp.

7.1.1 Report of Proposed Debt Issuance

California Government Code Section 8855(i)(1) states that state or local government issuers of proposed debt issuance must file a *Report of Proposed Debt Issuance* with CDIAC no later than 30 days before the sale of debt. The *Report of Proposed Debt Issuance* consists of information related to the issuer, the authorization of the issuance, and details of the proposed issuance. The information submitted includes, but is not limited to the following: name of issuer, name of project, proposed amount of issuance, repayment source and term, type of debt instrument, type of sale, tax status of issuance, purpose of issuance and the legal authorization for the proposed issuance.

CERTIFICATION OF LOCAL DEBT POLICIES - Issuers must certify on the *Report of Proposed Debt Issuance* that they have adopted local policies concerning the

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use of debt and that the proposed debt issuance is consistent with those policies. Specifically, an issuer should certify that its local debt policies include the components listed in Government Code Section 8855(i)(1)(A) through (E), as follows:

A. The purposes for which the debt proceeds may be used
B. The types of debt that may be issued
C. The relationship of the debt to, and integration with, the issuer's capital improvement program or budget, if applicable
D. Policy goals related to the issuer's planning goals and objectives
E. The internal control procedures that the issuer has implemented, or will implement, to ensure that the **proceeds** of the proposed debt issuance will be directed to the intended use

A conduit issuer must certify that it has adopted local debt policies in compliance with Section 8855(i)(1) and that these local debt policies include (A) through (E) of Section 8855(i)(1). Alternatively, a conduit issuer that has adopted local debt policies in compliance with Section 8855(i)(1), with policies that include (A) and (B) above, may rely upon a certification from the borrower. The borrower of the proceeds of the conduit bond in this case must certify that it has adopted local debt policies in compliance with Section 8855(i)(1) and that the local debt policies of the other government entity include (C), (D), and (E), above.

7.1.2 Report of Final Sale

After public agency debt is sold, California Government Code Section 8855(j) requires the issuer to file a *Report of Final Sale* with CDIAC, no later than 21 days after the sale date. This report must include a copy of the final Official Statement (OS) for the debt issuance, if one was prepared. If there is no OS, the issuer must provide a copy of the following documents, if prepared for the financing: the **indenture**, **installment sale agreement**, **loan agreement**, promissory note, **bond purchase agreement**, authorizing resolution, bond specimen, and any other **disclosure** document. Information to be reported after the sale of debt is detailed and includes but is not limited to, the **principal** amount sold, sale date, maturity schedule, source of repayment, election information if voter approved, tax status, financing team participants, credit rating, and costs of issuance.[2]

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[2] California Government Code Section 8855(j) and California Code of Regulations, Title 4, Division 9.6, Chapter 1, Article 2, Section 6020.

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REASONS FOR PRIVATE SALE OF REFUNDING BONDS
AND FOR PRIVATE SALE OF REVENUE BONDS

Local agencies issuing bonds under the Local Agency Refunding Law (Government Code Section 53580 et seq.) or the *Revenue Bond Law of 1941* (Government Code Section 54300 et seq.) respectively, are subject to the following reporting requirements if the bonds were sold in a private or **negotiated sale**.

1. Reason for Negotiated Refunding

   Under California Government Code Section 53583(c)(2)(B), a local agency issuing refunding bonds under the *Revenue Bond Law of 1941* (Government Code Sections 54300–54700) in a private or negotiated sale must provide CDIAC a written statement within 2 weeks of the sale explaining why a private or negotiated sale was used.

2. Reason for Private Sale of Revenue Bonds

   Pursuant to California Government Code Section 54418, a local agency issuing revenue bonds under the *Revenue Bond Law of 1941* (Government Code Sections 54300–54700) in a private or negotiated sale must provide CDIAC with a written statement within 2 weeks of the sale explaining why a private or negotiated sale was used.

Furnishing this information on the *Report of Final Sale* meets the requirements of a written statement pursuant to Government Code Sections 53583(c)(2)(B) and 54418. Note that the *Reason for Private Sale of Refunding/Revenue Bonds* is due 2 weeks (14 days) after the sale date; while the *Report of Final Sale* is due within 21 days after the sale date.

7.1.3 Annual Debt Transparency Report

California Government Code Section 8855(k) requires state and local government issuers to submit an *Annual Debt Transparency Report* for any issue of debt for which they have submitted a Report of Final Sale to CDIAC on or after January 21, 2017.

An Annual Debt Transparency Report is due to CDIAC within 7 months of the close of the reporting period, defined as July 1 through June 30. This provision makes January 31 the effective deadline for submittal of the report filing. Issuers

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will continue to submit an *Annual Debt Transparency Report* to CDIAC on or before January 31 each year until the later date on which the debt is no longer outstanding or the proceeds have been fully spent. At a minimum, the *Annual Debt Transparency Report* will require issuers to include the following:

A. Debt authorized during the reporting period, which includes the following:

- Debt authorized at the beginning of the reporting period
- Debt authorized and issued during the reporting period
- Debt authorized but not issued at the end of the reporting period
- Debt authority that has lapsed during the reporting period.

B. Debt outstanding during the reporting period, which includes the following:

- Principal balance at the beginning of the reporting period
- Principal paid during the reporting period
- Principal outstanding at the end of the reporting period

C. The use of proceeds of issued debt during the reporting period, which includes the following:

- Debt proceeds available at the beginning of the reporting period
- Proceeds spent during the reporting and the purposes for which it was spent
- Debt proceeds remaining at the end of the reporting period

7.1.4 Mello-Roos Community Facilities District Reports

California Government Code Section 53359.5, which is a part of the *Mello-Roos Community Facilities Act of 1982*, requires all issuers selling community facilities district (CFD) bonds after January 1, 1993 to report certain information about the bond issues through the completion of the following two reports:

1. *Yearly Fiscal Status Report*
2. *Draw on the Reserve Fund or Default Report*

Issuers are required to file a *Yearly Fiscal Status Report* if they have sold bonds on or before June 30 of each year and each year thereafter until the bonds are no

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longer outstanding.[3] The report is due to CDIAC by October 30. Information reported to CDIAC as part of the *Yearly Fiscal Status Report,*[4] includes, but is not limited to the following:

1. Issuer name
2. CFD number or name
3. Name, title, and series of the bond issue
4. Credit **rating** and name of the rating agency
5. Date of the bond issue and the original principal amount
6. Principal amount of bonds outstanding
7. Reserve fund minimum balance required
8. Balance in the **bond reserve** fund
9. Balance in the **capitalized interest** fund, if any
10. Number of parcels and the total dollar amount of delinquent taxes that are delinquent with respect to their **special tax** payments, the amount that each parcel is delinquent, parcel number and the length of time that each has been delinquent, and when **foreclosure** was commenced for the delinquent parcels
11. Balance in any construction funds
12. Assessed value of all parcels subject to special tax to repay the bonds as shown on the most recent equalized roll
13. The total amount of special taxes due, the total amount of unpaid special taxes, and whether or not the special taxes are paid under the county's Teeter Plan
14. The reason and the date, if applicable, that the issue was retired

All issuers of CFD bonds, regardless of when bonds are sold, are required to report to CDIAC within 10 days any draw on reserve or **default** that occurs throughout the calendar year. Issuers of CFD bonds *can also voluntarily file Re-*

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[3] Final maturity is defined in California Code of Regulations, Title 4, Division 9.6, Chapter 1, Article 2, Section 6000(m). https://govt.westlaw.com/calregs/Document/IC84C8DC6EECC4020AE0E223DAFD99172?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=(sc.Default)&bhcp=1.

[4] Government Code Section 53359.5 directs the required information of the *Yearly Fiscal Status* reports submitted to CDIAC.

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plenishment of Draw on Reserves Reporting with CDIAC.[5] Instructions on filing a *Yearly Fiscal Report, Draw on Reserves/Default Report/Replenishment Report* are available on CDIAC's website.

7.1.5 Marks-Roos Reports

Under California Government Code Section 6599.1(b) any joint powers authority (JPA) selling bonds under the *Marks-Roos Local Bond Pooling Act*, on or after January 1, 1996 that uses the proceeds to acquire one or more local obligations is required to report annually on the fiscal status of the JPA bonds and the local obligations acquired until the final **maturity**[6] of the authority bonds. These financings are identified as reportable Marks-Roos issues. Both reports are due to CDIAC no later than October 30 each year.

1. *Yearly Fiscal Status for JPA Issuers*
2. *Yearly Fiscal Status for Local Obligors*

JPA issuers and local obligors are required to supply the following information in their Yearly Fiscal Status report to CDIAC:[7]

1. The principal amount of the bonds outstanding - both JPA bonds and local obligations purchased with the proceeds of the JPA bonds
2. The balance in the reserve fund
3. The costs of issuance, including ongoing fees
4. The total amount of administrative fees collected
5. The amount of administrative fees charged to each local obligation
6. The interest earnings and terms of all **guaranteed investment contracts**
7. Commissions and fees paid on guaranteed investment contracts
8. The delinquency rate on all local obligations

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[5] In 2011, CDIAC began accepting the voluntary filings of replenishments to reserve accounts.

[6] Final maturity is defined in California Code of Regulations, Title 4, Division 9.6, Chapter 1, Article 2, Section 6000(m), https://govt.westlaw.com/calregs/Document/IC84C8DC6EECC4020AE0E223DAFD99172?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=(sc.Default)&bhcp=1.

[7] California Government Code Section 6599.1(b).

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9. The balance in capitalized interest accounts

Additionally, California Government Code Section 6599.1(c) requires all agencies issuing Marks-Roos bonds, regardless of when sold, to notify CDIAC within 10 days of the occurrence of either of the following events:

1. The local agency or its **trustee** fails to pay principal and **interest** due on any scheduled payment date.
2. Funds are withdrawn from a reserve fund to pay principal and interest on the bonds issued by the JPA or on any bonds acquired by the JPA.

Beginning in 2011, CDIAC gave issuers the ability to voluntarily report the replenishment of any draw on reserve.

7.2 OTHER REPORTING REQUIREMENTS IMPOSED ON ISSUERS OF MUNICIPAL DEBT

The following is a partial list of other reporting requirements imposed on issuers by California statutes.

7.2.1 Local Bond Disclosures

Government Code Section 5852.1 requires the governing body of a local agency, before authorizing the issuance of debt with a term greater than 13 months, to provide a good faith estimate to the public of (1) the **true interest cost** of the bonds, (2) the finance charges of the bonds, (3) the amount of proceeds received from the sale of the bonds, and (4) the total amount to repaid. This good faith estimate may be provided by the **underwriter**, a **municipal advisor**, or a lender. If the proceeds are being lent by the local agency to a nongovernmental conduit borrower, the good faith estimate may be provided by the conduit borrower.

7.2.2 Local Issuer Bond Accountability

Government Code Sections 53410 and 53411 require a local agency that submits a bond measure for voter approval to provide accountability measures including but not limited to a statement indicating (1) the specific purposes of the bond, (2) a requirement that the proceeds be applied on the specific purposes identified, (3) the creation of an account into which the proceeds will be deposited, and (4)

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an annual report filed with the governing body describing the amount of funds collected and expended and the status of any projects required or authorized to be funded.

7.2.3 Joint Powers Authority Notices

Government Code Section 6586.7 requires a JPA that intends to issue or receive the sale of certain bonds under the *Marks-Roos Local Bond Pooling Act of 1985* to submit copies of public hearing notices and resolutions of intent to issue debt for capital improvements to the Attorney General. This requirement is in addition to the reporting to CDIAC of these same materials.

7.2.4 General Obligation Bond Issuance Costs

Government Code Section 53509.5 requires local agencies issuing general obligation bonds under the authority provided by Government Code Section 53506 to present the actual **cost of issuance** for the sale to the legislative body at the next public meeting after the sale.

7.2.5 School and Community College Bond Issuance Costs

Education Code Section 15146(d)(1) requires the governing board of a school or community college district to present the actual cost information for the sale of bonds under Education Code Section 15100 et seq. at its next scheduled public meeting.

7.2.6 Mello-Roos Community Facilities Reports

Government Code Section 53343.2 requires a local agency that has established a Mello-Roos CFD that has issued bonds and maintains an internet website to post its annual financial report or a link to its CDIAC Mello-Roos *Yearly Fiscal Status Report*.

7.2.7 California Debt Limit Allocation Committee Reports

Issuers that issue bonds using a **private activity bond** **volume cap** allocation (See Section 4.7.2.1, Volume Cap) must report the issuance of such bonds to the California Debt Limit Allocation Committee (CDLAC) and must file annual reports

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with CDLAC certifying compliance with the terms of the CDLAC resolution granting the allocation.

7.3 PROHIBITION OF GIFT OF PUBLIC FUNDS

Article XVI, Section 6 of the California Constitution prohibits a public agency from making any gift of public funds or from lending its public credit to any person. Article XVI, Section 6 also prohibits a public agency from becoming a stockholder in any private corporation. These provisions may affect redevelopment and other economic development activities where public finance transactions are used to provide benefit or inducement to private firms for the purpose of achieving economic advantages to the community and **public-private partnerships**, especially when the viability of the financing depends upon the public agency's credit.

California courts have, however, created a fairly broad "public purpose" exception to the prohibition, allowing California public agencies significantly greater flexibility than that allowed to public agencies in many other states. Under the "public purpose" exception, a transaction is not prohibited by Article XVI, Section 6 if there is a significant "public purpose," even if there is incidental benefit to private individuals.[8] Further, courts generally defer to legislative findings of public purpose if they are reasonable. If a proposed financing involves benefit to a private party, a public agency should review public benefits and, to the extent practicable, memorialize its public purpose determinations in the transaction documents or in the governing board resolution approving the transaction.

7.4 CALIFORNIA ENVIRONMENTAL QUALITY ACT

The *California Environmental Quality Act* (CEQA), California Public Resources Code Sections 21050 et seq.), is applicable to all local public agencies that "ap-

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[8] In County of Alameda v. Janssen, 16 Cal. 2d 276 (1940), the California Supreme Court described the analysis as follows: "In determining whether an appropriation of public funds or property is to be considered a gift, the primary question is whether the funds are to be used for a 'public' or a 'private' purpose. If they are for a 'public purpose', they are not a gift within the meaning of [the predecessor provision to Article XVI, Section 6]. The benefit to the state from an expenditure for a 'public purpose' is in the nature of consideration and the funds expended are therefore not a gift even though private persons are benefited therefrom. The determination of what constitutes a public purpose is primarily a matter for legislative discretion, which is not disturbed by the courts so long as it has a reasonable basis."

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prove" or carry out "projects" where such projects "may have significant effects on the environment." See California Public Resources Code Section 21151. The California Supreme Court has stated that the fundamental purpose of CEQA is to ensure that environmental considerations play a significant role in governmental decision-making (see Fullerton Joint Union High School District v. State Board of Education, 32 Cal. 3d 779 (1982)).

Consistent with that purpose, the Implementation Guidelines for the California Environmental Quality Act, California Code of Regulations Section 15000 et seq., and case law interpret the statutory requirements broadly. A "project," for example, includes not only construction or development activity but the "whole of an action, which has the potential for resulting in either a direct physical change in the environment, or a reasonably foreseeable indirect change in the environment," and an "approval," although limited to discretionary actions, includes any decision by a public agency "which commits the agency to a definite course of action in regard to a project" and may include permits for activities by private parties. Actions taken in violation of CEQA may be voided, and "actions" for this purpose may include the adoption of a resolution authorizing the sale and issuance of bonds. Should such a resolution be voided, the validity of the sale and issuance would be undermined.

Proceeds of municipal debt issuance are generally spent on "projects" as defined in CEQA and financing for a "project" can, and generally does, constitute an "approval" for CEQA purposes. Before adopting a resolution authorizing the issuance of debt, therefore, it is important for the public agency to determine that it has taken any actions required by CEQA to be taken before the authorization (often referred to as "CEQA regulatory compliance"). CEQA regulatory compliance can be based upon one or some combination of the following:

- A determination by the public agency that the proposed action is entirely ministerial (i.e., that there is no discretion exercised by the public agency, rarely the case in a municipal debt transaction)
- A determination by the public agency that a specific CEQA exemption is available (for example, the exemption for the issuance of conduit revenue bonds by certain state agencies)
- Subject to certain exceptions generally relating to cumulative environmental effects and special environmental conditions, a determination by the public agency

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that the proceeds will be used to finance minor additions or alterations to or replacement of existing facilities that involve negligible or no expansion of use

- A determination that the proceeds will be used for feasibility and planning studies (which may include the cost of environmental review)

- A determination by the public agency, evidenced by a "negative declaration," that the project will have no significant adverse impact (this may be based upon mitigation measures)

- Review and approval of the findings by the public agency of an environmental impact report

If not all projects on a list of potential expenditures have CEQA regulatory compliance, it is important that projects on the list with CEQA regulatory compliance have needs sufficient to allow the public agency to use all of the debt proceeds (i.e., that the public agency will not have "overissued" even if, however unlikely, the public agency elects following environmental review to abandon all projects without current CEQA regulatory compliance). When a **bond resolution** must be adopted early in the issuance process, some public agencies qualify approval on CEQA regulatory compliance before debt issuance. Whether the qualification is sufficient for the adoption of the resolution to not constitute an "approval" for CEQA purposes depends upon the particular circumstances. See Save Tara v. City of West Hollywood, 45 Cal. 4th 116 (2008).

Chapter 8. Post-Issuance Debt Management Requirements, Including Tax Compliance and Ongoing Disclosure Obligations

This chapter focuses on best practices regarding the development and administration of guidelines, policies, procedures, and plans to track and report on the use of bond funds in compliance with federal tax law and other requirements and obligations, including the terms and conditions of the borrowing, compliance with accounting and expenditure rules, and reporting and transparency. For purposes of this discussion, bond funds encompass not only the **proceeds** received from the sale of the bonds and the accounts into which the proceeds are deposited but also those funds dedicated to the repayment of debt service on the bonds and associated reserves and interest earnings (referred to in this chapter collectively as "bond funds").

Through organizations such as the California State Controller's Office, U.S. Government Accountability Office (GAO), and the Committee of Sponsoring Organizations of the Treadway Commission (COSO), abundant resources provide guidance on the development of financial and fiscal control, including internal control systems. When applied consistently and correctly these controls can provide both the agency and the public an assurance that government funds are being properly managed and accounted for. Internal control practices designed to oversee a public agency's administration of general operational funds should also include the disbursement of bond funds. To incur debt, keep records, and report

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on expenditures of bond funds, however, may require processes different from those set up to administer other governmental funds.

8.1 A FRAMEWORK FOR MANAGING BOND FUNDS

The proceeds of a bond sale should be understood to be governmental funds that are subject to the same administrative, policy, and financial management practices imposed on all funds under the public agency's control. The unique nature of bond funds—as moneys subject to federal and state regulations—imposes additional requirements on the public agency. The public agency must address these additional requirements in its post-issuance debt management strategy. That means the public agency must create an administrative process to implement the terms of the bond documents, including the control of bond funds and complying with federal and state tax and **disclosure** requirements. On a parallel track, the public agency's debt management practices should address transparency and accountability.

Public agencies should develop and administer guidelines, policies, procedures, and plans for the use of bond funds that take into consideration the set of laws, regulations, and contractual obligations that apply to bond funds. What is appropriate for a given public agency will vary depending on the complexity of the financings, the number of bond **issues** to be monitored, and the types of bond issues involved. For some public agencies, the coordination of compliance may be made the responsibility of a single individual.

In the case of public agencies that frequently issue tax-exempt bonds, including conduit issuers of **private activity bonds**, adopting policies and compliance practices that are integrated within the day-to-day practices of the entity may be advisable. A process for doing so may include the following:

- Form a working group of all individuals assigned legal, administrative, or program responsibilities concerning bond funds. The group should include the public agency's legal and executive departments, representatives from the agency's accounting, budget and program areas, and the agency's bond counsel. If the bond funds are earmarked for capital improvements the group may include project managers from the department overseeing public works or facilities. The group may also include those assigned responsibilities for auditing these funds.

- Identify the fundamental requirements and obligations imposed on the use of bond funds and the issuer by laws and regulations as well as contracts and

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agreements. This includes identifying the commitments made by the issuer to adhere to covenants regarding budgets, revenues, or additional **debt**. Relevant federal and state laws that direct the administration and expenditure of bond funds include the following:

- Constitutional limitations on debt and revenue (including tax revenue). See **Chapter 1, Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues**.

- Issuance authority, including voter ballots and taxpayer initiatives. See **Chapter 1, Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues**.

- Primary disclosure requirements relating to the sale of municipal securities. See **Chapter 6, Securities Laws Pertaining to Municipal Debt**.

- Tax compliance (including use of proceeds, arbitrage rebate, and records retention). See **Chapter 4, Federal and State Tax Law Requirements**.

- Investment of bond funds. See **Chapter 9, Investment of Bond Funds**.

- Other state and local laws. See **Chapter 1, Legally Incurring Debt - State Law Restrictions on Public Agency Debt and Revenues**.

- Translate these requirements and obligations into operational terms that may direct administrative, program, or financial decisions. For example, if the public agency has promised not to allow **debt service** costs to exceed a set percentage of revenues requires establishing, a rate-setting process is required to ensure compliance.

- Amend existing guidelines, policies, procedures, and plans to incorporate the needed administrative, program, and financial responsibilities identified by the working group to meet the legal and regulatory requirements and obligations imposed on the **issuer** for the use of bond funds. Issuers are encouraged to add these to existing documents and not to create separate guidelines, policies, procedures, and plans to reduce the risk that guidelines policies, procedures, and plans unique to bond funds will not be consistently applied.

- Formally review and adopt these guidelines, policies, procedures, and plans. Because these documents constitute legal and financial commitments made by the issuer they should be approved by the issuer's leadership.

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- Create and share access to a document library containing the bond documents and agreements. The final and executed versions of bond documents (including **Official Statements** (OSs), IRS filings, and other legal, regulatory and financial documents) relating to a debt financing can be found in an official closing transcript for the transaction. Typically, **bond counsel** provides the issuer with an electronic PDF version of an official closing transcript, usually within 3 or 4 weeks from date of bond closing. Additionally, the issuer should receive at least one transcript maintained in an agency's official files consisting of final bond documents with original signatures. All transcript copies should be consistently maintained in a safe, yet accessible location so that staff responsible for post-issuance debt management and other bond-related duties can easily locate bond financing resources when necessary.

8.1.1 Bond Documents

Examples of bond documents most relevant to the use of bond funds include bond **indentures**, lease agreements, ordinances, and resolutions relating to rights, obligations, and remedies protecting bondholders. The documents include provisions that control the administration of bond funds, such as the **security pledge**, **flow of funds**, disbursements (i.e., requisitions or officer certificates), **redemption**, credit enhancement, permitted investments, and various issuer specific debt **covenants**. See Chapter 2, Debt Structures: What Factors Drive Structuring Decisions?

In certain types of debt financings, there are legal documents other than an indenture that control the administration of bond funds. For example, in a Mello-Roos financing there may be an acquisition or funding agreement allowing the public agency to purchase a built facility.[1] When multiple agencies are involved, and the bond proceeds are to be allocated to another public entity, there may be a joint community facilities agreement. In the case of a conduit issuance, a **loan agreement** may cover some of the uses of funds.

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[1] Task Force on Bond Accountability, *Task Force Final Report*, p. 15, December 14, 2015, www.treasurer.ca.gov/tfba/final_report.pdf.

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8.2 ELEMENTS OF POST-ISSUANCE COMPLIANCE

8.2.1 Establishing a Compliance Program

According to the Government Finance Officers Association (GFOA) the design and implementation of a post-issuance compliance program "should consider the issuer's size, organizational structure, frequency of bond issuance, and budget/staffing resources."[2] The GFOA recommends that issuers identify a "chief compliance officer" by job title rather than name to assure continuity. The position will have the overall responsibility to implement and coordinate the compliance program.[3] The GFOA also specifies that large agencies may assign staff to specific responsibilities under the authority of the chief compliance officer. To ensure effective oversight, a compliance officer should be primarily responsible for verifying that post-issuance activities are performed by the various programs and personnel in accordance with applicable policies and procedures and other control documents.

To ensure effective oversight, the GFOA recommends that a compliance program achieve the following:

- Identify the individual or individuals responsible for coordinating activities.
- Provide for **due diligence** review at regular intervals.
- Facilitate training for responsible individuals.
- Describe retention of adequate records to substantiate compliance.
- Accommodate review that identifies areas most susceptible to noncompliance.
- Include procedures to correct identified noncompliance in a timely manner.

The Task Force on Bond Accountability's *Final Report* recommends that agencies have administrative practices to ensure that job descriptions and duty statements define responsibilities for compliance staff and integrate an agency's business operations with its debt management and internal control procedures for bond

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2 GFOA Best Practice - Post-Issuance Policies and Procedures, www.gfoa.org/materials/post-issuance-policies-and-procedures.

3 GFOA Best Practice - Post-Issuance Policies and Procedures, www.gfoa.org/materials/post-issuance-policies-and-procedures.

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funds.[4] This may include segregating duties and lines of authority and including reporting and communication with a governing body, addressed in the agency's internal control system.

8.2.2 Maintaining Tax-Exempt Status

Tax-exempt debt obligations issued by public agencies are generally subject to statutory requirements for the use of bond proceeds and bond-financed facilities and compliance with arbitrage and arbitrage rebate requirements. See **Section 8.3, Post-Issuance Federal Tax Law Requirements** and **Section 8.3.7, Changes in Use of Bond-Financed Property**. These statutory requirements are often a focus of an issuer's most fundamental post-issuance debt management and compliance responsibilities. A failure to adequately follow applicable legal requirements may result in examinations and other enforcement actions, including the loss of the bond's tax-exemption.

8.2.3 Recordkeeping and Reporting

As noted by GFOA, records necessary to document compliance should be maintained for the required time periods.[5] In addition, state or local record retention requirements need to be considered. In some cases, an issuer may need to amend its record retention policy in order to keep tax or other records for periods longer than otherwise required by state law for non-bond-related documents. See **Section 8.3.6, Recordkeeping and Retention**.

In general, an issuer of municipal debt must also meet disclosure requirements that help enable the underwriters of the issuer's securities to comply with federal securities laws, including **SEC Rule 15c2-12** (See **Section 8.4, Continuing Disclosure**). The GFOA noted that incorporating robust disclosure practices and demonstrating a solid disclosure track record will benefit an issuer by encouraging regulatory compliance and by enhancing credibility among **investors**, **credit rating** agencies, and the public.[6]

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[4] Task Force on Bond Accountability, *Task Force Final Report*, December 14, 2015, pp. 14, 17.

[5] Ibid.

[6] GFOA Best Practice - Understanding Your Continuing Disclosure Responsibilities, www.gfoa.org/materials/understanding-your-continuing-disclosure-responsibilities.

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8.2.4 Accounting Records

An agency's accounting and financial reporting practices should provide for the reconciliation of funds and accounts held by bond trustees. The agency's administrative and capital improvement programs should adopt business processes specific to the use and disbursement of bond funds.

8.2.5 Written Procedures

The GFOA Best Practice - *Post Issuance Policies and Procedures* recommends that issuers adopt and document post-issuance procedures. These may be included in debt management policies or other agency resources. Further, written procedures should describe the review process to ensure compliance and describe the actions that will be taken to correct any non-compliance.

The IRS notes that an issuer that has "established and followed written procedures promoting post-issuance compliance [is] less likely to violate the federal tax requirements related to its bonds than an issuer that does not have procedures."[7] For further guidance on the development of post-issuance tax compliance procedures, issuers may refer to the National Association of Bond Lawyers (NABL) and GFOA white paper, "**Considerations for Developing Post-Issuance Tax Compliance Procedures**."

Issuers should consistently and carefully monitor regulations, rules, and new interpretive guidance addressing changes in market practices and expectations, including the enactment of new state and local laws and amendments to existing statutes related to the administration of debt. In response to noted changes, issuers should update applicable policies and compliance procedures in a timely manner.

8.2.6 Compliance Checklists

While an issuer's debt administration and compliance activities should be documented in written procedures or desk manuals, agencies may also identify and track post-issuance compliance responsibilities using task schedules and tickler reminders. If so, these tools should identify the frequency of the tasks (i.e., week-

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[7] Internal Revenue Services, TEB Post-Issuance Compliance: Some Basic Concepts, August 7, 2017, **www.irs.gov/tax-exempt-bonds/teb-post-issuance-compliance-some-basic-concepts**.

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ly, monthly, quarterly, and annually) and the name/title of staff or organizational unit responsible for completing them.

There are sample compliance checklists for the administration of tax-exempt debt available from external sources, such as the **NABL/GFOA Post Issuance Compliance Checklist**. Many financial advisory firms also provide compliance checklists tailored to fit an issuer's debt management strategy. Additionally, information on federal compliance requirements for tax-advantaged bonds can be found on the **IRS website**.

The *Final Report* of the Task Force on Bond Accountability includes sample checklists for Debt Issuance and Management Review and Internal Control for Bond Requirements (see section titled "Internal Controls; Accountability of Bond Funds").

8.2.7 Audit Review

To ensure the internal control processes and procedures for the agency's bond program are effective, a public agency should employ periodic audits of the program. These may be performed by internal auditors or be incorporated in the external auditor's work plan. Any effort to monitor the agency's internal control system must include control functions performed by the conduit issuer in the case of a **conduit financing**.

When performed on bond funds, the scope and purpose of a financial audit may differ from that of a performance audit. A financial audit may track, account for, and report on specific expenditures of bond proceeds, while a performance audit may be used to determine the outcome of expenditures of proceeds.[8] The opportunity for an auditor to assess the value of bond expenditures when conducting a performance audit is a function of the specificity of the original bond act in defining the purpose or objectives of the bond program. A financial audit may answer questions about when, to whom, and how much was paid out, while a performance audit may address whether the funds were spent for the intended purposes. Audit findings should be considered an opportunity to improve the management of proceeds.

[8] Task Force on Bond Accountability, *Task Force Final Report*, p. 17.

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8.3 POST-ISSUANCE FEDERAL TAX LAW REQUIREMENTS

The opinion of bond counsel that **interest** on municipal debt securities is excluded from gross income for federal income tax purposes is premised upon, among other things, statements made by the issuer with regard to the expected use of the proceeds of the bonds. These expectations and related covenants and agreements are generally memorialized for a tax-exempt debt issuance in a tax certificate. See **Chapter 4, Federal and State Tax Law Requirements**. Compliance with tax covenants is required while the bonds are outstanding in order to maintain the bonds' "tax-exempt" status.

Post-issuance tax compliance generally falls into two broad categories: (1) qualified use of bond proceeds and bond-financed property, and (2) arbitrage rebate and **yield restriction**. The qualified use requirements necessitate monitoring the uses of bond-financed property over the life of the bonds and the arbitrage requirements necessitate monitoring certain investment activities over the life of the bonds and may require filings with the Internal Revenue Service (IRS).

8.3.1 Post-Issuance Tax Compliance Programs

Because the consequence of noncompliance with federal tax law requirements could result in serious adverse consequences for the tax-exempt status on tax-advantaged bonds and could affect investors or lenders in a material way, every public agency issuer should ensure that post-issuance tax compliance requirements are identified and included in applicable policies and procedures. While the scope of tax compliance activities may vary depending on the type of bonds involved, including private activity bonds issued by conduit issuers, key elements of a post-issuance tax compliance program may represent a cross-section of administrative and programmatic responsibilities within a public agency and may include the following:

- Designating a tax compliance point person(s) to monitor and report on compliance activities
- Developing written, post-issuance tax compliance procedures
- Tracking and allocating bond proceeds
- Monitoring the use of bond-financed property
- Addressing changes in use of bond-financed property

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- Monitoring investment income and arbitrage compliance
- Recordkeeping and retention
- Ongoing communication with outside tax specialists and continuing education

Written post-issuance procedures should contain the following at a minimum:

- Identification of the individual(s) with responsibility for monitoring post-issuance tax compliance and a description of the monitoring compliance training provided to them
- The frequency of compliance checks (most being at least annually)
- The nature of the compliance activities required to be undertaken
- The procedures used for timely identification and elevation of the resolution of a violation when it occurs or is expected to occur
- Procedures for the retention of all records material to substantiate compliance with federal tax law requirements
- Acknowledgement of the availability of the Voluntary Closing Agreement Program described below and other remedial actions

The federal tax rules are complex and are subject to change. Maintaining an ongoing relationship and dialogue with arbitrage specialists, tax counsel, or bond counsel can help ensure that policies and procedures are updated with information regarding changes in federal tax law applicable to tax-exempt bonds and the IRS filing requirements. In addition, public agency issuers should actively seek out educational opportunities to keep abreast of changes and developments in federal tax law.

8.3.2 Tracking and Allocating Bond Proceeds

The process of allocating bond proceeds and developing an accurate summary of bond-financed property on an issue-by-issue basis is an essential element of a tax compliance program. A public agency issuer should do the following:

- Identify at issuance the funds and accounts into which bond proceeds are to be deposited.
- Document the reimbursement of any pre-issuance expenditures.

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- Monitor the expenditure of bond proceeds to ensure that bond proceeds are spent within applicable time frames.

Upon project completion, the issuer should make a final allocation of bond proceeds and other funds to bond-financed property. This allocation should clearly reflect which portions of the project are treated as bond-financed property and, conversely, which portions are not bond-financed.

8.3.3 Monitoring Use of Bond-Financed Property

The use of property financed in whole or in part with the proceeds of tax-exempt bonds must be monitored over the life of the bonds to ensure that the property use does not violate the applicable federal tax law restrictions. For a governmental bond issue, the principal concern is that the property becomes used in the trade or business of a nongovernmental person with the result that the bonds become taxable private activity bonds. See Section 4.6, Governmental Bonds/Private Activity Bonds. Sale of bond-financed property to a nongovernmental person is an obvious concern. Private use of bond-financed property can also arise in other ways, however, including through a lease, license, management contract, or sponsored research contract. Public agency issuers should review the use of bond-financed property at least annually and should maintain vigilance with respect to agreements with private parties affecting the property beyond those contemplated and analyzed at the time of the issuance of the bonds. Issuers should consult with tax counsel to determine whether an arrangement creates private business use in excess of allowable amounts and to consider alternatives. Conduit issuers should consider policies and procedures that require obligated borrowers to consult with tax counsel to ensure that all applicable post-issuance requirements are met.

8.3.4 Monitoring Investment Income and Arbitrage Compliance

In addition to restrictions on the use of bond proceeds, federal tax law rules place limits on the investment of bond proceeds and require that issuers periodically file reporting forms with the IRS and rebate excess earnings to the U.S. Treasury Department, unless one or more rebate exceptions are satisfied. See Section 4.8, Arbitrage Yield Restriction and Section 4.9, Arbitrage Rebate. Issuers should, in particular, do the following:

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- Monitor compliance with "temporary period" exceptions for expenditure of project bond proceeds (typically 3 years for new money bonds) and provide for yield restriction of bond proceeds as necessary.
- Monitor compliance with the 24-month, 18-month, and 6-month rebate exceptions if the issuer seeks to take advantage of those exceptions.
- Establish procedures to ensure investments acquired with bond proceeds are purchased at fair market value.
- Consult with tax counsel before engaging in post-issuance credit enhancement transactions (e.g., **bond insurance**, **letter of credit**) or hedging transactions (e.g., interest rate swap, cap).
- Identify situations and establish procedures in which compliance with applicable yield restrictions depends upon later investments, and monitor implementation.
- Arrange for timely computation of rebate liability and, if rebate is payable, for timely filing of Form 8038T and payment of rebate.
- Arrange for timely computation and payment of "yield reduction payments," if applicable.

8.3.5 Arbitrage Rebate

Compliance with arbitrage rebate requirements and, if necessary, maintaining yield restriction compliance through yield reduction payments is a critical post-issuance issuer responsibility. See Section 4.9, Arbitrage Rebate and Section 4.8.5, Yield Restriction; Yield Reduction Payments. Calculations of arbitrage rebate liability and the necessity for yield reduction payments are generally not easy and results may not be intuitive. Because of the technical requirements and complexities involved, public agency issuers generally engage an expert that specializes in arbitrage rebate to provide rebate calculation services.

Arbitrage rebate payments are required to be made every 5 years and upon the final payment of a bond issue. See Section 4.9, Arbitrage Rebate. For bond issues where a positive rebate liability is likely, however, issuers are generally well advised to have rebate calculations performed on an annual basis. Annual calculations not only help prevent surprises, but they can also provide precise accrued rebate liability calculations for reflection in the issuer's annual financial statements and allow the issuer to set money aside for making the payments when due.

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8.3.6 Recordkeeping and Retention

Good recordkeeping and retention practices are essential in establishing compliance with applicable federal tax law requirements should an issuer become the subject of an IRS audit. Generally, the following documents should be retained for the life of the bonds (plus 3 years):

- Transcript of bond transaction
- Form 8038, Form 8038-G, or Form 8038-GC filed with IRS and provided as a part of the bond transcript
- Documentation evidencing use of bond-financed property by general public and nongovernmental users, including copies of management contracts and leases
- Documentation evidencing all sources of payment or security of the bonds
- Documentation pertaining to any investment of bond proceeds
- Documentation regarding the allocation of bond proceeds to expenditures
- Documentation regarding allocations of bond proceeds to bond issuance costs
- Copies of requisitions, draw schedules, draw requests, invoices, bills, and cancelled checks related to bond proceeds spent during the construction period
- Copies of all contracts entered into for the construction, renovation, or purchase of bond-financed facilities
- Records of expenditure reimbursements incurred before issuing bonds for facilities financed with bond proceeds
- Asset list or schedule of all bond-financed facilities or equipment
- Records regarding the purchase and sales of bond-financed assets
- Copies of rebate or yield restriction reports or calculations, together with any Form 8038-T filed in connection with rebate payments

If bonds are refunded with tax-exempt **refunding** bonds, the documents should be retained for the life of the refunding bonds (plus 3 years).

8.3.7 Changes in Use of Bond-Financed Property

Over the **term** of a bond issue, facts and circumstances can change and the issuer may desire to use bond-financed property in a manner inconsistent with its rea-

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sonable expectations on the **date of issuance**. In order to preserve the tax-exempt status of the bonds in these circumstances, any tax violations, such as the sale of bond-financed property or use of such property in a manner causing excessive private business use, must be quickly identified and remedied (this also applies to an obligated borrower for a private activity bond). If an issuer or obligated borrower engages in an activity causing bond-financed property to be used in a manner that violates the applicable use limitations, one or more "self-help" remedial actions may be considered. Possible remedial actions include defeasing the non-qualified portion of the **outstanding** bonds or using the amounts realized from the sale of the bond-financed property for another qualifying use.[9] Failure to identify noncompliance early enough to qualify for self-help remedial actions, or matters in which self-help is not available, may be addressed with the IRS under its Tax-Exempt Bonds Voluntary Closing Agreement Program (VCAP).

VCAP offers issuers who voluntarily come forward an opportunity to resolve a violation that cannot be rectified under self-help programs through a "closing agreement" in which the IRS agrees to not declare interest on the bonds to be taxable and the issuer agrees to make a payment to the IRS and take other required actions. Closing agreement terms and amounts may vary according to the degree of violation as well as the facts and circumstances surrounding the violation, but an issuer submitting a VCAP request can expect to settle the case on terms that are no less favorable, and generally on terms that are more favorable, than the settlement terms that would be expected had the violation been discovered as a result of an IRS audit.

VCAP is available to issuers of tax-advantaged bonds who have discovered a violation of the federal tax requirements applicable to their bonds. VCAP is not available for bonds under examination or bonds for which the tax-advantaged status is at issue in a federal court or before the IRS Office of Appeals. VCAP is generally not available, absent extraordinary circumstances, if the violation can be resolved under existing remedial action provisions.

Remedial actions and the VCAP process are complex and an issuer should therefore engage tax counsel to assist it in considering remediation alternatives and, if advisable, to guide the issuer through the VCAP process.

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9 There are specific rules regarding defeasement of a non-qualified portion of the outstanding bonds, and issuers are advised to seek counsel to understand these.

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8.4 CONTINUING DISCLOSURE

Public agencies take on certain responsibilities to file information regularly when they issue municipal securities, including an **annual report** and notices of certain events. The legal basis for this formal ongoing disclosure obligation is SEC Rule 15c2-12 under Section 15(c)(2) the *Securities Exchange Act of 1934* (See Chapter 6, Securities Laws Pertaining to Municipal Debt). SEC Rule 15c2-12, subject to certain exemptions described below, requires the bond **underwriter** to obtain a commitment from the issuer or other obligated party to provide this ongoing disclosure (also known as an "undertaking"). This undertaking generally takes the form of a **continuing disclosure certificate** or **continuing disclosure agreement** (CDA) executed by the issuer or other **obligated person** with respect to the securities, or other obligor, at closing. In most cases, the information to be provided subject to a CDA includes annual financial and operating information of the kind and substance contained in the offering documents, audited financial statements, notice of the occurrence of certain events, and notice of any failure to meet these reporting requirements.

The GFOA Best Practice - *Understanding Your Continue Disclosure Responsibilities* recommends that issuers have a clear understanding of their specific reporting responsibilities outlined in the CDA. If the issuer has included certain financial information in its OS it must take the appropriate steps to see that this information is updated and reported annually. It is imperative that issuers work with their bond counsel, underwriter, and other consultants to determine what will be reported and in what form. Additionally, issuers should work with bond counsel or other external consultants to ensure they understand how to implement changes to legal and regulatory requirements. For example, in 2010, the SEC implemented a widespread change to SEC Rule 15c2-12 that may affect an issuer's reporting requirements. See Section 8.4.2, Event Notices.

Both the annual report and any **event notices** are required to be filed in searchable PDF format through the **Electronic Municipal Market Access** website (EMMA) maintained by the **Municipal Securities Rulemaking Board**. Many issuers' filings are handled by finance or other staff, while others engage the **trustee**, financial advisor, or other outside consultant as a **dissemination agent**, to remind the issuer of the required filings and assist with their preparation and submission to EMMA.

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8.4.1 Annual Reports

The annual report has two parts: (1) the issuer's most recent audited financial statements, and (2) "financial information and operating data" for the issuer for the prior fiscal year of the type contained in the final OS, as specified in the undertaking. Some issuers include the latter information in their annual financial reports. SEC Rule 15c2-12 requires the issuer or obligor to specify a date in the undertaking (not more than 1 year after the end of the fiscal year being reported) by which the annual report must be submitted to EMMA. Issuers should take care to set a date that allows sufficient time for preparation and receipt by the governing board of the audited financial statements.

The description in any undertaking of other financial information and operating data to be provided should be specific (as opposed to a general statement requiring the issuer to provide information "of the type included in the OS"), and the issuer should, to the extent possible, limit the requirement to information that the issuer already updates each year and plans to continue to update. The issuer does not have to update original OS information that was obtained from other parties, and it does not have to update projections or forecasts; it must only report the actual results from the prior fiscal year. It is also helpful to be consistent so that the annual reporting requirements do not vary from one issue of securities to the next.

If the audited financial statements are not completed by the time the annual report is due, the SEC has provided guidance saying that the issuer should file unaudited financial statements with its annual report, and then file the audited statements as soon as they are available. Filing unaudited financial statements with an annual report could present a SEC Rule 10b-5 problem if the final audited financial statements are materially different than the unaudited versions that are filed.

Because the annual report is a document intended to be read by existing or future bondholders, it is subject to **SEC Rule 10b-5 standards**. An issuer must, therefore, be mindful to report—unless otherwise addressed in an OS or a voluntary filing—any material developments since the date of the last financial statements.

8.4.2 Event Notices

The undertaking also requires the issuer to provide notice "in a timely manner not in excess of 10 business days after the occurrence of" certain types of events relating of the securities for which the undertaking has been made that are likely

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Figure 8-1

NOTICE OF MATERIAL EVENTS (AS OF AUGUST 1, 2018)

EVENTS THAT ALWAYS REQUIRE NOTIFICATION	EVENTS THAT REQUIRE NOTIFICATION IF MATERIAL
• Principal and interest payment delinquencies • Unscheduled draws on debt service reserves reflecting financial difficulties • Unscheduled draws on credit enhancements reflecting financial difficulties • Substitution of credit or liquidity providers, or their failure to perform • Issuance by the Internal Revenue Service of proposed or final determination of taxability or of a Notice of Proposed Issue (IRS Form 5701 TEB) • Tender offers • Defeasances • Rating changes • Bankruptcy, insolvency, receivership, or similar event of the obligated person • Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties	• Unless described in the left-hand column, adverse tax opinions or other material notices or determinations by the Internal Revenue Service with respect to the tax status of the securities or other material events affecting the tax status of the securities • Modifications to rights of holders of the securities • Optional, unscheduled, or contingent bond calls • Release, substitution, or sale of property securing repayment of the securities • Non-payment-related defaults • The consummation of a merger, consolidation or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action, or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms • Appointment of a successor or additional trustee or the change of name of a trustee • Incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material

to be material to bondholders or potential investors. SEC Rule 15c2-12 was amended, effective December 1, 2010, again, effective February 27, 2019,[10] to expand this list of events. Figure 8-1 lists the notification requirements for various events.

[10] SEC Press Release, SEC Adopts Rule Amendments to Improve Municipal Securities Disclosure, Washington, DC. August 20, 2018, www.sec.gov/news/press-release/2018-158. SEC, Final Rule, Amendments to Municipal Securities Disclosure, Release No. 34-83885, File No. S7-01-17, www.sec.gov/rules/final/2018/34-83885.pdf.

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There are regular discussions and proposals for the SEC to modify the list in Table 8-1. Issuers and obligors that have to prepare undertakings need to stay up to date with the latest version of SEC Rule 15c2-12. CDAs must track the required lists. In rare instances, however, underwriters may advise an issuer that additional events critical to the security for the deal should be included. Of course, issuers may also provide notices of the occurrence of other events through voluntary EMMA filings.

8.4.3 Exceptions to SEC Rule 15c2-12 Continuing Disclosure Requirements

There are some exceptions to SEC Rule 15c2-12. Securities with a par amount less than $1 million or maturing in 270 days or less (typically, **commercial paper** notes) are exempt from the ongoing disclosure requirements of SEC Rule 15c2-12, as are certain privately placed securities. Although SEC Rule 15c2-12 was amended effective December 1, 2010 to include new issues of variable-rate demand bonds, variable-rate bonds that were outstanding as of November 30, 2010 can be **remarketed** or reoffered without a continuing disclosure undertaking as long as the bonds continuously maintain a $100,000 minimum **denomination** and tender rights of 9 months or less. Certain short-term securities (with **maturities** of 18 months or less) are subject to lesser ongoing disclosure requirements. Finally, if the issuer of the securities is a conduit issuer or otherwise is not the only party responsible for repaying the securities, the ultimate obligor or obligors are the parties required to execute the undertaking and provide the ongoing disclosure. In certain cases there may be multiple parties making up the complete undertaking, each covering certain data.

8.4.4 Incentives for Compliance

As an incentive to issuers, SEC Rule 15c2-12 requires any instances of material noncompliance with undertakings during the previous 5 years to be disclosed in each of the issuer's OSs, even if the noncompliance has been "remedied." Underwriters (both in negotiated and competitive offerings) are required under SEC Rule 15c2-12 to make diligent inquiry to ensure that the issuer has properly disclosed any material noncompliance within the prior 5 years in the **preliminary official statement**. The SEC has said, however, that it is not enough for underwriters to rely on issuers' own representations regarding past compliance. Rather, underwriters must perform their own re-

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view (which may include engaging counsel or other consultants) to obtain evidence reasonably sufficient to determine whether the issuer has complied with its obligations under each of its prior undertakings. This has led underwriters to conduct 5-year look-back reviews regarding issuers' compliance when they are involved in a new bond financing.

The SEC has brought a series of enforcement actions against both issuers and underwriters based on findings that issuers had either falsely stated in an OS that they were in material compliance with all continuing disclosure undertakings for the prior 5 years or had omitted to disclose noncompliance. See Section 6.1.4, SEC Enforcement Actions. These cases have generally involved late or nonexistent filings, but the SEC has declined to (a) define how late of a filing would constitute "material" noncompliance with a CDA or (b) to otherwise define "material compliance." As a result, issuers generally list in their OS any noncompliance with an undertaking within the prior 5 years, no matter how technical or minor.

In addition to legal activity, there has generally been increased attention to continuing disclosure compliance by investors and a call by investors and the SEC to increase the frequency, timeliness, and scope of municipal continuing disclosures. From a positive perspective, providing updated and accurate information on a timely basis confirms that the issuer is managing its affairs well and careful and diligent attention to each undertaking can improve an issuer's relations with investors for future financings. In light of market expectations and the SEC enforcement agenda it is important for issuers to establish internal policies and procedures regarding disclosure responsibilities.

The GFOA Best Practice - *Understanding Your Continuing Disclosure Responsibilities* recommends that issuers consider adopting policies and procedures to apply best practices in the manner that is relevant and most practical for their agency. These best practices include designating a person, or the holder of a specific office, to be responsible for filing the annual reports accurately and timely, and for tracking and reporting on the events that must be reported within 10 business days. Issuers should also be aware of required filing dates in a continuing disclosure certificate or CDA and plan ahead to avoid late filings.

While issuers may rely on outside consultants (such as dissemination agents) to assist in the filing process, it is the issuers that ultimately suffer the consequences of a late filing. Accordingly, issuers should allow for sufficient time to

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review contents of filings by internal staff and outside consultants, including bond or **disclosure counsel**, before the due dates of filings. The issuer's policies and procedures should clearly articulate the information that it must submit in its annual filings and should include a list of required reporting events, as mandated by the SEC and/or stated in a continuing disclosure certificate or CDA.

8.5 OTHER DISCLOSURES TO THE MARKET

Governmental entities make many public statements and make large amounts of information available to the public. This information may be used by many types of constituents, such as investors, credit rating agencies, voters, taxpayers, and others. While investors appreciate that a broad context of information may improve market transparency, public agencies must exercise care in making statements or providing information intended or likely to reach the securities market. The two principal concerns are as follows:

1. Making public statements that mislead market participants (especially statements that are overly optimistic or present only the positive side of a two-sided issue)

2. Making material information available to some market participants that can use it to gain an unfair advantage over other market participants (a problem referred to in securities law as "selective disclosure")

Strategies for addressing these concerns are generally focused on vetting information for misstatements or material omissions before it is made public and making complete and accurate information on topics of interest available to the entire market.

8.5.1 Audited Financial Statements

A public agency's audited financial statements are the foundational disclosure concerning its financial condition. Financial statements are provided to the market as statements by the public agency when included in an OS or an annual continuing disclosure report. Financial statements must be prepared and audited in accordance with the highest accounting standards.

From a securities law perspective, audited financial statements contain inherent risks:

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- Financial statements include qualitative as well as quantitative information, especially the interpretations in the management's discussion and analysis. A public agency should have its audited financial statements reviewed by its financial and legal team for statements that may be incorrectly read or improperly relied upon by securities market participants.

- Financial statements are not the complete story. Although they are generally an important component of an issuer's disclosure to investors, it is rare that the issuer's audited financial statements contain all of the information required to make an informed investment decision. Issuers providing financial statements to the market must determine what additional information is necessary to provide a full picture.

- Balance sheets address a situation on a historical date and revenue statements address activity during a historical period. An issuer providing audited financial statements must determine whether balance sheets and revenue statements must be accompanied by more current information to avoid being misleading. Material developments since the end of the period covered by the financial statements could indicate a weakening of the issuer's financial position (e.g., closure of a facility owned by a major taxpayer; a major carrier withdrawing from an airport).

8.5.2 Informal Statements and Websites

Informal statements by officials and officers of an issuer, even those not taking place during the course of a bond financing, can also be considered disclosure or "speaking" to the market. Public statements, press releases, website postings and statements to the press and governing board proceedings are all widely and publicly available and are often monitored by rating agencies, investor analysts, and other market participants. "Newsworthy" developments, such as natural disasters or the emergence of financial setbacks or challenges, present heightened risk. Officials and officers of issuers should take care not to make unconsidered public statements that may provide only a partial story or distort investors' perception of the issuer's financial strength. Further, issuers should always consider whether informal statements should be accompanied by other material information to avoid being misleading.

Issuer websites can be useful tools for providing information, but they present unique risks. First, a website may facilitate the ongoing and continuous availabil-

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ity of stale or outdated information about the issuer, and even information that is no longer online may be accessible to researchers. Second, there is the potential for the simultaneous availability of inconsistent information. Third, websites facilitate routine "publication" of vast amounts of information that is available to the investing public and may not have been reviewed from the perspective of the issuer's compliance with securities laws.

8.5.3 Questions from Investors

Investors may contact issuers directly from time to time with questions regarding the issuer's finances or operations. Providing information to particular investors can, however, raise "selective disclosure" concerns. Fielding questions from investors is not prohibited, but it is a best practice for issuers to identify a single point person for responding to investor inquiries, to maintain consistency and to respond to inquiries with information that is already available to the general public to the extent possible. Under some circumstances, issuers must decline to provide an investor with helpful information because that information is not yet publicly available. Sometimes an investor inquiry will prompt a voluntary disclosure so that a question that identifies something **material** is shared with the market at large.

8.5.4 Managing Disclosure Risk

The most effective approach to addressing the risks of misleading informal statements to the market and selective disclosure is generally to provide information on topics of interest—reviewed for completeness and accuracy from a securities law perspective—accessible to all market participants. An issuer may, for example, use EMMA to post voluntary disclosure to the market that does not fit in one of the "traditional" required disclosure categories of offering document, annual report, or other material event notice. Issuers have used this option to disclose the approval of potential refunding transactions, anticipated tender offers, and updates on significant developments that do not fit one of the **listed events** from SEC Rule 15c2-12.

Another strategy is to create and maintain an "investor relations" page on the issuer's website as a repository for the issuer's statements to the market and other information investors or potential investors frequently seek out. The site can be available to members of the general public who read and accept an ap-

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propriate disclosure and disclaimer before accessing the site, including a statement that no content contained in or accessible by link from the issuer's website is intended to be relied upon in connection with the purchase or sale of the issuer's securities. The issuer must, however, control, maintain, and update the content of the website. Disclosures to the market should be dated and should clearly state that the disclosure speaks only as of its date and that the issuer has not undertaken to update or correct the information based on events occurring after that date.

Chapter 9. Investment of Bond Funds

Public agencies invest available funds, including bond proceeds and funds earmarked to pay **debt service**, to generate investment earnings. These earnings can increase the amount of funds available for **project financing** or can directly offset financing costs. Designing and implementing an investment strategy that maximizes earnings, while ensuring the safety and **liquidity** of invested funds and complying with federal **tax** law, is an important component of minimizing overall, or "net," borrowing costs.

This chapter provides background on the authority to invest bond funds, legal and regulatory controls on investments, commonly used investment options, and the role of an investment oversight committee.

9.1 A TEAM APPROACH TO INVESTING BOND FUNDS

California Government Code Section 53600.3 provides that with respect to the investment of public funds, public officials are fiduciaries subject to the prudent investor standard. While a local agency's fiduciary responsibilities cannot be delegated regardless of the fiduciary standards imposed on other municipal professionals, a team approach may help to ensure that an agency's investment objectives are achieved.

The framework for investing and administering investments differs between agencies, the type of debt issued, and purpose for which it was issued. These differences are the product of several factors, including the following:

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- *Expertise*. Some public agencies have the investment expertise in house, or they have access to external resources such as investment advisors or investment services provided by another public agency.

- ***Cash Flow*** *Needs*. The purpose for which the debt was issued is an essential consideration in selecting an appropriate investment strategy. Capital improvement projects are driven by a project schedule that relies on cash being available to pay for materials and labor, and debt service fund (DSF) investments must mature or be redeemable before debt service payments are due.

- *Investment Policies*. Public agencies are provided broad authority when investing bond proceeds. Their decision, however, may be subject to policies written to limit risk or to reflect other social or political objectives.

- *Type of Debt Issued*. The type of debt may dictate the investment strategy. Investment of the **proceeds** of refunding bonds held in trust to meet the debt service obligations on the refunded bonds, for example, may be limited to obligations issued or guaranteed by the United States government.

Weighing the relevance of each of these factors is beyond the scope of this guidebook. Public agencies should, however, undertake the work needed to appropriately manage their bond funds. This management starts with the formation of a working group composed of agency staff and consultants responsible for investment decisions, including at a minimum the following roles:

- *Debt Managers* - who are responsible for administering the bonds, including post-issuance reporting and tax compliance

- *Bond Counsel* - who have prepared bond documents and are aware of the **covenants** and other terms regulating the use of the **proceeds**

- *Project or Program Staff* - who manage expenditures and know when funds need to be available and in what amount

- *Investment Staff (internal) or Registered Investment Advisors (external)* - who provide guidance on the risk, liquidity, and return of different investment alternatives

- *Municipal Advisors* - who have participated in the bond sale and understand the timing of disbursements and the debt service schedule

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- ***Trustees*** - who may be administratively or statutorily assigned responsibility over the bond funds

As a team, these and others may devise an appropriate system for investing bond funds that considers the public agency's investment authority, its administrative structure, its expertise, and its policies.

9.2 TYPES OF FUNDS AVAILABLE FOR INVESTMENT

"Bond funds" viewed broadly are funds that are the proceeds from the issuance and sale of municipal debt obligations (referred to in this chapter as "bonds") or amounts to be used for the payment of bonds. The various funds and accounts in which bond funds are held are established by the **indenture**, trust agreement, **bond resolution**, or other documents providing for the issuance of and security for the bonds (referred to in this chapter as "bond documents"). See Section 2.4, Other Common Document Provisions. The following sections discuss the types of funds available for investment.

9.2.1 Project Fund

Monies in project funds (also known as "program funds," "acquisition funds," and "construction funds") are used to pay project costs such as land and equipment acquisitions, architectural and other planning costs, site preparation, and construction costs. These monies are expended early, but they constitute the great majority of bond proceeds. See Section 2.4.3, Funds and Accounts; **Flow of Funds**. Developing an expected expenditure timetable, or draw schedule, for monies in these funds is usually an integral part of sizing a local agency debt financing and is the logical place to start in developing an investment plan for a project fund.

9.2.2 Capitalized Interest Fund

Many projects financed by public agencies produce revenue that is the primary source of repayment for the obligations. Lease revenue obligations, for example, may be issued to underwrite the cost of construction, but until the facility is operational and occupied the agency will not begin to make lease payments. When revenues will not be immediately available to meet debt service obligations, an alternative source must be established to pay the **interest** portion owed to bondholders (**capitalized interest fund**). For non-revenue-producing

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facilities, public agencies may delay debt service payments during the construction phase but continue to make interest payments on any debt issued. To do so they may borrow, as part of the original financing, an amount that, together with interest earnings thereon, will be sufficient to pay interest during the construction phase. See Section 2.4.3, Funds and Accounts; Flow of Funds. Because this process essentially turns the interest owed during the construction period into a project cost, it is said to be "capitalized."

9.2.3 Debt Service Reserve Fund

A **debt service reserve fund** (DSRF) is designed to meet unexpected difficulties that might keep a public agency from paying debt service for a short period of time. They are common to all forms of **debt** with the exception of general obligation bonds and variable-rate obligations secured by a direct pay credit facility. DSRFs commonly contain an amount equal to the maximum annual debt service on the bonds. See Section 2.4.4, Debt Service Reserve Fund. While **investors** derive substantial comfort from the existence of a DSRF, **issuers** are unlikely ever to access them.

9.2.4 Debt Service Funds

A debt service fund (DSF), often referred to as a "revenue fund," is typically composed of interest, **principal**, and/or **redemption** accounts, and is intended to facilitate proper matching of revenues and debt service obligations. In the past, and typically for revenue bonds, DSFs were often required to be funded in advance of actual principal and interest payment dates, typically on a monthly basis (for example, one-sixth of the next interest requirement and one-twelfth of the next principal requirement). This advance funding pattern effectively imposes a relatively short **maturity** (and commensurately low **yields**) on DSF investments. This advance funding approach is uncommon in general obligations and lease obligations.

9.2.5 Refunding Escrow Funds

Refunding escrow funds are designed to pay debt service on prior obligations that cannot be redeemed immediately. Refunding escrows must satisfy the requirements of the bond documents for the bonds to be considered "defeased" and the issuer's payment obligation discharged. Refunding escrows are usually the only

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source of repayment available for the holders of prior bonds and therefore almost always comprise a carefully selected portfolio of U.S. Treasury securities that generate cash flow sufficient to pay debt service on the refinanced bonds. Refunding escrows also are subject to especially complex and restrictive federal tax law limitations. See Section 3.7.6, Refunding Bonds.

9.3 INVESTMENT AUTHORITY AND CONTROLLING DOCUMENTS

The authority to invest the proceeds of debt differ from those imposed on investments of public agency surplus funds. California law and bond documents, providing for the holding of bond funds pending disbursement, generally limit the investment of such funds to particular types of securities and investments of limited duration. See Section 2.4.7, Investments. An issuer's investment policies may also impose additional authorities on proceeds. The proceeds of tax-exempt obligations are subject to federal tax law restricting yields on particular funds and requiring the rebate of arbitrage earnings. These may also affect a public agency's investment strategy.

9.3.1 Statutory Authority

California Government Code Section 53601 (Section 53601) lists the securities in which local public agencies are authorized to invest. These securities are generally referred to as "permitted investments." Section 53601(m), however, provides that bond funds may be invested according the terms of the financing as long as these are not inconsistent with the statutes governing the issuance of the bonds. Specifically, Section 53601(m) reads:

> Moneys held by a trustee or **fiscal agent** and **pledged** to the payment or security of bonds or other indebtedness, or obligations under a lease, installment sale, or other agreement of a local agency, or certificates of participation in those bonds, indebtedness, or lease installment sale or other agreements may be invested in accordance with the statutory provisions governing the issuance of those bonds, indebtedness, or lease installment sale, or other agreement, or to the extent not inconsistent therewith or if there are no specific statutory provisions, in accordance with the ordinance, resolution, indenture, or agreement of the local agency providing for the issuance.

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Under Section 53601(m) a local public agency and its creditors may agree to a broader, as well as to a more limited, set of permitted investments than the investments specified in Section 53601.

California Government Code Sections 5903 and 5922 provide similar flexibility for local and state agencies with respect to hedging transactions.

9.3.2 Bond Document Provisions

The bond document provisions must strike a balance between allowing the public agency[1] flexibility to generate investment income and protecting bondholders against the risk that funds will not be available to pay debt service when due for one or more of the following reasons:

Capital loss: The obligor fails to pay debt service.

Market loss: The market value of the investment security decreases because, for example, market **interest rates** rise.

Illiquidity: The municipal debt issuer or the trustee is unable to convert the investment security to cash because of an inability to sell it or because the terms of the security do not require the obligor to provide cash for a stated period from the time requested (e.g., a notice period for withdrawal).

How the balance is struck may depend on the type of transaction, the requirements for obtaining desired **credit ratings** on the bonds, and the purposes for which invested bond funds are to be used.

A public agency should consider several questions when deciding how to invest bond funds, and the answers to these should be reflected in the bond documents:

WHO DETERMINES INVESTMENTS? - Public agencies are generally given control over investments, subject to the requirements set forth in the bond documents and the agency's investment policies. If funds are held by a bond trustee, the trustee is directed to follow the agency's investment instructions, and the bond documents

[1] In a conduit offering, the bond funds are generally funds of the conduit borrower and not the public agency conduit issuer. In such case, the considerations in this chapter relating to the "issuer" relate instead to the conduit borrower.

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generally provide that if the trustee does not receive instructions, funds are to be held uninvested or to be invested in a money market fund such as the trustee's sweep account. See **Section 9.4.2, Investments Specific to Bond Funds**. Within the agency the responsibility for investing bond funds may be assigned to the debt management staff or to a unit performing general treasury services such as investments and payments. There is no right approach and, as discussed earlier, it is in the agency's best interests to convene a working group to assess its needs and opportunities and make decisions about how the funds should be managed before the bond funds become available.

WHERE DO INVESTMENT EARNINGS GO? - Earnings on the investment of bond funds can be routed in several ways:

- Retained in the fund for which the investment relates
- Transferred to the debt service fund
- Released to the public agency

Bond documents may, for example, provide that earnings on the investment of DSRF monies be retained in the DSRF if the DSRF is not funded at its required level and otherwise transferred to the debt service fund. Construction, program, and capitalized interest funds may be "gross refunded" (sized from bond sale proceeds assuming no investment earnings) with investment earnings transferred to the debt service fund or "net funded" (sized from bond **sale proceeds** assuming the receipt of investment earnings) with investment earnings retained in the fund. Because investment earnings are "bond proceeds" for federal tax purposes, it is generally advisable that they not be mixed with other funds that are not bond proceeds.

WHAT TYPES OF INVESTMENTS ARE PERMITTED? - Bond documents generally include a list of "permitted investments," "investment securities," or "authorized investments" and require that funds held by the bond trustee be invested only in investment securities on the list. The list is generally structured so that the risk of capital loss is no greater than the risk that the public agency will fail to make timely debt service payments on the bonds (expressed a different way, so that allowing investment in a particular investment security will not result in a lower **rating** on the bonds). Investments are generally limited to high-grade debt securities.

WHEN MUST INVESTMENTS MATURE? - To avoid interest rate risk and liquidity risk, bond documents generally require that bond fund investments **mature** "on or

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before the dates on which money is anticipated to be needed for disbursements." For debt service funds, the funds will be needed on scheduled debt service payment dates and for construction funds there may be an anticipated expenditure schedule. DSRFs, by contrast, may not be used until the issuer makes the final payment on the bonds, although to minimize market loss risk DSRF investments may be limited to specified **term** (e.g., not more than 5 years).

WHAT INVESTMENT SECURITIES ARE REQUIRED FOR A LEGAL DEFEASANCE? - A public agency may generally discharge its debt service payment obligations by depositing investment securities in an escrow fund, typically held by the bond trustee. The interest earned on the investment securities, as well as the principal received when those investments mature, together with cash in the escrow fund, must be sufficient to pay the "defeased" bonds through maturity or prior redemption. See Section 2.4.10, Discharge and Defeasance and Section 3.7.6, Refunding Bonds. Because the holders of defeased bonds may look solely to amounts in the escrow fund for payment, bond documents generally require that investment securities used for defeasance be of very high credit quality. Bond documents vary, but a requirement that "defeasance securities" be direct obligations of or obligations guaranteed by the U.S. Treasury is common.

9.3.3 Investment Policies

In general, an investment policy serves as the foundation of a public agency's investment goals and priorities. The investment of bond funds should be reflected in an investment policy that is reviewed annually and approved by a public agency's legislative body. Public agencies that adopt investment policies demonstrate their commitment to the fiduciary care of public funds. With careful implementation of solid investment policies, public agencies can also ensure that legal and investment considerations relating to the proceeds of tax-exempt bonds are appropriately applied. Policies can be helpful when roles and responsibilities for investing tax-exempt bond proceeds are separated between treasury/debt management staff and investment portfolio managers/advisors. As described in the GFOA Best Practice - *Investment and Management of Bonds Proceeds*, adherence to policies can ensure that agencies meet legal and regulatory requirements, receive fair market value bids, and meet their own objectives for various uses of proceeds.[2]

[2] GFOA Best Practice – Investment and Management of Bond Proceeds, www.gfoa.org/materials/investment-and-management-of-bond-proceeds.

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Resources are available to assist public agencies in developing or updating an investment policy. The Association of Public Treasurers of the United States and Canada offers an **Investment Policy Program** that provides public investors with guidance and technical assistance in developing a comprehensive written investment policy. The GFOA also has a sample investment policy available for purchase. The California Municipal Treasurers Association has sample investment policies that were certified through its **Investment Policy Certification Program**. Additional sources for recommended elements of an investment policy can be found in CDIAC's ***California Public Fund Investment Primer*** and ***Investment Policy Reporting Practices: An Informational Guide***.

9.4 COMMON TYPES OF INVESTMENTS FOR BOND FUNDS

9.4.1 Permitted Investments

Under California Government Code Section 53601(m), bond proceeds may be invested in investment vehicles set forth in the bond documents. For most bond **issues**, these include the following.

INDIVIDUAL FIXED-INCOME SECURITIES - Generally, individual fixed-income securities permitted for bond funds are limited to direct obligations of the U.S. Treasury, obligations of federal agencies, and debt obligations of other entities, including municipal and corporate debt securities, that are of high credit quality and relatively short duration.

While investment opportunities relating to individual securities may provide an issuer with flexibility to meet specific investment objectives, managing a portfolio of individual securities requires expertise to analyze credit and other risks and implement strategies that may affect the balance between safety, liquidity, and yield. See **Section 9.4.2, Investments Specific to Bond Funds**.

Equity or stock investments by public agencies are generally prohibited under Article XVI, Section 6 of the California Constitution and, because they are subject to substantial market volatility, are seldom permitted for bond fund investments.

POOLED INVESTMENT FUNDS - Pooled investment funds include governmental pools and commercial, for-profit mutual funds or money market funds. Pooled investment funds relieve agencies of the work of managing their investments and

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offer higher-than-average yields and liquidity. These pooled investment funds do so by leveraging the economies of scale in professional management, purchasing power, transaction costs, credit risk diversification, and liquidity requirements to improve upon what a smaller or less experienced investor could accomplish through purchases of individual securities.

PUBLIC INVESTMENT FUNDS - Public Investment Funds (also referred to as Local Government Investment Pools) are liquidity pools established by state or local governmental entities that provide eligible public agency investors with convenient, low-cost methods to pool their funds for investment meet their liquidity needs. Government Code Section 53684 also provides local government agencies authority to invest funds in a "local pool" managed by the treasurer of the local jurisdiction. Some agencies, such as schools, may be required to invest their bond funds with their county treasurer, while other agencies may be authorized to invest in their local pools. For public agency investors that can participate in their local pool, investment portfolios may vary by liquidity, yield, weighted average maturity (i.e., risk tolerance), and credit ratings (if rated). Other considerations may include the terms for the withdrawal of funds and how the principal value or base unit is priced for withdrawal e.g., fixed at $1 or fluctuating, with the unit price based on net asset value (NAV) of the pool.

MULTI-JURISDICTIONAL GOVERNMENT INVESTMENT POOLS - STATEWIDE ELIGIBILITY - California statutes also allow public agencies to invest in public investment funds available for voluntary participation on a statewide jurisdictional basis (referred to as Multi-Jurisdictional Government Investment Pools).

- *Local Agency Investment Fund (LAIF).* Under California Government Code Section 16429, LAIF, established in 1977, is a voluntary investment program for local government, including special districts. As a component of the State's Pooled Money Investment Account, the LAIF program offers local agencies the opportunity to participate in a major fixed-income portfolio managed by the State Treasurer with oversight provided by the Pooled Money Investment Board. See www.treasurer.ca.gov/pmia-laif/laif/index.asp.

- *California Asset Management Program (CAMP).* Established in 1989, CAMP is a California JPA created to provide public agencies with professional investment services. The CAMP Pool is a permitted investment for all local agencies under California Government Code Section 53601(p). CAMP is directed by a Board of Trustees, which is made up of experienced local government fi-

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nance directors and treasurers and managed by the financial advisory firm of PFM Asset Management LLC. See www.camponline.com.

- *CalTRUST.* Created by public agencies in 2005, CalTRUST is a JPA that allows public agencies to pool their assets according to California Government Code Sections 6500 and 6509.7. CalTRUST is governed by a Board of Trustees made up of experienced local agency treasurers and investment officers. See http://caltrust.biz/.

Figure 9-1 compares multi-jurisdictional government investment pools that offer statewide eligibility to local agencies.

PRIVATE INVESTMENT FUNDS - Public agencies have the authority to invest in shares of mutual funds and money market funds as described in Government Code Sections 53601(l) and 53601.6(b). These investment products are investment funds privately run by money managers and regulated under the *Investment Company Act of 1940*.

Figure 9-1

FEATURES OF MULTI-JURISDICTIONAL GOVERNMENT INVESTMENT POOLS—STATEWIDE ELIGIBILITY

	LOCAL AGENCY INVESTMENT FUND (LAIF)	CALIFORNIA ASSET MANAGEMENT PROGRAM (CAMP)	CALTRUST		
			SHORT TERM	MEDIUM TERM	MONEY MARKET FUND
LIQUIDITY	Daily	Daily	Requires advanced notification	Requires advanced notification	Daily
NAV	$1.00 Unit Price ("Dollar In, Dollar Out") Regardless of NAV	Stable $1.00 NAV	Variable NAV	Variable NAV	Stable $1.00 NAV
RATING	Not Rated	AAAm	AAf./S1+	Not Rated	AAAm
HOW MANAGED	By the State Treasurer with Oversight from the Pooled Money Investment Board	On a not-for-profit basis by a private entity pursuant to a JPA	On a not-for-profit basis by a private entity pursuant to a JPA		By a private entity

Source: LAIF, CAMP and CalTRUST websites.

NAV = net asset value, JPA = joint powers authority

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In general, to be a permitted investment, a mutual fund or money market fund should meet the following statutory conditions (see CDIAC's Local Agency Investment Guide, Update for 2018 - CDIAC 18.02):

- Must receive the highest ranking or the highest letter and numerical rating by no less than two **Nationally Recognized Statistical Rating Organizations**

  OR

  Must retain an investment advisor who is registered or exempt from **registration** with the SEC and has at least 5 years' experience investing in specified securities and managing assets in excess of $500 million

- Mutual Funds must abide by the same investment restrictions and regulations that apply to public agencies in California (see California Government Code Section 53601).

- Money Market Funds must follow regulations specified by the SEC under the *Investment Company Act of 1940* (15 U.S.C. Section 80a-1 et seq.)

Bond documents may permit the investment of bond proceeds in non-rated mutual funds and money market funds. While a mutual fund or money market fund tailored to the institutional or governmental investor may not carry a rating, to be eligible as a permitted investment the fund should primarily be invested in asset classes that would otherwise be a permitted investment under Government Code Section 53601. A mutual fund's investment holdings, for example, should not include equities. Equity investments are not a permitted investment, because they do not allow public agencies to meet the requirements of safety, liquidity, and yield when investing public funds.

9.4.2 Investments Specific to Bond Funds

Certain types of investment securities have been designed specifically for the investment of bond funds. These allow for the investment of funds without market loss risk, simplify investment of trustee-held funds, and/or limit the difficulty of complying with federal tax law **yield restrictions**.

TRUSTEE SWEEP ACCOUNTS - "Trustee sweep accounts" are money market funds managed by the bond trustee and limited to investments in federal securities. They contain little or no market risk and offer the public agency the assurance that funds will remain fully invested.

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TREASURY SECURITIES - STATE AND LOCAL GOVERNMENT SERIES - The State and Local Government Series, (**SLGS**, pronounced "slugs"), are a special type of U.S. Treasury securities issued to enable state and local government issuers to comply with the yield restriction requirements of federal tax law. "Time Deposit" SLGS are fixed-rate obligations maturing on a date specified by the public agency, bearing interest at a specified rate (commonly referred to as "SLGS rates"). "Demand Deposit" SLGS are redeemable on any date and bear interest at a rate that is adjusted daily. These SLGS are direct obligations of the U.S. Treasury and are unavailable from time to time, depending upon the status of the federal debt ceiling.

INVESTMENT AGREEMENTS - These investments, often referred to as **guaranteed investment contracts** or "GICs," are another type of investment geared particularly to bond funds. GICs provide agencies the ability to invest bond funds in a way that conforms to specific liquidity, yield, and safety requirements. See Section 4.8.3.2, Guaranteed Investment Contracts. In most cases, the public agency or the bond trustee agrees to invest all funds held in a particular fund or account (e.g., the construction fund or the DSRF) with the investment agreement provider and the provider agrees to pay the agency or the trustee a **fixed-rate** of interest on invested funds. Investments are generally not transferable (except to a successor trustee) and funds may not be withdrawn for the purpose of reinvestment.

Investment agreements assume different forms, depending upon the provider, the types of investments securing the funds, and any regulatory restrictions. An investment agreement may, for example, be structured as a time deposit with a bank, a series of repurchase agreements with a broker-dealer, or a loan contract with a special-purpose entity whose payment obligations are guaranteed by an insurance company. Investment agreements may allow for withdrawal whenever funds are needed for expenditure (a "full flex agreement"), or only at specified times, and may have different notice requirements for draws.

Investment agreements are generally obtained through a bidding process that specifies all material terms, with the contract awarded to the party satisfying the minimum bid requirements offering the highest interest rate. Because the public agency takes credit risk on the provider, investment agreements are generally entered into only with highly rated financial institutions. The provider's repayment obligation is often required to be collateralized. Investment agreements are complex financial instruments. Public agencies are advised to engage a specialized investment consultant or financial advisor and **bond counsel** to assist in the bidding and negotiation of these agreements and ensure compliance with applicable "safe harbor" requirements.

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9.5 LEGAL AND INVESTMENT CONSIDERATIONS

9.5.1 Arbitrage Rebate and Yield Restriction

Proceeds of tax-exempt bonds, unlike other governmental funds, are subject to federal tax laws respecting arbitrage, including provisions restricting the yield on the investment of certain bond funds and arbitrage rebate, requiring earnings in excess of the yield on the bonds to be paid to the U.S. Treasury. The yield restriction requirements of the arbitrage rules are discussed in Section 4.8, Arbitrage Yield Restriction. Arbitrage rebate requirements are discussed in Section 4.9, Arbitrage Rebate and Section 8.3, Post-Issuance Federal Tax Law Requirements.

For investment of bond funds, these federal tax law provisions have three important implications:

1. Bond fund investments must be separable (directly or by allocation) from other funds. Bond funds and **investment proceeds** of bond funds should be monitored and tracked as part of a public agency's processes for monitoring all of its funds. For tax-exempt debt, bond funds should not be commingled with general funds of the public agency.

2. It is often essential to know the exact yield on bond fund investments, which may be greater than the yield actually realized on the investments. Following the requirements of the federal tax law "safe harbors" and other rules for determining the prices at which investment securities are acquired or disposed of is important, especially with respect to securities such as investment agreements or defeasance escrow portfolios, for which there is no established market.

3. Because investment returns in excess of the yield on the bonds accrue to the benefit of the U.S. Treasury under arbitrage rebate rules, while investment losses are borne by the agency, public agencies should be encouraged to take a more conservative approach when investing bond funds.

9.5.2 Investment Considerations

Bond funds, similar to surplus operating funds and reserve funds, are primarily invested according to a prudent investor standard for *safety, liquidity, and yield*. This means minimizing credit risk (the risk that the obligor under an investment **defaults**), market risk (the risk that an investment will decrease in value or be-

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come unmarketable), and opportunity risk (the risk that an investment precludes the ability to make a later, higher-yielding investment).[3] The GFOA Best Practice - ***Investment and Management of Bond Proceeds*** recommends that issuers consider the following:

> Establishing guidelines for permitted investments to reduce credit risk, developing good cash flow estimates and periodically updating those estimates to reduce market risk, and integrating knowledge of prevailing and expected future market conditions with cash flow requirements to reduce opportunity risk. As with investment decisions made with other public funds, the balance generally is weighted heavily towards the preservation of capital (avoiding risk), maintaining liquidity second, and yield last.

In practice, intelligent use of the various investment vehicles can result in a strategy that maximizes earnings within appropriate safety, liquidity, and federal tax law constraints yet provides investment earnings that may minimize an issuer's overall net borrowing costs.[4]

INVESTING PROJECT FUNDS - Project schedules usually range from 1 to 3 years and are relatively unpredictable. Because the 0–5-year portion of the **yield curve** can be relatively steep at times, substantial yield is sacrificed if investments are overly liquid. Investments that mature before monies are actually needed must be reinvested for relatively short periods of time and, generally that translates into a lower investment yield. It is important, therefore, to understand how reliable a projected draw schedule is and whether deviations are likely to cause delays in or speed up expenditures. With this information in hand, the appropriate investment vehicles can be evaluated for yield and liquidity. Investment agreements can be tailored to eliminate liquidity and reinvestment risk in a project fund, but safety and yield also must be evaluated. Investment decisions are circumstance-specific but investing in a portfolio of fixed-rate securities maturing on dates and in amounts corresponding to expected expenditures purchased with the vast

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3 Public fund investment objectives are enumerated in Government Code Section 53600.5.

4 California Government Code Sections 53821.5, 53841.5, 53852.5 and 53859.02(b) prohibit the investment of the proceeds of temporary borrowing in securities that have terms exceeding those of the temporary borrowing itself. Accordingly, agencies are prevented from using the proceeds of Tax and Revenue Anticipation Notes (TRANs) and Grant Anticipation Notes (GANs), to purchase long-term securities in order to achieve higher investment yields in a manner that could limit liquidity needed to ensure sufficient cash to repay the temporary borrowing when due.

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majority of proceeds, supplemented by a money market fund to address liquidity concerns, is usually worth consideration.

INVESTING CAPITALIZED INTEREST FUNDS - If the local agency obligations bear interest at fixed-rate, investing capitalized interest funds is a function of how much money will be needed and when. Investments should be selected to mature on or just before an interest payment date on the bonds and in an amount that, together with interest earnings thereon, will be sufficient to pay the interest on the public agency's obligations.

INVESTING DEBT SERVICE RESERVE FUNDS - While analysis must be circumstance-specific, DSRF investments can be of longer duration than other bond proceeds investments. However, because securities with long maturities may be subject to significant changes in market value, bond documents often limit the term of such investments. See **Section 2.4.7, Investments**. This longer duration usually translates into greater yield. Because project and other fund investments tend to have short average lives and commensurately lower yields, they tend to produce so-called negative arbitrage. In other words, their investment yield is lower than the borrowing cost of the funds. DSRF investments frequently present an opportunity to earn positive arbitrage; that is, the investment yield is greater than the borrowing cost on the monies deposited into the fund. Federal tax law generally prohibits tax-exempt issuers from retaining arbitrage earnings, but because positive and negative arbitrage offset each other from fund to fund and over time (for the life of the bond issue), DSRF investments often present a valuable opportunity to fully offset negative arbitrage in other funds.

INVESTING DEBT SERVICE FUNDS - The predictability of when monies will be needed to make debt service payments suggests that issuers can purchase or instruct their trustee to purchase securities with DSF deposits that mature on or shortly before the debt service requirement date. However, because the average life of any investment must be less than 6 months in order to meet the debt service schedule, the yield on these investments is likely low. Public agencies may consider using tailored investment agreements (GICs), forward purchase agreements, and certain pooled investment funds (other than money market funds) to provide additional yield. See **Section 9.4.2, Investments Specific to Bond Funds**.

INVESTING REFUNDING ESCROWED FUNDS - Refunding escrows are almost always structured by professional investment advisors and then verified for tax law compliance and cash flow sufficiency by an independent certified public account-

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ing firm. SLGS are commonly used for refunding escrows. See Section 9.4.2, Investments Specific to Bond Funds.

9.6 INVESTMENT REVIEW AND OVERSIGHT

For all bond funds, public agencies should periodically review their investment decisions and the management of these investments for compliance with laws, rules, regulations, and the public agency's own investment policies and report the status of investments, including a summary of investment activities and compliance audits, to any oversight committees. For bond fund investments, public agencies should also periodically reconcile all deposits, expenditures, and withdrawals of monies from bond funds to ensure compliance with bond documents, including arbitrage rebate and yield restriction requirements, bond and financing rules. Public agencies should also establish procedures for internal control and management of bond proceeds. See Section 8.3, Post-Issuance Federal Tax Law Requirements.

California Government Code Sections 27131 through 27132.4 address the formation, composition, and role of a county treasury oversight committee. While no longer required by statute, a treasury oversight committee can monitor and review the county investment policy by conducting or causing an annual audit and discussing its findings at a public meeting. The rationale behind the creation of an oversight committee is to give local agencies and private sector citizens a say in the policies governing the county investment pool.

Cities and other local agencies are not required to have a treasury oversight committee; however, they may wish to consider whether an oversight committee is appropriate based on the agency's treasury management procedures, the complexity of its portfolio, the frequency of its securities transactions, and the skill level of its staff. If a city or other local agency does form a treasury oversight committee, it is not subject to the limitations and restrictions associated with membership imposed on a county treasury oversight committee.

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Appendix A. Legal References

INSTRUCTIONS

Appendix A provides web links to the California Legislative Information website where statutory and legal references can be found that California local governments may use to incur debt and obtain the funds needed to repay it. There are seven (7) sections related to state constitutional and statutory authority as shown below.

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DEBT TYPE DESCRIPTION (DEBT WATCH)	ABBREVIATION	GUIDE SECTION
Assessment Bonds	ASM	3.3.7
Certificates of Participation/Lease Revenue Bonds	COP/LR	3.6.3
Commercial Paper	CP	3.4.3
Conduit Revenue Bonds	CRB	3.3.9
General Obligation Bonds	GO	3.3.1, 3.9.1
Limited Tax Obligation Bonds	LTOB	3.3.7.2
Pension Obligation Bonds	POB	3.3.2.2
Revenue Bonds	REV	3.3.6
Sales Tax Revenue Bonds	STR	3.3.3
Tax Allocation Bonds	TAB	3.3.7
Tax and Revenue Anticipation Notes	TRNS	3.3.4

A.1 CALIFORNIA CONSITUTIONAL PROVISIONS RELATING TO LOCAL PUBLIC AGENCY DEBT

GENERAL DESCRIPTION	WEB LINKS TO LEGINFO	GUIDE SECTION
Article II - Voting, Initiative and Referendum and Recall	Sections 8-11	1.6
Initiative Power	Section 8	
Referendum Power	Section 9	
Approval, Amendment, Circulation	Section 10	
Procedures by City or County	Section 11	
Article XI - Local Government - Charter City Powers	Section 5	1.1.3
Article XIII - Taxation - State Tax Exemption	Section 26(b)	4.1
Article XIIIA - Tax Limitation	Sections 1-7	1.4.4
Maximum Ad Valorum Tax and Exceptions	Section 1	
Valuation of Property	Section 2	
Voting Requirement	Section 3	
Special Taxes by City, County, Special District	Section 4	
Effective Date	Section 5	
Invalidity, Remain in Force	Section 6	
Section 3 Exception for Tobacco Tax Revenue	Section 7	
Article XIIIB - Government Spending Limitation	Sections 1-15	1.7.2
Article XIIIC - Voter Approval for Local Tax Levies	Sections 1-3	1.4.2, 1.4.5
Article XIIID - Assessment and Property Related Fee Reform	Sections 1-6	1.4.7, 1.4.9
Article XVI Public Finance	Sections 6, 18	1.2
Gift of Public Funds; Loan of Public Credit	Section 6	
Debt Limit - City, County and School District	Section 18	

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A.2 AUTHORITY FOR CITIES, COUNTIES AND K-14 SCHOOL DISTRICTS TO ISSUE DEBT

GOVERNMENTAL ENTITY	GOVERNANCE STATUTES	DEBT TYPES MOST ISSUED	DEBT AUTHORIZATION CITATION
Counties	GOV 23000-33205	TRNS, REV, COP/ LR, POB, CRB, GO	GOV 29900 (GO) GOV 23004 (COP/LR) GOV 25351 (COP/LR) GOV 26301 (REV)
Cities	GOV 34000-45345	GO, REV, TAB, COP/ LR, CRB, ASM, TRNS	
General City			GOV 43600 (GO) GOV 37350 (COP/LR)
Charter City			City's Approved Charter
School Districts	EDC 35000-35787	COP/LR, GO, TRNS	EDC 15100 (GO) GOV 53506 (GO) EDC 17400 (COP/LR)
Community College Districts	EDC 66000-67400	COP/LR, GO, TRNS	EDC 15100 (GO) GOV 53506 (GO) EDC 81360 (COP/LR)
County Boards of Education	EDC 1000-1097	COP/LR, TRNS	EDC 1042 (COP/LR)

A.3 ORGANIC STATUTES OF SPECIFIC ENTITIES AUTHORIZED TO ISSUE DEBT

ORGANIC ACT-The statute under which a particular governmental entity is organized. Generally, this term is used to describe an act that specifies the manner of organization and the powers of a single agency, authority, or district named in the act, rather than the type of statute under which, for example, any city or county could cause to be created an agency of the type described in the statute. Compare, for example, the statute under which the California Housing Finance Agency is organized (Health and Safety Code Sections 50900 et seq.) with the statute under which a city or county may create a housing authority (Health and Safety Code Sections 34200 et seq.). Following is a partial list of organic statues by agency.

SPECIAL DISTRICTS CREATED BY STATUTE	ORGANIC STATUTE	DEBT TYPES MOST ISSUED	DEBT AUTHORIZATION CITATION
TRANSIT DISTRICTS			
Transit Districts in Alameda or Contra Costa Counties	PUC 24501-27509	GO, REV	PUC 26201-26352
San Francisco Bay Area Rapid Transit District	PUC 28500-29757	GO, REV, STR	PUC 29150-29293 (GO, REV) 29143 (STR)
Southern California Rapid Transit District	PUC 30000-33021	GO, REV, LTOB	PUC 30900-30982
Orange County Transit District	PUC 40000-40617	GO, REV, STR	PUC 40225-40266 (GO, REV) 130420 (STR)

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A.3 ORGANIC STATUTES, CONTINUED

SPECIAL DISTRICTS CREATED BY STATUTE	ORGANIC STATUTE	DEBT TYPES MOST ISSUED	DEBT AUTHORIZATION CITATION
San Joaquin Regional Transit District	PUC 50000-50507	GO, REV	PUC 50225-50266
Yolo County Transportation District	PUC 60000-60164	STR, REV	PUC 60150-60151
Marin County Transit District	PUC 70000-80019	GO, REV, STR	PUC 70225-70266 (GO, REV) 70223.1 (STR)
San Diego County Transit District	PUC 90000-93017	GO, REV	PUC 90600-90721
Santa Barbara Metropolitan Transit District	PUC 95000-97007	GO, REV	PUC 96400-96591
Santa Cruz Metropolitan Transit District	PUC 98000-98407	GO, REV, STR	PUC 98310-98381 (GO, REV) 98296 (STR)
Santa Clara Valley Transportation Authority	PUC 100000-100619	GO, REV, STR	PUC 100400-100492 (GO, REV) 100256 (STR)
Golden Empire Transit District	PUC 101000-101372	GO, REV	PUC 101280-101336
Sacramento Regional Transit District	PUC 102000-102700	GO, REV, STR	PUC 102500-102603 (GO, REV) 102350 (STR)
San Mateo County Transit District	PUC 103000-103700	GO, REV, STR	PUC 103500-103602 (GO, REV) 103356 (STR)
Sonoma-Marin Area Rail Transit District	PUC 105000-105337	GO, REV, STR	PUC 105200-105262 (GO, REV) 105115 (STR)
Monterey-Salinas Transit District	PUC 106000-106064	REV, STR	PUC 106060-106064
Gold Coast Transit District	PUC 107000-107025	REV, STR	PUC 107018
North County Transit District	PUC 125000-125716	REV, STR	PUC 125700-125716 (REV) 125480 (STR)
Los Angeles County Transportation Commission	PUC 130500-130553	REV, STR	PUC 130530-130545
San Bernardino County Transportation Authority	PUC 130800-130828.1	STR	PUC 130809
Counties in Nine-County San Francisco Bay Area	PUC 131000-131304	STR	PUC 131100-131122
San Diego County Regional Transportation Commission	PUC 132000-132334	REV, STR	PUC 132310
Fresno County Transportation Authority	PUC 142000-142277	STR	PUC 142250-142277

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A.3 ORGANIC STATUTES, CONTINUED

SPECIAL DISTRICTS CREATED BY STATUTE	ORGANIC STATUTE	DEBT TYPES MOST ISSUED	DEBT AUTHORIZATION CITATION
Tuolumne County Traffic Authority	PUC 150000-150214	REV, STR	PUC 150209
Riverside County Transportation Commission	PUC 240000-240323	STR	PUC 240300-240323
AIR POLLUTION CONTROL DISTRICTS			
Bay Area Air Quality Management District	HSC 40200-40276	COP/LR	HSC 40270
South Coast Air Quality Management District	HSC 40400-40540	COP/LR	HSC 40526
Sacramento Metropolitan Air Quality Management District	HSC 40950-41082	COP/LR	GOV 54240-54245
Mojave Desert Air Qualitiy Management District	HSC 41200 - 41267	COP/LR	HSC 41243
Antelope Valley Air Quality Management District	HSC 41300-41357	COP/LR	HSC 41333
OTHER STATUTORILY CREATED ENTITIES			
San Joaquin County Regional Justice Facility Financing Agency	GOV 26290-26293.4	REV, STR	GOV 26292.7-26292.8
Orange County Regional Justice Facilities Commission	GOV 26295-26298.58	REV, STR	GOV 26298-26298.58
STATE OF CALIFORNIA FINANCING AUTHORITIES			
CA Pollution Control Financing Authority	HSC 44500-44563	CRB	HSC 44540
CA Health Facilities Financing Authority	GOV 15430-15463	CRB	GOV 15438
CA Alternative Energy and Advanced Transportation Financing Authority	PRC 26000-26082	CRB	PRC 26022
CA Educational Facilities Authority	EDC 94100-94213	CRB	EDC 94140
CA School Finance Authority	EDC 17170-17199.6	CRB	EDC 17183
CA Transportation Financing Authority	GOV 64100-64132	CRB	GOV 64105
CA Infrastructure and Economic Development Bank	GOV 63000-63089.98	CRB	GOV 63025.1
CA Housing Finance Agency	HSC 50900-51511	CRB	HSC 51050

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A.4 JOINT POWERS AGENCIES/AUTHORITIES

GENERAL DESCRIPTION	CODE SECTION	DEBT TYPES MOST ISSUED	GUIDE SECTION
Joint Powers Agreements	GOV 6500-6539	COP/LR, CRB, REV, ASM, TRNS	3.6.4
Creation of Agency or Entity	GOV 6503.5		
Authority to Issue Revenue Bonds	GOV 6540-6579.5		
Purpose of Financed Projects and Programs	GOV 6546		
Marks-Roos Local Bond Pooling Act of 1985	GOV 6584-6599.3		

A.5 FINANCING TOOLS CONTAINED IN STATUTE

GENERAL DESCRIPTION	CODE SECTION	DEBT TYPES	GUIDE SECTION
ASSESSMENT DISTRICTS[1]		ASM	3.3.7
The Improvement Act of 1911	SHC 5000-6794		
The Improvement Bond Act of 1915	SHC 8500-8887		
The Municipal Improvement Act of 1913	SHC 10000-10706		
Park and Playground Act of 1909	GOV 38000-38011		
Pedestrian Mall Law of 1960	SHC 11000-11806		
Street Lighting Act of 1915	SHC 18000-18193		
Street Lighting Act of 1931	SHC 18300-18440		
Municipal Lighting Maintenance District Act of 1927	SHC 18600-18781		
Highway Lighting District Act	SHC 19000-19328		
Tree Planting Act of 1931	SHC 22000-22202		
The Landscaping and Lighting Assessment Act of 1972	SHC 22500-22679		
Vehicle Parking District Law of 1943	SHC 31500-31933		
Parking District Law of 1951	SHC 35100-35708		
LEASES		COP/LR	3.6.3
Economic Opportunity - Sales and Leases	GOV 52200-52203		
Employee Rental Housing - City/County	GOV 54700.1- 54702.15		
Public Leasebacks	GOV 54240-54245		

[1] Subject to CA CONS Article XIIIC, CA CONS Article XIIID, GOV 53739 and 53750-53758

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A.5 FINANCING TOOLS CONTAINED IN STATUTE, CONTINUED

GENERAL DESCRIPTION	CODE SECTION	DEBT TYPES	GUIDE SECTION
REVENUE BONDS		REV	3.3.6
Sewer Revenue Bonds	HSC 4950-5072		
Revenue Bonds for County Improvements	GOV 26301-26400.53		
Limited Obligation Bonds	GOV 50665.1-50670.4		
Revenue Bonds - Golf Courses, Marinas, Small Craft Harbors	GOV 50701-50798.4		
Revenue Bond Law of 1941	GOV 54300 - 54700		
SPECIAL TAXES		LTOB	3.3.7.2
Local Transportation Authority and Improvement Act	PUC 180000-180264		
Mello-Roos Community Facilities Act of 1982	GOV 53311-53368.3		
TAX ALLOCATION BONDS (TAX INCREMENT)		TAB	3.3.7
Infrastructure and Revitalization Financing Districts	GOV 53369-53369.49		
Infrastructure Financing Districts (IFD)	GOV 53395-53397.11		
IFDs in the Border Development Zone	GOV 53398-53398.47		
Enhanced Infrastructure Financing Districts	GOV 53398.5 - 53398.88		
Community Revitalization and Investment Authorities	GOV 62000-62208		
Teeter Plan Bond Law of 1994	GOV 54773-54783		
Temporary Borrowing	GOV 53820-53833		
Temporary Borrowing, Alternative Method	GOV 53850-53858		
OTHER SPECIAL DISTRICTS		Varies	
Air Pollution Control Districts (see also Section A-3)	HSC 40000-41357	COP/LR	
Airport Districts	PUC 22001-22909	CRB, GO, REV	
Bridge and Highway Districts	SHC 27000-27567	GO	
California Water Districts	WAT 34000-38501	ASM, GO, REV	
Cemetery Districts	HSC 9000-9093	COP/LR	
Community Energy Authorites	GOV 52000-52190	REV	
Community Facilities Law of 1911	HSC 4600-4650	GO	
Community Rehabilitation District	GOV 53370-53394	GO	
Community Services Districts	GOV 61000-61250	ASM, COP/LR, GO, REV, TRNS	

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A.5 FINANCING TOOLS CONTAINED IN STATUTE, CONTINUED

GENERAL DESCRIPTION	CODE SECTION	DEBT TYPES	GUIDE SECTION
County Drainage Districts	WAT 56000-56130	ASM, COP/ LR, GO, REV	
County Sanitation Districts	HSC 4700-4859	ASM, GO, REV	
County Service Areas	GOV 25210-25217.4	GO	
County Transportation Commissions (see also Section A-3)	PUC 130000-130827	CP, REV, STR	
County Water Agencies	Water Code Appendix	ASM, GO	
County Water Authorities	Water Code Appendix	GO	
County Water Districts	WAT 30000-33901	ASM, GO, REV	
County Waterworks Districts	WAT 55000-55991	ASM, GO, REV	
Drainage Districts	Uncodified Water Code	ASM	
Fire Protection Districts and service zones	HSC 13800-13970	ASM, COP/ LR, GO, TRNS	
Garbage and Refuse Disposal Districts	PRC 49000-49195	GO	
Geologic Hazard Abatement Districts	PRC 26500-26654	ASM	
Harbor Districts	HNC 6000-6110	GO, REV	
Harbor Improvement Districts	HNC 5800-5956	ASM, GO	
Health Care Districts/ Local Hospital Districts	HSC 32000-32499.4	ASM, GO, REV	
Housing Authorities	HSC 34200-34606	REV, CRB	
Industrial Development Authorities	GOV 91500-91574	CRB	
Integrated Financing Districts	GOV 53175-53199	ASM	
Irrigation Districts	WAT 20500-29978	ASM, COP/ LR, GO, REV	
Joint Highway Districts	SHC 25000-25521	GO	
Levee Districts	WAT 70000-70272	ASM	
Library Districts	EDC 19400-19532	GO, TRNS	
Library Districts - Unified School Districts/Union High Schools Districts	EDC 18300-18571	GO	
Library Districts and Museums	EDC 19600-19734	GO	
Local Housing Finance Agencies	HSC 52000-52106	CRB	
Local Transportation Authorities	PUC 180000-180264	REV, STR	
Maintenance Districts	SHC 5820-5856	ASM	
Memorial Districts	MVC 1170-1259	GO	
Mosquito Abatement and Vector Control Districts	HSC 2000-2093	ASM	
Municipal Park Improvement Districts	PRC 5350-5370	GO	
Municipal Utility Districts	PUC 11501-14403.5	ASM, GO, REV	

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A.5 FINANCING TOOLS CONTAINED IN STATUTE, CONTINUED

GENERAL DESCRIPTION	CODE SECTION	DEBT TYPES	GUIDE SECTION
Municipal Water Districts	WAT 71000-73001	ASM, COP/ LR, GO, REV	
Nonprofit Public Benefit Corporations	CORP 5110-6910	COP/LR	
Parking Authorities	SHC 32500-33552	COP/LR, REV	
Pest Abatement Districts	HSC 2800-2910	ASM	
Port Districts	HNC 6200-6372	GO, REV	
Public Utility Districts	PUC 15501-18055	COP/LR, GO, REV	
Reclamation Districts	WAT 50000-53901	ASM	
Recreation and Park Districts	PRC 5780-5796.20	ASM, COP/ LR, GO	
Regional Park, Park, and Open-Space Districts	PRC 5500-5595	ASM, GO	
Resort Improvement Districts	PRC 13000-13233	ASM, GO, REV	
Resource Conservation Districts	PRC 9151-9491	ASM	
River Port Districts	HNC 6800-6963	ASM, COP/ LR, GO, REV	
Sanitary Districts	HSC 6400-6982	ASM, COP/ LR, GO, REV	
School Facilities Improvement Districts	EDC 15300-15425	GO	
Separation of Grade Districts	SHC 8100-8297	GO	
Small Craft Harbor Districts	HNC 7000-7340	GO, REV	
Storm Water Districts	Water Code Appendix	GO	
Successor Agencies	HSC 34177-34178.7	TAB	
Transit Districts (see also Section A-3)	PUC 24501-107025	GO, REV, STR	
Water Conservation Districts	WAT 74000-76501	ASM, COP/ LR, GO, REV	
Water Replenishment Districts	WAT 60000-60622	COP/LR, GO, REV	
County Regional Justice Facility Agency	GOV 26299-26299.083	STR	

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A.6 GENERAL BOND STATUTES

General bond statutes cover numerous aspects of debt that issuers can use ranging from refunding bonds, bond registration, execution, security pledges for bonds, interest payment dates, and bonds using an indenture, trust agreement or another instrument.

GENERAL DESCRIPTION	CODE SECTION
Validation Actions	CCP 860-870.5
Conflicts of Interest of Public Officials	GOV 1090-1099
Sales of Public Securities	GOV 1100-1102
Pledge of Revenues	GOV 5450-5452
Denominations	GOV 5600-5604
GENERAL BOND PROVISIONS	
General Bond Provisions	GOV 5850-5854
Non-Semiannual Interest Payments	GOV 5851
Issuance Per Resolution, Indenture, Etc.	GOV 5852
Public Disclosure of Financial Terms of Bonds	GOV 5852.1
Taxable Bonds	GOV 5900-5909
Swaps and Forwards - Financial Contract Authority	GOV 5920-5921; 5923
Interest Rate Swaps and Hedges	GOV 5922(a)
Bonds Payable in Other Currency	GOV 5922(b)
Credit Enhancement and Liquidity Agreements	GOV 5922(c)
Security Pledge	GOV 5922(d)
Fractional Interest of Local Agency Obligations	GOV 5950-5955
Debt Reporting to CDIAC	GOV 8855-8859
State Funds - Permitted Investments	GOV 16430-16495.5
Refunding Local Agency Bonds, Alternative Method	GOV 53506-53509.5
Maximum Interest Rate	GOV 53530-53533
Interest Rate Swaps	GOV 53534
Issuance of Authorized but Unissued Bonds	GOV 53540-53541
Refunding Local Agency Bonds	GOV 53550-53569
Refunding Local Agency Revenue Bonds	GOV 53570-53572
Refunding Bonds - General Provisions	GOV 53580-53589.5
Financial Advisor, Bond Counsel and Underwriter Limitations	GOV 53590-53594
LOCAL AGENCY DEPOSIT OF FUNDS	GOV 53630-53686
Local Agency Permitted Investments	GOV 53600-53610
Commercial Paper Investment Concentration Limits	GOV 53635
Eligibility of Depository Entities	GOV 53635.2
Borrowing Funds in Excess of $100,000	GOV 53635.7

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A.6 GENERAL BOND STATUTES, CONTINUED

GENERAL DESCRIPTION	CODE SECTION
SALE OF SECURITIES	
Sale of Securities	GOV 53690-53692
Bids by Financial Advisors	GOV 53691
Competitive Sale Notice Requirements	GOV 53692
Voter Approval of Taxes	GOV 53720-53730
Meetings (Brown Act)	GOV 54950-54963

A.7 OTHER HELPFUL STATUTES

GENERAL DESCRIPTION	CODE SECTION
K-14 School GO Bond Statutory Lien	EDC 15251
Conduit Financing Transparency and Accountability	GOV 5870-5872
Acquisition of Property, Federal Purposes	GOV 50360-50370
Local Agency GO Bond Statutory Lien	GOV 53515
Municipal Bankruptcy	GOV 53760-53760.9
Neutral Evaluation Process	GOV 53760.3
Declaration of Fiscal Emergency	GOV 53760.5
California Environmental Quality Act	PRC 21050-21189.57

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Appendix B. School Finance

B.1 SCHOOL FACILITY FINANCE

B.1.1 Overview of School Facility Financing

For the 2017–18 school year California had 1,026 Kindergarten through 12th grade (K–12) school districts with 6.2 million enrolled students.[1] Providing facilities for California's student population is an ongoing effort of school districts and communities statewide.

In California, school operations, not including the construction and modernization of facilities, are funded primarily by the State, with smaller shares coming from local sources (primarily local property tax revenue) and the federal government.[2] Proceeds from the state lottery account for approximately 1% of public education's overall revenue.[3]

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1 California Department of Education, Fingertip Facts on Education in California - CalEdFacts, www.cde.ca.gov/ds/sd/cb/ceffingertipfacts.asp.

2 Legislative Analyst's Office, *The 2017–18 Budget, Proposition 98 Education Analysis*, February 9, 2017, p. 12, www.lao.ca.gov/publications/report/3549.

3 California State Lottery, Education, See Where the Money Goes, www.calottery.com/giving-back/education/where-money-goes.

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School construction and modernization programs generally rely on funding provided by debt issued by the State and allocated through the School Facility Program or issued by the local school district. From November 2002 through 2017, voters authorized $99 billion in local general obligation (GO) bonds[4] and $35.7 billion in state-level school facility GO bonds[5] for K–12 school facilities. In the 2016 general election alone, voters authorized $23.5 billion of local school facility GO initiatives[6] and $7 billion in state-level education authorization that will fund K–12 facilities.[7] The financing of school facilities represents a major proportion of public debt issuance in California by purpose, with K–12 school facilities representing over 20% of the debt issued by California's public agencies in 2017, for a total of approximately $18.5 billion ($13.8 billion in new money and $4.6 billion in refundings).[8] Of the $86 billion issued by all California public agencies in 2017, K–12 local school districts represent the largest local issuer type by volume with $12.8 billion issued.[9]

California's system of school facility finance has evolved slowly, with periodic changes in state policy resulting from extraordinary events. This section describes

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4 CDIAC, *K-14 Voter Approved General Obligation Bonds: Authorized But Unissued - 2017 Update*, p.1, www.treasurer.ca.gov/cdiac/publications/k14update-2017.pdf. The report references $133 billion of K-14 authorization with $99 billion attributed to K-12 authorization.

5 Sum of funding from Propositions 47 (2002), 55 (2004), 1D (2006), and 51 (2016) directed to K–12 facilities. These four propositions total $44.9 billion in K–12 funding. Office of Public School Construction, *School Facility Program Handbook*, July 2007, p. 3. www.documents.dgs.ca.gov/opsc/Publications/Handbooks/SFP_Hdbk.pdf and Ballotpedia, Proposition 51, The California Public School Facility Bonds Initiative, (2016), https://ballotpedia.org/California_Proposition_51,_Public_School_Facility_Bonds_(2016).

6 CDIAC, *Results of the 2016 General Election, Bond and Tax Measures Appearing on the 2016 General Ballots*, November 8, 2016, p. 4, www.treasurer.ca.gov/cdiac/reports/elections/201611.pdf.

7 Proposition 51, authorized the issuance of $9 billion for education: $7 billion for K-12; $2 billion for community colleges. Ballotpedia, Proposition 51, The California Public School Facility Bonds Initiative, (2016), *Kindergarten Through Community College Public Education Facilities Bond Act of 2016*. https://ballotpedia.org/California_Proposition_51,_Public_School_Facility_Bonds_(2016).

8 CDIAC, *2017 Summary of California Public Debt Issuance*, Table 15, 2016 California Public Debt Issuance by Purpose and Refunding, June 2018, pp. 364-366. www.treasurer.ca.gov/cdiac/reports/annual/2017/summary.pdf.

9 CDIAC, *2017 Annual Report*, Figure 2, Principal Amount Issued and Number of Issues, All California Issuers, 2016 and 2017, June 2017, p. 15. www.treasurer.ca.gov/cdiac/reports/annual/2017/annual.pdf.

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the history of school facility finance in California and documents the various programs that have been used to finance K–12 facilities.

B.1.1.1 SCHOOL FACILITY FINANCE BEFORE PROPOSITION 13

Early in California history, local tax revenue supported the construction of schools.[10] A revision to the California State Constitution in 1879 granted school districts the authority to issue bonds to finance school construction projects, subject to the approval of two-thirds of voters within the district. Local GO bonds were repaid with property tax revenue raised from a special tax assessment on all property within a school district. Districts could issue additional bonds up to their debt capacity level, which was set at 1.25% of assessed value (AV) for elementary and secondary districts and 2.5% for unified districts; districts are still subject to these statutory debt limitations.[11] From that time until 1933, proceeds from local school bond elections were the primary source of local revenue for school construction projects.

The 1933 Long Beach earthquake, which damaged or destroyed numerous school buildings in Long Beach and surrounding communities, prompted the passage of the *Field Act* to address seismic safety concerns for school facilities.[12] The *Field Act* requires the Division of the State Architect (DSA) to set standards for earthquake-resistant design and rigorous quality control throughout the design and construction process for public schools.[13] Under the *Field Act*, public school buildings must be designed by a California licensed Architect or Structural Engineer and submitted to the DSA for review.[14] Requiring the approval of DSA for school facility plans broadened the state's involvement in the construction of school facilities.

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[10] Legislative Analyst's Office, The 2015–16 Budget: Rethinking How the State Funds School Facilities, February 2015 p. 2.

[11] Districts can apply to the California State Board of Education for an exemption to the debt limit.

[12] AB 2432, (Field), Chapter 602, Statutes of 1933. (Education Code Sections 17280–17317 and 80030–81149).

[13] Seismic Safety Commission, *The Field Act and its Relative Effectiveness in Reducing Earthquake Damage in California Public Schools*, October 2009, p. V. https://ssc.ca.gov/forms_pubs/cssc_09-02_field_act_report.pdf.

[14] Seismic Safety Commission, *The Field Act and its Relative Effectiveness in Reducing Earthquake Damage in California Public Schools*, October 2009, p. V. https://ssc.ca.gov/forms_pubs/cssc_09-02_field_act_report.pdf.

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Growth in the student population ("the baby boom") following WWII created an immediate need for additional educational facilities. In response, the State created the State Allocation Board (SAB) in 1947 to allocate state funds for school facility construction.[15] In the beginning the SAB allocated resources for school facilities through a loan program, in which districts used property tax revenues to repay the loan.

The Legislature subsequently passed the State School Building Aid Law of 1949, which was designed to provide assistance to school districts for the construction and acquisition of new school facilities. To secure funding for the new loan program, California's first statewide school bond initiative, Proposition 1, was placed on the November 1949 statewide general election ballot and approved by voters. The proposition authorized the sale of $250 million of state bonds to provide school districts with funds for new school construction and improvement. For the next 30 years, the state provided financing for school facilities in the form of leases and loans through the issuance of similar, voter approved bonds.

The passage of Proposition 13, however, required SAB to shift its policy focus from the loan program to the School Facilities Program[16] (See B.1.2, State-Level Facility Funding).

B.1.1.2 PROPOSITION 13

In 1978, California voters approved Proposition 13, the *People's Initiative to Limit Property Taxation,* amending the State Constitution to limit *ad valorem* property taxes (see Section 1.7.1 Proposition 13 (1978), Jarvis-Gann Initiative)[17] in response to a decade of rapidly rising property tax bills.[18] Before Proposition 13, a property tax payer paid different tax rates to the local agencies providing services, including several special districts, one or more school districts, a city, and the county. In addition, local governments could generally set the property tax rate—the

15 Chapter 243, Statutes of 1947.

16 California Research Bureau, California State Library, *School Facility Financing, A History of the Role of the State Allocation Board and Options for the Distribution of Proposition 1A Funds*, Joel Cohen, CRB99-01, p. 6

17 Proposition 13 added Article XIIIA to the State Constitution. Proposition 13 was on the June 6, 1978, statewide Primary ballot.

18 California Proposition 13 (1978), Ballotpedia, https://ballotpedia.org/California_Proposition_13,_Tax_Limitations_Initiative_(1978).

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percentage of AV that would be imposed annually as a tax—in accordance with the revenue needs of the local government.[19, 20] Before 1978, real property was appraised cyclically, with no more than a 5-year interval between reassessments. Because property values were systematically reviewed and updated, AVs were usually kept at or near current market value levels, and the average property tax rate before Proposition 13 was approximately 3% of the property's market value. This tax rate, combined with the rapid increase in real estate values in California, especially for single-family residences, caused the tax bills of homeowners to rise at a rapid rate.

Proposition 13 accomplished property tax relief in two important ways. First, it limited the annual property tax rate to 1% of the full cash value of the property. Second, it defined the full cash value to be the value shown on the 1975–76 assessment roll—a 2-year rollback of property values—or the actual market value upon sale of the property. Once sold, property is reassessed at 1% of the sale price, and the 2% annual growth cap applies to each subsequent year after the sale.[21] This has resulted in what some have called an acquisition value approach to taxation, which in a rising real estate market requires new buyers to pay dramatically higher taxes compared to those who have owned their property for longer periods.[22]

The passage of Proposition 13 marked a watershed moment in California local government finance. For school districts, the passage of Proposition 13 eliminated their ability to levy additional special property taxes to pay off their facility indebtedness.[23] By capping the *ad valorem* tax rate on real property at 1%, the corresponding income from property taxes was also capped to such an extent that it virtually eliminated this source as a means for repayment. Further limiting school districts, Proposition 13 prohibited new *ad valorem* property taxes, but allowed special taxes with two-thirds voter approval. Special taxes, however, were

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19 Public Policy Institute of California, Proposition 13: Some Unintended Consequences, www.ppic.org/content/pubs/op/OP_998JCOP.pdf.

20 CDIAC, *California Debt Issuance Primer*, 2006, p. 85.

21 After a property is sold it can only increase in AV by an annual maximum of the lesser of the Consumer Price Index or 2%.

22 CDIAC, *California Debt Issuance Primer*, 2006, p. 86.

23 Cohen, Joel, California Research Bureau; *School Facility Financing, A History of the Role of the State Allocation Board and Options for the Distribution of Proposition 1A Funds*, February 1999, p. 12.

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not defined.[24] As a result of Proposition 13 county property tax revenues dropped from $10.3 billion in 1977–78 to $5.04 billion in 1978–79, prompting a fiscal crisis for many local governments.[25]

Proposition 13 allowed local governments to levy voter-approved debt above the 1% rate to pay for indebtedness approved by voters before 1978.[26] While most pre-1978 approved debt has been paid off, there are still two common pre-1978 obligations paid with voter-approved debt: local government voter-approved retirement benefits and payments to the State Water Project.[27]

The passage of Proposition 13 shifted the primary responsibility for financing new school construction and modernization from local school districts to the State. By prohibiting property tax overrides to fund local GO bonds, Proposition 13 eliminated the primary source of local revenue for new school construction and modernization. Proposition 13 was the first of several state-level initiatives (see **Section 1.7 Historical Overview of Voter-Approved Limitations on Local Government Revenues**) directed at the fiscal affairs of state and local government that dramatically limited fiscal flexibility and have been the catalyst for many of the financing programs and techniques discussed in this section of the Guidebook.

Since the passage of Proposition 13, two amendments to the California Constitution have allowed school districts to again finance school facilities through the issuance of GO bonds. Proposition 46, approved in 1986, allows public agencies with taxing power (including school districts) to issue GO bonds to finance the acquisition or improvement of real property and to levy taxes above the Proposition 13 limit (1% of AV) to pay debt service on the bonds with two-thirds voter approval. Proposition 39, approved in 2000, allows school districts and community college districts to issue GO bonds to finance the construction, reconstruction, rehabilitation or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition of lease of real property for school facilities with 55% voter approval.

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[24] Public Policy Institute of California, *Proposition 13: Some Unintended Consequences*, p. 3. www.ppic.org/content/pubs/op/OP_998JCOP.pdf.

[25] Board of Equalization, California Property Tax - An Overview, Publication 29, July 2015, p. 1.

[26] Legislative Analyst Office, *A Look at Voter-Approval Requirements for Local Taxes*, March 20, 2014, p. 2. www.lao.ca.gov/Publications/Detail/2978.

[27] LAO, Understanding California's Property Taxes, November 29, 2012, p. 9.

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B.1.2 State-Level Facility Funding

THE SCHOOL FACILITY PROGRAM (SFP). Established in 1998 by the *Leroy F. Greene School Facilities Act of 1998*, the SFP marked a new policy direction for state financing assistance to districts for the construction of school facilities.[28] The grant program, funded by voter-approved state GO bonds, replaced the Lease-Purchase Program[29] and was designed to simplify the overall structure of the state's school facilities program and create a more transparent and equitable funding mechanism.[30] State funding is provided under the SFP in the form of per-pupil grants, with supplemental grants for site development, site acquisition, and other project specific costs; all grants are considered to be the full and final apportionment from the state.[31] The SFP provides funding grants for school districts to acquire school sites, construct new school facilities, or modernize existing school facilities. Two major funding types are *new construction* projects funded on a 50/50 state/local matching basis and *modernization* projects funded on a 60/40 basis.[32]

Funding for the School Facility Program comes exclusively from state GO bonds approved by the voters. Since 1998, California voters have approved five statewide bond issues totaling $54.1 billion and providing $42.4 billion for the SFP Program:[33]

1. Proposition 1A (1998) authorized $9.2 billion, with $6.7 billion for K–12 public school facilities and $25 billion for higher education facilities.[34]

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[28] SB 50 (Greene), Chapter 407, Statutes of 1998.

[29] In 1976, the Legislature approved the Lease-Purchase Program but it was not funded until voters approved funding in 1982. Brunner, Eric J., *Financing School Facilities in California*, Quinnipiac University, Hamden, CT October 25, 2006 p. III.

[30] Office of Public School Construction, *School Facility Program Handbook*, April 2018, p. 1.

[31] Office of Public School Construction, *School Facility Program Handbook*, April 2018, p. 1.

[32] Office of Public School Construction, *School Facility Program Handbook*, April 2018, p. 1.

[33] Note that each proposition contained proposed projects for community colleges in addition to K–12 facilities.

[34] Legislative Analyst's Office, *Proposition 1A, Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998*, November 1998. https://lao.ca.gov/ballot/1998/1A_11_1998.htm.

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2. Proposition 47 (2002) authorized $13.2 billion, with $11.4 billion for K–12 public school facilities and $1.65 billion for higher education facilities.[35]
3. Proposition 55 (2004) authorized $12.3 billion, with $10 billion for K–12 public school facilities and $2.3 for higher education facilities.[36]
4. Proposition 1D (2006) authorized $10.416 billion, with $7.3 billion for K–12 public school facilities and $3.1 billion for higher education facilities.[37]
5. Proposition 51 (2016) authorized $9 billion, with $7 billion for K–12 public school facilities and $2 billion for higher education facilities.[38]

Each state education bond act approved by voters includes a breakdown of how the authorized funds are to be distributed. For example, the recent passage of Proposition 51 (2016) stipulated that the $9 billion in approved funds were to be distributed in the following manner:

- $3 billion for construction of new facilities
- $500 million for providing school facilities for charter schools
- $3 billion for modernization of school facilities
- $500 million for providing facilities for career technical education programs
- $2 billion for acquiring, constructing, renovating, and equipping community college facilities

Bond funds for K–12 facilities are administered through the SFP, while funds for community colleges are administered by the California Community Colleges, Chancellor's Office.[39]

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35 EdSource, Proposition 47, Bonds to Construct and Modernize Public Education Facilities. September 2002. https://edsource.org/wp-content/publications/Prop47Final.orig.pdf.

36 Ballotpedia, California Proposition 55, Bonds for Schools, March 2004. https://ballotpedia.org/California_Proposition_55,_Bonds_for_Schools_(March_2004).

37 Legislative Analsyt's Office, Proposition 1D, Kindergarten-University Public Education Facilities Bond Act of 2006; https://lao.ca.gov/ballot/2006/1D_11_2006.htm.

38 Legislative Analyst's Office, Proposition 51, School Bonds. Funding for K-12 School and Community College Facilities. Initiative Statutory Amendment, July 2016. https://lao.ca.gov/ballot/2016/Prop51-110816.pdf.

39 Legislative Analyst's Office, Overview of School Facilities Bond Measures, May 18, 2016, p. 8. http://www.lao.ca.gov/handouts/education/2016/Overview-School-Facilities-Bond-Measure-051816.pdf.

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Allocations of state bond proceeds under the SFP are awarded by the SAB. For more information on SAB, see B.1.1.1 School Facility Finance Before Proposition 13.

Grants allocated by the SAB under the SFP are administered by the Office of Public School Construction (OPSC). The OPSC, under the authority of the California Department of General Services, is responsible for carrying out and implementing the various programs of the SAB, including the SFP. The grants administered by OPSC and allocated by the SAB are funded exclusively from state GO bonds approved by the voters of California as discussed above.[40] As staff to the SAB, the OPSC is responsible for allocating state funding for eligible new construction and modernization projects to provide safe and adequate facilities for California public school children. The OPSC is also responsible for the management of these funds and the expenditures made with them. Per Education Code Section 41024, a local agency that receives any funds pursuant to the *Leroy F. Greene School Facilities Act of 1998* after April 1, 2017 will have their project audited as part of that local educational agency's audit for the fiscal year in which the project is reported complete. It is the responsibility of the OPSC to prepare regulations, policies, and procedures for approval by the SAB that carry out the mandates of state law.[41]

Design and construction oversight for K–12 schools, community colleges, and various other state-owned and leased facilities is provided by the DSA. As mentioned earlier, the *Field Act* mandated DSA to develop earthquake-resistant design and construction for all public schools in the state. DSA also develops accessibility, structural safety, and historical building codes and standards for various public and private buildings throughout California.[42] Pursuant to Education Code Section 17072.30, school districts are required to obtain DSA approval of project plans and specifications before submitting an application to the OPSC. The DSA approves project design by reviewing plans for structural integrity, fire/life safety, and accessibility.

To be considered for funding under the SFP, school districts are required to work with and receive approval from several state agencies. The California Department of Education, School Facilities Planning Division reviews and approves school district sites (site approval process for proximity to airports, freeways and power

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[40] Office of Public School Construction, School Facility Program Handbook, April 2018; p. 3. www.documents.dgs.ca.gov/opsc/Publications/Handbooks/SFP_Hdbk.pdf.

[41] Office of Public School Construction, School Facility Program Handbook, April 2018; p. 6. www.documents.dgs.ca.gov/opsc/Publications/Handbooks/SFP_Hdbk.pdf.

[42] Division of State Architect, home page; www.dgs.ca.gov/dsa/Home.aspx.

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transmission lines) and construction plans.[43] The School Facilities Planning Division reviews construction plans to determine the adequacy of the proposed facility and whether the needs of students and faculty will be met. The Department of Toxic Substances Control assists districts with an assessment of any possible contamination and if necessary with the development and implementation of a mitigation plan.[44] In addition, before receiving SFP funds, a district must certify that a labor compliance program has been approved by the Department of Industrial Relations or the district has contracted with the Department of Industrial Relations for prevailing wage monitoring and enforcement.[45]

Although the program has gone through numerous changes since 1998, the basic structure of the SFP is still in place today. The **SFP Handbook**, available on the OPSC website, can guide potential applicants through the steps in the SFP application process.

B.1.3 School District Financing Options

Local districts finance their share of school construction and modernization project costs primarily with revenue raised through local GO bond elections. From November 2002 through 2017, voters authorized over $99 billion in local GO bonds[46] to finance school facility improvements. School facilities can also be financed by developer fees, parcel taxes and other voter-approved debt such as special taxes, and these amounts are in addition to and not reflected in the $99 billion identified above.

B.1.3.1 LOCAL GENERAL OBLIGATION BONDS

GO bonds have become the primary financing tool used by California school districts to construct or improve school facilities. Local school GO bonds are

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43 Office of Public School Construction, School Facility Program Handbook, April 2018; p. 7. www.documents.dgs.ca.gov/opsc/Publications/Handbooks/SFP_Hdbk.pdf.

44 Office of Public School Construction, School Facility Program Handbook, April 2018; p. 7. www.documents.dgs.ca.gov/opsc/Publications/Handbooks/SFP_Hdbk.pdf.

45 Office of Public School Construction, Application for Funding (Form SAB 50-04), Revision January 2018; p. 10. www.documents.dgs.ca.gov/opsc/Forms/SAB_50-04.pdf.

46 CDIAC, K-14 Voter Approved General Obligation Bonds: Authorized, But Unissued - 2017 Update, p.1, www.treasurer.ca.gov/cdiac/publications/k14update-2017.pdf.

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backed by an obligation to levy *ad valorem* property taxes in an *unlimited* amount as needed to pay debt service.[47] The agency issuing a GO bond is authorized to levy (via the county treasurer) *ad valorem* property taxes at the rate necessary to repay the principal and interest of the bonds. The unlimited tax obligation backing of local school GO bonds establishes a fundamental relationship between AV and the tax rates such that increasing AVs generally lead to stable or declining property tax rates and falling AVs lead to higher or increasing tax rates. School districts in California may issue GO bonds under two different statutory schemes, Proposition 46 (1986) and Proposition 39 (2000). See **Section 3.3.1 Local Agency General Obligation Bonds**.

PROPOSITION 46. In 1986, voters approved Proposition 46, which amended the provisions of Proposition 13 in the California Constitution to restore the authority for cities, counties, school districts and certain other special districts to issue GO bonds with two-thirds voter approval.[48] Under Proposition 46 public agencies with taxing authority can exceed the 1% property tax to finance GO bonds if two-thirds of voters approve the measure. The proceeds from bonds authorized under Proposition 46 can be used for "the acquisition or improvement of real property," which generally has been accepted to mean the acquisition of land, the construction or acquisition of school buildings and facilities, the expansion, restoration, remodeling or improvement of school facilities, and the permanent improvement of school grounds.[49] While the Education Code appears to allow a wider scope of project costs that include furniture, equipment, and buses, Proposition 46 prohibits the use of bond proceeds to acquire vehicles, furnishings, or equipment (unless the equipment is affixed to real property and treated as real property for legal purposes).[50]

While Proposition 46 enabled public agencies to secure additional *ad valorem* property taxes with voter approval, it did not remove the limit on the total amount of outstanding city, county, or school district debt. This debt limit is

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[47] A County is obligated to take the necessary steps to raise property tax rates to a level necessary to make the required principal and interest payments.

[48] Amended Proposition 13, allowing districts to augment the 1% cap on property taxes to secure additional bond indebtedness to build and improve their schools.

[49] *The XYZs of California School District Debt Financing*, Third Edition; Greg Harrington, John Hartenstein, and Donald Field; ORRICK; pg. 25.

[50] *The XYZs of California School District Debt Financing*, Third Edition; Greg Harrington, John Hartenstein, and Donald Field; ORRICK; pg. 25.

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based on the AV of the property within the boundaries of the public agency. The GO debt limit for unified school districts and community college districts may not exceed 2.5% of AV and for elementary and high school districts it may not exceed 1.25% of AV.[51] Figure B-1 summarizes California statutory debt limits.

Figure B-1

STATUTORY DEBT LIMITS

ISSUER TYPE	BONDING CAPACITY (AS PERCENTAGE OF ASSESSED VALUE OF ALL TAXABLE PROPERTY)
General Law Cities	3.75%
Counties	1.25%
	3.75% for water conservation and flood control projects and the construction of select county roads
Unified School Districts, Community College Districts	2.5%
Elementary School Districts, High School Districts	1.25%

PROPOSITION 39. In November 2000, voters in California approved Proposition 39, the *Smaller Classes, Safer Schools and Financial Accountability Act*, amending Article XIII, Section 1 and Article XVI, Section 18 of the California Constitution to provide school districts the authority to issue a GO bond with only 55% voter approval. Proceeds from Proposition 39 bonds can be used for "the construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities" by K–12 school districts and community college districts. In contrast to Proposition 46, bond proceeds authorized under Proposition 39 can be spent on furniture and equipment.[52] Pursuant to Proposition 39 companion statutes, Education Code Sections 15268 through 15270, the principal issued under any single bond authorization cannot cause the total debt service for all bonds issued under the authorized bond program to exceed a property tax rate of $30 per $100,000 of AV within an elementary and high school district, $60 per $100,000 of AV within a unified school district, or $25 per $100,000 of AV within a commu-

[51] The GO debt limit also applies to GO bonds issued under Proposition 39 authorization.

[52] The Constitution still prohibits the use of general obligation bonds to finance ordinary operation or maintenance expenses regardless of which authority the bonds are approved under.

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nity college district (i.e., 0.03%, 0.06%, or 0.025%, respectively). In addition, under Proposition 39 a district must comply with accountability requirements that include a citizen's bond oversight committee, annual performance audits, and financial audits on the use of bond proceeds.

The bond measure on which taxpayers cast their ballots sets forth the principal amount of the bonds to be issued and the estimated maximum tax rate at which properties within the district will be taxed. If the bond measure receives the required amount of voter support in the district, it passes; providing the district the authority to issue bonds up to the amount authorized. The vast majority of the California school and community college bond issuance authority is granted by voters through elections under Proposition 39 and, as a result, districts are pledging to issue only the debt that can be serviced within their tax rate limitations.[53] Under Proposition 39, simply having the bond authority is not enough justification for a school district to issue the bonds. Districts must establish that they will generate the tax revenues, given the limits, required to service the debt as long as it is outstanding.

At a glance, the unlimited tax obligation at the core of school district GO bonds appears to be in direct conflict with the tax rate limitations imposed by Proposition 39. In reality, there is no conflict. The Proposition 39 tax rate limit applies at the time bonds are sold, based on AV within the district at the time of issuance and a projection of AV growth in the future.[54] Once the bonds are issued, however, the unlimited tax pledge means the tax rate will be adjusted regardless of the applicable tax rule limitations based on annual debt service payments and AVs.

The dynamics imposed by Proposition 39 and the unlimited tax obligation pledge are key to understanding the relationship between AV growth and a district's ability to issue the bonds that voters approve. When a district issues bonds for the first time under a new authorization, it securitizes the tax revenues generated by the chosen tax rate applied against the entire AV (as long as the tax rate applied at issuance does not exceed Proposition 39 limits).

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[53] CDIAC, *K-14 Voter Approved General Obligation Bonds: Authorized But Unissued - 2016 Update*, January 2016; www.treasurer.ca.gov/cdiac/publications/k14update.pdf. Of the 818 K–14 bond elections approved by voters between November 2002 and November 2015, 801 (97.9%) were approved under Proposition 39.

[54] CDIAC, *K-14 Voter Approved General Obligation Bonds: Authorized But Unissued - 2016 Update*, January 2016; www.treasurer.ca.gov/cdiac/publications/k14update.pdf.

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Citizen's Oversight Committee - After successful passage of a bond initiative under Proposition 39, the school district will be required to establish a citizens' oversight committee as directed by Education Code Section 15278. The committee is to be established within 60 days of entering the election results in the district's board minutes. The purpose of the citizen's oversight committee is to inform the public about the expenditures of bond proceeds and bring some transparency to the bond administration process. The committee is not granted any power to determine how bond funds may be spent but is to ensure that the bonds are spent as stated in the bond measure. To fulfill their purpose, committee members may review the annual, independent financial and performance audits required by Proposition 39, physically inspect school facilities and grounds, review the district's deferred maintenance plans, and review the district's cost-saving efforts for design and use of the facilities.[55] Pursuant to statute, the district will provide the necessary support for the committee to perform its duties and to publicize its conclusions.

The composition of a citizen's oversight committee is also guided by statute.[56] Committees must have a minimum of seven members, five of which are to represent specific community groups. For example, one member must be active in a bona fide taxpayers' organization. Committee members serve a 2-year term and cannot serve more than three consecutive terms. Members cannot be district employees or a vendor, contractor, or consultant of the district. There is no limit to the maximum size of the committee. Members are not compensated for their time.

B.1.3.1.1 Process for Approval of Local School District GO Bonds

EDUCATION CODE VS. GOVERNMENT CODE. For districts there are two separate statutory options when issuing GO bonds: Education Code Section 15100 et seq. or Government Code Section 53506 et seq. Each statutory option outlines the parameters districts must follow to comply with the authority conferred in statute. Each section contains information regarding redemption requirements, maximum maturity, and maximum interest rate, as well as other limitations. The main difference in authorization between the Education and Government Codes is the maximum maturity.

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[55] California Education Code Section 15278(c).

[56] California Education Code Section 15282.

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Under Education Code Section 15100 et seq., bonds can be issued by the district or on behalf of the district by the county in which the county superintendent has jurisdiction over the district. Bonds under the Education Code have a maximum maturity of 25 years and may be subject to a maximum interest rate of 8%. In addition, bonds can be sold either through a negotiated sale or competitive bid.[57] Before the sale of the bonds, the district must adopt a resolution that among other things indicates the reasons for the selected method of sale.[58]

GO bonds issued under Government Code Section 53506 are generally issued by the district. They, subject to certain limitations, have a maximum maturity of 40 years and a maximum interest rate of 12%. Districts can issue bonds through both a negotiated or competitive sale. However, in a negotiated sale, the district must adopt a resolution that contains among other things, the reasons for selecting the negotiated method of sale.[59]

Regardless of the statutory option used to issue GO debt, districts need to communicate with the county about their debt issuance activity in order to ensure that the county can levy and collect taxes, pay bonds, and hold bond proceeds and tax funds for the GO bonds issued and sold under their voter-approved authority. Education Code Section 15140(c) requires that, whenever the governing board of a school district or community college district issues bonds or refunding bonds payable from *ad valorem* taxes, the governing board must transmit the authorizing resolution and debt service schedule, including the debt service schedule for the bonds to be refunded, to the county auditor and county treasurer in sufficient time to permit the county to establish tax rates and necessary funds or accounts for the bonds.

B.1.3.1.2 GO Bond Structures

CURRENT INTEREST BONDS. A current interest bond (CIB) is a bond with a debt schedule that is structured with interest payments due on a periodic basis, typically twice per year. CIBs are also referred to as current coupon bonds. See Section 2.2.2.1 Long-Term Fixed-Rate Debt.

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57 California Education Code Section 15140(a).

58 California Education Code Section 15146(b)(1).

59 California Government Code Section 53508.9.

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CAPITAL APPRECIATION BONDS. A Capital Appreciation Bond (CAB) is a financing structure that allows issuers to raise capital for projects while postponing debt service during periods when property tax or other revenue needed for debt service is low. In a CAB structure, the borrower is not required to make periodic interest payments to the investor; instead, for each payment period (typically twice per year), the interest is added to the unpaid principal balance. The rate at which interest grows is called the "accretion rate." The accretion rate is to a CAB what the coupon rate is to a CIB. When the bond is due to be repaid (maturity) the issuer makes a single payment (maturity value) representing both the principal amount of the bond and all of the accumulated and compounded interest. As a result of compounding, CABs are issued at a significant discount to their maturity value. See Section 2.2.2.1 Long-Term Fixed-Rate Debt.

School districts issue CABs to address challenges faced when financing facilities, including stagnant property values, demand for capital improvements, and limited state support for the construction of educational facilities. CABs are usually issued in combination with CIBs to securitize the projected growth in tax revenues, smooth debt service schedules and reduce the negative effects of fluctuating revenues. Districts can also issue a "convertible CAB," which is structured as a CAB for a period of time, then "converts" to a CIB on a specified date, at which time the interest payment calculation is based on the accreted value of the CAB at the conversion date. The convertible CAB structure allows the issuer the flexibility to postpone debt service payments during periods of low tax revenue while increasing them during periods of higher projected tax revenue, thereby smoothing debt service schedules.

School and community college districts are subject to the following statutory limitations when issuing CABs secured by a levy of *ad valorem* taxes:[60]

1. The term is not to exceed 25 years (Ed Code 15144).
2. The ratio of total debt service to principal for each bond series is not to exceed 4:1 (Ed Code 15144.1).
3. Bonds may be subject an interest rate limit of 8% (Ed Code 15143).
4. If the bond matures more than 10 years after its date of issuance, the bond may be subject to redemption 10 years after its issue date and before its fixed maturity date (Ed Code 15144.2).

[60] AB 182 (Buchanan), Chapter 477, Statutes of 2013.

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B.1.3.1.3 Policy Considerations for Issuing GO Bonds[61]

ADVANTAGES. Among bond types, GO bonds have historically provided issuers with the lowest borrowing costs because the broad security pledge yields the highest possible bond rating and widest investor acceptance. A reserve fund is usually not required (or even permitted) for GO bonds, leaving more bond proceeds for project purposes (or keeping the bond par to the minimum necessary). Many financing terms are dictated by statute, often allowing the legal documentation to be less complex than for other types of bond issues. Lastly, local GO bond debt service is paid from property tax proceeds, not the district's operating funds.

Recent legislation has strengthened the security pledge for repayment of GO bonds issued by California public agencies and backed by ad valorem property taxes. SB 222 (Chapter 78, Statutes of 2015) which went into effect on January 1, 2016, requires all local agencies (including school districts) issuing GO bonds to place a statutory lien on all property tax revenues derived from taxes levied to pay debt service on the bonds. Creating a first lien priority for GO bonds issued by local agencies, SB 222 provides more protections for GO bond investors in the event that the local agency files for bankruptcy. Strengthening California's local agency GO bonds allows these agencies to potentially reduce their financing costs.

DISADVANTAGES. Districts may find some of the legal and procedural requirements of GO bonds to be disadvantageous, if not insurmountable. They include:

- **Voter Approval Required.** Voter approval (Proposition 46 requires two-thirds; Proposition 39 requires 55%) can be difficult to obtain. Further, no taxpayer funds may be used to support the bond measure campaign.

- **Timing Requirement.** At least 88 days is required for a school district to call an election. Additional time is needed to certify the election results before the local agency may even begin proceedings to authorize the debt issue.

- **General Fund Cost.** Regardless of the outcome of the election, the district's general fund will have to bear the cost of holding the election.[62]

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[61] CDIAC, *California Debt Issuance Primer*, 2006 pg. 137-139.

[62] Orrick, Herrington & Sutcliffe LLP, *X, Y, Z's of School District Financing*, Third Edition, 2005. p. 30.

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B.1.3.2 SCHOOL FACILITIES IMPROVEMENT DISTRICTS

According to Education Code Section 15300 et seq., school districts (and community college districts) can form School Facilities Improvement Districts (SFID) to impose a special tax to support the issuance of GO bonds to finance school facilities. With an SFID, a district can narrow its focus to specific areas within its boundaries—those areas that benefit particularly from the financed facilities— to levy a special tax. The two-thirds and 55% voter approval requirements apply to voters in the SFID and the special tax levies securing the GO bonds are levied on property in the SFID.

B.1.3.3 CERTIFICATES OF PARTICIPATION/LEASES

A financing lease provides a public agency with an alternative to voter-authorized debt to finance capital assets over a multi-year period (see Section 3.3.2.1 Lease Revenue Bonds and Certificates of Participation). Tax-exempt leasing for purposes of this discussion often involves the sale of Certificates of Participation (COPs) in the municipal market. A tax-exempt lease may be used to finance any property that the public agency has the statutory authorization to lease. As a general matter, only land and depreciable property may be leased. Generally, the leased property is a capital asset to be used by the public agency in its own operations. Any lease by a public agency must be in furtherance of a proper public purpose. School districts execute lease-purchase agreements and COPs, to finance not only minor equipment procurements, but also the construction or acquisition costs of major capital projects, such as school facilities.

A properly structured lease does not create a "debt" subject to the voter-approval requirements of the California Constitution. See Section 1.2.4.3 Lease Exception (the "Offner-Dean" Lease Exception). Although a lease is not a "debt," a district should treat the schedule of lease payments as it would the repayment schedule of principal and interest on any loan, bond, or debt obligation.

Districts use COPs to finance a construction project or to leverage an existing unencumbered school facility to raise funds to complete other projects, known as an asset transfer (see Section 3.6.3 Certificates of Participation).[63] For a complete discussion of the policy considerations for leases and COPs, see ***Guidelines for Leases and Certification of Participation*** (CDIAC 1993).

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[63] CDIAC, *California Debt Issuance Primer*, 2006, p. 127.

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B.1.4 Other Financing Sources

In a 1991 report on Mello-Roos financing, CDIAC identified additional strategies for financing local agency projects that had emerged as a result of the constitutional restrictions on taxation imposed by Proposition 13 as well as declining levels of federal assistance.[64] These strategies, which included Mello-Roos bonds, parcel taxes, and developer fees, can still be viable options to finance facilities for districts.

B.1.4.1 COMMUNITY FACILITIES DISTRICTS/MELLO-ROOS BONDS

The Legislature enacted the *Mello-Roos Community Facilities District Act of 1982*, commonly referred to as the Mello-Roos Act, to provide a flexible financing mechanism to local governments after the passage of Proposition 13[65] through the formation of Community Facilities Districts (CFDs) and subsequent issuance of Mello-Roos Bonds. See **Section 3.3.7 Special Assessments, Special Taxes and Tax Increments**. Use of Mello-Roos bonds has proven to be popular with local governments and are used to finance projects in communities throughout California including school facilities, roads, and sewer and water systems. For school districts, the Mello-Roos Act allows districts to create CFDs within its boundaries to fund new school construction.[66] Once established, CFDs are governed by the legislative body that approved their formation.

B.1.4.2 DEVELOPER FEES

Since January 1, 1987, school districts are authorized to levy a fee, charge, dedication or other requirement (collectively referred to as "developer fees") against any construction within the boundaries of the district to help the district mitigate the impact of new development on the district's facilities.[67] These developer fees may only be used for projects to accommodate students resulting from the new development.

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[64] CDIAC, *Mello-Roos Financing in California*, September 1991, p. ii, www.treasurer.ca.gov/cdiac/reports/M-Roos/financings.pdf.

[65] The *Mello-Roos Community Facilities Act of 1982*, Government Code Sections 53311-53368.3.

[66] Government Code Section 53313 lists eligible projects.

[67] Education Code 17620.

BACK

While districts are authorized to impose fees on new development pursuant to Education Code Section 17620, Government Code Section 65995 actually establishes the corresponding fee schedule. The initial fees established in 1987 are referred to as Level 1 developer fees and were established with a cap of $1.50 per square foot on new residential construction and $0.25 per square foot for commercial/industrial construction. Beginning in 2000, the maximum allowable amount of developer fees has been adjusted every 2 years based on the change in the statewide cost index for class B construction by the SAB.[68] The fees, last adjusted in 2018, were increased to $3.79 and $0.61 per square foot, respectively. To levy Level I Fees, a school district must prepare an analysis commonly referred to as a "School Fee Justification Study."

Additional fee levels were established as a result of the passage of Proposition 1A, the *Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998*. In corresponding legislation, Senate Bill 50 (SB 50), the *Leroy F. Greene School Facilities Act of 1998*, districts were authorized to levy "alternative school fees" or what have become known as Level II Fees and Level III Fees.[69] As with Level I fees, there are requirements for the levying of alternative school fees that include the preparation of a School Facilities Needs Analysis. Districts using developer fees to finance school construction are constrained by the inherent limitations of it as a "pay-as-you-go" revenue source.

B.1.4.3 PARCEL TAXES

In California, local agencies including school and community college districts are authorized to impose parcel taxes approved by voters for specified purposes and within certain limitations under Government Code Section 50075 et seq. Parcel taxes are a fee that appears on a property owner's property tax bill. A parcel tax is different from an *ad valorem* property tax, in that it is imposed on a per-parcel basis, and is not based on the AV of the property. Parcel taxes are legally distinct from similar types of levies on property such as special assessments, which are based on a special benefit conferred on the parcel being assessed. There is generally no requirement that a parcel tax be based on any benefit received by either the property owner or the parcel being taxed.

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[68] Government Code 65995(b)(3).

[69] Government Code Sections 65995.5, 65995.6 and 65995.7.

BACK

Parcel taxes are special taxes and pursuant to Government Code Section 50077 require two-thirds voter approval. The passage of Proposition 39 in 2000, which lowered the voter approval requirement for local education bonds from a two-thirds vote to a 55% vote, does not apply to parcel taxes. Districts must declare the specific purposes of the tax in the ballot measure. A parcel tax can be approved for a set period of time (e.g., 10 years) or can be permanent. Statute requires districts to report annually to their school boards on the amount of funds collected and spent and provide the status of any project or purpose identified in the ballot measure.[70]

Parcel taxes apply to all property owners equally and are referred to as regressive because they typically require owners of smaller or lower valued property to pay the *same* amount as owners of larger or higher valued property.

B.1.5 Additional Financing Tools for School Districts

B.1.5.1 TAX AND REVENUE ANTICIPATION NOTES

Tax and revenue anticipation notes (TRANs) are short-term debt instruments used to finance cash flow deficits in a school district's fiscal year in anticipation of receiving tax and other revenues later in the fiscal year (see Section 3.3.4 TRANs and RANs). Government Code Sections 53820–53859.09 authorize school districts to engage in temporary borrowing for various purposes, but TRANs are usually issued under Government Code Section 53850 et seq. Federal tax limits restrict the amount of TRANs a district can issue to the maximum cash flow deficit in its current fiscal year (see Section 4.5 Cash Flow Borrowings).

B.1.5.2 BOND ANTICIPATION NOTES

Bond anticipation notes (BANs) are an interim form of financing or short-term borrowing issued by local public agencies to cover initial project costs in anticipation of issuing permanent, long-term debt. School districts issue BANs in anticipation of issuing GO Bonds that have been authorized but not yet issued (see Section 3.7.3 Bond Anticipation Notes; Grant Anticipation Notes).

70 Government Code Section 50075.3.

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B.1.5.3 REFUNDING BONDS

Refunding bonds are issued by districts to refinance an existing issue of bonds with a new issue of bonds (see Section 3.7.6 Refunding Bonds). The term can include bonds, notes, or COPs. In a refunding, the proceeds of the refunding bonds are used to pay the existing or "refunded" bonds, either at maturity or, if the refunded bonds are subject to optional redemption before maturity, at an earlier redemption date. When an issuer undertakes a refunding they are essentially refinancing their debt, like refinancing a home mortgage.

School districts use refundings to take advantage of favorable interest rate environments, to amend/remove restrictive bond covenants, and/or to restructure debt service payments. The benefits to the local agency of issuing refunding bonds to refund GO bonds are indirect because any debt service savings must be passed on to taxpayers rather than retained by the issuing entity. Overall savings are not necessarily an immediate savings or a lower tax rate; rather, the savings are realized over time or by the final maturity.

California school districts can issue new money bonds under different statutory provisions including the education and government codes. Refunding bonds can be issued by all public agency issuers pursuant to Government Code Section 53550, referred to as Article 9, and 53580, referred to as Article 11. Refundings involving voter-approved debt do not require additional voter approval because they use existing voter authorization. The refunded debt is considered a change in the form of indebtedness, not an increase in additional outstanding debt. A refunding is a variation on basic financing techniques because the proceeds of the refunding bonds are applied to the payment of the refunded bonds rather than the costs of a project. It is not uncommon for refunding bonds and capital project bonds to be sold at the same time by an issuer. Any costs of issuance paid from sources other than refunding bond proceeds (and interest earned thereon) must be added to the costs of the refunding bonds.

Refundings are subject to a complex set of arbitrage and rebate requirements and restrictions under the Internal Revenue Code. Issuers should understand these requirements and would be best served meeting with counsel before considering a refunding to address these requirements (see Section 4.12 Refunding Bonds). Under the Internal Revenue Code, refundings are classified as either "advance refundings" or "current refundings."

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B.1.6 Other Types of Education Providers in California

B.1.6.1 CHARTER SCHOOL FACILITIES

Charter schools are public schools. They can be operated by nonprofit public benefit corporations, for profit corporations or may be unincorporated with authorization and oversight by their public school districts, county offices of education or the State Board of Education. Charter schools can access the Charter School Facilities Program (CSFP) to finance new or modernize existing facilities.[71] The CSFP is jointly administered by the California School Finance Authority (CSFA) and the OPSC. The Charter School Facilities Program, like the SFP, is funded by voter-approved state GO bonds. Propositions 47 (2002), 55 (2004), 1D (2006) and51 (2016) provided $1.4 billion for the construction of new charter school facilities or the rehabilitation of existing school district facilities for charter school use. This program allows charter schools to access facility funding directly or through the school district in which the project will be built. To qualify for funding, a charter school must be deemed financially sound by the CSFA.

Charter schools may also be able to use conduit financing to finance facilities (see Section 3.3.9 Conduit Revenue Bonds).

B.1.6.2 NONPROFIT AND RELIGIOUS SCHOOL FACILITIES

State funding and voter-approved special taxes are generally not available to finance educational facilities for nonprofit and religious based schools; however, conduit financing maybe an available option to finance educational facilities (see Section 3.3.9 Conduit Revenue Bonds).

[71] Charter School Facilities Program, www.treasurer.ca.gov/csfa/charter.asp.

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Appendix C. Additional Sources of Information

The list of additional sources of information in this appendix is not intended to be an exhaustive list as the information below has been selected for its accessibility on public websites and relevance to further aid readers in their understanding of related subject matter topics described throughout the various chapters of the California Debt Financing Guide. By utilizing weblinks to the organizations identified in this appendix, readers may find additional guidance, educational presentations, policy analysis, regulatory information and research material on specific topics or pertaining to public finance, generally. Descriptions of organizations and their work products are largely taken from the organizations' own websites or literature, respectively and have not been independently verified.

C.1 POLICY RELATED AND EDUCATIONAL RESOURCES FOR PUBLIC FINANCE

C.1.1 State and Local Organizations

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION (CDIAC)

The state's clearinghouse for information on public debt and public fund investments.
www.treasurer.ca.gov/cdiac/introduction.asp
Includes access to research, educational material and regulatory information on debt issuance and public funds investments. See Regulatory Resources for information on rules and regulations relating to the issuance and post-issuance administration of public debt.

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- CDIAC DEBT ISSUANCE PRIMER (2006)
  www.treasurer.ca.gov/cdiac/debtpubs/primer.pdf

- LOCAL AGENCY INVESTMENT GUIDELINES
  www.treasurer.ca.gov/cdiac/LAIG/guideline.pdf

- CALIFORNIA PUBLIC FUND INVESTMENT PRIMER (2009)
  www.treasurer.ca.gov/cdiac/invest/primer.pdf

- DEBT LINE
  A legislatively-mandated monthly newsletter providing a calendar listing of all proposed and sold debt issues reported to CDIAC, as required by law, as well as summary tables and articles related to debt issuance and public fund investment. CDIAC has published Debt Line on a monthly basis since 1982.
  www.treasurer.ca.gov/cdiac/debtpubs/debtline.asp

- STATE TREASURER'S TASK FORCE ON BOND ACCOUNTABILITY
  www.treasurer.ca.gov/cdiac/reports/task-force.pdf

- SEARCHABLE PUBLICATION AND SEMINAR DATABASE
  - CDIAC PUBLICATIONS LIBRARY
    www.treasurer.ca.gov/cdiac/publications.asp
  - CDIAC EDUCATION SEMINARS
    www.treasurer.ca.gov/cdiac/seminars/index.asp

STATE TREASURER'S OFFICE (STO)

Provides centralized treasury, cash management, debt issuance and pooled investment management to state agencies.
www.treasurer.ca.gov/about.asp
Includes access to publications, research and historical data on the issuance of debt in the State of California.

- STO DEBTWATCH
  Explore more than thirty years of data on bonds, notes and other public debt issued by California State and local governmental entities, and bond and tax election data dating back to 1986.
  www.treasurer.ca.gov/cdiac/debt.asp

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- STO PUBLICATIONS
  www.treasurer.ca.gov/publications/index.asp

STATE OF CALIFORNIA - DEPARTMENT OF FINANCE
REDEVELOPMENT AGENCY DISSOLUTION

This website serves as the primary conduit for Finance to share information related to the redevelopment dissolution legislation and communicate with Successor Agencies (SAs), who are responsible for overseeing the winding down at the local level, and County Auditors-Controllers, who are charged with property tax distribution.
www.dof.ca.gov/Programs/Redevelopment/

CALIFORNIA STATE LEGISLATURE

www.legislature.ca.gov/
Includes links to assembly and senate members, committees and legislative information.

- CALIFORNIA STATE ASSEMBLY
  http://assembly.ca.gov/

- CALIFORNIA STATE SENATE
  http://senate.ca.gov/

- BILL SEARCH (SEE REGULATORY RESOURCES)
  http://leginfo.legislature.ca.gov/

LEGISLATIVE ANALYST OFFICE (LAO)

Provides legislative and policy analysis for the State Legislature.
www.lao.ca.gov/About
Includes budgetary and other information on lawmaking in the State of California.

- LAO PUBLICATIONS
  www.lao.ca.gov/Publications

- PROPOSITIONS AND INITIATIVES
  www.lao.ca.gov/BallotAnalysis

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CALIFORNIA SOCIETY OF MUNICIPAL FINANCE OFFICERS (CSMFO)

Serves government finance professionals through innovation, collaboration, continuing education and professional development.
www.csmfo.org/about/
Includes access to conference presentations and other educational materials on relevant topics relating to public finance.

- CONFERENCE PRESENTATIONS
  www.csmfo.org/events/presentations/
- SAMPLE DOCUMENTS
  www.csmfo.org/resources/documents/
- PROFESSIONAL DEVELOPMENT
  www.csmfo.org/training/

CALIFORNIA STATE ASSOCIATION OF COUNTIES (CSAC)

Represents all 58 counties before the California Legislature, administrative agencies and the federal government.
www.counties.org/about-csac

- WEBINAR LIBRARY
  www.counties.org/csac-webinar-library
- RESOURCES
  www.counties.org/resources-3

CALIFORNIA MUNICIPAL TREASURER'S ASSOCIATION

Aims to enhance the role of the governmental treasurer as a key official in local government.
www.cmta.org/

- CONFERENCE PRESENTATIONS
  www.cmta.org/page/ConferencePresentations

CALIFORNIA TRANSIT ASSOCIATION

Advocate for public transit and infrastructure in California.
https://caltransit.org/

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- PUBLICATIONS
  https://caltransit.org/news-publications/

- WEBINARS
  https://caltransit.org/news-publications/webinars/

LEAGUE OF CALIFORNIA CITIES

Represents California cities and provides education and training programs to city officials.
www.cacities.org/Top/About-Us

- RESOURCES FOR CITIES
  www.cacities.org/Resources

INSTITUTE FOR LOCAL GOVERNMENT

Promotes good government at the local level with practical, impartial and easy-to-use resources for California communities.
www.ca-ilg.org/about-institute-local-government

- UNDERSTANDING THE BASICS OF MUNICIPAL REVENUES IN CALIFORNIA
  www.ca-ilg.org/sites/main/files/file-attachments/basics_of_municipal_revenue_2016.pdf

C.1.2 National Organizations

GOVERNMENT FINANCE OFFICERS ASSOCIATION (GFOA)

Professional association of state, provincial and local finance officers in the U.S. and Canada.
www.gfoa.org/about-gfoa
Includes access to publications, research and guidance relating to public finance, including best practices for the issuance and administration of debt.

- GFOA BEST PRACTICES, ADVISORIES AND RESEARCH
  www.gfoa.org/best-practices
  www.gfoa.org/public-policy-statements
  www.gfoa.org/research-reports

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- GFOA PUBLICATIONS
  www.gfoa.org/materials

COUNCIL OF DEVELOPMENT FINANCE AGENCIES

An association dedicated to the advancement of development finance concerns and interests.
www.cdfa.net/cdfa/cdfaweb.nsf/pages/about.html

- EDUCATION
  www.cdfa.net/cdfa/cdfaweb.nsf/pages/education.html

- RESOURCES
  www.cdfa.net/cdfa/cdfaweb.nsf/pages/resources.html

NATIONAL ASSOCIATION OF HEALTH AND EDUCATIONAL FACILITIES AUTHORITIES

The Association promotes the common interest of organizations which have the authority to provide capital financing for not-for-profit healthcare and higher education institutions and facilitates national advocacy, support, networking and education on behalf of its members. NAHEFFA focuses its efforts on issues which directly influence the availability of, or access to tax-exempt financing for healthcare and higher educational institutions.
www.naheffa.com/

- PUBLICATIONS AND OTHER RESOURCES
  www.naheffa.com/publications.html

NATIONAL ASSOCIATION OF BOND LAWYERS (NABL)

Promotes the integrity of the municipal market through the education of its members in the laws affecting state and municipal bonds.
www.nabl.org/about

- COMMENT LETTERS/POSITION STATEMENTS
  www.nabl.org/Comment-Letters-Position-Statements

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NATIONAL ASSOCIATION OF COUNTIES

Achieve healthy, vibrant and safe counties across America.
www.naco.org/what-we-do/about-naco

- TOPICS
  www.naco.org/topics

- RESOURCES
  www.naco.org/resources

NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS

An organization for state officials tasked with the financial management of state government.
www.nasact.org/about_us

- WEBINARS
  www.nasact.org/webinars

- PUBLICATIONS
  www.nasact.org/news_pubs

COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO)

Provides thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence to improve organizational performance and governance and to reduce the extent of fraud in organizations.
www.coso.org/Pages/aboutus.aspx

- GUIDANCE ON INTERNAL CONTROLS
  www.coso.org/Pages/guidance.aspx

C.2 REGULATORY RESOURCES

In general, the regulatory resources listed below relate to state and federal laws applicable to tax-exempt municipal debt as described throughout various chapters of the [Guidebook]. Public agencies should work with bond counsel, financial

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advisors and other public finance professionals to ensure they fully understand regulatory and other legal requirements regarding the issuance and post-issuance administration of debt.

CDIAC (CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION)

Provides resources about selected topics in municipal market regulations. A list of selected regulatory topics that affect municipal issuers is provided below along with links to additional resources and information.

Although most regulation efforts over the last few years are implementations of the Dodd-Frank Act's objectives for a more accountable and transparent financial market, the SEC and MSRB enact rules that affect the municipal market outside of that Act. Additionally, both the federal and state governments routinely introduce legislation that affects municipal markets, for instance by creating new vehicles to finance debt or refining permissible debt issuance and investment practices.
www.treasurer.ca.gov/cdiac/introduction.asp

- REGULATORY RESOURCES FOR MUNICIPAL ISSUERS
  www.treasurer.ca.gov/cdiac/mmra/index.asp

- CDIAC DEBT ISSUANCE REPORTING REQUIREMENTS
  www.treasurer.ca.gov/cdiac/reporting.asp

CALIFORNIA LEGISLATIVE BILL SEARCH

www.leginfo.ca.gov/legpubs.html

- ASSEMBLY AND SENATE BILL SEARCH
  http://leginfo.legislature.ca.gov/faces/billSearchClient.xhtml

- STATE STATUTES AND BILLS - OFFICIAL CALIFORNIA LEGISLATIVE INFORMATION
  http://leginfo.legislature.ca.gov/

CALIFORNIA DEBT LIMIT ALLOCATION COMMITTEE (CDLAC)

Federal law limits how much tax-exempt debt a state can issue in a calendar year for private projects that have a qualified public benefit. This cap is determined by a population-based formula. CDLAC was created to set and allocate California's annual debt ceiling, and administer the State's tax-exempt bond program to issue the debt. CDLAC's programs are used to finance affordable housing developments for

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low-income Californians, build solid waste disposal and waste recycling facilities, and finance direct loans used by in-need college students and their parents.
www.treasurer.ca.gov/cdlac/index.asp

CALAFCO (CALIFORNIA ASSOCIATION LOCAL AGENCY FORMATION COMMISSION)

The California Association of Local Agency Formation Commissions (CALAFCO) is a 501(c)3 non-profit founded in 1971. CALAFCO serves as an organization dedicated to assisting member LAFCos with educational, technical and legislative resources that otherwise would not be available. The Association provides state-wide coordination of LAFCo activities, serves as a resource to the Legislature and other bodies, and offers a structure for sharing information among the various LAFCos and other governmental agencies.
https://calafco.org/

MUNICIPAL SECURITIES RULEMAKING BOARD (MSRB)

As part of its mission to promote a fair and efficient market, the MSRB maintains industry rules and guidance for municipal securities dealer and municipal advisors.
www.msrb.org/About-MSRB.aspx

- MSRB EDUCATION
  www.msrb.org/EducationCenter.aspx
- MSRB RULES AND GUIDANCE
  www.msrb.org/Rules-and-Interpretations.aspx
- MSRB NOTICES
  www.msrb.org/Rules-and-Interpretations/Regulatory-Notices.aspx
- MSRB POLICY AND ANALYSIS
  www.msrb.org/Market-Topics.aspx
- MSRB GLOSSARY
  www.msrb.org/glossary.aspx

ELECTRONIC MUNICIPAL MARKET ACCESS (EMMA)

EMMA is a vital tool in fulfilling the MSRB's mission to protect investors and municipal securities issuers. The EMMA Help page provides information on how to

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use the resources and tools available on EMMA. See "Chapter 5 - Sale of Municipal Debt – Improving Transparency and Investor Access to the Municipal Market". https://emma.msrb.org/EmmaHelp/Index

- OFFICIAL SOURCE FOR MUNICIPAL SECURITIES DATA AND DOCUMENTS
  https://emma.msrb.org/

- EMMA HELP
  https://emma.msrb.org/EmmaHelp/Index

INTERNAL REVENUE SERVICE (IRS)

www.irs.gov/government-entities/federal-state-local-governments
Includes access to information on tax-exempt debt, including forms, guides and checklists relating to compliance with federal tax requirements.

- INFORMATION FOR THE TAX-EXEMPT BOND COMMUNITY
  www.irs.gov/tax-exempt-bonds

- VCAP (VOLUNTARY CLOSING AGREEMENT PROGRAM)
  www.irs.gov/tax-exempt-bonds/tax-exempt-bonds-voluntary-compliance

U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust.
www.sec.gov/about.shtml

- REGULATORY ACTIONS AND RULEMAKING
  www.sec.gov/rules.shtml

- OFFICE OF CREDIT RATINGS (FOR RATINGS DEFINITIONS, SEE CREDIT RATING AGENCIES)
  www.sec.gov/page/ocr-section-landing

GOVERNMENT ACCOUNTING STANDARDS BOARD (GASB)

The GASB is the independent, private-sector organization that establishes accounting and financial reporting standards for U.S. state and local governments that follow Generally Accepted Accounting Principles.
www.gasb.org/jsp/GASB/Page/GASBLandingPage&cid=1175804799024

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- REFERENCE LIBRARY
  www.gasb.org/jsp/GASB/Page/GASBLandingPage&cid=1175804799014

- STANDARDS AND GUIDANCE
  www.gasb.org/jsp/GASB/Page/GASBLandingPage&cid=1176160042327

UNITED STATES FEDERAL COURTS

The U.S. Courts were created under Article III of the Constitution to administer justice fairly and impartially, within the jurisdiction established by the Constitution and Congress.
www.uscourts.gov/about-federal-courts

- CHAPTER 9 – BANKRUPTCY BASICS
  www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics

C.3 CREDIT RATING AGENCIES

For a description of credit rating agencies and the credit rating process, see Chapter 5, Sale of Municipal Debt, Section 5.6, Credit Ratings.

C.3.1 Regulatory Oversight

SEC OFFICE OF CREDIT RATINGS

www.sec.gov/page/ocr-section-landing

- CURRENT NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
  www.sec.gov/ocr/ocr-current-nrsros.html

C.3.2 Commonly Used Credit Ratings in the Municipal Market

FITCH RATINGS, INC.

www.fitchratings.com/site/home

- FITCH RATINGS DEFINITIONS
  www.fitchratings.com/site/definitions

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KROLL BOND RATING AGENCY, INC.

www.krollbondratings.com/

- KROLL RATINGS SCALES
  www.krollbondratings.com/ratings/methodologies/rating-scales

MOODY'S INVESTOR SERVICE, INC.

www.moodys.com/

- MOODY'S RATING SYMBOLS AND DEFINITIONS
  www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf

S&P GLOBAL RATINGS

www.standardandpoors.com/en_US/web/guest/home

- S&P GLOBAL RATINGS DEFINITIONS
  www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352

C.4 STATE FINANCE AND JOINT POWERS AUTHORITIES WITH STATEWIDE JURISDICTION[1]

In general, State Finance Authorities and Joint Powers Authorities/Agencies formed by local agencies/political subdivisions are conduit issuers that provide eligible borrowers/obligated parties with access to the tax-exempt municipal market, grants, loans and other financing programs. See Appendix A.3 – State of California Financing Authorities and Appendix A.4 – Joint Powers Agencies/Authorities for a listing of statutory authorizations.

[1] Generally, for information on conduit issuers, JPA's and other financing programs available within a local jurisdiction, contact the city's or county's office of economic development or community development and inquire about available financing resources for capital improvements and other eligible projects.

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C.4.1 State Finance Authorities

CALIFORNIA ALTERNATIVE ENERGY AND ADVANCED TRANSPORTATION FINANCING AUTHORITY (CAEATFA)

CAEATFA works collaboratively with public and private partners to provide innovative and effective financing solutions for California's industries, assisting in reducing the state's greenhouse gas emissions by increasing the development and deployment of renewable energy sources, energy efficiency, and advanced transportation and manufacturing technologies to reduce air pollution, conserve energy, and promote economic development and jobs.
www.treasurer.ca.gov/caeatfa/index.asp

- CLEAN ENERGY BOND PROGRAM
  www.treasurer.ca.gov/caeatfa/incentives.asp
- PACE LOAN LOSS RESERVE PROGRAM
  www.treasurer.ca.gov/caeatfa/pace/index.asp
- CALIFORNIA HUB FOR ENERGY EFFICIENCY FINANCING
  www.treasurer.ca.gov/caeatfa/cheef/index.asp
- SALES TAX EXCLUSION FOR MANUFACTURERS
  www.treasurer.ca.gov/caeatfa/ste/index.asp

CALIFORNIA EDUCATIONAL FACILITIES AUTHORITY (CEFA)

CEFA provides private, nonprofit higher education institutions with the assistance needed to reduce the cost of financing the construction of campus facilities through a tax-exempt revenue bond program. The construction and improvement to facilities will help qualifying schools better serve their student population by offering more opportunities and better access to academic programs.
www.treasurer.ca.gov/cefa/index.asp

- BOND FINANCING PROGRAM
  www.treasurer.ca.gov/cefa/bond.asp
- COLLEGE ACCESS TAX CREDIT FUND
  www.treasurer.ca.gov/cefa/catc/index.asp

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CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY (CHFFA)

CHFFA was established to be the State's vehicle for providing financial assistance to public and non-profit health care providers through loans, grants and tax-exempt bonds.
www.treasurer.ca.gov/chffa/index.asp

- BOND FINANCING PROGRAM
  www.treasurer.ca.gov/chffa/programs/bond.asp
- TAX-EXEMPT EQUIPMENT FINANCING PROGRAM
  www.treasurer.ca.gov/chffa/programs/tax.asp
- CHILDREN'S HOSPITAL PROGRAM
  www.treasurer.ca.gov/chffa/hospital.asp
- HEALTHCARE EXPANSION LOAN PROGRAM II
  www.treasurer.ca.gov/chffa/programs/help.asp
- MENTAL HEALTH WELLNESS GRANTS
  www.treasurer.ca.gov/chffa/imhwa/index.asp
- PEER RESPITE CARE GRANTS
  www.treasurer.ca.gov/chffa/imhwa/peer.asp
- CALIFORNIA HEALTH ACCESS MODEL PROGRAM
  www.treasurer.ca.gov/chffa/champ/index.asp
- LIFELINE GRANT PROGRAM
  www.treasurer.ca.gov/chffa/clg/index.asp

CALIFORNIA POLLUTION CONTROL FINANCING AUTHORITY (CPCFA)

CPCFA has been providing low-cost innovative financing to California businesses since 1972 with an objective of making California more economically prosperous and environmentally clean. As a government agency that issues tax-exempt private activity bonds, CPCFA can facilitate low cost financing to qualified waste and recycling projects, and other projects to control pollution and improve water supply.

CPCFA also administers the California Capital Access Program (CalCAP), which encourages financial institutions to make loans to small businesses and provides

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for specialty programs targeted toward building an improved infrastructure for zero- and partial-emission vehicles and helping small businesses comply with the federal Americans With Disabilities Act.
www.treasurer.ca.gov/cpcfa/index.asp

- TAX-EXEMPT BOND FINANCING PROGRAM
  www.treasurer.ca.gov/cpcfa/tax_exempt.asp

- CALIFORNIA CAPITAL ACCESS PROGRAM
  www.treasurer.ca.gov/cpcfa/calcap/index.asp

- CALIFORNIA RECYCLE UNDERUTILIZED SITES
  www.treasurer.ca.gov/cpcfa/calreuse.asp

- RATE REDUCTION BOND PROGRAM
  www.treasurer.ca.gov/cpcfa/reduction/index.asp

CALIFORNIA SCHOOL FINANCE AUTHORITY (CSFA)

CSFA was created in 1985 to finance educational facilities and provide school districts and community college districts access to working capital. Since its inception, the Authority has developed a number of school facilities financing programs primarily focuses on assisting charter schools to meet their working capital and facility needs.
www.treasurer.ca.gov/csfa/index.asp

- BOND FINANCING
  www.treasurer.ca.gov/csfa/financings/index.asp

- CHARTER SCHOOL FACILITIES PROGRAM
  www.treasurer.ca.gov/csfa/charter.asp

- CHARTER SCHOOL FACILITY GRANT PROGRAM
  www.treasurer.ca.gov/csfa/csfgp/index.asp

- CHARTER SCHOOL FACILITIES CREDIT ENHANCEMENT GRANT PROGRAM
  www.treasurer.ca.gov/csfa/enhancement/index.asp

- STATE CHARTER SCHOOL FACILITIES INCENTIVE GRANTS PROGRAM
  www.treasurer.ca.gov/csfa/incentive.asp

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- CHARTER SCHOOL REVOLVING LOAN FUND PROGRAM
  www.treasurer.ca.gov/csfa/csrlf/index.asp

- QUALIFIED PUBLIC EDUCATIONAL FACILITY BOND PROGRAM
  www.treasurer.ca.gov/csfa/qpefb/index.asp

- CHARTER SCHOOL BANK LOAN PROGRAM
  www.treasurer.ca.gov/csfa/csblp/index.asp

- PROJECT ACCELERATION NOTES AND CREDIT ENHANCEMENT ALTERNATIVES
  www.treasurer.ca.gov/csfa/panacea/index.asp

CALIFORNIA TRANSPORTATION FINANCING AUTHORITY (CTFA)

The Governor on October 11, 2009 signed AB 798, creating CTFA within the State Treasurer's Office. The statute authorizes the CTFA to issue, or approve the issuance of, revenue bonds to finance transportation projects. The CTFA will review proposed projects to ensure they are financially sound, and has the ability to approve tolls as part of the financing plans to repay revenue bonds.

AB 798 provides innovative financing that will help California meet its transportation needs without busting state and local budgets. Through the CTFA, local transportation agencies will have greater ability to sell revenue bonds -- backed by non-general fund monies -- in the municipal bond market. And the state will ensure that projects and financing are consistent with state transportation policy objectives.
www.treasurer.ca.gov/ctfa/index.asp

CALIFORNIA HOUSING FINANCE AGENCY (CalHFA)

Established in 1975, CalHFA was chartered as the state's affordable housing lender. The Agency's Multifamily Division finances affordable rental housing through partnerships with jurisdictions, developers and more, while its Single Family Division provides first mortgage loans and down payment assistance to first-time homebuyers. CalHFA is a completely self-supporting state agency, and its bonds are repaid by revenues generated through mortgage loans, not taxpayer dollars.
www.calhfa.ca.gov/

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CALIFORNIA INFRASTRUCTURE AND ECONOMIC DEVELOPMENT BANK (I-BANK)

The I-Bank was created in 1994 to finance public infrastructure and private development that promote a healthy climate for jobs, contribute to a strong economy and improve the quality of life in California communities. I-Bank operates pursuant to the Bergeson-Peace Infrastructure and Economic Development Bank Act contained in the California (Government Code Sections 63000-63089.98) et seq. I-Bank is located within the Governor's Office of Business and Economic Development and is governed by a five-member Board of Directors.

I-Bank has broad authority to issue tax-exempt and taxable revenue bonds, provide financing to public agencies, provide credit enhancements, acquire or lease facilities, and leverage State and Federal funds. I-Bank's current programs include the Infrastructure State Revolving Fund (ISRF) Loan Program, California Lending for Energy and Environmental Needs (CLEEN) Center, Small Business Finance Center and the Bond Financing Program.
www.ibank.ca.gov/

CALIFORNIA MARITIME INFRASTRUCTURE AUTHORITY (CMIA)

CMIA was formed at the request of the California Marine Affairs and Navigation Conference and codified as Sections 6516.5 and 6571 of the Government Code and Part 1 (commencing with Section 1690) of Division 6 of the Harbors and Navigation Code of the State of California.

CMIA may also function as a Public Agency, under Code Section 1700, with its authority to establish one or more joint powers under State Law for the purpose of establishing an infrastructure fund for pooled financing of port or harbor infrastructure. CMIA is a joint exercise of powers authority formed under and pursuant to Article 1 of Chapter 5 of Division 7 of Title 1 of the Government Code of the State of California and a joint exercise of powers agreement among the Authority's member Districts.

CMIA can issue debt, establish and administer infrastructure funds, receive or administer public and private grants, and expend tax revenues, appropriated funds, and other financings on behalf of its member Districts.
www.californiamaritimeinfrastructureauthority.org/

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C.4.2 Joint Powers Authorities/Agencies (JPAs)

ASSOCIATION OF BAY AREA GOVERNMENTS (ABAG) FINANCE AUTHORITY FOR NONPROFIT CORPORATIONS

The ABAG Finance Authority has provided conduit financing to various public and private organizations throughout the State of California since 1978. Its programs provide convenient, cost saving, and secure means to meet the capital financing needs of public agencies and their nonprofit partners serving the public interest.
https://abag.ca.gov/services/finance/index.html

CALIFORNIA COMMUNITY COLLEGE FINANCING AUTHORITY

The California Community College Financing Authority was created to accomplish the purposes of the JPA Law and Bond Pooling Act, including the financing of Public Capital improvements and the purchase of certain obligations, including tax and revenue anticipation notes, issued by Members of the California Community College Financing Authority or other public agencies or the sale of such obligations or issuance of bonds of the Authority.
www.ccleague.org/district-services/financing-authority

CALIFORNIA ENTERPRISE DEVELOPMENT AUTHORITY

The California Association for Local Economic Development established the California Enterprise Development Authority (CEDA), a JPA, to address gaps in Economic Development financing. Specifically, CEDA's goal is to issue industrial development bonds (IDBs) for small- to medium-sized California manufacturers. IDBs are a powerful incentive for business expansion and location. CEDA also issues 501(c)3 Non-Profit bonds and has recently seen success in refinancing existing debt for non-profit businesses such as private schools, community centers, and health clinics. Additionally, CEDA can form assessment districts and issue bonds to finance energy and conservation upgrades for property owners within member jurisdictions through the Figtree Financing PACE program.
https://ceda.caled.org/about-ceda/

CALIFORNIA MUNICIPAL FINANCE AUTHORITY (CMFA)

CMFA's mission is to support economic development, job creation and social programs throughout the State of California while giving back to California communities. By supporting our member communities and their local charities with

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a portion of revenue generated through the issuance of taxable and tax-exempt bonds for public, private and non-profit entities, the Authority is able to directly contribute to the health and welfare of the residents of California.
www.cmfa-ca.com/

CALIFORNIA PUBLIC FINANCE AUTHORITY (CalPFA)

CalPFA is a political subdivision of the State of California established under the Joint Exercise of Powers Act for the purpose of issuing tax-exempt and taxable conduit bonds for public and private entities throughout California. CalPFA was created by Kings County and the Housing Authority of Kings County.

CalPFA is empowered to promote economic, cultural, and community development opportunities that create temporary and permanent jobs, affordable housing, community infrastructure and improve the overall quality of life in local communities.
www.calpfa.org/

CALIFORNIA STATEWIDE COMMUNITIES DEVELOPMENT AUTHORITY (CSCDA)

CSCDA was created in 1988, under California's Joint Exercise of Powers Act, to provide California's local governments with an effective tool for the timely financing of community-based public benefit projects.

Currently, more than 500 cities, counties and special districts have become Program Participants to CSCDA – which serves as their conduit issuer and provides access to an efficient mechanism to finance locally-approved projects. CSCDA helps local governments build community infrastructure, provide affordable housing, create jobs, make access available to quality healthcare and education, and more. CSCDA provides an important resource to our local government members.
http://cscda.org/

INDEPENDENT CITIES FINANCE AUTHORITY

The Independent Cities Finance Authority provides local government, nonprofits and other agencies the clout they need to finance important projects throughout California including housing projects, charter schools, hospitals and more.
www.icfauthority.org/

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C.4.3 Other Financing Resources[2]

CALIFORNIA FINANCING COORDINATING COMMITTEE (CFCC)

CFCC combines the resources of five State and two Federal funding agencies to provide a one-stop shop for available grants, loans and bond financing for infrastructure projects. Since 1998, the CFCC has conducted free funding fairs statewide each year to educate the public and offer potential customers the opportunity to meet with financial representatives from each agency and learn more about their currently available funding programs.
www.cfcc.ca.gov/

C.4.4 Other Resources for Local Agencies

CALIFORNIA LOCAL GOVERNMENT FINANCE ALMANAC

www.californiacityfinance.com/

WESTERN CITY
THE MONTHLY MAGAZINE OF THE LEAGUE OF CALIFORNIA CITIES

www.westerncity.com/

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

www.cdtfa.ca.gov/

- FORMS AND PUBLICATIONS
  www.cdtfa.ca.gov/formspubs/
- CITY AND COUNTY SALES AND USE TAX RATES
  www.cdtfa.ca.gov/taxes-and-fees/sales-use-tax-rates.htm

[2] See also, CDIAC 05-10 "Tools to Revitalize California Communities", available on the CDIAC website at www.treasurer.ca.gov/cdiac/reports/tools2006.pdf.

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Appendix D. Municipal Bankruptcy

D.1 PUBLIC AGENCIES AND BANKRUPTCY

Chapter 9 of the United States Bankruptcy Code ("Chapter 9") offers protection to insolvent local public agencies that meet the eligibility requirements of Chapter 9 and California Government Code Sections 53760 et seq. Public agency insolvency is usually the result of either (1) an unexpected catastrophic occurrence (e.g., major investment losses, a large legal judgment or an epic natural disaster) or (2) structural economic problems (expenditures consistently in excess of revenues) leading over time to the draining of reserves. Bankruptcy protection can provide an opportunity to "right the ship". The importance, however, of transparency with respect to financial problems and attending to issues in advance of and with the goal of avoiding, if at all possible, a bankruptcy filing cannot be overstated.

Chapter 9, in deference to the Tenth Amendment to the United States Constitution and the practical realities of entities providing essential public services, differs in important respects from the United States Bankruptcy Code provisions applicable to the bankruptcy of individuals and to private corporations. A Chapter 9 proceeding, for example, may be initiated only by the bankrupt public agency itself; a public agency's creditors cannot force a Chapter 9 filing. Further, as a general matter, a federal bankruptcy court may not interfere with a public agency's political or governmental powers, properties or revenues or its use of income producing properties. Specifically, Chapter 9 does not authorize a bankruptcy court to:

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1. Liquidate a public agency,
2. Take over operation of a public agency or appoint a receiver,
3. Direct or remove an elected governing board,
4. Halt the provision of public services,
5. Order the sale of public property, or
6. Authorize the overriding of state law requirements respecting the imposition or increase of taxes or revenues or restrictions on the uses of funds.

In determining eligibility, overseeing the assumption or rejection of contracts and leases, evaluating the avoidability of certain transfers and confirming or declining to confirm the public agency's plan of adjustment, the federal bankruptcy court does, however, exercise significant power.

D.1.1 Eligibility

To seek protection under Chapter 9, however, a public agency must satisfy the eligibility criteria established by Chapter 9 and by state law. Chapter 9 protection is not available to states themselves but is open to any "political subdivision or public municipality or instrumentality of a state." The Internal Revenue Service defines an instrumentality as an "organization created by or pursuant to state statute and operated for public purposes."[1] To be eligible, however, a local public agency must:

1. Be "insolvent". Insolvency is determined under general bankruptcy law principles and requires that the public agency be not able to pay undisputed debts as they become due or be unable to make such payments in the near future (e.g., in the current or immediately ensuing fiscal year). Likely financial failure "down the road" is not sufficient.

2. "Desire to effect a plan to adjust its debt". A plan does not need to be in existence as a precondition to a Chapter 9 filing, but the public agency must be able to show that it intends to develop and effect one.

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[1] U.S. Internal Revenue Service - *What are Governmental Entities and Their Federal Tax Obligations?* www.irs.gov/government-entities/federal-state-local-governments/government-entities-and-their-federal-tax-obligations.

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3. Demonstrate that a Chapter 9 filing is necessary. The public agency must prove one of the following:
    - It has obtained the agreement of creditors holding a majority in amount of claims of each class the public agency intends to impair.
    - It has negotiated in good faith and is unable to reach such an agreement.
    - Negotiations are impracticable (e.g., because of the number of creditors).
    - A creditor is attempting to gain a preference over other creditors.
4. Be authorized to file for bankruptcy under state law. Laws of the State of California impose preconditions and some other states do not allow municipal bankruptcy filings.

California Government Code Sections 53760 et seq. permits Chapter 9 filings by any "county, city, district, public authority, public agency or other entity . . . that is a municipality as defined in the [the federal bankruptcy code] or that qualifies as a debtor under any other federal bankruptcy law applicable to local public entities," but specifically excludes school districts. California Government Code Section 53760 provides further that a local public agency may only file a petition under Chapter 9 if it has either:

1. Participated in a neutral evaluation process, or
2. Declared a fiscal emergency through adoption of a resolution by majority vote of its governing board.

Government Code Section 53760.3 provides a detailed process for a "neutral evaluation", including notice to interested parties and discussions overseen by a neutral expert. Government Code Section 53760.5 requires that a "fiscal emergency" declaration be made only following a noticed public hearing and a finding that the local public agency will be unable to pay its obligations within the next 60 days.

D.1.2 Process

Few municipal bankruptcies are a smooth sail. The process, however, usually follows a general course. Because the bankruptcy judge retains the ability to dismiss the case at any point, the bankruptcy court can ensure a fair and orderly process which may include the following:

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FILING AND AUTOMATIC STAY. The public agency's filing triggers the "automatic stay" provisions of Chapter 9. These prevent or stay litigation against the public agency and the exercise by creditors of enforcement remedies.

ELIGIBILITY DETERMINATION. The bankruptcy judge must determine whether the public agency has satisfied the eligibility requirements described above. The public agency's assertion of eligibility may be, and often is, challenged by creditors.

ORGANIZATION. The public agency causes publication of notice of the filing and submits a list of known creditors. Official creditor committees, representing the various types and classes of creditors, are formed.

RESOLUTION OF DISPUTES RELATING TO OBLIGATIONS AND PRIORITIES. A variety of legal questions may be presented. Common issues addressed include:

1. The proposed assumption or rejection by the public agency of contracts and leases. Agreements entered into through collective bargaining and pension obligations are generally accorded greater protection than other obligations.

2. The validity of various contracts and claims made.

3. Special revenue determinations. A number of public agency revenues, including assessments, enterprise revenues and proceeds of dedicated taxes, are not legally available to satisfy claims of the public agency's general creditors. Obligations payable from sufficient "special revenues" may be treated as secured obligations and collection of such revenues may be excepted from the automatic stay. Payment of operating expenses, however, takes precedence over the payment of debt service even if a debt obligation is secured by a pledge of "gross revenues". See Section 3.3.6.1, Enterprise Public Revenue Bonds.

4. Lien determinations. In general "statutory liens" (liens created by state statute as opposed to liens created by contract) securing particular obligations are respected.

PREPARATION AND APPROVAL OF A PLAN OF ADJUSTMENT. The public agency prepares, through negotiation with creditors and creditor committees, a plan of adjustment, which may provide for the reducing or deferring the payment of claims, and must provide a reasonable basis to conclude the public agency will be able to operate on a financially sustainable basis after it has emerged from bankruptcy. The plan is subject to approval by the bankruptcy judge and may be

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challenged by disadvantaged creditors. Approval of the plan of adjustment is the final step of the bankruptcy process.

D.1.3 Advantages and Disadvantages

A Chapter 9 proceeding offers an eligible public agency several advantages:

1. Protection From Creditor Actions. The automatic stay prevents individual creditors from pursuing disruptive remedies and allows the public agency breathing space to negotiate with all creditors in a considered manner.

2. Single Forum. A bankruptcy case allows all claims and legal issues to be addressed in a single place under the supervision of an expert judge.

3. Adjustment of Obligations. The public agency's ability to reject certain unfavorable contracts and leases and to reduce or defer obligations affords an opportunity to work with creditors to establish a financially sustainable operating model.

A bankruptcy case, however, also has significant disadvantages:

1. Adverse Credit Market Reaction. A public agency seeking bankruptcy relief should expect suspension or downgrading of its credit ratings. The bankruptcy taint may impact not only the public agency's access to capital markets during the pendency of the bankruptcy proceeding but, unless debt holders are fully paid, for many years thereafter.

2. Cost. Bankruptcy proceedings are very costly in terms of legal and advisory fees and staff time. Resources directed to a bankruptcy proceeding are resources not available to address important public needs.

3. Community Stigma. "Bankruptcy" can impact public confidence and the local business climate, the effects of which are difficult to calculate but could be significant.

In sum, bankruptcy may be an inevitable and useful tool for a public agency with financial difficulties that cannot be addressed any other way. It is far better, however, for a public agency to address an intractable financial situation when actual insolvency is still far down the road.

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Appendix E. Glossary of Terms

This appendix is designed to provide definitions in plain English for terms and concepts used in connection with debt issuance. To be consistent with customary industry practice, the term "bonds" is used to mean either longterm bonds or, more generally, bonds, notes, commercial paper, certificates of participation, and other types of evidence of debt. The Municipal Securities Rulemaking Board (MSRB) Glossary of Municipal Securities Terms published by the Municipal Securities Rulemaking Board, the source for a number of the definitions in this Appendix, is a useful reference guide for municipal debt terms, especially technical terms relating to the sale of municipal securities.

ABATEMENT CLAUSE

A provision of a lease that relieves a lessee of the obligation to make lease payments in the event that the leased property cannot be used (e.g., because of construction delays, property damage, or other causes). See **Section 1.2.4.3, Lease Exception (the "Offner-Dean Lease Exception")**" and **Section 3.6.1, Financing Leases**.

ACCELERATION

A remedy provided in an agreement (including many indentures and bond resolutions) by which the trustee or bondholders may declare all future payments of principal immediately due and payable after the occurrence of certain specified events—usually "events of default." See **Section 2.4.8, Events of Defaults and Remedies**.

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ACCRUED INTEREST

In general, interest that has been earned on a bond but not yet paid—usually because it is not yet due.

AD VALOREM TAXES

An annual tax that is a uniform percentage of the value (or assessed value) of property. See **Section 1.4.3, Ad Valorem Real Property Taxes**.

ADDITIONAL BONDS

A term found in indentures, trust agreements, bond resolutions, and other bond documents referring to bonds that may be issued in the future in addition to the bonds being issued under the current document.

Additional bonds are generally on a parity with the bonds being issued initially and may not be issued without meeting certain conditions involving the level of revenues available to repay the initial bonds and additional bonds, maximum amount limitations, and other conditions.

See **Parity**.

ADDITIONAL BONDS TEST/ADDITIONAL BONDS COVENANT

The financial test that must be satisfied under agreements securing outstanding revenue bonds or other types of municipal debt as a condition to issuing additional bonds or incurring additional debt. See **Section 2.4.6 Additional Debt**.

ADVANCE REFUNDING

See **Refunding**.

AGENCY SECURITIES

A term for securities issued by a federal agency or certain federally chartered entities (often referred to as government-sponsored enterprises or GSEs).

AGREED UPON PROCEDURES LETTER

A letter from an auditor to the underwriters of a new issue of municipal securities setting forth the procedures undertaken with respect to the review of specified financial information (e.g., interim period financial statements or

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other information not covered by audited statements) appearing in the official statement and providing certain conclusions regarding the information with respect to which the review procedures were applied. See **Section 6.2.1, Municipal Advisors and Underwriters**.

AGREEMENT AMONG UNDERWRITERS (AAU)

The contract among the members of an underwriting syndicate establishing the syndicate rules, including the rights, duties, and commitments of the senior manager and the other syndicate members with respect to the new issue of municipal securities being underwritten.

ALTERNATIVE MINIMUM TAX (AMT)

An income tax based on a separate and alternative method of calculating taxable income and a separate and alternative schedule of rates.

With respect to bonds, the interest on certain types of qualified private activity bonds is included in income for purposes of the individual and corporate alternative minimum tax.

In addition, the interest received by a corporation on certain bonds held by it is included in adjusted current earnings for federal income tax purposes, which may increase the alternative minimum taxable income of that corporation.

See **Chapter 4, Federal and State Tax Law Requirements**.

AMORTIZE

To retire the principal of an issue by periodic payments either directly to bondholders, or first to a sinking fund and then to bondholders. Compare to **Balloon** and **Bullet**.

ANNUAL APPROPRIATION LEASE

Under an annual appropriation lease, a public agency lessee agrees to annually appropriate the lease payment. Under this lease structure a public agency lessee may terminate the lease by declining to make an appropriation for an annual lease payment. This type of lease structure is one of the exceptions to the Constitutional Debt Limit. See **Section 1.2.4.2, Annual Appropriation Exception** and **Section 3.6.1, Financing Leases**.

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ANNUAL COMPREHENSIVE FINANCIAL REPORT (ACFR)

A report issued by a governmental entity that includes the entity's audited statements for the fiscal year as well as other information about the entity meeting specific standards established by the Governmental Accounting Standards Board (GASB).

ANNUAL DEBT TRANSPARENCY REPORT

An annual report to CDIAC pursuant to California Government Code Section 8855(k) providing beginning and end balances on principal and outstanding, authority remaining, and use of bond proceeds for all debt sold after January 21, 2017.

ANNUAL REPORT

The annual report is the report containing annual financial and operating data prepared and filed through the Electronic Municipal Market Access (EMMA) website maintained by the Municipal Securities Rulemaking Board under Securities and Exchange Commission (SEC) Rule 15c2-12. See Section 8.5.1, Annual Reports.

ANTI-FRAUD PROVISIONS

This term usually refers to the provisions of federal law prohibiting fraud (typically in the form of material omissions or misstatements or deceptive devices, schemes, or conduct) in the issuance, purchase and sale of securities, regardless of whether those securities are subject to registration with the SEC, including Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, and other related rules. See Section 6.1.1, Anti-fraud Rules.

ARBITRAGE

Arbitrage generally refers to the difference between the interest paid on tax-exempt bonds and the interest earned by investing the proceeds of the tax-exempt bonds in higher-yielding taxable securities. Federal income tax laws generally restrict the ability to earn arbitrage in connection with tax-exempt bonds or other federally tax-advantaged bonds. See Section 4.8, Arbitrage Yield Restriction, Section 4.9, Arbitrage Rebate and Section 8.3.5, Arbitrage Rebate.

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ARBITRAGE BONDS

Bonds not complying with the federal tax law requirements relating to arbitrage. See **Section 4.8.1, Arbitrage Yield Restriction**.

ARBITRAGE CERTIFICATE

See **Tax Certificate**.

ARBITRAGE REBATE

Payments made by an issuer to the federal government in connection with an issue of tax-exempt or other federally tax-advantaged bonds. See **Section 4.9, Arbitrage Rebate** and **Section 8.3.5, Arbitrage Rebate**.

ARBITRAGE YIELD RESTRICTIONS

Federal tax law limitations on the ability to use gross proceeds of tax-exempt bonds to acquire materially higher-yielding taxable investment property. See **Section 4.8, Arbitrage Yield Restriction**.

ASSESSED VALUE

The appraised value of a property as set by a taxing authority for purposes of *ad valorem* taxation. See ***Ad Valorem* Taxes**.

ASSESSMENTS

Assessments are charges upon property owners to pay the costs of facilities or improvements that benefit the property.

Payment of the amount assessed (together with interest if not paid upon assessment) is secured by a direct fixed lien on the property.

See **Section 1.4.7 Assessments** and **Section 3.3.7.1– Assessment Bonds**.

AUCTION-RATE SECURITIES

Securities on which the interest is periodically reset through an auction process. The collapse of the auction-rate securities market was one of the events that occurred during the 2008 financial crisis. See **Section 2.2.2.3 Variable-Rate Debt** and **Section 3.4.2, Long-Term, Variable-Rate Debt**.

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AUTHENTICATING AGENT

The agent of the issuer appointed to authenticate bonds (i.e., to sign them as being authentic) upon initial issuance or upon transfer or exchange.

AUTHORIZED DENOMINATION

The par value at which a municipal security can be purchased as authorized by the bond documents.

AVERAGE LIFE

With respect to an issue of bonds, the weighted period of time required to repay half of the issue through scheduled principal payments (e.g., maturity, sinking fund redemption, etc.). The average life, also referred to as the "weighted average life" or "weighted average maturity" or "WAM," is a reflection of the rapidity with which the principal of an issue is expected to be paid.

AWARD

The official acceptance by the issuer of a bid or offer to purchase a new issue of municipal securities by an underwriter. See Section 5.2, Competitive Sales.

BALLOON

Principal of an issue to be paid in a single final maturity that constitutes a large percentage of the total principal of the issue. See also **Bullet**.

BANK ELIGIBLE SECURITIES

Securities in which banks are permitted to invest under federal banking and securities laws.

BANK QUALIFIED BONDS

Tax-exempt bonds that are issued by certain qualified small issuers and that do not need to be taken into account for purposes of determining the portion of certain financial institutions' interest expense, which is disallowed as a deduction for federal tax purposes, because the interest expense is allocable to debt (including deposits) deemed to have been incurred by the financial institution to carry tax-exempt bonds. See Section 4.11, Bank Qualified Bonds.

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BASIS POINT

See **Point/Basis Point**.

BENEFICIAL OWNER

The person to whom the benefits of ownership of given securities accrue, even though the securities might be held by, or in the name of, another person or held in an account over which another person has investment discretion.

See **Bondholder**. Compare **Registered Owner**.

BID

A bona fide offer to purchase securities at a specified price and yield.

BIDDING LIMITATIONS

The restrictions established by the issuer in the notice of sale for a competitive bid underwriting on the terms of bids submitted by prospective underwriters.

These restrictions might include maximum range of permissible interest rates; the number of different interest rates permitted; a particular interest rate structure (such as ascending coupons only, no zero-coupon bonds, etc.); and the amount of any permitted discount or premium. See **Section 5.2, Competitive Sales**.

BLIND POOL ISSUE

See **Pooling of Debt Issues**.

BLUE SKY LAWS/BLUE SKY SURVEY OR MEMORANDUM

Blue Sky laws are the state statutes that regulate the manner of offering and selling of securities, bonds, investment contracts, and stocks. See **Section 6.5, State Securities Laws**.

Generally, in a public offering, a memorandum called a Blue Sky Survey is prepared, which summarizes the treatment of the issue under the securities laws of each state and, occasionally, the laws of Puerto Rico, Guam, the District of Columbia, and the U.S. Virgin Islands. The memorandum specifies the states in which no filings need be made to offer and sell the securities, the states in which action will be taken by the issuer to allow the securities to be offered and sold,

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and the states in which no action will be taken and in which the securities are not, therefore, permitted to be offered or sold.

BOND ANTICIPATION NOTES (BANs)

Debt obligations anticipated to be paid from the proceeds of to be issued debt obligations. See **Notes** and Section 3.7.3 Bond Anticipation Notes; Grant Anticipation Notes.

BOND BANK

An agency or instrumentality created in certain states to buy issues of bonds directly from municipalities or other local governmental entities, with the purchases financed by the issuance of bonds by the bond bank.

BOND COUNSEL

An attorney or law firm retained by the issuer to assist the issuer in connection with a municipal debt issuance and to give a legal opinion that the proposed debt is a legally valid obligation of the issuer and, to the extent applicable, that the interest on the proposed debt is exempt from federal or state income tax.

BOND FUND

Investment Related: Professionally managed investment funds such as bond mutual funds or exchange traded funds.

Issuer Related: In general, a bond fund is a type of governmental fund, including a debt service fund and capital project account fund. See **Governmental Fund**.

A bond fund is typically established by a bond trustee to secure and administer bond proceeds and other amounts for a debt issuance. A bond fund may include other types of funds and accounts such as a debt service reserve fund, capitalized interest fund, escrow fund, and administrative expense account.

BOND INSURANCE

Non-cancellable insurance purchased, generally by the issuer, from a bond insurer under which the insurer is obligated to make scheduled payments of interest, principal, and mandatory sinking fund payments on an issue if the issuer fails to make timely payments.

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Payment of an installment by the insurer does not relieve the issuer of its obligation to pay that installment. The issuer remains liable to pay that installment to the insurer.

See **Section 2.3.2.1, Bond Insurance**.

BOND OVERSIGHT COMMITTEE

A committee that may be formed by a public agency to oversee the expenditure of bond proceeds for capital projects. A citizen's bond oversight committee is one of the accountability measures required of school districts in California that receive voter authorization to issue general obligation bonds under Proposition 39. See **Appendix B.1, School Facility Finance**.

BOND PURCHASE CONTRACT OR AGREEMENT

In a negotiated sale, the bond purchase contract is an agreement between an issuer and an underwriter or a group of underwriters who have agreed to purchase the issue. See **Section 5.3.3, Documentation for a Negotiated Public Offering**.

In a competitive sale, the notice of sale, the underwriter's bid, and the issuer's acceptance of the bid together constitute a bond purchase contract. Generally, these three items taken together contain items similar to those in a negotiated bond purchase contract. See **Section 5.2.3, Documentation for a Competitive Sale**.

BOND REGISTER

A record, kept by a transfer agent or registrar on behalf of the issuer that lists the names and addresses of the holders of registered bonds. See **Registered Bond**.

BOND RESOLUTION

Either the resolution of the issuer's governing board approving the issuance of bonds and the execution and delivery of related documents, or the document providing for the issuance and specifying the terms of and security for bonds.

See **Indenture/Bond Resolution (General, Supplemental, and Series)**.

BOND TRANSCRIPT

All legal and financial documents, including bond counsel's legal opinion and other opinions, associated with the offering of new issue of municipal securities.

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BONDED DEBT

The portion of an issuer's total tax-supported debt represented by outstanding bonds. Bonded debt can be calculated in several manners:

Direct Debt or Gross Bonded Debt - The sum of the total bonded debt and any short-term debt of the issuer. Direct debt may be incurred in the issuer's own name or assumed through the annexation of territory or consolidation with another governmental unit.

Net Direct Debt or Net Bonded Debt - Direct debt less sinking fund accumulations and all self-supporting debt.

Overall Debt or Total Overall Debt or Total Direct and Overlapping Debt - Total direct debt plus the issuer's applicable share of the total debt of all overlapping jurisdictions.

Net Overall Debt or Total Direct and Overlapping Debt - Net direct debt plus the issuer's applicable share of the net debt of all overlapping jurisdictions.

Overlapping Debt - The issuer's proportionate share of the debt of other local governmental units that either overlap it (the issuer is located either wholly or partly within the geographic limits of the other units) or underlie it (the other units are located within the geographic limits of the issuer). The debt is generally apportioned based upon relative assessed values.

BONDHOLDER

The person or entity having a true and legal ownership interest in a municipal bond. See **Beneficial Owner**.

BOOK ENTRY ONLY REGISTRATION

A form of registration of the ownership of registered bonds in which the owners of bonds are not entitled to the receipt of printed bonds. Rather, the terms of the bonds are specified by the indenture or bond resolution or by the form of a single bond delivered to a securities depository, generally, The Depository Trust Company (DTC), and the beneficial ownership of bonds is determined by entries on the registration books of the registrar or by the records of members of the securities depository.

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The sale of a bond issued in book entry form is evidenced by a receipt provided by the broker-dealer to the investor and not by the issuance of a new registered bond with the owner's name.

BOOK VALUE

The value at which a security is carried on the financial records of its owner, which may be the original cost of acquisition of the security or original cost adjusted by amortization of a premium or accretion of a discount.

BROKER

(1) A person or firm that is engaged in the business of effecting securities transactions for the account of others. A broker engaged in the business of effecting such transactions in municipal securities is known as a "municipal securities broker."

(2) Commonly used to refer to a registered representative or a municipal securities representative who interacts directly with a customer.

Compare **Dealer**.

BROKER-DEALER

A general term for a securities firm that is engaged in both buying and selling securities for customers (i.e., agency or riskless principal trades) and/or for its own account (i.e., principal trades).

BULLET

Principal of an issue to be retired in a single final maturity that constitutes the entire principal of the issue.

A bullet issue has no amortization of principal or sinking fund redemption before its final maturity. There may, however, be a sinking fund to accumulate the amount necessary to make the final maturity payment.

CALAMITY CALL

An extraordinary redemption triggered by the destruction of or substantial damage to the facilities from which the revenues of the bond were payable. See Section 2.3.1 Redemption or Prepayment.

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CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION (CDIAC)

The California Debt and Investment Advisory Commission (CDIAC) provides information, education, and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals. The Commission was created in 1981 with the passage of Chapter 1088, Statutes of 1981 (Assembly Bill (AB) 1192, Costa), which established CDIAC (formerly, the California Debt Advisory Commission) as the State's clearinghouse for public debt issuance information and required it to assist state and local agencies with the monitoring, issuance, and management of public debt. With the passage of Chapter 833, Statutes of 1996 (AB 1197, Takasugi), CDIAC's mission was expanded to cover public investments.

CALIFORNIA ENVIRONMENTAL QUALITY ACT (CEQA)

The California Environmental Quality Act (CEQA) is a statute that requires state and local agencies to identify the environmental impacts of their actions and to avoid or mitigate those impacts, if feasible.

CALL

To give notice of redemption; to redeem. See **Section 2.3.1 Redemption or Prepayment**.

CALL PROTECTION

The aspects of the redemption provisions of an issue of callable bonds that partially protect an investor against an issuer's prepayment of the bonds before maturity or act as a disincentive to the issuer's exercise of its call privileges.

Call protection features may include restrictions on an issuer's right to call bonds for a period of time after issuance (for example, an issue that cannot be called for 10 years after its issuance is said to have "10 years of call protection" or "10-year no-call") or requirements that an issuer pay a premium call price for bonds called within a certain period of time after issuance. See **Section 2.3.1 Redemption or Prepayment**.

CALLABLE BOND

A bond that the issuer is permitted to redeem before the stated maturity at a specified price, usually at or above par, by giving notice of redemption in a manner specified in the bond contract.

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CAPITAL APPRECIATION BOND

See **Compound Interest Bond**.

CAPITAL EXPENDITURES

Capital expenditures are payments by a public agency to acquire or improve long-term capital assets, like buildings and equipment. See **Working Capital Expenses** and **Section 4.8.2.2, Expenditure of Gross Proceeds**.

CAPITALIZED INTEREST (FUNDED INTEREST)

Bond proceeds reserved to pay interest on an issue for a period of time early in the term of the issue—also called funded interest. Capitalized interest may also refer to the interest to be so paid.

Interest is commonly capitalized through the date on which it is anticipated that construction of the projects being financed with the proceeds will be completed and ready for use. See **Section 4.4.3, Capitalized Interest**.

CASH FLOW

A comparison of cash receipts (revenues) to required payments (generally, debt service and operating expenses).

A cash flow may demonstrate that receipts by an issuer from a project's revenues or a mortgage portfolio, or from collection of a tax, fee, or other charge will be sufficient to equal or exceed, in each year the sum of payments of principal and interest on an issue and related expenses, generally on the basis of specified assumptions, which may include a "worst case" scenario. See **Section 3.2, Diagrams of Basic Debt Obligations**.

A cash flow may be used in the context of showing that payments of principal and interest received on investments held in an escrow will be received at such times and in sufficient amounts to equal or exceed debt service on the issue for which the escrow fund has been established, such as is required for an advance refunding. See **Section 3.7.6, Refunding Bonds**.

In a tax and revenue anticipation note financing, a cash flow may be used to determine the amount of the issuer's operating deficit, which is a factor in determining the permitted size of the issue under federal tax rules. See **Section 3.3.4, TRANs and RANs** and **Section 4.5, Cash Flow Borrowings**.

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CASH FLOW FINANCING

A financing in which the proceeds of the issue are used to pay current expenses of the issuer when the issuer's current income is temporarily insufficient for that purpose. See **Section 3.3.4, TRANs and RANs** and **Section 4.5, Cash Flow Borrowings**.

CERTIFICATE OF PARTICIPATION (COP)

A certificate representing an undivided interest in the payments made by a public agency pursuant to a financing lease or an installment sale agreement. See **Sections 1.3.1 Lease Revenue Bonds and Certificates of Participation** and **3.6.3 Certificates of Participation**.

CHAPTER 9 BANKRUPTCY

Chapter 9 of the United States Bankruptcy Code governs public agency bankruptcy. See **Appendix D, Municipal Bankruptcy**.

CHARTER CITY

A California city with a voter-approved city charter. See **Section 1.5, Charter Cities**. Compare **General Law City**.

CLOSING

The exchange of securities for payment in a new issue.

CLOSING DATE

The date on which an issue of bonds is issued and delivered by the issuer to, and paid for by, the original purchaser (often an underwriter). Also called the delivery date. This may be a different date than the sale date or the dated date.

CO-BOND COUNSEL

An attorney or law firm working for the issuer as a bond counsel in cooperation with another bond counsel.

BACK

COMMERCIAL PAPER (CP)

Notes of varying, very shortterm maturities (no more than 270 days and generally 1 to 90 days) that are generally rolled over in a series of current refundings as portions of the issue mature from time to time. See Section 3.4.3, Commercial Paper.

COMMISSION

A form of remuneration received by a municipal securities dealer purchasing or selling securities when acting as agent for a customer.

COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO)

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of professional accounting organizations dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control, and fraud deterrence.

COMPETITIVE SALE

The sale of bonds to the bidder presenting the best bid at the time and place specified in a published notice of sale (also called a public sale). See Section 5.2, Competitive Sales.

COMPOSITE ISSUE

Two or more issues that have substantially identical terms and that are sold and delivered at the same time (by one or more issuers).

Generally, each issue in a composite issue is used to finance a separate project or purpose. The proceeds are not pooled but rather, the issues are pooled into a composite issue for purposes of marketing. A single Official Statement is used to sell the issues.

See also **Pooling of Debt Issues**.

COMPOUND

To treat accrued interest as if it were principal, so that interest thereafter accrues on the sum of the principal and the compounded interest.

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COMPOUND INTEREST BOND

A bond on which interest is not payable until maturity (or earlier redemption), but compounds periodically to accumulate to a stated maturity amount.

Compound interest bonds are also called capital appreciation bonds or CABs and are sometimes misnamed "zero-coupon bonds."

See Section 2.2.2.1, Long-Term, Fixed-Rate Debt.

CONDITIONAL CALL NOTICE

A notice of redemption published by an issuer in which the issuer retains the right to rescind the notice and cancel the redemption.

CONDUIT FINANCING

A financing in which the proceeds of the issue are loaned to a nongovernmental borrower who then applies the proceeds for a project financing. See Section 3.3.9, Conduit Revenue Bonds.

CONDUIT ISSUER

A governmental agency that issues bonds in connection with a conduit financing.

CONFIRMATION

A written summary of the details of a transaction involving the purchase or sale of municipal securities provided by a municipal securities dealer to a customer.

CONTINGENT OBLIGATION

A public agency obligation contingent upon the existence or non-existence or occurrence or non-occurrence of a contingency. See Section 1.2.4.5, Contingent Obligation Exception.

CONTINUING DISCLOSURE

The ongoing disclosure provided by an issuer or obligated person as part of an undertaking entered into to allow the underwriter to comply with SEC Rule 15c2-12. See Section 8.5, Continuing Disclosure.

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CONTINUING DISCLOSURE AGREEMENT

An agreement (sometimes a certificate) of an issuer or an obligated person containing undertakings to provide annual reports and event notices under SEC Rule 15c2-12. See Section 8.5, Continuing Disclosure.

COP

See **Certificate of Participation (COP)**.

COSTS OF ISSUANCE (COI)

The expenses paid by or on behalf of the issuer in connection with the sale and issuance of bonds. These expenses may include, but are not limited to, bond counsel's fees, disclosure counsel fees, trustee's fees, financial advisor's fees, feasibility consultant's fees, accounting fees, costs of printing the bonds, costs of printing the Official Statement or other disclosure documents, costs associated with obtaining a credit rating, and underwriter's gross spread.

COUPON BOND

A bond that generally has a number of interest coupons attached to it and that is transferable merely by delivering it to its new owner.

Each coupon is a negotiable instrument representing interest to be paid on the bond for a specified period, usually 6 months. To receive an interest payment on a coupon bond, the holder must detach the coupon and present it at the office of the trustee or paying agent—or at the holder's own bank if the bank is willing to provide the service of presenting the coupon for payment.

Coupon bonds are sometimes referred to as bearer bonds, because payment may be made to any bearer of the bond or coupon, rather than to a particular registered owner.

Compare to **Registered Bond**.

COVENANTS

Contractual obligations in financing agreements whereby the party making the promises agrees to perform or refrain from performing certain actions or to comply with certain requirements. See Section 2.4.5, Covenants.

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COVERAGE

The extent to which revenues in addition to the amount necessary to pay operating expenses and debt service are required to be collected by a rate covenant or by the conditions to the issuance of additional parity bonds.

For example, the bond resolution under which water revenue bonds are issued may require the issuer to maintain fees and charges for the sale of water at levels sufficient to enable it to collect in each year the amount necessary to pay all of its water system operating expenses, debt service on the bonds, plus an amount equal to 25% of debt service on the bonds. The additional 25% is referred to as coverage.

See **Section 3.3.6, Enterprise Fund Debt Obligations**.

CREDIT ENHANCEMENT

A facility providing security for the timely payment of principal and interest on debt whether or not those amounts are paid by the issuer. See **Section 2.3.2, Credit Enhancement and Liquidity Support**.

CREDIT RATING

An evaluation by a rating agency of the ability of the issuer of debt to make timely payments of principal and interest. See **Section 5.6, Credit Ratings** and **Nationally Recognized Statistical Rating Organization (NRSRO)**.

CROSSOVER REFUNDING

See **Refunding**.

CURRENT INTEREST BOND

A bond on which interest payments are made to the bondholders on a periodic basis. Compare **Compound Interest Bond**.

CURRENT REFUNDING

See **Refunding**.

CUSIP

The Committee on Uniform Security Identification Procedures (CUSIP) was established under the auspices of the American Bankers Association as a uniform

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method of identifying municipal, United States government, and corporate securities. A separate CUSIP number is assigned for each maturity of each issue and is printed on each bond.

DATE OF ISSUANCE

See **Closing Date**.

DATED DATE

The first date from which interest is deemed to accrue on a bond.

The dated date is typically printed on the front of the bond and can be before or as of the closing date, but not after the closing date.

DEALER

A person or firm engaged in the business of effecting securities transactions for that person's or firm's own account. Dealer is defined in the Securities Exchange Act of 1934. Compare **Broker**.

DEBT

See Introduction and Section 4.3, What Is An Issue of Debt?

DEBT LIMIT

A statutory or constitutional limit on the amount of debt that an issuer may incur or that it may have outstanding at any one time.

The constitutional debt limit for California cities and counties is in the California Constitution at Article XVI, Section 18, and for the State of California is Article XVI, Section 1. See Section 1.2, Constitutional Debt Limit. California statutes also provide debt limits for different entities.

DEBT LIMIT EXCEPTIONS

Exceptions to the Constitutional debt limit recognized by California courts. The principal debt limit "exceptions" are the following:

1. Current Fiscal Year Exception
2. Annual Appropriation Exception

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3. Lease Exception (Offner-Dean Lease Exception)
4. Special Fund Exception
5. Contingent Obligation Exception
6. Obligations Imposed by Law Exception

See **Section 1.2.4, Exceptions to the Debt Limit**.

DEBT POLICY

GFOA has defined Debt Policies as "written guidelines, allowances, and restrictions that guide the debt issuance practice of state or local governments, including the issuance process, management of a debt portfolio, and adherence to various laws and regulations".

DEBT RATIOS

Comparative statistics showing the relationship between the issuer's outstanding debt and such factors as its tax base, income, or population. Some of the more commonly used ratios are (a) net overall debt to assessed valuation, (b) net overall debt to estimated full valuation, (c) net overall debt per capital, and (d) tax-supported debt to personal income.

DEBT SERVICE

The total of interest, principal, and mandatory sinking fund payments.

DEBT SERVICE ACCOUNT (BOND ACCOUNT OR PRINCIPAL, INTEREST, AND REDEMPTION ACCOUNTS)

The account or accounts into which the issuer makes periodic deposits to assure the timely availability of sufficient monies for the payment of debt service on an issue. See **Section 2.4.3, Funds and Accounts; Flow of Funds**.

DEBT SERVICE RESERVE ACCOUNT

See **Reserve Account (Bond Reserve Account or Debt Service Reserve Account)**.

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DEBT SERVICE RESERVE FUND REQUIREMENT

The amount required to be maintained in a reserve fund or reserve account. See **Section 2.4.4, Debt Service Reserve Fund**.

DEDICATED POOL

See **Pooling of Debt Issues**.

DEEMED FINAL

Under SEC Rule 15c2-12, before bidding for, offering, or selling bonds, an underwriter must obtain and review an Official Statement (usually a Preliminary Official Statement) deemed final as of its date by the issuer. See **Section 6.2.1, Municipal Advisors and Underwriters**.

DEFAULT/EVENT OF DEFAULT

Failure to make prompt payment on a bond or otherwise comply with other covenants in financing agreements. See **Section 2.4.8, Events of Default and Remedies**.

DEFEASANCE

The termination of the rights and interests (including the pledge of revenues but not including the right to payment) of the bondholders under the indenture or bond resolution upon provision for payment of all debt service on bonds, all in the specific manner required by the indenture or bond resolution. See **Section 2.4.10, Discharge and Defeasance**.

DEFERRED INTEREST BOND

See **Capital Appreciation Bond**.

DELIVERY DATE

See **Closing Date**.

DEMAND BOND (PUT BOND OR TENDER OPTION BOND)

A bond that the holder has the right to sell back to the issuer, a nongovernmental borrower, or another party at specified times and for a specified price (usually par).

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Demand bonds are sometimes referred to as put bonds or tender option bonds because the holder can "put," or has an option to tender, the bond back to the issuer.

See Section 2.2.2.3, Variable-Rate Debt and Section 3.4.2, Long-Term, Variable-Rate Debt.

DENOMINATION

The face amount of a bond—generally its original principal amount. Usually the denominations are $5,000 or any integral multiple of $5,000. In some shortterm or variable-rate financings, denominations may be multiples of $100,000 or in multiples of $5,000 in excess of $100,000. Bonds privately placed with institutional investors generally have large minimum denominations. See Section 5.5, Private Placements.

For compound interest bonds, denominations may be expressed in terms of either the original principal amount (in which case they may be odd dollar amounts) or compounded maturity or conversion amount (in which case they will commonly be multiples of $5,000).

DEPOSITORY

A registered clearing agency that provides immobilization, safekeeping and book-entry and settlement services to its participants.

DERIVATIVE

A product whose value is derived from an underlying security or other asset structured to deliver varying benefits to different market segments and participants. The term encompasses a wide range of products offered in the marketplace including interest rate swaps, caps, floors, collars, and other synthetic variable-rate products. See Chapter 2 - Debt Structures - Interest Rate Swaps and Synthetic Structures.

DILLION'S RULE

Dillon's rule is used in interpreting state law when there is a question of whether or not a local government has a certain power. See Section 1.1, A Public Agency's Authority to Borrow. See **Home Rule**.

DIRECT LEASE

Generally, a lease to finance the acquisition of equipment under which a public agency leases property from a vendor. See Section 3.7, Direct Leases.

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DIRECT LOAN

A loan to a municipal issuer from a banking institution or another lender. The obligations may constitute municipal securities. See Section 5.5, Private Placements.

DIRECT SUBSIDY

A federal cash subsidy paid directly to the issuer of municipal securities in an amount that may be equal to a percentage of the interest paid on the municipal securities. The subsidy is typically provided in lieu of the exemption from gross income for federal income tax purposes of the bondholders of such municipal securities. See Chapter 4 - Federal and State Tax Law Requirements.

DIRECT SUBSIDY BOND

A municipal security that entitles the issuer to receive direct pay subsidies. New issues of direct subsidy bonds were eliminated by the "Tax Cuts and Jobs Act"[1] enacted in December 2017. See Chapter 4 - Federal and State Tax Law Requirements.

DISCLOSURE

Providing to investors (usually in the form of an Official Statement) all material facts relating to an issue. See Section 6.1, Federal Securities Laws.

DISCLOSURE COUNSEL

An attorney or law firm retained by the issuer to provide advice on the issuer's securities law disclosure obligations and to assist in the preparation of the official statement or other offering document.

DISCLOSURE POLICY

Provide specific guidance on who, how, and when the issuer will provide ongoing disclosures as required by SEC Rule 15c2-12.

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[1] Although originally introduced as the "Tax Cuts and Jobs Act," that title was not included in the final enacted legislation but continues to be a colloquial reference. The official title of the tax reform legislation (Public Law 115-97) is *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*.

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DISCOUNT

The amount, if any, by which the sale price of a bond is less than its principal amount or par value. See also **Underwriter's Gross Spread (Underwriter's Discount)**.

Original issue discount (OID) is the amount by which the principal amount or par value of a bond exceeds the offering price to the public at the time it is originally sold, or if sold in a private placement, the price to its first purchaser.

DISSEMINATION AGENT

An agent appointed under a continuing disclosure agreement for the purpose of filing annual reports and event notices with the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) system and state information depositories. See **EMMA** and **Section 8.5, Continuing Disclosure**.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (DODD-FRANK ACT)

Financial reform legislation enacted by Congress in 2010 that amended various federal laws including the federal securities laws.

DRAWDOWN SCHEDULE

A schedule of estimated expenditures to be made from bond proceeds and other available funds on a construction project.

DUE DILIGENCE

The inquiry made to reveal or confirm facts about the issuer, the issue, and the security for the issue that would be material to a prudent investor in making a decision to purchase the issue.

Due diligence inquiries are made by underwriters and lawyers to determine, for example, whether the issue follows the purpose and scope outlined by the enabling legislation, statutes, and resolutions of the issuer and whether all material facts have been accurately disclosed in the Official Statement. Courts have generally concluded that participants who demonstrate that they have conducted reasonable investigations resulting in a reasonable belief in the accuracy and sufficiency of the disclosure document have satisfied their responsibilities under the disclosure laws relating to municipal bonds.

See **Section 6.3, The Official Statement**.

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ECONOMIC USEFUL LIFE

The period over which an asset may reasonably be expected to yield economic benefit to its owner.

Because economic factors can render property useless for its intended purpose long before the property deteriorates physically, the economic useful life of an asset is often different from its physical life. The maturity of an issue of bonds generally may not exceed 120% of the weighted average useful life of financed facilities if interest on the bonds is to be taxexempt. In determining the economic useful life for this purpose, a safe harbor is available by reference to periods prescribed by the Internal Revenue Service under its Asset Depreciation Range (ADR) system.

See **Section 4.4, Capital Expenditures Financings**.

ELECTRONIC BID

The process of submitting a competitive bid for a new issue of municipal securities or a bid on a secondary market trade through any of several proprietary services that facilitate the collection of bids by electronic means. See **Section 5.2.3, Documentation for a Competitive Sale**.

ELECTRONIC MUNICIPAL MARKET ACCESS (EMMA)

The Electronic Municipal Market Access (EMMA) system is a centralized online source for free access to municipal disclosures, market transparency data and educational materials about the municipal securities market operated by the Municipal Securities Rulemaking Board (MSRB). Among other things, EMMA serves as the official source for official statements and other primary market disclosure documents for new issues of municipal securities as well as the official source for continuing disclosures for outstanding issues of municipal securities for which the issuer or obligated person has entered into a continuing disclosure agreement as contemplated under SEC Rule 15c2-12.

ELIGIBLE COSTS

"Eligible costs" generally refers to the costs that issuers can pay or be reimbursed for with the proceeds of a particular type of bond under the Internal Revenue Code of 1986 or under the statutes and authorizations pursuant which particular bonds are issued. Eligible costs will vary from issue to issue, but generally

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include direct costs of issuance such as costs paid directly to financial and legal advisors, trustees, paying agents, rating agencies and other professional services; underwriter's fees and expenses; and project costs such as the costs of acquiring, constructing, and/or renovating the proposed project.

See **Costs of Issuance**, **Proceeds/Sale Proceeds/Investment Proceeds/Gross Proceeds/Net Proceeds**. See **Chapter 4, Federal and State Tax Law Requirements**, **Section 4.6, Government Bonds/Private Activity Bonds**, **Section 4.7 Qualified Private Activity Bonds**, **Section 5.3.3, Documentation for a Negotiated Public Offering** and **Section 5.4.2 Underwriting Fees and Expenses**.

ENTERPRISE

A defined revenue-producing set of facilities that are operationally integrated and have a common service purpose.

An enterprise may consist of all of the facilities of a special district, such as a municipal water district, or may consist of only a portion of the assets of a general-purpose governmental entity, such as the water system of a city.

See **Section 3.3.6, Enterprise Fund Debt Obligations**.

ESCROW AGENT

With respect to an advance refunding, the commercial bank or trust company retained to hold the investments purchased with the proceeds of the refunding and, customarily, to use the amounts received as payments on such investments to pay debt service on the refunded bonds. See **Section 3.7.6, Refunding Bonds**.

ESCROW AGREEMENT/ESCROW DEPOSIT AGREEMENT

An agreement that typically provides for the deposit of funds or securities in an escrow account to refund an outstanding issue of municipal securities. See **Section 2.4.10, Discharge and Defeasance** and **Section 3.7.6, –Refunding Bonds**.

EVENT NOTICE

Disclosure of certain enumerated events relating to a municipal security required to be made by an issuer or obligated person to the Electronic Municipal Market Access (EMMA) system pursuant to a continuing disclosure agreement or undertaking meeting the requirements of SEC Rule 15c2-12. These disclosures

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are sometimes referred to as material event notices or disclosures even though a materiality standard applies to only certain of the required disclosures. Prior to July 1, 2009, these disclosures were made to the National Recognized Municipal Securities Information Repositories (NRMSIRs) and any state information depository. See Section 8.5, Continuing Disclosure.

EXEMPT FACILITIES

As defined in the Internal Revenue Code, airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas, local district heating or cooling facilities, and qualified hazardous waste facilities.

Qualified private activity bonds may be issued to finance exempt facilities.

See Section 3.3.91, Exempt Facilities and Section 4.7.1.1, Exempt Facility Bonds.

FAIRNESS LETTER OR FAIRNESS OPINION

A letter or opinion prepared by a financial advisor, pricing advisor or similarly qualified person opining on the fairness of the price paid by the underwriters to the issuer in connection with the new issue of municipal securities or paid by purchasers of assets.

FAST AUTOMATED SECURITIES TRANSFER (FAST)

An arrangement between The Depository Trust and Clearing Corporation and transfer agents to hold securities registered in DTC's nominee Cede & Co. in book-entry form.

FEASIBILITY CONSULTANT

The person or firm retained, customarily by the issuer, to express an opinion (generally printed as an appendix to the Official Statement) on the economic feasibility of a facility, enterprise, or lending program to be undertaken with the proceeds of an issue.

Feasibility consultants are retained for a wide variety of different types of financings, ranging from large, single projects such as a hydroelectric power plant to lending programs such as a multi-developer singlefamily mortgage revenue program. The objective of a feasibility report is to provide an assessment of one or

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more aspects of the economic feasibility of the purpose of a financing. The views of the feasibility consultant are taken into account by the credit rating agencies and investors in the process of marketing the bonds.

FIDUCIARY

A party having the duty of acting in a capacity of special trust for the benefit and in the best interests of another.

FINANCING LEASE

The document by which a public agency or other obligor leases the project to be acquired or constructed with the proceeds of the issue and by which the obligor/lessee agrees to make periodic lease payments to the issuer, generally for the period of time the issue is outstanding. See **Section 3.6.1, Financing Leases**.

FIRST COUPON

The date on which an issuer's initial interest payment to bondholders on a particular security is due.

FISCAL AGENT

A commercial bank or trust company designated by an issuer under the indenture or bond resolution to act as a fiduciary and as the custodian of monies relating to an issue.

The fiscal agent's duties typically are limited to receiving monies from the issuer that are to be held in funds and accounts created under the indenture or bond resolution and, when acting as paying agent, paying out principal and interest to bondholders.

See also **Trustee.**

FIXED-RATE

An interest rate that is set at the time a bond is issued and that does not vary during the term of the bond.

Compare to **Variable-Rate**.

FLOATING-RATE

See **Variable-Rate**.

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FLOATING-RATE NOTES

Floating-rate notes are obligations (which can be bonds) that bear interest at an index rate but are subject to mandatory tender for purchase on a future date, generally between 2 and 4 years from the offering date. See **Section 3.4.2.2, Tender or Demand Obligations**.

FLOW OF FUNDS

The provisions of an indenture or bond resolution under which pledged revenues are periodically allocated in a specified priority to accounts, if any, for operating expenses, debt service, the bond reserve account, redemption of bonds before maturity, other reserves, surplus, etc. See **Section 2.4.3, Funds and Accounts; Flow of Funds**.

FORECLOSURE

A lawsuit by which the issuer of assessments or Mello-Roos bonds enforces the payment obligation against a defaulting landowner by suing to have the property sold to repay the debt. See **Section 3.3.7.2, Mello-Roos Bonds (Community Facilities Districts)**.

GENERAL FUND

A general fund is the governmental fund where a public agency accounts for everything not reported in another fund. See **Governmental Fund**.

GENERAL LAW CITY

A California city without a voter-approved charter. Compare **Charter City**.

GENERAL TAX

A tax levied by a general-purpose local governmental entity for general revenue purposes. See **Section 1.4.5, General Taxes**.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Standards adopted by the Financial Accounting Standards Board (FASB) for preparing financial statements of private enterprises and by the Governmental Accounting Standards Board (GASB) for preparing financial statements of state and local governments.

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GOOD FAITH DEPOSIT

A deposit made with the issuer of a new issue by an underwriter in a negotiated sale or a winning bidder in a competitive sale as assurance that the underwriter or winning bidder will proceed with the closing of the purchase of the issue if the issuer meets all of the conditions of the bond purchase contract and notice of sale.

The good faith deposit is often 1% of the par value of the issue, and can be provided in the form of a certified or cashier's check or a wire transfer. In the event the winning bidder or underwriter fails to take delivery of and pay for the new issue for reasons other than those permitted under the notice of sale or the bond purchase contract, the good faith deposit may be retained by the issuer as liquidated damages.

See Section 5.3, Negotiated Public Offerings and Section 5.2, Competitive Sales.

GOVERNMENT FINANCE OFFICERS ASSOCIATION (GFOA)

The Government Finance Officers Association (GFOA) represents public finance officials throughout the United States and Canada. The GFOA's mission is to promote excellence in state and local government financial management.

GOVERNMENTAL ACCOUNTING STANDARDS BOARD (GASB)

The Governmental Accounting Standards Board (GASB) is a standard-setting body that establishes the standard of financial accounting and reporting practices for state and local governmental units.

GOVERNMENTAL BONDS

Bonds that are issued by a public agency and are not private activity bonds. See Section 4.6, Governmental Bonds/Private Activity Bonds.

GOVERNMENTAL FUND

Types of funds defined by the Governmental Accounting Standards Board that are used by governmental entities for accounting and reporting. Governmental fund types include general fund, special revenue fund, capital projects fund, debt service fund, and permanent fund.

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GREEN BONDS

Municipal debt securities the proceeds of which will be used to finance environmentally beneficial projects. See **Section 5.7.2, Targeting Investors**.

GROSS PROCEEDS

See **Proceeds/Sale Proceeds/Investment Proceeds/Gross Proceeds/Net Proceeds**.

GROSS REVENUES

See **Revenues/Gross Revenues/Net Revenues**.

GROSS-UP CLAUSE

A provision in a bond contract in which the issuer agrees to pay a higher rate of interest in the event of the occurrence of certain events, typically where interest on bonds issued as tax-exempt bonds becomes taxable.

GUARANTEED INVESTMENT CONTRACT (GIC)

Proceeds of bonds may be invested under investment agreements commonly known as "guaranteed investment contracts" (GICs), where the issuer is guaranteed a certain rate of return on the amount of bond proceeds being invested with an investment provider. GICs usually involve the portion of bond proceeds used to finance capital improvements or held as a reasonably required reserve fund. See **Section 4.8.3.2, Guaranteed Investment Contract**.

HEDGE

An investment entered into to reduce or offset the risk of adverse price movements in a security by taking an offsetting position in another investment.

HEDGE BONDS

Bonds issued substantially in advance of when monies will be needed for the purpose being financed, in order to hedge against subsequent interest rate increases. See **Section 4.4.1, Issue Sizing and Term**.

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HIGH-YIELD BOND

A bond that is typically non-rated or rated below investment grade. High-yield bonds trade at higher yields than investment-grade securities.

HOME RULE

California is known as a "Home Rule" state. The California Constitution provides both general law and charter cities and counties the authority to: make and enforce all local laws and regulations not in conflict with general state laws (article XI, section 7); and, to be free from state legislation delegating to a private person or body control over county or city property, funds, tax levies and municipal functions (article XI, section 11); and provides both general law and charter cities the authority to establish, purchase, and operate public works and utilities or franchise others to do so (article XI, section 9).

Cities with voter-approved charters have additional authority or "home rule" over their municipal affairs, police, subgovernments, elections, and their elected and appointed officials and employees as delineated in the state constitution, under article XI, section 5. The provisions of a charter and the local ordinances adopted by a charter city prevail over general state law in areas that a court has determined are municipal affairs, including the areas identified under article XI, section 5. For matters of statewide concern, charter cities remain subject to state law.

Counties with voter-approved charters have greater flexibility than other counties respecting organization and the manner of performing county functions (article XI, section 4).

INDENTURE/BOND RESOLUTION (GENERAL, SUPPLEMENTAL, AND SERIES)

An agreement executed by an issuer and a trustee (or fiscal agent) that pledges certain revenues and other property as security for the repayment of the issue, sets forth the terms of the bonds, and contains the responsibilities and duties of the trustee and the rights of the bondholders.

A bond resolution differs from an indenture in that the issuer unilaterally adopts the resolution, which is then accepted as an agreement by the trustee or fiscal agent in a separate document. The provisions of a resolution used in this manner do not differ substantially from those of an indenture.

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General and series indentures are used when several issues of parity bonds are to be issued. The general indenture customarily specifies the matters that will be common to all series of bonds, and the series indenture is a supplemental indenture that specifies the terms of the particular series and any other features that are unique to that series.

A supplemental indenture is an indenture that amends or supplements a prior indenture, whether that prior indenture stands by itself, is a general indenture, or a series indenture.

See **Section 3.1.4, Unique Public Agency Financings that Address Legal Constraints or Public Policy Issues**.

The term bond resolution is often also used to mean a resolution that authorizes the issuance of bonds, and may or may not also authorize the execution of an indenture. See **Bond Resolution.**

INDEX DEBT

A debt obligation, the interest on which is adjusted periodically in accordance with a published formula. See **Section 3.4.2, Long-Term, Variable-Rate Debt**.

INDUCEMENT RESOLUTION

A very preliminary resolution of the governing body of an issuer confirming its then-current intent to issue qualified private activity bonds for a specified project.

An inducement resolution is not legally binding on the issuer, but serves to mark the time under federal tax rules after which costs expended on the project qualify for financing with taxexempt bonds.

See **Section 4.4.5, Reimbursement of Prior Expenditures**.

INFORMATION REPORTING REQUIREMENT

The requirement to report to the Internal Revenue Service certain information about a new issue if interest on the issue is to be taxexempt. These reports must be filed on IRS Form 8038, 8038-G, or 8038-GC and must be submitted no later than the 15th day of the second month following the close of the calendar quarter in which the bonds are issued.

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INITIAL OFFERING PRICE

The price at which a new issue of municipal securities is offered to the public at the time of original issuance. This price is sometimes referred to as the "public offering price."

The initial offering price may be at a discount to par, par, or a premium to par.

INITIATIVE POWER

The power reserved to the people to effect changes to the California Constitution or to enact or amend statutes through the initiative process. See Section 1.6, The Initiative and Referendum Powers.

INSIDER TRADING

Conduct in violation of federal securities laws, whereby a person buys or sells a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, non-public information. Insider trading also may occur when, in breach of a fiduciary duty, a person discloses such material, non-public information to a third party who buys or sells a security on the basis of that information.

INSTALLMENT SALE AGREEMENT/INSTALLMENT PURCHASE CONTRACT

The document by which a public agency or other obligor purchases the project to be acquired or constructed with the proceeds of an issue and by which the obligor/purchaser agrees to make periodic installment payments, generally for the period of time the issue is outstanding. See Section 3.6.2, Installment Sale Agreements.

INSTRUMENT

An instrument or debt instrument is a paper or electronic obligation that enables the issuing party to raise funds by promising to repay a lender in accordance with terms of a contract. Types of debt instruments include notes, bonds, debentures, certificates, mortgages, leases or other agreements between a lender and a borrower. These instruments provide a way for market participants to easily transfer the ownership of debt obligations from one party to another.

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INTERCEPT PROGRAM

An intercept program is a program by which bond documents permit the bond trustee to intercept revenues from a third party that would otherwise flow to the issuer in order to pay debt service on the bonds. The most common such program in California relates to motor vehicle license fee revenues, which are normally collected by the state and distributed to cities and counties under a formula. Under California Government Code Section 37351.5 (for cities) and Section 25350.55 (for counties), cities and counties can elect to have certain lease obligations (such as **COPs**) secured by a pledge of motor vehicle license fee revenues. If the issuer then fails to make a lease payment when due, the trustee can notify the State Controller and obtain funds directly from the issuer's account within the State Motor Vehicle License Fee Fund to make the lease payment.

INTEREST/INTEREST RATE

A charge paid to the bondholder by the issuer for the use or borrowing of money. The interest rate is the interest charge expressed as a percentage of principal (which generally corresponds roughly to the amount borrowed) accruing over a specified period (generally a year) so long as the debt remains unpaid.

Interest may be paid or may compound at intervals different from the period used to express the interest rate. For example, interest on current interest fixed-rate bonds generally is expressed as an annual rate, but is paid twice per year, with each payment being onehalf of the amount that would accrue over an entire year. Interest on compound interest, fixed-rate bonds generally is compounded twice per year and paid at maturity. Interest on variable-rate bonds accrues at a rate that changes from time to time (perhaps as often as daily), but each such rate is nevertheless generally expressed as a percentage per year.

The amount of interest that has accrued over a period shorter than the payment or compounding interval may be determined by one of several different rules. For example, if interest accrues "on the basis of a 360-day year of 12 30-day months," the amount of interest that has accrued since the last payment or compounding date is calculated assuming that 1/12 of 1 year's interest accrues for each complete calendar month and 1/360 of 1 year's interest accrues for each additional day. On the other hand, if interest is calculated on the basis of a year of 365 days and the actual number of days elapsed, the amount of interest accrued since the last payment or compounding date is calculated assuming that 1/365 of 1 year's interest accrues each day.

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Generally, interest on fixed-rate bonds is calculated on the basis of a 360day year and interest on variable-rate bonds is calculated on the basis of a 365day year.

See **Section 2.2.2, Term and Interest Rate Mode**.

INTEREST RATE SWAP

See **Derivative** and **Section 2.3.3, Interest Rate Swaps and Synthetic Structures**.

INVESTMENT AGREEMENT

See **Guaranteed Investment Contract (GIC)**.

INVESTMENT OF PROCEEDS

The investment of proceeds and other monies relating to an issue, typically governed by state law, and by the indenture or bond resolution and the issuer's investment policies. See **Chapter 9 - Investment of Bond Funds**.

INVESTMENT PROCEEDS

See **Proceeds**.

INVESTORS/INSTITUTIONAL INVESTORS/RETAIL INVESTORS

Investors are persons or firms who purchase bonds. They are in effect loaning their money (the amount of their investment) to the issuer of the bonds in exchange for the issuer's obligation to repay them with interest. Investors are often thought of in two broad classes: institutional and retail.

An institutional investor is a mutual fund, insurance company, bank, or other financial institution that buys bonds, usually in very large blocks (sometimes in the tens of millions of dollars). Institutional investors have professional staffs whose purpose is to analyze credit risk, monitor investments, and manage the investor's assets.

A retail investor is an individual who purchases bonds, usually in small blocks—as small as $5,000. Retail investors vary from the quite unsophisticated investor with a small amount of savings (often colloquially referred to as the "widows and orphans") to so called "high net worth" individuals who may have significant holdings and experience in the bond market.

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ISSUE (NOUN)

One or more bonds initially delivered by an issuer in a substantially simultaneous transaction and which are generally designated in a manner that distinguishes them from bonds of other issues.

Bonds of a single issue may vary in maturity, interest rate, redemption, and other provisions.

For federal income tax purposes, the meaning of the term issue may depend upon the context in which it is used and may differ from definitions used under state law or in bond documents. For example, bonds of different issuers sold at substantially the same time, payable from substantially the same source of funds, and sold under a common financing plan may be a single issue for certain federal tax purposes.

ISSUE (VERB)

To execute and deliver securities for sale in the primary market. For federal income tax purposes, securities are "issued" when delivered and paid for.

ISSUER

The public agency issuing (selling) the municipal debt (even in a conduit financing).

JOINT POWERS AUTHORITY

Joint powers authority (JPA) is a type of constituted authority created under Government Code Section 6500 et seq. See Section 3.8, Joint Exercise of Powers Agencies.

LEAD UNDERWRITER

The member or members, in the case of a shared lead role, of an underwriting syndicate charged with primary responsibility for conducting the affairs of the syndicate for the purpose of purchasing an issue from an issuer; or the underwriter of an issue when no underwriting syndicate has been formed.

LESSOR/LESSEE

The landlord (lessor) or tenant (lessee) under a lease. See Section 3.6.1, Financing Leases.

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LETTER OF CREDIT

An arrangement with a bank that provides additional security that money will be available to pay debt service on an issue.

Letters of credit are also used as liquidity facilities in connection with obligations such as commercial paper or demand bonds. The trustee may draw upon the letter of credit if commercial paper has matured and not been rolled over by issuing new commercial paper, or if demand bond owners put them to the issuer, and the remarketing agent is unable to find new purchasers.

Customarily, a letter of credit is issued by a commercial bank directly to the trustee and is irrevocable until a specified date. The letter of credit entitles the trustee, if certain conditions are met, to draw upon the letter of credit by submitting to the bank a written request for payment (a draft) and other carefully specified documents and certificates. If the documents submitted for the draw meet the requirements specified in the letter of credit, the bank must pay as provided in the letter of credit.

See **Section 2.3.2, Credit Enhancement and Liquidity Support**. Compare **Line of Credit**.

LEVEL DEBT SERVICE

A debt service schedule in which the combined annual amount of principal and interest payments remains relatively constant over the life of the issue of bonds.

LEVEL PRINCIPAL

A debt service schedule in which the annual amount of principal payments remains relatively constant over the life of the issue of bonds, resulting in declining annual debt service as the annual amount of interest payments declines. This is sometimes referred to as "declining debt service."

LIABILITIES

Amounts a government owes to a person, group or vendor outside the government. (definition from GASB's An Analyst's Guide to Government Financial Statements.)

LINE OF CREDIT

A line of credit is a contract between the issuer and a bank that provides a source of borrowed monies to the issuer in the event that monies available to pay debt

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service (e.g., on commercial paper) or to purchase a demand bond are insufficient for that purpose. See Section 2.3.2, Credit Enhancement and Liquidity Support. Compare **Letter of Credit**.

LIQUIDITY

The ease with which an investment may be converted to cash, either by selling it in the secondary market or by demanding its repurchase under a put or other prearranged agreement with the issuer or another party.

LIQUIDITY FACILITY OR LIQUIDITY SUPPORT

See **Letter of Credit** and **Line of Credit**.

LISTED EVENT

An event that is required to be reported through the Electronic Municipal Market Access (EMMA) website maintained by the Municipal Securities Rulemaking Board (MSRB) under an undertaking to provide continuing disclosure under SEC Rule 15c2-12. See Section 8.4.2, Event Notices.

LOAN AGREEMENT

An agreement under which the proceeds of a conduit financing are loaned to the nongovernmental borrower and the borrower agrees to pay to the issuer or the trustee the amounts necessary to pay debt service on the issue.

A loan agreement usually includes a set of covenants, financial tests, and restrictive provisions governing the borrower and the project financed.

See Section 3.3.9, –Conduit Revenue Bonds and Section 8.1.1, Bond Documents.

LOCAL PUBLIC AGENCY

Any city, city and county, county, public district, public corporation, joint exercise of powers authority (JPA), agency, board, commission, or other local public entity.

LOCAL REVENUE SOURCES

See Section 1.4, Local Government Revenue Sources – Security for and Repayment of Debt.

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LONDON INTERBANK OFFERED RATE (LIBOR)

The London Interbank Offered Rate (LIBOR) represents the average rate at which a leading bank can obtain unsecured funding in the London interbank market, it is based on the rates that Banks believe they can borrow at and is not based on actual transactions. LIBOR has served as a benchmark or index used globally as the standard to price or set interest rates on a variety of financial instruments in the variable-rate municipal market. Due to the nature of the rate setting process, LIBOR will be discontinued by the end of 2021. See **SOFR**.

MAKE-WHOLE CALL

A type of redemption provision allowing the issuer to pay off debt early that is designed to protect the investor from losses as a result of the earlier call, with the redemption provision derived from a formula based on the net present value of future interest payments that will not be paid as a result of the call. See **Section 2.3.1, Redemption or Prepayment**.

MANAGEMENT FEE

See **Underwriter's Gross Spread (Underwriter's Discount)**.

MANAGING UNDERWRITER

See **Lead Underwriter**.

MARKETABILITY

The ease or difficulty with which securities can be sold in the market.

MARK-TO-MARKET

A process whereby the value of a security for accounting purposes is adjusted to reflect its current market value.

MARKS-ROOS BONDS

Bonds issued by a joint exercise of powers agency under the Marks-Roos Local Bond Pooling Act of 1985. See **Section 3.8, Joint Exercise of Powers Agencies**.

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MATERIAL/MATERIAL FACTS

Generally, facts that a reasonable investor would want to know in making an investment decision. See **Section 6.1.1, Anti-fraud Rules**.

MATURE

With respect to principal, to become due and payable under a bond's original terms (not by acceleration). See also **Maturity**.

MATURITY

With respect to a single bond, the date upon which the principal of the bond is stated to be due. With respect to an issue, all of the bonds of an issue that are due on a single date. See also **Term**.

MATURITY SCHEDULE

A schedule listing the dates upon which the issuer is obligated to repay principal on the debt and the corresponding amount of the issuer's repayment obligation.

MELLO-ROOS BONDS

Bonds issued under the Mello-Roos Community Facilities District Act of 1982. See **Section 3.3.7.2. Mello-Roos Bonds**.

MONEY MARKET ELIGIBLE SECURITIES

Securities that are permissible investments for money market funds under SEC Rule 2a-7.

MORAL OBLIGATION BOND

A bond that, in addition to its primary source of security, is also secured by a non-binding covenant that any amount necessary to make up any deficiency in debt service will be included in the budget recommendation made to the governing body, which may appropriate funds to make up the shortfall where the governing body is not legally obligated to make the appropriation.

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MULTIMODAL BONDS

Bonds that can be converted to different interest rate modes at the option of the issuer—or in the case of conduit bonds, the borrower.

Typically, multimodal bond documents permit bonds to be remarketed in daily, weekly, or monthly interest rate modes as variable-rate tender option bonds and in term or fixed-rate modes as well. Sometimes, "commercial paper mode" or "flexible-rate mode" is included to allow the bonds to be broken up into pieces that have different interest rate periods.

See Section 3.4.2, Long-Term, Variable-Rate Debt.

MUNICIPAL ADVISOR

A person or entity (with certain exceptions) that (a) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning the financial products or issues, or (b) solicits a municipal entity, for compensation, on behalf of an unaffiliated municipal securities dealer, Municipal Advisor, or investment advisor to engage that party in connection with municipal financial products, the issuance of municipal securities, or investment advisory services.

MUNICIPAL AFFAIRS

Term used in interpreting state law when there is a question of whether or not a charter city has a certain power. See Section 1.1.3, Borrowing Authority of Charter Cities and Section 1.5.1, Charter City Powers – Municipal Affairs vs. Statewide Concerns.

MUNICIPAL DEBT STRUCTURES

See Chapter 2, Debt Structures: What Factors Drive Structuring Decisions? and Chapter 3, Types of Debt Obligations Issued by Public Agencies.

MUNICIPAL SECURITIES RULEMAKING BOARD (MSRB)

An independent, self-regulatory organization established by Congress in 1975 having general rulemaking authority over municipal securities market participants (generally brokers and dealers).

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The MSRB is required by federal law to propose and adopt rules in the areas of professional qualification standards, rules of fair practice, record keeping, the scope and frequency of compliance examinations, the form and content of municipal bond quotations, and sales to related portfolios during the underwriting period.

Members of the board include: securities firm representatives, bank dealer representatives, municipal advisors and public members. All market participants subject to MSRB jurisdiction are required to register with the SEC. Its jurisdiction does not extend to issuers of municipal securities. In recognition of the existing regulatory structure in place for banks and securities firms, the MSRB does not have inspection or enforcement authority.

NATIONAL ASSOCIATION OF BOND LAWYERS (NABL)

The National Association of Bond Lawyers (NABL) was established to promote the integrity of the municipal market through the education of its members in the laws affecting state and municipal bonds.

NATIONALLY RECOGNIZED MUNICIPAL SECURITIES INFORMATION REPOSITORY (NRMSIR)

Nationally Recognized Municipal Securities Information Repository or NRMSIRs were the repositories for all annual reports and event notices filed under SEC Rule 15c2-12 prior to July 1, 2009. Beginning on that date, all reporting under SEC Rule 15c2-12 must be submitted to the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) System. See **Electronic Municipal Market Access (EMMA) System**.

NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION (NRSRO)

A credit rating agency is required to register as a Nationally Recognized Statistical Rating Organization (NRSRO) with the United States Securities and Exchange Commission (SEC). See **Section 5.6, Credit Ratings** and **Credit Rating Agency**.

NATURAL PERSON

Legally, a natural person is the reference to an individual, living human being with certain rights and responsibilities under the law. A legal person is different because it can be a group of people or a corporation that is acting as a single individual under the law.

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NEGATIVE ARBITRAGE

Investment of bond proceeds and other related funds at a rate below the bond yield or the amount of investment earnings below the amount of earnings that would have been earned had the investment of funds earned interest at the bond yield.

NEGOTIATED SALE

A sale of bonds, the terms and price of which are negotiated by the issuer through an exclusive agreement with a previously selected underwriter and/or underwriting syndicate. See **Section 5.3, Negotiated Public Offerings**.

NET DIRECT DEBT

With respect to any given issuer, the amount of all outstanding debt of that issuer (direct debt), less the sum of any amounts accumulated in sinking funds for that debt and the amount of that debt that is selfsupporting.

NET INTEREST COST (NIC)

A measure of the interest cost of an issue derived by adding together all interest payments for the term of the issue and dividing that sum by the sum for all bonds of the amount of each bond multiplied by the number of years it is outstanding.

If the bonds are to be issued at a discount, the amount of the discount is added to the interest total as if it had been paid by the issuer. If the bonds are to be issued at a premium, that amount is subtracted from the interest total. The formula is as follows:

$$\text{NIC} = \frac{\text{Total Interest Payments + Discount (or - Premium)}}{\text{Bond Year Dollars}}$$

The denominator, bond year dollars, measures the amount of bonds outstanding over the time they are outstanding. Bond years equal the number of bonds outstanding (in \$1,000 denominations) multiplied by the number of years they are outstanding. One bond year is one \$1,000 bond outstanding for one year. Bond year dollars are the number of bond years multiplied by \$1,000 for each bond.

NIC is distinguished from the True Interest Cost (TIC) measure in that the NIC does not take into account the time value of money.

The NIC is sometimes used to compare bids at a competitive sale.

Compare **True Interest Cost (TIC)**.

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NET OVERALL DEBT

With respect to any given issuer, the amount of that issuer's net direct debt plus the issuer's share of the overlapping net direct debt of other public entities.

NET PROCEEDS

Generally, proceeds from the sale of a new issue of municipal securities less costs of issuance.

NET REVENUES

See **Revenues/Gross Revenues/Net Revenues**.

NO-LITIGATION CERTIFICATE

A certificate signed on behalf of the issuer, dated as of and delivered at the closing, to the effect that no litigation is pending that would adversely affect the financing.

NOMINEE

An entity established by a bank, securities firm, or other corporation (such as a depository) to be used as the holder of record for registered securities owned by the bank, securities firm, or corporation.

NONGOVERNMENTAL BORROWER

A nongovernmental entity using the proceeds of a municipal securities offering and obligated to make payments to be used to pay debt service on the municipal securities. See **Section 3.3.9, Conduit Revenue Bonds**.

NONPROFIT OR NOT-FOR-PROFIT ORGANIZATION

Organizations qualifying for nonprofit status under state law, including entities that are tax-exempt under Section 501(c)(3) of the Internal Revenue Code and that are formed to provide public benefit.

NOTE

A short-term obligation of an issuer to repay a specified principal amount on a certain date, together with interest at a stated rate, usually payable from a defined

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source of anticipated revenues. Notes usually mature in one year or less, although notes of longer maturities are also issued. See **Bond Anticipation Notes (BANs)**, **Commercial Paper (CP)**, **Tax and Revenue Anticipation Notes (TRANs)**.

NOTICE OF SALE

The document that issuers use to solicit bids from prospective underwriters for a competitive sale of bonds.

The notice of sale, the winning bid, and the issuer's acceptance of the winning bid together constitute an agreement for the purchase and sale of the issue in a competitive sale.

See **Section 5.2.3, Documentation for a Competitive Sale**.

OBLIGATED PERSON

Any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of that person committed by contract or other arrangement to support payment of all, or part, of the obligations on the municipal securities (other than providers of credit enhancement). See **Section 8.5, Continuing Disclosure**.

OBLIGATION

A debt security or commitment to repay.

OBLIGOR

A party having a financial obligation or arrangement to make all or part of the amounts to be used to pay debt service on a municipal security.

OFFICIAL STATEMENT/PRELIMINARY OFFICIAL STATEMENT

An Official Statement is a document containing information about the bonds being offered, the issuer, and the sources of repayment of the bonds.

A Preliminary Official Statement is the version of an Official Statement or Offering Circular used by the issuer or underwriters to inform the marketplace of the terms of the bonds being issued before receipt of bids at a competitive sale or before the determination of interest rates and purchase price in a negotiated sale.

See **Section 6.3, The Official Statement**.

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"OFFNER-DEAN" LEASE EXCEPTION

A lease under the terms of which the public agency lessee's payment obligation is abated if the public agency does not have use and occupancy of the leased property. See **Section 1.2.4.3, Lease Exception (the "Offner Dean Lease Exception")** and **Section 3.6.1, Financing Leases**.

ORGANIC ACT

The statute under which a particular governmental entity is organized.

This term is used to describe an act that specifies the manner of organization and the powers of a single agency, authority, or district named in the act, rather than the type of statute under which, for example, any city or county could cause to be created an agency of the type described in the statute.

ORIGINAL ISSUANCE DATE

See **Closing Date**.

ORIGINAL ISSUE DISCOUNT

See **Discount**.

ORIGINAL ISSUE PREMIUM

See **Premium**.

OTHER POST-EMPLOYMENT BENEFITS (OPEBS)

Future liabilities incurred by certain governmental entities for benefits, other than pension benefits, owed to retired employees, such as certain medical and other benefits.

OUTSTANDING PRINCIPAL

In general, as used with respect to the principal of an issue, the amount remaining unpaid.

The terms of indentures and bond resolutions often provide that bonds, which are not yet paid but are the subject of a defeasance or an advance refunding, are treated as no longer being outstanding.

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OVERLAPPING DEBT

With respect to any given issuer, debt of other public entities the jurisdictions of which overlap the jurisdiction of such issuer.

The issuer may partially overlap another public entity (e.g., a special district may contain parts of several counties), may be within another public entity (e.g., a city is entirely within a county), or may wholly encompass another public entity (e.g., a county normally contains a number of cities).

The term may be used with respect to both general obligation debt payable from *ad valorem* taxes (in which case it is generally apportioned on the basis of relative assessed value), or may be used with respect to special assessment, special tax, or other revenue-based debt, in which case other methods of apportionment may be used, such as relative amounts of benefit or service delivered.

PAR/PAR VALUE

Par or par value refers to the principal amount of a bond.

A bond may be purchased at par, meaning the price of the bond is equal to its principal amount; below par, meaning the price is below its principal amount; or above par, meaning the price is above its principal amount. See also **Discount** and **Premium**.

PARITY

Obligations secured on an equal basis by a pledge of revenues or an asset or pool of assets.

PASSIVE VALIDATION

This strategy of allowing the 60-day period following approval for challenging a bond financing to run before consummation of the financing. See also **Reverse Validation Action** and **Validation Action**.

PAYING AGENT

The institution—usually a commercial bank or trust company—appointed in the indenture or bond resolution to act as the agent of the issuer to pay principal and interest from monies provided by or on behalf of the issuer. See also **Trustee**.

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PENSION OBLIGATION BONDS

Debt issued to finance a public agency's pension funding obligation. See Section 3.3.2.2, Pension Obligation Bonds.

PERMITTED INVESTMENTS

Types of investments that are eligible for bond funds as authorized by statute and/or bond document provisions. See Section 9.4.1, Permitted Investments.

PLACEMENT AGENT

An individual or firm acting as agent on behalf of the issuer or obligor to arrange for the sale of a new issue of municipal securities to investors rather than by purchasing the municipal securities from the issuer and reselling it to investors.

PLEDGE

To grant a security interest in or lien on an asset to provide security for the repayment of bonds or the performance of some other obligation.

A pledge may cover an existing asset (such as a reserve account) or a stream of revenues to be received in the future (such as the income of a defined enterprise). See **Security and Source of Payment**.

POINT/BASIS POINT

Point is a shorthand reference to 1%.

Basis point is a shorthand reference to one onehundredth of 1% (0.01%). The term is generally used to describe interest rates rather than prices.

POOLING OF DEBT ISSUES

This term encompasses two different concepts: pooled financings (including both blind pools and dedicated pools), and composite issues. See Section 3.7.7, Pool Bonds.

Open Pool (Blind Pool) Issue

A reference to bonds that are issued to finance projects not identified at the time of bond issuance. If some but not all of the users are identified, the pool is partially blind.

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Closed Pool (Dedicated Pool)

An issue the proceeds of which are to be used to finance loans to, or projects for, entities that are identified and committed to the financing at the time the bonds are issued.

PRELIMINARY OFFICIAL STATEMENT

See **Official Statement/Preliminary Official Statement**.

PREMIUM

The amount by which the price of a bond exceeds its principal amount or par value.

A redemption premium is the premium an issuer is required (by the terms of a bond) to pay to redeem (call) the bond before its stated maturity.

See also **Discount**.

PREMIUM BOND

A security purchased at a price in excess of the par value.

PRESENT VALUE

The current value of a payment or stream of payments expected to be received in the future, discounted at a given interest rate or rates.

PRESENT VALUE SAVINGS

Difference expressed in terms of current dollars between the debt service on a refunded bond issue and the debt service on a refunding bond issue for an issuer, calculated by discounting the difference in the future debt service payments on the two issues at a given rate. See **Section 3.7.6, Refunding Bonds**.

PRICING/REPRICING

The determination (or redetermination) by the underwriters in a negotiated sale of the interest rates and reoffering prices at which an issue will be offered to investors.

On the pricing date, bonds are offered at yields proposed by the underwriters and agreed to by the issuer. If not enough or too many orders are received from

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investors on the original terms, the issue may be repriced to be more attractive to investors or to give a better rate to the issuer, as the case may be.

See **Section 5.3, Negotiated Public Offerings**.

PRINCIPAL

With respect to a loan, the amount loaned and to be repaid, i.e., the amount for the use of which interest is charged. Similarly, with respect to a bond, principal is the amount on which interest accrues and which is to be paid to the bondholder on the maturity date (not including interest).

The principal of a bond is sometimes referred to as its face amount because the amount to be paid at maturity is printed on the front (the face) of the bond.

See also **Original Issue Discount** and **Par/Par Value**.

PRIVATE ACTIVITY BONDS

In general, bonds of which 10% or more of the proceeds are used in the trade or business of nongovernmental persons and 10% or more of the debt service is secured by or derived from property used in the trade or business of nongovernmental persons, or 5% or more of the proceeds are loaned to nongovernmental persons. See **Section 4.6, Governmental Bonds/Private Activity Bonds**.

PRIVATE PLACEMENT

The offer and sale of an issue by the issuer directly to one or more investors, rather than through an underwriter. See **Section 5.5, Private Placements**.

PRIVATE PLACEMENT MEMORANDUM

A memorandum that takes the place of an Official Statement in a private placement and contains a description of the bonds, the financing structure, and the issuer.

PRIVATE SALE

See **Negotiated Sale**.

PRIVATE USE

Use of a financed project in the trade or business of any person other than a state or local government, which differs from the use of the project by the general public.

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PRO FORMA

A revenue projection showing anticipated costs and revenue for the period of the projection.

PROCEEDS/SALE PROCEEDS/INVESTMENT PROCEEDS/ GROSS PROCEEDS/NET PROCEEDS

Proceeds are comprised of sale proceeds and investment proceeds. Sale proceeds are the amount paid by the ultimate purchasers (not including an underwriter) of a new issue, excluding any accrued interest.

The term gross proceeds refers to all of the monies relating to an issue, which are subject to arbitrage limitations and rebate under the Tax Code. Gross proceeds include sale proceeds, investment proceeds, and any other monies pledged to pay debt service and expected to be used to pay debt service, including monies in a sinking fund and monies in a reserve account.

See **Section 4.8.2, Bond Proceeds**.

PROJECT FINANCING

An issue for the purpose of financing all or a portion of the costs of acquiring, constructing, and/or renovating a specified project for a public or private entity.

Generally, the term is used in situations in which the issue is to be repaid with revenues relating to the project financed, although other revenues and guarantees may also secure the issue.

See also **Conduit Financing**.

PUBLIC OFFERING

The sale of bonds (generally through an underwriter) to the general public (or a limited section of the general public).

The issuer may market a proposed public offering either via a competitive sale or a negotiated sale.

See **Section 5.2, Competitive Sales** and **Section 5.3, Negotiated Public Offerings** and **Competitive Sales**.

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PUBLIC PRIVATE PARTNERSHIPS (P3S)

A generic term for a wide variety of financial arrangements whereby governmental and private entities agree to transfer an ownership interest of, or substantial management control over, a governmental asset to the private entity in exchange for upfront or ongoing payments.

PUBLIC SALE

See **Competitive Sale**.

PUT BOND

See **Demand Bond (Put Bond or Tender Option Bond)**.

QUALIFIED 501(C)(3) BONDS

Private activity bonds issued for certain nonprofit organizations (including hospitals and universities) described in Section 501(c)(3) of the Internal Revenue Code. See **Section 4.7.1.7, Qualified 501(c)(3) Bonds**.

QUALIFIED PRIVATE ACTIVITY BONDS

Private activity bonds that may be issued as tax-exempt bonds. See **Section 4.7, Qualified Private Activity Bonds** and **Section 3.3.9, Conduit Revenue Bonds**.

RATE COVENANT

A covenant to establish rates and charges at levels that will generate revenues sufficient to achieve a stated minimum ratio of net revenues to debt service. See **Coverage**.

RATING

An alphanumeric grade (assigned to an issue of municipal securities by a nationally recognized rating agency) that represents the rating agency's opinion of the issuer's or obligor's ability to meet debt service payment obligations in a timely manner. See **Section 5.6, Credit Ratings** and **Credit Rating/Credit Rating Agency**.

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REBATE REQUIREMENT

The obligation to pay to the U.S. government amounts earned from the investment of gross proceeds at a yield in excess of the yield on the issue.

See **Section 4.9, Arbitrage Rebate** and **Section 8.3.5, Arbitrage Rebate**.

RECORD DATE

A predetermined date before the interest payment date on an issue of registered securities that is used to determine to whom the next interest payment will be made, with persons who are listed as the registered owners of the securities on the record date receiving the interest payment.

REDEMPTION

The payment of principal of a bond before maturity. Redemption before maturity may be optional, mandatory, or extraordinary (sometimes also called special).

Redemption of a bond by the issuer before maturity is sometimes referred to as calling the bond.

See **Section 2.3.1, Redemption or Prepayment**.

REDEMPTION PREMIUM

An amount paid to the bondholder called for redemption in addition to the principal amount of (and any accrued interest on) the security.

REFERENDUM POWER

The power reserved to the people to reject legislative actions through the referendum process. See **Section 1.6, The Initiative and Referendum Powers**.

REFUNDING

An issue of bonds (the refunding bonds) to pay debt service on a prior issue (the refunded bonds).

See **Section 3.7.6, Refunding Bonds**.

See also **Defeasance**.

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Advance Refunding

A refunding in which the refunding bonds are issued more than 90 days before the date upon which the refunded bonds will be repaid. Compare to **Current Refunding**.

Crossover Refunding

A refunding in which the revenues originally pledged to secure the refunded bonds zcontinue to be applied to pay the refunded bonds until the refunded bonds mature or are redeemed.

On the date the refunded bonds are paid in full, the pledged revenues "cross over" and are thereafter pledged to pay the refunding bonds.

During the period when both the refunded and the refunding bonds are outstanding, the escrow containing the proceeds of the refunding bonds pays interest on the refunding bonds. Then on the crossover date, the escrow pays the principal of the refunded bonds.

Current Refunding

A refunding in which refunding bonds are issued not more than 90 days before the date upon which the refunded bonds will be paid.

REGISTERED BOND

A bond for which the name and address of the legal owner is required to be listed on the bond registration books of the trustee or a registrar.

Generally, interest payments on a registered bond are made by check or wire sent to the registered owner. The registered owner may not be the beneficial owner of the bond, but rather a nominee for the beneficial owner. Registered bonds are often held in the name of a securities depository or in the name of a nominee for a securities depository, such as The Depository Trust Company, which then keeps a record of the broker-dealers whose clients are the beneficial owners of the bonds.

Compare **Coupon Bond**.

REGISTERED OWNER

The person or entity in whose name a municipal security's ownership is registered under the bond contract. See **Bondholder**. Compare **Beneficial Owner**.

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REGISTRAR

The agent of the issuer appointed to maintain a list of the names and addresses of all registered owners of the bonds and to record transfers and exchanges of the bonds. See also **Trustee**.

REIMBURSEMENT RESOLUTION

A resolution of the governing body, of an issuer declaring its intent to reimburse itself for expenditures for specified projects from the proceeds of tax-exempt bonds. See **Seciton 4.4.5, Reimbursement of Prior Expenditures**.

REMARKET

To buy and resell to the public previously issued bonds that have been or are required to be purchased from the original or subsequent holders of the bonds by the issuer or another party upon the occurrence of certain events specified in the legal documents. See **Section 3.4.2, Long-Term Variable-Rate Debt**.

REMARKETING AGENT

The investment bank or commercial bank retained to remarket bonds that have been tendered for purchase by the issuer or another party under an option to sell (a put) that accompanies the bond. See **Section 3.4.2, Long-Term Variable-Rate Debt**.

See also **Remarket, Demand Bond (Put Bond or Tender Option Bond)**, and **Variable-Rate**.

REOFFERING

Literally, offering again.

This term is used in two contexts. First, it is used to describe the offering of bonds by the underwriter to the public. For example, the initial offering price to the public is often referred to in shorthand as the reoffering price. Second, the term reoffering is used to describe a form of remarketing in which an issuer exercises the right to require bondholders to mandatorily tender their bonds for reoffering to the public, customarily in the context of a conversion from a variable-rate to a fixed-rate.

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REPORT OF PROPOSED DEBT ISSUANCE

The report that must be submitted to the California Debt and Investment Advisory Commission by issuers before the sale of any municipal securities under California Government Code Section 8855(i). See **Section 7.1, Reporting to the California Debt and Investment Advisory Commission (CDIAC)**.

REPORT OF FINAL SALE

The report that must be submitted to the California Debt and Investment Advisory Commission by issuers after the sale of any municipal securities under California Government Code Section 8855(i). See **Section 7.1, Reporting to the California Debt and Investment Advisory Commission (CDIAC)**.

REPRICING

See **Pricing/Repricing**.

REQUEST FOR PROPOSAL (RFP)

A request sent by an issuer to financing professionals for proposals to serve on the issuer's financing team.

RESERVE ACCOUNT (BOND RESERVE ACCOUNT OR DEBT SERVICE RESERVE ACCOUNT)

An account from which monies may be drawn to pay debt service on an issue if pledged revenues and other amounts available to satisfy debt service are temporarily insufficient. See **Section 2.4.4, Debt Service Reserve Fund**.

See also **Surety**.

REVENUES/GROSS REVENUES/NET REVENUES

The income produced by a given source.

In the context of revenue bonds, revenues typically means the income and receipts generated from the operation of the project or loan program being financed, or from the enterprise of which the project or loan program is a part, or from other nontax sources. Examples include water charges in the case of water revenue bonds, lease payments in the case of lease revenue bonds, or loan repayments in the case of mortgage revenue bonds or a conduit financing. These revenues would

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normally be pledged to the payment of the revenue bonds. See Chapter 3, Types of Financing Obligations Issued by Public Agencies.

Gross revenues refer to the total receipts derived from the operation of the project, program, or enterprise. Net revenues refer to the amount available after subtracting certain costs and expenses, most commonly for operation and maintenance, from gross revenues. See Section 3.3.6, Enterprise Fund Debt Obligations.

REVERSE VALIDATION ACTION

This term is sometimes used to describe the exclusive procedure under the California law for an interested person to challenge the legality of a bond financing. The validation statutes provide that if the issuer does not file a validation action concerning the financing, then any interested person may file an action within 60 days after the financing is approved—a socalled reverse validation action. Once an interested person files a reverse validation action, the case proceeds in a manner similar to a validation action by the issuer. See also **Passive Validation** and **Validation Action**.

SECURITIES AND EXCHANGE COMMISSION (SEC)

The Securities and Exchange Commission (SEC) is a federal regulatory agency that oversees the securities market in the United States.

SEC REGISTRATION

The filing of information with the SEC in accordance with the Securities Act of 1933 as a prerequisite to selling or marketing securities.

Most bonds issued by or on behalf of state or local governmental entities are exempt from these registration requirements.

See Section 6.1, Federal Securities Laws.

SEC RULE 10B-5

A rule adopted by the SEC under the Securities Exchange Act of 1934 and Securities Act of 1933 concerning anti-fraud provisions public agencies are subject to. See Section 6.1, Federal Securities Laws.

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SEC RULE 10B-5 OPINION

A letter of counsel, sometimes referred to as a due diligence opinion, generally based upon an investigation of specified facts and addressing the accuracy and completeness of the official statement. See **Section 6.2, Roles and Responsibilities of Other Financing Participants**.

SEC RULE 10B-5 STANDARD

SEC Rule 10b-5 standard refers to the formulation of the anti-fraud rule in securities law contained in SEC Rule 10b-5. See **Section 6.1.1, Anti-fraud Rules**.

SEC RULE 15c2-12

A rule promulgated by the SEC under the Securities Exchange Act of 1934 concerning disclosure and continuing disclosure requirements for municipal securities. See **Section 8.5, Continuing Disclosure**.

SECONDARY MARKET

The market in which bonds are purchased from bondholders who have held the bonds for investment purposes, as opposed to being purchased directly from the issuer or from the issuer through an underwriter.

SECURED OVERNIGHT FINANCING RATE (SOFR)

An interest rate index based on actual transactions in the Treasury repurchase market that the New York Federal Reserve began to publish in April 2018 as an alternative to LIBOR. The rate would be used, instead of LIBOR, for U.S. dollar based derivatives and loans.

SECURITY

A security is any bond, debenture, note, certificate, or other evidence of indebtedness, issued by a corporation, a government or political subdivision thereof.

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SECURITY AND SOURCE OF PAYMENT

The features of a debt instrument designed to reduce the risk of nonpayment or late payment, including the sources of monies for timely payment.

The security for repayment may include a pledge of taxes or revenues on a pledge of assets.

Credit enhancement may provide additional security.

See **Section 2.4.2, Source of Payment; Pledge** and **pledge**.

SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

The Securities Industry and Financial Markets Association (SIFMA), formerly the Bond Market Association, represents broker-dealers, banks, and asset managers providing access to the capital markets in the United States.

SELF-INSURANCE RESERVE FINANCING

A financing in which the proceeds of the issue are deposited in an insurance reserve fund that is used to pay liability claims against participating entities as claims arise.

The fund is invested and, depending upon the investment earnings and the claims paid, may require additional deposits from participating entities.

Typically, an entity separate from the participating entities, such as a joint powers authority, is the issuer of the bonds and is responsible for the administration of the insurance reserve fund, including the investment of the fund and the payment of claims (although a separate entity may administer these functions through a contractual arrangement with the issuer). Insurance is provided to participating entities (which may be cities, counties, and other public entities) that pay premiums for the coverage. The premiums paid by the participating entities constitute the revenue source for the repayment of the issue.

SELF-LIQUIDITY

A term used in connection with variable-rate bond financings whereby the issuer or conduit borrower agrees to repurchase with its own funds bonds that have been tendered but not yet remarketed without procuring a third-party liquidity facility. See **Section 2.3.2, Credit Enhancement and Liquidity Support**. Compare **Liquidity Facility**.

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SELLING GROUP

A group of municipal securities dealers that assists in the distribution of a new issue of municipal securities. Compare: **Syndicate**.

SENIOR LIEN BONDS

Bonds having the priority claim against pledged revenues superior to the claim against the pledged revenues or security of other obligations.

SERIAL BONDS

Bonds of an issue, which are payable as to principal in amounts due at successive regular intervals, generally annual or semiannual, and usually in the earlier years of the term of the issue. Compare **Term Bonds**.

SHORT-TERM DEBT

Generally, obligations maturing within 1 year of issuance or payable from the revenues of the current fiscal year.

SINKING FUND PAYMENTS OR INSTALLMENTS

Payments made by an issuer (often into a sinking fund) to provide for the redemption or payment at maturity of term bonds. Also called mandatory sinking account payments or sinking fund installments.

Generally, sinking fund payments are mandatory in a specified amount for each payment period to provide for the periodic redemption of term bonds before their final maturity. The individual term bonds to be redeemed each year are generally required to be selected at random by the trustee.

See **Section 2.3.1.1, Mandatory Redemption**.

SOURCES AND USES

A table, commonly included in an official statement, identifying the source from which funds are derived, including bond proceeds and other available funds, and the application of the funds in connection with a new issue of municipal securities.

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SPECIAL DISTRICT

Single-purpose or limited-purpose units of government formed under state enabling legislation to meet certain local needs not satisfied by existing general purpose governments in a given geographical area.

SPECIAL FUND

A fund, from which debt service is payable that is separate from a public agency's general fund. See **Section 1.2.4.4, Special Fund Exception**. See **Governmental Fund**.

SPECIAL TAX

A tax levied by a special-purpose local governmental entity or levied by a general-purpose local governmental entity for a purpose other than general revenue purposes (i.e., for a special purpose). See **Section 1.4.6, Special Taxes**.

SPECIAL TAX COUNSEL

A law firm retained by the issuer to render the opinion that interest on an issue is taxexempt under circumstances where the firm retained as bond counsel either does not have the expertise or is otherwise unable to render that opinion.

SPREAD

See **Underwriter's Gross Spread (Underwriter's Discount)**.

STANDBY PURCHASE AGREEMENT

An agreement between an issuer and a financial institution, usually a bank, whereby the bank agrees to purchase bonds in the event the bondholders tender them to the issuer and they are not remarketed to new purchasers. See **Section 2.3.2.4, Lines of Credit and Standby Bond Purchase Agreements**.

See also **Demand Bond (Put Bond or Tender Option Bond)** and compare to **Letter of Credit** and **Line of Credit**.

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STATE AND LOCAL GOVERNMENT SERIES (SLGS)

The State and Local Government Series securities program, referred to as SLGS (pronounced "slugs") are U.S. Treasury securities offered to public agency issuers of tax-exempt debt to comply with yield restrictions requirements of the federal tax law. See **Section 9.4.2, Investments Specific to Bond Funds**.

STATE AGENCY

The state or any department, agency, board, commission, or authority of the state.

STATUTE

The specific, codified statement of a law that has been enacted by the legislative body of a government.

STEPPED COUPON BONDS

Bonds on which the fixed interest rate periodically changes (generally by increasing) over their life on specified dates and at specified interest rates.

SURETY/RESERVE FUNDS SURETY

In the public finance context, a surety policy is a form of insurance provided by a bond insurer to satisfy a reserve fund requirement for a bond issue. See **Section 2.3.2.2, Debt Service Reserve Fund Surety Bonds**.

SYNDICATE

A group of underwriters formed and bound by agreement to purchase a new issue of municipal securities from an issuer.

TAKEDOWN

See **Underwriter's Gross Spread (Underwriter's Discount).**

TAX

See **Section 1.4.2, What Is a Tax?**

TAX AND REVENUE ANTICIPATION NOTES (TRANS)

Tax and revenue anticipation notes. See **Section 3.3.4, TRANs and RANs**.

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TAX ALLOCATION (TAX INCREMENT)

Property tax revenues above the base year level in a redevelopment project area. See **Section 3.3.7.3, Redevelopment Agencies**.

TAX CALL

A provision in the bond contract requiring the redemption of the bonds if it is determined that the interest on the bonds does not qualify as exempt interest to the bondholders under the Internal Revenue Code.

TAX CERTIFICATE

A tax certificate is usually prepared by bond counsel or special tax counsel. The certificate contains the factual representations (expectations, covenants and agreements) that are the basis of the legal opinion that the interest on the bonds is excluded from gross income tax under tax law. The term "arbitrage certificate" is also used.

TAX CODE

The Internal Revenue Code of 1986, as amended. See **Chapter 4, Federal and State Law Requirements**. See also **Treasury Regulations**.

TAX CREDIT BONDS

Municipal securities that entitle the bondholder to receive, in lieu of interest payments, a credit against federal income tax. New issues of tax credit bonds were eliminated by the "Tax Cuts and Jobs Act" enacted in December 2017. See **Section 3.5, Tax Treatment of Municipal Bonds**.

TAX TREATMENT

The treatment for federal income tax and State of California personal income taxes of interest on bonds issued by a public agency. The requirements for the favorable tax treatment of bonds issued by state and local governments are contained in **26 U.S. Code §103**. See **Section 3.5, Tax Treatment of Municipal Bonds**.

TAXABLE EQUIVALENT YIELD

The interest rate that must be received on a taxable security to provide the bondholder the same aftertax return as that earned on a tax-exempt bond.

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TAXABLE SECURITY

A bond or other security that does not qualify for an exclusion from gross income under federal tax law.

TEFRA NOTICE, HEARING, AND APPROVAL

The published notice, public hearing, and approval by elected officials required by Section 147(f) of the Internal Revenue Code for qualified private activity bonds, originally enacted in the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. See **Section 4.7.2, Additional Requirements Applicable to Qualified Private Activity Bonds**.

TEMPORARY PERIODS

The periods during which the federal tax rules relating to arbitrage yield restriction permit certain gross proceeds of an issue to be invested at a yield that is materially higher than the yield on the issue. See **Section 4.8.4, Arbitrage Yield Restrictions Exceptions**.

TENDER

The surrender of a security to the issuer or its agent (e.g., a tender agent) for purchase.

A tender may be mandatory or optional.

TENDER OFFER

The process by which a potential purchaser of bonds (which may be the issuer of the bonds) solicits from the holders of the bonds offers to sell those bonds to the purchaser upon the terms specified in the solicitation.

This technique borrows its name from the corporate securities arena, where shares in a company may be acquired by the purchase of common stock on the open market under a tender offer. In the context of public finance, a tender offer may be a refinancing method in which an issuer distributes, by publication or otherwise, to the owners of its bonds an offer either to purchase a specific aggregate amount of the bonds at a specific price if the bonds are tendered by a specified date, or to use a stated amount of money to purchase the bonds by accepting tenders of the bonds in order of price until the stated amount is exhausted. Bonds purchased by an issuer under a tender offer are usually deemed retired and no longer outstanding under the indenture or bond resolution.

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TENDER OPTION

(1) A provision in an indenture or trust agreement under which the investor has the right, on specified dates after required notification, to surrender the securities to the issuer (or someone acting on the issuer's behalf, such as a tender agent) at the predetermined price (usually par). This is sometimes referred to as an "optional tender" or "put option."

(2) An instrument issued by a financial institution that permits the purchaser to sell, after giving required notice, a specified amount of securities from a specified issue to the financial institution on a predetermined future date or dates (the "expiration date(s)") at a predetermined price (the "strike price").

(3) An agreement made by the parties to a particular transaction under which the purchaser has the right to surrender the securities to the seller at a specified price on a specified future date or dates.

TENDER OPTION BOND

See **Demand Bond (Put Bond or Tender Option Bond)**.

TERM

With respect to a single bond, the period of time until the maturity date of the bond and with respect to an issue, the period until the maturity date of the last bond of the issue to mature.

TERM BONDS

A maturity that is subject to redemption over a specified period from sinking fund payments.

Compare **Serial Bonds**. See also **Redemption** and **Sinking Fund Payments or Installments**.

TRANCHE

A colloquial term used to refer to a portion of financing for a project or program. Sometimes used to describe a series of bonds. Derived from the French, the term originally meant a series of bonds issued for sale in a foreign country.

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TRANS

See Section 3.3.4 TRANs and RANs.

TRANSFERRED PROCEEDS

Under the Internal Revenue Code, unspent proceeds of a refunded issue that are allocated to a refunding issue when the proceeds of the refunding issue are used to pay the principal of the refunded issue. See Section 4.12, Refunding Bonds.

TREASURY REGULATIONS

The federal income tax regulations adopted by the U.S. Treasury Department.

Treasury Regulations are designed to provide additional detail and interpretation of the Tax Code.

See Chapter 4, Federal and State Tax Law Requirements.

TREASURY SECURITIES

Debt obligations of the U.S. Government sold by the U.S. Treasury Department in the form of bills, notes, and bonds (as well as SLGS sold to issuers of municipal securities) backed by the full faith and credit of the U.S. Government. See Section 9.4.2, Investments Specific to Bond Funds.

TRUE INTEREST COST (TIC)

A measure of the interest cost of an issue that accounts for the time value of money. The TIC is sometimes also called the internal rate of return or the net effective interest rate.

The TIC for an issue is the annual discount rate which, when used to discount all debt service payments on the issue to the date of initial delivery of the issue, using a compounding interval equal to the interest payment periods for the issue, results in the aggregate present value of the debt service payments being equal to the original purchase price (including accrued interest) of the issue. For the purpose of calculating the TIC, sinking fund payments for any term bonds are considered principal payments. Because there is no algebraic formula for the direct computation of the TIC, it must be determined either by successive approximation on a computer or calculator or by using present value tables.

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The TIC is often used to compare bids at a competitive sale.

Compare **Net Interest Cost (NIC)**.

TRUSTEE

A financial institution with trust powers, designated by the issuer or borrower, that acts, under an indenture or trust agreement, in a fiduciary capacity for the benefit of the bondholders in enforcing the terms of the indenture or trust agreement.

In many cases, the trustee also acts as custodian, paying agent, registrar and/or transfer agent for the bonds.

UNDERLYING RATING

In the case of a security for which credit enhancement has been obtained, the rating assigned by a rating agency to the security, on a stand-alone basis, without regard to credit enhancement. See **Section 5.5, Credit Ratings**.

UNDERTAKING

To meet the disclosure requirements of SEC Rule 15c2-12, bond underwriters obtain a commitment from the issuer or other obligated party to provide ongoing disclosure, this is known as an undertaking or continuing disclosure undertaking (CDU). The undertaking generally takes the form of a continuing disclosure certificate or continuing disclosure agreement (CDA) executed by the issuer or other obligated person with respect to the securities, or other obligor, at closing. The Official Statement (OS) will generally include a summary of the issuer's undertaking to provide continuing disclosure. See **Continuing Disclosure Agreement (CDA)**.

UNDERWRITE

To agree to purchase bonds, generally upon initial issuance, in a guaranteed amount, for a guaranteed price, and with the intention to resell the bonds to investors.

In a best efforts underwriting, the underwriter agrees only to use its best efforts to resell bonds to be purchased from the issuer and only agrees to purchase those bonds if the underwriter can resell them.

See also **Competitive Sale** and **Negotiated Sale**.

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UNDERWRITER

An entity that purchases municipal securities from the issuer with an intention to resell all or a portion of the instruments or evidences of indebtedness to investors.

UNDERWRITER'S COUNSEL

An attorney or law firm retained to represent the interests of an underwriter in connection with the purchase of a new issue of municipal securities.

The duties of underwriter's counsel may include review of the issuer's bond resolution and documentation on behalf of the underwriter, review of the accuracy an adequacy of disclosure in the official statement, preparation of the agreement among underwriters, purchase contract and/or the official statement, assisting the underwriter in meeting the underwriter's due diligence obligation, and delivery of a SEC Rule 10b-5 opinion.

See Section 5.3, Negotiated Public Offerings.

UNDERWRITER'S GROSS SPREAD (UNDERWRITER'S DISCOUNT)

The difference between the purchase price paid to the issuer for a new issue and the sum of the prices at which the bonds are initially offered to the investing public by the underwriter.

To the extent that the initial offering prices are subsequently lowered by the underwriter, the full amount of the spread may not be realized by the underwriter. The spread is usually expressed in points or fractions thereof. The spread generally consists of:

- **Management Fee.** A fee paid to the managing underwriter for handling the affairs of the syndicate, including, in the case of a negotiated sale, structuring the issue and negotiating with the issuer.
- **Expenses.** Any advertising and printing costs to the underwriter, underwriter's counsel's fees and expenses, travel expenses, MSRB fees, CDIAC fees, and other similar expenses.
- **Takedown.** Normally the largest component of the spread, similar to a commission, the takedown represents the income derived by the selling broker or dealer from the sale of the bonds. If bonds are sold by a member of a syndicate, the seller is entitled to the full takedown (also called the total takedown). If bonds are sold by a dealer, which is not a member of the syndicate, the seller receives only

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that portion of the takedown known as the concession or dealer's allowance, with the balance (often termed the additional takedown) retained by the syndicate.

- **Risk.** This is the amount of compensation for risks incurred by the underwriter in underwriting the bond issue, relating to the difficulty of marketing the issue, bond market conditions, and the amount of bonds remaining to be resold after the execution of the bond purchase agreement. There is rarely a risk component in the underwriting spread.

VALIDATION

Sometimes refers to the process of undertaking a validation action. Validation may also refer to the validating acts passed each year by the California Legislature to validate certain types of actions taken by local agencies, including bond financings. These legislative acts do not, however, protect a bond financing from challenge on the grounds of unconstitutionality under the California Constitution.

VALIDATION ACTION

A special procedure under California law that allows an issuer to have the legality of a bond financing approved, including any issue regarding constitutionality of the bond issue. The issuer files a lawsuit naming "all interested persons" as defendants. Notice of the lawsuit is given by publication in the newspaper and by posting public notices. If no interested person comes forward and challenges the financing, the issuer may ask the court for a judgment declaring that the financing is valid. This process takes approximately 45 days. Once the court issues a validation judgment, and the 30day appeal period expires, the financing cannot later be challenged in court. However, if an interested person does step forward in a timely manner to challenge the financing, the process can take much longer.

See also **Passive Validation** and **Reverse Validation Action.**

VARIABLE-RATE

An interest rate that periodically changes based upon an index or a pricing procedure. See **Section 3.4.2, Long-Term Variable-Rate Debt**.

VERIFICATION REPORT

In a refunding or other defeasance, a report prepared by a certified public accountant or other independent third party that verifies the yield of the investments

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held in escrow in connection with an advance refunding bond issue and demonstrates that the cash flow from investment purchased with the proceeds of the refunding bonds and other funds held in escrow are sufficient to pay the principal of and interest on the refunded bonds that are being defeased. See Section .4.10, Discharge and Defeasance and Section 3.7.6, –Refunding Bonds.

VOLUME CAP

Under federal tax law, the limit on the aggregate amount of certain taxexempt qualified private activity bonds that may be issued during any calendar year. See Section 4.7.2.1, Volume Cap.

WORKING CAPITAL EXPENSES

Day-to-day expenses. See Section 4.8.2.2, Expenditure of Gross Proceeds.

WORKOUT

The process of trying to resolve a default or other payment problem in a bond financing. A workout may involve assembling a workout team of professionals to assist in the process. Workouts often involve negotiations with the bondholders (such as seeking approval to restructure the debt) and with the persons who are obligated to provide funds for repayment of the bonds (such as defaulting landowners in an assessment district).

See Appendix D, Municipal Bankruptcy.

YIELD

As used in the Tax Code, the discount rate that makes the present value of all payments with respect to an investment equal to its purchase price or, in the case of bonds, equal to the initial offering price at which a substantial amount of the governmental obligations is sold to the public. See Section 4.8.3, Yield.

YIELD CURVE

Yield curve means the curve obtained by plotting the yield of investment or debt instruments (on the yaxis) against time (on the xaxis). The typical yield curve is upward sloping, so that the shorter the maturity of the instrument, the lower the yield of that instrument. The yield curve varies over time in response to general economic conditions and the yield curve may be differently sloped for different types of instruments depending on credit quality, taxexempt status, and other factors.

YIELD RESTRICTION

See **Arbitrage Yield Restriction**.

YIELD TO CALL

The rate of return to the investor earned from payments of principal and interest, with interest compounded twice per year at the stated yield, presuming that the security is redeemed on a specified call date (if the security is redeemed at a premium call price, the amount of the premium is also reflected in the yield). Compare **Yield to Maturity**.

YIELD TO MATURITY

The rate of return to the investor earned from payments of principal and interest, with interest compounded semi-annually at the stated yield, presuming that the security remains outstanding until the maturity date. Compare **Yield to Call**.

YIELD VERIFICATION CONSULTANT

The firm retained by the issuer to verify the calculations leading to the conclusion that the yield on investments acquired with the proceeds of an issue does not exceed the amount permitted under the federal arbitrage rules.

ZERO COUPON BONDS

See **Compound Interest Bond**.

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