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   - Professionals Involved in a Bond Financing Transaction
   - Six Things to Know When Issuing Municipal Bonds
   - The Financing Team
   - Duties and Obligations of Municipal Advisors to Issuers of Municipal Securities

2. GFOA: Debt Management Policy

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   - Application of Antifraud Provisions to Public Statements of Issuers and Obligated Persons of Municipal Securities in the Secondary Market: Staff Legal Bulletin No. 21 (OMS) (2/7/20)


7. SEC Rule 10b-5 (retrieved May 10, 2021)

8. Other Materials:
   - CDIAC - Leases in California: Their Form and Function [Excerpted Chapters] (September 1990)
MSRB materials
The nearly $4 trillion municipal securities market provides state and local governments with access to capital for important infrastructure projects. Follow a city as it navigates Muniland to finance a new school, and learn how the Municipal Securities Rulemaking Board protects the city and its investors along the way.

**PLAYERS**
- City Officials
- Municipal Advisor
- Underwriter
- Broker-Dealer

**MSRB ROLE**
- Regulation of Municipal Advisors, Underwriters and Broker-Dealers
- Transparency through Electronic Municipal Market Access (EMMA®) Website
- Resources in MSRB Education Center

**OVERCROWDED SCHOOL**

1. **City decides to issue school bonds.**
2. **City uses MSRB Education Center to learn about the issuance process.**
3. **City decides whether to hire a municipal advisor. If no, skip ahead two spaces.**
4. **City Selects Underwriter**
   - Underwriter must deal fairly with City and investors, and offer a fair price.
   - Underwriter provides City's official statement to investors on the EMMA website.

**PRIMARY MARKET**

1. **Underwriter Provides City's Official Statement to Investors**
2. **City Uses Bond Proceeds**
3. **City Hires Municipal Advisor**
   - Municipal advisor owes a fiduciary duty to put City's interest first.
4. **City Selects Underwriter**
5. **City Makes Continuing Disclosures**
   - MSRB Education Center resources help City understand its disclosure obligations to investors.

**SECONDARY MARKET**

1. **Investors Trade Bonds Through Brokers**
   - Investors learn about buying and selling bonds in the secondary market.
   - Investors use EMMA to access updated information about City's financial health.
2. **Brokers Report Trades to EMMA**
   - Real-time trade prices on EMMA help investors and City evaluate pricing.
3. **Brokers**
   - Brokers must give suitable recommendations, disclose information on features and risks and provide a fair price for investors.
   - Brokers buy and sell bonds for investors in the secondary market.

**NEW SCHOOL**

1. **City Repays Principal & Interest until Bonds Mature**

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Professionals Involved in a Competitive Municipal Bond Financing Transaction

- Issuer
- Bond Counsel
- Disclosure Counsel*
- Rating Agencies*
- Feasibility Consultant*
- Credit Enhancer*
- Auditor *
- Underwriter(s)
- Underwriter’s Counsel
- Municipal Advisor(s)
- Trustee *
- Underwriter’s Counsel

DEAL TABLE

*Participation depends upon type, size, and features of a transaction

- MSRB-Regulated
- MSRB-Protected
- Other Transaction Participants
Six Things to Know When Issuing Municipal Bonds

State and local governments rely on the municipal securities market to raise money to finance their capital projects. Issuing bonds, whether done once a decade or many times a year, generally requires municipal governments to hire financial professionals.

The Municipal Securities Rulemaking Board (MSRB) plays an important role in defining the relationship that municipal governments have with their financial professionals. It also plays a role in helping state and local governments communicate with investors.

This document explains six key things state and local governments should know about issuing municipal bonds.

1. MSRB registration is required for underwriters and municipal advisors.

When state or local governments issue bonds, an underwriter may help bring the bonds to market. State and local governments may also hire a municipal advisor to provide advice related to the issuance of the bonds. Both underwriters and municipal advisors are required to register with the MSRB and are subject to MSRB rules. Municipal bond issuers can visit the “Working with Financial Professionals” page in the MSRB’s Education Center at msrb.org to confirm that their underwriters or municipal advisors are properly registered. To view rules that apply to underwriters and municipal advisors, click on the “MSRB Rules” page in the Rules and Guidance section at msrb.org.

The MSRB maintains qualification standards for professionals at underwriter and municipal advisor firms through its licensing and examination activities. For example, financial professionals at underwriter firms must pass the MSRB’s Municipal Securities Representative Qualification Examination (Series 52) to engage in fundamental municipal securities activities such as underwriting and trading. Similarly, municipal advisor professionals must pass the MSRB’s Municipal Advisor Representative Qualification Examination (Series 50) to engage in municipal advisory activities. To read more about these professional qualifications, click on the “Professional Qualification” page in the MSRB’s Compliance Center at msrb.org.

2. Underwriters and municipal advisors must provide accurate information related to the sale of bonds.

State and local governments should expect a high level of professional conduct from both underwriters and municipal advisors. These financial professionals are
prohibited from deceiving or defrauding state and local governments. Additionally, MSRB rules require both underwriters and municipal advisors to deal fairly with issuers. Both underwriters and municipal advisors are required to provide accurate information when working with an issuer on the sale of its bonds. An underwriters’ fair-dealing requirement also includes honoring commitments made to an issuer regarding the distribution of its bonds.

MSRB rules also prohibit certain material conflicts of interest. For example, financial professionals cannot act as a municipal advisor to a state or local government in the issuance of a bond, and then become an underwriter for the same issuance. MSRB rules further require the disclosure of certain other conflicts even if not altogether prohibited.

3. Municipal advisors owe a fiduciary duty to their municipal entity issuer clients.

Municipal advisors have a fiduciary duty to their municipal entity issuer clients. Among other things, municipal advisors are required to act in the best interests of their issuer clients without regard to their own financial or other interests.

Underwriters do not have a fiduciary duty to their issuer clients, but, as stated above, they must deal fairly with and not deceive or defraud issuers.

4. Issuers can use different approaches to issue bonds.

In a competitive bond sale, underwriters submit bids to purchase the issuer’s bonds in accordance with the terms set by the issuer in a notice of sale. Generally, the issuer awards the right to purchase all of the bonds to the underwriter that meets the requirements in the notice of sale and enables the issuer to borrow at the lowest cost.

In a negotiated bond sale, an issuer hires an underwriter to find investors for the bonds. An issuer approves the terms and conditions of the sale, as well as defines retail order period requirements and determines which orders receive priority. Additionally, issuers have the right to determine how the bonds are distributed among investors in connection with the offering. In both types of sales, underwriters are subject to primary offering practices as defined by MSRB rules.

5. Issuers can use the EMMA® website to communicate important information directly to investors.

Issuers of municipal bonds generally commit to provide to investors certain annual financial information and other updated data about their bonds until they mature or are otherwise redeemed. The MSRB operates the Electronic Municipal
Market Access (EMMA®) website as the centralized platform for municipal bond issuers to communicate important information about themselves and their bonds to investors.

Additionally, the MSRB receives and disseminates on EMMA certain voluntary disclosures that may be submitted by issuers, such as annual budgets, pre-sale documents and information concerning bank loans and other material financial obligations.

6. Issuers can use EMMA to evaluate municipal market trading.

Issuers can review trade data related to their bonds on the EMMA website, as well as trade data related to over one million other outstanding bonds. Issuers can find this data on EMMA by entering a CUSIP number or an issuer name and selecting the “Trade Activity” tab.

The MSRB Education Center is a multimedia library of information about the municipal securities market. Free and objective resources are geared toward investors and state and local governments to help them make informed decisions. Issuers can access resources to assist them during every step of the process, from putting together a deal team to submitting annual financial disclosures for outstanding bonds. Learn more about the free educational documents, videos and podcasts available in the online MSRB Education Center.
A key part of issuing new debt is to assemble a team that works for the state or local government. Generally, the bond offering process is a coordinated effort among various professionals to finance a state or local government’s capital projects. A municipal government can benefit from an understanding of the roles and responsibilities of its deal team.

Once a state or local government decides to finance a capital project by issuing bonds, it would hire a financing team to finalize the financing plan, develop offering documents, prepare for any rating agency and investor presentations, market the bond offering to investors, price the bonds and close the transaction.

The roles and responsibilities of an issuer’s team may vary depending upon the bond offering method of sale — competitive bid, negotiated sale or private placement.

In a negotiated sale, an initial bond offering by an issuer is directly sold to an underwriter or underwriting syndicate selected by the issuer. In addition to the underwriter or underwriting syndicate, the professionals involved in a negotiated municipal bond financing transaction may include municipal advisors, underwriter’s counsel, bond counsel, feasibility consultants, credit enhancers, selling group members, auditors, rating agencies, trustees, disclosure counsel and other counsel.

The bond offering process is a coordinated effort among various professionals to finance a state or local government’s capital projects.

A competitive bid is a transaction in which potential underwriters submit proposals for the purchase of a new issue of municipal securities and the securities are awarded to the underwriter or underwriting syndicate presenting the best bid according to stipulated criteria set forth in the notice of sale. The underwriting of securities in this manner may also be referred to as a “public sale” or “competitive sale.” The professionals that may be involved in competitive transactions include underwriters, municipal advisors, underwriter’s counsel, bond counsel, feasibility consultants, credit enhancers, auditors, rating agencies and trustees.

Among the primary points of negotiation for an issuer are the interest rate, call features and purchase price of the issue, as well as covenants or other key terms of the bond documents viewed as important in marketing the new issue.

The following provides general descriptions of the role, activities and responsibilities of members of a bond financing team in an initial bond offering. Other activities conducted by these professionals will depend on the particular type of transaction, the presence of additional financing team members and any restricted role they perform as the issuer may determine.
The State or Local Government

- Defines the financing requirements
- Determines the method of sale
- Sets and implements debt management policies and procedures of the municipality
- Determines available resources for payment of principal and interest of new debt issue
- Selects and manages the financing team
- Prepares offering documents in consultation with the financing team
- Works with the senior manager to determine how orders are filled or allotted to investors from the bond pricing order period
- Determines participation of the senior manager and syndicate members’ liability in a negotiated bond issuance
- Determines the compensation of financing team
- Negotiates with the underwriter the final purchase price of the bonds
-Executes the bond purchase agreement with the senior manager
-Adopts bond resolution and/or executes any trust indenture, loan agreement or other bond financing documents
-Pays principal and interest on the bonds as they become due
-Complies with tax and other covenants included in the bond financing documents
-Submits continuing disclosures to the MSRB’s Electronic Municipal Market Access (EMMA®) system under the issuer’s continuing disclosure agreement

Municipal Advisor

- Acts in a fiduciary capacity for the state or local government
- Develops requests for proposals and qualifications for underwriters, bond or disclosure counsel, credit enhancement facilities and investment products
- Assists in developing the plan of finance and related transaction timetable
- Identifies and analyzes financing solutions and alternatives for funding capital improvement plan
- Advises on the method of sale, taking into account market conditions and near-term activity in the municipal market
- Assists in preparation of any rating agency strategies and presentations
- Coordinates internal/external accountants, feasibility consultants and escrow agents
- Assists with the selection of underwriters, underwriter compensation issues, syndicate structure and bond allocations
- Assists with negotiated sales, including advice regarding retail order periods and institutional marketing, analysis of comparable bonds and secondary market data
- Assists with competitive bond sales, including preparation of notice of sale and preliminary official statement, bid verification, true interest cost (TIC) calculations and reconciliations/verifications of bidding platform calculations, preparation of notice of sale, obtaining CUSIP numbers
- Prepares preliminary cash flows/preliminary refunding analysis

The state or local government selects and manages the financing team.
• Analyzes whether to use SLGS, open markets and/or agency securities for purposes of investment of bond proceeds
• Manages the escrow bids or reviewing SLGS applications for structuring advance refunding escrow
• Assists in procuring printers, verification agents, etc.
• Verifies cash flow calculations
• Plans and coordinates bond closings
• Prepares any required post-sale reports of bond sales
• Evaluates market conditions and pricing performance of senior manager and co-managers’ distribution of bonds

**Bond Counsel**

• Drafts bond resolution, indenture, loan agreement and/or other bond financing documents
• Reviews applicable law to confirm the issuer's authority to issue the bonds and its conformity with other legal requirements
• Affirms issuer's authorization of the bond offering
• Discloses and examines litigation that may jeopardize the validity of the bond issue
• Interprets arbitrage regulations and tax law
• Attests to the validity and enforceability of the bonds
• Provides guidance in structuring issues related to tax law
• Confirms tax-exempt status
• Drafts tax certificate

**Underwriter (also known as Senior Manager, Lead Manager or Bookrunner)**

• Has an “arm’s-length” relationship with the municipal government
• Provides proceeds at closing and obtains funds from investors
• Manages the affairs of any underwriting syndicate formed in connection with a new issue
• In a negotiated offering:
  – Works with state or local government and municipal advisor to design the plan of finance
  – Develops the bond structure
  – Assists in determining timing to sell bonds based on market conditions
  – Assists in the development of the bond documents
  – Assists in preparing any rating agency strategy and presentation
  – “Runs numbers” providing quantitative analysis of financing structure
  – Manages the pricing process
  – Executes pre-sale marketing
  – Solicits price views from syndicate members, which provides preliminary pricing indications among underwriters and customers about the offering range of a new issue
• Prepares distribution analysis
  – Works with the state or local government to determine how orders are filled from the bond pricing order period
  – Executes the bond purchase agreement with the municipal government on behalf of the syndicate

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The underwriter has an “arm’s-length” relationship with the municipal government.
Roles and Responsibilities: The Financing Team in an Initial Municipal Bond Offering

Subscribe to issuer education and EMMA email updates from the MSRB.

- Submits bid in a competitive sale following evaluation of pricing of comparable issues, discussions with potential investors, accessing supply of bonds in the market or bonds scheduled to come to market, weighing possible competition from other firms

**Underwriting Syndicate**
(also known as Co-Manager(s))
- Has an “arm’s-length” relationship with the state or local government
- Under the direction of the senior manager, purchases an initial bond issue from state or local government and offers it for resale to investors
- Provides sufficient capital to purchase an issue
- Shares the risks of underwriting the issue with the senior manager
- Distributes the bonds to investors

**Rating Agencies**
- Assess the credit quality of the bonds
- Assigns rating to the bond issue
- Updates ratings periodically while debt is outstanding

**Trustee (also known as Paying Agent, or Registrar)**
- Acts in a fiduciary role for the benefit of bondholders in enforcing the terms of the trust indenture
- Transmits principal and interest payments from an issuer of municipal securities to the bondholders
- Holds and invests moneys held in a construction fund, reserve fund or other funds that serve as security for payment of debt service on the bonds
- Maintains records on behalf of the issuer that identify the registered owners of the bonds and related matters
- Represents the interests of bondholders in the event of a default

Depending upon the type of transaction, other deal participants may be retained as required including:

**Other Counsel**
Other counsel in the bond issuance process may include disclosure counsel, special tax counsel, bank counsel, and borrower’s counsel. Such special counsel may be necessary for specific issues that are more complex or have particular characteristics.

**Feasibility Consultant**
- Writes the feasibility report prepared for revenue bond sales (such as in airport and water and sewer revenue bond offerings) and included in the official statements.
The report may evaluate the economic viability, or the adequacy of revenues generated by a capital project or program to repay debt. The report generally describes historic and projected demand for the services, economic trends, user base, user fees and rates that generate revenues pledged to cover debt service.

**Credit Enhancers**
- Support an issuer’s credit in exchange for a fee or a premium, in the form of enhancement such as bond insurance or a letter of credit

**Selling Group Members**
- Assist in the distribution of a new issue of municipal securities
- Acquire new issue securities from the underwriting syndicate but do not participate in residual syndicate profits nor share any liability for unsold bonds

**Verification Agent**
- Verifies cash flow sufficiency to the call date of the escrow securities to pay principal and interest on refunded bonds

**Escrow Agent**
- Serves as custodian of funds and holds securities to pay debt service on refunded bonds

**Printer**
- Prints, or creates the electronic version of, the preliminary and final official statements for distribution to the marketplace

**Auditor**
- Compiles and examines the municipal government’s financial statements upon which the auditor has expressed or disclaimed an opinion
- Reports, audits or investigates a municipal government’s financial position and results of operations for a set period of time

Generally, the audit includes: (a) a statement of the scope of the audit; (b) explanatory comments concerning exceptions from generally accepted accounting principles and auditing standards; (c) expression or disclaimer of opinions; (d) explanatory comments concerning verification procedures; (e) financial statements and schedules; and (f) statistical tables, supplementary comments and recommendations.
Private placements also are sold by negotiation and involve the sale by a placement agent directly to institutional or private investors rather than through an offering to the general investing public. Investors purchasing privately placed securities often must meet certain standards of sophistication and also are often required to agree to restrictions as to resale and are sometimes required to provide a private placement letter to that effect.

Allotments are the number of bonds that are actually sold by an underwriter to an investor.

Participation is the portion of a new municipal bond issue, expressed as a percentage of the number of bonds, for which the senior manager and syndicate members have a legal liability, regardless of whether they sell that many bonds. There are two major types of syndication agreements:

Undivided or Eastern Account — A method for determining liability stated in the agreement among underwriters in which each member of the underwriting syndicate is liable for any unsold portion of the issue according to each member’s percentage participation in the syndicate. Syndicates most frequently are structured as undivided accounts.

Divided or Western Account — A method for determining liability stated in the agreement among underwriters in which each member of an underwriting syndicate is liable only for the amount of its participation in the issue, and not for any unsold portion of the participation amounts allocated to the other underwriters.

Bond purchase agreement is the contract between an underwriter and issuer setting forth final terms, prices and any other relevant conditions upon which underwriter purchases a new municipal bond issue.

MSRB Rule G-42 sets forth the core elements of the fiduciary duty standard as consistent with the mandates of the Dodd-Frank Act and the federal fiduciary duty imposed on municipal advisors in their relationship with municipal entity clients under Section 15B(c)(1) of the Securities Exchange Act of 1934.

SLGS are U.S. Treasury securities issued under its State and Local Government Series program for purposes of complying with arbitrage rules under the federal tax code.

MSRB Rule G-17 requires dealers to deal fairly with issuers in connection with the underwriting of municipal securities and to disclose to the issuer that its primary role is to purchases securities with a view to distribution in an arm’s-length commercial transaction.

Blue sky memorandum specifies the way a specific issue will be treated under state securities laws, usually including all 50 states and U.S. Territories, as well as the steps that must be undertaken to qualify the issue for sale in those jurisdictions.

Agreement among underwriters is a contract among syndicate group members setting forth their rights, duties and underwriter’s commitments to each other with respect to a new issue of securities.
State and local government issuers rely on the municipal securities market to raise money to finance their capital projects. Whether they issue securities once a decade or many times a year, state and local government issuers generally hire a municipal advisor, an underwriter or both to assist with the offering. This document provides an overview of the duties and obligations of municipal advisors and dealers that are regulated by the Municipal Securities Rulemaking Board (MSRB), and summarizes the key responsibilities of these professionals under MSRB rules.¹

The MSRB is a self-regulatory organization for the municipal securities market and is authorized by federal law to write rules with respect to certain securities activities of brokers, dealers and municipal securities dealers (collectively, “dealers”) and advisory activities of municipal advisors. The mission of the MSRB is to protect investors, municipal entities, obligated persons and the public interest, by promoting a fair and efficient municipal securities market.²

more >>
Municipal Advisors and Dealers Must Register with the MSRB

Dealers and municipal advisors must register with the MSRB before engaging in certain municipal securities and advisory activities. To access the list of dealers and municipal advisors registered with the MSRB, click on the “Registration Status” link under the “Compliance Center” tab of MSRB.org. Additionally, non-bank dealers and municipal advisors generally are required to register with the U.S. Securities and Exchange Commission.

Municipal Advisors and Dealers Have a General Duty of Fair Dealing

In the conduct of their municipal securities or municipal advisory activities, MSRB Rule G-17 requires that dealers and municipal advisors deal fairly with all persons, including their state and local government clients, and prohibits dealers and municipal advisors from engaging in any deceptive, dishonest or unfair practice. For more information on the duty of fair dealing for dealers and municipal advisors, see “What to Expect from Your Underwriter,” and “What to Expect from Your Municipal Advisor,” respectively.

Underwriters and Municipal Advisors Must Steer Clear of Pay to Play

MSRB Rule G-37 does not prohibit dealers and municipal advisors from making political contributions. However, it does restrict dealers and municipal advisors from engaging in municipal securities business or municipal advisory business, as applicable, with a municipal entity for two years after certain political contributions have been made to an official of that municipal entity.

In addition, Rule G-37 also subjects dealers and municipal advisors to certain prohibitions on soliciting and coordinating contributions and payments. For purposes of Rule G-37, municipal securities business includes acting as an underwriter in a negotiated offering (but not a competitive offering), including when acting as a syndicate member but not as a selling group member. Additionally, private placements and other offerings (such as acting as primary distributor for a 529 savings plan), and remarketing agent services with respect to a negotiated primary offering also constitute municipal securities business.

Municipal advisory business includes: (i) providing advice to or on behalf of a client 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 such financial products or issues; and (ii) solicitation of a municipal entity or obligated person acting in such capacity.

Contributions include any gift, subscription, loan, advance or deposit of money or anything of value made to an official of a municipal entity: (i) for the purpose of influencing any election for federal, state or local office; (ii) for the payment of debt incurred in connection with any such election; or (iii) for transition or inaugural expenses incurred by the successful candidate for state or local office.

Contributions that can trigger a restriction are contributions by: the dealer or municipal advisor; certain persons associated with the dealer or municipal advisor called municipal finance professionals or municipal advisor professionals; dealer- or municipal

About the MSRB

The mission of the Municipal Securities Rulemaking Board (MSRB) is to protect investors, municipal entities, and the public interest by promoting a fair and efficient municipal securities market. As part of its mission to protect investors, the MSRB creates rules with specific obligations for municipal securities professionals which regulate their conduct with investors. The MSRB provides market transparency through its Electronic Municipal Market Access (EMMA®) website, the official source for municipal securities data and documents. Also, the MSRB serves as an objective resource on the municipal market and conducts extensive education and outreach to market stakeholders.
finance professional-controlled political action committees; and certain solicitors called municipal third-party solicitors. An exception applies for contributions made by municipal finance professionals and municipal advisor professionals to an official for whom they are entitled to vote if their contributions to that official do not exceed $250 per election.

Dealers and municipal advisors also must submit quarterly disclosures to the MSRB about their municipal securities or municipal advisory business and any related political contributions.

**Bond Ballot Campaign Contributions are Subject to Disclosure**

**MSRB Rule G-37** also governs contributions made to bond ballot campaigns. Accordingly, dealers and municipal advisors must publicly disclose to the MSRB detailed information about cash or in-kind contributions to bond ballot campaigns and any resulting municipal securities business. Note there is a de minimis exception from disclosure if the bond ballot contributor is entitled to vote on the ballot initiative and the contribution to the ballot campaign does not exceed in total $250 per initiative.

**Certain Payments Related to the Solicitation of Business are Prohibited**

**MSRB Rule G-38** generally prohibits dealers from providing or agreeing to provide, directly or indirectly, payment to any unaffiliated person for soliciting municipal securities business on its behalf. For purposes of this rule, a solicitation is any direct or indirect communication with a municipal entity for the purposes of obtaining or retaining municipal securities business. The determination of whether a particular communication is a solicitation depends on the specific facts and circumstances.

**There are Limitations on Gifts and Gratuities**

**MSRB Rule G-20** prohibits dealers and municipal advisors from making certain gifts and gratuities. Generally, dealers and municipal advisors cannot give or provide, directly or indirectly, any thing or service of value, including gratuities, in excess of $100 per year to a person, if such payments or services are in relation to the municipal securities or municipal advisory activities of the employer of the recipient of the payment or service ($100 limit). Most importantly, this limit generally applies to gifts or gratuities to issuer personnel.

However, there are exclusions from the $100 limit for certain gifts if those gifts do not give rise to any apparent or actual material conflict of interest. For example, there is an exclusion for normal business dealings. Occasional meals or tickets to theatrical, sporting events, and other entertainment hosted by dealers or municipal advisors and the sponsoring regulated entity of legitimate business functions that are recognized by the Internal Revenue Service are permitted as deductible business expenses, provided that they are not so frequent or extensive as to raise any question of propriety. There also are limited exclusions from the $100 limit for various other gifts, including de minimis gifts or promotional gifts of nominal value that otherwise satisfy certain conditions.

Rule G-20 also prohibits a dealer or municipal advisor from seeking reimbursement from the offering proceeds of the municipal securities for certain entertainment costs or expenses. However, this prohibition does not apply to ordinary and reasonable expenses for meals hosted by the dealer or municipal advisor and directly related to the offering for which the dealer or municipal advisor was retained.

With some exceptions, Rule G-20 also generally limits a dealer or any of its associated persons from accepting or providing certain non-cash compensation in connection with the sale and distribution of a primary offering of municipal securities.

Various state and local laws applicable to gifts and gratuities in an issuer’s jurisdiction may establish different standards, which may be more or less restrictive than Rule G-20.

**Non-Solicitor Municipal Advisors Must Uphold Certain Standards of Conduct**

In addition to the standard of fair dealing, municipal advisors must follow certain standards of conduct when providing advice to their clients. As a matter of federal securities law, municipal advisors owe a fiduciary duty to municipal entity clients when advising them concerning the issuance of municipal securities and certain other matters. In defining that fiduciary duty, MSRB rules provide that municipal advisors owe their municipal entity clients a duty of loyalty and a duty of care.
In conduit borrowings, municipal advisors owe a duty of care to their obligated person clients.

For all municipal advisory clients, MSRB Rule G-42 requires municipal advisors to disclose material conflicts of interest and to document in writing the scope of their advisory relationship. In addition, Rule G-42 requires municipal advisors to conduct reasonable due diligence prior to making any recommendations to their clients.

Financial Professionals are Prohibited from Certain Role Switching

MSRB Rule G-23 generally prohibits a dealer that has a financial advisory relationship with an issuer with respect to the issuance of municipal securities from acquiring, as a principal acting alone or as a syndicate member, directly or indirectly, all or any portion of the offering or act as a placement agent for the offering. Generally, a financial professional can only serve in one capacity with respect to an issuance of municipal securities — as either a municipal advisor or an underwriter.

Underwriters Must Adhere to the Retail Order Periods and Priority Orders Specified by the Issuer

Under MSRB Rule G-11, before the offer of securities by the underwriting syndicate, the senior syndicate manager is required to provide the other syndicate members and selling group members, in writing, certain information about the offering, including, among other things, any of the issuer's terms and conditions on the offering, the issuer's retail order period requirements and priority provisions, as well as procedures, if any, by which the priority provisions may be changed. If a retail order period is established, certain retail bond purchase orders generally must be given priority over other orders based on eligibility criteria established by the issuer.

Underwriters and Municipal Advisors are Generally Required to Obtain CUSIP Numbers for a New Issuance

MSRB Rule G-34 requires the underwriter in a negotiated offering to apply for CUSIP numbers for the new issue no later than the time that pricing information for the new issue is finalized. This ensures sufficient time for CUSIP number assignment to occur prior to the formal award of the issue.

In a competitive offering, the municipal advisor must apply to obtain CUSIP numbers for the new offering by no later than one day after the dissemination of the notice of sale or other similar such document. In a competitive offering where CUSIP numbers have not been preassigned, the underwriter is required to apply for CUSIP numbers immediately after receiving notification of the award from the issuer.

The requirement to obtain CUSIP numbers also generally applies to placement agents in the private placement of municipal securities unless the private placement is a direct purchase by a bank or a non-broker-dealer control affiliate of a bank (or a consortium of such entities) or the purchasing entity meets certain other criteria (e.g., state revolving fund or bond bank), and the underwriter or municipal advisor reasonably believes the purchaser has the present intent to hold the municipal securities to maturity or earlier redemption or mandatory tender.

UNDERWRITERS MUST DETERMINE THAT AN ISSUER HAS COMMITTED TO PROVIDE CERTAIN INFORMATION TO THE MSRB

Underwriters also have responsibilities under other securities laws applicable to municipal securities offerings. For example, the U.S. Securities and Exchange Commission's Rule 15c2-12 generally prohibits an underwriter from purchasing or selling municipal securities unless the underwriter has determined that the issuer has committed through a written agreement or contract (i.e., continuing disclosure agreement or continuing disclosure undertaking) to provide certain updated information on a periodic basis to the MSRB. Consequently, issuers of municipal securities generally commit to submit annual disclosures with updated financial information and operating data to the MSRB’s EMMA website.
Underwriters are Required to Report Certain Information about a New Issuance

MSRB Rule G-32 requires underwriters of municipal securities to submit certain information about a new issue of municipal securities information to the New Issue Information Dissemination Service (NIIDS) of the Depository Trust and Clearing Corporation. Relatedly, program dealers and remarketing agents must submit information to the MSRB’s Short-term Obligation Rate Transparency (SHORT) System for dissemination to the public.

Underwriters Must Post Certain Disclosures to EMMA for a New Issuance

MSRB Rule G-32 requires underwriters to submit official statements, if available, and advance refunding documents and certain other new issue information for posting on the MSRB’s Electronic Municipal Market Assess (EMMA®) website within certain time periods.

1 Underwriters also have responsibilities under other securities laws applicable to municipal securities offerings. This summary does not describe all applicable provisions of rules and interpretations, nor does it include all exceptions from general requirements. The MSRB may amend any such rules or interpretations, or may adopt additional rules or interpretations, from time to time. The complete text of specific rules and interpretations, and related definitions, are available at http://msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx. In addition, other laws (including state and local rules) may be applicable to certain activities described herein. This document does not create new legal or regulatory requirements, or new interpretations of existing requirements and should not be interpreted by regulated entities or examining authorities as establishing new standards of conduct.

2 The term “municipal entity” includes any state, political subdivision of a state, or municipal corporate instrumentality of a state, including any agency, authority, or instrumentality of the state, political subdivision, or municipal corporate instrumentality; any plan, program, or pool of assets sponsored or established by the state, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and any other issuer of municipal securities. Certain other terms used in this document, including “non-solicitor municipal advisor,” “retail order period,” “syndicate,” “selling group,” “municipal advisor,” “non-cash compensation,” “primary offering,” “regulated entity,” “bond ballot campaign,” “municipal securities business,” “municipal advisory business,” “municipal advisor professional,” “municipal finance professional,” “contribution” and “solicitation,” have specific definitions under MSRB rules, which, for the sake of conciseness, are omitted or not fully included herein.
GFOA: Debt Management Policy
State and local governments should adopt comprehensive written debt management policies.

The London Interbank Offered Rate (LIBOR) is scheduled to end by December 31, 2021, and possibly sooner as the market moves towards the replacement benchmark, the Secured Overnight Financing Rate (SOFR). Therefore, existing contracts that reference LIBOR will need to be revised to perform as intended and new contracts may have to reference SOFR.

Finance officers should review financial contracts and agreements for LIBOR exposure and discuss with your finance team (including your counsel, swap advisor and municipal advisor) regarding changes that may need to occur in legacy contracts.

- International Swaps and Derivatives Association (ISDA) Resources
- GFOA Resource Document

Utilizing municipal bonds to fund public infrastructure is a valuable strategy for governments to spread the cost of significant long term assets over their useful life. It is important to involve all stakeholders in the decision to issue debt and to make sure resources are identified to prepare for the issuance, address all disclosure requirements and maintain the accounting through the life of the bonds. GFOA Best Practices provide a comprehensive overview of the requirements associated with a debt issuance. It is also recommended that any government or authority considering entering the bond market consult the expertise of bond counsel, disclosure counsel, and municipal advisor to determine the best course of action for their specific project and to assist with the development of debt management policies.
Debt management policies are written guidelines, allowances, and requirements that guide the debt issuance practices of state or local governments, including the issuance process, management of a debt portfolio, adherence to various laws and regulations, post issuance compliance for IRS purposes, and post issuance compliance for continuing disclosure purposes. A debt management policy should 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. Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed and therefore is likely to meet its debt obligations in a timely manner. Debt management policies should be written with attention to the issuer's specific needs and available financing options and are typically implemented through more specific operating procedures. Finally, debt management policies should be approved by the issuer’s governing body to provide credibility, transparency and to ensure that there is a common understanding among elected officials and staff regarding the issuer’s approach to debt financing.

“Financial obligation” means a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of (i) or (ii). Some examples of financial obligations include but are not limited to:

- Direct placements, loans, lines of credit or other credit arrangements with private lenders or commercial banks;
- Letters of credit issued in connection with variable rate debt issuance;
- Interest rate swaps entered into in connection with debt issuance.

GFOA recommends that state and local governments adopt comprehensive written debt management policies. These policies should reflect local, state, and federal laws and regulations. To assist with the development of these policies GFOA recommends that a government’s Debt Management Policy (Policy) should be reviewed periodically (and updated if necessary) and should address at least the following:

1. **Debt Limits.** The Policy should consider setting specific limits or acceptable ranges for each type of debt. Limits generally are set for legal, public policy, and financial restrictions and planning considerations.

   1. *Legal restrictions* may be determined by:
2. Public Policies will address the internal standards and considerations within a government and can include:

- Purposes for which debt proceeds may be used or prohibited,
- Types of debt that may be issued or prohibited,
- Relationship to and integration with the Capital Improvement Program, and
- Policy goals related to economic development, including use of tax increment financing and public-private partnerships.

3. Financial restrictions or planning considerations generally reflect public policy or other financial resources constraints, such as reduced use of a particular type of debt due to changing financial conditions. Appropriate debt limits can have a positive impact on bond ratings, particularly if the government demonstrates adherence to such policies over time. Financial limits often are expressed as ratios customarily used by credit analysts. Different financial limits are used for different types of debt. Examples include:

1. Direct Debt, including general obligation bonds, are subject to legal requirements and may be able to be measured or limited by the following ratios:

   - Debt per capita,
   - Debt to personal income,
   - Debt to taxable property value, and
   - Debt service payments as a percentage of general fund revenues or expenditures.
2. *Revenue Debt* levels often are limited by debt service coverage ratios (e.g., annual net pledged revenues to annual debt service), additional bond provisions contained in bond covenants, and potential credit rating impacts.

3. *Conduit Debt* limitations may reflect the right of the issuing government to approve the borrower’s creditworthiness, including a minimum credit rating, and the purpose of the borrowing issue. Such limitations reflect sound public policy, particularly if there is a contingent impact on the general revenues of the government or marketability of the government’s own direct debt.

4. *Short-Term Debt Issuance* should describe the specific purposes and circumstances under which it can be used, as well as limitations in term or size of borrowing.

5. *Variable Rate Debt* should include information about when using non-fixed rate debt is acceptable to the entity either due to the term of the project, market conditions, or debt portfolio structuring purposes.

2. **Debt Structuring Practices.** The Policy should include specific guidelines regarding the debt structuring practices for each type of bond, including:

   - Maximum term (often stated in absolute terms or based on the useful life of the asset(s)),
   - Average maturity,
   - Debt service pattern such as equal payments or equal principal amortization,
   - Use of optional redemption features that reflect market conditions and/or needs of the government,
   - Use of variable or fixed-rate debt, credit/liquidity enhancements, derivatives, short-term debt, and limitations as to when, and to what extent, each can be used, and
Other structuring practices should be considered, such as capitalizing interest during the construction of the project and deferral of principal, and/or other internal credit support, including general obligation pledges.

3. Debt Issuance Practices. The Policy should provide guidance regarding the issuance process, which may differ for each type of debt. These practices include:

- Selection and use of professional service providers, including an independent municipal advisor, to assist with determining the method of sale and the selection of other financing team members,
- Criteria for determining the sale method (competitive, negotiated, private placement, bank loan) and investment of proceeds,
- Use of comparative bond pricing services or market indices as a benchmark in negotiated transactions, as well as to evaluate final bond pricing results,
- Criteria for issuance of advance refunding, current refunding, and taxable bonds, and
- Use of credit ratings, minimum bond ratings, determination of the number of ratings, and selection of rating services.

4. Debt Management Practices. The Policy should provide guidance for ongoing administrative activities including:

- Investment of bond proceeds,
- Primary market disclosure practices and procedures, including annual certifications as required,
- Continuing disclosure procedures; including those related to ensure compliance with any continuing disclosure undertaking (CDA),
- Arbitrage rebate monitoring and filing,
- Monitoring use of tax-exempt bond financed facilities for private use,
- Federal and state law compliance practices, and
- Ongoing market and investor relations efforts.
5. **Use of Derivatives.** The Debt Management Policy should clearly state whether or not the entity can or should use derivatives. If the policy allows for the use of derivatives, a separate and comprehensive derivatives policy should be developed (see GFOA’s Advisory, Developing a Derivatives Policy and Derivatives Checklist).

Notes:

- Post Issuance Compliance Checklist

References:

- GFOA Best Practice: Post-Issuance Policies and Procedures, 2020
- GFOA Best Practice: Understanding Your Continuing Disclosure Responsibilities, 2020
- GFOA Best Practice: Refunding Municipal Bonds, 2019
- GFOA Best Practice: Bank Loans and Direct Placements, 2020.
- GFOA Best Practice: Selecting Bond Counsel, 2008.
- GFOA Best Practice: Selecting and Managing Municipal Advisors, 2014.
- GFOA Best Practice: Selecting Underwriters for a Negotiated Bond Sale, 2008.
- Debt Management Policy Examples

- **Board approval date:** Friday, March 6, 2020
SEC Staff Guidance Regarding Secondary Market Disclosure


**Summary**


Securities and Exchange Commission (“SEC”) Chairman Clayton had directed the “Office of Municipal Securities to put together a staff legal bulletin summarizing the application of the federal securities laws to various disclosure scenarios,” prompted in part by the following concern:

> [T]he timeliness of municipal issuer financial reporting . . . is an area where we have heard there are questions in the market about the application of our federal securities laws and, in particular, how the antifraud provisions of the federal securities laws apply to information that is made publicly available by municipal issuers through various channels. I have been informed recently that some issuers are receiving advice that, in connection with the distribution of information that is material to an investment decision, disclosing that information to investors on the MSRB’s EMMA system triggers a more rigorous liability standard for that information than disclosing the same information to investors through other means.1

In response to this direction, the Bulletin summarizes certain previous SEC statements regarding the application of the antifraud provisions of the federal securities laws to, among other matters, information on issuer websites; hyperlinks; public reports containing financial information or operating data; and statements made by public officials. In addition, the Bulletin notes the importance of municipal issuers adopting comprehensive disclosure policies and procedures.

The principal basis for the guidance provided in the Bulletin is an interpretive release that the SEC published in 1994.3 In that release, the SEC stated that “when it [a municipal issuer] releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.” (emphasis added) This language tracks language from ten years earlier that the SEC had used in the corporate context: “The antifraud provisions of the federal securities laws apply to all company statements that can reasonably be expected to reach investors and the trading markets, whoever the intended primary audience.”4 (emphasis added)

The first (and to date, only) time that the SEC brought an enforcement action in the municipal context on the basis of the guidance provided in the 1994 Interpretive Release was in the administrative proceeding in 2013 against the City of Harrisburg, Pennsylvania. In connection with that administrative proceeding, the SEC issued a separate report5 in which it further explained the basis for the enforcement action and provided guidance as to how a municipal issuer could reduce the risk of misleading investors, with a particular focus on written disclosure policies and procedures. Both that enforcement action and the accompanying report were the subject of a Hawkins Advisory dated May 10, 2013. In that Advisory, we also set forth our suggestions regarding the key elements of a comprehensive disclosure program. That Advisory is linked here: [https://www.hawkins.com/about/publications/2013-05-10-hawkins-advisory-secs-report-and-order-regarding-harrisburg](https://www.hawkins.com/about/publications/2013-05-10-hawkins-advisory-secs-report-and-order-regarding-harrisburg).

**Analysis**

In publishing the Bulletin, the SEC Staff intended to provide guidance to the market regarding topics that include the application of the federal securities laws to the dissemination of financial information by municipal issuers (in a context in which such information is not required to be disseminated pursuant to a continuing disclosure agreement). In doing so, the SEC Staff was guided by both the language in the 1994 Interpretive Release and the Harrisburg enforcement action (and accompanying report).

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2 Id.
Although the Harrisburg enforcement action concerned a unique factual setting (a failure by the City of Harrisburg over a period of years to submit annual financial information, audited financial statements, notices of failure to provide required annual financial information, and material event notices), the Staff cautions in the Bulletin that “all statements of a municipal issuer that are reasonably expected to reach investors and the trading markets are subject to the antifraud provisions, regardless of the municipal issuer’s compliance with its continuing disclosure obligations.” (emphasis added) That broad conclusion results in the Bulletin recommending that written disclosure controls and procedures should “identify the documents, reports, etc. which customarily contain current information about, for example, the financial and operational condition of the issuer and establish a process by which the issuer makes such documents, reports, etc. regularly available to investors.” It is not practicable for a municipal issuer to review for federal securities law purposes all financial and operational information that is regularly published for a variety of purposes. The Harrisburg 21(a) Report notes that statements by public officials are more likely to be relied upon in the absence of contractually-required disclosures, and that context must keep in mind when considering the day-to-day practical impact of the broad language of the Bulletin.

Notwithstanding the broad language in the 1994 Interpretive Release and the reliance of the Bulletin on the Harrisburg enforcement action, there are two key aspects of the Bulletin that provide helpful guidance to municipal issuers that desire to provide financial information beyond that required by their continuing disclosure agreements, if any.

The Bulletin notes that the standard of liability for secondary market disclosure requires recklessness or intentional deceit for a violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The negligence standard of Section 17(a) of the Securities Act of 1933 is not applicable, because Section 17(a) applies to the “offer or sale of any securities,” i.e., the initial offer and sale in a primary offering.

Another helpful aspect of the Bulletin is its emphasis on the importance of written disclosure controls and procedures:

[R]easonably designed policies and procedures, when consistently implemented, can help a municipal issuer regularly provide more accurate, timely, and comprehensive information to investors; better manage communications with their investors; and comply with the antifraud provisions. For that reason, the staff encourages issuers to adopt policies and procedures which, among other things, designate an individual responsible for compliance with such policies and procedures; establish a periodic training schedule for issuer staff and officials responsible for developing, reviewing, and disseminating issuer disclosures; identify the documents, reports, etc. which customarily contain current information about, for example, the financial and operational condition of the issuer and establish a process by which the issuer makes such documents, reports, etc. regularly available to investors; and identify the place or places at which the issuer makes such documents, reports, etc. regularly available to the public, which may include a central repository, such as the EMMA system, or an investor-relations website.

The SEC Staff further notes, as an explanation of the list quoted above:

This list is not intended to create any legal obligation for an issuer to develop such policies and procedures but rather sets forth the staff’s view on the types of provisions which could enable an issuer to provide more accurate, timely, and comprehensive information to investors; better manage communications with their investors; and comply with the antifraud provisions. (emphasis added)

It is reasonable to read this recommendation that an issuer’s procedures “identify the documents . . . which customarily contain current information about [its] financial and operational condition” as referring to documents that it intends to make available for disclosure purposes, which need not be limited to the contractual requirements of its continuing disclosure agreements. It is also reasonable to read the Bulletin as reminding issuers that such documents may be subject to liability under Rule 10b-5.

**Recommendation**

The SEC has encouraged municipal issuers to develop written disclosure controls and procedures, and has often made development of them a condition of settlement in enforcement actions. A key component of such controls is that the appropriate financial and legal officers of a municipal issuer carefully review the information that is intended to reach investors. This process is not practicable unless such review can be limited to the particular “financial information or operating data” that is posted on EMMA (and/or on a municipal issuer’s investor information webpage). It is to

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6 Assuming, at the time of the disclosure in question, that there is not an ongoing contemporaneous primary offering of the municipal issuer’s securities.

7 Fn. 67 in the Bulletin.
everyone’s benefit that a municipal issuer be able to define what information is intended for investors and to assure that such information is properly and comprehensively reviewed.

Accordingly, absent intentional fraud, a municipal issuer may look to insulate itself from federal securities law liability if a municipal issuer cautions investors that the only “financial information or operating data” intended for their consideration and on which they can rely is posted on EMMA (and/or on the issuer’s investor information webpage). In doing so, the municipal issuer would have clearly separated the information intended for investors from that financial or budgetary information posted on its general website for other intended interested parties (e.g., citizens interested in budgetary materials).

It should be noted that the Bulletin states that it was “not intended to create any legal obligation for an issuer to develop [disclosure] policies and procedures” and that it “has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.” For those municipal issuers, however, which wish to do so, the implementation of the suggestions below should allow such municipal issuer to address the concerns of the SEC, analysts, and investors for more timely and transparent financial information, without increasing such municipal issuer’s exposure to federal securities law liability.

In accordance with the 1994 Interpretive Release, the Harrisburg 21(a) Report, and the Bulletin, a municipal issuer that wishes to voluntarily post financial information (beyond that required by its continuing disclosure agreements, if any) should carefully consider the following guidelines:

1. The municipal issuer should comply with its continuing disclosure agreements in all material respects, including the timely filing of its annual financial information and material event notices. In doing so, the municipal issuer has taken itself outside the context of the Harrisburg enforcement action.

2. The municipal issuer shares other information that it intends to reach investors by posting the voluntary information on EMMA (and/or the issuer’s investor information webpage). Correspondingly, the municipal issuer should add a disclaimer to its general website that the only information intended for investors has been posted on EMMA (or the issuer’s investor information webpage). This should insulate a municipal issuer against a private litigant, which has to demonstrate reliance. In addition, there should not be an SEC enforcement action concerning financial information or operating data that was not posted on EMMA (or a municipal issuer’s investor information webpage), unless there was either intentional fraud or a very unusual set of facts such as was present in the Harrisburg enforcement action.

3. The municipal issuer should implement the guidance provided by the SEC in the Harrisburg 21(a) Report, as expanded upon by the Bulletin:

   a. “adopting policies and procedures that are reasonably designed to result in accurate, timely, and complete public disclosures”

   b. “identifying those persons involved in the disclosure process”

   c. “evaluating other public disclosures that the municipal issuer has made, including financial information and other statements, prior to public dissemination”

   d. “assuring that responsible individuals receive adequate training about their obligations under the federal securities laws”

   e. “designate an individual responsible for compliance with such policies and procedures”

In summary, notwithstanding the “reasonably expected to reach investors” language in the 1994 Interpretive Release and the reliance of the Bulletin on the Harrisburg enforcement action, it is our thinking that as a practical matter a municipal issuer should be able to utilize, in effect, a “reasonably intended” guideline if (i) the issuer is in compliance with its continuing disclosure undertakings (i.e., not in a Harrisburg (or similarly materially non-compliant) fact setting), (ii) the issuer adopts and follows comprehensive disclosure policies and procedures, which would include associated periodic training, and (iii) the issuer advises that the only information on which investors should rely is either on EMMA and/or on the issuer’s investor information webpage. This matter is not settled, however, and each municipal issuer should consult with its counsel on these points.
About Hawkins Advisory

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Implementing the Rule 15c2-12 Amendments
### Rule 15c2-12 Amendments —Implementation

**Introduction**

The compliance date for the recent amendments to Securities and Exchange Commission ("SEC") Rule 15c2-12¹ was February 27, 2019. Hawkins published Advisories on August 22, 2018, and October 10, 2018, which described these amendments and the guidance provided in the Adopting Release.² We also made suggestions for complying with these amendments. We noted that there may be additional guidance from the SEC staff³ as various issues are considered in implementing the amendments. This Advisory describes the SEC staff guidance that has been provided to date on several significant matters arising under the amendments.

**The Amendments**

The amendments add two paragraphs that must be included in any continuing disclosure agreement ("CDA")⁴ that is executed on or after February 27, 2019. The additional paragraphs are the following:

**Rule 15c2-12(b)(5)(i)(C)(15):**

Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material.

**Rule 15c2-12(b)(5)(i)(C)(16):**

Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.

Significantly, the introductory language of Rule 15c2-12(b)(5)(i)(C) provides that notice of the listed events must be provided “[i]n a timely manner not in excess of ten business days after the occurrence of the event . . . with respect to the securities being offered in the Offering.” Accordingly, notice of the incurrence of a financial obligation or execution of an agreement described in paragraph (15) or an event specified in paragraph (16) is required to be filed with the Municipal Securities Rulemaking Board (the “MSRB”) only if it is material, directly or indirectly, to the holders of the securities that are the subject of the applicable CDA.

The term “financial obligation” is key to paragraphs (15) and (16) and is defined in new paragraph (f)(11) of Rule 15c2-12 as follows:

(11)(i) The term financial obligation means a:

- (A) Debt obligation;
- (B) Derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or
- (C) Guarantee of (f)(11)(i)(A) or (B).

(ii) The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

**Key Implementation Points**

- **Event (15)** has two distinct elements. One, the “[i]ncurrence of a financial obligation.” And two, an “agreement to covenants [etc.] . . . of a financial obligation.” The second element of event (15), as is the case with respect to event (16), applies to all financial obligations of the obligated person, including those in effect prior to the compliance date of February 27, 2019.

- The Adopting Release states that “the definition of the term ‘financial obligation’ does not include ordinary financial and operating liabilities incurred in the normal course of an issuer’s or obligated person’s business, only an issuer’s or obligated person’s debt, debt-like, and debt-related obligations.”

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¹ 17 CFR § 240.15c2-12.
² SEC Rel. No. 34-83885 [Aug. 20, 2018].
³ This Advisory distinguishes between guidance provided by the Commission and guidance provided by SEC staff. The Commission was established by Section 4 of the Securities Exchange Act of 1934. The Adopting Release is a statement of the Commission. The SEC staff advice is informal, and is not binding on the Commission.
⁴ “Continuing disclosure agreement” or “CDA” as used in this Advisory mean the “written agreement or contract” required by and described in detail in Rule 15c2-12(b)(5)(i).
The SEC staff has advised that draw-down bonds and commercial paper are “incurred” when the related program is established and the legal documents are executed, which may be before the first draw occurs. Consequently, a notice is required only when the legal documents are executed and not when each draw is made or each issuance (or roll) of commercial paper occurs.

The Adopting Release provides the following advice regarding a material event notice of an event described in paragraph (15):

[The notice] generally should include a description of the material terms of the financial obligation. Examples of some material terms may be the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates); other terms may be appropriate as well, depending on the circumstances. . . .

. . . .

[But any such notice would not] require the provision of confidential information such as contact information, account numbers, or other personally identifiable information.

The notice may include a redacted document or a summary of its terms consistent with the foregoing.

A debt issue that meets the private placement exemption in Rule 15c2-12(d)(1)(i) is a “debt obligation” and as such a “financial obligation” for which a notice is required under paragraph (15). If an issuer wants to exclude such debt issue from the definition of “financial obligation,” it must file the related final Official Statement with the MSRB and enter into a CDA for such municipal securities, notwithstanding that such debt issue is exempt from the Rule. This conclusion is based on advice from the SEC staff regarding how to interpret the phrase “consistent with this rule” in Rule 15c2-12(f)(11)(ii).

Certain “guarantees” or “derivative instruments” are “financial obligations.” The definition of “financial obligation” by its terms only excludes “municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.” Nevertheless, the SEC staff has advised that if the principal terms of the “guarantee” or the “derivative instrument” are set forth in a final Official Statement that is filed with the MSRB, such filing will result in the associated guarantee or derivative being excluded from the definition of “financial obligation.”

Regarding such analysis, it is important to distinguish the respective contractual obligations’ of the guarantor and of the beneficiary of the guarantee. For example, in the case of a guarantee by a governmental entity (e.g., a State) of a governmental issuer’s (e.g., a County) municipal securities, the State as the guarantor and an obligated person would be subject to its own notice requirement. The County can exclude from the definition of “financial obligation” an associated State guarantee by filing the related final Official Statement that describes the terms of the municipal security and the guarantee, and associating the Official Statement with the County’s affected CUSIPs. The State as guarantor is required, under any post-February 27, 2019 CDA to which it is a party, to make an event (15) filing for the guarantee. The filing could be accomplished by filing the County’s Official Statement and associating such filing with the State’s CUSIPs of bonds that are secured, directly or indirectly, by the same source of funds that backs the State’s guarantee.

The SEC staff has advised that the phrase “reflect financial difficulties” as used in event (16) should be read to mean “caused by financial difficulties.” Note that event (16), similar to certain other events, is not modified by the phrase “if material.”

With respect to a “debt obligation” as an element of “financial obligation,” the Adopting Release states that whether an obligation was “debt” for state law purposes is not determinative:

[In the context of Rule 15c2-12, the Commission is not limiting the term “debt obligation” to debt as it may be defined for state law purposes, but instead is applying it more broadly to circumstances under which an issuer or obligated person has borrowed money. . . . The Commission believes that, for the purposes of Rule 15c2-12, a narrow interpretation of “debt” would be under-inclusive because issuers and obligated persons

5 Event (15) relates to “[i]ncurrence of a financial obligation of the obligated person.” “Guarantee” is an element of the term “financial obligation.” In the case of a moral obligation of the guarantor or a guarantee subject to legislative appropriation, it is unclear whether the guarantor would be an “obligated person,” which is defined in Rule 15c2-12(f)(10) as a “person committed by contract or other arrangement.”

6 Prior to the 2010 amendments to Rule 15c2-12, the ten events requiring notice were preceded by the phrase “if material.” In 2010, four events were added to the Rule, the phrase “if material” was deleted from the lead-in clause, and “if material” was inserted after some events and not others. This is best read as the Commission concluding that some events were, in effect, deemed to be material in all instances, and therefore notice would always be required.
can, and often do, borrow money through a variety of transactions, many of which would not qualify as “debt” under relevant state laws.

- Certain of the numerous interpretive issues regarding leases as financial obligations are addressed under a separate heading below.

**Leases: Are They Financial Obligations?**

In the release that proposed the amendments (the “Proposing Release”), the SEC defined the term “financial obligation” to include a “lease” as a separate specified type of financial obligation. In the Adopting Release, however, the SEC recognized that the term “lease” was too broad:

The Commission agrees with commenters that, as proposed, the term “lease” was too broad. Accordingly, the Commission believes that it is appropriate to limit the Rule’s coverage of leases to those that operate as vehicles to borrow money. The Commission believes that this is appropriate because a lease entered into as a vehicle to borrow money could represent competing debt of the issuer or obligated person. (emphasis added)

Accordingly, a lease entered into as a vehicle to borrow money should be treated as a variety of “debt obligation” rather than a separate type of “financial obligation,” as had been proposed.

The SEC also stated in the Adopting Release that in light of GASB Statement 87, Leases, which eliminated the distinction between operating and capital leases for governmental accounting purposes, a distinction between operating and capital leases was also not useful in determining what leases may be “financial obligations.”

In the Adopting Release, the SEC provided examples of the types of leases that could be considered debt obligations, and therefore would be financial obligations:

For example, the types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions. Typically, in a lease-revenue transaction, an issuer or obligated person borrows money to finance an equipment or real property acquisition or improvement and a lease secures the issuer’s or obligated person’s obligation to make principal and interest payments to the lender . . . . In a certificates of participation transaction, the issuer or obligated person sells certificates of participation and the proceeds of the certificates are used, typically, to finance an equipment or real property acquisition or improvement by the issuer or obligated person.

In the Adopting Release, the SEC also provided examples of leases that would not be financial obligations because they do not operate as vehicles to borrow money. The Adopting Release states:

With respect to leases that do not operate as vehicles to borrow money, the Commission agrees with commenters that the burden of assessing their materiality and disclosing such leases within ten business days would not justify the benefit of such disclosures. While the Commission continues to believe that lease arrangements that are not vehicles to borrow money might be relevant to the general financial condition of an issuer or obligated person, the Commission also believes that such lease arrangements do not warrant inclusion in the Commission’s definition of “financial obligation” because they generally do not represent competing debt of the issuer or obligated person . . . .

Examples of such leases that are typically not vehicles to borrow money that are common among issuers and obligated persons include, but are not limited to: commercial office building leases, airline and concessionaire leases at airport facilities, and copy machine leases.

The SEC staff advised that a critical factor in its analysis of whether a lease was a financial obligation was the presence or absence of a third-party lender.

**Underwriter and Issuer Responsibilities**

A broker-dealer acting as an underwriter in a primary offering of municipal securities is required, pursuant to Rule 15c2-12(b)(5), to reasonably determine that a governmental issuer and any obligated person will comply with their respective continuing disclosure obligations as set forth in the CDA executed in connection with such securities offering. To establish such reasonable determination, underwriters will be considering, among other issues, whether the issuer and any obligated person (i) have trained the appropriate personnel regarding the two new events, (ii) will be in a position to make the determinations whether an event is a “financial obligation,” and if it is, whether such event was “material” ([paragraph (15)]) or “reflect[ed] financial difficulties” ([paragraph (16)]), and (iii) could provide notice to the MSRB in a timely manner, not in excess of ten business days after the occurrence of the event.

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It is important to note that in connection with an issuer’s initial CDA executed after the compliance date of February 27, 2019, an underwriter’s diligence review will include careful consideration of the points noted in the preceding paragraph. For subsequent financings, the underwriter’s diligence review will also include a review of the issuer’s and any obligated person’s history of compliance with those CDAs that include new events (15) and (16).

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Rule 15c2-12 Compliance Alert
RULE 15c2-12 AMENDMENTS – COMPLIANCE ALERT

Introduction

This Compliance Alert supplements the Hawkins Advisory entitled “Rule 15c2-12 Amendments,” which was dated August 22, 2018. That Advisory is appended to this Alert. The Advisory describes two new paragraphs (15 and 16) that are required to be added to continuing disclosure agreements that are entered into pursuant to Rule 15c2-12 (“CDAs”) on and after February 27, 2019 (the “compliance date,” which is 180 days after the publication of the Adopting Release in the Federal Register\(^1\)). Thus, CDAs that are entered into on or after February 27, 2019, must incorporate new paragraphs (15) and (16). This Alert brings to your attention some considerations to keep in mind as the compliance date approaches.

“Financial Obligation”

The term “financial obligation” is key to paragraphs (15) and (16), and is defined in new paragraph (f)(11), as follows:

The term financial obligation means a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii). The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

The exclusion for “municipal securities as to which a final official statement” was provided to the MSRB only excludes the municipal securities themselves, and does not exclude any associated financial obligation, such as a derivative instrument or a guarantee of either a derivative instrument or a debt obligation. That is the case even if such associated financial obligation was entered into in connection with or pledged as security for the municipal securities and was described in the related official statement.

The phrase “provided to the Municipal Securities Rulemaking Board consistent with this rule,” would include official statements that are provided to the MSRB voluntarily. Thus, for municipal securities for which the related official statement was provided to the MSRB, either because required by Rule 15c2-12 or voluntarily, a notice would not be required under paragraph (15) relating to the issuance of such securities.

The SEC noted that “the definition of the term ‘financial obligation’ does not include ordinary financial and operating liabilities incurred in the normal course of an issuer’s or obligated person’s business, only an issuer’s or obligated person’s debt, debt-like, and debt-related obligations.” This limitation must be viewed in light of the SEC’s statement that whether an obligation is “debt” for state law purposes is not determinative for the purposes of Rule 15c2-12, and that “a narrow interpretation of ‘debt’ would be under-inclusive because issuers and obligated persons can, and often do, borrow money through a variety of transactions, many of which would not qualify as ‘debt’ under relevant state laws.”

Pursuant to paragraph (15), the “incurrence” of a financial obligation triggers the disclosure obligation. With respect to financial obligations arising under contracts that are not municipal securities subject to a CDA, the Adopting Release states that the financial obligation “generally should be considered to be incurred when it is enforceable against an issuer or obligated person.” The Adopting Release notes that this is consistent with the instructions for Item 2.03 of Exchange Act Form 8-K, which provide that a registrant:

has no obligation to disclose information . . . until the registrant enters into an agreement enforceable against the registrant, whether or not subject to conditions, under which the direct financial obligation will arise or be created or issued.

For many transactions (other than municipal securities subject to a CDA), where a contractual commitment or sale agreement has been entered into prior to closing or funding (e.g., certain bank loans), it may be prudent to treat the incurrence of financial obligations as occurring upon the sale or commitment date rather than the closing date.

**Preparation for Compliance Date**

Paragraph (15) relates to the incurrence of financial obligations or entering into certain agreements that occur on or after the compliance date of February 27, 2019. Paragraph (16), however, includes defaults or other events with respect to financial obligations entered into on, after, or prior to February 27, 2019, including currently existing financial obligations. Thus, an issuer or obligated person that expects to become a party to a CDA entered into after the compliance date should begin well in advance of such compliance date to identify the contracts under which it may have financial obligations and the payment, pledge, priority, financial covenant, default, and remedy provisions that are most likely to trigger a filing under paragraph (16).

Many governmental issuers, and certain other obligated persons, may find that their audited financial statements and audit process may provide a useful starting point for identifying existing financial obligations. As an example, a governmental issuer whose financial statements comply with Governmental Accounting Standards Board (“GASB”) standards is required, for reporting periods beginning after June 15, 2018, to comply with GASB 88, entitled “Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements.” GASB 88 defines “debt,” for purposes of disclosures in notes to financial statements, “as a liability that arises from a contractual obligation to pay cash . . . in one or more payments to settle an amount that is fixed at the date the contractual obligation is established . . . debt does not include leases, except for contracts reported as a financed purchase of the underlying asset.”

However, even governmental issuers and obligated persons whose financial statements comply with GASB requirements should be aware that both the scope of their particular financial obligations that satisfy the Rule 15c2-12 “financial obligation” definition and the content of required disclosures thereunder may well vary from GASB requirements. In addition, timing of disclosure also will be different under applicable CDAs. One of the express purposes of the amendments to Rule 15c2-12 is to require disclosure of a paragraph (15) or (16) event prior to the time that financial statements are published. As stated in the Adopting Release, “GASB Statement No. 88 is not a substitute for [the] amendments.”

All of these obligations will need to be reconciled with any confidentiality or non-disclosure provisions that may apply, and these should be carefully reviewed with your advisors. With respect to financial obligations or agreements of the type described in paragraph (15) that are incurred or agreed to after the compliance date of February 27, 2019, an issuer or obligated person should consider an express acknowledgement by the contracting party that disclosure may be required under any CDA that includes paragraph (15).

There may be additional guidance from the SEC staff as various issues are considered in implementing paragraphs (15) and (16). For example, the SEC retained the introductory language of Rule 15c2-12(b)(5)(i)(C), which provides that notice of the listed events must be provided “in a timely manner not in excess of ten business days after the occurrence of the event . . . with respect to the securities being offered in the Offering.” Accordingly, notice of the incurrence of a financial obligation or execution of an agreement described in paragraph (15) ought to be required to be filed with the MSRB only if it is material, directly or indirectly, to the holders of the securities that are the subject of the applicable CDA.

In addition to establishing a comprehensive list of financial obligations, an issuer should revise any written continuing disclosure controls and procedures, and update any associated training presentations or materials, to reflect paragraphs (15) and (16).

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2 GASB 88 amends GASB 34, paragraph 119. Paragraph 119 currently requires “[i]nformation about long-term liabilities [which] should include both long-term debt (such as bonds, notes, loans, and leases payable) and other long-term liabilities.”
Rule 15c2-12 Amendments
**RULE 15c2-12 AMENDMENTS**

**Introduction**

On August 20, 2018, the Securities and Exchange Commission ("SEC" or "Commission") adopted amendments to Securities Exchange Act of 1934 Rule 15c2-12 (17 CFR § 240.15c2-12) ("Rule 15c2-12" or the "Rule"). The amendments add two events that must be included in any continuing disclosure agreement that is entered into after the compliance date (approximately six months from now; see "Compliance Date" below). The two additional events are the following:

**Rule 15c2-12(b)(5)(i)(C)(15):**

Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material.

**Rule 15c2-12(b)(5)(i)(C)(16):**

Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.

The disclosures that would be required by the amendments are already being made. The amendments address when such disclosures must be made. In general, material financial information of the type described in new paragraphs (15) and (16) is included in official statements and/or audited financial statements. The SEC, however, wanted to have such disclosures made closer to the time of the incurrence or event, to provide greater transparency to the market. The Adopting Release notes:

[I]nvestors and other market participants may not learn that the issuer or obligated person has incurred a financial obligation if the issuer or obligated person does not provide annual financial information or audited financial statements to EMMA or does not subsequently issue debt in a primary offering subject to Rule 15c2-12 that results in the provision of a final official statement to EMMA.

The impetus for the amendments was the increasing use of direct purchases of municipal securities and direct loans as alternatives to public offerings of municipal securities. Although market participants had encouraged the years voluntary disclosure of such financial obligations, the SEC concluded that “despite these ongoing efforts, few issuers or obligated persons have made voluntary disclosures of financial obligations, including direct placements, to the MSRB [Municipal Securities Rulemaking Board].”

**Analysis of Provisions**

The two new provisions reference “financial obligation of the obligated person.”

Note that, pursuant to existing paragraph (b)(5)(i), the party to the continuing disclosure agreement may be either the issuer or the obligated person (even if the issuer is not an obligated person).

The term “financial obligation” would be added by the amendments as new paragraph (f)(11), as follows:

The term financial obligation means a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii). The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

The amendments in proposed form had included “lease” as a distinct financial obligation. The SEC did not include “lease” in the definition as adopted on the rationale that item (11)(i), “debt obligation,” would include those leases the SEC considered to be financial obligations:

| 2 | “Continuing disclosure agreement” references the “written agreement or contract” required by and set forth in detail in Rule 15c2-12(b)(5)(i). |
| 3 | “Obligated person” is defined in Rule 15c2-12(f)(10) as follows: |

The term obligated person means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).
The Commission agrees with commenters that, as proposed, the term “lease” was too broad. Accordingly, the Commission believes that it is appropriate to limit the Rule’s coverage of leases to those that operate as vehicles to borrow money. The Commission believes that this is appropriate because a lease entered into as a vehicle to borrow money could represent competing debt of the issuer or obligated person.

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With respect to leases that do not operate as vehicles to borrow money . . . the Commission also believes that such lease arrangements do not warrant inclusion in the Commission’s definition of “financial obligation” because they generally do not represent competing debt of the issuer or obligated person.

In addition, the amendments in proposed form had included as a “financial obligation” a “monetary obligation resulting from a judicial, administrative, or arbitration proceeding.” The SEC determined to not include such monetary obligation on the reasoning that any such obligation is typically covered by reserve funding or insurance, and further that any initial judgment in such a proceeding may not reflect the ultimate disposition of the proceeding.

With respect to item (11)(i), “debt obligation,” the SEC noted that whether an obligation was “debt” for state law purposes was not determinative:

[I]n the context of Rule 15c2-12, the Commission is not limiting the term “debt obligation” to debt as it may be defined for state law purposes, but instead is applying it more broadly to circumstances under which an issuer or obligated person has borrowed money. . . . The Commission believes that, for the purposes of Rule 15c2-12, a narrow interpretation of “debt” would be under-inclusive because issuers and obligated persons can, and often do, borrow money through a variety of transactions, many of which would not qualify as “debt” under relevant state laws.

In connection with the phrase “reflect financial difficulties” in paragraph (16), the SEC reasoned that such phrase does not need further clarification because the same phrasing is used in paragraphs 15c2-12(b)(5)(i)(C)(3) and (4), as in effect since 1995.

For purposes of a material event notice of an event described in paragraph (b)(5)(i)(C)(15), the SEC advised that such notice:

[G]enerally should include a description of the material terms of the financial obligation. Examples of some material terms may be the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates); other terms may be appropriate as well, depending on the circumstances.

**Compliance Date**

The compliance date is 180 days after publication of the SEC Release in the Federal Register. The SEC notes that the amendments would apply to “continuing disclosure agreements that are entered into in connection with Offerings occurring on or after the compliance date of the amendments.” The use of the term “Offerings” could create some ambiguity because, for purposes of Rule 15c2-12(b)(1), the SEC had tied such term to the use of a Preliminary Official Statement. In the Adopting Release, the SEC provided the needed clarification: “For the purposes of these amendments, the Commission believes that an Offering generally should be considered to occur on the date the continuing disclosure agreement is executed.” Such execution will generally occur on the settlement date. The SEC notes, however, that:

[I]f a preliminary official statement is distributed before the compliance date, with an expectation that the Offering will occur on or after the compliance date, the preliminary official statement should generally attach a form of continuing disclosure agreement that reflects the adopted amendments.

The SEC also advised that “an event under the terms of a financial obligation pursuant to (b)(5)(i)(C)(16) that occurs on or after the compliance date must be disclosed regardless of whether such obligation was incurred before or after the compliance date.” Thus, for example, assuming a compliance date of February 25, 2019, and a continuing disclosure agreement executed after such date that incorporates new paragraph (16), notice of an event as described in such paragraph (e.g., default or termination event) must be posted on EMMA, even if the associated financial obligation was entered into prior to February 25, 2019.

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4 SEC No-Action Letter [Mudge Rose letter] dated April 4, 1990: “The term ‘offer’ traditionally has been defined broadly under the federal securities laws and, for purposes of Rule 15c2-12, would encompass the distribution of a Preliminary Official Statement by the underwriter.”
Cybersecurity – Municipal Disclosure
**CYBERSECURITY**

**Introduction**

This Advisory describes recent developments regarding disclosure of cybersecurity risks and incidents and their import for municipal disclosure.

The Securities and Exchange Commission (the “SEC”) recently published interpretive guidance (the “2018 Guidance”) to assist public companies (i.e., those companies subject to registration with the SEC) in preparing disclosures about cybersecurity risks and incidents. The 2018 Guidance updated guidance provided in 2011 by the Staff of the SEC’s Division of Corporation Finance. In each guidance, the SEC did not mandate any particular disclosure, but rather advised registrants to consider the materiality of cybersecurity risks and incidents when preparing the disclosure that is required in registration statements and periodic and current reports. Although each guidance was directed to corporate SEC registrants, these guidances are also relevant to municipal issuers.

The general antifraud rules apply to all securities disclosure, regardless of whether the related security is exempt from SEC registration. In addition, last month, in an administrative proceeding dated April 24, 2018 (the “Yahoo Enforcement Action”), the SEC found that Yahoo’s risk factor disclosures in its annual and quarterly reports from 2014 through 2016 were materially misleading in not disclosing a massive data breach that had occurred in 2014.

Recently, there have been significant cybersecurity incidents affecting municipal agencies, including a freezing of systems of the City of Atlanta; an attack on Baltimore’s 911 system; an attack on the Colorado Department of Transportation’s computers; and a closing of the Port of Los Angeles’s largest terminal. Municipal agencies, similar to other business entities, face significant risks relating to the use and application of computer software and hardware.

Set forth below is a summary of the 2018 Guidance and the Yahoo Enforcement Action, and questions for consideration regarding cybersecurity risks and incidents in the municipal context.

**The 2018 Guidance**

The 2018 Guidance states the following:

In determining their disclosure obligations regarding cybersecurity risks and incidents, companies generally weigh, among other things, the potential materiality of any identified risk and, in the case of incidents, the importance of any compromised information and of the impact of the incident on the company’s operations. The materiality of cybersecurity risks or incidents depends upon their nature, extent, and potential magnitude, particularly as they relate to any compromised information on the business and scope of company operations. The materiality of cybersecurity risks and incidents also depends on the range of harm that such incidents could cause. This includes harm to a company’s reputation, financial performance, and customer and vendor relationships, as well as the possibility of litigation or regulatory investigations or actions, including regulatory actions by state and federal governmental authorities and non-U.S. authorities.

2018 Guidance, pp. 10-11 (footnotes omitted)

The 2018 Guidance further noted that “[c]ompanies should avoid generic cybersecurity-related disclosure and provide specific information that is useful to investors.”

The 2018 Guidance identified the following issues, among others, in evaluating cybersecurity risk factor disclosure:

- the occurrence of prior cybersecurity incidents, including their severity and frequency;

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1. The SEC Staff, in its 2011 guidance, cited the “Whatis.com” website for its definition of cybersecurity, which currently reads: “the body of technologies, processes and practices designed to protect networks, computers, programs and data from attack, damage or unauthorized access.”
4. “Municipal issuers,” as used in this Advisory, also includes “obligated persons” as defined in SEC Rule 15c2-12.
5. Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 and Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933.
• the probability of the occurrence and potential magnitude of cybersecurity incidents;
• the adequacy of preventative actions taken to reduce cybersecurity risks and the associated costs, including, if appropriate, discussing the limits of the company’s ability to prevent or mitigate certain cybersecurity risks;
• the aspects of the company’s business and operations that give rise to material cybersecurity risks and the potential costs and consequences of such risks, including industry-specific risks and third party supplier and service provider risks;
• the costs associated with maintaining cybersecurity protections, including, if applicable, insurance coverage relating to cybersecurity incidents or payments to service providers;
• the potential for reputational harm;
• existing or pending laws and regulations that may affect the requirements to which companies are subject relating to cybersecurity and the associated costs to companies; and
• litigation, regulatory investigation, and remediation costs associated with cybersecurity incidents.

**The Yahoo Enforcement Action**

In late 2014, Yahoo incurred “a massive breach of its user database that resulted in the theft, unauthorized access, and acquisition of hundreds of millions of its users’ data, including usernames, birthdates, and telephone numbers.” Despite such knowledge, Yahoo did not include information regarding the breach in its annual and quarterly filings from 2014 through 2016.

In the summer of 2016, Yahoo was engaged in negotiations with Verizon Communications, Inc. (“Verizon”) regarding the sale of Yahoo’s operating business, and an agreement was reached on July 23, 2016. During the course of the negotiations, Verizon had made inquiries of Yahoo regarding past data breaches, but Yahoo did not disclose the 2014 data breach to Verizon or to the public until September 2016. After such disclosure, Verizon renegotiated the stock purchase agreement to reduce the purchase price by 7.25%.

Yahoo had been making generic risk disclosure in 2014-2016 regarding only potential data breaches even after it was aware of an actual massive data breach that occurred in late 2014. But as the SEC noted in the 2018 Guidance, such generic disclosure may not be sufficient: “if a company previously experienced a material cybersecurity incident involving denial-of-service, it likely would not be sufficient for the company to disclose that there is a risk that a denial-of-service incident may occur.” In addition, the SEC noted that Yahoo’s senior management and legal teams did not share information regarding the breach with Yahoo’s auditors or outside counsel in order to assess the company’s disclosure obligations in its public filings. The SEC further noted that Yahoo did not maintain disclosure controls and procedures designed to ensure that reports from Yahoo’s information security team were timely shared with responsible officials.

The SEC found that Yahoo violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (negligence standard, in connection with materially misleading disclosure). Yahoo paid a civil money penalty of $35 million.

**Municipal Securities Disclosure**

Disclosure by municipal issuers of cybersecurity risks and incidents is governed by the same guidelines and standards that apply to municipal disclosure generally – namely, what is material to an investor regarding the particular securities being offered. The following are questions that may be asked to aid in analyzing whether disclosure of cybersecurity risks or incidents is appropriate:

**Cybersecurity Incidents**

- Has a cybersecurity incident\(^8\) occurred within the last five years?
- Was such incident unintentional or deliberate?
- Was such incident the result of attacks by insiders or third parties, including cybercriminals, competitors, nation-states, and “hacktivists”?
- Have the security flaws been corrected?
- What were the remediation costs? Liability amounts?
- What are the increased cybersecurity protection costs (including additional personnel, training employees, and engaging third party experts and consultants)?
- Is the issuer currently subject to litigation, regulatory investigation, or remediation costs associated with a cybersecurity incident?

Even if there have been no cybersecurity incidents, disclosure may be appropriate if a risk of such incidents exists. The SEC noted in the 2018 Guidance:

Given the frequency, magnitude and cost of cybersecurity incidents, the Commission believes that it is critical that public companies take all required actions to inform investors about material cybersecurity risks and incidents.

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\(^8\) Yahoo Enforcement Action.

\(^9\) The 2018 Guidance, at fn. 3, quotes from the U.S. Computer Emergency Readiness Team website in defining “cybersecurity incident” as follows: “[a]n occurrence that actually or potentially results in adverse consequences to . . . an information system or the information that the system processes, stores, or transmits and that may require a response action to mitigate the consequences.”
in a timely fashion, including those companies that are subject to material cybersecurity risks but may not yet have been the target of a cyber-attack.\(^{10}\)

**Cybersecurity Risks**

- Is the issuer (obligated person) particularly vulnerable to, or attractive as a target for, cybersecurity attacks?
  - Hospitals and health systems have suffered data breaches
  - Municipal utilities have made payments to regain access to their systems
  - Power supply systems and infrastructure generally may be vulnerable to cybersecurity attacks
- Is the issuer subject to regulatory requirements?
  - S&P notes that the North American Electric Reliability Organization establishes and polices cybersecurity standards for electric utilities\(^{11}\)
- Has the issuer established cybersecurity risk management policies and procedures and conducted associated training regarding cybersecurity risks and incidents?
- Has the issuer analyzed the probability and potential magnitude of cybersecurity incidents?
- Does the issuer carry insurance against cybersecurity incidents? What is the coverage provided?
- Is the issuer vulnerable to risks of cybersecurity attacks on third-party supplier and service providers?

**Conclusion**

The SEC has provided interpretive guidance to public companies regarding the disclosure of cybersecurity risks and incidents, and has brought its first enforcement action for misleading disclosures regarding such issues. The general antifraud provisions that govern securities disclosure are the same for a public company and a municipal issuer. Accordingly, the SEC’s 2018 Guidance and the Yahoo Enforcement Action deserve careful consideration in the context of a municipal securities offering, and the questions identified above are intended to aid in such analysis.

\(^{10}\) 2018 Guidance, p.4.


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The Importance of Disclosure for our Municipal Markets
Public Statement

The Importance of Disclosure for our Municipal Markets

Chairman Jay Clayton

Rebecca Olsen
Director, Office of Municipal Securities

May 4, 2020

The Effects of COVID-19 Have Raised Uncertainties Regarding the Financial Status of State and Local Governments and Special Purpose Entitles; Municipal Securities Issuers are Encouraged to Provide Updated Financial and Other Disclosures; Financial Professionals are Encouraged to Discuss These Matters With Main Street Investors

Introduction[1]

On April 8, the Chairman and the Director of the Division of Corporation Finance issued a statement (Corporate Issuer Statement) with observations and requests about the disclosures of public companies in light of the effects and uncertainties created by COVID-19.[2] The Corporate Issuer Statement noted the presence of significant investor uncertainty— for both equity and fixed income investors— regarding the financial and operating status of many companies, as well as their future prospects, and the resulting thirst for information from investors and the marketplace more generally.
This statement is directed to issuers of municipal securities[3] as well as investors and market participants more generally and is intended to parallel the Corporate Issuer Statement.

The Corporate Issuer Statement urged companies to provide investors with as much information as practicable regarding their current financial and operating status. In addition, and recognizing the difficulties in providing accurate and meaningful forward-looking disclosure, the Corporate Issuer Statement also urged companies to disclose as much material information as is practicable regarding their planning for, and expectations regarding, the company’s future financial condition and operating status. The statement also reminded corporate issuers to strive for consistency across their various public and confidential disclosures and to fulfill their legal requirements with respect to the disclosure and dissemination of material non-public information.[4]

Following on from the recognition that forward-looking information, generally and particularly in times of broad societal and economic stress, is subject to various assumptions and factors beyond the control of the company, the Corporate Issuer Statement noted that good faith attempts to provide appropriately framed forward-looking information were not expected to be second guessed by the SEC. The Corporate Issuer Statement also highlighted the availability of (and encouraged the use of) safe harbors for forward-looking statements.

While there are significant differences between our corporate capital markets and our municipal securities markets, the importance of high quality disclosure, particularly in times of uncertainty, is consistent. Accordingly, we believe a similar approach to the provision of current and, to the extent practicable, forward-looking disclosure would provide significant benefits to investors, issuers and the municipal securities market generally. [5] In order to facilitate the provision of these important municipal securities-related disclosures, and the digestion of those disclosures by investors and other market participants, we offer the following observations and requests.[6]

Market Participants Should Recognize the Size, Importance, Complexity and Specialized Nature of the Municipal Securities Market

The municipal securities market is a large, diverse, important, complex and specialized segment of the U.S. capital markets and our domestic economy more generally. States, cities, local governments and special-purpose entities issue municipal securities to raise long-term funding, and, to a more limited extent, short-term funding. These funding needs support a vast array of important projects that promote the public good such as hospitals, transportation systems, schools and utilities. Providing a capital markets-based funding source for these vital, public-sector needs has long been the role of our municipal securities market. It is generally accepted that the continued functioning of this market is
essential to the continued funding and operation of state and local governments and our economy more generally.

The municipal securities market is dominated by retail investors. At the end of 2019, Main Street investors held directly, and indirectly through funds and other managed products, over 72 percent of the market, or approximately $3 trillion of outstanding municipal securities. This retail focus is driven largely by the favorable federal, state and local tax treatment holders of municipal securities often receive. As a result, investors and accounts that do not benefit from favorable municipal securities tax treatment—e.g., pension funds and retirement accounts—generally do not purchase municipal securities.

In addition to being largely retail investor driven, the municipal securities market differs from other fixed income markets—e.g., corporate bonds and U.S. Treasuries—in other important respects. The market is remarkably diverse and issuers vary tremendously in size, purpose, and capital needs. There are approximately 50,000 issuers of municipal securities, including states, their political subdivisions (such as cities, towns, counties, and school districts), their agencies and instrumentalities (such as housing, health care, airport, port, and economic development authorities and agencies), as well as a variety of private entities that access the market through “conduit” financings (such as hospitals, senior living and continuing care retirement communities, and museums).[7] There are approximately one million different municipal securities outstanding compared to approximately 30,000 corporate bonds outstanding.[8] Offerings of municipal securities range in size from thousands of dollars to billions of dollars, and the payments of principal and interest on these securities come from a variety of sources, including general revenues, specific tax receipts, or revenues from a particular project, among others.

The municipal securities market also is generally more fragmented than other fixed income markets. Typically characterized as a “buy and hold” market, in ordinary market conditions, a significant number of municipal bonds never trade or only trade infrequently after the initial offering period. This generally means that liquidity can vary significantly depending on the issuer, how long the bonds have been outstanding, the size of the series and other idiosyncratic factors. Nevertheless, daily trade volume when measured in dollars and number of trades is significant—approximately $12.4 billion and 34,467 per day, respectively.[9]

Just as it is diverse, the municipal securities market is also complex. In addition to the traditional general obligation bonds backed by the taxing power and/or “full faith and credit” of the issuing entity, municipal issuers employ a variety of complex and issuer-specific credit structures to support their bonds. For example, municipal issuers also issue revenue bonds backed by specific revenues such as sales and use taxes, tax increments, or the revenues of the enterprise being financed—e.g., a utility system, a toll road or transit system. In a conduit revenue bond
financing, the bondholder generally cannot look to the issuer of the bonds, but instead must rely on the revenue stream pledged by the conduit borrower. Adding complexity to these myriad credit structures, municipal issuers also utilize a variety of derivative products as part of their capital financing portfolios and other risk-management strategies. These derivatives generally are designed to reduce risks, but in some cases their performance may be material to an investment decision.

Municipal issuers and investors in municipal securities should recognize that these factors generally mean that to some meaningful extent both issuer-specific disclosures and security-specific disclosures are material.[10] In addition, we encourage financial professionals to discuss the importance of issuer-specific and security-specific disclosures with the Main Street investors they serve and to consider the extent of such disclosures when providing recommendations and investment advice to Main Street investors.

The Importance of Robust, Timely and Accurate Municipal Issuer Disclosures Has Become Even Greater as a Result of the Effects of COVID-19

Over the years, the Commission has encouraged municipal issuers to provide robust, timely and accurate information to investors and market participants.[11] The SEC’s focus on this issue has intensified in the past several years as we, together with our colleagues in the Office of Municipal Securities, have frequently called on municipal issuers to provide investors with more timely information, and also generally raised awareness about the importance of investor access to current financial information.[12]

Today, in light of the potentially significant effects of COVID-19 on the finances and operations of many municipal issuers, we increase this focus and request that municipal issuers provide investors with as much information about their current financial and operating condition as is reasonably practicable. The fluid and unpredictable nature of the public health crisis and its financial and economic impacts on municipal issuers has placed investor need for timely financial information into stark relief. We observe that, in today’s markets, the typical practice of providing historic financial information in the form of an annual information filing or similar disclosure may not enable investors to make informed assessments of the municipal issuer’s current and expected future financial condition.

Important Considerations that Generally Weigh in Favor of Providing Updated Investor-Oriented Disclosures that Discuss the Current and Anticipated Effects of COVID-19

We acknowledge that developing voluntary, unaudited, and non-routine disclosures regarding current financial status and operating conditions may be challenging, particularly under the current circumstances. For example, we recognize that such disclosures likely would not have the
benefit of a formal audit process or an established framework. We also recognize that, in many cases and even for disclosures regarding current status, certain financial disclosure would be based on estimates and assumptions as well as projections regarding future circumstances. Nevertheless, we believe providing as much current issuer- and security-specific information as is practicable will benefit issuers, investors and our municipal securities markets more generally.

We also encourage municipal issuers to provide investors with forward-looking information regarding the potential future impact of COVID-19 on their financial and operating conditions. We understand that providing detailed information regarding future operating conditions and resource needs is challenging, particularly as response strategies designed to mitigate and more effectively treat COVID-19 are evolving rapidly and are likely to change in the future.

We recognize that the issue of liability often is raised when voluntary disclosures—or the expansion of required disclosures—are considered. While each issuer, in many cases in consultation with legal counsel, will have to assess this risk in the context of its particular circumstances, we believe there are various factors that generally weigh in favor of making these disclosures.

- Disclosure of the current financial and operating condition will not only aid investors in making informed investment decisions, but will also be important to the issuer-specific and more general functioning of the municipal securities market, including the ability to refinance existing obligations and raise new capital.
- Accompanying those disclosures with meaningful cautionary language—including, for example, (1) a description of relevant facts or assumptions affecting the reasonableness of reliance on and the materiality of the information provided, (2) a description of how certain important information may be incomplete or unknown, and (3) the process or methodology (audited vs. unaudited) used by the municipal issuer to produce the information—will not only improve the quality of the disclosure but also will reduce legal and other risks.
- Issuers may be required to disclose similar information to other parties, including, for example, in connection with (1) efforts by federal and state governments to assess the financial impact of COVID-19 on states, municipalities and special purpose entities and (2) the pursuit by municipal securities issuers of funding or other support from governmental authorities and private parties. For various legal and other reasons, ensuring that disclosure of this type is (1) consistent across all contexts, regardless of the purpose and (2) kept confidential until disclosed and, when disclosed, disclosed broadly, is extremely important.
- We would not expect good faith attempts to provide appropriately framed current and/or forward-looking information to be second
guessed by the SEC.

- While the safe harbors for forward looking statements that are available to certain corporate issuers are not available to issuers of municipal securities, we believe that a municipal issuer’s approach to forward-looking disclosures should be informed by the judicially developed “bespeaks caution” doctrine.[13]

We also recognize the issue of timing—e.g., when to make updating disclosure—often is raised in these circumstances. For municipal issuers with pending offerings of securities or required filings, we encourage you to include the disclosures discussed above, including for reasons of completeness. We also observe that not all municipal issuers with outstanding securities will conduct new offerings or be required to make a disclosure filing in the coming months. However, for the reasons of consistency and fair dissemination of disclosure discussed above, and because the operational and financial condition of a municipal issuer, particularly under the current circumstances, can change rapidly, we urge these issuers to consider providing voluntary disclosure regarding the current and reasonably anticipated future impacts of COVID-19 on their operational and financial condition.

**Examples of Information Municipal Issuers Could Provide to Investors**

While not intended to be an exclusive list, the following sets forth examples of certain types of disclosures that we believe may be important to provide to investors and the marketplace more generally at this time, whether in a primary offering document, a contractually required continuing disclosure filing,[14] or in a voluntary public statement.[15]

- **Information Regarding the Impact of COVID-19 on Operations and Financial Condition.** Our collective national effort to mitigate the COVID-19 pandemic has caused a deep contraction in vast areas of our economy, with many municipal issuers facing potentially sharp declines in revenues and, in some cases, with increases in un-budgeted costs.

  Disclosures should reflect the issuer’s assessment of this state of affairs and outlook and, in particular municipal issuers should provide information regarding: (1) their current operational and financial status, including decreases in revenues and delays in collection of revenues; (2) how their COVID-19 response including efforts to protect the health and well-being of residents and employees has impacted their operational and financial condition, including un-budgeted costs; and (3) how their operational and financial condition may change as efforts to fight COVID-19 evolve. In these circumstances, comparisons to historical information may be relatively less significant.

- **Information Regarding Sources of Liquidity.** A description of cash on hand, access to reserves or other funds (and to what extent
such access is limited), access to liquidity facilities and whether current liquidity is expected to be adequate to fund essential services and make timely debt service payments. If not otherwise disclosed, we encourage municipal issuers to disclose the material terms of any liquidity facility the issuer has used or expects it may use.

- **Information Regarding Availability of Federal, State and Local Aid.**
  A description of available federal, state or local aid the issuer has sought or is planning to seek and the anticipated timing of such aid. In addition, if the municipal issuer has obtained any such aid, it should disclose the nature, amount, and other material terms of the aid if it materially affects or reasonably likely will materially affect its operational or financial condition.

- **Reports Prepared for Other Governmental Purposes.** Municipal issuers routinely prepare reports for governance purposes that may be significant sources of current information. As front-line responders, these reports could provide powerful insight into local, regional, and sector-specific strategies to fight and recover from COVID-19. Accordingly, municipal issuers should consider making these reports more readily accessible to investors.

### Conclusion

We welcome engagement on these matters and encourage participants in the municipal securities markets to continue to reach out to us on these and other important issues. We also again encourage financial professionals to discuss these matters with their investors who buy, sell and hold municipal securities, including in particular when providing recommendations and investment advice to Main Street investors.

In these challenging times, it is only appropriate to conclude by recognizing that various municipal issuers are integrally involved in our efforts to fight COVID-19, including employing many front-line responders. On behalf of all our colleagues, we thank them for their selfless and lifesaving efforts.

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[1] This statement represents the views of the Chairman and the Director of the Office of Municipal Securities of the U.S. Securities and Exchange Commission (“SEC” or “Commission”). It is not a rule, regulation, or statement of the SEC. The Commission has neither approved nor disapproved its content. This statement does not alter or amend applicable law and has no legal force or effect. This statement creates no new or additional obligations for any person.

[2] See Chairman Jay Clayton and William Hinman, the Director, Division of Corporation Finance, The Deep and Essential Connections Among Markets, Businesses, and Workers and the Importance of Maintaining
For purposes of this statement, the term “municipal issuer” includes an obligated person, as defined in 15 U.S.C. § 78o-4(e)(10) and 17 C.F.R. § 240.15c2-12(f)(10).

See also Regulation Fair Disclosure, Exchange Act Release No. 43154, 65 FR 51716 (Aug. 24, 2000) (addressing selective disclosure by public company issuers). Regulation FD codified best practices by corporate issuers and while it does not apply to municipal issuers, it provides municipal issuers with a helpful guide for framing their disclosure practices and procedures.

We note that municipal issuers do not have a safe harbor from private liability for forward-looking statements. The safe harbor for forward-looking statements from private actions set forth in Section 27A of the Securities Act and Section 21E of the Exchange Act applies to issuers that are reporting companies under Sections 13(a) or 15(d) of the Securities Exchange Act and, accordingly, has limited application for municipal issuers. As discussed below, see infra n. 13, a municipal issuer’s approach to forward-looking statements may be informed by the judicially created “bespeaks caution” doctrine.

We make this statement mindful of the many municipal issuers that have already provided, and continue to provide, information to investors about the impacts of COVID-19 on their financial and operating condition. We commend these municipal issuers for providing such voluntary disclosures and encourage others to provide this important information to investors.

Notably, municipal securities often trade in minimum denominations of $5,000 and, accordingly, an individual bond could be held by hundreds or even thousands of investors.


See Exchange Act Release No. 34-34961 (Nov. 10, 1994), 59 FR 59590, 59593 (Nov. 17, 1994). The Commission has previously noted that the diverse nature of this market means it is particularly ill-suited to a “one size fits all” approach to such disclosure. The Commission has historically taken a principles-based approach to disclosure in the municipal securities market, guided by the doctrine of materiality. As a general matter, a fact is material if there is a substantial likelihood that the
information would have been viewed by a reasonable investor as having significantly altered the total mix of information available. This assessment necessarily involves a consideration of the particular facts and circumstances of the situation. As we encourage municipal issuers to make COVID-19-related disclosures, we continue to use materiality as our guide and follow a principles-based approach that recognizes the unique nature of each municipal issuer.


This is an important topic particularly for our Main Street investors that I have addressed before.


Because of the contractual nature of a municipal issuer’s Rule 15c2-12-related continuing disclosure obligations, we expect municipal issuers to continue to make their annual and event-based disclosures through the Electronic Municipal Market Access (“EMMA”) system of the Municipal Securities Rulemaking Board (the “MSRB”).

We encourage municipal issuers to make such statements available to the public in the place or places at which they regularly make information available; such places may include the MSRB’s EMMA system or an investor relations webpage maintained by the municipal issuer.
The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19
The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19

April 8, 2020

The SEC’s three part mission—maintain market integrity, facilitate capital formation and protect investors—takes on particular importance in times of economic uncertainty. Disclosure—providing the public with the information necessary to make informed investment decisions—is fundamental to furthering each aspect of our mission.[i]

In the coming weeks, our public companies will be issuing earnings releases and conducting analyst and investor calls. We urge companies to provide as much information as is practicable regarding their current financial and operating status, as well as their future operational and financial planning. In an effort to facilitate robust disclosure and engagement, we provide the following observations and requests (discussed in more detail below):

- Our collective national effort to mitigate the COVID-19 pandemic has caused a deep contraction in vast areas of our economy, with many workers and businesses facing profound challenges.
- There is broad support for this national, full-mitigation response to COVID-19, but also broad recognition that our strategy must evolve to effectively address the health risks of COVID-19 while fostering a meaningful, responsible increase in economic activity.
- Executing such a strategy will require constant coordination among workers, consumers, businesses, governmental...
authorities and investors, both broadly and at the individual and firm-specific level.

- There now appears to be an emerging consensus that, as we develop more tools to fight COVID-19—increased testing, enhanced monitoring, data analysis, and identification of effective therapeutics—we can, anchored by advice of healthcare specialists, incrementally foster economic activity.

- Company disclosures should reflect this state of affairs and outlook and, in particular, respond to investor interest in: (1) where the company stands today, operationally and financially, (2) how the company’s COVID-19 response, including its efforts to protect the health and well-being of its workforce and its customers, is progressing, and (3) how its operations and financial condition may change as all our efforts to fight COVID-19 progress. Historical information may be relatively less significant.

- Providing detailed information regarding future operating conditions and resource needs is challenging, including because our response strategies are in their incipient stages (and are likely to change), but it is important on many levels. Updating and refining these estimates should become less difficult over time.

- High quality disclosure will not only provide benefits to investors and companies, it also will enhance valuable communication and coordination across our economy—including between the public and private sectors—as together we pursue the fight against COVID-19.

  - This transparency can foster confidence in countless specific instances, for example, between a supplier and a manufacturer as well as between an investor and a company, which in combination will benefit all.

- We encourage companies that respond to our call for forward-looking disclosure to avail themselves of the safe-harbors for such statements and also note that we would not expect good faith attempts to provide appropriately framed forward-looking information to be second guessed by the SEC.

Detailed Discussion of the Importance of Disclosure, Particularly Forward-Looking Disclosure, for Investors, Markets and our Fight Against COVID-19

Our Collective, Full Mitigation Response to COVID-19 Has Substantially Affected our Economy and Our Markets. In less than
one month, in the interest of saving as many lives as possible, we—all Americans—have undertaken, with remarkable spirit and selflessness, a massive restriction in how we interact. This collective, full-mitigation response to COVID-19 has resulted in a sharp contraction in many aspects of our economy and increased volatility and uncertainty in our capital markets. Policymakers have responded to the most apparent and acute economic and market consequences with unprecedented monetary and fiscal policy actions.

SEC Actions Have Focused on Market Integrity and Function. In response, the women and men of the SEC have taken dozens of actions, many in close coordination with the Federal Reserve, the Treasury Department and other U.S. and international authorities. These actions have focused on facilitating market function and preserving market integrity, as well as providing guidance and relief to market participants affected by COVID-19.\[ii\] In crafting and executing these responsive measures, our colleagues have been guided by our commitment to market integrity and the long term interests of our Main Street investors, knowing that more than 52 percent of US households have investments in our capital markets.\[iii\]

There is Broad Support Among Market Participants for COVID-19 Mitigation Efforts. Over the past several weeks, we have engaged with a wide array of market participants—retail investors, institutional investors, exchanges, public companies, small businesses and workers—as well as various members of the Executive and Legislative branches\[iv\] regarding our current course of action to combat COVID-19 and its effect on our economy. Laudably, to a person, they have expressed unequivocal support for the efforts to mitigate the spread of COVID-19, recognizing both the enormous economic cost of following social-distancing instructions and the reality that current guidelines and directives are likely to continue at least through April.\[v\] They also express awe and profound thanks to the healthcare workers on the front lines, as well as to those working countless hours to provide much-needed equipment to, and otherwise support, our front-line heroes.

There is Broad Recognition of the Need for a Transition to Forward-Looking, Health and Welfare Strategies. In these meetings, we have also discussed the stark reality that virtually all participants in our highly integrated economy—including our workers, our retail investors and our small businesses—are facing profound economic challenges and personal uncertainties that are not of their own making and over which they have little control. Discussions of the scope and size of these millions of individual challenges inevitably lead to near unanimous agreement that the current strategy—combining dramatic health-focused mitigation efforts with massive monetary and fiscal intervention—must evolve over the longer-term. This, in turn, leads to a question that is in the minds of investors, market participants and almost every American: What strategy or strategies, nationally and regionally, and by industry and company, should we follow? We agree with the emerging view that,
during this period of intense mitigation, all of us should strive to identify
and, as appropriate, pursue a course of action that continues to mitigate
and (hopefully) more effectively treat the health risks of COVID-19 while
fostering responsible increased economic activity.[vi] We also recognize
that, as we move forward, course corrections will be required and they
may be significant.

**Frameworks for Forward-Looking Health and Welfare Strategies are
Coming Into Focus.** We are optimistic that broad frameworks for such
forward-looking strategies are coming into focus.[vii] We expect that, in
the coming months, as we all learn more from the ongoing efforts to
address the current pandemic, and develop more tools to fight COVID-
19—including increased testing, enhanced monitoring and data analysis,
and identification and acceptance of effective therapeutics—we can,
anchored by the advice of our healthcare specialists, tailor our mitigation
efforts and correspondingly foster economic activity more generally. One
key component of any strategy will be continuing to target the fiscal
assistance provided by the CARES Act and related efforts on those
workers and businesses that remain constrained by health and safety
directives. Another key component will be adjusting operational norms to
ensure continued worker and customer safety, including complying with
health guidelines as they are modified and supplemented.

**Extensive Coordination Across the Public and Private Sectors Will
Be Essential to Our Success in Fighting COVID-19.** Importantly, in
the same way that the magnitude and speed of our society’s collective
commitment to “stop the spread” saved and will continue to save many
lives, our nation’s ability to move forward with a thoughtful, nimble,
combined health and economic strategy will significantly affect future
health and economic outcomes. Effectively executing such a strategy will
require constant coordination among workers, consumers, businesses,
governmental authorities and investors, both broadly and at the individual
and firm-specific level. Said another way, in our highly integrated
economy, isolated, uncoordinated strategies—whether active or
passive—are less likely to prove successful.

**Q1 Earnings Reports and Related Investor and Analyst Calls Will
Not be Routine.** In the coming weeks, our public companies will be
doing what they routinely do after quarter-end—issuing earnings
statements and convening calls with analysts and investors. This
quarterly routine is fundamental to the functioning of our equity and credit
markets. SEC-registered public companies—which include over 60 of
the world’s 100 largest companies—provide investors and our markets
with information, in many cases extensive information, regarding their
operational and financial condition at least quarterly. This information,
particularly the quantitative information (e.g., financial statements) is
predominately historical. Investors and analysts use this information,
including management commentary regarding trends, and future
expectations of financial condition and risks, to gauge value and estimate
future firm performance. These historically-based projections of future
performance have long been among the most meaningful drivers of investment decisions.

**There is Intense Investor Interest in Company-Specific Operational and Financial Status and Plans for Addressing the Effects of COVID-19.** This quarter, earnings statements and calls will not be routine. In many cases, historical information may be substantially less relevant. Investors and analysts are thirsting to know where companies stand today and, importantly, how they have adjusted, and expect to adjust in the future, their operational and financial affairs to most effectively work through the COVID-19 health crisis. Producing comprehensive financial and operational reports, may present challenges for companies in the current circumstances, particularly reports that include forward-looking information. We recognize these challenges, as well as the heightened importance of issuer-investor engagement in this uncertain time, and the SEC staff has encouraged earnings and related disclosures that are as timely, accurate and robust as practicable under the circumstances.[viii]

**We Request that Companies Provide as Much Information as is Practicable Regarding Their Current Status and Plans for Addressing the Effects of COVID-19.** Speaking for ourselves, and recognizing the challenges inherent in our request, we urge our public companies, in their earnings releases and analyst calls, as well as in subsequent communications to the marketplace, to provide as much information as is practicable regarding their current operating status and their future operating plans under various COVID-19-related mitigation conditions. Detailed discussions of current liquidity positions and expected financial resource needs would be particularly helpful to our investors and markets. Beyond the income statement and the balance sheet effects, we recognize that COVID-19 may significantly impact operations, including as a result of company efforts to protect worker health and well-being and customer safety. The impact of company actions and policies in this area may be of material interest to investors, and we encourage disclosures that address that interest. In addition, companies and financial institutions may be receiving financial assistance under the CARES Act or other similar COVID-19 related federal and state programs. Such assistance may take various forms and is intended to mitigate COVID-19 effects for companies and their workers. If these or other types of financial assistance have materially affected, or are reasonably likely to have a material future effect upon, financial condition or results of operations, the affected companies should provide disclosure of the nature, amounts and effects of such assistance.

**We Recognize that Producing Forward-Looking Disclosure Can be Challenging and Believe that Taking On that Challenge is Appropriate.** We recognize that for many companies, providing forward-looking information, particularly detailed information regarding future operating conditions and resource needs, may present difficulties, including because any shift to a forward-looking health and welfare
Strategy is at most in its incipient stage. As time passes, and our strategies come into greater focus, making and refining theses estimates should become less difficult.

We know from experience in various scenarios that estimates of the type we are requesting are unavoidably based on a mix of assumptions, including assumptions regarding matters beyond the control of the company. For example, in the context of our current challenges, key drivers of future operational status and financial results—most notably, the time frames for current COVID-19 social distancing guidelines and other mitigation-related requirements—are not uniform and are likely to undergo material change. We also recognize that, in light of these forecasting challenges, it may be tempting to resort to generic, or boilerplate, disclosures that do little to inform investors of company-specific status, operational strategies and risks. We encourage companies and their advisers to make all reasonable efforts to convey meaningful information—information that provides investors a level of insight that allows them to see the key operational and financial considerations and challenges the company faces through the eyes of management. In this regard, we encourage companies to consider the broad frameworks of some of the strategies that have been suggested, how following those strategies may affect their operations and whether that analysis would be of material interest to investors.

Robust, Forward-Looking Disclosures Will Benefit Investors, Companies and, More Generally, Our Fight against COVID-19. Such Disclosures Will Facilitate Communication and Coordination Among the Public and Private Sectors. This request that companies strive to provide, and update and supplement, as much forward-looking information as is practicable is driven by three primary considerations: (1) the information will benefit investors, (2) market digestion of the information will benefit the company, and (3) the broad dissemination and exchange of firm-specific plans for addressing the effects of COVID-19 under various scenarios will substantially contribute to our nation's collective effort to fight and recover from COVID-19.

The first two points require limited elaboration. The more investors know about how management is assessing, planning for, and taking steps to address, the effects of COVID-19, the better investment decisions investors will make. Relatedly, the more confidence investors (and the markets more generally) have that a company has a well thought out and executable strategy for addressing the effects of COVID-19, the more willing investors will be to provide credit and other financing to the company.

The third point is less familiar.[ix] Investors are not the only ones who are interested in how companies will adjust their affairs as we pursue our collective fight against COVID-19. As discussed above, broad and extensive coordination across workers, firms, investors and governmental officials will be critical to successfully emerge from this fight. The exchange of forward-looking information is essential to that coordination.
As just one of millions of examples, if the owner of an industrial laundry business becomes comfortable that the hotel industry is soon to pursue a credible plan for increasing activity, the laundry business may be less likely to furlough (or may plan to rehire) employees. More broadly, when a company articulates its strategy publicly, it gives investors and the public a heightened level of confidence and understanding. This increased confidence and understanding reduces risk aversion and facilitates action. This type of positive dynamic plays out across our economy in countless ways and further demonstrates the need for, and the power of, a coordinated, dynamic and forward-looking public-private strategy for fighting COVID-19.

**Discussion of Investor Protection, Market Integrity and Legal Risk**

In closing, a few words about investor protection, market integrity and legal risk. The SEC’s commitment to investor protection and market integrity is unwavering, and we are laser-focused on identifying bad actors who would seek to use the current uncertainty to prey on our investors. In addition, our Divisions of Enforcement and Corporation Finance recently issued statements reminding companies to practice good corporate hygiene, particularly with regard to the protection and distribution of material non-public information. In this regard, companies and their investors are well served when the type of information we outlined above is held closely until disclosed, and, when disclosed, is broadly disseminated.

We further recognize that companies often are cautioned to limit their forward-looking disclosures, and particularly specific estimates, to those required by our rules to limit legal risk in the event the forward-looking estimates prove to be incorrect. In this regard, we encourage companies to avail themselves of the safe-harbors for forward-looking statements. We appreciate that in many cases actual financial and operational results may differ substantially from what would now appear to be reasonable estimates. Given the uncertainty in our current business environment, we would not expect to second guess good faith attempts to provide investors and other market participants appropriately framed forward-looking information.

We and our colleagues at the SEC welcome engagement on these matters. We particularly encourage market participants who are facing challenges as a result of COVID-19 to continue to reach out to us.

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[i] This statement represents the views of the Chairman and the Director of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (“SEC” or “Commission”). It is not a rule, regulation, or statement of the SEC. The Commission has neither approved nor disapproved its content. This statement does not alter or amend applicable law and has no legal force or effect. This statement
creates no new or additional obligations for any person.


[iv] Including officials at the United States Treasury, Federal Reserve Board and the National Economic Council.


[viii] Starting with our fundamental commitments to investor protection and transparency, and recognizing the operational hardships and challenges posed to companies by COVID-19, our Division of Corporation Finance issued extensive disclosure and other guidance to assist issuers as they consider their disclosure obligations in connection with their assessment of the potential effects of COVID-19 on their operations. See Division of Corporation Finance, CF Disclosure Guidance: Topic No. 9 (March 25, 2020), available at https://www.sec.gov/corpfin/coronavirus-covid-19.


See Section 27A of the Securities Act and Section 21E of the Exchange Act.
Application of Antifraud Provisions to Public Statements of Issuers and Obligated Persons of Municipal Securities in the Secondary Market: Staff Legal Bulletin No. 21
Action: Publication of OMS Staff Legal Bulletin

Date: February 7, 2020

Summary: This staff legal bulletin provides the views of the staff of the Office of Municipal Securities (the “Office” or the “staff”) regarding the application of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934,[1] and Rule 10b-5[2] promulgated thereunder (together, the “antifraud provisions”) to public statements (a “statement” or “statements”) made by issuers of municipal securities and obligated persons (each, a “municipal issuer”[3] and, together, “municipal issuers”) in the secondary market.[4] As more fully discussed in this bulletin, the antifraud provisions apply to any statement of a municipal issuer that is reasonably expected to reach investors and the trading markets.

Supplementary Information: The statements in this legal bulletin represent the views of the Office. This legal bulletin is not a rule, regulation or statement of the Securities and Exchange Commission (the “Commission”). Further, the Commission has neither approved nor disapproved its content. This bulletin, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

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I. THE PURPOSE OF THIS BULLETIN

Market participants have raised questions about the application of the antifraud provisions to statements of municipal issuers, including annual and continuing disclosures accessible on the Electronic Municipal Market

SEC.gov | Application of Antifraud Provisions to Public Statements of Is...
Access (“EMMA”) system of the Municipal Securities Rulemaking Board (“MSRB”), as well as other statements of municipal issuers.

The Office is issuing this bulletin to outline previous Commission statements relevant to understanding the application of the antifraud provisions to any statement of a municipal issuer that is reasonably expected to reach investors and the trading markets and, thereby, promote more informed disclosure practices by municipal issuers in the secondary market; facilitate investor access to accurate, timely, and comprehensive information; and improve investor protection. Specifically, this bulletin presents the Office’s views on:

- certain elements of Section 10(b) of the Exchange Act and Rule 10b-5;[5]
- the scope of coverage under the antifraud provisions with respect to statements made by municipal issuers in the secondary market; and
- the role of policies and procedures in providing accurate, timely, and comprehensive information to investors and the trading markets.

II. BACKGROUND

One of the primary purposes of the federal securities laws is to ensure that the investing public is provided with comprehensive and accurate information about entities whose securities are publicly traded.[6] A lack of consistent disclosure impairs investors’ ability to acquire information necessary to make informed decisions, and thus, to protect themselves from fraud.[7] The staff observes that the Commission has long been concerned with disclosure in both the primary and secondary markets for municipal securities[8] and has regularly encouraged municipal issuers to provide timely and accurate information to investors and the trading markets.[9]

In the absence of a statutory scheme for municipal securities registration and on-going reporting requirements for municipal issuers, the Commission’s investor protection efforts in the municipal securities market have been accomplished primarily through regulation of broker-dealers and municipal securities dealers, including through Exchange Act Rule 15c2-12 (“Rule 15c2-12”); Commission interpretations; Commission oversight of the MSRB; and enforcement of the antifraud provisions of the federal securities laws.[10] To facilitate the availability of important information about municipal issuers in the secondary market for municipal securities, Rule 15c2-12 requires an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more (subject to certain exemptions set forth in Rule 15c2-12) to reasonably determine that a municipal issuer has undertaken in a written agreement or contract for the benefit of holders of the municipal securities, to provide certain enumerated annual and event-based disclosures to the MSRB’s EMMA system.[11]
In 1994, the Commission provided interpretive guidance regarding, *inter alia*, the application of the antifraud provisions to statements made by municipal issuers following an initial offering of municipal securities.[12] In the 1994 Interpretive Release, the Commission provided principles-based guidance to assist municipal issuers, and others, in meeting their obligations under the federal securities laws, including under the antifraud provisions. Specifically, the Commission stated that when a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions because such statements are a principal source of significant, current information about the municipal issuer.[13] The Commission’s principles-based approach to the application of the antifraud provisions applies to all statements of municipal issuers that are reasonably expected to reach investors and the trading markets notwithstanding changes in municipal issuer disclosure practices, technology, investor expectations, and regulatory framework.[14]

### III. ELEMENTS OF SECTION 10(b) of the Exchange Act AND RULE 10b-5 LIABILITY (“ANTIFRAUD PROVISIONS”)

The antifraud provisions apply to the purchase and sale of municipal securities in the secondary market, including to statements made by municipal issuers that are reasonably expected to reach investors and trading markets.[15] Section 10(b) of the Exchange Act prohibits the use or employment, in connection with the purchase and sale of any security, of any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.[16] Rule 10b-5, in part, prohibits, in connection with the purchase or sale of any security, the making of any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[17]

#### A. Scienter Standard

Scienter is a required element of a violation of Section 10(b) of the Exchange Act and Rule 10b-5.[18] The term “scienter” refers to a mental state embracing intent to deceive, manipulate, or defraud.[19] Courts and the Commission have stated that the scienter requirement for violations of the antifraud provisions may be satisfied by a showing of recklessness.[20] Recklessness has been defined as an “extreme departure from the standards of ordinary care, and which represents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”[21]

#### B. Materiality and the “Total Mix” of Information

For purposes of Section 10(b) of the Exchange Act and Rule 10b-5, a
fact is material if there is a substantial likelihood that the information would have been viewed by the reasonable investor as having significantly altered the total mix of information available.[22] As the Commission has stated, whether a statement of a municipal issuer significantly alters the total mix of information for purposes of Section 10(b) of the Exchange Act and Rule 10b-5 is determined based on the facts and circumstances in each instance.[23] The staff observes that due to the facts and circumstances nature of the “total mix” analysis, the scope of information that may be viewed by a reasonable investor to significantly alter the total mix of information available could differ among municipal issuers. For example, the assessment of whether a particular piece of information about a municipal issuer significantly alters the total mix might differ if access to accurate, timely, and comprehensive information about that municipal issuer is “uneven and inefficient” rather than regularly available to investors either through the MSRB’s EMMA system or some other investor relations-focused public medium (e.g., investor website).[24]

In the staff’s view, the 2013 Harrisburg Report illustrates the facts and circumstances nature of the “total mix” analysis. In the Harrisburg Report, the Commission noted that “[i]nvestors may be more likely to rely upon statements from public officials where written undertakings made pursuant to Rule 15c2-12 have not been fulfilled and required continuing disclosures are not available through [EMMA].”[25] The Harrisburg Report involved circumstances in which officials who worked within the city’s administration released statements and financial information that omitted or misstated material information about Harrisburg’s financial condition.[26] The misstatements and omissions were recurrent, spanned from one fiscal year into the next, and occurred during a period in which the City of Harrisburg failed to submit annual financial information, audited financial statements, notices of failure to provide required annual financial information, and material event notices.[27]

Though the Harrisburg Report presents a scenario in which the municipal issuer failed to fulfill its contractual continuing disclosure obligations, the staff does not believe that such circumstances—i.e., a municipal issuer’s failure to submit annual financial information, audited financial statements, notices of failure to provide required annual financial information and material event notices during a more than two-year period—are necessary for a municipal issuer to be subject to liability for violations of the antifraud provisions. Rather, the staff believes, consistent with the Commission’s prior statements that all statements of a municipal issuer that are reasonably expected to reach investors and the trading markets are subject to the antifraud provisions, regardless of the municipal issuer’s compliance with its continuing disclosure obligations. Nevertheless, because such statements are evaluated for antifraud purposes in light of the circumstances in which they are made, the extent to which the municipal issuer has made other statements may increase or decrease the risk that the statements may significantly alter the total mix of information.[28]
C. Information Reasonably Expected to Reach Investors

As noted above, the Commission has stated that the antifraud provisions apply to all statements made by municipal issuers that provide information that is reasonably expected to reach investors and the trading markets.[29] The Commission observed in the 1994 Interpretive Release

As a practical matter . . . municipal issuers do not have the option of remaining silent. Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a municipal offering.[30]

Municipal issuers disclose current information about themselves in a variety of ways, including public announcements, press releases, interviews with media representatives, and discussions with groups whose members have a particular interest in their affairs.[31] In addition, information about municipal issuers is collected by state and local governmental bodies and routinely made publicly available.[32] Because, as the Commission has noted, access to "current and reliable information is uneven and inefficient"[33] in the municipal securities market, these types of statements are "a principal source of significant, current information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading markets."[34] The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate the antifraud provisions.[35]

IV. EXAMPLES OF STATEMENTS COVERED BY THE ANTIFRAUD PROVISIONS

As noted above, like public companies,[36] municipal issuers disclose current information about themselves in a variety of ways, including continuing disclosure documents to the EMMA system,[37] public announcements, press releases, interviews with media representatives, and discussions with groups whose members have a particular interest in their affairs. The Commission has long encouraged public company disclosure through informal channels as a complement to the disclosure requirements of the Exchange Act.[38]

As also discussed above, the antifraud provisions apply to all municipal issuer statements that provide information that is reasonably expected to reach investors and the trading markets, whoever the intended primary audience and whatever the medium of delivery.[39] Notably, this standard applies to all statements by a municipal issuer, whether on the MSRB's EMMA system or elsewhere, whether written or oral, and regardless of the extent to which the municipal issuer has fulfilled its contractual continuing disclosure obligations. The following sets forth a non-
exhaustive list of examples of statements (other than disclosures on the MSRB’s EMMA system) in the municipal securities market that could be subject to the antifraud provisions.

A. Information on Municipal Issuer Websites

1. General
The Commission has stated that municipal issuers are responsible for the accuracy of their statements that are reasonably expected to reach investors or the securities markets regardless of the medium through which the statements are made, including the Internet. The Commission further stated that “it is important for issuers, including municipal securities issuers, to keep in mind that the federal securities laws apply in the same manner to the content of their websites as to any other statements made by or attributable to them,” and these laws include the antifraud provisions. Accordingly, the staff believes that municipal issuers should ensure that the information on their websites is accurate and not misleading.

2. Historical Information
Information posted to a website potentially has a long life. In the context of public companies, the Commission has stated that it does not believe that the maintenance of previously posted materials or statements on public company websites constitutes a reissuance or republication of such materials or information for purposes of the antifraud provisions merely because the materials or statements remain accessible to the public. However, the Commission noted, in circumstances where it is not apparent to the reasonable person that the posted materials or statements speak as of a certain date or earlier period, previously posted materials or statements that have been put on a public company’s website should be separately identified as historical or previously posted materials or statements, and located in a separate section of the website. The staff encourages municipal issuers to follow the Commission’s guidance regarding the application of the antifraud provisions to historical information on the websites of public companies with respect to the display of historical information on the websites of municipal issuers.

3. Hyperlinks
The Commission has provided guidance regarding the liability of a public company and a municipal issuer under the antifraud provisions for information on third-party websites for which the public company or municipal issuer has provided a hyperlink on its own website. Addressing all issuers with respect to hyperlinked information, the Commission has noted that liability under the “entanglement” theory would depend upon an issuer’s level of pre-publication involvement in the preparation of the information, whereas liability under the “adoption” theory would depend upon whether, after its publication, an issuer, explicitly or implicitly, endorses or approves the hyperlinked
The Commission cited several factors that may be relevant in determining whether an issuer has adopted hyperlinked information, including the context of the hyperlink, the risk of confusing investors, and the presentation of the hyperlinked information. Subsequently, in 2008, the Commission provided further guidance for public companies, stating that the focus in evaluating liability for hyperlinked information should be on whether the public company has explicitly or implicitly approved or endorsed the statement of a third party. In making such evaluation, the Commission noted that public company statements about the hyperlink, including why the public company is including the hyperlink on its website, the nature of the hyperlink, and use of disclaimers, “exit notices,” or “intermediate screens,” could all be factors in the analysis.

The staff encourages municipal issuers to follow the Commission’s 2008 guidance regarding the application of the antifraud provisions to the use of hyperlinks on the websites of public companies with respect to the use of hyperlinks on the websites of municipal issuers.

4. Summary Information
Municipal issuers often provide on their websites summaries or overviews of information, particularly financial information. In the context of public companies, the Commission has stated that such summary information can be helpful to investors. However, the Commission noted that public companies must consider the context in which such summary information is provided to avoid confusing or misleading investors. The Commission encouraged public companies using summaries and overviews to highlight the nature of such information, including the use of appropriate titles and explanatory language, the use and placement of hyperlinks to the more detailed information being summarized, and the use of “layered” or “tiered” formats in presenting such information. The staff encourages municipal issuers to follow the Commission’s guidance regarding the application of the antifraud provisions to the display of summary information on the websites of public companies with respect to the display of summary information on the websites of municipal issuers.

C. Public Reports Delivered to other Governmental or Institutional Bodies
In many cases, municipal issuers prepare and disseminate reports or other documents containing financial information and/or operating data to various governmental or institutional bodies, or to the public. The Commission previously has cited certain of these reports, including Comprehensive Annual Financial Reports, budgets, and mid-year financial reports, as information reasonably expected to reach investors and the trading markets, and therefore subject to the antifraud provisions, even if not filed with EMMA. Though the Commission has not specifically identified other types of reports which, once public, would be subject to the antifraud provisions, the staff believes that additional types
of reports could be covered by the antifraud provisions depending on the facts and circumstances.[56] In the staff’s view, additional types of reports that could, depending on the facts and circumstances, be included in this category may include (but may not be limited to) reports submitted by a municipality to a state agency, reports made by a state or local official to a legislative body (such as a state legislature or city council), and other reports made part of a public record and available to the public. In the staff’s view, depending on the facts and circumstances, such reports could be a source of significant, current information about the municipal issuer and thus could reasonably be expected to reach investors and the trading markets.

D. Statements Made by Municipal Issuer Officials

The statements of municipal issuer officials[57] are also subject to the antifraud provisions if their statements are reasonably expected to reach investors or the securities markets.[58] Notably, statements by municipal issuer officials “who may be viewed as having knowledge regarding the financial condition and operation of a municipal issuer” could be a principal source of significant, current information about the issuer of the security and thus be reasonably expected to influence investors and the secondary market.[59] Accordingly, depending on the facts and circumstances, the statements of municipal issuer officials that may be subject to the antifraud provisions could include verbal statements made by municipal issuer officials, such as speeches,[60] public announcements, and interviews with media representatives,[61] as well as statements disseminated through other avenues such as, in the staff’s view, social media.[62]

V. Role of Policies and Procedures

Given the potential for liability of municipal issuers and their officials with respect to information made publicly available about the municipal issuer that is reasonably expected to reach investors and the trading markets, the statements of a municipal issuer and its officials who may be viewed as having knowledge regarding the financial condition and operations of a municipal issuer should be carefully evaluated to assure that they are not materially false or misleading.[63] The Commission has historically encouraged municipal issuers and their officials to take steps to reduce the risk of misleading investors.[64] For example, in the 1994 Interpretive Release, in order to minimize the risk of misleading investors, the Commission recommended that municipal issuers “should establish practices and procedures to identify and timely disclose, in a manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the security.”[65] In the Harrisburg Report, the Commission recommended that municipal issuers and their officials, at a minimum, “consider adopting policies and procedures that are reasonably designed to result in accurate, timely, and complete public disclosures; identifying those persons involved in the disclosure process; evaluating other public
disclosures that the municipal issuer has made, including financial information and other statements, prior to public dissemination; and assuring that responsible individuals receive adequate training about their obligations under the federal securities laws."[66]

In the staff’s view, such reasonably designed policies and procedures, when consistently implemented, can help a municipal issuer regularly provide more accurate, timely, and comprehensive information to investors; better manage communications with their investors; and comply with the antifraud provisions. For that reason, the staff encourages issuers to adopt policies and procedures which, among other things, designate an individual responsible for compliance with such policies and procedures; establish a periodic training schedule for issuer staff and officials responsible for developing, reviewing, and disseminating issuer disclosures; identify the documents, reports, etc. which customarily contain current information about, for example, the financial and operational condition of the issuer and establish a process by which the issuer makes such documents, reports, etc. regularly available to investors; and identify the place or places at which the issuer makes such documents, reports, etc. regularly available to the public, which may include a central repository, such as the EMMA system, or an investor-relations website.[67]

[3] For purposes of this bulletin, the term “municipal issuer” includes an obligated person, as defined in 15 U.S.C. § 78o-4(e)(10) and 17 C.F.R. § 240.15c2-12(f)(10).
[4] For purposes of this bulletin, the terms “statement” or “statements” include any publicly available written or oral communication of a municipal issuer, regardless of the intended audience or medium of delivery.
[5] While this bulletin focuses solely on Section 10(b) of the Exchange Act and Rule 10b-5, the Office notes that other antifraud provisions, such as Section 17(a) of Securities Act of 1933, may apply to statements in the offer or sale of securities. 15 U.S.C. § 77q (2019).


[13] Id. at 12756 (citing to prior Commission guidance regarding public statements by corporate representatives in the 1984 Release).


[18] See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (“§10(b) was addressed to practices that involve some element of scienter, and cannot be read to impose liability for negligent conduct alone.”); Aaron v. SEC, 446 U.S. 680, 701-02 (1980).


[24] Id.

[25] Id.

[26] Id.

[27] Id.

[28] Despite its focus on municipal issuer officials, the staff believes that
the Harrisburg Report is instructive for municipal issuers as well.


[31] Id. at 12755-56.

[32] Id.

[33] The staff acknowledges that the Commission’s statement regarding the uneven and inefficient access to current and reliable information about municipal issuers predates the creation and designation of EMMA as the central repository for municipal disclosures; nevertheless, the staff continues to believe that, though much improved, access to current and reliable information remains uneven and inefficient. See 2012 Report, supra note 10, Section III(B) at 69-83. For an example of an investor’s perspective regarding the inconsistency of access to disclosure, see Transcript of The Road Ahead: Municipal Securities Disclosure in an Evolving Market (Dec. 6, 2018) at 186, available at https://www.sec.gov/spotlight/municipalsecurities/municipal-securities-conference-120618-transcript.pdf; see also Letter to Chairman Jay Clayton, Securities and Exchange Commission from Scott Andreson, Chair, National Federation of Municipal Analysts (May 3, 2019), available at https://www.nfma.org/assets/documents/position.stmt/nfmaLetterSECMSRBmay3.pdf (highlighting issues with respect to the timeliness of financial disclosures in the municipal securities market).

[34] See 1994 Interpretive Release, supra note 9, 59 FR at 12756.

[35] Id.

[36] As used in this bulletin, the terms “public company” and “public companies” are meant to refer, as appropriate, to publicly held companies, operating companies, and companies as such terms are used by the Commission in the 1984 Release (supra note 6), the 2000 Electronic Media Release (supra note 29), and the 2008 Website Release (infra note 38).

[37] The staff acknowledges that, unlike public companies, a municipal issuer provides its formal secondary market disclosures under the terms of a contractual undertaking entered into for the benefit of the holders of the related municipal securities through which the municipal issuer contractually agrees to provide certain secondary market disclosures set forth in Rule 15c2-12.

[38] See Exchange Act Release No. 58288 (Aug. 1, 2008), 73 FR 45862, 45864 (Aug. 7, 2008) (the “2008 Website Release”) (encouraging public companies to make disclosure “more readily available to investors in a variety of locations and formats to facilitate investor access to that information” through websites because of the “enormous potential for the
Internet to promote the goals of the federal securities laws” and because websites “can serve as effective information and analytical tools for investors.”).


[40] 2008 Website Release, supra note 38, 73 FR at 45863; see also Harrisburg Report, supra note 14.


[42] Id.


[44] See 2000 Electronic Media Release, supra note 29, 65 FR at 25855 (as observed by the Commission with respect to the websites of all issuers). For purposes of this bulletin, any reference to “all issuers” includes public companies, investment companies, and municipal issuers.


[46] Id.

[47] See 2000 Electronic Media Release, supra note 29, 65 FR at 25848-49 (addressing obligations of all issuers) and 2008 Website Release, supra note 38, 73 FR at 45870-71 (addressing only the obligations of public companies).


[49] Id.


[51] Id.

[52] Id. at 45872.

[53] Id.

[54] Id.


[56] See 1994 Interpretive Release, supra note 9, 59 FR at 12755-56 (discussing application of antifraud provisions to various public statements made by municipal issuers).

[57] For purposes of this bulletin, the term “municipal issuer official” includes elected officials, appointed officials, and employees or their functional equivalents, of any municipal issuer, and is intended to have the same meaning as the term “public official” as used in the Harrisburg Report. See Harrisburg Report, supra note 14.

[58] See id.
In the staff’s view, in light of the previous Commission statements that issuers are responsible for the accuracy of their statements that reasonably can be expected to reach investors or the securities markets regardless of the medium through which the statements are made, officials of municipal securities issuers should be mindful of the accuracy of statements distributed via all channels, including social media.

This list is not intended to create any legal obligation for an issuer to develop such policies and procedures but rather sets forth the staff’s view on the types of provisions which could enable an issuer to provide more accurate, timely, and comprehensive information to investors; better manage communications with their investors; and comply with the antifraud provisions.
General Continuing Disclosure Considerations for Municipal Securities Issuers Including Those Related to COVID-19 Financial Matters
AUGUST 2020

These considerations have been developed by a municipal industry workgroup to provide guidance to issuers on timely disclosure. The ongoing COVID-19 pandemic and its impact on all municipal governments and their respective economies highlights a need for accurate, timely, and responsive municipal disclosure. While we feel the considerations below are general in nature, different issuers of different credits may need to take into account other specific considerations while addressing disclosure both generally and during the COVID-19 pandemic. While the following recommendations are actions that municipal issuers should consider, all issuers are encouraged to discuss COVID-19 disclosure with their entire financing team, including with their bond or disclosure counsel.

- **MATERIAL EVENT FILINGS.** Governments are reminded that when a credit is changed (either by a downgrade or an upgrade) by a credit rating agency that a material event filing must be made within 10 business days in the EMMA system. Other events resulting from the COVID-19 crisis (such as draws on debt service reserve funds and changes in terms and conditions of financial obligations) may also require a material event filing. Governments are encouraged to speak with their bond or disclosure counsel about the need to make a filing and information to provide in the filing. **Importantly, the SEC Rule 15c2-12 reporting requirement of 10 business days for listed material events is NOT relaxed during this time.** Please be mindful of material events and track the time that has lapsed to ensure timely reporting within the 10 business-day reporting requirement.

- **KNOW YOUR ANNUAL DISCLOSURE FILING DATES.** Governments should always be aware of the dates in their continuing disclosure agreements (CDA) when annual disclosures are due to EMMA, and make those filings accordingly. Although this is an unprecedented crisis, governmental entities continue to have responsibilities to make annual disclosure filings, per their continuing disclosure agreement(s), within the EMMA system. **The SEC has NOT suspended annual disclosure filing requirements.**

- **MAKING ANNUAL CONTINUING DISCLOSURE FILINGS.** If a government is unable to make a filing on time, due to current circumstances – including many governments not being physically in the office to complete financials, and/or delayed internal and external audits, governments must follow the requirements contained in their CDA, which may require a filing with EMMA with an explanation as to why the submission is late. Governments should consider filing on EMMA the parts of the required annual disclosures that are available by the date such annual disclosure is due. Some partial filing may be a requirement under the CDA. If any part of annual disclosure submissions did not occur as required in your CDA, information related to the failure to file required information will need to be disclosed in future issuance documents. Again, it is important to note the reasons why any part of the submission(s) was late – due to the inability to complete financials and/or audits or other reasons related the COVID-19 crisis – as underwriters of future issuances will need to understand these reasons.

- [Primary Market Disclosure](#)
- [Understanding Your Continuing Disclosure Responsibilities](#)
GOOD INVESTOR RELATIONS. Governments endeavoring to promote good investor relations may want to consider facilitating widespread and contemporaneous access to information provided to individual investors (including lenders), and, perhaps, rating agencies, by providing the same information on their website or via a filing on EMMA so that it is available for all investors, and should consult their bond or disclosure counsel if there are questions or concerns.

DETERMINING WHETHER AND/OR WHEN TO MAKE VOLUNTARY DISCLOSURE FILINGS. Governments may be facing various fiscal challenges due to the crisis. Further, some market sectors may be affected more immediately than others. While urgency is important in providing information about the pandemic’s impact, governments should take care to put these challenges into context and discuss with their internal and external financing teams (including bond and/or disclosure counsel) what should be voluntarily disclosed on EMMA to reflect any financial or operational problems caused by COVID-19. Actual and factual information should be clearly separated from any estimates or projections of revenues and budgets that are disclosed. In addition, distinguishing actual, factual, and any official estimates or projections from political speech or press reporting is also a key consideration. Governments are reminded that information on their own investor relations or similar web page on the entity's web site might be deemed disclosure of the government regardless if such disclosure is voluntarily submitted to EMMA.

PRESENTING COVID-19 VOLUNTARY DISCLOSURE INFORMATION. After determining if certain information should be voluntarily disclosed, what is and how it should be presented is an important consideration. For instance, any use of revenue or budget projections should be official estimates of the government and should be clearly marked as such, as should unaudited financial information. Further, per the SEC Public Statement of May 4, 2020 (linked below), the regulator encouraged municipal issuers to provide investors with forward-looking information regarding the impact of COVID-19 on their financial and operating conditions. The SEC also provided that an entity may wish to add “...meaningful cautionary language - including for example, (1) a description of relevant facts or assumptions affecting the reasonableness of reliance on and the materiality of the information provided, (2) a description of how certain important information may be incomplete or unknown, and (3) the process or methodology (audited vs. unaudited) used by the municipal issuer to produce the information...” The SEC notes that such information “will not only improve the quality of the disclosure but also will reduce legal and other risks.” The SEC also stresses good faith forward-looking information will not be second-guessed by the SEC. These disclaimers should be provided whether the information appears on an entity’s general web site, an entity’s investor relations web page, or in an EMMA filing.

The Importance of Disclosure for our Municipal Markets (SEC Chairman Clayton and Director Olsen)

EMMA FILINGS. Governments should make sure that when making annual, continuing, or voluntary disclosure filings within the EMMA system that they are filed correctly and for all relevant CUSIP numbers. The current COVID-19 crisis may cause different filings with the EMMA system, but issuers should focus the EMMA filing on the results or potential impact from the COVID-19 crisis (such as revenue and budget updates, draw on reserves, change in financial obligation terms and conditions, etc.). It is probable that single EMMA filings could be made under multiple filing categories under the EMMA system. The MSRB makes the following resources available to assist issuers with submitting disclosures to the EMMA system:

Continuing Disclosure Submission Manual
Continuing Disclosure Submission Video Tutorials
Selecting Financial/Operating Disclosure Categories on EMMA Dataport
Selecting Event Disclosure Categories on EMMA Dataport

POST-ISSUANCE COMPLIANCE FOR TAX LAW PURPOSES. The IRS has NOT suspended the post-issuance responsibilities for issuers of municipal debt. Issuers are required to make federal arbitrage rebate and yield reduction payments, adhere to private use regulations, and comply with other obligations related to tax-exempt bond issuances.

Post-Issuance Policies and Procedures
Debt 101

Similar to issuer responses to the COVID-19 pandemic, the best practices related to voluntary disclosure are growing and evolving. Over time, this municipal industry workgroup intends to review and update these considerations to address disclosure efforts that may not be addressed at this time, either for specific credits, issuers, or situations.
ADTR - Annual Debt Transparency Report
Reporting Guidelines

The California Debt and Investment Advisory Commission (CDIAC) provides the following definitions and instructions to facilitate the collection of high quality data and provide guidance to those responsible for submitting information to CDIAC under Government Code section 8855(k) (effective January 1, 2017). The definitions, data field requirements, and guidance for completing the report are intended to operationalize the statute while maintaining consistency with operative terms and processes formally defined under statute and California Code of Regulations, Title 4, Sections 6000 to 6062. CDIAC does not represent that these guidelines for the Annual Debt Transparency Report (ADTR) carry regulatory weight. They may be modified through a formal rulemaking process.

Definitions:

“Accreted Interest” means the amount of unpaid interest that has been accrued or added to the initial principal during the Reporting Period and become a repayment obligation of the issuer upon redemption of the Debt. Interest or value accretion is a feature of capital appreciation bond financing. Accreted Interest during the Reporting Period is also described as the compound accreted value of the Debt at the end of the Reporting Period less the compound accreted value at the beginning of the Reporting Period.

“Acquire” means to use the proceeds of a Marks-Roos authority bond financing to purchase the bonds of a local agency, make a loan to a local agency or transfer the proceeds to a local agency.

“Annual Debt Transparency Report (ADTR)” means the collection of all information required to be submitted to the Commission pursuant to Government Code section 8855(k).

“Authority” means the authorization to issue an amount of Debt, inclusive of the amount issued and subject to this ADTR, that is approved by vote of the electorate, taxpayers, or property owners, or, if absent a voter authorization, by act of the Legislative Body.

“Authorization Date” means the date that the voters, taxpayers or property owners approved the ballot measure or, if absent a voter authorization, the date the legislative body approved the issue of Debt associated with this Authority.

“Authorization Measure Name and Number” means the measure name/number of the authorization as it appeared on the ballot which was approved by voters.

“Debt” means 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. [See CCR Title 4, Section 6000(k)].

“Issue” means Debt entered into by an issuer and sold on a contemporaneous or nearly contemporaneous basis, in one or more series, under the terms of one Debt contract with the same Creditor.

“Lapsed” means Debt for which the authority to issue expired during the Reporting Period.
“Legislative Body” means the governing body which authorized the issuance of the Debt when a vote of the electorate, taxpayers, or property owners was not required to obtain issuance authority.

“Outstanding” means the original principal received from the sale of Debt and accreted interest, if any, has not been fully repaid to debtholders.

“Proceeds” means total funds available to the issuer to spend or value of the assets transferred from the creditor to issuer that are a direct result of the Debt issue for which the ADTR is submitted. Proceeds of the Debt issue do not include interest earnings on proceeds deposited in interest bearing accounts or comingled proceeds from other Debt issues.

“Principal” means the gross amount of money or value of the assets transferred from the creditor to the issuer in an Issue of Debt, not inclusive of original issue premium or discount, or accrued interest.

“Redemption Payment Date” means the date that the issuer made the payment, inclusive of principal, interest, or other sums due, to repay all or part of a Debt Issue.

“Refund/Refinance” means Debt issued to pay-down, refinance, or redeem outstanding Debt of the issuer.

“Replenishment” means an increase to the authorization amount that was caused by one or more Issues of debt, as when a long term issuance pays down other issuance under an interim (short-term) program.

“Reporting Period” means July 1 through June 30, annually.

“Resolution Number and Name” means the name and number given the resolution approved by the legislative body that provided the authority to Issue the Debt.

“Spent” means the use of the Proceeds of the Debt Issue to pay for goods, services, or obligations of the issuer.

State Law

Government Code section 8855(k) requires all state and local agencies submit an annual report for any issue of debt for which it has submitted a report of final sale on or after January 21, 2017. The report must be submitted within seven months after the end of the Reporting Period. The annual report must be submitted until the debt is no longer outstanding and all proceeds have been spent.

To facilitate and ensure consistency in reporting, CDIAC has developed the Annual Debt Transparency Report (ADTR).
**IMPORTANT NOTES FOR SUCCESSFUL COMPLETION OF THE ADTR**

1) You will be allowed 60 minutes of inactivity once you have logged into the ADTR. After 45 minutes of inactivity, a warning that the session will expire in 15 minutes will appear on screen. The warning will ask if you want to extend the session. If you answer “yes”, a new 60 minute inactivity allotment will begin with the same warning appearing again after 45 minutes. If you do not extend a session and allow any session to expire before you have submitted the report, you will not be able to submit your ADTR and all entered data will be lost.

2) Do not enter any text (in names, terms, or descriptions) containing apostrophes. Due to the design and composition of the form, use of apostrophes in any of the data fields will cause errors and invalidate the submittal.

3) Move from data entry field to data entry field using the <TAB> key or by placing your cursor in a field with your mouse. **DO NOT use <Enter>**.

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<td>Prepopulated from ADTR Landing page - <strong>No edits allowed.</strong> If the year is incorrect exit the report and enter the correct fiscal year.</td>
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<td>CDIAC #</td>
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**SECTION I: GENERAL INFORMATION**

I.A. Issuer | Prepopulated with data submitted on the *Report of Final Sale (RFS)* - **No edits allowed.**

I.B. Issue Name | Prepopulated with data submitted on the *Report of Final Sale (RFS)* conformed to CDIAC’s naming convention. - **No edits allowed.**

I.C. Project Name | Prepopulated with data submitted on the *Report of Final Sale (RFS)* conformed to CDIAC’s naming convention. - **No edits allowed.**

I.D. Date of Sale | Prepopulated with data submitted on the *Report of Final Sale (RFS)* - **No edits allowed.**

I.E. Original Principal Amount of Issue | Prepopulated with data submitted on the *Report of Final Sale (RFS)* - **No edits allowed.**

I.F. Net Original Issue Premium (Discount) | Prepopulated with data submitted on the *Report of Final Sale (RFS)* - **No edits allowed.**

I.G. Proceeds Used to Acquire Local Obligations (Marks-Roos Only) | Enter amount used to acquire a local obligation(s) under a Marks-Roos financing structure. **Optional entry field.**

I.H. Total Reportable Proceeds | Calculated field – **No entry. NOTE: This total must equal the total amounts reported for all fund categories reported under Section V.B.**
## SECTION II: ISSUANCE AUTHORIZATION I

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<td>Auto-populates with previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
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<td>B</td>
<td>Authorization Date</td>
<td>Auto-populates with previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>C</td>
<td>Authorization Measure/Resolution Name and Number</td>
<td>Auto-populates with previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>D</td>
<td>Debt Authorized – Beginning of the Reporting Period</td>
<td>Enter data if this is the initial ADTR. Auto-populates for subsequent reports. <strong>EDIT IF NECESSARY.</strong></td>
</tr>
<tr>
<td>E</td>
<td>Debt Authorized – During the Reporting Period</td>
<td>If the authorization occurred within the reporting period, enter the original authorized amount. Or, if the authorized amount increased during the reporting period <strong>not</strong> as a result of a replenishment reported to CDIAC on a Report of Final Sale, enter the amount here. <strong>Mandatory entry field.</strong></td>
</tr>
<tr>
<td>F</td>
<td>Total Debt Authorized</td>
<td>Calculated field. <strong>No entry.</strong></td>
</tr>
<tr>
<td>G</td>
<td>Debt Issued</td>
<td>Auto-populates with previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>H</td>
<td>Replenishment Reported During Reporting Period</td>
<td>Auto-populates with previously submitted data. <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>I</td>
<td>Debt Authorized but Unissued</td>
<td>Calculated field – <strong>No entry.</strong></td>
</tr>
<tr>
<td>J</td>
<td>Debt Authority – Lapsed</td>
<td>Enter the amount of authorization that lapsed during the reporting period. <strong>Mandatory entry field.</strong></td>
</tr>
<tr>
<td>K</td>
<td>Total Authorization Remaining</td>
<td>Calculated field – <strong>No entry.</strong></td>
</tr>
</tbody>
</table>

## SECTION II: ISSUANCE AUTHORIZATION II

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Original Voter/Legislative Body Authorized Amount</td>
<td>Auto-populates if data was previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>B</td>
<td>Authorization Date</td>
<td>Auto-populates if data was previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>C</td>
<td>Authorization Measure/Resolution Name and Number</td>
<td>Auto-populates if data was previously submitted data. <strong>No entry allowed.</strong> <em>(If this data needs revision, please contact CDIAC.)</em></td>
</tr>
<tr>
<td>D</td>
<td>Debt Authorized – Beginning of the Reporting Period</td>
<td>Enter data if this is the initial ADTR. Auto-populates for subsequent reports. <strong>EDIT IF NECESSARY.</strong></td>
</tr>
<tr>
<td>E</td>
<td>Debt Authorized – During the Reporting Period</td>
<td>If the authorization occurred within the reporting period, enter the original authorized amount. Or, if the authorized amount increased during the reporting period <strong>not</strong> as a</td>
</tr>
</tbody>
</table>
result of a replenishment reported to CDIAC on a Report of
Final Sale, enter the amount here. **Mandatory entry field.**

F. Total Debt Authorized
   Calculated field. **No entry.**

G. Debt Issued During the Reporting Period
   Auto-populates with previously submitted data. **No entry allowed.** *(If this data needs revision, please contact CDIAC.)*

H. Replenishment Reported During Reporting Period
   Auto-populates with previously submitted data. *(If this data needs revision, please contact CDIAC.)*

I. Debt Authorized but Unissued
   Calculated field – **No entry.**

J. Debt Authority – Lapsed
   Enter the amount of authorization that lapsed during the reporting period. **Mandatory entry field.**

K. Total Authorization Remaining
   Calculated field – **No entry.**

### SECTION III: PRINCIPAL OUTSTANDING

III.A. Principal Balance – Beginning of the Reporting Period
   For initial reports, this field is prepopulated with the principal amount issued. For subsequent reports, it is prepopulated with the balance remaining at the end of the prior reporting period. **Edit if necessary.**

III.B. Accreted Interest
   Enter the amount of accreted interest, if applicable – **Optional entry field**

III.C. Total Principal and Accreted Interest
   Calculated field – **No entry.**

III.D. Principal Paid During the Reporting Period with Proceeds from Other Debt Issues.
   Enter the principal that has been redeemed or paid down during the Reporting Period by debt issues reported to CDIAC. **Mandatory entry field.**

III.E Principal Payments (not reported in III.D.) Made During the Reporting Period.
   Enter the principal that has been paid during the Reporting Period. **Mandatory entry field.**

III.F. Principal Outstanding - Ending
   Calculated field – **No entry.**

### SECTION IV: REFUNDING/REFINACING ISSUES

CDIAC Number
   If the principal of the issue subject of this report has been redeemed or paid down, entirely or partially, during the Reporting Period, enter the CDIAC number(s) of the Debt issue(s) that was the source of the funds for the redemption. **Optional entry field.**

Refunding/Refinancing Amount(s)
   If the principal of the issue that is subject to this report has been redeemed or paid down, entirely or partially, during the Reporting Period, enter the amount of the proceeds from the refunding/refinancing Debt that were used for
the redemption or pay-down. **Optional entry field.**

**NOTE: The total amount of proceeds reported as used to redeem or pay-down the principal subject to this report may not be greater than that which is reported in III.D.**

Redemption/Payment Date

Enter the redemption or payment date(s) that the principal and interest due were paid. **NOTE: Date must be within the Reporting Period. Optional entry field.**

---

**SECTION V: USE OF PROCEEDS**

**A. Reportable Proceeds**

V.A.(1) Report Period End

Prepopulated from ADTR Landing – **No edits allowed.**

V.A.(2) Begin

Prepopulated with amount of “Total Reportable Proceeds” field (Section I.H.) for the initial ADTR report. For subsequent reports, prepopulated with the prior year “Reportable Proceeds Remaining Balance” – **No edits allowed.**

V.A.(3) Spent

Populates with total of amounts from Section V.B “Proceeds Spent Current Reporting Period” – **No edits allowed.**

V.A.(4) Remain

Calculated field – **No entry.**

**B. Proceeds Spent / Unspent**

V.B.(1) Fund Category

For the initial ADTR, select Fund Category from drop-down menu if pertinent category name is not listed, select “Other” and enter the name of fund in text box below the drop-down menu. **NOTE: A specific fund category name may be used only once. For example, if two categories “Refunding Escrow Account” are needed, choose one from the drop-down menu and choose the second as “Other” and enter “Refunding Escrow Account 2” to differentiate the two different funds.**

For subsequent years, these fields will be prepopulated with data from prior year(s) reports. Edit as necessary.

V.B.(2) Total Reportable Proceeds Available

For the initial ADTR, enter the amount of proceeds available at the beginning of the Reporting Period for the fund category selected. **NOTE: The available proceeds established for each category, when totaled together, must equal the amount reported as “Total Reportable Proceeds” under Section I.H.**

“Add Fund” (build itemized list)

Click “Add Fund” to begin itemized list. Repeat items V.B. 1 & 2 above to enter data for the next fund category. Click “Edit” to the right of each line to make changes to the category or quantities in that line. Click “Update” to add
C. Expenditure of Proceeds

V.C.(1)  Fund Category
Select Fund Category from drop-down menu.

V.C.(2)  Purpose
Enter the description of the purpose for which expenditure was made (e.g., “insurance premium”, “site preparation”, etc.)

NOTE: Only expenditures with identical purpose descriptions will be summed year-to-year (e.g., an expenditure for “site preparation” in year 1 will not be added to an expenditure for “site prep” in year 2.)

V.C.(3)  Expenditure in Current Reporting Period
Enter amount of proceeds spent during the Reporting Period for the purpose indicated.

Refunded CDIAC #
If the expenditure was made to refund, refinance, or pay-down a prior Debt issue (i.e., the Fund Category selected was “Refunding Escrow”), enter the CDIAC number of the issue that was refunded, refinanced or paid-down with the proceeds of the issue subject to this report.

“Add Details” (build itemized list)
Click “Add Details” to begin itemized list. Repeat items V.B. 1, 2, and 3 above to enter data for the next fund category. Click “Edit” to the right of each line to make changes to the category, purpose, or quantities in that line. Click “Update” to add changes to list. Click “Delete” to remove the line from the list.

For subsequent years, these fields will be prepopulated with data from prior year(s) reports. Edit as necessary.

SECTION VI: ADTR REPORTABLE

VI.A. Reportable in Next Fiscal Year
Automatically populates with “Y” or “N” based upon responses to following questions. **No entry allowed.**

VI.B. Principal Balance has been:
Select “Not Retired” (i.e., there is principal balance that remains outstanding), “Repaid”, “Redeemed”, or “Matured”. If any selection other than “Not Retired” is made, enter the pertinent redemption or maturity date in the Date field to the right of the selections. **NOTE:** “Repaid”, “Redeemed”, or “Matured” may only be selected if the amount displayed in III.F is zero. **Mandatory entry field.**

VI.C. Proceeds have been fully spent
Select “No” if there are proceeds that remain unspent at the conclusion of the Reporting Period. Select “Yes” if all proceeds have been spent and enter the date upon which the last proceeds were spent in the Date field to the right.
of the selections. Date must be within the Reporting Period. **NOTE: “Yes” may only be selected if the amounts displayed as remaining or unspent in V.A. and V.B. are zero. Mandatory entry field.**

**SECTION VII: NAME OF PARTY COMPLETING THIS FORM**

First Name, Last Name, Title, Firm/Agency, 1st Address, City, State, Zip Code, Area Code, Phone Number are prepopulated with contact information from the report of final sale. Make updates as necessary. An email address must be provided. – Mandatory entry fields. Edit as necessary.

**SECTION VIII: ADDITIONAL COMMENTS**

Type comments or additional information into the space provided. DO NOT USE APOSTROPHEs or other special characters (otherwise the report will not submit).

<table>
<thead>
<tr>
<th>Validate Form</th>
<th>Click “Validate Form” when data entry is complete. User will be directed to any mandatory entry fields left blank or with invalid entries. When all fields are complete, a scroll box will appear allowing user to review and/or edit information.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Submit the Report</td>
<td>If all information is correct, scroll down to the end of the review/edit box and click “Yes”. If edits are needed, clicking “No” will return the user to the entry form to make any desired changes and repeat the review/submit process.</td>
</tr>
<tr>
<td>Printing PDF copy of the Report</td>
<td>Click “Print PDF” ONCE and WAIT for the form to appear in the browser window. Print a hard copy of the form and/or save in the desired format once it appears.</td>
</tr>
</tbody>
</table>
SEC Rule 10b-5
§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(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 which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Statutory Authority

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

Authority Note Applicable to 17 CFR Ch. II, Pt. 240

History


Annotations

Notes to Decisions

Administrative Law: Governmental Information: General Overview

Antitrust & Trade Law: Clayton Act: Defenses

Antitrust & Trade Law: Industry Regulation: Professional Associations & Higher Education: Professional Associations

Antitrust & Trade Law: Private Actions: Racketeer Influenced & Corrupt Organizations: Claims: Fraud

Antitrust & Trade Law: Sherman Act: Claims

III. TYPES OF DEBT, DEBT LIMITATIONS AND TECHNIQUES OF DEBT LIMIT AVOIDANCE

A. Types of Debt

1. General Obligation Bonds

How does a bondholder enforce a general obligation pledge? There are three general categories of general obligation bonds: unlimited tax general obligation bonds ("UTGOs"), limited tax general obligation bonds ("LTGOs"), and general obligation bonds payable from the issuer’s general fund ("GFGOs"). In some states, it is also possible that a general obligation bond may be issued as a "double-barreled bond," which is also secured by another defined source of revenues (e.g., water or sewer revenues or excise taxes).

In broad terms, the characteristics of UTGOs, LTGOs, and GFGOs are set forth in the adjacent table, though depending upon the state and local law at issue there are many variations on these concepts.

<table>
<thead>
<tr>
<th></th>
<th>UTGO</th>
<th>LTGO</th>
<th>GFGO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Faith and Credit</td>
<td>May be secured by full faith and credit of the issuer.</td>
<td>May be secured by full faith and credit of the issuer.</td>
<td>May be secured by full faith and credit of the issuer.</td>
</tr>
<tr>
<td>Taxing Power</td>
<td>May be secured by a promise to levy ad valorem property taxes, unlimited as to rate or amount, levied by an issuer on all taxable property within its territorial limits. In many states, this is a separate identified mill levy (levied solely to pay debt service) and the tax revenues from the levy are sometimes segregated from other issuer revenues.</td>
<td>May be secured by a limited ad valorem property tax. The tax may be limited as to rate or amount. The issuer cannot be compelled to levy in excess of the rate or amount. In some states, this is not separated from the mill levy for the general fund, but in other states, it is a separately identified mill levy and the tax revenues are sometimes segregated from other issuer revenues.</td>
<td>No specific pledge of taxing power. The issuer cannot be compelled to increase taxes, but may be required in good faith to use its general revenue-producing powers.</td>
</tr>
<tr>
<td>Voter Approval</td>
<td>Voter approval often required.</td>
<td>Voter approval often not required.</td>
<td>Voter approval often not required.</td>
</tr>
<tr>
<td>Statutory Obligation to Repay</td>
<td>May be accompanied by an affirmative statutory requirement to provide for maturing debt service in the annual budget.</td>
<td>May be accompanied by an affirmative statutory requirement to provide for maturing debt service in the annual budget.</td>
<td>May be accompanied by an affirmative statutory requirement to provide for maturing debt service in the annual budget.</td>
</tr>
</tbody>
</table>
The remedies available to bondholders are informed by the procedural steps an issuer has promised to undertake to ensure payment of debt service on its general obligation bonds, whether certain funds or specific taxes are pledged, and whether pledged funds are subject to a statutory or other lien. The specific remedies that are available may be based upon provisions of state constitutions, statutes and codes, charters, ordinances or contracts.

**Writ of Mandamus.** A common equitable remedy available to bondholders of general obligation bonds is to compel specific performance by writ of mandamus directing a public official to perform an official duty, such as the payment of debt service when due. Because courts do not impose taxes directly due to principles of separation of powers, a mandamus action is the proper remedy to compel the imposition, collection and application of pledged taxes by a recalcitrant official or legislative authority of local government.

**Appointment of Receiver.** In many states, the power to appoint a receiver to undertake budgetary or other issuer functions of governmental finance may be available as a remedy under statute (legislative appointment) or compelled by a court (judicial appointment). The powers available to a receiver will vary by state and may depend upon the source of the power of appointment. In some states, appointment of a receiver may interfere with powers that have been legally delegated to elected or appointed officials.

**Asset Seizure.** In most states, the seizure of public property is not likely to be an available remedy to the owners of general obligation bonds. A creditor generally has little or no recourse to the assets of a state or local government debtor. A state or local government owns property as a means of accomplishing governmental functions, so private parties, including the holders of general obligation bonds, generally do not have the power to impede those functions by seizing property.\(^2\) McQuillen, *Law on Mun. Corps.* §§ 49.45, 49.47 (3d ed. 1995); McQuillen, *Law on Mun. Corps.* §28.73 (3d ed. 1995); *Bradford v. Brennan*, 631 A.2d 1165 (Conn. Super. Ct. 1992); and *City of Westminster v. Brannan Sand & Gravel Co.*, 940 P.2d 393 (Colo. 1997).

**Acceleration.** Because the taxes and other revenues pledged to pay debt service cannot be accelerated, general obligation bonds are generally not themselves subject to acceleration. Bondholders will ordinarily not be able to direct an acceleration of the payment date upon a default or seek payment of accelerated principal. In the event of successive defaults in payment of principal or interest, bondholders may need to bring a separate mandamus or other enforcement action for each such payment not made.

### 2. Revenue Bonds

Revenue bonds are payable solely from revenues from a specific source or pooled revenues from various sources. Revenue bonds may be project-based (payable from user fees such as water or sewage charges) or tax-based (payable from specific project-oriented taxes such as hotel and motel taxes dedicated to a convention center issue). Questions may arise as to what types of income constitute “revenues.” Also, a practical prerequisite to the validity or enforceability of revenue bonds secured by an encumbrance of the revenue of a system (such as a water and sewage system) is the ownership of the system by the municipal authority issuing the bonds or a valid assignment of some other entity’s revenues.

Reimbursements from the state to a state hospital have been held not to constitute revenues for purposes of determining whether bonds are self-liquidating.\(^3\)

The Florida Supreme Court has held that a municipality could not pledge all non-ad valorem revenues received by the county and also covenant to maintain services necessary to collect such fees, fines, etc., as this creates an indirect pledge of ad valorem taxes and requires a referendum under Florida’s constitution.\(^4\)

State revenue bonds secured by highway user, excise, and other vehicle taxes violated the special fund doctrine (discussed in B.3. below) and were considered “debt.”\(^5\)

Generally, the debt limitations discussed in the subsection “Debt Limitations Generally,” herein, do
EXECUTIVE SUMMARY

The National Federation of Municipal Analysts (NFMA) is publishing this White Paper to call attention to the lack of uniform, transparent and clear disclosure of the payment sources and security protections afforded to General Obligation (GO) bondholders. Our concern has to do with whether GO bond documents have complete and appropriate disclosure relating to the presence of a state statutory lien, revenue pledge or other “security arrangement” that entitles GO bondholders to priority repayment or recovery. Such disclosure is deemed particularly important in the event that the government borrower is able to file a petition for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code (U.S. Bankruptcy Code or Bankruptcy Code). While it is recognized that all states do not explicitly allow for a voluntary Chapter 9 filing for local governmental entities, knowledge of the existence of a state statutory lien or other security arrangement serves a useful forward-looking purpose in the event a state alters its laws to permit bankruptcy filings. In addition, as not all state statutory liens qualify for the special protections afforded “statutory liens” under the Bankruptcy Code, the GO bond offering statement should disclose the exact wording of the state statutory lien language so that municipal investors can determine if these special bankruptcy protections are available.

This paper is being published while Puerto Rico attempts to restructure its debt. Puerto Rico (a U.S. territory) does not currently have access to Chapter 9 of the Bankruptcy Code and is instead using a process created by Congress under the Puerto Rico Oversight, Management and Economic Stability Act (“PROMESA”), which borrows heavily from U.S. Bankruptcy law. As part of this restructuring, litigation has been filed to validate various statutory liens or invalidate what bondholders believed were statutory liens. Similar litigation has been filed for certain special revenue pledges, although these types of pledges are not the subject of this paper. This litigation demonstrates the importance of providing bondholders with detailed disclosure ahead of the bond issuance about the presence of a statutory lien (or not), access to any related analysis and/or opinions commissioned by the issuer and/or financing team and an assessment of the degree of certainty surrounding such conclusions. At the same time, these liens are being litigated in Puerto Rico, the market is seeing increasing use of dedicated tax or securitization bonds by issuers looking to lower borrowing costs, often through higher ratings, because of the anticipated benefits of statutory liens and/or special revenues. It is critical that potential investors fully understand the
benefits and limitations of a statutory lien is and the degree of certainty regarding the durability (i.e. ultimate value) of such in bankruptcy before investing.

INTRODUCTION

Since its inception in 1983, the National Federation of Municipal Analysts (NFMA) has been at the forefront of efforts to improve the disclosure of credit and market risks facing analysts and investors in the taxable and tax-exempt municipal bond markets. The NFMA is an organization of over 1,300 members, primarily research analysts who evaluate credit and other risks of municipal securities. These individuals represent mutual funds, insurance companies, broker/dealers, financial advisors, bond insurers, and rating agencies, among other stakeholders.

One of the NFMA’s principal goals is the promotion of timely and materially complete and accurate disclosure of information needed to assess municipal securities risks. The organization’s disclosure efforts have addressed broad areas of concern, ranging from industrywide topics to detailed work on specific credit sectors. Some of this work has been communicated to members of Congress and federal regulatory agencies. The NFMA’s work has been recognized as authoritative market guidance by other industry associations and various regulatory bodies. For further information on continuing efforts to improve disclosure, see the Disclosure Guidelines and Position Statements in the Publications section of the NFMA’s website (www.nfma.org).

In order to develop its white papers, seasoned NFMA analysts representing different types of companies work together to develop information and best practice suggestions on a particular topic. The NFMA provides the municipal securities industry with an opportunity to comment on proposed white papers. These papers provide other industry participants with specific information needed both to help analysts do their jobs better and to allow investors to make better-informed investment decisions. The NFMA believes that the best practice in disclosure will always be the one that provides a steady flow of timely material information from issuers, borrowers, and obligors to the entire market.

This White Paper on General Obligation Bond Payments applies to securities in the GO bond market. It is not intended to supplant Securities and Exchange Commission (SEC) Rule 15c2-12 or Rule 2a-7, and should be used in conjunction with guidance provided in those rules. In addition, this white paper is not intended as a summary or discussion of the legal standards or laws/regulations governing conflicts or ethics in municipal finance transactions. It is important to note that the NFMA’s disclosure efforts are a continuing process. The NFMA’s white papers are not static documents; they will be revisited and changed as market conditions warrant. The NFMA encourages interested parties to submit comments at any time to lgood@nfma.org so that they can be considered in the development of future versions of this white paper.
Please note that this white paper does not constitute legal advice to any participant in the municipal bond market, including, among others, bond issuers, obligors, broker-dealers, and/or law firms. The white paper represents the NFMA’s recommended primary market disclosure, based on the experience of its members, and informational needs of investors, as municipal credit analysts and market participants, of information that is important for assessing the credit features and security provisions of municipal bonds.

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OVERVIEW: GOALS OF THIS WHITE PAPER

In this paper, the NFMA intends to comment on the following issues relating to statutory liens:

- Circumstances in the municipal market have changed in a way that has elevated the significance of statutory liens benefitting debt obligations as a security feature of GO bonds.

- GO issuers should adopt best practice disclosure that clearly details the existence (or non-existence), terms and significance of statutory liens in all offering documents going forward.

- The application of statutory liens varies on a state-by-state basis and is still evolving. However, recent legal challenges to the payment of GO bonds in Chapter 9 have reinforced the legal importance and applicability of this type of lien and disclosure of its provisions especially if the statutory lien will be recognized in bankruptcy.

- The widespread differences in disclosure relating to security provisions for GO bonds limits market appreciation for the various treatments of these bonds in Chapter 9. Existing disclosure is frequently inadequate. We believe security provision disclosures should include a discussion on the presence (or lack thereof) of a statutory lien on pledged revenues, if any.

- While this paper focuses on statutory liens, there are many other issues that affect the treatment of bondholders in a municipal bankruptcy, such as whether the revenues pledged to pay the bonds constitute “special revenues” under the U.S. Bankruptcy Code, or are subject to mandatory set asides, priorities, or appropriation under state statutory or constitutional provisions. As a disclosure matter, these types of details deserve the same attention from market participants as statutory liens, and this paper is meant in no way to diminish their importance to investors.

The goal of this paper is to provide guidance and recommendations about the best practices for the disclosure of statutory liens in GO bond issues. After a discussion of why the disclosure of statutory liens has become critical, we take stock of the information that is currently being delivered to municipal market participants about the presence of statutory liens through a survey of recent offering documents, rating agency commentary and legal opinions. Finding a muddled message, we build the case for improved disclosure and point out specific disclosure issues that need to be addressed. The NFMA hopes this paper will draw the attention of regulators and industry groups to the importance of disclosing detailed security provisions as a standard practice.

We recommend this white paper be supplemented by the NFMA’s June 2014 “White Paper on Best Municipal Bond Issuance and Disclosure Practices” for a thorough discussion of best practices related to the issuance of municipal bonds. This white paper expands on Section IV of the 2014 white paper. We also recommend reviewing the NFMA’s 2015 “Recommended Best Practices in Disclosure for State Government General Obligation and Appropriation Debt” for a comprehensive overview of disclosure for state GO bonds.
SECTION 1: WHAT IS A STATUTORY LIEN UNDER STATE LAW AND THE US BANKRUPTCY CODE?

• A statutory lien is created by state law found in a state statute.

• The clarity of the language in statutes is inconsistent, and often it is difficult to tell if a statutory lien exists.

• Issuers should work with counsel to determine if their bonds are subject to a statutory lien and then disclose it.

A statutory lien is different from a Uniform Commercial Code (“UCC”) security interest which arises solely out of a contractual arrangement between the issuer and the debt holder, such as a consensual lien created by a security agreement, bond indenture, bond resolution or ordinance. The difference between statutory liens and consensual liens is critical because a statutory lien could attach to revenues received by the municipality after it files for bankruptcy, while the latter does not. Under Section 552(a) of the Bankruptcy Code, a perfected consensual security interest in property can terminate upon the filing of a Chapter 9 (except in certain circumstances such as a consensual lien on special revenues).

The Bankruptcy Code provides a more restrictive definition of a statutory lien calling it “a lien arising solely by force of a statute on specified circumstances or conditions….“ The hallmark of a statutory lien is that the lien must arise automatically with no need for consent of the borrower or notice of other conditions—it arises purely by operation of law. The importance of a statutory lien on revenues under the Bankruptcy Code is that the statutory lien continues on revenues post-petition (a similar treatment is given to “special revenues”). Hence the secured status of a GO bond with a statutory lien would include pledged revenues (e.g., property taxes) to be collected in the future and not just assessed and collected prior to the bankruptcy petition. Although the general definition of a statutory lien may be straightforward, it is not always easy to tell if the statute itself creates a lien on specific revenues. In fact, the difficulty of identifying the existence of a statutory lien may be one of the reasons that the quality of disclosure in this area is so lacking as it may require advice or opinion of legal counsel. The state statute does not need to specifically say that a “statutory lien” is present, but the force and effect of the language of the statute itself must create the charge against or interest in the specific asset of the debtor to secure the debt. Since the average municipal bond analyst is not also an attorney, it is important that bond counsel or disclosure counsel clearly state whether a statutory lien exists.

Some state statutes are very clear by their language and may even use the words “statutory lien”, although the words “statutory lien” do not have to exist. Others may state that the taxes, revenues and other income pledged by the municipality are immediately subject to the lien of such pledge from the time the pledge is made (i.e., from the time the bonds are issued). In either case, if the law establishes a lien or pledge and therefore a statutory lien is present, this should be disclosed. Sometimes these statutes underscore the point by including additional language that mandates the priority of the lien on pledged revenues over other claims and liens, or that the pledged revenues can only be used to pay the debt obligation. Alternatively, some statutes also provide for an

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intercept of the tax revenue pledge so that taxes are paid directly to a special account or bond trustee for the benefit of bondholders. However, such “earmarking”, or restricted use or direct intercept of certain revenues does not in itself create a statutory lien.

Laws that create statutory liens can be confused with other statutes that relate to revenues pledged by a municipality, which further demonstrates the need for clear disclosure. For example, there are statutes that deal with the perfection of a security interest in pledged municipal revenues, the purpose of which is to establish the perfected secured status of a secured creditor without the need of any further filing with the Secretary of the State or with any other governmental entity, as might otherwise be required by the UCC Article 9. (e.g., See UCC 9-109(c)(2)). In effect, these types of state laws assume the pre-existence of a valid lien, pledge or security; but they do not create the lien itself. Laws that create statutory liens usually include this type of “automatic perfection” provision, but a statutory lien and perfected lien should not be construed as one and the same thing. Their purposes are entirely different. One creates the lien, while the other makes clear that there is no need for any further act in order to perfect the lien. Under the Bankruptcy Code definition of a statutory lien, the lien itself must arise by operation of law with no steps needed for perfection.

Ultimately the analysis of whether a particular statute creates a statutory lien is a legal one. We do not undertake in this paper to offer definitive conclusions on whether a statutory lien on GO bonds exists under the laws of any given state. Each issuer, with the assistance of counsel, should conduct its own analysis of the applicable state law to determine if its bonds have the benefit of a statutory lien. Instead, our goal is to impress upon issuers, counsel, and all other parties involved in the preparation of offering documents, the importance of examining this issue and making their findings known.

SECTION 2: WHY NOW?

• Until the Great Recession, statutory liens were not an active part of the conventional analytical dialogue related to GO bonds.

• Statutory liens give bondholders a secured claim on pledged revenues, and thus are important to determining risk because the lien continues to attach to revenues arising after a bankruptcy filing.

• Whether a bondholder is treated as a secured or unsecured creditor has been one of the key factors in determining bondholder recoveries in bankruptcy.

The harsh effects of the Great Recession on the finances of state and local governments are well known. Large job losses, precipitous declines in property values, and generally reduced economic activity led to sharp drops in tax revenue and, at the same time, new demands were being placed on government resources. The credit quality of many municipalities suffered as a result. In certain cases, the economic strain came suddenly, while in others the Great Recession exacerbated problems that were years in the making. The downturn even led some local governments, most notably the City of Detroit, to file for bankruptcy.
The recent spate of municipal bankruptcies has challenged certain assumptions about the promises made by cities and towns to repay bonded debt from any and all available taxes. Once thought to be the ultimate form of security, the sanctity of this “general obligation” pledge has been questioned and to a large extent, undermined, by the claims of bankruptcy debtors. Holders of GO bonds have received lower recoveries than pensioners and even other classes of municipal bondholders in several court-approved settlements, including the Detroit case. Discovering that the rights to repayment of a GO bondholder can be inferior to those of other creditors has challenged the past beliefs of the investor community related to security.

In the wake of these recent cases, the market has focused on trying to determine where GO bondholders fit in the hierarchy of creditor claims and under what circumstances GO bondholders are treated as secured or unsecured creditors. A secured creditor is one that has a specific charge against or interest in property to secure the debt, including revenue, for the payment of debt, whereas an unsecured creditor does not. In the context of GO bonds, this enhanced right to repayment, if it exists, typically comes in the form of a statutory lien and/or in some cases, special revenues. Having a statutory lien is therefore significant because it can ensure the priority of bondholder claims over those of other creditors.

Historically, whether a bondholder had a security interest, statutory lien, or otherwise constitutionally mandated payments was not part of the conventional analytical dialogue related to GO bonds. They received scant attention prior to the Great Recession, in large part due to the extremely low default and bankruptcy rates of municipalities. On the relatively rare occasions in which local government bankruptcies did occur, such as in the case of San Jose Unified School District in 1983, investors expected to receive, and normally did receive, full recovery of what was owed to them on GO bonds. Moreover, the market relied heavily on the strength and history of the “full faith and credit pledge,” commonly used by local governments, which entitles bondholders to receive the benefit of a specific unlimited tax levy to repay bonds, often approved by voters under a statutory provision of state law.

The protections afforded GO Unlimited Tax Bonds (ULTGOs) were directly challenged in the City of Detroit’s bankruptcy filing by the Emergency Manager (EM), who proposed that the City’s ULTGOs be treated as unsecured debt due to the absence of explicit language that the EM believed would be sufficient to support a statutory lien determination or security interest of any type. While a legal settlement rather than a judgment by the U.S. Bankruptcy Court was used to determine the recovery value on Detroit’s ULTGOs, the legal challenge on the grounds that the GOs were not secured debt was clearly enough to spark a legitimate call by investors for more clear and detailed disclosure on the GO bond’s secured status both outside and inside a Chapter 9 bankruptcy.

As Detroit and other recent Chapter 9 cases have demonstrated, the protections afforded by the Bankruptcy Code to different types of municipal bonds have entered the mix of information that must form the basis of a sound investment decision. In particular, the presence or absence of a statutory lien can have a major impact on whether and to what extent GO bondholders have a secured claim and get paid once a municipality files for bankruptcy.

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3 The San Jose Unified School District filed for Chapter 9 municipal bankruptcy on July 1, 1983 and continued to make scheduled debt service payment on its unlimited tax general obligation bond when due.
In general, adequate disclosure of whether a bond has a statutory or consensual lien, has thus assumed increased importance. In order to have a full understanding of what they are buying, investors of GO bonds should be aware of their rights under state law and under Chapter 9 bankruptcy, and know the extent to which their GO holdings are protected from impairment. Even outside of the bankruptcy context, understanding exactly what a bondholder’s security is, is critical. Such security features might also affect the price an investor might be willing to buy a particular GO bond. It is therefore incumbent on those who sell such bonds to provide investors that information.

Section 2A: The Presence of Statutory Liens Affects Many Market Participants

Many factors influence ratings, the decision to buy or sell, insurability, and pricing in the primary and secondary markets. The presence of a statutory lien influences the decisions of the various market participants, and is particularly important in the case of obligors with weaker credit profiles or an increased risk of defaulting or entering into bankruptcy. The presence or absence of a statutory lien may inform market participants’ opinions of potential recovery rates and the fair value of the bond, demonstrating the importance of this information to the proper functioning of the municipal market. Because of the importance of statutory liens to so many market participants, clear disclosure is necessary.

Section 2B: History and Potential Impact on Recovery in the Event of a Bankruptcy

While Chapter 9 filings remain rare, statutory liens become particularly meaningful in the event of a municipal bankruptcy filing. The lien on an entity’s taxes or revenues may be terminated upon the filing of a bankruptcy proceeding unless there is a statutory lien or pledge of special revenues. Therefore having a statutory lien which extends to post-filing assets of a debtor is of critical importance to a bondholder. Although there is not much case law, statutory liens have repeatedly been ruled not to be invalidated as part of a Chapter 9 filing, allowing applicable bonds to be classified as secured debt during the Chapter 9 process. Generally, the U.S. Bankruptcy Code currently dictates that secured debt receives priority of payment—up to the value of the collateral—including in a Chapter 9 proceeding. However, determining the value of the secured GO bondholders’ claim in bankruptcy has not been litigated, and many uncertainties exist as to secured claim valuation of GO bondholder claims.

In the following table, we present five case studies of recent Chapter 9 proceedings. While not all of these Chapter 9 proceedings involved ULTGO bonds, and many recoveries were negotiated

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4 A statutory lien should remain unaltered in a Chapter 9 proceeding, and there is a continuing right to be timely paid after the filing of a Chapter 9. Such unimpairment was recognized in the Chapter 9 proceedings of Orange County, California in 1994 (delay in payment due to appeal and reversal of Bankruptcy Court as to effect of a statutory lien) and the Sierra Kings Health Care District Chapter 9 in 2009 (relating to the General Obligation Bonds).
as opposed to court ordered, this summary underscores the importance of understanding whether you have a statutory lien or not going into a Chapter 9 proceeding.⁵

### Historical Chapter 9 Recovery Rates

<table>
<thead>
<tr>
<th>Debtor</th>
<th>Year Filed</th>
<th>Type of Debt</th>
<th>Plan Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Orange County, CA</td>
<td>1994</td>
<td>TRANs</td>
<td>100%</td>
</tr>
<tr>
<td>Sierra Kings Healthcare District, CA</td>
<td>2009</td>
<td>ULTGO Bonds</td>
<td>100%</td>
</tr>
<tr>
<td>Central Falls, RI</td>
<td>2011</td>
<td>ULTGO Bonds</td>
<td>100%</td>
</tr>
<tr>
<td>Jefferson County, AL</td>
<td>2011</td>
<td>Sewer Warrants</td>
<td>60%-80%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>LTGO Warrants</td>
<td>88%-95%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lease Revenue Warrants</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>LO School Warrants</td>
<td>100%</td>
</tr>
<tr>
<td>Detroit, MI</td>
<td>2013</td>
<td>ULTGO Bonds (Insured)</td>
<td>74%⁶</td>
</tr>
</tbody>
</table>

Key:
- TRANs=tax and revenue anticipation notes
- ULTGO=unlimited tax general obligation
- LTGO=limited tax general obligation
- LO=limited obligation

**Orange County, California:** During Orange County’s 1994-1995 bankruptcy proceedings, there was considerable debate as to whether the county’s tax and revenue anticipation notes (TRANs) were subject to a statutory lien. The accompanying state statute, California Government Code section 53856, stated that “the note or notes and the interest thereon shall be a first lien and charge against, and shall be payable from the first moneys received” by the entity.

Under the note resolution, the county was obligated to set aside pledged revenues on a monthly basis and make up any deficiency from generally available funds. Following the county’s filing for Chapter 9 protection in December 1994, the county ceased making set aside payments believing they were no longer required, relying on 11 U.S.C. Section 552(a).⁷ Noteholders sought relief in bankruptcy court, calling for the county to make set aside payments. The bankruptcy court found noteholders had a security interest as opposed to a statutory lien, with the security interest cut off due to the county’s Chapter 9 filing. On appeal, the U.S. District Court reversed the lower court’s decision, finding the county’s approximately $60 million of TRANs were subject to a statutory lien, which survived the Chapter 9 filing.⁸ The matter was remanded back to the bankruptcy court with instructions to provide appellants protection of their interests.

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⁶ ULTGO bonds had a recovery rate of 74%. Because the bonds were insured, bondholders experienced no principal reduction, but insurers had to make up for the difference between the 74% recovery and par value, or 26%.


⁸ Ibid.
The applicable debt was eventually refinanced and paid in full as part of the county’s debt adjustment.

**Sierra Kings Healthcare District, California:** Sierra Kings Healthcare District provides a useful example of a special district ULTGO subject to a statutory lien, which was upheld in bankruptcy proceedings, as part of a negotiated settlement. The district filed for Chapter 9 protection in October 2009. Included in the district’s debt at the time was $5.7 million of ULTGO bonds paid from a property tax levy within the district, as well as $7.1 million of revenue bonds.

As part of the bankruptcy proceedings and pursuant to a negotiated settlement between the parties, the U.S. Bankruptcy Court, Eastern District of California (Case 2009-19728) confirmed the district pledge of ad valorem taxes as both a special revenue pledge and a statutory lien. The court further ruled that the Chapter 9 proceedings and any resulting debt adjustment plan could not interfere with bonds, notes or municipal obligations that were special revenue pledges or subject to a statutory lien. The district’s revenue bonds were not provided similar protections.

**Central Falls, Rhode Island:** Central Falls provides one of the strongest supports for the value of statutory liens during bankruptcy. Prior to the city’s filing for Chapter 9 in 2011, the Rhode Island State Legislature instituted a statutory lien on local GO debt which applied to previously issued debt as well as future issuance. Section 45-12-1 of the Rhode Island State Statutes now states:

“…the pledge of ad valorem taxes and general fund revenues is subject to the lien of the pledge without delivery or segregation, and the first lien on ad valorem taxes and general fund revenues is valid and binding against all parties having claims of contract or tort or otherwise against the city or town, whether or not the parties have notice thereof. The pledge shall be a statutory lien effective by operation of law and shall apply to all general obligation bonds and notes and other financing obligations of cities, towns and districts heretofore or hereafter issued and shall not require a security agreement to be effective.”

The city continued to make full and timely debt service payments on its unlimited tax GO bonds throughout bankruptcy proceedings, while GO bondholders realized a 100% recovery rate from the city’s bankruptcy plan. Lease holders, pension beneficiaries and vendors all were subject to varying levels of reductions.

**Jefferson County, Alabama:** Jefferson County filed a Chapter 9 petition for relief in November 2011. Sewer warrants represented the vast majority of outstanding debt at the time of the filing, while limited tax GO warrants, limited obligation school warrants and lease revenue warrants

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10 U.S. Bankruptcy Court, District of Rhode Island Case 11-13105.
were also outstanding. At the time of the proceedings, there was no statutory lien for GO debt in the state of Alabama.

While the county’s GO debt was not subject to a statutory lien, GO warrant holders’ recovery rates ranged from 88% to 95%.\textsuperscript{11} Lease revenue warrants, which were secured by lease rental payments made by the county to the Jefferson County Public Building Authority, and the limited obligation school warrants, secured by a pledge of 1% of gross Education Sales Tax revenues, were not impaired by the county’s debt adjustment plan.\textsuperscript{12}

Sewer warrant holders’ recovery was as low as a 40% loss for those who did not consent to the settlement with the bond insurers contained in the plan of adjustment, but most bondholders consented to the settlement and were paid approximately 80% of principal. The lower recovery rate for sewer warrant holders was mainly driven by the lack of pledged revenues to meet debt service due to a failure of the county to comply with the original projected rate schedule and rate covenant. While special revenue pledges are treated as secured debt under Chapter 9, debt service on such bonds are subject to available pledged revenues less necessary operating expenses of the system.\textsuperscript{13}

\textbf{Detroit, Michigan:} After filing for Chapter 9 bankruptcy in 2013, the City of Detroit defaulted on many aspects of its debt, including its ULTGO bonds. As part of the ensuing proceedings, the city’s EM argued that its ULTGO and Limited Tax GO (LTGO) bonds not additionally secured by distributable state aid should be treated as unsecured debt by the court.\textsuperscript{14} There was question as to whether there was sufficiently explicit language granting the bonds a statutory lien on tax revenues in Michigan prior to or during the city’s Chapter 9 proceedings. Article IX Section 25 of the Michigan Constitution provided: “The repayment of voter approval bonded indebtedness is guaranteed” and the ULTGO were voted approved with the collected tax revenues intended to be paid to voter approved debt.\textsuperscript{15}

Pursuant to a settlement between the city and its ULTGO bondholders, ULTGO bonds had a recovery rate of 74% to insurers and 100% to bondholders with the balance (26%), coming from the bond insurers under their insurance policy. This was the highest recovery rate among the city’s

\textsuperscript{11} Moody’s Investor’s Service. Jefferson County’s Lower GO Leverage Fuels Higher Recovery than Sewer. March 18, 2014.
\textsuperscript{15} Legislation was introduced in Michigan legislature in 2014 to clarify and confirm that the ULTGO statutory pledge of the revenues to the Bondholders was intended to be a statutory lien (H.B. 4495). This legislation has passed the Michigan House and is awaiting passage by the Michigan Senate at the time of this writing. Passage of the bill could help mitigate the stigma and cloud raised by the Detroit bankruptcy, improve market acceptance of Michigan ULTGOs for schools and cities and lower the borrowing costs. Failure to enact the law could confirm fears that the concerns raised by Detroit that increase borrowing costs for schools and municipalities issuing ULTGOs by about 100 basis points was correct and the additional cost will likely become a permanent burden.
general fund debts, yet below that experienced by many statutory lien ULTGOs in other Chapter 9 proceedings. Unsecured LTGO bondholders received a 41% recovery rate.

**SECTION 3: CURRENT PRACTICES RELATED TO DISCLOSURE OF STATUTORY LIENS**

Issuers typically describe the security for their bonds in a brief section of the official statement. For bonds backed by a GO pledge, this description often specifies the limited or unlimited nature of the ad valorem taxing authority for the payment of debt service, and may also include a pledge of the full faith and credit of the issuer. Given increased investor focus on the importance of statutory liens, however, recent challenges to the payment of GO bondholder claims as fully secured claims, historic offering statement disclosure regarding GO bond security disclosure is no longer adequate.

This section looks at how the disclosure of statutory liens has been handled in specific cases. Certain cases provide helpful models, but they are the exception. For the most part, the GO security disclosure is hard to understand, incomplete, or non-existent.

**Section 3A: Disclosure in States that Provide for a Statutory Lien**

Statutes conferring a lien on tax revenues pledged for debt service currently exist in various states (e.g., California, Colorado, Idaho, and Rhode Island). In addition, Florida provides for a lien on the escrow for refunded bonds, and New Jersey recently enacted legislation creating a statutory lien on state aid for bonds additionally secured under the state’s Municipal Qualified Bond Act.

Issuers in Colorado, Louisiana, and Rhode Island have made specific reference to statutory liens or to the statute creating the lien in their offering documents. In the official statement for its Series 2015 issue, Poudre School District R-1 in Colorado described the security as follows (emphasis added):

“The Bonds are general obligations of the District payable from ad valorem taxes which may be levied against all taxable property within the District without limitation of rate and in an amount sufficient to pay the principal of and interest on the Bonds when due….The Bonds are not secured by land within the District, but rather by the District’s obligation to certify to the Board of County Commissioners of the County a rate of levy sufficient,

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together with other legally available revenues, to meet the debt service requirements on the Bonds. *Such annual levy for debt service creates a statutory tax lien.*"  

Similarly, Rhode Island issuers have explicitly stated that bondholders enjoy a statutory lien on tax revenues pledged for debt service. In the offering documents for its series 2014 A and B issue, Providence, Rhode Island additionally provides a summary of the statute creating the lien (emphasis added):

> “In July of 2011, *the General Assembly enacted amendments to Section 45-12-1 of the Rhode Island General Laws to provide for a statutory lien on ad valorem taxes and general fund revenues for the benefit of general obligation debt of cities and towns such that the statutory lien has a priority in a bankruptcy.* The amendments provide, in part, as follows…”  

Although Louisiana issuers have generally not used the phrase “statutory lien” in describing the security in their official statements, they have noted that pledged tax revenues are subject to the lien of the pledge, and have cited the statute that creates the lien. In its Series 2015 issue, Bossier Parishwide School District stated the following (emphasis added):

> “The Issuer pledges the revenues of the special, unlimited ad valorem tax referenced above as security for the Bonds….Pursuant to the Louisiana Constitution, the proceeds of such tax may only be used to pay debt service on the Bonds, and pursuant to Section 39:1430.1 of the Louisiana Revised Statutes of 1950, as amended, *the tax collections so pledged and then or thereafter received by the Issuer or paying agent shall be subject to the lien of such pledge.*”

California recently enacted legislation (SB 222) that clarified the statutory lien security for GO bonds. Subsequently, San Diego Unified School District became one of the first examples of disclosure on the new law, having issued GO bonds in November 2015. The official statement for that offering provided the following language, which describes the specific instance and broader application of the new law (emphasis added):

> “California Senate Bill 222 (2015) ("SB 222), which becomes effective January 1, 2016, provides that general obligation bonds issued by California local agencies, like the District, are secured by a statutory lien on the ad valorem taxes levied and collected to pay principal and interest on the bonds, regardless of whether the bond issuer or bondholders take any steps to pledge, record, or take possession of the taxes.”

While SB 222 provides for a statutory lien, bond counsel reportedly also provided a special opinion stating the ad valorem property taxes securing the bonds would be considered special revenues in the event of Chapter 9 proceeding and would be exempt from automatic stay

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provisions.22 In order to make timely debt service payment, the Board of Supervisors of San Diego County is obligated to levy ad valorem taxes, without limitation as to rate or amount. Collected ad valorem revenues are required to be deposited in the district’s Interest and Sinking Fund, which is required by law to be used solely to make payments on the district’s GO debt.23

Disclosure of Special Opinions: If counsel provides an opinion or analysis on statutory liens, special revenues or security provisions in general that is used to support statements in the preliminary offering statement (POS) or other sales materials, the NFMA asserts that those opinions should be made public in the offering documents and available to all potential investors since they clearly are material information intended to influence an investment decision. If these opinions or analyses are provided to the rating agencies to influence the rating of the bonds, NFMA argues for their disclosure in the POS for the same reasons. It is NFMA’s belief that all of these legal opinions or analyses contain material assumptions and exceptions that must be disclosed so that investors can assess the reasonableness of the opinions. The NFMA has consistently taken the position that disclosure of material information to only one market participant, such as a rating agency, should not occur, and any material information used to rate or price bonds should be available to all investors and disclosed in the POS. If counsel’s opinion or analysis is confidential or not subject to public disclosure, that fact needs to be stated and appropriate risk disclosures put in the POS regarding reliance on “confidential” legal opinions. In any case, the full text of the relevant statutes should be included in the POS so that investors may derive their own conclusions with advice of counsel, and any relevant state higher state court decisions on the statute should be cited.

Section 3B: Disclosure in States that Do Not Provide for a Statutory Lien

Among issuers in states that either do not provide for a statutory lien or where the language is unclear as to its status, only those in Connecticut seem to regularly disclose this fact. The following excerpt from North Haven, CT’s official statement for its 2015 issue is typical of disclosure from Connecticut issuers:24

“There are no statutory provisions for priorities in the payment of general obligations of the town. There are no statutory provisions for a lien on any portion of the tax levy or other revenues or property to secure the bonds, or judgments thereon, in priority to other claims.”

Aside from Connecticut, we have been unable to find examples of disclosure on statutory liens in states where they do not exist.

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SECTION 4: WHAT IS NEEDED FOR MORE DETAILED GO PAYMENT PROTECTION DISCLOSURE?

Section 4A: What Should Disclosure Look Like?

• The disclosure should discuss whether a state statutory lien exists, where that authorization comes from, and include the full text of the statutory lien. If there is a lack of clarity on the existence of a statutory lien, the uncertainty should be clearly stated. Whether a state statutory lien can be avoided under Section 545 of the Bankruptcy Code should also be discussed.

• Any opinions or analyses provided by bond counsel and used by any market participant in conjunction with the issuance of the bonds should be disclosed publicly in the offering document.25

• Also important to understanding statutory liens is disclosure of whether pledged revenues are commingled with non-pledged revenues. We think there is a growing importance in understanding any other purposes an issuer could use pledged revenues for. It will also make it easier to make and assessment of the strength of intercepts and make special revenue determinations.

• The issue of state statutory liens is one that lends itself to standardized disclosure for issuers of GO bonds within the same state.

• If debt is issued under newly passed statutory lien legislation and there was debt outstanding at the time of the legislation, issuers (or their advisors) should disclose whether the statute retroactively applies to previously issued debt.

As discussed in Section 1 of this white paper, the Bankruptcy Code gives special treatment to certain statutory lien bonds through a continuing post-petition claim on identifiable, pledged revenues received by a debtor after the filing of a bankruptcy case. This continuing, post-petition lien in turn helps enhance the secured status of the GO bondholder claim and increases the difficulty of impairing that secured claim in a Chapter 9 bankruptcy. The cases discussed demonstrate that the primary benefit of this special treatment is the prospect of higher recoveries in bankruptcy. Rating agencies and numerous other commentators have noted the superior recovery prospects of statutory lien bonds as a reason to favor them over other types of bonds.26 Having a statutory lien also raises the possibility that payments to bondholders will continue uninterrupted through the bankruptcy process. These two advantages – the prospect of higher recoveries and the possibility of uninterrupted payment – prove the importance of a statutory lien to bondholders.

Presented with the choice between owning two bonds at the same price, one with a statutory lien on pledged revenues and one without any lien on those same revenues, investors would reasonably...

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25 As also stated in the NFMA White Paper on Best Municipal Bond Issuance Practices, Section III-P, we do not think there should be disclosure of any information to only rating agencies or any one market participant. June 25, 2014.

prefer the one with a statutory lien, all other things being equal. Yet in today’s market, most investors are not able to make this distinction because they are not given the relevant information.

As noted earlier in this white paper, the answer as to whether a statutory lien exists may not always be clear. Investors must understand that the kind of certitude they seek may not be possible. But ambiguity or debates as to the law should not excuse issuers and underwriters from their disclosure obligations. Even uncertainty or the desire for further legislative clarification can be clearly stated. Therefore, in cases where it is not readily apparent that a statutory lien exists, it is still reasonable for investors to expect a diligent examination of the law and a summary of the analysis. True clarity of disclosure is to state either a statutory lien exists or does not, or, if it is unclear, to explain the reasons why it is unclear. As with any legal issue pertaining to the issuance of municipal bonds, the conclusions of counsel should be presented to investors following a review of the relevant law. As a best practice, the statutory or constitutional provision that gives rise to the statutory lien should be referenced.

Beyond answering the basic question of whether a statutory lien exists, the discussion of this security provision should help investors understand the significance of such a lien. Such an analysis naturally involves consideration of bankruptcy provisions and the legal standing of a statutory pledge within the framework of Chapter 9. It is thus critical to explain the special status of statutory lien bonds as secured debt and the rights of statutory lien bondholders to post-petition revenues. Whether payment on bonds backed by a statutory lien are subject to the automatic stay is another important disclosure point.

Other points of disclosure depend on the specific state law at hand. The state law may direct the payment of a dedicated revenue stream into a special account that is held by a third party. Alternatively, the law may restrict the permitted uses of the revenues subject to the statutory lien. For example, in California, the recently enacted Senate Bill 222 requires all taxes collected on behalf of school districts to be credited to an interest or sinking fund of the school district held by the governing county and used solely for the payment of debt service. A bankruptcy court cannot impair, limit, stay or interfere with state’s power to control by legislation or otherwise a municipality’s exercise of its political or governmental powers, including as to expenditures, and therefore, the details of state law are worthy of attention since they could affect the treatment of the pledged revenues in bankruptcy.27

A related GO payment concern that must be addressed regarding statutory liens is the commingling of pledged revenues. It is a general principle of UCC Article 9 (security interests) and other state laws and case law, that a lien, pledge or security on revenues can be lost if the pledged revenues are commingled with non-pledged revenues in an account. So despite having a statutory lien on pledged revenues (e.g., property tax collections), if the pledged revenues are deposited in a government account with other revenues, bondholders can lose their lien unless

27Sections 903 and 904 of the Bankruptcy Code contain the language required by the Ashton and Bekins cases cited below that the Bankruptcy Court must honor and cannot stay or interfere with any state statutory or constitutionally mandated required payment of tax revenues or proceeds of property as collected are to be paid to the debt it is so pledged and dedicated to. The municipality as debtor cannot consent or act contrary to such state statutory or constitutional mandated payments. For a detailed analysis of the legal support for this, see Ashton v. Cameron County Water Improvement District Number 1, 298 U.S. 513 (1936) and In United States v. Bekins, 304 U.S. 27 (1938).
they can identify the pledged revenues in the account—which can be difficult. Therefore, full disclosure of whether pledged revenues are commingled is necessary.

At the time of this writing, there are a number of states that are actively considering legislation to grant a statutory lien to GO bonds. The goal of such legal changes is to elevate the status of bondholder claims or to confirm existing law, thereby ensuring that municipalities are able to access the market at the lowest possible cost. Given the potential to affect the security and pricing of bonds if such legislation becomes law, it is important for investors to know if legislative efforts are underway in a given state and the relevant details of the legislation.

Since a state legislature could pass law to create a statutory lien at any time, it is important that issuers disclose whether the legislation applies to previously issued debt as well as debt issued in the future. If it is unclear whether the legislation is retroactive to debt outstanding at the time of the legislation, that too should be disclosed.

We note that the disclosure of statutory liens is one that lends itself to standardization. Since the relevant state law applies equally to all GO bonds within a state, the disclosure could be the same. Connecticut and Rhode Island are examples of places where uniform disclosure has taken hold.

For issuers and counsel, standardization may ease the burden of crafting language that accurately reflects state law as a separate exercise for each bond issue while also satisfying their respective disclosure responsibilities. Therefore, we encourage collaboration among bond lawyers to create uniform disclosure for each state.

Section 4B: Disclosure of the Existence or Non-Existence of a Statutory Lien Should Be Made in All Cases.

It may be argued that information related to statutory liens is important only if a bankruptcy filing is imminent. While it is true that the benefits of a statutory lien are especially useful in the context of bankruptcy, this does not mean issuers should wait until they are in financial distress to tell investors whether a statutory lien exists. First, it is impossible to know with certainty at the time of issuance if a municipality will remain financially solvent through the life of the bonds. Any conjecture along these lines involves a level of subjectivity that makes it impossible to develop a common standard of disclosure. Therefore, it is simply not feasible to use the relative credit strength of the issuer as a gauge to measure whether this disclosure is necessary.

Second, there are many situations in which bonds include special security features that only come into play if the issuer runs into financial difficulty. For example, debt service reserve funds provide an extra layer of protection to bondholders if the normal flow of revenues runs dry. Their presence is always disclosed in the offering documents even though at the time of issuance no one expects them to be used. The same is true of mortgages and bond insurance. So while the existence of a statutory lien may be especially important to know for issuers near bankruptcy, it always forms

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28 See, e.g., HB 4495 in Michigan and LB 67 in Nebraska.
part of the overall security package, and therefore should be disclosed in all cases at the time of debt issuance.

It may be tempting to point out that not all states allow municipalities to file for bankruptcy, and in those non-bankruptcy states, the issue of a statutory lien is moot. But as with the financial condition of a city, laws can change. Indeed, states may change their municipal bankruptcy laws precisely when a community is in fiscal distress. Michigan tweaked its emergency manager law as pressure mounted on Detroit, and Rhode Island passed legislation in anticipation of the Central Falls bankruptcy. Since states can alter the bankruptcy authorization at any time, clarification on the lien status is needed regardless of whether bankruptcy is currently available to municipalities within a particular state.

Section 4C: Summary of Disclosure Recommendations

• We believe that statutory lien disclosure can be standardized, particularly within a given state.

• Disclosure should outline whether a statutory lien exists and clearly state if it does not. Legislation creating the statutory lien should be included, excerpted or cited.

• If there is uncertainty as to whether a statutory lien exists, a discussion of the reason for the lack of clarity should also be included.

• Any legislation under consideration that could impact the bond’s security should also be disclosed.

Section 5: Concluding Thoughts

Recent municipal bankruptcy cases have demonstrated the value to bondholders of having a statutory lien and being treated as a secured creditor. Currently, investors have difficulty determining if GO bonds have the benefit of a statutory lien because the offering documents often do not provide this information. The NFMA strongly recommends that issuers, underwriters, and legal counsel improve and update all future GO bond disclosures to clearly state the existence or non-existence of a statutory lien pledge. The offering documents for GO bonds should also explain the basis under existing laws in which the lien has been created and the significance of such a legal security in the context of state laws as well as the Bankruptcy Code.

While this paper has focused on statutory liens, there are many other issues that affect the treatment of bondholders in a municipal bankruptcy, such as whether the revenues pledged to pay the bonds constitute “special revenues” under the Bankruptcy Code, or are subject to mandatory set asides, priorities, or appropriation under state statutory or constitutional provisions. As a disclosure matter, these types of details deserve the same attention from market participants as statutory liens, and this paper is meant in no way to diminish or dispute their importance to investors. Indeed, as discussed herein, state laws can fundamentally link these other issues with the issue of statutory liens.
Better disclosure of statutory liens and other matters affecting bondholder treatment in municipal bankruptcy should not be viewed as a burden, but rather as an opportunity for issuers to improve market credibility and acceptance. More detailed security disclosure should be especially beneficial to municipalities that issue GO bonds with statutory liens. In addition to lowering borrowing costs generally, it can help distressed issuers maintain market access when it is most needed. In all cases, full and accurate disclosure enables informed investment decisions and provides a better understanding of these critical issues. Finally, insofar as it may improve disclosure in the market, we ask for clarity in state laws. The task of figuring out whether a statutory lien exists should not be made unnecessarily difficult.

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CDIAC - Leases in California: Their Form and Function
March 1, 1991

As part of an ongoing effort to provide state and local governments with the latest information on debt issuance and management, the California Debt Advisory Commission is pleased to issue Leases in California: Their Form and Function. The report focuses on the use of tax-exempt leasing to meet the real property and equipment needs of public entities.

While the use of tax-exempt leasing in California represents a recognized alternative to more traditional forms of financing such as pay-as-you-go and bonded indebtedness, little has been written about the form and function of public leasing arrangements. This report attempts to fill that void by providing some insight as to why public agencies employ leases, the types of leases which are entered into, and the purposes for which leases are used. The report also discusses the legal, regulatory, and tax considerations associated with tax-exempt leasing.

It should be noted that the overriding purpose of this report is to serve the informational and educational needs of state and local agencies which utilize tax-exempt leasing to meet their capital and equipment needs and for those agencies which may be considering such arrangements. The report does not attempt to evaluate the appropriateness or cost-effectiveness of various types of lease arrangements, nor does it advocate leasing over other forms of financing.

Recognizing the importance, however, of providing policy direction on this issue, the Commission will make available a companion piece, Leases in California: Summary and Recommendations, to provide recommendations regarding further research and policy development that may be appropriate with regard to tax-exempt leasing in this state.
In closing, I would like to acknowledge the efforts of the many fine individuals and firms who worked on this report, including Russell Lombard and James Dudick of Transocean Funding, Inc.; Lisa Cole of Cole & Associates; Joshua Cooperman of Gaston & Snow; Robert Butler of Public Resources, Inc.; and Eileen Park, Martha Riley, and Janae Root of the Commission's staff.

Sincerely,

Kathleen Brown
California State Treasurer
Chairperson, California Debt Advisory Commission
California Debt Advisory Commission

The California Debt Advisory Commission is the state's clearinghouse for public debt issuance information. The Commission was created by the California Legislature in 1981 to assist state and local government agencies with the monitoring, issuance, and management of public debt.

The California Debt Advisory Commission members include:

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Additional information concerning this report or the program of the California Debt Advisory Commission may be obtained by contacting:

Steve Juarez  
Executive Secretary
LEASES IN CALIFORNIA:
THEIR FORM AND FUNCTION

A Study Prepared for the
California Debt Advisory Commission

September 1990

Transocean Funding, Inc.
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 Lease financing is a popular way that governments around the country obtain real property and equipment. Whether the lease leads to ownership or just use of the asset by the government, it provides an alternative to traditional pay-as-you-go and debt financing approaches.

The following report on tax-exempt leasing resulted from a Request for Proposal by the California Debt Advisory Commission (CDAC) as part of its continuing role to serve as the State's statistical center for state and local debt issues, to provide technical assistance to state and local governments in the areas of debt issuance and management, and to research and provide policy guidance on debt-related topics.

The Commission collects information on types of debt instruments used by public agencies to fund their public projects. Lease issuance information is important to the Commission since lease financing is often used by local agencies as part of their capital expenditure programs, and is generally included in any review of creditworthiness or rating evaluation.

As the report details, there are many variations on the theme of tax-exempt leasing. Regardless of which form is used, governments use tax-exempt leases to finance essential assets at reasonable costs and match their capital needs with cash flow realities.

The report is intended as an educational aid for local and state government officials interested in public lease financing.
ACKNOWLEDGMENTS

This report would not have been possible without the assistance of numerous individuals and organizations. Their contributions were invaluable.

First and foremost, we would like to express our gratitude to the California Debt Advisory Commission for funding the study. In particular, we would like to thank the staff for their untiring advice and support, especially Harriet Kiyan, Eileen Park, Martha Riley, and Janae Root.

To provide guidance to the consultants, an Ad Hoc Review Committee was formed. The committee members -- experts on leasing, themselves -- reviewed our drafts, offered written and verbal comments, served as resources as we conducted our research, and met with us on several occasions. The individual members are: David Brodsly, City of Los Angeles; Barbara Cooper, University of California, Berkeley; Calvin Grigsby, Grigsby, Brandford & Co., Inc.; Robert E. Hoover, California Department of General Services; Linda Leopardi, California School Boards Association; William H. Madison, Jones Hall Hill & White; Terry Neset, BancOne Leasing Corporation; and Jeanne Olivas, Trust Services Division, State Treasurer's Office. To them we extend our great appreciation.

Further, much of our work resulted from the collective expertise of a number of individuals with many years of experience in public finance and municipal leasing. We would like to thank: David Hobson and Jennifer Royster of the Association for Governmental Leasing & Finance; Ray F. Smith, Citicorp North America, Inc.; L. Gary Simmons, Chrysler Capital Public Finance Corporation; Thomas M. Jaschik, MNC Leasing Corporation; David Glessner and John Miller, GE Capital Fleet Services; Ronald S. Morton, Municipal Leasing Associates, Inc.; David Herskovits, Attorney; Steven Swendiman, County Supervisors Association of California; Dari Barzel, Association of Bay Area Governments; Sheila Flanagan, MBIA; Eric Shapiro, Financial Guaranty Insurance Company; Michael Hark, Sutro & Co., Incorporated; James Bemis, Sumitomo Bank; Martha Lewis, California Financial Services; Dennis Fenwick, Office of the Attorney General, State of Arizona; James Anaya, Hitachi Systems; Charles Vihon, Verrill & Dana; Edwin Huddleson, Volpe, Boskey & Lyons; Richard Hiscocks, Orrick, Herrington & Sutcliffe; and Jeffrey Wong, Cooper, White & Cooper.

We also wish to thank our contributors from Gaston & Snow: Richard Tardiff, Kathryn Sedor and Allen Bass.

The authors take full responsibility for the report's contents. And, in this day and age, as our counsel advises, we would be remiss
without including the requisite disclaimer that this report has been prepared for general informational purposes only and may not necessarily be applicable to the precise circumstances under consideration by any party. It is not intended to constitute legal or financial advice and any persons or organizations interested in entering into a tax-exempt lease are urged to seek the advice of financial, legal, accounting, and other advisers expert in the tax-exempt leasing area.

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September 1990
INTRODUCTION

This report explains how and why governments -- state and local -- in California use tax-exempt leasing.

Tax-exempt leases generally are considered financing arrangements obligating the governmental lessee to payments of principal and interest for a stated period of time. Legally, in California, leases are not considered debt when they contain an abatement provision that allows a lessee to discontinue making lease payments if it does not have use of or access to the leased asset. In most other states (and occasionally in California), the lease may contain a provision that allows a lessee to terminate the lease if funds are not appropriated for payments (the non-appropriations provision), to prevent its characterization as debt. As a result, properly documented tax-exempt leases do not figure into statutory debt limits in most states. However, these same tax-exempt leases are considered debt for most accounting and credit analysis purposes and are factored into the calculations of outstanding debt by the credit rating agencies and accountants.

Governments are attracted to tax-exempt leasing because it can serve as an alternative to bond financing and as a supplement in any capital improvement program. A government gains great flexibility from tax-exempt leasing because a transaction can be arranged quickly and, therefore, can be used to respond to immediate pressures for new equipment or capital improvements. Because there have been relatively few "problem" tax-exempt leases (leases where non-appropriation or abatement has resulted in non-payment), the market for them is well developed and highly competitive; and leases generally are financed at attractive rates.

The popularity of tax-exempt leasing has led to the development of a very sophisticated national market. The volume of tax-exempt leases nationally has increased from approximately $500 million per year in the late 1970s to greater than $7 billion in 1986, just prior to the effective date of the 1986 federal tax amendments. Since then, the annual volume is estimated to have dropped to between $5 and $6 billion, corresponding to an overall decline in the volume of tax-exempt notes and bonds. Among leases rated nationally by Standard & Poor's in 1989, transactions in California accounted for almost 36 percent of annual lease volume and 52 percent of the total number of rated transactions.

In examining leasing, this report considers structural variations from privately placed vendor-financed leases to certificates of participation for major construction projects.
The report defines operating leases -- when the lessee has use of but not ownership of the asset -- but only for comparative purposes with tax-exempt leases. Asset-based transfers, sale leasebacks, or transactions in which governments act as lessor and lease assets to private organizations are not discussed.

This report is presented in three parts. Part I is divided into seven chapters. Chapter One reviews briefly why governments lease, the different types of lease structures, and the participants in these structures. It describes how funds flow in lease transactions and provides graphic presentations of the relationships of the participants to each other in the different structures.

Chapter Two provides historical perspective to leasing, including legal questions such as why most tax-exempt leases are not legally considered debt under a state law analysis.

Federal and state legislative and regulatory requirements affecting tax-exempt leases are discussed in Chapter Three. These considerations include federal tax, securities and bankruptcy laws and regulations. State requirements concerning legal authority, procurement issues, usury laws and secured party transactions are also reviewed. Based on the legal issues already addressed, Chapter Four analyzes the different provisions in a lease contract and its various attachments.

Chapter Five presents a discussion of the accounting treatment that governments apply to their leases. Chapter Six details how leases are marketed to the private sector and discusses the factors lessees should consider when evaluating their lease bids. Chapter Seven follows with a review of the credit issues surrounding leases including credit ratings and credit enhancements.

Part II provides ten case studies of different lease transactions entered into by California jurisdictions. These analyses show how certain governments have structured their financings to incorporate the various leasing elements reviewed in Part One. Commentary on the case study examples explains why certain transactions were structured the way they were and evaluates some of these approaches.

Part III is a brief look at the future of tax-exempt leasing in California.

The appendices include a glossary of terms and a listing of resources for additional information on leasing.
PART ONE
CHAPTER ONE
Types and Purposes of Leases
CHAPTER ONE
TYPES AND PURPOSES OF LEASE FINANCINGS

This chapter reviews different types of tax-exempt leases in which state and local governments participate. It discusses how the different types of leases are structured, who is involved in them, and how cash flows within them.

This section will also review master leases and lease pools -- arrangements that help lessees acquire, on a single financing, assets of different types or that permit two or more lessees to combine their financing needs in one transaction. This discussion is complemented with figures (flowcharts) that depict the flow of funds.

State and local agencies can participate in different types of leasing arrangements that range from operating leases -- where they have use, but not ownership of the property (these leases are not tax-exempt) -- to variations on tax-exempt financing leases, all of which lead to property ownership. This discussion does not examine operating leases except for comparison with tax-exempt leases.

The primary distinction among tax-exempt leases is their packaging -- whether they are small, privately placed transactions (usually for equipment) or whether they are sold to investors through certificates of participation (COPs). The principal distinction among certificated leases is whether they are sold to a limited number of investors or publicly distributed on the retail securities market.

Regardless of the source of funding, the flow of funds for a typical tax-exempt lease is fairly straightforward. Once the lessee has selected the asset and the cost is known, the financing can be arranged. The lessor funds the asset cost to be paid either directly to the vendor/contractor or to an escrow for later disbursement. The lessor may act as investor and make the funds available itself or raise them from among other investors (either individuals, banks, credit companies, corporations, etc.). The lessee makes its regular payments either to the lessor, the trustee or another assignee. Title to the asset will pass to the lessee either at the outset of the lease or at its conclusion, based upon the legal requirements of each transaction.

As the name implies, tax-exempt leases involve interest components calculated at tax-exempt rates. The lessee, as ultimate owner of the leased asset, has the advantage of lower interest payments and the investor earns tax-exempt income. This contrasts with operating leases in which governments obtain use of an asset over
the lease term but ownership stays with the lessor. Interest on operating leases, although not always separately stated, is taxable to the lessor and is, therefore, computed at higher rates.

A municipality enters into a tax-exempt lease to finance the purchase of equipment or the purchase or construction of real property. Among the types of assets that can be lease financed are the traditional equipment needs — such as computers, telephones, firetrucks, automobiles and garbage trucks — and real estate projects such as jails, administration buildings, and waste-to-energy facilities. However, financed assets, in a few cases, have included less traditional items such as computer software, systems integration and building maintenance.

The term of the financing is generally equivalent to the useful life of the asset being financed. Hence, few equipment leases extend beyond 7 to 10 years but real property leases may exceed 20 years. For instance, police vehicles are usually financed for two to three years, while computers, telecommunications systems and firetrucks are financeable for five to seven (and, perhaps, ten) years. Buildings generally can be financed for 20 years while it may be possible to finance some environmental facilities (wastewater, solid waste, etc.) for up to 30 years.

WHY LEASE?

The value of leasing to governments is that it serves as an alternative to bond financing and can be an essential part of a capital improvement program to supplement the issuance of bonds. A government gains flexibility from tax-exempt leasing because a transaction can be arranged quickly and, therefore, it can adapted to unusual or unique circumstances requiring the acquisition of assets in an expedited manner.

Among the reasons that governments participate in tax-exempt leases are:

- they provide 100 percent financing of asset cost;
- they spread out the cost of equipment or facilities over the assets' useful lives;
- the short useful lives of certain assets do not justify bond financing;
- selling bonds, including obtaining voter approval, can be time consuming and, given the time value of money, may increase the acquisition cost;
equipment leases are relatively simple to complete and allow governments to obtain their equipment quickly;

the bond market may not be an option because the lessee has no bond rating or market experience, or the lessee is unable to have a bond referendum approved;

they offer the opportunity to preserve cash for other projects or activities for which leasing is not an alternative; and

they do not require voter approval.

Tax-exempt leases also may be referred to as: municipal leases, installment sales, lease-purchase agreements, conditional sales, and lease-to-ownership agreements.

NON-APPROPRIATIONS AND ABATEMENT PROVISIONS

The difference between a bond or note and a lease is that in most instances a tax-exempt lease is not legally considered debt because of the non-appropriations or abatement provision found in leases. The non-appropriations provision states that in the event that future years' lease payments are not appropriated, the lessee can terminate the lease without being in default and without obligation to make further lease payments. The lessee, however, must return the asset. Under the statutes of most states (and upheld by courts in at least 30 states), the effect of the non-appropriations language is to make lease payments operating, rather than capital, expenses.

As protection for the investors, most non-appropriations leases also contain a non-substitution provision which states that following a non-appropriation, the lessee, for a specified period, cannot substitute like equipment or contract for services that the leased asset would have provided. They also contain covenants requiring best efforts by the lessee to request funding of lease payments in future fiscal periods and a confirmation of the essential use of the equipment being funded.

As a result of the perceived risks of non-appropriation, tax-exempt leases are arranged for essential assets -- those assets regularly used in the day-to-day operations of the lessee. In the view of investors, rating agencies, and credit enhancement providers, it is less likely that a lessee will non-appropriate for an asset on which it relies to perform an essential function (i.e., a computer that keeps tax roles and handles all other accounting functions.)
In California, however, many tax-exempt leases are structured with abatement clauses that allow lessees to stop rental payments if they do not have use of the leased asset. These clauses may allow or call for abatement of all rents or may permit proportionate abatement of an amount of rents applicable to that portion of the asset(s) not available for use. This provision may be in addition to a non-appropriation provision but more likely replaces it. California courts have ruled that abatement leases do not legally constitute debt. Further, they have held that such leases can be executed for multi-year periods, can have rental payments payable from any legally available source, and can have stronger default provisions. To protect investors from abatement risks, many of these leases require the lessee to purchase rental interruption insurance to supplement the usual requirement of property and casualty insurance.

The market perceptions of non-appropriations and abatement leases differ. In general, an abatement lease, particularly when supported by rental interruption insurance, is viewed as a less risky investment because the lessee is obligated to budget for and make its lease payments. Lease payments can be terminated without a default if the lessee is denied use of the asset. On the other hand, a non-appropriations lease allows the lessee to terminate a lease, without being in default, if it should non-appropriate for lease payments.

TYPES OF LESSORS

To understand tax-exempt lease arrangements, it also is helpful to know the types of participants who act as lessors for such transactions. Tax-exempt leasing dates back at least to 1954 when the federal tax courts first began to determine how the interest portion of lease payments made by a governmental unit would qualify as exempt from federal income tax. At that time, tax-exempt leasing generally involved transactions between a lessee and an equipment vendor. By treating part of the lease payment as tax-exempt interest, the vendor could be more competitive in its lease rates to governmental customers and presumably could sell more equipment.

As early as 1970, lease brokers, who traditionally facilitated taxable lease transactions, began to provide their services to the tax-exempt lease market. The lease broker is typically an organization that specializes in assisting vendors or lessees in locating investors to fund the sale/purchase of assets. Throughout the early and mid 1970s, the typical client (investor) of the lease broker was an institution, such as an insurance company or bank, with some brokers or investment bankers selling small leases directly to wealthy individuals. The lease broker gradually became more sophisticated and created both lessor companies and brokerage (or lease placement) companies. Sometimes these affiliated companies have
different names which make the involvement of the lease broker's affiliates less apparent to lessees and investors.

Starting in the late 1970s, institutional investors began to participate directly in the structuring of tax-exempt lease transactions and now actively solicit transactions among lessees. These types of investors are typically large finance companies which are often affiliated with corporate conglomerates (e.g., General Electric Credit Corporation, IBM Credit Corporation, etc.) or subsidiaries of major commercial banks. In addition, captive credit companies (which only finance assets that their affiliates produce) have also increased their activities in tax-exempt leasing.

Finally, with the enormous growth of tax-exempt leasing that occurred in the 1980s, a new financing source joined the list of participants. This is the individual investor represented by an underwriter who primarily sells tax-exempt leases through the certificate of participation format. Although underwriters can and do sell some transactions on a private placement basis, their greatest contribution is in the retail distribution of COPs to large numbers of individual investors. The availability of retail market distribution has contributed greatly to the increased volume of tax-exempt leases. However, underwriters generally cannot act as lessors. Therefore, another group of lessors -- including non-profit corporations, joint powers authorities, and other special authorities -- have developed to facilitate large underwritten transactions.

With this brief introduction to tax-exempt leases and lessors, the next sections discuss different types of leasing arrangements, why and how they are structured, who participates in them, and the flow of funds.

TYPES OF LEASES

Privately Placed Tax-Exempt Leases

Although the general terms and conditions of most tax-exempt leases are similar, some structures are more complex than others and involve more participants. The simpler leases generally include fewer participants, tend to be for relatively small dollar volume acquisitions and are sometimes termed "middle market" transactions.

The first lease structure reviewed is of the simpler (usually smaller) leases which are collectively referred to as privately placed tax-exempt leases. The label "privately placed" refers to the fact that the leases ultimately are sold privately to a few investors and frequently are sold to a single investor as a single lease.
Because there are no reporting requirements either nationally or in most states, the annual number of privately placed leases is unknown but is thought to be quite high. At the same time, however, the total dollar volume is estimated to be low, particularly in relation to the dollar volume of certificates of participation.

The typical privately placed lease involves a lessee that wants to acquire property (usually equipment but sometimes real property) with a relatively low dollar cost. The dollar amount of each lease can run from $10,000 to $5,000,000 or sometimes even more. However, most privately placed leases usually are for less than $1 million.

Privately placed leases are used to finance capital assets in many states around the country. In California, these leases have either abatement or non-appropriations provisions. However, in most other states, privately placed leases contain non-appropriations provisions.

Lessees seek their financing either competitively or through negotiated bids. This decision may be dictated by state or local laws that require competition. Some lessees may choose to negotiate the financing in order to expedite the process or because the transaction size is too small to interest or warrant an extensive bidding process or is too time-consuming to warrant any resulting savings.

Most lessees enter into a privately placed lease when they need equipment and they do not have the cash to pay outright or they are unable to or do not want to use bond proceeds for the purchase. Generally, the lessee selects the asset needed and solicits proposals for its acquisition. It may ask the vendor to state a purchase price that includes a lease rate or to provide both a cash purchase price and a calculation of what lease payments would be.

However, many lessees will solicit vendor prices for the asset acquisition only and will independently seek lease financing rates from third-party companies and financial institutions accustomed to investing in tax-exempt leases. This permits the lessee to obtain the most cost effective price as well as financing cost. Many vendors do not specialize in financing their products and, as a result, either will offer to finance at high rates (and serve as the investor) or will introduce a third-party lessor/investor. In the latter situation, the involvement of the vendor as lease broker tends to drive up the financing cost. Lessees also may benefit from separating asset acquisition from financing bids by potentially broadening the equipment supplier market. This occurs because some vendors cannot or do not offer financing and would be excluded from bidding on a combined sales and finance package.
The two primary categories of privately placed tax-exempt leases are described below.

**Vendor-Financed Leases**

As its name implies, the vendor-financed lease involves a vendor of equipment handling the financing of the leased asset. In this type of lease, the vendor usually acts as lessor and investor and holds the lease for its full term. Alternatively, the vendor may assign the lease to one or more subsequent investors. The vendor/lessor is responsible for providing the leased asset -- both its manufacture and its financing. Usually, no funds are required in a vendor-financed lease until the asset is delivered and accepted, at which time lease payments commence from the lessee to the vendor/lessor.

The primary incentive to the vendor/lessor is usually to accommodate the sale of the assets it manufactures. If the vendor retains the lease as an investment, the vendor will also receive tax-exempt interest from the future lease payments. If the vendor assigns the lease to other investors, the vendor may receive a broker's fee from the new investor, adding another layer of cost to the financing. Many vendor/lessors, however, do assign leases to investors without making an additional financing profit. In these cases, the vendor provides the financing to its customers as a service, presumably to encourage future sales of its products.

The vendor-financed lease is usually the easiest and quickest to document. It typically involves a single (often preprinted form) lease between the vendor/lessor and the lessee. The lessee will be expected to provide an opinion of its counsel that the lease is valid and binding and that the lessee has complied with the bidding and procurement statutes. A separate bond or tax counsel opinion is generally not required. Since the vendor is typically the initial lessor, an escrow of funds to assure payment of the acquisition price is unnecessary and rarely found in these transactions. Figure 1 presents a flow chart of this sample transaction.

**Third-Party Financed Leases**

In a third-party financed lease, someone other than the vendor assumes the responsibility of providing or arranging the financing of the leased assets. The third party may be a direct investor or a lease broker, either of whom usually acts as lessor, although occasionally the vendor may continue as lessor. The difference between a vendor/lessor in a vendor-financed lease and a vendor/lessor in a third-party financed lease is the level of financing responsibility the lessor assumes.
Vendor-Financed Lease Purchase

Lessee

Leases Equipment

Lease-Purchase Agreement (LPA)

Makes Lease Payments

Lessee (Vendor)

Assigns LPA

Investor

Some vendors retain lease-purchase obligations for their own investment account and do not assign them to outside investors.
In the simplest form of a third-party financed lease, the lessor leases to the lessee who accepts the asset from the vendor, following which the lessor pays the vendor and the lessee makes lease payments to the lessor. After the lessee has selected the asset and the lease financing is documented, the vendor is authorized to deliver the asset. If the leased asset is not accepted in its entirety at the time the lease is funded, some or all of the purchase price may be placed in an escrow account. In such cases, the services of an escrow agent/trustee will be required. The escrow agent holds the lease proceeds until the lessee accepts the asset and authorizes the escrow agent to pay the vendor.

A third-party financed lease generally takes more time to document than a vendor-financed lease, frequently three weeks or longer. The lessee will be required to provide the same type of legal opinion as required for a vendor-financed lease. However, the third party may also require a separate opinion of tax counsel concerning the tax-exempt treatment of the interest portion of the lease payments under federal and state income tax laws.

The various parties in this case benefit from the transaction in different ways. The lessee finances its assets at tax-exempt interest rates without incurring debt. The vendor benefits from the sale of its product. The third-party lessor/investor earns a profit from receiving tax-exempt income or, where it assigns the lease to investors, from a "spread" in the financing rate it receives from the lessee and the rate at which it obtains money from investors. For instance, in a lease in which the third-party lessor assigns its interests to another party, the lessee may be paying an interest rate of 7.5 percent and the lessor may find an investor willing to fund the transaction at a tax-exempt yield of 6.75 percent. The spread of .75 percent is the lessor's gross profit and the new investor becomes the beneficiary of tax-exempt income. The lessor's gross profit is reduced by any closing costs (legal fees, etc.) to achieve its net profit. Usually the smaller the dollar volume of the lease, the larger the spread to compensate the participants to the transaction. The actual dollar margins will depend on the size of the financing, the terms of the lease, and the payment frequency. For example, to receive 1 percent of margin (or gross profit) on a three-year lease with monthly payments in arrears, the lessor will require an interest rate spread of approximately .67 percent (67 basis points); to achieve the equivalent margin, for a lease with a five-year term, the spread is reduced to .42 percent (42 basis points). Similarly, a monthly payment structure will provide less margin to the lessor than quarterly payments due to the present value of cash flows.

Figure 2 outlines the flow of activities in a typical third-party financed lease.
Certificates of Participation

A popular form of lease packaging involves a certificate of participation (COP). A COP is a variant of a lease financing in which the lease is divided by the lessor into individual units sold separately to investors. More precisely, a COP is a security (issued in a form similar to a municipal bond) that evidences the undivided fractional interest the investor holds in a particular lease and, as appropriate, a security interest in the rental to be paid and the assets being financed. The number of parties, the documentation and the cash flow patterns mirror those of a bond sale. COPs also can have as many structural variations as bonds.

The volume of COPs increased significantly in the 1980s with governments in California accounting for the vast majority of those transactions. By example, the California Debt Advisory Commission (CDAC) reported in 1988 that 165 COPs were issued in that state for a total dollar volume of more than $2.2 billion. Standard & Poor's Corporation reported for the same period that, nationally, it rated more than $3.5 billion of tax-exempt leases, with leases by California governments representing 47.1 percent of that total. The primary reason for the high volume of COPs in California is the impact of several legislative referenda (including Proposition 13 and the Gann initiative) that severely limit property taxes as a source of revenue to governments in the state and require a 2/3 majority voter approval for any general obligation debt financing. Decreased revenues have led, quite naturally, to a leveraging of that revenue to lease financing.

COPs are used for all types of assets but have been widely used for large real property purchases. The distinction between a COP and a privately placed transaction is that COPs are generally sold to more than one investor. Although they may be sold privately to sophisticated investors, they frequently are sold publicly, through broker-dealers, in an underwritten transaction to a diverse group of investors.

A COP is more complex than a privately placed lease. While the underlying lease has the same contractual features (non-appropriation or abatement, essentiality, etc.), the transaction requires more time to organize and involves more participants.

The participants in a COP transaction include the governmental lessee, the lessor, the vendor(s) and an underwriter who will solicit investors. Many COP transactions also require a trustee. The trustee acts on behalf of the multiple investors primarily to collect rent from the lessee and to disburse it to the respective investors. In some transactions, the trustee also holds the acquisition funds in an escrow account until payment to the vendors or contractors is required. Finally, the trustee has a duty to act for the investors' interest if the lessee defaults, abates, or non-appropriates on the
lease. The trustee may also be substituted by a paying agent or escrow agent.
Some third-party lessors do not assign the lease obligations but retain them as their own investment.

Figure 2
Most of the parties will be represented by counsel and a bond or tax counsel will participate to render the opinion that the transaction is tax-exempt. Other participants may include the credit rating agency analysts (if the transaction is to be rated) and representatives of the credit enhancement provider (if it is to be enhanced). The enhancer will also be represented by counsel. Of course, lessee's counsel will be involved during the preparation and negotiation of the documents.

COPs are or may be structured with a nominal lessor that may be a non-profit corporation, a private entity, a joint powers authority, or another special agency. This structure typically involves a trustee who receives the proceeds of the COPs sale and to whom the lessor assigns the duties to disburse the proceeds to the vendor(s), the collection of lease payments, and the disbursement of principal and interest payments to the certificate holders.

COPs can be sold competitively or on a negotiated basis. If competitive, the lessee, usually assisted by special counsel and a financial advisor, prepares the documents, issues the official statement, takes bids on a specified date and awards to the lowest bidder. When negotiated, the underwriter works closely with the lessee in structuring the transaction and preparing the documents, including the official statement; the pricing is negotiated between the underwriter and the lessee. In a negotiated transaction, the lessee may be in a position to bring its COPs to market at an advantageous time relative to interest rate volatility. In addition, negotiation sometimes allows the lessee to market more complicated COPs to specialized investors (those who understand the lease document and the risks of non-appropriation or abatement). On the other hand, the competitive sale of COPs assures open bidding among a wide source of underwriters and, for straight-forward transactions, may produce the lowest interest cost.

One way in which a COP structure may differ from that of a bond is that COPs may call for a debt service reserve fund that may mitigate the risks of non-appropriation or abatement. In this case, COPs are funded for more than the asset cost to provide for the debt service reserve account. In accordance with the 1986 Tax Reform Act, reserves from bond or lease transactions may not exceed 10 percent of the initial offering.

COPs are generally sold through an official statement that describes the transaction, the sources of repayment, and the general economic, financial and demographic trends of the lessee. Like bonds, COPs may be rated. They may also have credit enhancements to offset the investment risks of non-appropriation or abatement. COPs are traded in established securities markets and for public offerings are typically sold in $5,000 denominations.

Figure 3 shows the typical way in which funds and responsibilities flow in a COP transaction.
Lease Revenue Bonds

Lease revenue bonds in some instances are the equivalent of COPs except the word "bond" may make them more acceptable in the financial marketplace. For example, if a building authority issues revenue bonds to finance the construction of a jail or office buildings and then leases that facility to another state agency, the underlying lease most likely will contain the same language and provisions common to the tax-exempt leases previously discussed. Therefore, a revenue bond relying on the pledge of the lease payments has similar risks as a COP. Lease revenue bonds also are not treated as debt for state law purposes, either under the "lease" exception discussed in Chapter Two or under the special revenue exception to debt limitations.

However, many lease revenue bonds will also be supported by a specific pledge of the income derived from the leased asset. For example, the lease of a wastewater treatment facility by an improvement authority to a municipal sewer utility would likely contain a pledge of net sewer fees charged by the utility to its customers. This type of lease revenue bond is principally evaluated on the strength of the pledged revenue stream and not primarily on the other provisions of the lease.

In California, issuers of lease revenue bonds (also called enterprise leases) include non-profit corporations, joint powers authorities, redevelopment agencies, and parking authorities. In other states, other types of governmental entities can issue these bonds as long as they are supported by project revenues.

Lease revenue bonds involve similar parties with similar roles as already reviewed above in the discussion on COPs.
Certificate of Participation

- **Lessee**
  - Provides Equipment
  - Makes Lease Payments
  - Lease-Purchase Agreement (LPA)

- **Lessor**
  - Assigns LPA
  - Lease-Purchase Certificates (LPA)

- **Trustee**
  - Issues Certificates
  - Pays Certificates
  - Pays for Equipment

- **Vendor**
  - Provides Equipment

- **Investors**
  - Trustee

- **Underwriter**
  - Sells Certificates
  - Pays P & I

Figure 3
Master Leases, Lines of Credit and Lease Pools

Master Leases

A master lease can provide governmental lessees with many economies and efficiencies. By entering into such an arrangement, a lessee is able to acquire various pieces and types of real and/or personal property from different vendors over a period of time under one lease contract. In addition to the benefits of working with one set of documents for multiple acquisitions, the lessee does not have to seek financing each time a new acquisition occurs. Frequently, master leases are arranged to consolidate outstanding leases or to coordinate the leasing activities of many agencies within one government.

The flow of funds of a master lease will mirror either that of a third-party financed lease or a COP (except that a trustee or paying agent is usually involved to hold funds and disburse to vendors as appropriate). The primary difference between a master lease and other tax-exempt leases is that there generally is more than one vendor and there may be more than one user. Frequently, a primary lessee in a master lease (such as a state purchasing bureau) may sublease the assets to other qualified municipal agencies.

When a master lease involves assets to be used by many agencies within one government, an additional set of agreements may be required, depending on the authority of the central governmental unit acting as lessee in the master lease. The central lessee may simply be authorized by statute to act on behalf of all agencies or it may require the agencies to specifically authorize its actions. If an authorization document is needed, it could be in the form of a sublease agreement incorporating all the provisions of the master lease, or it could be a simple memorandum of understanding committing the user agencies to abide by the terms of the master lease.

Figure 4 outlines the master lease transaction which typically occurs when operating departments of a governmental unit request a central purchasing or finance office (the "primary lessee") to lease assets to serve each department's unique needs. The primary lessee enters into a lease with a lessor who generally assigns the lease to a trustee who issues certificates of participation to an underwriter. The underwriter sells the COPs to investors and deposits those proceeds (less commission) with the trustee for payment to vendors after delivery and acceptance of assets by the operating departments. The primary lessee is responsible for collecting rents from the operating departments and remitting these to the trustee, who in turn pays the investors.

Many master leases with non-appropriations provisions are structured as "all or nothing" leases to enhance their security value. In other words, if a lessee chooses to non-appropriate, it must non-
appropriate all assets acquired under the master lease. With this restriction, the risk of non-appropriation is minimized.
The use of leased equipment by individual agencies sometimes requires a sublease agreement or a memorandum of understanding between the central government unit and each agency.
**Lease Lines of Credit**

Many master leases are also organized as lines of credit with the interest rates set by formula as the funds are needed. At the point at which funds are drawn down, the rate is fixed pursuant to an index or continues to float on an index. As a result of this structure, lessees know or can calculate the cost of financing from the outset and are assured that their costs are competitive and reflect current interest rates.

Lease lines of credit are normally provided directly by investors or some lease brokers who arrange to provide the requisite financing on demand whenever the lessee receives assets under the program. The line of credit lessor agrees to pay vendors identified by the lessee as and when assets are delivered and accepted. Specific assets are not identified when the line is negotiated; however, an understanding is reached during the negotiation of the documents as to the types of assets and the useful lives that are acceptable. When each asset or group of assets is paid for, a schedule is added to the lease to identify the asset, the financing term, and the applicable payments.

A lease line of credit frequently does not involve a trustee or paying agent because the line provider acts both as lessor and investor. A trustee or paying agent may be used if a subsequent sale to multiple investors is anticipated.

**Lease Pools**

In the last several years, some state associations have sponsored tax-exempt lease pools. In California, for instance, the County Supervisors Association, the California School Boards Association, the California Special Districts Association and the Association of Bay Area Governments have set up lease pools for their members. Similar programs have been set up by the Florida School Boards Association and the Utah School Boards Association.

These lease pools typically are organized with a subsidiary of the sponsoring organization acting as nominal lessor and usually involve a group of separate leases to several lessees. The pools are organized and sized to respond to the lease needs of the member governments. In active programs, lease pools may be financed annually or more frequently.

A lease pool will always involve a trustee to receive lease payments from multiple lessees and disburse them to the investors. The trustee will issue COPs representing undivided interests in all leases in the pool. An investor assumes a portion of the risk associated with each lease. However, since each lease is legally a separate obligation, the risks of non-appropriation or abatement are limited to the specific lessee; the different lessees are not responsible for the obligations of other lessees.
A credit enhancement in the form of a liquidity letter of credit can be of particular benefit to lease pools that involve a number of different lessees. Because of the differing levels of creditworthiness among the lessees in a pool, a liquidity letter of credit can contribute to its marketability by providing a uniform level of credit to the lessees and assuring investors of prompt payment.

Because of their complexity and the larger number of lessees in lease pools, bond counsel and other special counsel will assist in the preparation of documents to assure their compliance with federal tax and securities laws. In addition, each lessee's counsel will be involved in the transactions.

CONCLUSION

In summary, the roles of the different participants to a lease transaction are outlined in Exhibit 1 below. As the prior discussion reveals, these parties may or may not be in all leases; they may play more than one role; and they may play different roles.

While the size of transactions and the sources of funding may vary, the underlying leases are very similar. Lessees select the lease packaging that best fits their needs -- whether it is a vendor-financed transaction for a small equipment purchase or a publicly sold COP that will finance a new city hall. The flow of funds and responsibilities in these transactions may differ in their complexity as may the number of parties involved but the result is the same. A government has acquired an asset and has not incurred debt but has undertaken a payment obligation. The investors receive tax-exempt income and have a secured interest in an asset that they hope never to possess.
**EXHIBIT 1**

**TAX-EXEMPT LEASING: PARTICIPANTS AND THEIR ROLES**

<table>
<thead>
<tr>
<th>Who</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessee</td>
<td>Governmental unit that uses the leased asset, makes periodic payments of principal and interest, and gains ownership of the asset at some point during the transaction. The lessee chooses the asset and financing source.</td>
</tr>
<tr>
<td>Lessor</td>
<td>Party that may provide the funds and act as investor or that may assign its interest in the leased property to another party. If a nominal lessor, it acts as a conduit to acquire the asset for resale to the lessee. The lessor may be the vendor/contractor, the investor, or a public or private third party.</td>
</tr>
<tr>
<td>Vendor/Contractor</td>
<td>Party that provides the asset to the lessee. These parties are selected by the lessee and perform according to lessee specifications.</td>
</tr>
<tr>
<td>Underwriter</td>
<td>Original purchaser of COPs (from the lessee or escrow agent) with the intent to resell the certificates to investors.</td>
</tr>
<tr>
<td>Assignee</td>
<td>Party to whom lessor assigns its rights and interests in the leased asset.</td>
</tr>
<tr>
<td>Credit Rating Agency</td>
<td>Provides the credit rating to some lease transactions.</td>
</tr>
<tr>
<td>Credit Enhancement Provider</td>
<td>Party that protects the investors against risks of non-appropriation abatement or default by providing a financial guaranty.</td>
</tr>
<tr>
<td>Trustee/Escrow Agent</td>
<td>Usually a financial institution that provides administrative services, through an escrow or trust agreement, for the benefit of the parties to the lease including, among other services, the safekeeping of proceeds, and holding physical possession of title documents for the leased asset. Depending on</td>
</tr>
</tbody>
</table>
the structure, the lessee or lessor pays trustee fees which, depending on the transaction, may be assessed annually or are paid at lease commencement.

**Financial Advisor**

Consultant who provides assistance in the structure, timing, terms and other topics concerning new or existing leases.
CHAPTER TWO

Debt Restrictions and California Case Law
CHAPTER TWO

DEBT RESTRICTIONS AND CALIFORNIA CASE LAW

This chapter analyzes how tax-exempt leases are treated to avoid constitutional debt limitations and ensure that the tax-exempt nature of the "rental" payments is not jeopardized.

RESTRICTIONS ON DEBT

Most states prohibit the incurrence of debt to be paid over a multi-year period without voter (and, as required, legislative) approval. These restrictions developed following extensive defaults caused by extravagant borrowings in the late 19th century. To forestall further mortgaging of future general tax revenues, the legislatures of most states enacted restrictions on the incurrence of multi-year debt by municipalities absent voter or other types of approval. The restrictions focus on obligations funded from general ad valorem taxes in future years. When the obligations are repaid from funds other than such taxes, the restrictions generally do not apply.

Given the financial straitjacket imposed on governments and the capital needs of growing communities, exceptions to the statutory framework were developed by legislative bodies or promulgated by the courts. These included exceptions for special "assessment" districts, for revenue-based obligations, for project-type financings not encumbering the general taxing power as well as for special districts. In essence, if the source of payment does not encumber the general tax revenues, or if the district is not enumerated within the debt limitations (such as a special district or special assessment district), the restrictions do not apply.

The "Lease" Exception

In addition to exceptions for "special districts" or "projects", the courts have long held that lease contracts which were to be paid within the fiscal year or which obligated the municipality to provide payment only on a year-to-year "renewable" basis were not constitutionally debt. The courts reasoned that the payments were akin to contingent obligations or current expenses, for which future annual revenues technically were not being pledged. Accordingly, they were not long-term debt. This concept was cloaked under various rationales, the two most cited by the courts being the "contingency" exception and the "lease" exception.

In California, this analysis was particularly elucidated in a series of cases, the most prominent of which are City of Los Angeles v. Offner and Dean v. Kuchel. In these cases, the courts indicated that where the lessee's specific obligation is limited to the rentals
paid during the fiscal year for the item, and to monies currently available (and do not relate to, or encumber funds in, other periods), the lease is valid. This results even if the total sum of rentals may equal the purchase price (plus a finance charge) and title passes to the lessee automatically at the end of the lease. Provided these qualifications are structured into the rental obligation, no debt is created.

**Offner-Dean Rule**

*Offner* involved a proposed long-term lease of an incinerator to be erected on City-owned land and leased by the lessor to the City. The lease provided for purchase options at specified periods, at the greater of a minimum price specified in the bid or an appraised value. The lease was challenged on the basis that it constituted an installment sale over a multi-year period and violated the debt limitations. The court held that the proposed agreement constituted a lease, not an installment sale, because the rentals and purchase options represented "fair value". Accordingly, the court reasoned the City would not feel compelled "to exercise [its] ... option in order to protect its prior investment in the form of rental payments." Since the rental payments did not exceed fair rental value, by the terms of the court's analysis, there was less likelihood that the rentals constituted equity. As a consequence, the rentals could be viewed as payment for "the consideration actually furnished that year", and not a subterfuge for future consideration to be paid. As stated by the court, where the lease obligation, even if multi-year, was entered into in good faith and confined liability for rent to each installment as it becomes due, and the rental was for consideration (quiet enjoyment and use) of the asset furnished during the year, "no violence is done to the constitutional provision." Citing a prior case involving the furnishing of services (hauling of sewage) to a municipality in which the liability was contingent upon performance, the court reiterated that provided the payments were for services or consideration furnished in that year, the same result should apply, upholding the contract.

The rationale in *Offner* was amplified in *Dean v. Kuchel*, a subsequent case involving the lease of a building by the State on a triple net lease basis over a multi-year period. The lease was structured to conform to *Offner*, in that the rental was "for and in consideration" of use of the facility. However, unlike *Offner*, the State was to receive title upon expiration of the lease without any further payment, and in any event (even if the State defaulted), 10 years following the stated term of the lease. Notwithstanding these factors, the court held the principles of *Offner* applied. Dismissing the difference between the two cases over the purchase option and reversion of title, it held that "no substantial or logical difference [existed] between the option to purchase in the *Offner* case and the vesting of title at the end of the term in this case." In fact, the court specifically emphasized that "no useful purpose would be served by reviewing other cases ...", content to republish the factors cited in *Offner*. The court reviewed the character of the monetary
obligation needed for the State to lease purchase the facility. Since
the court viewed the rental obligation as similar to that of Offner
(despite the fact the purchase option price, a key element for
characterizing operating leases, was now absent), the lease was upheld
as outside the debt limitation.

Dean expanded application of Offner to situations where the
lessee received title at the end of the lease without any payment of a
purchase option or an appraised value. While such -- leases more
typically are treated as finance leases, the court treated the
situation as parallel to Offner. Since the base rentals (the
principal and interest amortization) had to be paid in either case --
regardless of the different buy-out provisions -- the court
characterized the contract as a lease.¹

A year later, in County of Los Angeles v. Byram,⁴ the court was
compelled to focus again on the "lease/debt" issue, but in this case
the facts were even more weighted toward a finance lease. The lease
was for 50 years and the lessee received a purchase option which
decreased 2 percent annually until zero at expiration, similar to Dean.
Moreover, the statutes authorizing the lessor to lease permitted
termination following the lessor's recovery of its investment plus
interest. Since the lease was perceived by the court as
indistinguishable from Dean, the court upheld the lease. In doing so,
it quoted with approval certain characteristics of the lease:

lessee shall pay "rental" of $25,000 for "use of the
premises" for each month at the end thereof [plus liens and
insurance premiums, and] ... "it is expressly understood and
agreed that each month's rental shall become due only in
consideration of the right to possess, occupy, and use the
Building during the preceding month, and it shall be the
responsibility of the Lessor to provide such Building at all
times"...⁵

Accordingly, the characterization of the lease (as an operating
or finance lease) and the amount (or lack thereof) of a purchase
option at expiration were not factors to be emphasized. Rather, the
court focused on the monetary obligation required during the lease,
and when and for what period the rental obligation accrued. Provided
the rental approximated fair rental value, rent was conditioned on,
and in consideration of, the right to use, and the rental liability
was periodic (monthly, quarterly, etc.) and related to the period in
which the consideration was provided, the lease would be reviewed
favorably.

These cases have been followed by seven lower court opinions
which considered the "lease" exception in the context of the debt
restriction. Certain characteristics from these cases shed additional
perspectives on the Offner-Dean rule.

In McClain v. County of Alameda,⁶ in rejecting the notion that a
low purchase option price created an inference that rent was a
"credit" on the purchase price, the court implied that focus on the purchase option price for determining lease vs. debt treatment was misplaced. The essence of the Dean rule was not in "balancing [the] rentals with [the] option prices"; it was whether the payments constituted consideration for "a month to month use of the building." In fact, as an appendix to the case, the court listed in column form 12 substantive lease provisions from Byram and compared them to the lease, in essence providing a road map as to how to document an acceptable lease.

This columnar treatment was also adopted in Lagiss v. County of Contra Costa, in which the court upheld a lease, with a final $1 buyout, as valid, refusing to nitpick how the purchase option prices may have differed from those in Byram and McClain. Since the liability created was "month to month for consideration furnished by the lease in each month, and the total payments each year are for consideration actually promised that year", the lease was valid. However, in response to a second argument that the rent was in excess of fair market value, the court specifically noted that "there is no requirement that the County pay a 'reasonable rental' as such term is generally understood in legal parlance as applied to the ordinary business activity." For purposes of complying with certain governmental codes (and not with respect to private party commercial transactions), specified definitions of fair rental value could be applied.

As if this were not sufficient to end the arguments over validity, a succeeding court in County of Los Angeles v. Nesvig indicated that while the municipality as a lessee might incur liability in a lease following default, effectively precluding the municipality from "walking away from the lease", the lease was valid. In absence of an acceleration clause in the event of default and due to a continued bankruptcy/credit risk to the lessor, the rentals were sufficiently contingent to satisfy the constitutional requirements. Again, the focus was on the character of the fixed annual rental obligation, not on whether the lessee effectively committed itself to a long-term payment obligation.

... in absence of any provision which would accelerate payment of debt on default, the obligation of the County remains the same, viz., to pay certain fixed annual rentals whether the bidder [lessor] reenters or not.

This analysis was further mirrored in a subsequent case, Ruane v. City of San Diego, in which the City agreed to a front-loaded rental structure, with approximately 25 percent of the total rental paid at execution of the lease (and not after accrual of any rental period). Refusing to be drawn into an analysis of advance rent and fair rental value, and whether the lump sum payment was in reality a disguised equity downpayment, the court merely looked at the future rental obligation. Because the future rentals were "not payable until the due date" and no liability arose until then, the lease was valid.
Starr v. City and County of San Francisco\textsuperscript{11} probably sums up most succinctly how courts now view what that court termed as the Offner-Dean rule. Provided that "each installment (rental payment) will be supported by consideration furnished that year, i.e., the occupancy and use of the project", the lease will be valid. As the court specifically stated, "this is the essence of the Offner-Dean rule."

To summarize, if the rental obligation is conditioned upon use of the property and the rent relates to the period in which the consideration is provided, the abatement clause and lease will be upheld.

**Appropriation Leases**

With the exception of Ruane, all the cases involved the lease or real estate of facilities. While most tax-exempt real estate and equipment leases in California incorporate abatement language, the courts do not preclude use of other language such as non-appropriation clauses, to avoid the debt limitation. Rather, Offner and Dean and their progeny involved leases where the contingency to payment of rent was "occupancy or use" of the asset. In fact, Offner relied upon an earlier case, McBean v. City of Fresno\textsuperscript{12} involving the contingency exception, where the court upheld a multi-year contract for services on the theory that payment was contingent on performance of the services and, therefore, no future obligation was incurred. Since payment for future periods in non-appropriation leases is also contingent upon performance by both the lessor and lessee (including appropriation of funds), the concept espoused in McBean should apply. Furthermore, since the non-appropriation clause makes the rentals contingent on a year-to-year basis, it may be difficult to demonstrate a multi-year obligation has been created, but the question has yet to be addressed formally.

In conclusion, leases will generally not be considered debt if rentals can be terminated through:

--abatement language (a condition subsequent -- loss of use or quiet enjoyment) or

--non-appropriation language (failure to appropriate sufficient funds).

However, certain important distinctions exist in California between the two types of leases. In a non-appropriations lease, the lessee can terminate lease obligations for future fiscal periods, typically on an annual basis. Conceptually the lease is, in essence, a series of multiple consecutive one-year contracts. On the other hand, in an abatement lease, the lessee may contract for a multi-year period with a covenant to fund annually, provided that (i) rentals can be abated for loss of use, (ii) the lease term is shorter than the asset's useful life, (iii) payments are made from any legally available funds, and (iv) the lessor cannot accelerate rents, but must sue annually for rentals due in that fiscal year. Since abatement
leases can be for multi-year terms and contain default provisions respecting future payments, they are perceived as a stronger document, particularly if rental interruption insurance is obtained to protect against abatement events. Accordingly, they are utilized for larger, longer-term transactions, especially where real property is financed.

**Non-"Constitutional" Lease Characterization**

Paradoxically, although municipal leases are not debt under the constitution, they are neither a current expense liability for other purposes. For example, tax-exempt leases are treated as long-term debt under the accounting guidelines for capital leases. Similarly, for school districts in California, a portion of the lease payments are included as debt service in calculating bonded indebtedness limits. Moody's Investors Services and Standard & Poor's Corporation, among other financial and credit rating agencies, also treat the leases as long-term obligations, whether or not they contain abatement or non-appropriation clauses, and include them in calculating debt ratios.

Similarly, for federal tax purposes, the Internal Revenue Service characterizes such leases (assuming nominal purchase options) as conditional sales arrangements. As a result, the lessee is treated as acquiring the asset at lease inception, with rental payments constituting principal and interest much like a loan, regardless of whether the lessee obtains formal title at lease inception or following completion of payments.

Local commercial law also is in accord. Article 9 of the Uniform Commercial Code as in effect in most states, respecting personal property secured transactions, defines a secured transaction (as opposed to a lease) to include circumstances where the lessee, for nominal or no consideration, becomes owner of the property. Since a municipal lease must be a conditional sales agreement to be tax-exempt (and generally contains a nominal purchase option), tax-exempt leases should be within the definition of a financing arrangement. New Article 2A of the Uniform Commercial Code specifically dealing with leases further mirrors this analysis. Where a transaction disguised as a lease is in reality a sale or a security arrangement, it is governed by existing law under Article 2 for sales or Article 9 for security interests, and not under Article 2A.

Although one might argue that a lease cannot be a long-term obligation or "conditional" sale arrangement for certain purposes, but constitute an operating agreement for other requirements, it is this very inconsistency in characterization among municipal bond law, federal tax law, secured transaction law, and financial accounting guidelines that makes the tax-exempt lease structure work. Were it not for the non-appropriation or abatement clauses, most tax-exempt leases for a term exceeding one year would likely constitute debt and require legislative and voter approval. However, if these leases are not treated as conditional sales contracts for federal tax purposes, tax-exempt interest would be unavailable. Consequently, the lease
document has to be carefully drafted -- to satisfy potentially conflicting, but overlapping, rules of the bond, tax and accounting communities.

2. 19 Cal.2d 483 (1942) and 35 Cal.2d 444 (1950), respectively.

3. A strong lone dissent dealt heavily on the lack of a real purchase option at expiration (as well as the triple net nature of the lease and the requirement of the lessee to repair the buildings in event of destruction) as indicative of the contract being a subterfuge for debt, but this was ignored by the majority.

4. 36 Cal.2d 694 (1951).

5. 36 Cal.2d at 696.


9. 231 Cal.App.2d at 611.


12. 112 Cal. 159 (1896).

13. See also Section 1-201(37) of the Uniform Commercial Code. The UCC is discussed in Chapter Three under "State Law Considerations."

14. Article 2A has been enacted in only a handful of states, including California, where it became effective on January 1, 1990. It is codified as Section 10101 et seq. of the California Commercial Code.

CHAPTER THREE

Federal and State Legislative and Regulatory Issues
CHAPTER THREE

FEDERAL AND STATE LEGISLATIVE AND REGULATORY INFLUENCES

This chapter summarizes major tax legislation affecting tax-exempt leases, including recent modifications to the arbitrage rebate rules. It also discusses promulgations of the Securities and Exchange Commission on municipal disclosure and summarizes federal bankruptcy law as applicable to tax-exempt leases and lessees.

Following the federal discussion is an analysis of state law considerations respecting tax-exempt leases, principally authorization to lease, the Uniform Commercial Code, procurement concerns, and usury considerations.

FEDERAL LAW CONSIDERATIONS

Taxes

Although tax-exempt leases are not considered debt for state law purposes, to be exempt for federal income tax purposes, they must be treated as conditional sale arrangements, akin to installment-type debt, under the Internal Revenue Code.¹

Revenue Ruling 55-540² provides tests for determining conditional sale versus lease treatment. Satisfaction of the tests is generally sufficient for conditional sale treatment.³ These include:

- A portion of the rentals is specifically designated as interest.
- The lessee acquires title following payment of all rent, or of the specified rentals plus a purchase amount that is nominal or below market value at that time.
- Prior to expiration of the lease term, the lessee has the option to acquire title following payment of a purchase option price approximating the unamortized principal plus accrued and unpaid rent.

Assuming satisfaction with the tests, the lessee is treated as owner of the asset being financed.

As conditional sale obligations under the Internal Revenue Code, tax-exempt leases receive the same benefits as other governmental obligations, including the tax exemption for interest, provided the requirements of Sections 103 and 141-149 of the Internal Revenue Code are met.
Tax-Exempt Interest Requirements - The Issuer

Under Section 103 interest on any state or local bond which meets certain criteria (for arbitrage, private activity bonds and registration) is exempt from taxation. A state or local bond is defined as an obligation of a state or any subdivision thereof. Under the regulations, a "subdivision" may include any municipal corporation or governmental unit delegated the right to exercise substantial amounts of one of three sovereign powers -- the power to tax, the power of eminent domain or the general police power. It is not necessary that the subdivision exercise or be delegated all these powers as long as it has the ability to exercise substantial amounts of at least one of the powers.

Subdivisions also include authorities, commissions, special purpose districts and entities operating "on behalf of" a state or political subdivision (regional governmental agencies, state university systems, or state community college systems). Certain quasi-governmental bodies or agencies acting under or pursuant to state statute, or even non-profit corporations, organized on behalf of a governmental entity, to issue tax-exempt obligations to finance property, also may qualify as subdivisions.

Even if the lease is structured as a conditional sale and the lessee is qualified to issue tax-exempt securities, the obligation must still satisfy the private activity, arbitrage and reporting rules in the Internal Revenue Code. Since the penalties for non-compliance may be severe, it is important that lessees understand and comply with these requirements.

Private Activity Bonds

To qualify for tax exemption, a municipal lease must either be a governmental or a qualified private activity bond. Under Section 141 of the Code, all bonds of governmental entities are governmental bonds unless categorized as private activity bonds.

Private Business Tests

Private activity bonds are defined in two tests -- the private loan financing test (generally not relevant to tax-exempt leases) and the private business tests.

The private business tests in general are satisfied where more than 10 percent of the bond proceeds are used by a non-governmental person (i.e., private party, non-profit entity or even the federal government) and more than 10 percent of the principal and interest payments are derived from or secured by that person's trade or business. The percentages are reduced to 5 percent if the person's usage is unrelated to the government's use of the asset.
By way of illustration, a lease of a courthouse by a county government is not a private activity bond if the entire structure is used for governmental services, even if the facility is available for any community group to use in the off-hours. In contrast, if more than 10 percent of the courthouse is subleased or dedicated to a non-governmental person for a use related to the county's judicial functions (e.g., a privately run cafeteria for county court staff) and rental payments by the lessee are linked to the cafeteria's "sublease" payments or secured by the cafeteria's assets, the lease will be a private activity bond. Where the private use is unrelated (private attorneys or stenographers lease offices in the courthouse), the allowable percentage will be reduced to 5 percent. Private management contracts (for example, a privately managed county detention center in the courthouse) are also taken into consideration in these computations, unless they satisfy certain criteria.

If possible, a lease should avoid satisfying the private business test and qualifying as a private activity bond. Besides having to meet additional criteria noted below, the lease will also then be subject to the alternative minimum tax, which may result in an interest rate increase to the lessee. Therefore, proper structuring of payments and monitoring of use by the lessee is essential.

**Qualified Private Activity Bonds**

To receive tax-exempt status, private activity bonds must satisfy additional restrictions as "qualified private activity bonds."

Under Section 141(e), they are limited to certain categories, including:

- exempt facility bonds;
- airports; docks and wharfs; mass commuting facilities;
- qualified residential rental projects;
- electric or gas generation facilities; heating and cooling facilities; water projects; sewage facilities; solid waste disposal facilities;
- qualified hazardous waste disposal facilities;
- 01(c)(3) hospital facilities;
- qualified small issue bonds;
- qualified redevelopment agency bonds;
- qualified 501(c)(3) bonds.

Besides having to fall within specific project categories, private activity bonds also must comply with additional limitations to
be tax-exempt (unless specifically excepted from these limitations). These are:

(a) Compliance with state volume limitations. This is an annual statewide ceiling limiting the volume of private activity bonds (with certain exclusions). The cap is set at the greater of $150 million or $50 per capita for each state. 501(c)(3) and certain exempt facility bonds are not included in the cap.

(b) Allocation of proceeds to the permitted purposes. Generally, at least 95 percent of proceeds (net of reasonable reserve funds) must be allocated to the permitted purpose. Of the 5 percent remaining, costs of issuance may not exceed 2 percent.

(c) Limitation on maturity. With certain exceptions, the average weighted maturity of the bond or lease cannot exceed 120 percent of the asset's anticipated useful life.

(d) Public hearing requirements. Public hearing, notice and approval requirements are mandated.

(e) Land limitations. With certain exceptions, land acquisition may not exceed approximately 25 percent of the proceeds.

(f) Facility limitations. In general, existing facilities and other used property may not be financed unless the property is to be substantially rehabilitated.

(g) Prohibited facilities. Proceeds may not be used to acquire a gambling facility, health club, stadium box, airplane or package liquor store.

(h) Office space. In general, office space may not be financed unless the office space is located on the same premises as the facility being financed and is directly related to the daily operations of such facility.

Arbitrage and Rebate Requirements

Additional requirements concern arbitrage and rebate. In the 1980's, Congress enacted strict limitations on arbitrage earnings available to issuers and lessees on all tax-exempt obligations due to abuses and over-borrowings by issuers. Only in narrowly defined circumstances may issuers invest proceeds at a "yield" in excess of the bond's tax-exempt rate, and all arbitrage earnings must be rebated to the United States government, unless subject to an exemption from rebate under the Internal Revenue Code.

The arbitrage provisions consist principally of (a) limitations on investment yield, (b) reserve fund sizing restrictions and (c) the rebate requirements.
Investment Yield and Reserve Fund Sizing

The investment yield provisions generally restrict investment of proceeds to the approximate yield (e.g., interest rate) on the issue, with certain exceptions for temporary short periods, reserve funds and a "minor portion" of an issue. The reserve fund rules restrict the amount of the reserve fund from proceeds to the lesser of (i) 10 percent of the total issue, (ii) an amount equivalent to the maximum annual debt service, or (iii) 125 percent of the average annual debt service.

Rebate

The requirements in Section 148 mandate rebate of arbitrage from yields materially higher than the interest rate of the tax-exempt obligations, with certain exceptions. Relevant exceptions include:

- bona fide debt service funds earning under $100,000 annually;
- arbitrage earned during a period not exceeding six months (generally for advance funded transactions), subject to expenditure of all, or in certain instances, substantially all, of the proceeds within that period;
- for certain longer construction period projects, a new two-year phased arbitrage limitation (discussed below);
- obligations of "small issuers" (excluding private activity bonds); and
- investment of proceeds in certain other tax-exempt obligations.

The arbitrage provisions have influenced how leases are documented. Arbitrage certificates are now routinely requested of lessees in COP transactions and some larger private placements. In addition, lessees claiming to be small issuers are required to represent, in a formal resolution or by confirmation, that they qualify for the small issuer rebate exception.

Two-Year Construction Period Rebate Relief

Congress liberalized the rebate requirements in 1989 for certain construction projects. Rebate relief is now provided to projects with construction periods of up to two years, as opposed to the prior more restrictive six-month relief provision. In general, for real property leases that are advance funded or have reserve funds, issuers may receive positive arbitrage on such funds for a period of up to two years, without rebate to the federal government. However, the new provision requires that 10 percent of the defined "net proceeds" be spent within six months of issuance, 45 percent within the first year, 75 percent within eighteen months and the balance within two years. The provision is also limited to construction expenditures (and
earnings on reserve funds during the two-year period) and to the leases with governmental and 501(c)(3) issuers. Large construction projects with longer construction periods, as well as equipment acquisitions, are ineligible. Consequently, the benefits of this provision may be limited to smaller projects with shorter construction terms, such as schools, recreation centers, etc.

As the above summary implies, the post-1986 rules on private activity bonds, arbitrage and rebate are very complex and, to an extent, may be a "trap for the unwary." Compliance costs may also be significant, especially for small transactions involving less sophisticated issuers. To avoid these costs and complications, lessees may wish to "keep it simple" and concentrate on purely governmental-use projects within the permissible arbitrage period exceptions.

**Filing Requirements and Registered Format**

**Filing Requirements**

The 1986 Tax Reform Act imposed mandatory reporting requirements on issuers of all tax-exempt obligations, regardless of their qualification for other exemptions.

Issuers (including lessees) of tax-exempt obligations are required to file reports with the Internal Revenue Service that contain information on the issuer/lessee, the asset financed, proof of compliance with the volume cap (if applicable), and yield and maturity information. These are provided for governmental bonds on IRS forms 8038-G and 8038-GC and for tax-exempt private activity bonds on form 8038.

Form 8038-G for leases of at least $100,000 must be filed within 45 days of the calendar quarter in which "the issue is issued." Form 8038-GC, which aggregates all smaller transactions, is due on or before February 15 of the calendar year after the "issue is issued." Both forms specifically include tax-exempt leases in their scope. Such leases are treated as issued on the date interest begins to accrue for federal tax purposes.

Form 8038 is applicable to any obligation that qualifies as a tax-exempt private activity bond, including tax-exempt leases, and also must be filed within 45 days of the calendar quarter of the "issue date."

Issuers subject to rebate under the arbitrage provisions must also file form 8038-T when paying the rebate. This form is due "60 days after the end of every fifth bond year during the term of the issue," with a final report due "60 days after the date the last bond of the issue is discharged."

Failure of the issuer to execute and file these reports results in an otherwise tax-exempt obligation becoming taxable, although the
Internal Revenue Service excuses late filing under certain circumstances. The Internal Revenue Code places reporting and filing responsibilities on the issuer/lessee, even if the issuer relies on its advisors for the actual information and filing.

**Registered Format**

Tax-exempt leases must also be in registered form. This can be effected through a simple stipulation that transfer occurs only through a surrender of an old instrument to, and reissuance by, the issuer (or its agent), or may be achieved through a qualified book entry system maintained by the issuer (or its agent), or by a combination of both. Information on book entry systems is generally available from the underwriter or Depository Trust Company of New York, which maintains a large book entry system.

**Investor Issues - Bank Qualification; De-Minimus Rule; Alternative Minimum Tax**

**Bank Qualification**

The 1986 Tax Reform Act restricted the investment appeal of tax-exempt obligations to commercial banks by denying them a deduction for a portion of their carrying cost for most tax-exempt bonds and leases. Formerly, banks could deduct 80 percent of the interest cost on funds used to acquire or "carry" tax-exempt obligations. The new provisions permit a deduction only on funds borrowed to invest in properly designated obligations of certain governmental units that borrow no more than $10 million in a calendar year. Such bonds or leases are referred to as "bank qualified." Commercial banks may invest in non-bank qualified leases, but the loss of the interest deduction usually requires additional compensation through a higher interest rate for non-bank qualified leases.

The practical impact of this provision has been to restrict bank investment to either the smaller issuers with more limited tax-exempt financing requirements or to larger issuers who do not issue more than $10 million of tax-exempt obligations in the calendar year. However, a more serious problem for those banks that continue to acquire tax-exempt obligations is the impact of the alternative minimum tax (discussed below) on their portfolios. The cumulative effect of both rules has been to decrease investment by banks in these obligations.

**De-Minimus Rule**

A variation of the "bank qualified" rule denies a deduction to other investors for interest expense on debt "incurred or continued" for the purpose of purchasing or acquiring a tax-exempt obligation. Under a longstanding safe harbor rule, the Internal Revenue Service will generally "presume" that debt was not incurred to acquire or retain tax-exempt obligations if the average value of the taxpayer's tax-exempt holdings during a taxable year does not exceed 2 percent of
the average "adjusted basis" of the person's portfolio (for an individual) and 2 percent of the average total active business assets (for a corporation). This safe harbor rule is referred to as the "de-minimus rule."

Where a corporation (e.g., captive credit corporation) receives a tax-exempt obligation in payment for goods and services (such as occurs in a vendor lease) and does not satisfy the 2% rule, the Internal Revenue Service now requires that the tax-exempt obligation be "non-salable" (not able to be sold) or non-transferable, not just "non-negotiable," to avoid denial of the interest deduction. This standard is difficult to satisfy, and may increase the business costs of vendors and their lessors, not within the safe harbor, by denying interest deductions on carrying costs of the tax-exempt leases. A corresponding increase in the bid prices of such vendors and lessors may be a consequence.

Alternative Minimum Tax

The 1986 Act also affects investors subject to the alternative minimum tax (AMT). Under the AMT, taxpayers who reduce their regular tax liability significantly through preferentially treated income (called preferences) must recalculate their tax liability by adding back certain preferences into income. As a result of the 1986 Act, for the first time, both individuals and corporations are subject to the AMT on tax-exempt obligations.

For individuals, this applies only to tax-exempt income received on private activity bonds. This amount is treated as a tax preference item, potentially increasing an individual's tax liability if the individual becomes subject to the 21 percent AMT (and, in essence, imposing a tax for the first time on otherwise tax-exempt income).

Of more importance in the municipal leasing arena is the impact of AMT on corporations, including financial institutions and insurance companies. Traditionally the prime investors in tax-exempt obligations, they now are potentially subject to a minimum tax on income from all types of tax-exempt obligations held (not only private activity bonds), even if they would otherwise not owe any corporate taxes in that year. This is due to a corporate tax preference created by treating as income (for alternative tax purposes) a percentage of the difference between book income and tax return income, due to tax-exempt interest. This may reduce the attractiveness of tax-exempt obligations, including tax-exempt leases, to major categories of investors subject to corporate AMT -- and effectively raise the yield thresholds these investors require.

SECURITIES CONSIDERATIONS

The two principal federal laws governing securities are the Securities Act of 1933 (the "1933 Act") and the Securities and Exchange Act of 1934 (the "1934 Act"). The threshold question is
whether a tax-exempt lease constitutes a security under those Acts as well as for Securities and Exchange Commission ("SEC") regulatory purposes. For 1933 Act purposes, this issue is far from resolved for the lease itself.\textsuperscript{16} However, SEC staff and the municipal finance industry generally view certificates of participation as a security.

**Governmental Security Exemption**

Under the 1933 Act, securities, including certificates of participation (and, as applicable, tax-exempt leases), must be registered prior to sale unless they are exempt from registration. Section 3(a)(2) provides an exemption from registration for governmental securities, which are defined to include:

\[
\ldots\text{any security issued or guaranteed by the United States or any Territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories.}\]

The exemption in general applies whether or not the governmental security is treated as tax-exempt under the Internal Revenue Code.\textsuperscript{17} The exemption covers the security, including both the initial offer and sale, assignments to investors pursuant to certificates of participation, and any trading in the secondary market.

According to the SEC staff, the governmental security exemption is applicable to certificates of participation provided that the lessee (i) is the "primary source" for rental payments and other sums due under the lease, (ii) the lease is triple net, with all costs of maintenance, taxes and insurance paid by the lessee, and (iii) the lessee authorizes assignment of the lease by the lessor in the event the lessor's interest is sold through certificates of participation.\textsuperscript{18} For these purposes, it should also be noted that although a trustee or lessor may execute and deliver the certificates of participation, the lessee is considered as the issuer of the certificates.

A second exemption from registration for tax-exempt leases is available under Section 4(2) of the 1933 Act in cases of private sales of securities. This exemption, however, is applicable only to the specific offer and sale and does not extend to subsequent transfers (which must have their own exemption or face registration) or to the security in general. Under the safe harbor in SEC Regulation D for the 1933 Act, private placements may be made to no more than 35 investors, in addition to investors treated in the regulation as "accredited."\textsuperscript{19} Other conditions also apply, including differing disclosure requirements for specific sizes of the private placement contemplated.

Exemption from registration does not imply that disclosure is not required. Particularly with adoption of Rule 15c2-12 by the SEC under the 1934 Act (discussed below), underwriters must prepare adequate disclosure material in selling municipal securities. The guidelines
for the necessary information arise from industry (as opposed to SEC) standards.\textsuperscript{20} For certificates of participation (and, as applicable, tax-exempt leases), for example, these are set forth in disclosure lists assembled by the National Federation of Municipal Analysts. These now serve as checklists for bond and underwriter's counsel in preparing the disclosure documentation that the underwriting and investment communities have come to expect.

Notwithstanding possible exemptions under the 1933 Act, the certificates (and, as applicable, the lease) must also satisfy the 1934 Act, which, in general, addresses how securities are distributed. Section 10(b) of the 1934 Act (and the anti-fraud provisions of Rule 10b-5 promulgated under it) applies to municipal securities and the parties offering and selling them. Rule 10b-5 prohibits any issuer, underwriter or person purchasing or selling a security from making any false or misleading material statement, or omitting any material facts which make the statement misleading, in the offering or sale of a security (including all disclosure materials, such as the official statements). It applies to municipal securities, whether publicly offered or privately placed.

Remedies are also available under "blue sky laws", federal and state case law and common law rules. In addition, the sale of certificates must satisfy regulations of the Municipal Securities Rulemaking Board ("MSRB"), which are approved by the SEC and enforced by the National Association of Securities Dealers (NASD), although remedies under MSRB provisions are generally not available to investors.

State securities laws (commonly termed "blue sky laws")\textsuperscript{21} may affect the certificates of participation and tax-exempt leases. The certificates of participation (and, as applicable, the tax-exempt lease) will require their own specific exemption from registration under these laws, as well as compliance with state anti-fraud rules.

**Rule 15c2-12**

Rule 15c2-12, adopted by the SEC in June 1989, was promulgated partly due to concerns arising from the defaults of Washington Public Power Supply System and other issuers. The perception of the SEC of the increasing frequency and dollar volume of defaulted tax-exempt issues, created momentum for mandating greater due diligence in the issuance of municipal securities. It also precipitated tighter regulation of disclosure documents and information required by the industry trade groups. Following lengthy review, the SEC took its first steps in this area, by exercising formal rulemaking authority under the 1934 Act, in imposing formal disclosure procedures in the offer and sale of municipal securities.

Basically, the rule specifies how and when a participating underwriter must review and complete due diligence "in a professional manner" on a "close to final" official statement and how distribution of preliminary and final official statements must be effected to
customers and potential customers. Although specifically directed at underwriters, it will place additional burdens on all parties to the transaction and increase the underwriter's responsibility in assuring complete and accurate disclosure.\textsuperscript{22}

The provisions of Rule 15c2-12 apply to all municipal securities, including certificates of participation and lease revenue bonds (as well as tax-exempt leases to the extent they are securities under the 1934 Act). However, the rule covers only initial offerings of municipal securities and at this time does not extend to the secondary market. Issues of $1,000,000 or less in aggregate principal amount are excluded from its scope, which will diminish significantly the burdens on lessors and lessees in smaller certificate of participation transactions and tax-exempt leases. A "quasi-private placement" exemption from the rule is also available for primary offerings in authorized denominations of $100,000 or more, provided such offerings (i) are sold to no more than 35 persons who the underwriter reasonably believes are sophisticated investors and are purchasing for their own account, or (ii) have a maturity of nine months or less, or (iii) may be tendered at the investor's option to the issuer for redemption at least every nine months.

Consequently, the primary impact of the rule is on larger publicly sold COP transactions, where the SEC perceived a need for more formalized due diligence to protect individual investors. This need is less compelling for institutional private placements, where the market may have the capability to evaluate investment risks independently.

**Bankruptcy**

An additional federal law affecting the tax-exempt lease, and the rights of the lessor, investor and lessee, is chapter 9 of the federal bankruptcy code, which governs bankruptcy by municipalities and other local governmental agencies.

Chapter 9\textsuperscript{23} provides relief from financial distress to a "municipality", which is defined as a "political subdivision or public agency or instrumentality of a State". A chapter 9 case may be commenced only by the municipality; a creditor may not commence an involuntary case against the municipality. Relief under chapter 9 is an adjustment of debts pursuant to a plan, not a liquidation of assets. As a bankruptcy proceeding, it is subject to bankruptcy codes, rules and law.

Since tax-exempt municipal leases are financing transactions and not "true" leases, for bankruptcy purposes the lessee is treated as a conditional purchaser and the lessor is characterized as the lender and/or the seller, with the "leased" property (and any related assets) being the collateral which secures the payment obligation. If non-bankruptcy law requirements governing a transaction have been properly fulfilled (for example, the filing of financing statements), the "lessor" is treated in the chapter 9 case as a creditor holding a
secured claim for amounts owed. Lessors who do not satisfy those non-
bankruptcy law requirements are treated as holding unsecured claims.²⁴

For the debtor/lessee, this distinction has two consequences. Holders of secured claims, under certain circumstances, may be
entitled to, and the debtor will be required to provide, "adequate
protection"²⁵ that the value of the creditor's collateral will not
decline during the bankruptcy. These protections may consist, in
part, of cash payments to the secured claim holder, or replacement or
supplementation of any lien held. This right is not provided to
unsecured claim holders. Unless otherwise agreed, the secured claim
holders also are entitled to receive the full present value of their
claim as part of the adjustment of debt. This requirement does not
apply to unsecured claim holders, whose rights in general are
subordinate to the rights of secured claim holders.

The filing under chapter 9 provides other specific statutory
benefits to the debtor. Filing automatically "stays" for the period
of bankruptcy any actions by any party against the debtor or its
property, such as the right to repossess the asset. The debtor is
also relieved of accrual of interest on its obligations during the
bankruptcy as well as the need to pay any obligations incurred prior
to the filing, pending the chapter 9 adjustment of debt.

For lessors and investors, a lessee's filing of bankruptcy under
chapter 9 poses certain obstacles to exercise of their rights and
remedies. Besides loss of accrual of interest during the bankruptcy
case, payment of the obligation may be delayed notwithstanding
"adequate protection" from the debtor. Secured creditors seeking
return of an asset also must first obtain relief from the automatic
stay. Such relief generally may be granted for cause or when the
debtor has no equity in the property and cannot demonstrate that the
property is necessary for an effective reorganization. In the context
of a chapter 9 case, such tests may be difficult to satisfy for a tax-
exempt lease, particularly given the lessee's prior representations of
"essential use" and the equity obtained by the lessee through any
principal payments prior to bankruptcy. Absent such relief, the
secured party remains the holder of a "secured claim" for the
principal, other sums due and pre-petition interest.

The outcome of a chapter 9 proceeding is the adjustment of debts
of the lessee.²⁶ In general, this requires the debtor to fulfill its
obligations pursuant to a negotiated schedule. This is intended to
provide creditors with maximum realization of the value of their
claims. However, valuation is subjective and the parties may differ
in their views of full value, given differing calculations of the time
value of money. Provided the debtor demonstrates in good faith that
it is accomplishing its utmost to satisfy its obligations, it will
have some discretion in determining how it adjusts its debts.

Bankruptcy plans are the subject of extensive negotiation by the
debtor with its claim holders. Provided the debtor meets the
statutory criteria of chapter 9, the debt adjustment plan may be
confirmed (and the debtor discharged from bankruptcy), despite opposition of certain claim holders.

With respect to the lease documentation, the filing of a bankruptcy petition renders unenforceable any ipso facto clause. (This is a clause which terminates or modifies the debtor's rights and responsibilities solely because of a bankruptcy filing or the debtor's financial condition.) Possible alternatives are discussed in "Events of Default" in Chapter Four.

STATE AND LOCAL LAW INFLUENCES

This section considers the application of certain state and local laws affecting tax-exempt leases, including issues of authority, secured property filing requirements under the Uniform Commercial Code, and questions respecting limitations on interest rates. State law restrictions on the incurrence of debt (and whether tax-exempt leases are subject to such restrictions) are discussed in the review of the legal bases for tax-exempt leases in Chapter Two.

Local Law Authority

Apart from constitutional restrictions which may be applicable to tax-exempt leases in a given jurisdiction, a lessee generally must have specific statutory authority to enter into lease or lease-purchase arrangements. However, if the lessee is a subdivision or entity operating under the aegis of a legally constituted body, it may be delegated authority from such body to enter into the lease.

The question of authority is important because, almost without exception, an opinion of counsel (either lessee's counsel or bond counsel) will be required by the lessor or investors to confirm that the lease has been duly authorized and is an enforceable obligation against the lessee.

The state law permutations are myriad, and it is outside the scope of this report to discuss the characteristics respecting each state and issuer. However, in general, the law governing the particular jurisdiction, whether state statutes or "home rule"-type charters, may provide authority to the jurisdiction to lease (or if specifically enumerated, to lease purchase). This is usually found in the general powers of the jurisdiction to acquire or own property, although it may be implied from a government's general powers to acquire property, to own assets, to procure goods and services, to enter into contracts, to engage in financings or to incur obligations or consummate contracts.27

Although specifically enumerated powers to lease purchase may be preferable to more general clauses, the lack of specificity does not appear to have impeded the tax-exempt leasing vehicle in the various states. However, reliance on implied powers or inferences from such
powers may permit a retroactive attack based upon a lack of explicit statutory authority, as has occurred on several occasions.  

**General vs. Specific Lease-Purchase Authority in California**

With one exception respecting "public leasebacks . . . [for] any city, county, charter city, district, public corporation or political subdivision of the state," no state omnibus statute exists to authorize tax-exempt leases in California. Rather, the authorization for state agencies and local jurisdictions to enter into leases or into contracts is distributed among the respective codes, generally in the provisions governing the formation of, and exercise of powers by, the specific district or entity that will act as lessee.

For example, Government Code Section 37350 permits cities to "purchase, lease, receive and hold" real and personal property, while counties are provided similar powers under Government Code Sections 23004 and 25351. Charter cities, such as San Francisco, generally have provisions set forth in their charters which permit the leasing of property. For San Francisco, Section 1.01 of its charter permits the City and County to "sell, lease and convey real and personal property." Los Angeles utilizes general provisions for "acquisition" or purchase of property and the making of contracts as set forth in Article 2(7) and 2(11)(k) and (l) of its charter. For San Diego, the authority is located in Article 1, Section 1 of its charter respecting the general power to own, lease and acquire property. Although California law requires city charters to define strictly a city's powers, many city charters have not followed this rule, and contain more permissive language. However, at least in the case of San Francisco, the charter restricts certain types of lease transactions by requiring prior voter approval.

School districts are provided both general and specific lease-purchase authority under the California Education Code. California Education Code Sections 39300-39325 and 39330-39333 afford broad powers to school districts specifically to enter as a lessee into a lease (and more precisely, lease-purchase) agreement for vehicles, buses, educational materials and other approved items as well as school buildings and facilities. Indeed, the Education Code provisions have specifically been drafted with the tax-exempt lease vehicle in mind, instead of a more general authority to lease or buy property granted in the other codes. Analogous provisions exist for community college districts (California Education Code Sections 81330-81351, 81520-81532 and 81550-81552).

Other general leasing powers include the authority to purchase or lease real or personal property for the University of California (Education Code 92431) and to purchase or lease real or personal property for redevelopment agencies (Health & Safety Code Section 33391), for irrigation districts (Water Code Section 24252 and 22436-7) and for hospital districts (Health & Safety Code Section 32121).
Regardless of whether authority is based upon a general power or a specific power to lease (or even lease purchase), it is also important to review any restrictions or administrative guidelines that may impact authorization or implementation of the lease. For instance, as noted above, leases by the City and County of San Francisco with a joint powers authority, a nonprofit corporation, the Redevelopment Agency, the Housing Authority or the Parking Authority require voter approval. In addition, statutes may limit specific provisions of the lease. Education Code Section 39332 limits the term of lease-purchase agreements for equipment to the lesser of the estimated useful life or ten years, while under Education Code Section 39303, leases of buildings may not exceed 40 years.

Restrictions may also be imposed by common law or judicial doctrines, under "public purpose" or other criteria. In one case, when an irrigation district leased an airstrip to an individual for $1 per year, after the district and the federal government had funded substantial development costs, the court ruled the arrangement was devoid of a proper public purpose and, therefore, in excess of authority. Although this doctrine was applied in the case of a government acting as a lessor, it is not specifically restricted to such instances.

**Procurement Issues**

Besides authority, lessees must also comply with procurement regulations and policies. These are unique to each jurisdiction. Issues include whether competitive (as opposed to negotiated) bids are required, whether sole source is an appropriate alternative, whether assets and financing should be acquired independently or jointly, and the number of responses necessary for a competitive bid.

Depending upon the jurisdiction, the lessor may be required to work either with the purchasing or procurement agencies, the finance department or treasurer's office (or perhaps a combination of both). For example, leases for the City and County of San Francisco are handled as a purchasing item and are bid either separately or bundled with bids for assets. The State of California also handles leases through its procurement office, but due to internal state procurement preferences for set-off rights and indemnification respecting performance, generally acquires assets and financing as part of a joint bid. The University of California arranges leases under $10 million in the purchasing department, whereas larger leases are the domain of the University treasurer's office.

Administrative inconsistencies and inefficiencies may result when different offices handle different size transactions. Where assets and financing are acquired through one procurement, the lessee may also pay a higher interest rate than if the procurements were separated to require the lowest bid on the respective cost and financing components.
Furthermore, such bundled bids may lead to arguments of discrimination on grounds of restricting eligible lessors to vendors' captive credit corporations or to lessors having "tie-ins" with vendors. At least one court has found a similar type of procurement practice offensive and, based upon these and economic concerns, that state has issued an advisory requiring bifurcation of all financed acquisitions into separate bids.

**Uniform Commercial Code**

Regardless of whether title passes to the lessee initially or at expiration of the lease, the Uniform Commercial Code governs whether a security arrangement has been created and the methods for perfecting the lessor's and investor's interest. The Uniform Commercial Code in general governs the creation and perfection of a security interest in the lease, any personal property or fixtures (but not realty) financed and related payment receivables. It is codified in California in the Commercial Code, particularly Article 9 (California Commercial Code Sections 9101 et seq.)

**Security Interest**

Section 1-201(37) of the Uniform Commercial Code (U.C.C.) in most states contains the statutory test for determining whether a lease constitutes a security interest under Article 9 of the Uniform Commercial Code. Of particular relevance to tax-exempt leases is the treatment in the definition of a lease with a nominal purchase option.

Whether a lease is intended as security is to be determined by the facts of each case; however, (a) inclusion of an option to purchase does not of itself make the lease one intended for security and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for nominal consideration does make the lease one intended for security. (emphasis supplied)

Whether or not the lessee obtains title initially or at the end of the lease, a tax-exempt lease should qualify as a secured transaction under provision (b) due to the "no or nominal" buyout present in the lease.

However, in those states (including California) that have enacted Article 2A of the Uniform Commercial Code, the analysis may be more difficult when title transfers at the end of the lease. In these states, application of the buyout provision requires satisfaction of two tests. As applied to tax-exempt leases, the tests require first, that there be a nominal or no-cost purchase option, and second, that the rental obligation of the lessee be an "obligation for the term of the lease not subject to termination by the lessee." The second test may require analysis of the lease documentation package, particularly for multi-year leases with non-appropriation or similar clauses. However, the parties should be able to present evidence from the essential use letter and good faith covenants respecting funding that
the lessee's "intent" and "economic expectation" is not to terminate payment of rent, notwithstanding a "non-appropriation" contingency.\textsuperscript{34}

The rent test was specifically enacted to correct the potential effect of case law from the bankruptcy area.\textsuperscript{35} Its impact on tax-exempt leases is likely unintended,\textsuperscript{36} particularly given the tax and accounting treatment of tax-exempt leases as conditional sale-type arrangements.

If the buyout provision is inapplicable, determination of whether the tax-exempt lease creates a security interest will be a function of all the facts and circumstances of the transaction. In such case, where title passes initially, a security interest should be available. In other instances, the nominal buy-out would be given significant weight,\textsuperscript{37} especially considering that the non-appropriation clause is present not for economic, but state constitutional debt, reasons.

**Article 9 Requirements**

If the lease constitutes a security arrangement, with the exception noted below, its treatment is normally governed under Article 9. To perfect the lessor's interest in the "security" (the asset, lease and rent receivable) against rights of other parties, the lessor in general must file a UCC-1 financing statement, either with the secretary of state or county recorder (or, in certain circumstances, both).

However, 1972 amendments to the Uniform Commercial Code adopted by a majority of states (including California) may have excluded municipal leases from the perfection mechanisms of Article 9. In California, for example, Section 9-104(e) excludes from Article 9 "a transfer, including creation of a security interest, by a government or governmental subdivision or agency."\textsuperscript{38} This may depend upon whether the lease is a "transfer" or "purchase" and is "by" or "to" the debtor. Moreover, the specific scope of this exception differs among the states. Massachusetts' version applies only to security interests (and not the broader term "transfer") and expressly limits it "to a government, governmental subdivision or agency to the extent that the creation, validity, enforceability, perfection or priority of such security interest is expressly governed by any other general or special law of this state." New York, utilizing almost analogous language to Massachusetts, also encompasses a "department, commission, board, authority, public benefit corporation or other governmental entity" within its scope.\textsuperscript{39}

If Article 9 does not apply, the UCC-1 financing statement potentially could be argued by a third party as not being legally effective, and the protections provided the lessor to priority against third party claims could be unavailable. While filing under such circumstances might provide notice to the third party, it may be open to attack unless the local lien laws provide that such a filing constitutes sufficient "notice" to third-party creditors.
In states that have adopted Article 2A respecting leases, use of its procedures may be available. However, Section 2A-103(j), defining a lease, excludes a lease intended as a security interest under the new definition of Section 1-207(37) noted above.\textsuperscript{40}

Article 2A (and potentially Article 9) may be voluntarily utilized by the parties to determine their rights.\textsuperscript{41} Many lessees have contractually or voluntarily elected to have Article 2A or Article 9 apply to the lease, but whether this would bind a third party creditor without notice of the lessor's interest is unclear. However, despite the ambiguity created by Section 9-104(e), most lessor's and underwriter's counsel insist on the applicable Article 9 filings being made. This may be less than a satisfactory solution, but the infrequency of municipal bankruptcies or conflicting creditor claims may diminish the urgency of any remedy at this time.

Since real property transactions are not covered by the Uniform Commercial Code, lessors of real property in tax-exempt leases must rely on mortgage, title, deed of trust and similar statutes in the jurisdiction where the property is located. In California, to the extent the lease is treated as creating a real property security interest for the lessor, akin to a deed of trust or mortgage, it would likely be subject to the limitations on judicial and private foreclosures. These include, as applicable, the one-action rule, restrictions on deficiency judgments, minimum notice requirements and, in certain cases, a right of redemption period following foreclosure.\textsuperscript{42} These provisions are very complex, and advice should be sought from counsel specializing in this area.

Usury

Usury laws and constitutional prohibitions differ among each jurisdiction. In California, they are covered by Article XV, Section 1(2) of the Constitution, which provides that the rate of interest for a non-personal loan cannot exceed the greater of (i) 10 percent per annum or (ii) 5 percent above the San Francisco Federal Reserve discount rate to member banks in effect at the earlier of execution of the contract or funding.\textsuperscript{43}

Given the favorable spread between taxable commercial rates and tax-exempt rates, usury will generally not be an issue. However, for smaller-sized transactions or less creditworthy lessees in California, where the lessor's interest rate may exceed the constitutional limit, reliance on judicial exceptions or constitutional exemptions to usury limitations may be necessary.\textsuperscript{44}

State or local statutes may provide additional restrictions on the rate of interest payable by issuers. In California, the Government Code restricts the maximum interest rate payable by "local agencies" on "bonds, warrants, notes or other evidences of indebtedness"\textsuperscript{45} to 12 percent, unless some higher rate is permitted by law.\textsuperscript{46} Government Code Section 53531.1(c) provides that the power to issue bonds at this rate is in addition to any power or limitation
made applicable to local agencies by any other law "unless the other law specifically provides otherwise."

**Business Qualification**

Almost all states require business entities to qualify to do business within the state if more than a minimal level of direct business involvement occurs, both for regulatory and state franchise tax purposes.

Failure to qualify (or in some cases to pay franchise taxes) typically will prevent a business from exercising its legal rights or defending itself in a judicial proceeding. However, this may also include, at least in California, a right extended to other parties to set aside contracts with the errant entity, even if the failure has since been remedied.47

This may impact lessors and investors. While most active lessors in California are "in good standing" as a matter of good corporate practice, more distant parties, such as a foreign trustee, escrow agent or paying agent, may not be, relying on general notions of exemption from franchise taxes or qualification based upon a lack of "contacts" for tax and regulatory purposes. To the extent it is determined that the "distant" party meets the statutory minimums, that party may find itself unknowingly subject to franchise tax and, as applicable, qualification procedures.

Failure to pay the statutory minimum franchise tax or to qualify may subsequently prevent the trustee from exercising, on behalf of the investors, rights and remedies under the tax-exempt lease, including suit for any pre-termination accrued but unpaid rent. It may even permit the lessee, at least in California, to terminate performance, on grounds the lease is "voidable" as to the trustee or escrow agent (and, therefore, as to any payment obligation, potentially unenforceable).

To avoid this, many lessors use State-chartered institutions as their trustee, or confirm corporate "good standing" sufficiently in advance to avert last-minute problems. However, lessee or bond counsel may wish to confirm the status of the other parties, particularly if an opinion as to enforceability will be required.

**Other Compliance Requirements**

Two specific additional areas affecting tax-exempt leases and certificates of participation should be noted.

Pursuant to California Government Code Section 8855(e), the California Debt Advisory Commission (CDAC), as the state's statistical center for state and local debt issues, requires that all state and local governmental issuers of public or privately sold debt file a notice of proposed sale 30 days prior to issuance, listing the issuer, underwriter, financial advisor, bond counsel, proposed size of issue,
purpose, estimated principal amount, source of repayment and other data. Following issuance, a supplemental filing listing the interest cost, maturity schedule, credit rating, gross spread, and advisor and counsel fees also must be completed.

Bond counsel generally file the requisite forms for debt issuances, including certificate of participation financings, as part of the financing documentation. For other situations, such as vendor leases and directly placed leases, compliance is less consistent, despite the fact no distinction exists among these structures for reporting purposes.

A fee not to exceed the lesser of $1,500 or one basis point (1/100 of 1 percent) of the par value of the issue sold is to be remitted to CDAC, except for transactions under $1,000,000 for which the fee is waived, and for issues with maturities of eighteen months or less for which the fee is $100. It is interesting to note that other states now require similar reporting for data collection.  

In the unlikely circumstance the lease constitutes a private activity bond, compliance with requirements of the California Debt Limit Allocation Committee is also necessary. The Committee was formed in 1986 pursuant to California Government Code Sections 8869.80-8869.93 to allocate the volume cap limitations of the Internal Revenue Code among the eligible projects of California state and local agencies, cities, charter cities and other issuers. In general, approval by the Committee is required for tax-exempt private activity bonds. Given competing demands of issuers and the increasing restrictions on these types of tax-exempt instruments, recent practice has been to seek approval as early in the year as possible.
ENDNOTES


4. Regulation (Reg.) Section 1.103-1; Estate of Alexander J. Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd. 144 F.2d 998 (2d Cir. 1944), cert. den., 323 U.S. 792 (1944).


6. See Rev. Proc. 82-26 (1982-1 C.B. 476) for the requirements for receiving confirmation of tax-exempt status by the IRS for such entities.

7. Section 141 (b)(3).
   In determining use of the facility, Congress has indicated that all facts and circumstances will apply. For applying the percentages, exclusive and special use by all nongovernmental persons is aggregated and all payments of nongovernmental persons (whether or not actually pledged or directly applied to lease payments) are considered.

8. In California, the value of qualified private activity bonds under the volume cap is estimated to have been limited to approximately $2 billion in 1987 and $1.3 billion in 1988, based upon 1986 population figures. This contrasts with the $14.6 billion of private activity bonds issued in 1985. Virginia L. Horler, Guide to Public Debt Financing in California (San Francisco, CA: Packard Press, 1987), at 38. In 1986, the California Debt Limit Allocation Committee was established to allocate the volume cap limitation among eligible projects, including lease-purchase arrangements.

9. A small issuer is defined as an entity issuing $5 million or less of tax-exempt obligations (excluding private activity bonds) in the calendar year (but including in the total any issues of subordinate entities and "on behalf of" obligors of that entity).


12. Under Rev. Proc. 72-18 (1972-1 C.B. 740), debt is presumed incurred to purchase or carry a tax-exempt obligation if (1) proceeds of the debt are used to acquire the tax-exempt obligation, (2) the tax-exempt obligation is used as collateral
for the debt, or (3) there is indirect evidence that debt was incurred to purchase the tax-exempt obligation.

13. Rev. Proc. 72-18, Sec. 3.05 (1972-1 C.B. 740, 741).


15. The 1933 Act specifies procedures for registering securities, and the 1934 Act governs the securities exchanges and trading in securities. The registration requirements of the securities laws should not be confused with the requirements of the Internal Revenue Code that the tax-exempt obligation be in registered form. This is discussed in the section on "Federal Law Considerations - Taxes" above.

16. See the discussion in A. John Vogt and Lisa A. Cole, A Guide to Municipal Leasing (Chicago, IL: Municipal Finance Officers Association, 1985), at 59 and n. 17. This may depend upon the status of the lessor and its intent and expectations in holding the lease.

17. Under certain circumstances, the exemption may not be available for certificates used to finance assets for industrial development-type purposes. Rule 131(a), defining a security for purposes of Section 3(a)(2), notes that "any part of an obligation evidenced by ... indebtedness" of an issuer in Section 3(a)(2) "payable from payments ... made in respect of property or money ... used, under a lease, sale or loan arrangement, by or for [an] industrial or commercial enterprise" is considered a separate security "issued by the lessee or obligor" requiring registration or its own exemption. (emphasis supplied) Rule 131(b) lists exclusions from this exception (and, therefore, under the governmental security exemption) for obligations payable from general revenues of the issuer (other than related to the enterprise), facilities owned and operated "on behalf of" issuers and facilities leased to private enterprise as part of a public project owned and controlled by the issuer.

18. No action letter issued on behalf of First Municipal Leasing Corporation (June 4, 1976); and no action letter issued on behalf of Smith Barney, Harris-Upham & Co., Inc. (November 11, 1976).

19. These are generally sophisticated investors with high net worths or who have an ability (such as pension funds, insurance companies, mutual funds, and large institutions) to analyze the risks associated with the securities.

20. The SEC is precluded by the Tower Act (Section 15B(d) of the 1934 Act, codified as 15 U.S.C. Section 78o-4) from requiring filing by "issuers ..., directly or indirectly through a purchaser or prospective purchaser," of official statements with the SEC as a
condition to the sale of municipal securities. This preclusion may not extend to other functions of the SEC, such as registration of municipal securities dealers and policing of the municipal securities markets (through regulation of underwriters and broker dealers). In this regard, note adoption of Rule 15c2-12 under the 1934 Act.

21. Blue sky laws govern the registration, offer and sale of securities within the individual states and are, to a degree, patterned after the federal statutes.


24. With certain exceptions, a creditor holding a secured claim in excess of the value of its collateral (or security), due-for instance-to a greater decline in value of the security than of the obligation it secures, is entitled to a secured claim for the value of its collateral, and an unsecured claim for the excess.


26. The debtor is also provided discretion in determining the proposed treatment of all claims on a class-by-class basis. In general, if the debtor's proposed treatment is to reinstate the priority of the holder of a secured claim as to other creditors, it must be accepted by such claim holder.

27. For example, in Arizona, the State Attorney General's office relies on the general power of the State to procure assets as a basis for authorization to enter into equipment lease-purchase transactions, but for real property or buildings, the director of administration is authorized specifically to "lease purchase," provided certain statutory requirements, including legislative review, are met. Arizona Revised Statutes 41-791.02.


29. Section 20670 et seq. of the California Public Contracts Code. However, note that California Government Code Sections 5700-5703, appointing the State Treasurer's office as sales agent of the State of California to offer and sell State bonds or evidences of indebtedness, specifically include "certificates of participation or interests in any rental or lease payments or purchase payments, in an aggregate principal amount exceeding $10,000,000" within their coverage. See also Virginia L. Horler, Guide to


30. Curiously, lease purchase of school sites is not included in the sections cited, and reliance for authority to lease the sites may be required under Section 35160, which states that a school district may "initiate" any activity or action "not in conflict with, inconsistent with or preempted by, any law and which is not in conflict with the purposes" of the school district. If broadly construed, this section could permit any activity, unless specifically prohibited by law, the reverse of what normally occurs in granting-type statutes.

31. Allen v. Hussey, 101 Cal. App. 2d 457, 225 P.2d 674 (2d Dist. 1950). See also Rathbun V. City of Salinas, 30 Cal. App. 3d 199 (1st Dist. 1973) (50-year lease of parking lot to a bank may be subject to attack where the value of rent received is low; severability clause in lease will not save an otherwise void transaction).

32. Prescott Courier, Inc. v. Moore, 35 Ariz. 26 (1929). Note also the potential influence of antitrust principles in this area, as highlighted by Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495 (1969) (loans by credit corporation conditioned upon purchase of products of its parent corporation constitute a per se illegal tying arrangement).

33. California Commercial Code Section 1201(37)(b) (as modified by the Article 2A amendments).

34. While legislative comment on the section considered a nominal purchase option a key element for a security interest, it coupled this with the need to satisfy the "rent" test. Report of the California Assembly Committee on Judiciary respecting Commercial Code Section 1201(37) (West Supp. 1990).


36. The rent test was inserted in Section 1-201(37)(b) as part of the changes required by adoption of Article 2A, which by its terms is not applicable to sales or security interests, however disguised. Report of the Assembly Committee on Judiciary respecting Commercial Code Section 10103 (West Supp. 1990).
37. See, e.g., In Re J.A. Thompson & Son, Inc., 665 F.2d 941 (9th Cir. 1982) and the cases cited in n. 6 therein. Strong judicial precedent exists for treating such structures as financing arrangements (and not true leases), for which a security interest can be created.

38. The drafters of the section assumed such transfers were "usually" governed by other statutes and, therefore, should be excluded from Article 9, citing the case of pledges of water, electricity or sewer revenues to secure revenue bond financings. The statutory language, however, has a broader scope, incorporating any "transfer." Although adequate state procedures may exist for encumbering funds for utility revenue bond financings, many states in other less-defined instances have yet to enact the "other statutes" the drafters assumed were present. See also A. John Vogt and Lisa A. Cole, A Guide to Municipal Leasing (Chicago, IL: Municipal Finance Officers Association, 1985), at 75 and n. 24. Note 39, following, provides citations of less restrictive statutory language.

39. Annotated Laws of Massachusetts, General Law Chapter 106, Section 9-104(e) and N.Y. [U.C.C.] Law Section 9-104(e) (Bender's).

40. See also Report of the Assembly Committee on Judiciary respecting Commercial Code Section 10103 (West Supp. 1990). Lien laws or other local common law rights and remedies may be an alternative if neither Article 2A nor Article 9 is available.

41. For Article 2A in California, see e.g., Commercial Code Section 10102 and the related commentary in the Report of the Assembly Committee on Judiciary. For Article 9, note the language in Commercial Code 9102 and the legislative commentary, and contrast this with Commercial Code Section 1102(3) and its commentary.

42. See, in general, California Code of Civil Procedure Sections 580b and 580d (anti-deficiency provisions), 726 (one action rule), and 729.030 (equity of redemption period) (West Supp. 1990). A comprehensive summary of these statutes can be found in R. Bernhardt, California Mortgage and Deed of Trust Practice (Berkeley, CA: Continuing Education of the Bar, 1989).

43. Subdivisions of the State have been held subject to usury provisions. Regents of University of California v. Superior Court of Alameda County, 17 Cal.3d 533 (1976).

44. These include the time-price doctrine, purchase-money installment theories and exemptions for specified classes of lenders. See Ehrlich v. McConnell, 214 Cal. App. 2d 280, 185 (2d Dist. 1963) ("usury laws do not apply ... [to] conditional sale contracts."); and Boerner v. Colwell, 21 Cal.3d 37 (1978) (credit sale by vendor with assignment to non-exempt financing institution not subject to usury). The time-price doctrine permits a sale for cash to be for a different amount than a sale for credit, without
usury limitations. This typically applies to situations where the vendor makes the sale on credit, and subsequently assigns the payment obligation to a lender, and may be of more marginal utility in non-vendor lease financings.

For exemptions, see California Financial Code Sections 1504 (state banks and national banks), 1716 (foreign (other state) and foreign (other nation) banks), 3707 (bank holding companies) and 22000 et seq. (personal property brokers) and the real property broker exemption in Art. XV, Sec. 1 of the Constitution.


46. Government Code Section 53531. See also Government Code Section 53531.1(c).


48. Other states (e.g., New Hampshire) now require similar reporting for data collection. In contrast, the Treasurer's Office of the State of North Carolina requires that all county and local governments and other local agencies sell bonds through its Local Government Commission (LGC). The LGC also oversees local accounting and auditing practices, and provides investment management services and technical assistance in public finance topics.
CHAPTER FIVE

ACCOUNTING FOR LEASES

The accounting standards under which tax-exempt leases are treated are another source of guidance that define their structure. The classification of leases for accounting and financial reporting purposes is set forth by the Governmental Accounting Standards Board (GASB) in various statements and amendments.

GASB is the standards-setting body for governmental accounting and, as a result, governments whose financial records are maintained in accordance with generally accepted accounting principles (GAAP) must adhere to the GASB pronouncements. GASB for its purposes, in turn, relies on certain of the standards set forth by the Financial Accounting Standards Board (FASB), the standards-setting body for accounting and financial reporting in the private sector. In California, governments conform to GAAP (as applicable under GASB pronouncements).

The primary standard for accounting for leases by governmental bodies appears in FASB Statement 13, which has been endorsed by GASB. Under FASB Statement 13, a lease is defined as "an agreement to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." FASB Statement 13 further divides leases into capital and operating leases.

CAPITAL LEASE

If a lease meets one or more of the following criteria, FASB Statement 13 defines it as a capital lease:

- if ownership of the property is transferred to the lessee by the end of the lease term;
- if the lessee has an option to purchase the property at a bargain price (typically $1.00);
- if the lease term equals 75 percent or more of the useful life of the leased asset; or
- if the present value of the lease payments, including any purchase price, equals at least 90 percent of the fair market value of the property at the beginning of the lease term.
For a capital lease, FASB Statement 13 requires that the lessee record the leased property as its asset at the inception of the lease and record a corresponding liability at the same time. The book value of the asset and liability should be equal to, and calculated as, the present value of the lessee's payment obligations, excluding lessee payments for insurance, maintenance and taxes. The discount rate used for present value calculations is to be determined by the lessee and may be the interest rate charged in the lease or another sustainable rate.

A comparison of these FASB/GASB rules on capital leases with the requirements of the Internal Revenue Service for conditional sale treatment that determine whether a lease is a tax-exempt lease (see Chapter Four, "Tax Considerations") shows that a tax-exempt lease is always a capital lease. Theoretically, the reverse is not true. For a lease to be tax-exempt, the Internal Revenue Service requires that interest be shown as a separate component on the schedule of lease payments and other rules be satisfied. The accounting rules do not require these distinctions. It would generally seem inconsistent for a lessee to enter into a capital lease without assuring the tax-exempt status for the corresponding lower interest rate.

Under GASB direction, governmental lessees are to record a capital outlay for the full fair market value of the leased property at the beginning of the lease. During the lease term, both the principal and interest portions of the lease payments should be recorded as debt service expenditures, and the outstanding liability for the lease obligation should be reduced with each lease payment by the portion of the lease payment attributable to principal. In contrast, under many state statutes for debt purposes and not GAAP, lease payments in a non-appropriation or abatement lease are recorded as operating expenses.

It is these conflicting requirements, that lease payments be treated as debt for accounting, tax and credit analysis purposes, but not for "debt limitation" purposes, that create much of the confusion over accounting for tax-exempt leases.

**OPERATING LEASE**

Under FASB Statement 13, if a lease is not a capital lease, it is an operating lease, much like a true lease as defined by the Internal Revenue Service. The key characteristic of an operating lease is the continued ownership of the leased property by the lessor. An operating lease also usually has a term shorter than the asset's useful life and the lease payments are treated as payments of rent, and not principal and interest.
CHAPTER SEVEN

Credit Analysis and Credit Enhancements
Chapter Seven

Credit Ratings and Credit Analysis

Credit ratings and credit analysis can be viewed from two different perspectives when discussing tax-exempt leasing. First, the credit rating agencies -- the primary ones being Standard & Poor's Corporation ("S&P"), Moody's Investors Service ("Moody's") and Fitch Investors Service ("Fitch") -- consider leases as obligations, akin to debt, even if treated as current obligations for state debt limitations. Second, the rating agencies, having become more familiar with tax-exempt leases, now rate the leases for both public and private placements. Therefore, some informal guidelines exist on structuring a lease for rating purposes and, as a result of the rating, selling it to investors advantageously.

Because rating agencies expect lessees to maintain financial reports and accounting records in accordance with GAAP (discussed in Chapter Five, "Accounting for Leases"), the leases should be considered as debt, even if they contain non-appropriation or abatement provisions. Therefore, the rating agencies factor lease payment obligations into the debt ratios they use for determining a government's general obligation credit rating. More precisely, when calculating total debt outstanding, debt per capita divided by per capita personal income, debt as a percent of assessed valuation, outstanding debt relative to debt ceilings and debt service as a percent of general fund expenditures, the credit analysts include all outstanding tax-exempt lease payment obligations of the lessee for which they have or can obtain data, in addition to the lessee's general obligation debt.

Ratings for Leases

Numerically, most leases are for small dollar amounts and are not rated. However, the highest dollar volume of leases originates with large certificate of participation transactions that are rated. Standard & Poor's estimates that the total of state and local government tax-exempt leases approached $8 billion in 1989. Of that total, $3.4 billion were rated by S&P and sold publicly without any credit enhancements. Most of the balance of $4.6 billion was for credit-enhanced leases. The 1989 volume of $3.4 billion S&P-rated leases compares to $3.6 billion in 1988 and $2.7 billion in 1987.¹

According to S&P, California continued to dominate the market for rated, unenhanced tax-exempt lease obligations in 1989 and accounted for over one-third of the dollar volume ($1.214 billion of the total of $3.4 billion) and over one-half (52%) of issues rated. Other states with high dollar volumes include Ohio and New York.²
Moody's, which may rate some of the same leases as S&P but also rates some not rated by S&P, reports that in 1989 it rated almost 250 leases for a total dollar volume in excess of $8 billion (this includes lease revenue bonds, which are not incorporated in the S&P figures). Of the total of 1,505 outstanding rated leases, Moody's attributes 486, or nearly one-third, to California governments.\(^3\)

In the last several years, the scope of projects being financed through tax-exempt leases has broadened to include prisons, office buildings, transportation facilities and mental health facilities. While the majority of leases (by dollar volume) has been for real property projects, S&P notes that over one-third are secured, in whole or in part, by equipment.

Since tax-exempt leases are not general obligations of the lessee and are subject to non-appropriation or abatement, an unenhanced lease will usually be rated lower than the lessee's general obligation rating. S&P and Moody's currently indicate that a rating for a non-appropriation lease will tend to be a full grade lower than the government's general obligation rating, assuming their criteria have been met. Fitch, on the other hand, considers the essentiality of the project and may not rate it a full step lower. The ratings on abatement leases, if they provide rental interruption insurance, are generally less than one full category below the general obligation debt rating, because of the decreased risk attributed to these transactions.

Because of the high volume of lease transactions in California, the rating agencies are familiar and comfortable with many of the features and risks -- such as abatement or non-appropriations -- common to leases in the state. In evaluating California (abatement) leases, the analysts look for investor protections in the form of rental interruption insurance, casualty and title insurance, adequate capitalized interest, performance bonds and builder's risk insurance during construction. These are in addition to reserve funds which may cushion the initial impact of any defaults.

Credit Criteria

The lease credit analysis will focus on the likelihood of non-appropriation or abatement and will evaluate the essentiality and need of the asset and the lease term (to ensure it does not exceed the asset's useful life). In addition, the history of leasing in the jurisdiction and the equity participation by the lessee in the lease (indicated by a downpayment or other type of investment) are factored into the analysis.

In jurisdictions where, because of constitutional or statutory limitations, leases may be the only financing option, they may receive more favorable ratings (e.g., Kansas, Kentucky, Indiana, Colorado, Idaho and South Dakota).\(^4\) For leases where the commencement of rentals depends upon successful completion or acceptance of the property, the
rating is "provisional." For a master lease, S&P sometimes requires that acceptance and the effective date of lease payments be tied to receipt of the major lease component.

Payment processes are an important consideration when leases are evaluated. Particularly for statewide master lease programs where numerous operating departments may be involved, a centralized appropriations process helps assure the timely payment of obligations. This averts problems with inconsistent bookkeeping among the local districts and the potential for missed or late payments that may cause the downgrading of the lessee.\textsuperscript{5}

In general, the rating agencies prefer reserve funds, which should equal the maximum annual debt service. If the arbitrage limitations imposed by the 1986 Tax Act, discussed in Chapter Three in "Federal Law Considerations - Taxes", conflict with this requirement, the lessee may be required to fund the balance from its own reserves or through a surety bond. For large certificate of participation transactions, the rating agencies usually have allowed the reserve requirement to be limited to the maximum amount permitted under the Internal Revenue Code. The reserve requirement applies equally to both non-appropriation and abatement leases.

When reviewing a lease, other factors which may be considered by the rating agencies are:

- the lease term and the term of the issue are the same which avoids exposure on renegotiation; if state law requires annual renewal, it should be automatic;

- the issue should fully fund the project being financed and avoid the unknowns of future access to the markets to finance a project under construction;

- in an abatement lease or a lease secured by project revenues, interest should be capitalized beyond the acceptance date so that delivery/construction delays can be covered;

- the lessee must unconditionally agree to make rental or purchase-option payments as stipulated -- a typical hell-or-high water clause will suffice but the lease should clearly state that "notwithstanding any other provisions to the contrary, lease rental payments are triple net and not subject to counterclaim or offset";

- the lease should be triple-net and insurance coverage should at least equal the concluding payment;

- the lessee agrees to request appropriations for lease payments in its annual budget;
in the event of a non-appropriation, the lessee agrees to make the specified purchase option payment or to return the asset to the lessor at its own expense;

o in abatement leases, the lessee maintains rental interruption insurance, and special hazards insurance coverage may be required for risks such as earthquakes;

o a security interest in the leased asset should be provided with the right of the lessor or its assignee to take possession of the leased asset should the lessee default or non-appropriate;

o potential taxability exposure to the investors should be addressed; and

o there should be non-substitution language.

CREDIT ENHANCEMENTS FOR TAX-EXEMPT LEASES

The credit quality of lease transactions and the subsequent interest rate to a lessee are in direct correlation to one another. An investor evaluating a lessee with a high credit quality will generally accept a lower interest rate than it would for a lessee with a lower rating.

The determination of credit quality comes from several different sources. As already discussed, the credit rating agencies provide the primary evaluation upon which many investors base their investment decisions. In addition to these agencies, some underwriters and institutional investors usually conduct their own credit analyses to determine if they will purchase a transaction and at what price.

In addition to these groups, when a credit enhancement is sought, the enhancers will conduct their own credit and risk analysis to determine their interest in and the cost of any credit enhancement. While the basic analysis of the enhancers is similar to that of the rating agencies, the purpose is different. The credit rating agencies provide ratings to help investors evaluate investment risk. The enhancers, on the other hand, take a financial risk in the transaction either by guaranteeing it against non-appropriation or abatement or by providing liquidity in the case of variable rate transactions with "put" options which allow the investor to sell back its certificates to the lessee. The letter of credit assures investors that money will be available to honor the put.

Credit enhancement is used to improve the creditworthiness (and marketability) of the lease, its marketability and concomitantly to obtain a lower interest rate for the lessee. Because the enhancer is the ultimate obligor in the event of default by the issuer, the rating agencies will provide a high credit rating based partly on the credit enhancer -- typically AAA -- to the lease transaction. The cost of
enhancement depends on the type used and may be paid as a one-time premium, normally assessed for lease insurance or a system of annual fees, common to letters of credit. Since the cost may be significant, enhancement generally will be sought only if its cost is more than offset by interest rate savings.

Credit enhancements are usually arranged by the lease broker or underwriter, but are typically paid for by the lessee or lessor, depending on the structure. In a COP transaction, all costs including that for the enhancement will be reflected in the financing. If the enhancement is provided by a letter of credit, the lessee will generally pay the administrative fee and the first annual premium at the time of closing from transaction proceeds. Future letter of credit premiums must be paid directly by the lessee to the financial institution. If the enhancement is provided by an insurance policy, the lessee generally will pay a one-time premium, equal to a percentage of the total projected principal and interest due during the full term of the lease. The premium typically is paid from transaction proceeds before payments are made to the vendors or trustee. In this case, ongoing lessee involvement is minimal; this contrasts to a letter of credit scenario which requires continuing lessee involvement through annual payments.

The decision to obtain a credit enhancement is usually made when the lease broker or underwriter is structuring the transaction and evaluating its marketing and marketability. Arrangements for the enhancement may be made well in advance of the sale or placement of the lease. However, in some instances, the enhancement is not sought until shortly before the closing. This latter circumstance could arise if the broker or investor initially evaluates the lease's marketability inaccurately and later requires the enhancement to attract investors. However, the timing of the decision of when to enhance must be coordinated with disclosure requirements of the SEC's Rule 15c2-12.

An enhancement is purchased when the interest savings offset its cost. Since an enhanced lease will usually have an interest rate comparable to an AA-rated general obligation bond, the enhancement cost must be calculated against the lease pricing without enhancement. In general, a lease without enhancement will be priced at least one notch below that of the lessee's general obligation bonds (i.e., if a lessee's GO rating is AA, its lease would be priced at A rates). To defray the cost of enhancement, the credit quality of the lease must be increased to justify the purchase. Therefore, credit enhancement is usually purchased only by lessees with credit ratings of A or below.

Prior to committing to provide enhancement, the enhancing party will conduct a credit analysis similar to that of the credit rating agencies. Enhancers evaluate the transaction by analyzing:

- the overall creditworthiness of the lessee, the asset itself (most enhancers prefer to protect real property
leases or real property leases with some and equipment included, although occasionally a lease solely for equipment will be enhanced),

- the essentiality of the asset, the construction risk (particularly in an abatement lease where a lessee can abate lease payments if it does not have access to and use of an uncompleted project),

- the lease term (not to exceed the useful life of the asset),

- the property and casualty insurance for the asset, and

- in abatement leases, rental interruption insurance.

Additionally, most enhancers will require that a debt service reserve fund be established to act as a buffer before the enhancement is accessed. For construction projects, the enhancers may require a performance or construction bond to ensure satisfactory completion of construction.

For these reasons, a credit enhancement may require on-going costs in addition to the premium. These include the expense of a reserve fund, if required, and legal and trustee fees, and in certain instances, counsel for the enhancer. Since credit enhanced transactions almost always are rated, any costs for the rating must also be factored into the structure.

Enhancement premiums are usually priced as a percent of the total principal and interest obligations guaranteed. The principal would include asset cost, expenses, reserve fund, etc. In a COP transaction, the amount guaranteed is the principal amount of the certificates issued since the costs are included in the principal. While it is difficult to generalize, lease guarantees or insurance generally cost 35 to 60 basis points (0.35% to 0.60%) of the total anticipated debt service. Letters of credit, on the other hand, have both a one time fee and an annual fee that usually is less than 50 basis points (0.50%) of the annual outstanding principal.

**Credit Enhancement Providers**

The majority of credit enhancements are provided by two types of organizations -- insurance companies and commercial banks. Where insurance companies are involved, the enhancement will be in the form of an insurance policy or surety bond protecting investors against non-payment of lease rents, including non-payment caused by non-appropriation or abatement. On the other hand, if a bank is involved, the enhancement is in the form of a letter of credit (LOC) that guarantees against all nonpayment risks. A bank letter of credit may also enhance liquidity to a lease with put options normally associated with variable interest rates. Since leases with these features may require lessees to maintain contingent funding for unanticipated
payments, a liquidity letter of credit assures investors that the lessee's obligations will be met.

The list of specific providers of credit enhancements varies with changes in the financial and insurance industries. For instance, when non-appropriation insurance first became widely available in the early 1980s, several individual insurance companies tended to be interested only in short-term (five to seven years) equipment leases. However, due to their strict underwriting criteria, these early lease insurers were "irregular" providers of enhancements.

Over time, more insurers became willing to enhance leases and for longer terms of up to 20 to 30 years for real estate. As the credit enhancement insurance industry evolved, participants have tended to be specialized companies owned by financial institutions and other property and casualty insurers (i.e., MBIA, FGIC, AMBAC, Capital Guaranty, etc.)

As with insurers, the commercial banks active in this area have also changed. Through the mid-1980s, domestic banks provided letters of credit for tax-exempt leases and bonds, but Japanese and other foreign financial institutions now predominate. Due to differing regulatory and capital criteria, foreign banks have been able to price their letters of credit below domestic banks, and the willingness of the foreign banks to provide enhancements at reasonable rates has allowed for the continuation of these structures.

Credit Enhancement Renewals

As already discussed, a letter of credit is paid for by the lessee with annual premiums in addition to an upfront administrative fee. The letter of credit usually is issued for a period less than the full lease term but for a maximum five- to seven-year period. If renewal is requested, the bank will conduct a new analysis of the transaction before renewing the LOC.

The renewal process can be complicated and may require interim negotiations prior to the expiration of the LOC. Most LOCs are written with an "evergreen" provision that gives a lessee an indication as to whether the LOC will be renewed. For example, if a bank provides a seven-year LOC, after the first two years, the lessee can renegotiate for another two years. If the renegotiation is unsuccessful, the lessee has five years to locate another bank. If no other bank is found, the original LOC bank will buy the lease from the original investor(s) but will charge the lessee a high interest rate premium.

Renewal can also become complicated, for example, where the lease structure permits the lessee to change from variable rate interest to fixed rate at the renewal date. Since some financial institutions will not accept the risk of "guaranteeing" fixed rate obligations, the lessee may find itself in need of a new LOC bank if it opts to fix the lease rate.
ENDNOTES


2. Id.


5. See e.g., "Payment snafu linked to Mass. downgrading," City and State (July 31, 1989), at 11.
APPENDICES
GLOSSARY OF TERMS

This glossary is designed from the perspective of the tax-exempt leasing industry. The glossary defines many terms that also apply to municipal bonds and defines others that have specific meaning for tax-exempt leases. Tax-exempt leasing terminology may vary by transaction structure, the types of parties involved, and even by the individuals involved. For instance, one lessor may request that a lessee execute an acceptance certificate; another may require an acceptance letter. In either case, the document serves the same purpose.

The terms that appear within the definitions in boldface are defined elsewhere in the glossary; certain commonly used phrases such as asset, lessee and lessor, are not highlighted at each of their references. Refer to the California Debt Issuance Primer, published by CDAC, for additional definitions that apply to the tax-exempt market in general.

Abatement -- a legal concept whereby the lessee reduces its rent proportionately or totally to the extent it does not have use of the leased asset. For tax-exempt leases, in California and some other states, a lessee is not required to make rental payments without use of the leased asset, permitting a termination of rent. Some leases allow a lessee to abate partial payments if use of the asset is limited. Lessor(s)/investor(s) are likely to protect their interests in leases that contain abatement provisions by requiring the lessee to maintain casualty and rental interruption insurance.

Abatement Lease -- a type of multi-year tax-exempt lease whereby the lessee can commit to make lease payments for the entire lease term unless the leased asset is not available for use, in which case abatement occurs. (This contrasts with a tax-exempt lease with a non-appropriations clause.)

Acceleration of Rents -- also called rental acceleration; an option, found in some tax-exempt leases and exercisable upon a lessee default, that allows the Lessor (or its Assignees) to declare all future rentals then due and payable.

Acceptance Certificate -- a certificate to be signed by the lessee confirming that a leased asset has been fully delivered, inspected, tested and accepted. By signing the acceptance certificate, the lessee acknowledges receipt of the asset as ordered and that it is in satisfactory operating condition. The acceptance certificate frequently serves as the document that authorizes the lessor or the trustee to make a payment to the vendor for the leased asset.
**Acceptance Date** -- the date on which the lessee verifies that it has received, inspected, tested and accepted as satisfactory the asset under lease. Some lease transactions use the acceptance date as the date on which the lessee begins its lease obligations.

**Advance Funding** -- a method of funding a lease before lessee acceptance of the leased asset. Lease proceeds are placed in an escrow account until they are authorized be disbursed to the vendor(s) or contractors.

**Advance Payment** -- also called payment in advance; a payment structure in which the lease payment is due at the beginning of each period to which the payment relates, as opposed to payment in arrears. In some leases, an advance payment may also refer to the payment of one or more periodic lease payments upon lease commencement in the form of or in lieu of a security deposit or downpayment.

**Amortization** -- the gradual reduction, redemption or liquidation of the balance (outstanding principal) of an obligation.

**Arbitrage** -- the interest earned as a result of the difference between the interest rate at which funds are borrowed and the rate at which they are invested. The Internal Revenue Code (as amended), with some exceptions requires the rebate to the US Treasury of most arbitrage earnings of tax-exempt borrowers. Arbitrage restrictions must be addressed in the structuring of certificates of participation as well as in other tax-exempt lease transactions in which lease proceeds are funded and escrowed in advance for the benefit of the lessee. A major exception to the rebate requirement was adopted in the 1989 amendments to the Internal Revenue Code. This exception permits a government that borrows funds (including through a lease transaction) for the purpose of a "construction" project to retain arbitrage earnings for up to a two-year period, subject to certain spending tests.

**Arbitrage Certificate** -- a certificate of lessee prepared by the lessor's counsel, bond counsel, or tax counsel confirming that the tax-exempt lease and investment of any proceeds will not violate arbitrage rules under the Internal Revenue Code. Also known as a No-arbitrage Certificate or a Certificate as to Arbitrage.

**Arrears** -- also called payment in arrears; a lease payment structure where payment is due at the end of each period to which the payment relates, as opposed to advance payment. Payments in arrears are more typical for tax-exempt leases.

**Asset** -- the items of personal or real property being acquired by the lessee through payments over a period of time pursuant to the tax-exempt lease.

**Asset-Based Transfer** -- see Sale-leaseback.

**Assignee** -- the party to which an assignment is made.
**Assignment** — a transfer of legal rights to another; typically, in a tax-exempt lease involving the transfer of the lease and rental payments from the **lessee** to a **paying agent** or **trustee** acting on behalf of the investors or to the investors directly. An assignment may also be used where one investor transfers its interest in the lease to another, especially common in COP transactions. Generally, the lessee will be asked to nominally approve and acknowledge any and all assignments made by the lessor. However, most lessees are themselves prohibited from assigning their rights in or responsibility for a leased asset to another party. If assignment by the lessee is permitted, the lessee is required to obtain the consent of the lessor and to continue to comply with IRC restrictions relative to the financing.

**Bank-Affiliated Leasing Company** — a subsidiary of a bank or bank holding company that is active as a lessee, frequently acting both as lessor, **lease broker** and/or underwriter.

**Bank Qualified** — under current provisions of the **Internal Revenue Code**, commercial banks can deduct 80% of their interest costs on funds used to acquire or "carry" tax-exempt obligations (bonds and leases) of governments that borrow no more than $10 million in a calendar year; otherwise, the interest cost is not deductible by the bank. The availability of the interest deduction on bank qualified leases makes them more attractive to commercial banks than obligations of larger issuers. Commercial banks may invest in non-bank qualified leases but the loss of the deduction for interest costs on funds borrowed by the bank for the initial investment in the lease, requires additional compensation through a higher interest rate in the lease than in a smaller bank qualified transaction.

**Basis Point** — an amount equal to one one-hundredth of one percent (.0001); a shorthand expression to describe differences in interest rates, e.g., the difference between 7.00% and 7.10% is ten basis points.

**Blue Sky Laws** — statutes enacted by state governments that relate to securities registration and prohibitions against fraud, dealer and broker regulations.

**Bond Opinion** — the opinion of counsel specializing in municipal bonds and other tax-exempt transactions that the lease transaction is legal, valid and binding on the lessee. The bond opinion may also incorporate the **tax opinion**. Lease transactions for small dollar amounts frequently do not have a bond opinion. In larger transactions, **bond counsel** may also provide a **10b-5** opinion respecting compliance with securities laws and **disclosure** requirements. Most well-known bond counsel are listed in a section of The Bond Buyer's Directory of Municipal Dealers of the United States, informally known as the "Red Book."
Book Entry Registration -- refers to the system of registration of tax-exempt securities, generally publicly traded, including lease financings, whereby individual securities (bonds or certificates) are not issued to investors. Instead, a record is maintained by an independent company that records the ownership of securities by members of the company, usually underwriters or financial institutions. These members (or "participants") are then responsible for the identification of the actual investors through the brokerage or trust accounts maintained by those members. The largest independent company performing "book entry" services is Depository Trust Company of New York; securities qualified as registered for book entry sometimes are called DTC eligible.

Call -- an option provided to the lessee to prepay the principal balance, accrued interest, and any prepayment premium at specific dates during the lease term which are earlier than the normal maturity date.

Call Protection -- refers to the period of time during which a tax-exempt lease cannot be prepaid; during this period, the investor is assured his yield and his investment is protected from early termination. This is similar to protections provided investors against early redemption of bonds. The investment community also uses this term informally to mean the payment premium.

Capital Lease -- an accounting term for a lease that provides to the lessee all of the rights and obligations to an asset on a basis similar to circumstances had the lessee purchased the asset on a conditional sale or installment purchase basis. Under FASB Statement 13, a lease is a capital lease if it meets one or more of the following criteria: ownership of the asset is transferred to the lessee by the end of the lease term; it has an option to purchase the asset at a bargain price (frequently $1.00); the lease term equals 75 percent or more of the useful life of the leased asset; or the present value of the lease payments, including any purchase price, equals at least 90 percent of the fair market value of the asset at the start of the lease term.

Capitalized Interest -- bond or lease proceeds that are reserved to pay interest for a period of time early in the term of the issue. In construction projects, interest frequently is capitalized through the construction period until the project is accepted by the lessee.

Captive Credit Corporation -- a wholly owned subsidiary of a corporate organization (usually a vendor) that lease finances the products of the parent corporation.

Certificate of Participation (COPs) -- a method of structuring and distributing tax-exempt leases to investors by dividing the rental payments and lease into fractionalized interests or shares for individual sale to investors. The share is represented by a formal certificate, much like a bond. COPs can be placed privately or sold
publicly. COPs generally are sold for large asset financing and tend
to be used more for real property rather than personal property
acquisitions. The volume of COPs has increased significantly in the
last several years with an estimated 50 percent of such offerings
originating in California.

**Certificate of Title** -- an instrument, normally issued by state motor
vehicle departments, evidencing title to a motor vehicle. The
certificate of title may either show the lessor as owner or it may
note the lessor as a secured party and the lessee as owner. Physical
possession of certificate of title may remain with the trustee.

**Choice of Law Clause** -- a clause generally found in the miscellaneous
provisions of lease specifying that the laws of a specified
jurisdiction will govern in construing the lease.

**Closing Costs** -- see Issuance Costs.

**Closing Date** -- also known as *issuance date*; the date on which the
lessor or investor provides funds equal to the principal amount of the
lease either to the trustee for subsequent transmittal to the
vendor(s) or to the vendor directly. This term is most commonly
associated with large COPs transactions where the execution of
documents occurs in a formal manner similar to bond closings.

**Commitment Fee** -- a fee sometimes required by the lessor from the date
it commits to act as lessor and finance the assets under the lease,
until the final funding date. This fee is most commonly applied in a
transaction where there is a lengthy period between the commitment by
the lessor and the actual funding date. The fee ensures availability
of the funds, and in certain instances, availability of a specified
interest rate. The commitment fee frequently is refunded by applying
an equal amount as a reduction of the lessee's first lease payment.
Payment of a commitment fee may not be allowed under local or state
law where payments can only be made if the asset is available for use
by the lessee.

**Competitive Bid** -- the response made by a vendor, contractor or
financial service provider to a request for bid proposal, usually
issued by a governmental unit. In tax-exempt leasing, the term
usually describes how a vendor of an asset is selected but may also
describe how the lease financing is selected, particularly among
small-dollar volume *privately placed* lease agreements or *vendor* lease
agreements.

**Competitive Sale** -- a term describing a method of selling financial
obligations (including tax-exempt bonds, leases or COPs) to the bidder
presenting the best sealed bid (in terms of price and compliance with
the transaction specifications) at the time and place specified by the
issuer/lessee (as opposed to a *negotiated sale.*
Concluding Payment -- in a conditional sales agreement (where title to the asset is transferred to the lessee at inception of the lease), this sum is payable by lessee to conclude or terminate the lease. It will include the outstanding principal, accrued interest, and any prepayment premium.

Conditional Sales Agreement -- a standard form of financing agreement whereby a buyer acquires the immediate use of an asset (and title thereto) and the seller retains a security interest in the asset and the buyer agrees to pay the seller a series of payments equal to the cost of the asset plus interest. Therefore, the transfer of title is conditionally subject to future payments. This is distinguished from an installment sale where the seller retains title until all installment payments are made. In both forms of sale, for federal tax purposes, the Internal Revenue Code treats the asset as owned by the purchaser with payments to the seller constituting principal and interest; for a governmental purchaser, interest usually is tax-exempt. This term is sometimes used interchangeably with the term tax-exempt lease; however, in California, there is an important distinction between the two (e.g., a lease is constitutionally legal and a conditional sale is not unless it is secured by a special fund.)

Contractor -- see also vendor; a term usually describing the party responsible for the construction of the real property improvements to be financed under the lease.

Credit Enhancement -- a way to protect investors from investment risks by having a third party provide insurance, a guaranty, or additional collateral (e.g., a letter of credit or guaranteed investment (GIC) to ensure performance by the lessee of its obligations under the lease. The investors and any rating agencies will evaluate the credit based upon the party providing the enhancement; assuming this party has a higher credit rating than the lessee, the rating of the overall transaction will be improved, resulting in a lower interest cost to the lessee. A credit enhancement usually provides assurances to the investor against the risks of non-appropriation or abatement as well as against the credit risk of the lessee.

Credit Enhancement Provider -- the party supplying the credit enhancement.

Credit Rating -- an independent appraisal of the credit quality of a bond issue or lease, usually supplied by a credit rating agency.

Credit Rating Agency -- an organization that analyzes new and outstanding obligations of the public and private sectors and assigns a rating as to their comparative credit quality to help investors make their decisions as to the rate at which they will loan funds. The three largest organizations are Moody's Investors Service, Standard & Poor's Corporation and Fitch Investors Service.
Cross-Default Provision -- a clause, if included in a lease, which states that if an event of default arises in other obligations of the lessee, it becomes an event of default under the lease.

Debt -- an obligation arising from the borrowing of money to be repaid over a period of time, and if over a multi-year period, subject to state and local constitutional provisions, statutes, and judicial and administrative determinations. In California, tax-exempt leases with non-appropriation or abatement clauses are not considered debt under the Offner-Dean series of court cases.

Default -- the failure of the lessee to pay payments or other sums or obligations when due under the lease or failure to observe a representation or warranty in the lease or violation of a covenant in the lease, and the expiration of applicable periods to cure the default. An event of non-appropriation or abatement is not normally considered an event of default, even when the remedies are substantially similar for each event.

Defeasance -- the termination of the obligations of a issuer/lessee by providing for the full prepayment of its obligations. Frequently, a properly documented, usually larger, tax-exempt lease can be defeased (like a bond) by the deposit of sufficient funds with a trustee to pay the future lease obligations until maturity or until the first date permitted for prepayment of the lease. Depending upon the structure, the amount of funds to be deposited may be determined by giving effect to investment earnings to be derived from the funds deposited, particularly when investments are made for stated maturities and at pre-determined rates. Defeasance is different than prepayment because although the lessee's obligations are fully satisfied, the lease and the related certificates remain outstanding to be paid later from the funds deposited, avoiding any prepayment premium or similar obligation. Defeasance usually occurs if a lessee wishes to discharge its obligations before the call protection period has expired and assuming the lease specifically permits such actions.

Delphis-Hanover Scale -- an index which is published regularly and reports the current level of interest rates applicable to municipal securities of various rated quality and term.

Disclaimer of Warranties -- a reference to typical provisions of tax-exempt leases under which a lessor, who is not a vendor, will disclaim (reject) any and all responsibility for the suitability or performance of the assets selected by the lessee to be financed under the lease agreement.

Disclosure -- information provided on the issuer/lessee, to permit an investor to evaluate the creditworthiness of the issuer/lessee, the risks associated with the financing, and the appropriate yield required by the investor for the investment. The information must include financial data. Under a 1989 rule of the federal Securities and Exchange Commission (Rule 15c2-12), the timing and filing of
Disclosure statements relating to tax-exempt financings have been regulated. Disclosure is usually provided through an official or offering statement or for private offerings, a private placement memorandum.

Effective Interest Rate -- see also implicit rate; the rate of interest payable by the lessee taking into account accrued and capitalized interest, issuance costs, discounts and premiums. (As opposed to Nominal Interest Rate.)

Enterprise Lease -- see Lease Revenue Bond.

Environmental Law Opinion -- an opinion of counsel (specializing in environmental and hazardous substances law), which may be required in some real property financings, respecting the environmental or toxic substances liabilities associated with the property being financed. Owners of real property (and potentially their lenders) may incur liabilities to remediate hazardous substances present or associated with the property.

Equipment Schedule -- the schedule or exhibit to a lease which identifies the property being leased.

Escrow Agent -- also known as trustee; usually a financial institution that provides administrative services, through an escrow agreement, for the benefit of the parties to a financing including the execution and delivery of COPs, the safekeeping of proceeds, and holding physical possession of title documents for the leased asset. Depending on the lease structure, the escrow agent may have other responsibilities such as disbursement of funds to vendors, investment of reserve and acquisition funds (until delivery or construction is completed) and arbitrage calculations. In COPs, the escrow agent's role may also include the collection of lease payments from the lessee(s) and the regular disbursement of payments of principal and interest to investors.

Escrow Agreement -- also known as a Trust Agreement; a legal document that outlines the duties and responsibilities of the escrow agent. This agreement specifies the terms of the securities issued including maturity dates, interest rates, security for payment, redemption procedures, rights of prepayment, etc. When transaction proceeds are to be held by the escrow agent, the agreement specifies the purpose, the documents and authorization needed for disbursement, and dictates the use of earnings on funds held prior to disbursement. The agreement also covers other procedural matters such as dealings with a credit enhancement provider, compensation or replacement of escrow agent, etc.

Essential Use Certificate -- a certificate executed by the lessee indicating that the asset being leased is essential to the lessee's governmental purposes and daily activities. Lessors in almost all tax-exempt lease transactions with a non-appropriations provision
require confirmation of essential use from the lessee, either through a representation in the lease or a separate certificate, or both. In addition, for some transactions, lessees may also be required to provide a project feasibility study and certify the feasibility of the leased asset as well as its essentiality.

**FASB Statement 13** -- the formal pronouncement of FASB relating to leases and their accounting applications; the GASB has specified that FASB Statement 13 is the standard by which governments using generally accepted accounting principles are to report and account for their lease transactions.

**Feasibility Study** -- a report analyzing the practicality of a proposed facility including review of operating, financial, engineering, and revenue estimates.

**Financial Accounting Standards Board (FASB)** -- the independent non-profit organization supported by the public accounting profession and charged with the responsibility of promulgating generally accepted accounting principles.

**Financial Advisor (FA)** -- a consultant to a lessee who provides assistance in the structure, timing, terms and other topics concerning new or existing leases. A financial advisor also assists a lessee in analyzing competitive bids received in response to a request for proposal or in the preparation of a preliminary official statement needed for competitive sale.

**Financing Statement** -- see UCC-1 Financing Statement.

**Form 8038, 8038-G, 8038-GC, 8038-T** -- forms of the Internal Revenue Service that governmental borrowers (including lessees) must complete to report on the issuance of tax-exempt securities, their general purpose, their general financial terms, the exemption used for tax-exempt private activity bonds, and to transmit arbitrage rebate amounts to the IRS.

**Full Service Lease** -- an operating lease in which asset maintenance or other service is the responsibility of the lessor.

**Funding Date** -- the date on which funds are transferred from the investor(s) to the vendor(s), or trustee if the lessee has not accepted the asset. Frequently, the closing date, funding date, and acceptance date occur simultaneously.

**Funding Resolution** -- the action taken by a governing body that authorizes the government to enter into a lease financing.

**Government Accounting Standards Board (GASB)** -- the standard-setting body for governmental accounting.
Government Finance Officers Association (GFOA) -- a non-profit organization that represents state and local finance professionals in the United States and Canada. Beginning in 1976, the GFOA, formerly the Municipal Finance Officers Association, has been in the forefront of promulgating voluntary disclosure guidelines for the issuance of tax-exempt securities.

Governmental Bonds -- a term used in connection with federal arbitrage regulations meaning obligations (bonds or leases) that are not private activity bonds.

Hell-or-High Water Clause -- a clause contained in most tax-exempt leases that holds the lessee responsible for its lease payments and all other obligations under the lease regardless of the status of the leased asset or any dispute between the lessee and any other party. This clause does not prevent the lessee from exercising its right to non-appropriate. In some states, such as California, the lease is altered to permit the lessee to terminate rental payments pursuant to an abatement clause.

Implicit Rate -- also called the effective interest rate; the interest rate at which the present value of all payments made by the lessee, including issuance costs and all rent payments, will equal the asset cost.

Incumbency Certificate -- a document executed by the lessee (usually the lessee's board secretary or clerk) that indicates the title and authority (as well as providing facsimile signatures) of persons authorized to execute and deliver the lease and other documents or instruments.

Indemnity Clause -- a clause contained in most tax-exempt leases that holds the lessor, trustee and credit enhancement provider harmless from any loss or damage suffered by the lessee or third parties due to the use of or because of the leased asset or the tax-exempt lease; such clauses may also extend to facts and circumstances concerning the tax-exempt nature of interest under the lease.

Independent Lessor -- a lessor that is not affiliated with a bank, credit corporation or any other organization or corporation. The independent lessor might be an investor using its own funds or it might be a lease broker using funds received or to be received from other investors.

Installment Sales Agreement -- see Conditional Sales Agreement and Lease Revenue Bond.

Insured Value -- the value at which assets are insured for casualty purposes under the lease; usually defined to include, at a minimum, the outstanding principal, accrued interest and any prepayment premium.
Integration Clause -- a clause generally found in the miscellaneous provisions of the lease specifying that the language in the lease documents (as to specific terms provided in such documents) controls over any and all oral or written understandings or arrangements respecting such items prior to execution of the lease.

Interest -- compensation paid for the use of money or the return on investment from money invested or lent; the interest rate is the interest charge expressed as a percentage of principal.

Internal Revenue Code (IRC) -- the codification of federal tax laws enforced by the U.S. government's Internal Revenue Service.

Investor -- in a tax-exempt lease, the party that provides the funds to pay for the leased asset and benefits from the tax-exempt interest whether directly as a single investor or in concert with many investors as a purchaser of certificates of participation.

Issuance Costs -- costs associated with closing and funding the principal amount of the lease including, but not limited to, fees for the bond, tax and securities counsel, printing costs, credit enhancement costs (if any), credit rating costs (if any), underwriter's discount (as applicable), financial advisor or other professional fees, governmental filing costs (if any) and, where appropriate, costs of feasibility studies.

Issuance Date -- see Closing Date.

Issuer -- see Lessee.

Joint Powers Authority -- a public authority created by a joint exercise of powers agreement between any two or more governmental agencies. An authority can perform any function which all parties to the agreement can perform independently and which will be of benefit to all parties. Such authorities are unique to California.

Lease Broker -- usually an independent leasing company that negotiates leases between lessees and investors. A lease broker may serve as nominal lessor or may underwrite or guarantee the financing. In either case, the broker assigns its rights and interests in the lease to an investor.

Lease Line of Credit -- an arrangement that allows a lessee to make periodic withdrawals from a line of credit established to finance lease acquisitions. The arrangement is documented as a single tax-exempt lease with multiple equipment schedules. A schedule is executed for and at the time of each acquisition by the lessee. Administratively, a line of credit eliminates the documentation hurdle of separate leases on smaller-valued assets and ensures a continued funding source at rates competitive with larger transactions. A lease line of credit is typically utilized in larger dollar financings with extended or variable delivery schedules or in lease pools.
**Lease Pool** -- an arrangement whereby a number of unrelated tax-exempt leases are grouped together for purposes of a single public offering. The governments are usually similar in nature (e.g., school districts) and are brought together through some common interest association. The lease pool is different than a *master lease* which groups the leasing needs of several departments or agencies in a single issuer/lessee, such as a state or county.

**Lease-Purchase Agreement** -- see *tax-exempt lease*.

**Lease Revenue Bond** -- also referred to as lease-backed revenue bond; a bond having as its repayment source a lease to which project revenues have been pledged for making regular payments, although the source of lease payments may also include General Fund revenues. In California, such leases are frequently referred to as *enterprise leases*, *installment sales agreements*, or *special fund leases*.

**Lease Term** -- the length of time during which the lessee has an obligation to make rental payments. The term should coincide with or be shorter than the useful life of the asset being leased.

**Lessee** -- also called the *issuer*; in a tax-exempt lease, the lessee is a unit of government otherwise qualified to issue tax-exempt obligations which finances the acquisition of assets through the tax-exempt lease by paying specified sums of interest and principal for a pre-determined period. In an operating lease, the lessee only uses the asset for a period of time and returns it to the lessor. To be tax-exempt, the lessee must be a qualifying governmental entity under the IRC.

**Lessee's Counsel** -- the attorney who provides the opinion to the lessor (and, as applicable, the assignee, paying agent, or trustee) that the lessee is a governmental entity, is authorized to enter into the transaction, that it has done so legally, that the officials executing the lease have the authority to do so, that the lease is in compliance with all procurement and other regulations, and that the transaction is legal, valid and binding on the lessee.

**Lessor** -- in a tax-exempt lease, the *secured party* (see *security interest*) that may provide the funds and act as investor or that may assign its interest in the leased property to another party for these purposes. If the lessor is also the investor, the lessor benefits from tax-exempt income. In an *operating lease*, the lessor owns the asset and derives the tax benefits of ownership which include, as applicable, depreciation.

**Lessor's Counsel** -- the attorney who provides the opinion that the lessor's involvement in the lease has been properly authorized and has been or will be entered into in compliance with lessor's corporate documents and procedures. Opinion of lessor's counsel is not provided in all leases, especially in smaller dollar-volume transactions.
**Letter of Credit** -- see also **credit enhancement**; a credit facility from a financial institution in which the institution agrees to provide specified funds to meet payments due under a tax-exempt lease, if the lessee does not make those payments. A letter of credit is used to allow the financial institution's credit rating to supplement that of the issuer and to provide additional security that money will be available to pay lease payments. The financial institution is typically reimbursed for any funds drawn by the issuer or by a **security interest** in the asset.

**Marketability** -- a term used to indicate how readily an obligation can be sold to lessors or investors. Also called financeability.

**Master Lease** -- an arrangement that involves one lease document for the acquisition of different types of assets at different times by one lessee or agencies and departments of one lessee.

**Municipal Securities Rulemaking Board (MSRB)** -- an independent, self-regulatory organization established by federal law with general rulemaking authority municipal securities market participants (generally, brokers and dealers). The MSRB proposes and adopts rules concerning professional qualifications 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.

**Negotiated Sale** -- the method of selling obligations (including tax-exempt bonds, leases or COPs) where the terms of the obligation, in particular the interest rate, are negotiated between the lessee and the financing source (as opposed to **competitive sale**).

**Net Interest Cost** -- a technical measure of the interest cost of a lease or bond derived by adding together all interest payments for the term of the issue or lease 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. Net interest cost differs from **true interest cost** in that NIC does not take into account the **time value of money**.

**Net Lease** -- see **Triple Net Lease**.

**No-Arbitrage Certificate** -- see **Arbitrage Certificate**.

**Nominal Buyout** -- a provision in some tax-exempt leases that allows the lessee to purchase the lessor's interest in the lease at the end of the **lease term** for a "nominal" price, usually $1.00.

**Nominal Interest Rate** -- see **effective interest rate**; the rate of interest often stated in a tax-exempt lease or quoted by a lessor which does not include the effect of **issuance costs, discounts, premiums**, or accrued and capitalized interest.
**Nominal Lessor** — an entity brought into a tax-exempt lease transaction for the sole purpose of acting as lessor and as a conduit of acquiring the asset for lease to the lessee through the tax-exempt lease. The nominal lessor may be a private organization that is paid for its services or may be a not-for-profit organization, such as an existing development agency, or a corporation organized for the sole purpose of acting as lessor. The nominal lessor has no responsibilities for nor rights to the leased asset.

**Non-appropriations Clause** — a provision contained in some California and most non-California tax-exempt leases that allows a lessee to discontinue its lease payments if, in future years, funds are not appropriated to make lease payments (usually following a best efforts undertaking by the lessee to obtain the funds.) A lessee is not in default under the lease if it non-appropriates. Due to this annual condition placed on the obligation to pay rent, the courts in many states view rental payments as operating expenses under state law and, therefore, not as debt. In the event of non-appropriation, the lessee loses use and possession of the asset.

**Non-appropriations Lease** — a type of tax-exempt lease in which the lease can be terminated if sufficient appropriations are unavailable to continue its payments. (This contrasts with an abatement lease.)

**Non-substitution Clause** — a provision contained in many tax-exempt leases that restricts a lessee from substituting other equipment or property, or as applicable, from obtaining the same equipment or services from third-party vendors, to provide the services of the assets for which payments have been non-appropriated or abated. The period during which a lessee cannot substitute can vary from one month to a year or to the term of the original lease.

**Obligation** — any written promise or commitment to pay money or take certain actions.

**Official Statement** — also called an OS or Offering Statement; the document by which the issuer provides financial and other information to potential investors respecting the transaction and the issuer to permit more educated investment decisions. For privately placed transactions, this document may also be called a private placement memorandum. In a competitive sale of COPs, the lessee and its advisors usually prepare a preliminary official statement (POS) which is distributed to prospective bidders (underwriters) prior to the time designated for submitting sealed bids. After the transaction is awarded, the final OS is prepared. In a negotiated sale of COPs, the underwriter usually assists in preparing the OS and its distribution to prospective investors prior to the pricing of the transaction. The review and distribution of official statements is discussed in the SEC's Rule 15(c)2-12.

**On-behalf Of Agency** — see 63-20 Organization; a non-profit agency or corporation organized to issue bonds or enter into lease transactions
on behalf of a government or a group of governments. The property so acquired must be owned by the establishing government(s).

**Operating Lease** -- a type of lease that has none of the characteristics of a capital lease for accounting purposes. In an operating lease, the lessee has use of the leased property but the lessor retains ownership, including ownership for tax purposes. The **implicit interest rate** in an operating lease is at taxable rates and payments are considered rent (and not payments of principal and interest). The lessee usually must agree to maintain and insure the property and pay all property and sales taxes in the same manner as in a **tax-exempt lease**. This type of lease is frequently used for assets that the lessee wishes to use for short periods that are less than the full useful of the asset.

**Paying Agent** -- in a COP or master lease arrangement, a party appointed by the lessor or the lessee(s) as agent to collect the proceeds at the sale of the COPs and other sums provided by the investors and disburse such monies as directed by the lessee(s). In addition, the paying agent collects rental payments from the lessee(s) and disburses them to the investor(s) as directed by the lessor or under an agreement with the lessor and lessee(s). This function is frequently performed by the escrow agent, also called trustee.

**Payment Schedule** -- a schedule or exhibit to the lease with the date and amount of each payment due and the principal and interest components of each payment. For purposes of the Internal Revenue Code to be tax-exempt, the interest component of rental payments must be identified and set forth at the inception of the lease. Most payment schedules will also identify the date and price at which the lessee can exercise its purchase option.

**Payment Terms** -- the frequency with which lease payments are made. Depending on the transaction, payments can be monthly, quarterly, semi-annually, or annually. Payments can be in arrears or in advance. Most COPs call for quarterly or semi-annual payments in arrears.

**Premium** -- the amount by which the price of an obligation exceeds its principal amount; for tax-exempt leases, this usually is expressed in the offering memorandum for the COPs (and may constitute funds available to the underwriter for issuance costs and underwriter's discount.

**Prepayment Premium** -- also called a prepayment penalty; if a lessee exercises its purchase option, it frequently will also have to pay a prepayment premium. The amount of the prepayment premium is generally shown on the payment schedule as part of the total purchase option price. The premium includes amounts necessary to cover issuance costs that were included in the original principal or interest rate for the transaction but have not yet been amortized. The prepayment premium may also include amounts to compensate for the early termination of the lessor/investor's investment. In some cases, the premium is
expressed as a specific percentage of the remaining lease principal obligation. However, in other transactions, the amount of premium is not clearly distinguished but is blended into a schedule of prepayment prices.

**Present Value** — the equivalent value today of money available in the future, either at one time or in a series of payments. The present value is influenced by the interest rate factor applied to the future payment(s).

**Principal** — the amount loaned and repaid, usually the cost of the asset and may include certain issuance costs. Interest is charged based on the outstanding principal.

**Private Activity Bond** — under federal tax law, bonds of which (i) 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 (ii) 5% or more of the proceeds are loaned to nongovernmental persons. Interest on private activity bonds is tax-exempt only if certain requirements of Section 141 of the IRC are satisfied.

**Private Placement** — a method of selling financial obligations (including tax-exempt bonds, leases and COPs) where the investors are a limited number of informed individual or institutional investors who purchase the obligations for their portfolios and not for resale (as opposed to a **public sale**).

**Private Placement Memorandum** — see also **official statement**; the disclosure document respecting the tax-exempt lease and lessee pursuant to which **private placements** are offered and sold.

**Progress Payments** — periodic payments made to a vendor or **contractor** for the completion of specified phases or deliveries of a project or asset. In a construction project, for example, a contractor will receive payments in reimbursement for work completed to date or in progress. To guarantee that the project will be totally completed, the contractor may be required to post a performance bond.

**Property and Casualty Insurance** — insurance that lessees are required to maintain on the leased asset to protect the investor in the event the asset is damaged or destroyed. The lessee can be required to maintain the insurance for the original or replacement value of the asset or for the outstanding **principal** balance. The lessee will have to sign a Certificate of Insurance or provide other proof that it has the insurance at the proper value.

**Public Sale** — a method of selling financial obligations (including tax-exempt bonds, leases, and COPs) where an underwriter offers the securities to a large number of investors in denominations as low as
$5,000. Normally a public sale is made pursuant to an official statement.

**Purchase Option** -- a provision that gives a lessee the opportunity to purchase the leased asset at specific times during the lease term by paying the then outstanding principal, accrued interest, and, as applicable, the **prepayment premium**.

**Purchase Option Price** -- the amount due to be paid by a lessee upon exercise of its **purchase option**. This amount includes the outstanding principal, accrued interest, and, as applicable, the **prepayment premium**. This amount may also serve as a casualty value or stipulated loss value for insurance purposes. **Purchase option prices** generally are shown in the **payment schedule**.

**Quiet Enjoyment Clause** -- a provision in the lease which specifically states that so long as a lessee is not in default, the lessee shall be entitled to the quiet use and enjoyment of the leased asset and that the lessor or its assignees shall not interfere or otherwise obstruct such use.

**Quit Claim Bill of Sale** -- legal evidence of a sale of an asset without warranty.

**Rebate** -- the payment of certain **arbitrage** earnings required to be paid to the United States Treasury under the **Internal Revenue Code**.

**Redemption** -- the repayment of principal of a lease or bond.

**Refunding** -- a financing structure applicable to government obligations, including tax-exempt leases, through which the obligation is redeemed by a new financing of the same or a related **issuer** on generally more favorable financial or legal terms. Refundings are subject to certain criteria under the **IRC**.

**Registration** -- see also **book entry registration**; the act of maintaining a listing of the names and addresses of the owners of municipal bonds and COPs. Registration usually is the responsibility of the **trustee** or a registrar. However, every issuer of tax-exempt securities with a term in excess of one year, including lease transactions, is responsible under the IRC for maintaining or causing to be maintained the registry of the holders of its securities.

**Renewable Lease** -- a lease written initially for a short term (commonly one or two years depending on the lessee's budget cycle) which is renewable for subsequent similar terms until a full term equal to the **useful life** of the asset is reached. In many such leases, renewal occurs automatically unless the lease is specifically terminated by the lessee.

**Rental Interruption Insurance** -- a form of insurance that provides a flow of funds to protect investors in the event that leased property...
is not usable and the lessee elects to use the abatement provisions of the lease. If the asset is not usable and, as a result of the lease contract, the lessee is not required to make lease payments, insurance proceeds would be used to continue the payment stream unless or until the property is restored to a usable condition or the investors are paid the principal and interest due. However, many rental interruption insurance contracts are limited to the payment of rentals for a fixed number of years (commonly two) which period is deemed adequate to restore the asset to useable condition.

Reserve Fund -- a special fund established from lease proceeds from which moneys can be drawn to make lease payments if the lessee is otherwise unable. The fund can be set up entirely from lease proceeds or can be partially funded by the lessee over the term of the lease. A typical reserve fund would be an amount equal to maximum annual payments for the lease, but not to exceed 10% of the original principal amount of the lease.

Rule 10b-5 -- a rule of the Securities and Exchange Commission under the Securities Exchange Act of 1934, which requires that persons purchasing or selling securities (whether or not registered) not engage in any device or scheme to defraud or make any untrue statement of a material fact or omit to state a material fact to cause the disclosure statement to be misleading. The liabilities of failing to disclose may extend to bond counsel, underwriter's counsel, underwriters and other participants in the lease financing.

Rule 15c2-12 -- a rule, effective January 1, 1990, of the Securities and Exchange Commission that governs the review and delivery by underwriters of official statements released in conjunction with the sale of municipal securities.

Safe Harbor -- an exemption from a rule or restriction provided that the conditions of the exemption are satisfied.

Sale-leaseback -- an arrangement where one party sells an asset it owns or is acquiring to another and leases it back so that the lessee receives an infusion of cash from the sale of the asset but still retains its use. The lease can be structured as an operating lease where the new owner can depreciate the asset or as a tax-exempt lease for which the new owner receives tax-exempt interest and the original owner reacquires the asset. In the latter case, the sale-leaseback may be referred to as a sale-saleback. This structure is frequently used to permit lessees to employ the equity in assets they own to finance capital expenditures or other programs. For some governmental units, a sale-leaseback is not possible since some may only be permitted to sell property if it is "surplus" to its needs. It would then be a contradiction to first declare an asset surplus for the sale and immediately declare it essential for the lease. Surplus property rules vary from one governmental unit to another even within the same state.
Secondary Market -- a term describing the purchase and sale of securities (including tax-exempt bonds, leases, and COPs) between investors at a time after the original sale of the securities. Frequently, the underwriter will maintain a secondary market for large issues to facilitate the orderly buying and selling of the securities at any time during their term. There is very little secondary market activity for individual privately placed tax-exempt leases. Some larger institutions have sold parts of their tax-exempt lease portfolios to other institutions or public unit trusts.

Section 103 -- the section of the Internal Revenue Code that defines the types of governmental units that qualify as tax exempt.

Security Interest -- a legal claim to property that provides security to an investor (the secured party) in the event the borrower/lessee fails to make all payments otherwise due. Security interests are usually granted under the terms of the lease agreement. In most cases, security interests are recorded through the filing of a UCC-1 for equipment or, for vehicles with license plates, by a notation on the vehicle's certificate of title of the secured party's interest. For transactions involving real property, the security interest is usually recorded in the same manner as a mortgage lien. Secured parties have superior rights to creditors of the lessee respecting the assets in which they have a security interest, both prior to and in bankruptcy proceedings.

Simple Interest -- interest charged only on the principal amount and not on interest earned but not paid.

63-20 Organization -- a shorthand expression for a non-profit corporation created by a municipality to act as nominal lessor to build and acquire assets for which the municipality is lessee. Its name is derived from Revenue Ruling 63-20 (of the Internal Revenue Service) which establishes the parameters for this type of organization.

Sublease -- also sublet; a document or act by which a lessee allows another party to use the leased asset. Subleasing by the initial lessee is often restricted by the terms of the tax-exempt lease. The restrictions usually are meant to ensure the continuation of the tax-exempt status and the security of the original lease.

Tax-Exempt Lease -- also called a municipal lease, installment purchase lease, conditional sales agreement, or a lease purchase agreement; a financing arrangement whereby a state or local government or agency or subdivision thereof, as lessee, obtains the use and ownership of an asset by making periodic lease payments of principal and interest. Because the lessee is a tax-exempt entity and will own the asset, and assuming compliance with the IRC and, in California, the Revenue and Taxation Code, interest it pays is exempt for federal and state income or franchise tax purposes.
**Tax Opinion** -- the opinion of counsel specializing in tax-exempt obligations that the interest portion of rental payments received by the lessor or investor(s) from the lessee is exempt from federal income taxes and, as applicable, state income or franchise taxes. The tax opinion may be incorporated into the **bond opinion** or be separately provided.

**Time Value of Money** -- see also **present value**; an economic concept which takes into account the fact that funds due in later periods may have a diminished present value due to the intervening period and loss of investment earnings by the lender until the payment is received.

**Triple Net Lease** -- also called a **net lease**; a term describing a lease agreement where the lessee is responsible for all maintenance, insurance, utility charges, taxes, etc., associated with the leased asset and that all lease payments to be made are net of all such expenses. Tax-exempt leases are usually triple net leases.

**True Interest Cost** -- see also **effective interest rate, net interest cost**; a measure of the interest cost of a lease or bond issue that accounts for the time value of money.

**True Lease** -- a lease, which does not involve tax-exempt interest, in which (i) the lessor owns and receives tax benefits of depreciation on the asset being financed, enjoys the benefit and risk of any residual value at the end of the lease term, and is considered the true owner of the asset and (ii) the lessee receives only a right to use (has no equity build-up), can deduct its rental payments (if the lessee is a taxable entity) and has the option to purchase the asset at approximately its fair market value at the end of the lease.

**Trust Agreement** -- see **Escrow Agreement**.

**Trustee** -- see **Escrow Agent**.

**UCC-1 Financing Statement** -- see also **Certificate of Title**; a form, that once executed by a lessee and lessor and filed with the appropriate state agency (viz., the Secretary of State and, as applicable, the county recorder) records and perfects the lessor/investor's **security interest** in the leased property. The UCC-1 is used in the vast majority of tax-exempt leases in which title to the leased property is in the name of the government lessee.

**Underwriter** -- purchases bonds or COPs from the lessee/issuer or **escrow agent** with the intent to resell the securities to investors. In a firm underwriting, the **underwriter** guarantees the purchase of securities at a predetermined interest rate. In a best efforts underwriting, the underwriter agrees to utilize all reasonable resources to sell the securities (but without liability to do so or to purchase unsold securities.) Where the purchase is guaranteed, the underwriter will usually pre-sell the certificates to investors prior
to closing or if unable to, the underwriter, for at least a temporary period, may be the owner of the certificates.

**Underwriter's Concession** -- also known as underwriter's spread; the amount deducted from the proceeds of the sale of securities by the underwriter as compensation for the undetermined selling efforts and related risks.

**Underwriter's Counsel** -- an attorney that represents the interests of the underwriter in a negotiated sale of COPs. Underwriter's counsel usually will review all transaction documents and will negotiate issues affecting the underwriter. Areas of particular concern include disclosure and securities laws compliance and registration requirements.

**Underwriter's Discount** -- also called underwriter's spread; the difference between the principal amount of a security and the purchase price paid to the issuer or the trustee by the underwriter.

**Useful Life** -- a period of time during which an asset will provide the desired service to the party using it. The useful life of a piece of technical equipment could be substantially less than its expected technical life (e.g., computers due to technical obsolescence.)

**Vendor** -- the seller or supplier of personal property.

**Yield** -- the rate of interest paid to an investor.
APPENDIX B

Resources
RESOURCES

This section lists publications and organizations that can serve as resources for further information on tax-exempt leasing. The list of references contains articles, pamphlets, and books that address various leasing issues. It does not provide an exhaustive bibliography on municipal debt management.

The second list is of national organizations that offer staff and/or technical assistance on lease financing. In addition to these national organizations, there are many state and regional associations that represent government officials that may also be able to provide assistance and from which readers can seek information. Additional information and assistance is also available from state agencies such as the California Debt Advisory Commission (CDAC).
PUBLICATIONS


___________. "Tax-Exempt Leasing Letter." Association for Governmental Leasing & Finance, bimonthly newsletter.


ORGANIZATIONS

Assocations

American Association of Equipment Lessors
1300 North 17th Street
Arlington, VA 22209
703/527-8655

Association for Governmental Leasing & Finance
1101 Connecticut Avenue, NW Suite 700
Washington, DC 20036
202/429-5135

Government Finance Officers Association
180 North Michigan Avenue 8th Floor
Chicago, IL 60601
312/977-9700

or

1750 K Street, NW Suite 200
Washington, DC 20006
202/429-2750

Public Securities Association
40 Broad Street 12th Floor
New York, NY 10004
212/809-7000

or

1000 Vermont Avenue, NW Suite 800
Washington, DC 20005
202/898-9390
Other Organizations

Capital Guaranty Insurance Company
One Market Plaza
San Francisco, CA 94105
415/995-8000

Financial Guaranty Insurance Company (FGIC)
175 Water Street
New York, NY 10038
212/607-3039

Fitch Investor Service, Inc.
One State Street Plaza
New York, NY 10004
212/908-0500 or 800/753-4824

Governmental Accounting Standards Board
P.O. Box 5116
Stamford, CT 06856
203/847-0700

MBIA Corp. (Municipal Bond Investors Assurance Corp.)
113 King Street
Armonk, NY 10504
914/273-4545

Moody's Investors Service
99 Church Street
New York, NY 10007
212/553-0826

National Association of Bond Lawyers
Box 397
Hinsdale, IL 60522
312/920-0160

Standard & Poor's Corporation
25 Broadway 21st Floor
New York, NY 10004
212/208-1779