

# Municipal Bond Law

## A Discussion of Certain Public Finance Concepts

Texas City Attorneys Association Summer Conference – June 15, 2016

## Overview

- What is Debt?
- Limitations on a City's Authority to Issue Tax-Supported Debt or Other Obligations
- Municipal Obligation Issuance Process
- Types of Obligations Cities Can Issue
- Specific Topical Questions

## What is Debt?

- A pecuniary liability that is not satisfied out of current revenues or out of “some fund” within the immediate control of the [municipality].  
*McNeil v. City of Waco*, 33 S.W. 322, 323 (Tex. 1895).
- Article XI, Section 5 of the Texas Constitution requires the “levy” of an ad valorem tax in order to create a valid debt. The tax levy each year must be sufficient to pay the interest on the debt and to create a “sinking fund” of at least 2% of the principal.
- A contractually imposed obligation of indemnity creates a “debt” in the constitutional sense, unless, at the time of the agreement, it is within the lawful and reasonable contemplation of the parties that the indemnity will be satisfied out of current revenues or some currently available fund. *T & N.O.R.R. Company v. Galveston County*, 169 S.W.2d 713 (Tex. 1943).

## What is Debt?

- A City can avoid the creation of debt in the constitutional sense by -
  - Making the source of payment from a designated revenue source (Special Fund Doctrine).
    - Governmental revenue bonds are considered to be special obligations payable from a separate fund created from the designated revenues and not a “debt.”
    - Municipal bonds secured by a pledge of enterprise revenues and not subject to a claim against ad valorem taxes are not a constitutional debt.
  - Making contracts terminable at will, usually on 30 days’ notice.
  - Making contracts subject to annual appropriations.

## Limitations on a City's Authority to Issue Tax-Supported Debt or Obligations

- There are five primary sources of limitations on state and local debt--the Texas Constitution; Texas statutes; home-rule city charters; Attorney General opinions, rules, and then-current interpretation of Texas law; and contractual limitations agreed to in public security proceedings.

## Constitutional Limitations -

- Article XI, Section 5 authorizes Cities having more than 5,000 inhabitants to adopt and amend city charters -
  - no charter or any ordinance passed under said charter shall contain any provision inconsistent with the Constitution of the State, or of the general laws enacted by the Legislature of the State.
  - no debt shall ever be created by any city, unless at the same time provision be made to assess and collect annually a sufficient sum to pay the interest thereon and creating a sinking fund of at least two percent.
  - no tax for any purpose shall ever be lawful for any one year, which shall exceed two and one-half percent (\$2.50 per \$100) of the taxable property of such city.
- A home-rule charter may contain any provision that is not inconsistent with the Texas Constitution or contrary to the General Laws of the State. Tex. Const. art. XI, s 5.

## Public Purpose Limitations -

- Article III, Section 52. “[L]egislature shall have no power to authorize any county, city, town or other political corporation or subdivision of the State to lend its credit or to grant public money or thing of value in aid of, or to any individual, association or corporation whatsoever, or to become a stockholder in such corporation, association or company.”
- A City may not gratuitously grant its funds to another political subdivision. *See e.g., Fort Worth Indep. Sch. Dist. v. City of Fort Worth*, 22 S.W.3d 831,842 (Tex. 2000) (determining that Article III, Sections 51 and 52 would not permit a city to gratuitously pay "the City's public money" to a school district).
- Article III, Section 52(a) prohibits the gratuitous application of public money by a political subdivision. *Tex. Mun. League Intergovernmental Risk Pool v. Tex. Workers' Comp. Comm'n*, 74 S.W.3d 377, 383 (Tex. 2002).

## Public Purpose Limitations -

- Three-part test to determine if the contemplated expenditure (of debt proceeds) is constitutional:
  - Is the predominant purpose of the expenditure to accomplish a public purpose, not to benefit private parties?
  - Are there sufficient controls to ensure the public purpose is accomplished and the public investment is protected?
  - Will the City receive a return benefit? *See Tex. Mun. League Intergov'tl Risk Pool v. Tex. Workers' Comp. Comm'n*, 74 S.W.3d 377, 384 (Tex. 2002) (setting forth public-purpose criteria).
- If the answer to all three prongs is yes, the expenditure is likely constitutional, but please consult with Bond Counsel before taking action.

## Public Purpose Limitations -

- In order to issue tax-supported debt or other obligations, a municipality must have specific statutory authority or home-rule charter authority. See *San Antonio Union Jr. Coll. Dist. v. Daniel*, 206 S.W.2d 995, 999 (Tex. 1947) (quoting *Keel v. Pulte*, 10 S.W.2d 694, 697 (Tex. Comm'n App. 1928, holding approved) ("The power to issue negotiable paper for public improvements . . . is a power which is . . . beyond the scope of power of the governing body of a city or a county unless it be specifically granted.")) (emphasis added).
- Generally, voter approval is required prior to the issuance of any debt payable in whole or part from ad valorem taxes. Section 1251.001, Texas Government Code.
- Chapter 1431, Texas Government Code establishes various limitations on the issuance of Anticipation Notes.
- Chapter 1331, Texas Government Code also provides authority for a city to issue debt payable from ad valorem taxes.

## Public Purpose Limitations -

- The Attorney General may impose additional limitations on the City's ability to issue debt during the bond approval process by application of regulation or interpretation of various statutes. Such regulations and interpretations of statutes are subject to change.
  - Section 1201.065, Texas Government Code authorizes the Attorney General to approve a new public security if he finds the security has been executed and issued as provided by law.
  - The Texas Supreme Court has recognized that the Attorney General, in carrying out his statutory duty to approve ad valorem tax bonds, has the power and duty to ascertain that an issuer with limited ad valorem taxing authority is capable of paying its ad valorem tax obligations and its operating expenses with its maximum authorized tax rate, taking into account other revenues available to pay operating expenses as necessary. *City of Houston v. McCraw*, 113 S.W.2d 1215, 1219 (Tex. 1938).

## City-specific, Attorney General Limitations -

- For home-rule cities having a total taxing authority of \$2.50/\$100 taxable value of property, the Attorney General imposes a maximum allowable tax rate of \$1.50 for debt service. 1 Tex. Admin. Code § 53.5(3).
- The Attorney General will apply a lower tax rate if imposed by a city's charter. 1 Tex. Admin. Code § 53.5(3), (9).
- The maximum annual debt service of all outstanding and to be issued indebtedness secured by a particular revenue stream may not exceed the pledged revenues (net of operations and maintenance expenses) collected annually during the prior three years. 11/2/87 All Bond Counsel Letter, par. 11.

## Municipal Obligation Issuance Process -

- Section 1331.052(b) of the Texas Government Code prohibits a home-rule municipality from issuing certain bonds unless the bonds have been authorized by a majority of the qualified voters of the municipality voting at an election held for that purpose.
- If an election is required, the governing body of the City must conduct such election prior to the debt issuance.
  - Ballot proposition must distinctly state the purpose of the bonds, the amount of the bonds, the interest rate, the imposition of taxes to pay debt service and create a sinking fund, and the bond maturity date.
- The following forms of tax-supported debt do not require a prior election:
  - Anticipation Notes: Chapter 1431, Texas Government Code
  - Pension Bonds: Chapter 107, Texas Local Government Code
  - City State Highway System Bonds: Chapter 1510, Texas Government Code
  - Certificates of Obligation: Chapter 271, Texas Local Government Code

## Municipal Obligation Issuance Process -

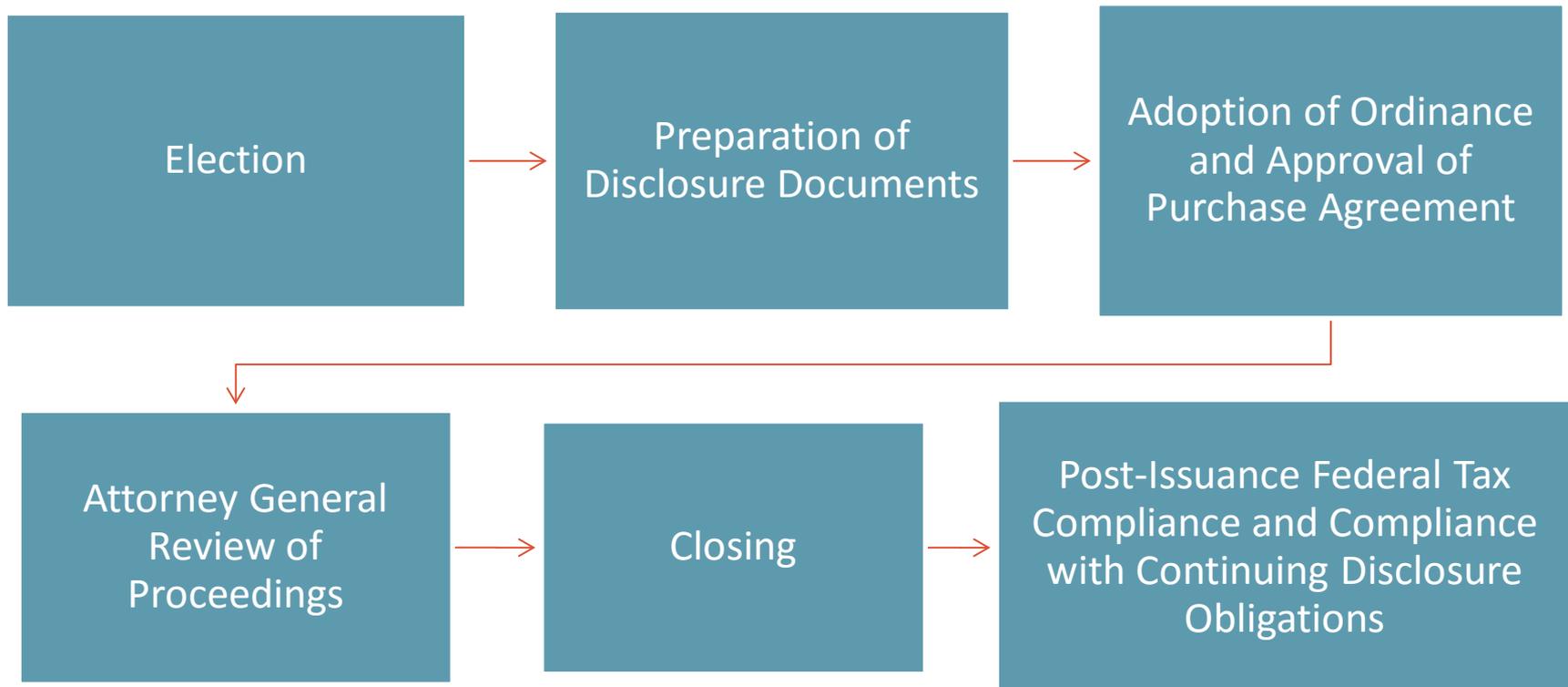
- Debt instruments must be validly authorized by the City's governing body.
  - Ordinance approves manner of sale, sets forth continuing disclosure undertakings, describes use of proceeds, and establishes delegation of authority for executing the instruments.
- Generally, tax-supported debt may be sold to a purchaser pursuant to a public sale (bidding process), negotiated contract with an underwriter, or private placement directly with a purchaser.
- Additional documents must be executed to sell and deliver the debt instruments to the Purchaser or Underwriter. [See interested-party disclosure discussion below.]
  - Purchase Agreement
  - Official Statement / Offering Document, if public sale or negotiated transaction
  - Continuing Disclosure Agreement

## Municipal Obligation Issuance Process -

- The Attorney General reviews a transcript of the proceedings issuing the security and issues an approving opinion that -
  - The security has been issued in accordance with law and are valid and binding obligations of the city.
  - Certifies the method of payment for the security.
  - In refunding transactions, firm banking arrangements have been made for the discharge and final payment of the refunded obligations.
  - The proceedings conform to legal requirements.
- The Comptroller of Public Accounts (the “Comptroller”) will then register the security.
- After approval by the Attorney General and registration by the Comptroller, the security is valid and incontestable in a court or other forum and is a binding obligation for all purposes according to its terms. Section 1202.006, Texas Government Code.

## Municipal Obligation Issuance Process -

- The issuance of new-money, tax-supported debt through a negotiated sale will generally follow this process:



## Types of Obligations Cities Can Issue – Tax-Supported, Voter-Approved Debt -

- Authority for Issuance:
  - Home Rule Charter, Chapter XXI, Section 2.
  - Chapter 1331, Texas Government Code
- Source of Repayment:
  - Ad valorem taxes
- Considerations:
  - Refer to limitations on city authority discussion (above)

## Types of Obligations Cities Can Issue - Special Revenue Obligations

- Authority for Issuance:
  - City charter
- Source of Repayment:
  - Revenues from city-owned enterprise activities (e.g. utilities)
- Considerations:
  - These obligations are not “debt” of the City.

# Types of Obligations Cities Can Issue - Certificates of Obligation

- Authority for Issuance:
  - Chapter 271, Texas Local Government Code
  - May be issued to pay for construction of any public work; purchase of materials, supplies, equipment, land, buildings, and rights-of-way for authorized needs; pay for professional services; pay change orders; pay for fees incurred in connection with water and sewer projects; pay for City employee costs attributable to project capital costs; and pay for demolition of dangerous structures
- Source of Repayment:
  - Ad valorem taxes, enterprise revenues (e.g. utilities), or a combination of both
- Considerations:
  - Prior notice provisions (published once/week for two consecutive weeks, at least 30 days prior to authorizing meeting); Election may be required if petitioned by 5% or more of registered voters
  - Cannot issue Certificates of Obligation for a purpose if voters did not authorize the issuance of bonds for the same purpose during the preceding three years

## Types of Obligations Cities Can Issue - Contractual Obligations

- Authority for Issuance:
  - Section 271.005, Texas Local Government Code
  - Leases can qualify
- Source of Repayment:
  - Payable from a pledge of all or any part of any revenues, funds, or taxes available to the governmental agency for its public purposes
- Considerations:
  - May only be used to finance personal property
  - Must also comply with provisions of Chapter 252, Texas Local Government Code regarding competitive bidding requirements

## Types of Obligations Cities Can Issue - Anticipation Notes

- Authority for Issuance:
  - The governing body of a municipality by ordinance may authorize the issuance of an anticipation note. Section 1431.002(b), Texas Government Code.
  - May be issued to pay for construction of any public work; purchase of materials, supplies, equipment, land, buildings, and rights-of-way for authorized needs; pay for professional services; pay operating or current expenses; and remedy cash flow deficits
- Source of Repayment:
  - Ad valorem taxes, revenue, combination of revenue and taxes, or bond proceeds
- Considerations:
  - Numerous limitations regarding use of proceeds, reimbursement timeframes, aggregate amount of issuance, and maturity

# Types of Obligations Cities Can Issue - Commercial Paper

- Authority for Issuance:
  - Must qualify as an “issuer” pursuant to Chapter 1371, Texas Government Code
  - May be issued to finance the acquisition or construction of or an improvement, addition, or extension to a public works, including a capital asset or facility incident and related to the operation, maintenance, or administration of the public works; an approved venue project; a project for which there exists authorized but unissued obligations approved by a majority of the voters of the issuer; or for which the issuer is authorized to issue other indebtedness payable from ad valorem taxes
- Source of Repayment:
  - Ad valorem tax proceeds, credit agreement proceeds, or any other lawful revenue
- Considerations:
  - If required by Chapter 1331, Texas Government Code, an election may be required; numerous limitations on transaction format

## Specific Topical Questions - Can a City sell “naming rights” to some of its bond-financed facilities?

- The IRS considers the benefit that a private entity (including a non-profit) receives from a naming right to be private use of the facility that generates private payments. Therefore, a sale of naming rights may cause the related bonds to exceed the private business test limitations.
- This would not include a City’s naming a building after a natural person unrelated to trade or business.
- Please contact Bond Counsel to discuss the tax consequences.
- When “naming rights” or other “private payments” are expected from the beginning of a project, the bonds can be structured to accommodate the structure from the beginning (i.e., part tax-exempt and part taxable bonds).

## Specific Topical Questions - Can a City issue general obligation bonds for economic development?

- A City cannot issue general obligation bonds for economic development without an election.
- Economic development is a “public purpose” but there is no separate statutory authority to issue bonds for that purpose (with the limited exception of Chapter 1509, Texas Government Code).
- The Attorney General has opined that the general Constitutional economic development provision does not authorize the issuance of bonds for economic development.
- A Home-Rule City’s Charter may permit the issuance of economic development bonds with an election if it permits the issuance of bonds for “any public purpose” or “any purpose not prohibited by law” or similar language.

## Specific Topical Questions - Can a City lease a bond-financed facility to a private entity or hire a private entity to run a city operation?

- Use of a bond-financed facility by a private user in a trade or business (which, for this purpose, includes the federal government and non-profits) through agreements such as leases and management agreements, can raise federal tax law issues for any bond-financed facility. This should trigger a call to your Bond Counsel, where the answers to the following questions will help speed the process and our answer:
  - **First Question:** Was the facility (or the part of the facility being leased) financed with bonds?
  - **Second Question:** Are those bonds still outstanding, or are any bonds issued to refund the original bonds still outstanding?
  - **Third Question:** What are the terms of the agreement (i.e., payments, term, etc.)
  - **Fourth Question:** Are there any other “private use” or “private payments” from the same issue of bonds that financed the facility?
  - **Fifth Question:** What was the total amount of the original bond issue; how much of the original issue was used for the facility being leased; what are the amounts of the subsequent refundings and what maturities were refunded?
  - (Note: there are ways to structure certain agreements so that they are not considered to give rise to private use for federal tax law purposes.)

## Specific Topical Questions - Can a City assess a higher debt service tax rate than it needs to pay debt service in any year?

- A City only has the authority to assess a debt tax sufficient to pay debt service coming due on its outstanding obligations in the next year (i.e., there is no authority to “over-levy”).
- A City can take into account its collection factor or percentage and assume less than 100% collection, which will naturally create a small “cushion” in the debt service fund that is acceptable for State law purposes and is treated as a “reasonably required reserve” for federal tax purposes.
- As the “cushion” builds up over time, then there could be federal tax law implications for an “overfunded” reserve that requires additional tax analysis, including yield restriction and, in the event of a refinancing, that a portion of the “cushion” be contributed to redemption of bonds.
- Contact Bond Counsel to discuss the specific facts and circumstances.

## Specific Topical Questions – What is interested-party disclosure, and what does it mean for City contracting?

- During the 2015 Legislative Session, the Texas Legislature adopted HB 1295, which added Section 2252.908, Texas Government Code and applies to covered contracts entered into on or after January 1, 2016.
- “A Governmental Entity or State Agency **may not** enter into a contract . . . with a Business Entity unless the Business Entity . . . submits a disclosure of Interested Parties to the Governmental Entity or State Agency **at the time** the Business Entity submits the signed contract to the Governmental Entity or State Agency.” Texas Government Code § 2252.908(d) [emphasis added].
- “Governmental Entity” means a municipality, county, public school district, or special-purpose district or authority. Texas Government Code § 2252.908(a)(2).
- “May not” imposes a prohibition and is synonymous with “shall not.” Texas Government Code § 311.016(5). **Noncompliance could lead to a voidable contract.**
- The statute applies to **every** city contract that either (i) requires an action or vote by its governing body before the contract may be signed; or (ii) has a value of more than \$1,000,000.

## Specific Topical Questions – What is post-issuance tax compliance, and what is my role?

- The Internal Revenue Service recommends that all issuers adopt written post-issuance compliance procedures that: (1) retains debt-related records for recommended timeframes, (2) tracks use and allocation of debt proceeds, (3) monitors arbitrage, (4) identifies conditions that could result in reissuance issues, and (5) provides for corrective actions, if required.
- Inadequate post-issuance tax compliance procedures may result in a determination by the IRS that:
  - In the case of tax-exempt debt, interest is **retroactively taxable to the date of issuance**.
  - In the case of tax credit debt, the **holders are not entitled to claim a tax credit or the issuer is not entitled to a direct subsidy payment**, as applicable.
- Assist bond counsel with the implementation of a post-issuance compliance plan.
- Be aware of post-issuance compliance issues when reviewing city contracts and agreements and contact bond counsel with questions.

## Specific Topical Questions – What should I know about SEC enforcement priorities?

- On March 10, 2014, the Enforcement Division of the Securities and Exchange Commission (SEC) announced the Municipalities Continuing Disclosure Cooperation Initiative – an offer for municipal issuers and their underwriters to (self) report certain potential violations of the securities laws in exchange for lighter punishments.
  - Covers potential violations of antifraud rules regarding description of issuer compliance with continuing disclosure agreements in Official Statements.
  - Market participants are generally aware of this initiative (and have made best-practice adjustments).
- The SEC has expanded its enforcement focus to municipal officials (including elected officials) under “control person” liability theory.
  - Settlement with the City of Allen Park, Michigan (City, former Mayor, and City Administrator).
  - Section 20(a) of the Exchange Act of 1934 - joint and several control person liability against persons with authority to oversee and direct individuals involved with securities offerings
  - Need not have participated in drafting disclosure documents or have knowledge of contents of disclosure documents.

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