The Bond Lawyer®

The Journal of the National Association of Bond Lawyers

Volume 42, Number 3 *Summer 2018*

Editor-in-Chief
Fredric A. (Rick) Weber
Norton Rose Fulbright US LLP, Houston, Texas

Contents

Notes from the Editor (on "Material") 2
Fredric A. (Rick) Weber
Norton Rose Fulbright US LLP, Houston, Texas

Tax-Exempt Financing of Sectarian Institutions Following the Supreme Court's Decision in *Trinity Lutheran Church of Columbia, Inc. v. Comer* 5
This article originally was published in the Winter 2018 edition of the Municipal Finance Journal (Volume 38, Number 4). The article is reprinted with the permission of the publisher, the Civic Research Institute.

Federal Securities Law 22
Paul S. Maco
Bracewell LLP, Washington, D.C.

Federal Tax Law: Tax Microphone 32
Michael G. Bailey
Foley & Lardner LLP, Chicago, Illinois

Because opinions with respect to the interpretation of state and federal laws relating to municipal obligations frequently differ, the National Association of Bond Lawyers ("NABL") has given the authors who contribute to *The Bond Lawyer®* and the editor the opportunity to express their individual legal interpretations, opinions, and positions. These interpretations, opinions, and positions, whether explicit or implicit, are not intended to reflect any position of NABL or of the law firms, branches of government, or organizations with which the authors and the editor are associated, unless they have been specifically adopted by such organizations. For educational purposes, the authors and editor may employ hyperbole or offer suggested interpretations for the purpose of stimulating discussion. While NABL subjects each of the articles which are contained herein to a review process, neither the authors, reviewers, and editor nor NABL take responsibility for the completeness or accuracy of the materials contained herein. Readers are encouraged to conduct independent research into the completeness and accuracy of the materials contained herein, including the original sources of authority. *The Bond Lawyer®* is not intended to provide legal advice or counsel as to any particular situation. Errors or omissions should be forwarded via e-mail to lwyman@nabl.org.

The Bond Lawyer®: The Journal of The National Association of Bond Lawyers is published four times a year, for distribution to members and associate members of the Association. Membership information may be obtained by writing to Linda H. Wyman, COO, National Association of Bond Lawyers, 601 Thirteenth Street, NW, Suite 800 South, Washington, DC 20005-3875; calling (202) 503-3300; emailing nabl@nabl.org; or at www.nabl.org. © 2018 , NABL. Copyright is not claimed for any portion hereof prepared by any official or employee of the United States of America in the course of his or her official duties nor for articles or other items separately copyrighted by their authors.

Notes from the Editor (on "Material")

Fredric A. (Rick) Weber, Norton Rose Fulbright US LLP, Houston, Texas

I commend to your attention two important pieces in this quarter's edition of *The Bond Lawyer*. Paul Maco's piece on the recently adopted amendments to SEC Rule 15c2-12, and an article on the constitutionality of financing religiously affiliated schools by four NABL members, reproduced with generous consent from the *Municipal Finance Journal*. Paul's article, in particular, points out many shoals that lurk below the surface of the seemingly straightforward amendments to Rule 15c2-12.

(I would have stressed the importance of Mike Bailey's always cogent column, too, had he not admitted that tax law developments were upstaged by securities law developments this past quarter.)

If two of the least used words in public finance transactions are the verbs "commandeer" and "dragoon" (see Notes from the Editor in the last edition of *The Bond Lawyer)*, "material" is one of the most used. It is worth exploring the meaning of "material" as we use the term in public finance, given the use of that term in the Rule 15c2-12 amendments and in light of the SEC's hopelessly confused attempt to distinguish MCDC precedent on materiality in its release adopting the amendments (see Federal Securities Law: Amendments to Rule 15c2-12 following).

"Material" is derived from the Middle English and Middle French words "materiel," which in turn is derived from the Late Latin term "materialis," derived from the Latin "materia," meaning substances with which to make buildings. *Webster's Third New International Dictionary* (1966). ("Materia" is derived from the Latin word "mater," meaning "mother," I suppose because buildings emanate from the material used to build them. So when someone accuses the SEC's use of "material" (to distinguish reportable events) as the mother of all impositions on issuers, he or she might be taken literally.)

In common usage, "material" means "being of real importance or great consequence: substantial" and "essential." Id. But is the common meaning of the term relevant to Rules 10b-5 and 15c2-12 or to the interpretation of continuing disclosure obligations required by the latter rule?

The SEC attempted to answer this question in its release adopting the Rule 15c2-12 amendments. In the release, it addressed criticism (including by NABL) that, absent better guidance, the materiality standard is too vague to distinguish between reportable and non-reportable events, and that, in view of precedents established by the SEC in MCDC consent orders, underwriters now force issuers to disclose immaterial breaches of continuing disclosure undertakings in subsequent offering documents. The SEC addressed these concerns by attempting to distinguish MCDC precedent regarding materiality: "The Commission believes that the type of analysis undertaken in connection with the MCDC Initiative is distinct from the analysis required to determine whether a piece of information is material and must be publicly disclosed to investors in offering materials." [1]

According to the SEC, the MCDC initiative "required an assessment of whether the issuer or obligated person materially fulfilled its contractual obligations under its continuing disclosure agreement, which required a consideration of applicable state law and basic principles of contract law." (Note to the SEC: Since *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), there is no separate federal contract law, so "basic principles of contract law" are found in, and are not an addition to, state law.) A reasonable conclusion is that Rule 15c2-12 requires an underwriter to obtain an official statement that discloses prior breaches of continuing disclosure undertakings only if the breaches are "material" under state contract law. (Read to the end before relying on this conclusion.)

Under the laws of most states, absent a controlling contract provision to the contrary, a contract breach is "material" if, unless and until cured, it would excuse performance of the contract by the other party. As summarized

[1] Securities Exchange Act Release No. 34-83885, 83 Fed. Reg. 44700, 44706 (Aug. 31, 2018)(the "*Adopting Release*").

by the *Restatement of the Law Second, Contracts*, a party's obligation to perform under a contract is subject to the implied condition "that there be no uncured material failure by the other party to render any such performance due at an earlier time." *Id. §237*. Whether a breach is "material" for these purposes depends on a facts and circumstances analysis:

> In determining whether a failure to render or to offer performance is material, the following circumstances are significant:
>
> (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
>
> (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
>
> (c) the extent to which the party failing to perform will suffer forfeiture;
>
> (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account all of the circumstances including any reasonable assurances; [and]
>
> (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

Id. §241.

So what should we make of the SEC's deference to state law in an attempt to make MCDC precedent inapposite?

First, for purposes of drawing a discernable line, the state law meaning of "material" isn't much better that its meaning in the antifraud provisions of the federal securities laws. As noted in the *Restatement*, the contract law standard of materiality "is necessarily imprecise and flexible." *Id. §241, Comment a*. How would breach of a continuing disclosure undertaking be evaluated under the standard (stated above) when the other party (the investor) has fully performed, the issuer has disclaimed monetary damages for breach, whether the investor will be damaged won't be known at the time of breach, and a late filing cure is itself the breach?

Second, the SEC's assertion (that responding to the MCDC initiative required a distinct assessment under state law) is patently false, and so obviously false as to suggest disingenuousness. The MCDC initiative invited issuers as well as underwriters to self-report. Issuers aren't subject to Rule 15c2-12, which applies only to underwriters. Consequently, in deciding whether they had something to self-report, issuers were concerned with whether failure to disclose a prior breach of any sort (whether or not material for state law purposes) resulted in a material misstatement or omission within the meaning of the anti-fraud provisions. In its MCDC consent orders, the SEC confirmed this focus of concern by charging issuers with violations of the antifraud provisions, including Rule 10b-5, rather than violations of Rule 15c2-12. Even underwriters were charged with violations of the antifraud provisions, rather than Rule 15c2-12, and they are exposed to those charges whenever undisclosed breaches are material within the meaning of the antifraud provisions, even if they were not material within the meaning of Rule 15c2-12, because not material breaches under state law. Consequently, the antifraud meaning of "material" is the appropriate standard for determining whether prior breaches must be disclosed in offering documents, and MCDC precedent informs market participants about how the SEC is likely to apply that standard.

But which meaning of "material" should be applied to determine whether an issuer must give notice of a new financial obligation under a continuing disclosure undertaking that comports with the new amendments? In the SEC's view, it is the antifraud meaning. After suggesting in its release that, for MCDC purposes, state law was the relevant standard for determining whether there was a disclosable material breach, the SEC asserted that "material" as used in the antifraud provisions is the standard for whether an event is reportable under undertakings comporting with the new amendments. Under the antifraud standard, a fact is "material" if it "would have been viewed by the reasonable

investor as having significantly altered the 'total mix' of information available."[2] Accordingly,

> [U]nder the Rule, as amended, an issuer or obligated person will need to consider whether a financial obligation or the terms of a financial obligation, if they affect securities holders, would be important to a reasonable investor when making an investment decision. As noted above, an issuer or obligated person may consider a number of factors when assessing the materiality of a particular financial obligation.[3]

The SEC acknowledged that the antifraud standard requires uncertain application of a "flexible facts-and-circumstances approach to assessing materiality" and that market participants could have different opinions as to whether particular information would be important to a reasonable investor when making an investment decision, and therefore material. Nonetheless, the SEC neither adopted a brighter line standard nor offered guidance in determining materiality.

Of course, whether a continuing disclosure undertaking's use of "material" will have the meaning intended by the SEC will be determined by state contract law and is likely to depend on whether the word is ambiguous and, if so, whether it is treated as a term of art and, if so, whether the applicable "art" is state contract law or Rule 15c2-12. Regardless of the answer, it seems likely that the SEC would assert that (a) disclosure of the undertaking to investors (as required by the definition of "final official statement" in Rule 15c2-12), absent further qualification, would imply that investors are likely to receive promised notices on time, so to prevent a misleading omission of material fact would require disclosure of prior undertaking breaches that are "material" within the antifraud meaning of the term, and (b) attempts to negate the implication of timely performance in the offering document (in lieu of disclosing any such breaches) would be ineffective. Consequently, as a practical matter, issuers will be stuck with the antifraud meaning of "material" in deciding what to report, even if state law principles of contract construction would lead to a different conclusion. Since the antifraud meaning refers to the judgment of a theoretical "reasonable investor," it can't be clearly determined by examining the actual practice of actual investors. Accordingly, "material" as used in the amendments effectively means whatever the SEC deems important. Hence, the continued relevance of MCDC precedent.

One thing is certain: "material" will not be given its meaning in accounting standards. That is probably a good thing, given the 9th Law of Accounting: "material" varies inversely with days to the audit deadline. And, of course, the original meaning of "material" (described above) helps explain why my accountant was so upset by Janet Jackson's wardrobe malfunction: He saw it as a material weakness.

September 2018

[2] Adopting Release, 83 Fed. Reg. at 44706 (citing *TSC Industries, Inc. v. Northway*, .426 U.S. 438, 440 (1976)).

[3] *Id*

Tax-Exempt Financing of Sectarian Institutions Following the Supreme Court's Decision in *Trinity Lutheran Church of Columbia, Inc. v. Comer*

Matthias M. Edrich, Kutak Rock LLP, Denver, CO

Lauren Ferrero, Norton Rose Fulbright US LLP, San Antonio, TX

Ann C. Lebowitz, Law Office of Ann C. Lebowitz, Philadelphia, PA

John Utley, Kennedy & Graven, Chartered, Minneapolis, MN

Paul Wisor, Garfield & Hecht, P.C., Avon, CO

I. INTRODUCTION

A fundamental role of bond counsel in a bond transaction is to provide an unqualified opinion regarding the validity of debt under state and federal law. The determination that debt is valid requires consideration of laws that apply to the particular type of transaction. In transactions benefiting religious organizations, courts have historically interpreted federal and state constitutional provisions that limit government involvement with religion using the tests applied by the United States Supreme Court (the "Court") in *Hunt v. McNair.*[1] Bond counsel must be versed in these tests to make a meaningful determination regarding the validity of a bond issue involving a sectarian institution. The purpose of this article is to assist bond counsel in making that determination by identifying and examining trends in court opinions dealing with sectarian institutions. The Court's recent opinion in *Trinity Lutheran Church of Columbia v. Comer*[2] suggests that jurisprudence in this field is still evolving.

Part II of this article describes the typical transaction structure that governmental entities use to assist sectarian organizations in a conduit bond financing. Part III summarizes the federal constitutional framework laid out in the Establishment Clause and the Free Exercise Clause of the First Amendment and in the Fourteenth Amendment of the United States Constitution relating to governmental aid to sectarian organizations. Part IV describes how federal constitutional limitations have historically been applied based on the Court's tests originating in *Lemon v. Kurtzman*[3] and *Agostini v. Felton*[4] and applied in the bond financing area in *Hunt*. Part IV also defines the term "pervasively sectarian," based on court interpretations. Part V explores the development of federal jurisprudence since *Hunt* based in part on the suggestion recited in footnote 7 of that case and later discussions in *Mitchell v. Helms*[5] and in the United States Court of Appeals for the Sixth Circuit (the "Sixth Circuit") decision in *Steele v. Industrial Development Board of Metropolitan Government Nashville*[6] (which held that bond financings are not the equivalent of direct government support). Part V also includes a discussion of the *Trinity Lutheran Church* decision. Part VI evaluates footnote 7 of the *Hunt* case concerning indirect government aid in the context of municipal bond financings. Part VII addresses the history of state law limitations imposed on government aid to sectarian organizations and provides examples of such limitations. The article concludes with a summary of this still uncertain area of law that poses particular challenges for bond attorneys.

---

[1] *Hunt v. McNair,* 413 U.S. 734 (1973).

[2] *Trinity Lutheran Church of Columbia, Inc. v. Comer*, 137 S. Ct. 2012 (2017).

[3] *Lemon v. Kurtzman*, 403 U.S. 602 (1971).

[4] *Agostini v. Felton*, 521 U.S. 203 (1997).

[5] *Mitchell v. Helms*, 530 U.S. 793 (2000).

[6] *Steele v. Indus. Dev. Bd.*, 301 F.3d 401 (6th Cir. 2002), *cert. denied*, 537 U.S. 1188 (2003).

II. TYPICAL TRANSACTION STRUCTURE

Municipal bond financings for religious institutions usually take the form of a "conduit issuer" financing, although the matters addressed in this article can also arise in transactions that do not involve a conduit issuer. In a typical conduit issuer transaction, a state or political subdivision thereof or an "on behalf of issuer" issues bonds and loans the proceeds of such bonds to a nongovernmental organization (the "borrower") under the terms of a loan agreement.[7] The terms of the bonds are established by a resolution adopted by the issuer, in an indenture of trust between the issuer and a bond trustee or in an agreement among the issuer, the borrower, and a bond trustee or bond purchaser. The borrower agrees to repay the loan in such amounts and on such dates as will be sufficient to repay the bonds when due. The loan repayments are pledged or assigned to the bondholders, and the borrower often provides additional security to the bondholders, such as a pledge of its revenues or a mortgage. The full faith and credit and taxing powers of the conduit issuer are not typically available to pay the bonds, and no assets of the issuer (except for the right to receive payments under the loan agreement) are pledged to bondholders. This financing structure may vary from state to state depending on the provisions of the applicable conduit bond laws.

Interest on municipal bonds, whether issued in a conduit financing or otherwise, may be tax exempt if applicable requirements of the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), are satisfied. Interest may also be exempt for state income tax purposes. The tax-exempt nature of the bonds results in a lower cost of financing and is a principal reason a borrower may seek to have tax-exempt bonds issued on its behalf.

III. FEDERAL CONSTITUTIONAL FRAMEWORK

The First Amendment of the United States Constitution states in relevant part that: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." The first clause, providing that Congress shall make no law respecting an establishment of religion, is designated as the Establishment Clause. According to the Court in *Walz v. Tax Commission,*[8] the Establishment Clause was intended to afford protection against "three main evils . . . : 'sponsorship, financial support, and active involvement of the sovereign in religious activity.'"[9] The second clause, providing that Congress shall make no law prohibiting the free exercise thereof, is designated as the Free Exercise Clause. The Free Exercise Clause and the Establishment Clause apply to the states under the Fourteenth Amendment to the United States Constitution.[10] The Court's decision in *Hunt* is the only Court decision addressing the application of the Establishment Clause to the issuance of municipal bonds by a state or local conduit issuer for the benefit of a religious institution. No Court decision has separately addressed the application of the Free Exercise Clause in municipal bond financing circumstances.

As discussed in more detail in Part VII, most state constitutions include provisions that forbid direct government aid to educational institutions with a religious affiliation. These provisions are commonly referred to as "Blaine Amendments." Although the scope of such constitutional provisions varies from state to state, the provisions may limit the ability of a state or a political subdivision conduit issuer to issue bonds to finance the facilities of a religious institution.

---

[7] Transaction structures vary from state to state depending on applicable state statutes and jurisprudence and may include, for example, the installment sale or lease of bond- financed property to the borrower, instead of a loan of the proceeds of the financing. In- stallment purchase or lease payments received by the conduit issuer are used to repay the financing source in such structures. As with loan structures, a conduit issuer may secure installment sales or leases with, for example, mortgages or assignments of revenue of the borrower. See, e.g., Assoc. for Govt'l Leasing & Finance, Fifty State Survey, Governmental Leasing: Surveys of Legislation and Case Law in the Fifty States, Federal Tax Law and Federal Securities Law (2012 Edition). References in this article to "loans" include loans, installment sales, leases, and similar financing structures.

[8] *Walz v. Tax Comm'n of N.Y.*, 397 U.S. 664 (1970).

[9] *Lemon v. Kurtzman*, 403 U.S. 602, 612 (1971).

[10] See *Cantwell v. Connecticut*, 310 U.S. 296, 303 (1940); and *Everson v. Bd. of Educ.*, 330 U.S. 1, 8 (1947); see also *Cal. Statewide Cmtys. Dev. Auth. v. All Persons Interested*, 152 P.2d 1070 (Cal. 2007).

IV. FIRST AMENDMENT TESTS IN LEMON, HUNT, AND AGOSTINI

The Court's current Establishment Clause jurisprudence is most notably represented by *Lemon*—decided in 1971—and by *Agostini*—decided in 1997. However, the Court's analysis of municipal bond financing begins with *Hunt*, which was decided in 1973. The following provides a brief summary of significant Establishment Clause jurisprudence, beginning with *Lemon*.

Lemon v. Kurtzman

In Lemon, the Court articulated a three-part test for determining whether a law violates the Establishment Clause by analyzing whether such law (1) has a secular legislative purpose, (2) has a principal or primary effect of advancing or inhibiting religion, and (3) fosters an excessive entanglement between government and religion.[11] This test, commonly known as the "*Lemon Test*," remains the foundational analysis used in examining the constitutionality of municipal bond financings for sectarian organizations.[12] In *Lemon*, the Court found that a state statute providing a salary supplement to teachers in nonpublic schools violated the Establishment Clause[13] based on the excessive entanglement between the government and religion.[14] Funding additional teacher compensation requires state certainty "that subsidized teachers do not inculcate religion" through "comprehensive, discriminating, and continuing state surveillance" to ensure Establishment Clause compliance.[15] The Court took the position that, "unlike a book, a teacher cannot be inspected once so as to determine the extent and intent of his or her personal beliefs and subjective acceptance of the limitations imposed by the First Amendment. These prophylactic contacts [would] involve excessive and enduring entanglement between state and church" and necessarily require continuous monitoring of teacher instruction.[16]

Hunt v. McNair

The Court has only once considered whether a municipal bond transaction satisfies the *Lemon* Test. In *Hunt*, the Court used the *Lemon* Test to uphold a conduit bond financing arrangement between a South Carolina public authority and a Baptist-controlled college. The Court found that the authority's approving action was based on a secular purpose because the authority's enabling statute was intended to promote education in all institutions of higher education regardless of religion.[17] The Court explained that the government aid satisfied the remaining *Lemon* prongs, emphasizing that the college was not a "pervasively sectarian" institution.[18] Consistent with this ruling (although not in the context of municipal bonds), the Court had previously determined in *Roemer v. Board of Public Works*[19] and *Tilton v. Richardson*[20] that state aid could not fund institutions that "are so 'pervasively sectarian' that secular activities cannot be separated from sectarian ones, and . . . that if secular activities can be separated out, they alone may be funded."[21]

---

11 *Lemon*, 403 U.S. at 612–613.

12 See, e.g., Martha Ratnoff Fleisher, Establishing Bonds Between Church and State: The Issuance of Tax-Exempt Bonds for Religious Institutions, 2 First Amend. L. Rev. 199, 206–207 (2004).

13 *Lemon*, 403 U.S. at 625.

14 *Id.* at 614.

15 *Id.* at 619.

16 *Id.*

17 *Hunt v. McNair,* 413 U.S. 734, 746 (1973).

18 *Id.* at 743–744.

19 *Roemer v. Bd. of Pub. Works*, 426 U.S. 736 (1967).

20 *Tilton v. Richardson*, 403 U.S. 672 (1971).

21 *Roemer*, 426 U.S. at 755; see also Tilton, 403 U.S. at 686–687.

While the Court in *Hunt* analyzed the transaction utilizing the *Lemon* Test, it expressed uncertainty that the sort of aid involved in a conduit bond financing should be subject to the same scrutiny as general expenditures. The Court suggested that "the 'state aid' involved in [the] case [was] of a very special sort. . . . [T]he only State aid consist[ed] not of financial assistance directly or indirectly which would implicate public funds or credit, but the creation of an instrumentality . . . through which educational institutions may borrow funds on the basis of their own credit and the security of their own property."[22] As Part V of this article describes, this suggestion underlies much of the recent jurisprudence relating to pervasively sectarian institutions.

Agostini v. Felton

The *Lemon* Test was modified by *Agostini*, where the Court folded the "excessive entanglement" prong into the "primary effects" prong. Under the new "*Lemon-Agostini* Test" with the combined primary effects prong, a court considers whether (1) the law has a secular legislative purpose, (2) the action results in governmental indoctrination, (3) the action defines its recipients by reference to religion, and (4) the action creates an excessive entanglement between the government and religion.[23]

The proper "primary effects" analysis must, according to the Court, focus on whether the allocation criteria underlying the government's actions favor or disfavor religion.[24] In *Agostini*, the Court held that a "federally funded program providing supplemental, remedial instruction to disadvantaged children on a neutral basis is not invalid under the Establishment Clause when such instruction is given on the premises of sectarian schools by government employees pursuant to a program containing safeguards such as those present" within New York's Title I program.[25] The Court in *Agostini* found this program distinguishable from Lemon due to the program's purpose of providing disadvantaged students, enrolled in both private and public schools, remedial education to prevent failure to meet state academic performance standards.[26] The Court found that the program did "not result in governmental indoctrination; define its recipients by reference to religion; or create an excessive entanglement."27 Furthermore, the primary effect of the program neither favored nor disfavored any religion (or no religion at all), and was made available to both religious and secular beneficiaries on a nondiscriminatory basis.[28] Notably, even incidental benefits to religion, as was the case in *Agostini*, resulting from a neutral and nondiscriminatory program have been held not to violate the Establishment Clause.[29]

The Pervasively Sectarian Standard

The Court in *Hunt* applied a "pervasively sectarian" standard in deter- mining whether an organization is subject to heightened review under the *Lemon* Test in connection with a municipal bond financing. A pervasively sectarian institution, according to the Court, is one where "a substantial portion of its functions are subsumed in the religious mission."[30] To determine the second prong of the *Lemon* Test—whether the primary effect of the act advanced or inhibited religion—the Court in *Hunt* focused on the institution's religious nature.[31] The Court found that the college was not pervasively sectarian even though the members of the College Board of Trustees were elected by the South Carolina Baptist Convention (the

[22] *Hunt,* 413 U.S. at 745 n.7. It should be noted that the Court in Hunt addressed a financing structure involving a loan agreement in which the borrower owned the property. In financing structures involving installment sales or lease structures, title to the financed property may remain with the conduit issuer until the termination of the financing structure. So long as the borrower has what is known as tax ownership of the property in question for the life of the financing, tax-exempt debt may be issued on its behalf if it otherwise qualifies.
[23] *Agostini v. Felton*, 521 U.S. 203, 234 (1997); see also Cal. Statewide Cmtys. Dev. Auth. v. All Persons Interested, 152 P.2d 1070, 1082 (Cal. 2007).
[24] *Id.* at 231.
[25] *Id.* at 234–235.
[26] *Id.* at 233–234.
[27] *Id.* at 234.
[28] *Id.* at 231.
[29] *Comm. for Pub. Educ. & Religious Liberty v. Regan*, 444 U.S. 646, 661–662 (1980) (State statute providing payments to nonpublic schools, including of costs incurred in complying with state-mandated requirements, found not to violate the First and Fourteenth Amendments).
[30] *Hunt v. McNair*, 413 U.S. 734, 743 (1973).
[31] *Id.* at 743.

"Convention"), the approval of the Convention was required for certain financial transactions, the charter of the college could be amended only by the Convention, and 60% of the college student body was Baptist.[32] The Court reasoned that because there were no religious qualifications for faculty membership or student admissions, and because the percentage of Baptist students was "roughly equivalent" to the percentage of Baptists in that geographical area, there was "no basis" to conclude that the college was pervasively sectarian.[33] According to *Hunt*, an institution's student admissions guidelines, the religious qualifications of teachers, and the extent to which religious coursework is required are also relevant factors in determining whether the institution is pervasively sectarian.[34]

In *Tilton*, the Court suggested that a pervasively sectarian school is one where the religiosity "permeates the secular education" provided.[35] The Court did not start with the assumption that all religiously affiliated schools are pervasively sectarian.[36] Rather, in demonstrating the proper analysis of the pervasively sectarian standard, the Court examined the "individual project" being funded and then evaluated whether that project possessed sectarian attributes.[37] The Court suggested that attributes of a pervasively sectarian organization include: (1) imposing religious restrictions on admissions; (2) requiring attendance at religious activities; (3) compelling obedience to the doctrines and dogmas of the particular faith in question; (4) requiring instruction in theology and doctrine; and (5) propagating a particular religion in every way possible.[38] The Court also listed the fol- lowing attributes contributing to the sectarian nature of an institution:

> Two of the five federally financed buildings involved in this case are libraries. The District Court found that no classes had been conducted in either of these facilities and that no restrictions were imposed by the institutions on the books that they acquired. . . . The third building was a language laboratory at Albertus Magnus College. The evidence showed that this facility was used solely to assist students with their pronunciation in modern foreign languages—a use which would seem peculiarly unrelated and unadaptable to religious indoctrination. Federal grants were also used to build a science building at Fairfield University and a music, drama, and arts building at Annhurst College. . . . [Courses at these institutions are taught according to the academic requirements intrinsic to the subject matter and the individual teacher's concept of professional standards. Although appellants introduced several institutional documents that stated certain religious restrictions on what could be taught, other evidence showed that these restrictions were not in fact enforced and that the schools were characterized by an atmosphere of academic freedom rather than religious indoctrination. All four institutions, for example, subscribe to the 1940 Statement of Principles on Academic Freedom and Tenure endorsed by the American Association of University Professors and the Association of American Colleges.[39]

The issue in *Tilton* was whether a federal statute that authorized grants and loans to institutions of higher education for the construction of a wide variety of academic facilities violated the Establishment Clause or the Free Exercise Clause.[40] To determine whether the statute reflected a secular legislative purpose (the first prong of the *Lemon* Test), the Court stated that "the crucial question is not whether some benefit accrues to a religious institution as a consequence of the legislative program, but whether its principal or primary effect advances religion."[41]

In *Roemer*, the State of Maryland offered monetary grants to private universities on the condition funds were not used for sectarian purposes.[42] The Court stated that non-mandatory religious services, along with additional factors, led to a finding

---

[32] *Id.* at 743–745.
[33] *Id.*
[34] *Id.*
[35] *Tilton v. Richardson,* 403 U.S. 672, 681 (1971).
[36] *Id.*
[37] *Id.* at 682.
[38] *Id.*
[39] *Id.* at 681–682.
[40] *Id.* at 674–675.
[41] *Id.* at 679.
[42] *Roemer v. Bd. of Pub. Works,* 426 U.S. 736, 740 (1967).

that the institution was not "pervasively sectarian," and applied the *Lemon* Test analysis to determine the grants as constitutionally permissible.[43]

Other courts have also used similar criteria to determine whether a particular institution is pervasively sectarian. The Supreme Court of Virginia in *Virginia College Building Authority v. Lynn*,[44] a case relating to the issuance of tax-exempt revenue bonds to finance a new college campus, applied the pervasively sectarian standard in a two-step analysis (1) questioning whether the institution is pervasively sectarian and (2) considering whether "the unique nature of the aid is nonetheless permitted without offending the Establishment Clause."[45] In this case, the court found that Regent University was pervasively sectarian after considering the following factors:

(1) whether the institution is formally affiliated with a church and the amount of institutional autonomy it enjoys apart from the church with which it is affiliated; (2) whether one of the purposes of the institution is the indoctrination of religion and whether the institution's activities reflect such a purpose or exert dominating religious influence over the academic curriculum; (3) whether the institution reflects an atmosphere of academic freedom; (4) the institution's policy on classroom prayer or other evidence of religion entering into elements of class- room instruction; (5) the existence and utilization of religious qualifications for faculty membership or student admission; and (6) the religious composition of the student population and faculty.[46]

The Court in *Mueller v. Allen*[47] found that tax deductions for expenses incurred in sending children to parochial schools did not have the primary effect of advancing sectarian aims and did not violate the Establishment Clause.[48] In concluding that a constitutional violation did not exist, the Court found the following factors "particularly significant": (1) the tax deduction at issue was "only one among many deductions . . . such as those for medical expenses . . . and charitable contributions . . . available under the Minnesota tax laws,"[49] (2) "the deduction is available for educational expenses incurred by *all* parents, including those whose children attend public schools and those whose children attend non-sectarian private schools or sectarian private schools,"[50] (3) "the Establishment Clause objections are 'reduced' by channeling whatever assistance [the deduction] may provide to parochial schools through individual parents,"[51](4) "[t]he historic purposes of the Clause simply do not encompass the sort of attenuated financial benefit, ultimately controlled by the private choices of individual parents, that eventually flows to parochial schools from the neutrally available tax benefit at issue in this case,"[52] and (5) "private educational institutions, and parents paying for their children to attend these schools, make special contributions to the areas in which they operate."[53]

The Court further considered the relevance of a pervasively sectarian institution in *Zobrest v. Catalina*[54] where petitioners, a deaf child and his parents, filed suit after respondent school district refused to provide a sign-language interpreter to accompany the child to classes at a Roman Catholic high school.[55] The Court noted: "We have consistently held that governmental programs that neutrally provide benefits to broad class of citizens defined without reference to religion are not readily subject to an Establishment Clause challenge just because sectarian institutions may also receive an attenuated financial benefit."[56] Here, the Court primarily relied on two factors to find that there was not an Establishment Clause violation: (1) the

---

[43] *Id.* at 760
[44] *Va. Coll. Bldg. Auth. v. Lynn*, 538 S.E.2d 682, 697 (Va. 2000).
[45] The court reached this two-step analysis by noting that some governmental aid involved pervasively sectarian schools, but was found to not violate the Establishment Clause because the nature of the aid (the bond-financing assistance) was dispositive, irrespective of the nature of the institution. *Id.* at 695.
[46] *Id.* at 697.
[47] *Mueller v. Allen*, 463 U.S. 388 (1983).
[48] *Id.* at 402.
[49] *Id.* at 396.
[50] *Id.* at 397.
[51] *Id.* at 399.
[52] *Id.* at 400.
[53] *Id.* at 401.
[54] *Zobrest v. Catalina Foothills Sch. Dist.*, 509 U.S. 1 (1993).
[55] *Id.* at 3.

service at issue is "part of a general government program that distributes benefits neutrally to any child qualifying as 'disabled' under the [Individuals with Disabilities Education Act, 20 U.S.C. § 1400 et seq.], without regard to the secretarian-nonsectarian, or public-nonpublic nature' of the school the child attends;"[57] and (2) because a sign-language interpreter does nothing more than "accurately interpret whatever material is presented to the class as a whole," the interpreter "will neither add to nor subtract from that environment."[58]

The Court has repeatedly upheld public-assisted financing for sectarian schools (including bond financing and other types of financial assistance), especially in instances where it was simple to trace funds between secular and non-secular uses. As set forth in *Lemon*, the entanglement of religion in a program "arises because of the religious activity and purpose of the church-affiliated schools, especially with respect to children of impressionable age in the primary grades, and the dangers that a teacher under religious control and discipline poses to the separation of religious from purely secular aspects of elementary education in such schools."[59] The Court typically is less concerned with religious indoctrination of college-aged students, based on the notion that these students are capable of independent thinking and are less susceptible to religious influence.[60] Additionally, a number of cases, including *Roemer, Hunt, and Tilton*, all draw a distinction between the religious nature found in colleges as compared to primary or secondary schools.[61] The Court in *Tilton* found that "[t] here are generally significant differences between the religious aspects of church-related institutions of higher learning and parochial elementary and secondary schools."[62] Potential Establishment Clause violations receive additional scrutiny if elementary or secondary schools are involved due to the age and vulnerable nature of students attending these institutions. "Since religious indoctrination is not a substantial purpose or activity of these church-related colleges and universities, there is less likelihood than in primary and secondary schools that religion will permeate the area of secular education"[63] (and such facts are typically considered a factor in a constitutional analysis). Even considering the susceptible nature of the students attending elementary and secondary schools, coupled with the Court's previous cautions as set forth above, in its most recent Establishment Clause jurisprudence, as discussed below in *Mitchell v. Helms*, the Court held that a federal program lending funds to local education agencies for distribution to both public and private schools was constitutional.[64]

V. DECLINE OF THE PERVASIVELY SECTARIAN STANDARD

The jurisprudence relating to governmental aid of sectarian organizations has continued to evolve since *Lemon, Hunt, and Agostini*. Indicative of this evolution is the criticism that has been leveled against the "pervasive sectarianism" inquiry under the *Lemon-Agostini* Test. The argument in footnote 7 of the *Hunt* opinion has also lent support to the proposition that certain types of governmental aid may be so general as to avoid any concern about governmental entanglement, although whether the underlying rationale of this argument applies to municipal bonds is still unclear.

Mitchell v. Helms

In *Mitchell*, the Court's plurality opinion (published in 2000) referred to the pervasive sectarianism inquiry as a test with a "shameful pedigree,"[65] "born of bigotry [that] should be buried now"[66] and offered several reasons to "formally dispense" with the test.[67] The Court noted that, at the time of the decision, no aid program had been struck down because of the test since 1985.[68]

---

[57] *Id.* at 10.
[58] *Id.* at 13.
[59] See *Lemon v. Kurtzman*, 403 U.S. 602, 603 (1971); see also *id.* at 616.
[60] *Tilton v. Richardson*, 403 U.S. 672, 686 (1971).
[61] *Hunt v. McNair*, 413 U.S. 734, 746 (1973).
[62] *Tilton,* 403 U.S. at 685.
[63] *Id.* at 687.
[64] *Mitchell v. Helms*, 530 U.S. 793, 801 (2000).
[65] *Id.* at 828.
[66] *Id.* at 829.
[67] *Id.* at 826.
[68] *Id.*

In fact, between 1985 and 2000, there were several cases where aid programs assisting pervasively sectarian schools were upheld.[69] The *Mitchell* Court explained that the important part of the constitutional analysis was whether the recipient adequately furthered the government's secular purposes and that the nature of the recipient should not matter.[70] In other words, government indoctrination cannot take place if the government aid is available to "religious, irreligious and a religious . . . alike" because the aid is neutrally available This holding effectively replaced the pervasively sectarian limitation with a neutrality approach as the dominant analytical starting point for determining whether government aid is constitutional. According to the plurality opinion:

> In distinguishing between indoctrination that is attributable to the State and indoctrination that is not, we have consistently turned to the principle of neutrality, upholding aid that is offered to a broad range of groups or persons without regard to their religion. . . . [I]f the government, seeking to further some legitimate secular purpose, offers aid on the same terms, without regard to religion, to all who adequately further that purpose . . . , then it is fair to say that any aid going to a religious recipient only has the effect of furthering that secular purpose.[72]

The plurality opinion stated that, in addition to being unnecessary, an inquiry into an aid recipient's religious views was offensive.[73] There are several examples of precedent that prohibit governments from discriminating in the distribution of public benefits based on religious affinity or status; therefore, discriminating against pervasively sectarian institutions in the distribution of government aid would be problematic.[74] The plurality opinion of the *Mitchell* Court also found that the Establishment Clause does not require the exclusion of pervasively sectarian schools from government aid programs and that doing so would bring back to life religious hostility and bigotry from the late nineteenth century.[75]

Footnote 7 to Hunt

In *Hunt*, the Court applied the *Lemon* Test to conclude that a bond financing transaction for a college with 60% Baptist students did not offend the Establishment Clause. Notwithstanding its application of the *Lemon* Test, the Court included a footnote ("footnote 7") that has been significant in the evolution of First Amendment jurisprudence. Footnote 7 states:

> The "state aid" involved in this case is of a very special sort. We have here no expenditure of public funds, either by grant or loan, no reimbursement by a State for expenditures made by a parochial school or college, and no extending or committing of a State's credit. Rather, the only state aid consists not of financial assistance directly or indirectly which would implicate public funds or credit, but the creation of an instrumentality . . . through which educational institutions may borrow funds on the basis of their own credit and the security of their own property upon more favorable interest terms than otherwise would be available. The Supreme Court of New Jersey characterized the assistance rendered an educational institution under an act generally similar to the South Carolina Act as merely being a 'governmental service.' . . . The South Carolina Supreme Court . . . described the role of the State as that of a 'mere conduit.' . . . Because we conclude that the primary effect of the assistance afforded here is neither to advance nor to inhibit religion under *Lemon* and *Tilton*, we need not decide whether . . . the importance of the tax exemption in the South Carolina scheme brings the present case under *Walz* . . . where this Court upheld a local property tax exemption which included religious institutions.[76]

---

[69] *Id.*; Agostini v. Felton, 521 U.S. 203 (1997); *Zobrest v. Catalina Foothills Sch. Dist.*, 509 U.S. 1 (1993).
[70] *Mitchell*, 530 U.S. at 827.
[71] *Id.* at 809.
[72] *Id.* at 809–810.
[73] *Id.* at 828.
[74] *Id.*
[75] *Id.*
[76] *Hunt v. McNair*, 413 U.S. 734, 745 n.7 (1973).

In footnote 7, the Court recognized the possibility that there may be certain types of aid that are so indirect as to not lead to government entanglement with religion in violation of the principles underlying the *Lemon* Test.

Steele stands for the line of cases concluding that financial assistance, including in the form of tax-exempt financing and tax exemptions, involving pervasively sectarian institutions is constitutional simply because the government aid is sufficiently indirect.[77] *Steele* involved the $15 million municipal bond financing of David Lipscomb University for the renovation of campus facilities. According to the findings in the lower court, the university qualified as a pervasively sectarian institution because the university integrated Christian perspectives into the curriculum and promoted spiritual growth in its students.[78] Opponents of the financing initiated an Establishment Clause challenge that ended in a decision by the Sixth Circuit in favor of the university. The Sixth Circuit held that, even though the university was pervasively sectarian, the United States Constitution did not prohibit tax-exempt financing because the government in such transactions serves as a mere conduit.[79] This government aid, according to the Sixth Circuit, is no different from religiously neutral tax exemptions or fire and police protection afforded to houses of religious worship.[80] Courts previously found tax exemptions constitutional in prior cases involving government aid to religious institutions. Unlike direct financial aid, the issuer's actions in tax-exempt financing transactions constitute no more than mere indirect transactional assistance. As the Court in *Hunt* explained, the issuer is "an instrumentality . . . through which educational institutions may borrow funds on the basis of their own credit and the security of their own property upon more favorable interest terms than otherwise would be available."[81] The Sixth Circuit concluded that "the nature of the institution is not the relevant inquiry in [a tax-exempt financing transaction]."[82] The Court denied certiorari.[83]

Trinity Lutheran v. Comer

In *Trinity Lutheran*, the recent 2017 case not involving bond financing, seven of the Court's justices agreed that the State of Missouri stood in violation of the Free Exercise Clause when it denied a state subsidy for playground resurfacing to a pre-school because the pre-school, which otherwise qualified for the grant, was affiliated with and operated by a church. The resurfacing subsidy would have reimbursed the church for a portion of the cost of replacing the playground's hazardous gravel surface with a safer surface of recycled tire rubber.[84] The seven justices voting in favor of the subsidy for the church-affiliated pre-school wrote four opinions with no single opinion gaining an unqualified majority. The various opinions of these seven justices suggest that the result in *Trinity Lutheran* was substantially driven by the particular facts of the case before the Court and that an attempt to read the case more broadly may be inappropriate.[85] Many bond counsel might have wished that the Court would have addressed the impact of the Establishment Clause on these facts. However, as *Trinity Lutheran* was briefed and argued to the Court, the Establishment Clause was not at issue. While the pre-school could be classified as pervasively sectarian, the subsidy offered by Missouri could readily be characterized as a general government service similar to

[77] See, e.g., *Zobrest v. Catalina Foothills Sch. Dist.*, 509 U.S. 1 (1993); *Witters v. Wash. Dep't of Servs for Blind*, 474 U.S. 481, 486–487 (1983); *Mueller v. Allen,* 463 U.S. 388, 399 (1983); *Walz v. Tax Comm'n of N.Y.*, 397 U.S. 664, 674 (1970).

[78] *Steele v. Indus. Dev. Bd.*, 301 F.3d 401, 418 (6th Cir. 2002).

[79] *Id.* at 414.

[80] See *Walz*, 397 U.S. at 676.

[81] *Hunt*, 413 U.S. at 745 n.7.

[82] *Steele*, 301 F.3d at 416.

[83] *Steele v. Indus. Dev. Bd. of Metro. Gov't Nashville*, 537 U.S. 1188 (2003).

[84] *Trinity Lutheran Church of Columbia, Inc. v. Comer,* 137 S. Ct. 2012 (2017).

[85] Justice Sotomayor, joined by Justice Ginsberg, wrote a dissenting opinion in which she chastised the Court for making the case appear too simple: "To hear the Court tell it, this is a simple case about recycling tires to resurface a playground." *Id.* at 2027 (Sotomayor, J., dissenting). While the dissenting justices viewed the stakes as much higher and the Court's ruling as a slight on its previous precedents concerning the beneficial separation of church and state, the *Trinity Lutheran* decision is nonetheless a very narrow holding. *Id.* at 2024 n. 3.

police and fire protection; one that operated, in the words of Justice Stephen Breyer's concurring opinion, "to secure or to improve the health and safety of children."As Chief Justice John Roberts observed during oral argument, the State of Missouri had already acknowledged in its brief that "there was no Establishment Clause problem here." Further, the parties in *Trinity Lutheran* agreed that the Establishment Clause did not prevent the state from including the church in the subsidized playground resurfacing pro- gram. Accordingly, the only issue before the Court was whether the Missouri policy of excluding otherwise qualified sectarian institutions from these subsidies violated the Free Exercise Clause by denying the church a public benefit solely on account of its religious identity. Notably, the par- ties did not ask the Court to reconsider its decision in Locke v. Davey,[86] where the Court upheld against a Free Exercise Clause challenge decision of the State of Washington, which refused to issue a general fund-based scholarship for ministerial training.[87]

Because the majority of the justices apparently viewed the *Trinity Lutheran* decision as factually limited, it is important to understand the factual underpinnings of the case.[88] To encourage the use of recycled materials, Missouri awarded a limited number of state subsidies to qualified applicants who sought funds to resurface school playgrounds. The program was funded by a fee imposed on new tire sales. The resurfacing grants were administered pursuant to a competitive process that evaluated each application under criteria such as the poverty level of the surrounding community and the applicant's plan to promote recycling. Trinity Lutheran Church operates a pre-school on its property. The school is open to children of any religion. Trinity Lutheran Church pointedly did not claim that it was entitled to a state subsidy. Rather, it asserted its right to participate in the state-funded program "without having to disavow its religious character."[89] Trinity Lutheran Church applied for the playground resurfacing grant to provide a safer playground surface for students of the pre-school and for children in the local community who used the playground during non- school hours. The church's application ranked fifth out of forty-four applicants. Fourteen grants were awarded under the program. Despite its high ranking, the church's application was rejected because the State of Missouri "had a strict and express policy of denying grants to any applicant owned or controlled by a church, sect or other religious entity" based on the provisions of Article I, Section 7, of the Missouri Constitution (Missouri's Blaine Amendment), which provides "[t]hat no money shall ever be taken from the public treasury, directly or indirectly, in aid of any church, sect or denomination of religion . . . ."[90]

Because the seven justices voting against Missouri's strict withholding of government assistance to religious institutions did not uniformly agree on a single opinion, an evaluation of *Trinity Lutheran's* scope and import for bond practice requires a "decisional roadmap." The Court's principal opinion was delivered by Chief Justice Roberts, who in footnote 3 to his opinion limited his decision to the church's particular claim of playground resurfacing discrimination.[91] This opinion was joined in full by Justices Anthony Kennedy, Samuel Alito, and Elena Kagan, who endorsed the opinion's limiting footnote. This restrictive reading of the *Trinity Lutheran* decision is supported by the opinions of Justices Clarence Thomas and Neil Gorsuch, who concurred in the result but specifically did not join the limiting footnote 3, indicating that they favored a broader ruling.[92] Also offering his view that the *Trinity Lutheran* decision is narrowly focused is the opinion of Justice Breyer

[86] *Locke v. Davey,* 540 U.S. 712 (2004).

[87] *Trinity Lutheran*, 137 S. Ct. at 2025 (Thomas, J., concurring).

[88] While it is not the purpose of this article to provide an exhaustive analysis of the First Amendment Establishment and Free Exercise clauses, it is worth noting that the multi-level analysis applied by the Court's past precedents on the parameters of the First Amendment religion clauses derives from a factually dependent analysis of the "'play in the joints' between what the Establishment Clause permits and the Free Exercise Clause compels." Id. at 2019. From the standpoint of the clarity and certainty required of the bond counsel opinion, it is difficult to extrapolate legal certainty from such fact-based (and limited) analyses.

[89] *Id.* at 2015.

[90] *Id.* at 2017 (quoting Mo. Const. of 1875, art I, § 7 (1945)).

[91] *Id.* at 2024 n.3. ("This case involves express discrimination based on religious identity with respect to playground resurfacing. We do not address religious uses of funding or other forms of discrimination.")

[92] *Id.* at 2025–2026 (Thomas, J., concurring).

[93] *Id.* at 2026–2027 (Breyer, J., concurring).

who, concurring only in the judgment, "find[s] relevant, and would emphasize the particular nature of the 'public benefit' at issue" as a matter of Missouri's discriminatory exclusion of the church from, as noted above, a "general program designed to secure or to improve the health and safety of children."[93] In Justice Breyer's view, the government denial of safe playground resurfacing is analogous to a denial of ordinary police and fire protection. Because the faith-based withholding of such general public benefits of safety is not within the purpose of the First Amendment, Justice Breyer "would leave the application of the Free Exercise Clause to other kinds of public benefits to another day."[94]

In sum, even assuming that the concurring opinions of Justices Thomas and Gorsuch demonstrate that they would have applied the *Trinity Lutheran* decision more broadly, at least five of the seven justices who concurred in the result made clear their limited view of the decisional import of Chief Justice Roberts' opinion.[95] Based on this analysis, the *Trinity Lutheran* decision would appear to provide little, if any, support for a change in the prevailing test for evaluating whether bond counsel can confidently provide a bond opinion as to the validity of municipal bond financings for pervasively sectarian institutions.

VI. ASSESSMENT OF INDIRECT GOVERNMENT AID IN THE CONTEXT OF MUNICIPAL BOND ISSUANCES

In considering whether a municipal bond financing could violate the Establishment Clause as a result of the advancement of religion by, or the excessive entanglement of the sectarian organization with, the government issuer, it is necessary to identify the differences between bond financing and other forms of aid and understand the significance of those differences. To do so, one must first look at the rights and obligations of the government when it issues conduit bonds.

What does it mean to say that the bonds are an obligation of the government? The answer will likely depend on the purpose of the inquiry. There are at least four perspectives that one might consider in answering this question: state law, securities law, federal and state tax law, and the economic reality of the financing.

The constitutional problem in issuing conduit bonds is one of state law validity. If the bond issuance is unconstitutional, the legal authority for the issuance of the bonds is lacking and the bonds would be invalid. Bonds that are invalid would not be enforceable in accordance with their terms, may not be exempt from securities law registration, and would not be tax exempt. Most state laws involving conduit issuers distinguish between bonds and a general obligation to repay the debt reflected by the bonds. Conduit bonds are generally considered the issuer's bonds, but the issuer is under no obligation to pay debt service on the bonds except to the extent the issuer receives payments from the conduit borrower. An issuer's bonds are subject to a variety of state law requirements that may include limitations on inter- est rate, permitted investment restrictions, purposes for which the bonds may be issued, maturity, principal amount, purchase price, security provisions, conflict of interest disclosure rules, and public notice and hearing requirements. Each of these requirements may place restrictions on the conduit borrower that could result in entanglement. For example, a state law limiting investments to federal securities or prohibiting bond proceeds from being spent on working capital or inventory may necessitate that the government make inquiry post-issuance into the manner in which the proceeds have been used.[96] However, if the government unit issuing the bonds has no general obligation to make payments on the bonds, and as a result the bonds are not considered a debt of the government, one can conclude that no public funds are used to provide aid to the borrower.[97]

---

[95] The justices who seemingly gave a very narrow interpretation of the *Trinity Lutheran* holding are Chief Justice Roberts and the three justices (Kennedy, Alito, and Kagan) whose joinder in the opinion was unqualified, including their unqualified joinder in the limiting footnote 3, and Justice Breyer, whose opinion emphasizes the constitutional impropriety of withholding a general public health and safety benefit solely for faith-based reasons. Accordingly, five of the nine justices who heard the *Trinity Lutheran* case agreed that the holding was a limited one.

[96] In many conduit financings, however, this type of monitoring is assigned to the bond trustee or is an obligation of the conduit borrower.

[97] It is possible that some government funds might be used to support the conduit issuer, but such support presumably would be neutral.

This state law distinction is relevant in assessing the extent to which the government could be considered as being entangled with the borrower resulting in a limitation on the free exercise of religion or advancing religion through providing indirect aid. One can distinguish aid in the form of providing hot lunches, textbooks, and shredded tires (as was the case in *Trinity Lutheran*) from the issuance of bonds because, for the most part, there is no ongoing relationship between the issuer and the borrower after lunches, books, and shredded tires are provided, while there may be continuing obligations of both the issuer and the borrower in the case of a bond financing. The extent of the entanglement will depend in each instance on the particular requirements imposed by the state law and by the conduit issuer. The extent of such an entanglement could be a factual inquiry determined on a case-by-case basis.

While the bonds may not be the debt of the issuer for state law purposes, federal securities law still considers the bonds to be securities of the issuer. As such, an issuer cannot eliminate its legal obligations and insulate itself from securities law liability by merely disavowing responsibility. A Government Finance Officers Association handbook on municipal bond disclosure[98] observes that it may be prudent for conduit issuers to undertake a review of the basic disclosure documents and ask questions as suggested by the language of the disclosure document. A representation in the offering document that the conduitissuer makes no representation as to the accuracy or adequacy of the information provided is not a guaranty that the conduit issuer will not face claims from regulators or investors if the conduit borrower's disclosure is defective. Such an inquiry could potentially entangle the issuer with the borrower and affect the borrower's free exercise of religion. No similar duty and liability would be found in the type of government aid or benefit programs represented by *Trinity Lutheran*.

Under federal tax law, obligations issued by or on behalf of a state or political subdivision may be tax-exempt. It is well-settled that, in the case of conduit bonds, the tax law treats the government entity as "the issuer."[99] As issuer, the government has certain rights and responsibilities. In the event that the tax-exempt status of a bond issue is challenged, it is the issuer and not the conduit borrower that has standing before the Internal Revenue Service to defend the tax exemption or tax credit status.[100] Investors generally expect that the issuer will covenant to undertake the defense of their bonds' tax benefits, although the issuer generally will look to the conduit borrower to prosecute and pay for the defense as well as indemnify the issuer for its expenses. In addition, the Internal Revenue Service procedures treat the issuer, but not the conduit borrower, as having the rights of confidentiality afforded to taxpayers.[101] But with that treatment comes responsibility. One telling case is Harbor Bancorp v. Commissioner,[102] in which conduit bonds were ostensibly issued to finance housing but were, in reality, invested in guaranteed investment contracts at yields in excess of the bond yields, the profits stripped off and pocketed and the housing never constructed. Certain participants in the financing were subsequently convicted of criminal violations, including fraud, and incarcerated. The issuer of the bonds, Riverside County Housing Authority, disclaimed responsibility as having been merely a conduit. The United States Tax Court had a different view in finding that:

> [A]s between it and the Federal Government, the Housing Authority should bear responsibility for what happened. The Housing Authority issued the Bonds and selected those who were responsible for implementing their issuance and applying the proceeds. Congress clearly wanted bond issuers to be responsible for meeting the requirements for tax exemption.

[98] Robert Dean Pope, Making Good Disclosure: The Role and Responsibilities of State and Local Officials Under the Federal Securities Laws (2001).
[99] See *Fairfax Cty. Econ. Dev. Auth. v. Comm'r,* 77 T.C. 546 (1981).
[100] IRM 4.81.1, Examining Process, Tax Exempt Bonds (TEB) Examination Program and Procedures, Tax Exempt Bonds Examination Process Overview.
[101] Internal Revenue Service, Understanding the Tax Exempt Bonds Examination Process, *https://www.irs.gov/tax-exempt-bonds/understanding-the-tax-exempt-bonds-exami- nation-process* (last updated Oct. 18, 2016); see also James L. Raybeck, *Essay: IRS Exami- nations of Tax-Exempt Bonds: An Agent's Perspective,* 4 Tenn. J. Bus. L. 259, 264 (2003).
[102] *Harbor Bancorp v. Comm'r,* 105 T.C. 260 (1995).

> The Housing Authority certified that the Bonds would qualify for tax exemption. Like any other local government bond issuer, the Housing Authority was responsible for paying any amount required by section 148(f)(2), regardless of whether it intended to generate the excess described in section 148(f)(2). It has thus far chosen not to do so. Unfortunately for its bondholders, the statutorily required result of this choice is that the interest on the Bonds is not exempt from Federal taxation. . . . Even if there may now be a higher level of consciousness among state and local bond issuers and their counsel about the levels of due diligence required, reasonableness is an objective and normative standard. By any such standard, the Riverside Housing Authority and its counsel were egregiously and inexcusably lax in failing to monitor the Whitewater and Ironwood transactions and in allowing the messes to happen. . . . [S]ection 103(b) [the applicable tax law provision] should not be read to encourage issuers both to be ignorant of the facts prospectively and to remain ignorant and do nothing after the fact.[103]

While it is often said that "bad facts make bad law," the decision in Harbor Bancorp suggests that under appropriate circumstances, conduit issuers may be required to engage in continuing diligence and responsibility, which on the one hand could lead to an endorsement of religion and on the other to an entanglement with the borrower.

Against this backdrop, there is the argument put forth in footnote 7 of the Hunt opinion and in Steele that the economic reality of the financing is that the investors loaned money to the borrower, the conduit issuer was not responsible for repaying the bonds, neither the amounts so invested nor the amounts repaid are the government's money, and, as such, there is neither establishment nor entanglement. However one views this conundrum, there appears to be a distinction between the active role of a bond issuer and the more passive administrator of a shredded tire program or the distributor of textbooks and school lunches.

There is also another way in which the issuance of tax-exempt bonds differs from other forms of aid. Conduit bonds issued for the benefit of pervasively sectarian borrowers in almost all instances need to qualify under Section 145 of the Internal Revenue Code as "qualified 501(c)(3) bonds" where the borrower is exempt from tax under Section 501(c)(3) of the Internal Revenue Code. One of the requirements that must be met is the public hearing and approval requirement.[104] In circumstances where the bond-financed property is not located within the jurisdiction of the issuer, such hearing and approval requirement must be met by both the issuer and the host (the governmental unit in which the property is to be located). The purpose of this requirement is to give persons affected by the facilities to be financed the opportunity to be heard.[105] The approval may be given by the applicable elected representative (e.g., the highest elected official or the elected legislative body) or by public referendum.

Although this approval requirement raises a question whether a program intended to be neutral can pass constitutional muster when there is an approval requirement that is vested in the discretion of a single official, a legislative body, or a local referendum, that is not exclusive to financings involving sectarian institutions. For example, an official or legislative body may be subject to pressures with respect to any potential conduit borrower not favored in its community (e.g., halfway houses, mental health facilities, etc.) Similar pressures could result in a referendum denying the required approval. While the approval issue is not limited to sectarian institutions, the necessity of obtaining this approval would appear to be a distinction between bond financing and other forms of public benefit programs.

---

103 *Id.* at 288–297.

104 I.R.C. § 147(f) (2012).

105 See H.R. Rep. No. 97-760 (1982), reprinted in 1982 U.S.C.C.A.N. 1190.

VII. STATE LAW LIMITATIONS: BLAINE AMENDMENTS

The importance of state law in evaluating the overall validity of municipal bonds issued for the benefit of religious organizations should not be underestimated. Assuming a particular issuance complies with both the Establishment Clause and the Free Exercise Clause, such issuances must overcome further restrictions found in many state constitutions prohibiting government aid to religiously affiliated institutions. This section provides a general overview of state constitutional provisions restricting state aid to religious organizations and examines the application of these provisions in certain states.

While constitutional provisions restricting the use of government funds to aid sectarian organizations vary from state to state, such provisions are generally known as "Blaine Amendments," named after Representative James Blaine of Maine, who introduced an amendment to the United States Constitution on December 17, 1875. The amendment provided:

No State shall make any law respecting an establishment of religion or prohibiting the free exercise thereof; and no money raised by taxa- tion in any State for the support of public schools, or derived from any public fund therefor, nor any public lands devoted thereto, shall ever be under the control of any religious sect, nor shall any money so raised or lands so devoted be divided between religious sects or denominations.[106]

Had it been adopted, the effect of this amendment would have been to directly apply the religion clauses of the First Amendment to the states (which, at the time, was not the case) as well as prevent states from providing financial support to private religious schools. While support for the federal Blaine Amendment may have been couched in terms of favoring secular education, it was well known the amendment was rooted in anti-Catholic sentiment. As Justice Thomas noted in *Mitchell*, "[c]onsideration of the amendment arose at a time of pervasive hostility to the Catholic Church and to Catholics in general, and it was an open secret that sectarian was code for Catholic."[107] While the federal Blaine Amendment easily passed the House, the amendment was ultimately defeated in the Senate.

Although the Blaine Amendment movement could have ended on the Senate floor, within a year of its defeat, 14 states had adopted legislation modeled after the federal Blaine Amendment. Within 20 years, nearly 30 states adopted Blaine-type amendments to their constitutions. Although a majority of states adopted Blaine Amendments voluntarily, many states were forced to incorporate Blaine Amendments into their constitutions as a condition to being admitted to the Union as a new state. Many of the provisions adopted, either voluntarily or not, focused on financial support for schools, but many expanded on the federal amendment to prohibit financial support for a wide variety of sectarian institutions.[108]

Today, there are more than 37 Blaine Amendments throughout the country,[109] and the language and scope of these amendments vary tremendously. Though it is beyond the scope of this article to detail each Blaine Amendment's effects on municipal bond financings, below is a general overview of how such amendments have been interpreted by courts throughout the country. While some Blaine Amendments prohibit the financing of sectarian institutions, other Blaine Amendments are narrowly construed to permit such financings. Some courts seem to have chosen to side-step the plain language of their state's Blaine Amendments, while other courts have directly relied on current First Amendment jurisprudence to determine whether particular financings are permissible.[110]

---

[106] H.R.J. Res. 1, 44th Cong., 1st Sess., 4 Cong. Rec. 205 (1875).

[107] *Mitchell v. Helms*, 530 U.S. 793, 828 (2000).

[108] See Mark Edward DeForrest, An Overview and Evaluation of State Blaine Amendments: Origins, Scope, and First Amendment Concerns, 26 HARVARD J. L. & PUB. POL'Y. 551, 588-590 (Spring 2003).

[109] See Ala. Const. art. XIV, § 263; Alaska Const. art. VII, § 1; Ariz. Const. art. IX, § 10; Ark. Const. art. XIV, § 2; Colo. Const. art V, § 34; Del. Const. art. X, § 3; Fla. Const. art. I,
§ 3, art. IX, § 6; Ga. Const. art. I, § 2, para. 7; Haw. Const. art. X, § 1; Idaho Const. art. IX,
§ 5; Ind. Const. art. I, § 6; Ky. Const. §§ 186, 189; Mass. Const. amend. XVIII, § 2; Mich. Const. art. I, § 4, art. VIII, § 2; Minn. Const. art. I, § 16, art. XIII, § 2; Miss. Const. art. VIII, § 208; Mo. Const. art. I, § 7, art. IX, §§ 5, 8; Neb. Const. art. VII, § 11; Nev. Const. art. XI, § 2; N.J. Const. art. VIII, § 4, para. 2; N.M. Const. art. XII, § 3; N.Y. Const. art. XI,
§ 3; N.C. Const. art V, § 12, art. IX, § 6; N.D. Const. art. VIII, § 1; Okla. Const. art. II, § 5, art. XI, § 5; S.D. Const. art VIII, § 16; Tex. Const. art. VII, § 5; Va. Const. art VIII, § 10; Wash. Const. art. I, § 11, art. IX, § 4; Wis. Const. art. X, § 6; Wyo. Const. art. VII, § 12.

[110] DeForrest, *supra* note 108.

In some states, the use of municipal bond financing has been found to be a direct violation of their version of the Blaine Amendment. In University of *Cumberlands v. Pennybacker*,[111] the Kentucky General Assembly authorized $10 million in public bond financing for the construction of a pharmacy school on the campus of a private Baptist college. Taxpayers challenged the financing as a violation of Section 189 of Kentucky's Constitution, which provides that "[n]o portion of any fund or as now existing, or that may hereafter be raised or levied for educational purposes, shall be appropriated to, or used by, or in aid of, any church, sectarian or denominational school." The Supreme Court of Kentucky found this financing to be a clear violation of Section 189. In so holding, the court noted that Section 189 was created in direct response to the common school movement, the movement that fueled the Blaine Amendment, and that the Kentucky framers specifically contemplated that no state monies were to be appropriated to religious schools.[112]

In certain other states, the use of municipal bond financing has been found permissible as a result of a narrow interpretation of the existing Blaine Amendment. In *Higher Educational Facilities Authority v. Booth Gardner*,[113] the Washington Higher Education Facilities Authority (the "Authority") issued bonds on behalf of Seattle University and Pacific Lutheran University, both religiously affiliated institutions. The Washing- ton Constitution contains two provisions calling such financing into question. Article 1, Section 11 of the Washington Constitution provides that "[n]o public money or property shall be appropriated for or applied to any religious worship, exercise or instruction, or the support of any religious establishment. . . ." In addition, Article 9, Section 4 mandates that "[a]ll schools maintained or supported wholly or in part by the public funds shall be forever free from sectarian control or influence." The Washington Supreme Court narrowly construed the two provisions by concluding that the use of the Authority's power to issue conduit bonds neither conferred "money" nor "property."[114] The benefit realized by the universities through the financing that was federally tax exempt was conferred by operation of the Internal Revenue Code rather than by the state. As such, the conduit financings were permissible under the Washington Constitution.

Similarly, the Illinois Constitution has been interpreted to permit tax- exempt financing in spite of a constitutional provision prohibiting aid to sectarian institutions. Section 3 of Article X of the Illinois Constitution provides that neither the state nor any political subdivision "shall ever make any appropriation or pay from any public fund whatever, anything in aid of any church or sectarian purpose, or to support or sustain any school, academy, seminary, college, university or other literary or scientific institution, controlled by any church or sectarian denomination whatever." In *Cecrle v. IEFA*,[115] this provision was applied to bonds issued by the Illinois Educational Facilities Authority on behalf of Lewis College, a private Catholic college. In holding that the financing did not violate the Illinois Constitution, the Illinois Supreme Court noted that the type of financing at issue was unknown when Section 3 of Article X was adopted.[116] The court pointed out, however, that the state constitution expressly authorizes the General Assembly to exempt from taxation property used for educational and religious purposes.[117] The court concluded that the state constitution was not intended to "prohibit the General Assembly from directly establishing a tax-exempt status for religiously affiliated schools."[118]

The Arizona state constitution contains two provisions that touch upon government aid to religious institutions. Article II, Section 12 (the religion clause), states in part: "No public money or property shall be appropriated for or applied to any religious worship, exercise, or institution, or to the support of any religious establishment." Article IX, Section 10 (the aid clause), says: "No tax shall be laid or appropriation of public money made in aid of any church, or private or sectarian school, or any public service corporation." *In Kotterman v. Killian*,[119] the Arizona Supreme Court was faced with the task of interpreting both clauses. Its decision to allow a government tax-exemption program based on application of the *Lemon* test and reference to the *Mueller* case underscores that indirect government aid or aid provided as a result of decisions made by individuals is not prohibited in Arizona based on (1) the actual language of the clauses and (2) the character of the aid.

---

[111] *Univ. of Cumberlands v. Pennybacker,* 308 S.W.3d 668 (Ky. 2010).

[112] *Id.* at 681–683.

[113] *Higher Educ. Facilities Auth. v. Gardner*, 103 Wash. 2d 838, 699 P.2d 1240 (Wash. 1985).

[114] *Id.* at 844.

[115] *Cecrle v. Ill. Educ. Facilities Auth.*, 288 N.E.2d 399 (Ill. 1972).

[116] *Id.* at 402.

[117] *Id.*

[118] *Id.*

[119] *Kotterman v. Killian*, 972 P.2d 606 (Ariz. 1999).

In other instances, municipal bond financing schemes have been found to be permissible on the basis that the Blaine Amendment is a parallel provision to the Establishment Clause.[120] In *Virginia College*, the Virginia College Building Authority issued bonds on behalf of Regent University, an institution affiliated with the Christian Broadcasting Network. The issuance was challenged as, among other things, a violation of Article I, Section 16 of the Virginia Constitution, which provides that the General Assembly "shall not make any appropriation of public funds, personal property, or real estate to any church or sectarian society, or any association or institution of any kind whatever which is entirely or partly, directly or indirectly, controlled by any church or sectarian society."[121] In deter- mining whether the financing violated the state constitution, the Supreme Court of Virginia noted that Establishment Clause jurisprudence had always directly informed its interpretation of the state constitution, as Article I, Section 16 was a parallel provision to the Establishment Clause.[122] As uch, the court analyzed the financing through the lens of the Establish- ment Clause as the case law existed at that point in time. Citing *Agostini* and *Mitchell*, the court ultimately concluded that the role of the state was merely that of a conduit and therefore the bond proceeds were not government aid received by Regent University.[123]

As with *Virginia College*, in some instances Establishment Clause jurisprudence has been applied even where the state constitutional provision is deemed more restrictive than the First Amendment, and courts have nevertheless concluded financing of sectarian institutions is permissible. In *State ex rel. Wisconsin Health Facilities Authority v. Lindner*, a hospital affiliated with the Roman Catholic Church sought funding to expand its facilities.[124] The parties agreed the statute authorizing the bond issuance had a "whole- some secular purpose" to improve health care delivery by lowering health care costs.[125] The court relied on *Hunt* in holding that "because the hospital is not a pervasively religious institution and because the Act insures against benefiting any significant religious activities within the hospital,. . . the Act does not have the primary effect of advancing religion."[126] As a result, under then-current First Amendment jurisprudence, the tax-exempt financing was determined to be valid under state law.[127]

In California, the state constitution generally prohibits government appropriation or payment from public funds or grants to organizations "controlled by any religious creed, church, or sectarian denomination whatever."[128] This strict limitation was tested in a bond validation proceeding that reached the California Supreme Court in 2007 in *California Statewide Communities Development Authority v. All Persons Interested*.[129] In the circumstances underlying the case, the conduit issuer petitioned for validation of tax-exempt bonds to be issued for the benefit of three educational institutions that were deemed to be pervasively sectarian.[130] The trial court concluded that "low cost financing for the [institutions] . . . involves financing religious indoctrination" using the issuer's bond program and thus violates the state's constitutional restriction.[131]

In reversing and remanding the case, the California Supreme Court established a four-part test to determine whether a bond program violates the constitution: (1) the bond program must serve the public inter- est and provide no more than an incidental benefit to religion; (2) the program must be available to both secular and sectarian institutions on an equal basis; (3) the program must prohibit use of bond proceeds for "religious projects"; and (4) the program must not impose any financial burden on the government.[132] To interpret part one of the test, the court relied in part on suggestions in *Hunt* and *Mitchell*, with reference to *Virginia College* and *Steele*, that any benefit to religion from the bond program would be merely incidental when there is no expenditure of public money.[133]

120 See, e.g., *Va. Coll. Bldg. Auth. v. Lynn,* 538 S.E.2d 682 (Va. 2000).
121 *Id.* at 689.
122 *Id.* at 691.
123 *Id.* at 699-700.
124 *State ex rel. Wis. Health Facilities Auth. v. Lindner,* 91 Wis.2d 145 (1979).
125 *Id.* at 152.
126 *Id.* at 161.
127 *Id.* at 163.
128 Ca. Const. art. XVI, sec. 5.
129 *Cal. Statewide Cmtys. Dev. Auth. v. All Persons Interested*, 152 P.2d 1070 (Cal. 2007)
130 *Id.* at 1072.
131 *Id.* at 1087.
132 *Id.* at 1077.
133 *Id.* at 1080.

Even before *Hunt*, certain tax-exempt financing programs were found to be broadly acceptable through the application of general First Amendment principles that have been applied without rigorous application or analysis of existing First Amendment jurisprudence. In 1969, the State of Florida enacted the Education Facilities Law, which provided for the financing of higher educational facilities through the issuance of tax-exempt bonds by various political subdivisions. The program was eventually challenged, in part, because Article I, Section 3 of the Florida Constitution provides that "[n]o revenue of the state or any political sub- division or agency thereof shall ever be taken from the public treasury directly or indirectly in aid of any church, sect, or religious denomination or in aid of any sectarian institution." The Florida Supreme Court held the Educational Facilities Law did not violate Article I, Section 3 of the state constitution because the Educational Facilities Law had the effect of promoting the general welfare of society, apart from any religious consideration, and its primary purpose was not to promote religion.[134]

VIII. CONCLUSION

A fundamental role of a bond attorney is to provide an "unqualified" legal opinion to bond purchasers concerning the legality and validity of municipal bonds.[135] An opinion may be unqualified if the bond attorney is firmly convinced[136] that, under the law in effect on the date of the opinion, the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issues, would reach the legal conclusions stated in the opinion.[137] Financings benefiting pervasively sectarian institutions pose particular challenges under this opinion standard given the current status of federal and state constitutions, statutes, and case law.

The federal framework each bond attorney must consider includes not only the Establishment and Free Exercise Clauses but also a myriad of interpretive case law, most importantly the Court's *Lemon, Agostini*, and *Hun*t cases, all discussed in this article. The legality and validity of bonds further depends on the particular state's constitutional and legislative limitations as well as the administrative positions of applicable state issuing agencies. While these laws and court opinions are a helpful guide to bond attorneys, jurisprudence has developed in an uncertain direction since *Hunt*, and the application of this new jurisprudence to the context of municipal bonds remains murky. For example, the Sixth Circuit decision in *Steele* and case law developing in response to footnote 7 in *Hunt* suggest that the constitutionality of government interaction with pervasively sectarian institutions may depend less on the character of the institution and more on the type of government aid provided. The Court's agreement to hear the *Trinity Lutheran* case in 2017 gave hope for clarity on this issue. In the opinion released in April 2017, however, the justices addressed only the Free Exercise Clause and appeared to limit the decision largely to its particular facts, which is likely to provide little substantive value to bond attorneys evaluating municipal bond financings for pervasively sectarian institutions. In the absence of further case law, the bond community is left with the *Lemon-Agostini* Test as applied in *Hunt*, in conjunction with individual bond attorney interpretations regarding the importance and relevance of *Steele*.

Winter 2018

[134] *Nohrr v. Brevard Cty. Educ. Facilities Auth.*, 247 So. 2d 304, 307 (Fl. 1971).

[135] Nat'l Assoc. of Bond Lawyers, The Function and Professional Responsibilities of Bond Counsel 6 (3rd ed. 2011).

[136] Also characterized as having "a high degree of confidence."

[137] Nat'l Assoc. of Bond Lawyers, Model Bond Opinion Report i (2003).

Federal Securities Law: Amendments to Rule 15c2-12

Paul S. Maco, Bracewell LLP, Washington, D.C.

Overview

On August 20, 2018, the Securities and Exchange Commission approved amendments (the "Amendments") to Rule 15c2-12 (the "Rule"), the Municipal Securities Disclosure Rule under the Securities Exchange Act of 1934, in a release adopted by unanimous vote of the four sitting Commissioners (the "Adopting Release").[1] The Amendments, described below, add two events—(15) and (16)--and the defined term "financial obligation" to the existing 14 events for which municipal securities obligors must commit to provide timely notice filings to the Municipal Securities Rulemaking Board's EMMA system. The compliance date for the Amendments, i.e., the date on or after which a continuing disclosure agreement (the "CDA") must include the two new events, is February 27, 2019 (the "Compliance Date").

Issuers and obligated persons should be aware that the new events apply to certain changes to and events under financial obligations entered into before the Compliance Date. Event (16) requires knowledge of their respective provisions to determine whether an event requiring a notice filing has occurred. The Adopting Release provides: "an event under the terms of a financial obligation pursuant to paragraph (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."[2] Even though event (16), like all other events, follows the words "with respect to the securities being offered in the Offering,"[3] the Adopting Release does not acknowledge this phrase, but rather discusses the Amendments as if the phrase does not apply. As a result, an event may occur requiring notice under event (16) at any time after an issuer or obligated person executes a CDA on or after the Compliance Date. Before executing a CDA on or after the Compliance Date, issuers and obligated persons should prepare for such an eventuality. The Commission doubled the time originally proposed for compliance from 90 to 180 days to provide "sufficient time for Participating Underwriters to revise their procedures to comply with the Rule, and for issuers and obligated persons to become aware of the Amendments and plan for their implementation."[4]

The Amendments will be less burdensome on issuers, obligated persons, and underwriters than the proposed amendments,[5] but will nevertheless burden issuers and obligated persons offering bonds subject to the Rule with an initial and ongoing monitoring and compliance regimen unlike any required by the Rule's existing 14 events. Unless issuers and obligated persons implement effective controls and procedures to manage compliance with post effective date CDAs, they will face potentially time consuming and costly due diligence reviews prior to subsequent offerings subject to the Rule and risk access to the public debt markets. The extended time prior to the Compliance Date provides an opportunity to prepare and for industry groups to produce best practices and forms to assist with compliance.

The compliance burden for all parties is complicated further by the way in which the Commission has adopted the Amendments. Early on the SEC made clear that "undertakings with respect to material events should list all events in the same language as is contained in the rule, without any qualifying words or phrases, except as the staff has indicated otherwise with respect to mandatory redemption of bonds." [6] An underwriter accepting a CDA not following this instruction may risk

---

[1] 83 FR 44700 (Aug. 31, 2018).
[2] 83 FR 44717.
[3] 17 CFR 240.15c2-12(b)(5)(i)(C). The phrase remains in the Rule and presumably will appear in all CDAs intended to comply with the Rule on or after the Compliance Date.
[4] Id at 44717.
[5] 82 FR 14282 (Mar. 17, 2017).
[6] Letter from Catherine McGuire to National Association of Bond Lawyers, Response to Question 2 (Sept. 19, 1995) ("NABL II").

sanction for violating the Rule, so a post Compliance Date CDA would presumably follow the instructions and use the language of the Rule without embellishment or qualification. Previously this was not a problem, because existing reportable events requiring further explanation include clarifying text within the Rule.[7] The language of the Amendments is sparse and direct, however the disclosure expected by the Commission is nuanced and contingent upon terms not defined in the Amendments but in the Adopting Release. Officials of an issuer or obligated person earnestly seeking to comply with the CDA may not be aware of guidance in the Adopting Release as to what the words in the Amendments are intended to mean, let alone how to access the guidance. Moreover, CDAs that parrot the Rule language without embellishment, when interpreted in accordance with state law, may impose contractual commitments that vary from the intent of the Amendments. In some circumstances "the same language as is contained in the rule" may not be problematic, such as intuitively reading in "a financial obligation as described in" into "Guarantee of paragraph (f)(11)(i)(A) or (B)." In other circumstances, such as understanding that "debt obligation" includes "a lease operating as a vehicle to borrow money" as well as revenue obligations, the meaning will be more difficult to intuit. More on this below. The Adopting Release suggests that many challenges posed by the Amendments may be addressed by enhanced disclosure policies and procedures, which Sarbanes-Oxley provided the Commission with authority to impose upon the corporate world and the SEC has required in settling municipal enforcement proceedings with most issuers since San Diego. [8]

While expanding the regulatory burden upon municipal issuers which it does not directly regulate and continuing to ignore municipal market requests for simplification,[9] the Commission was easing the regulatory burden upon those it does regulate, corporate registrants. Nearly simultaneous with approval of the Amendments, the Commission both approved rule amendments[10] and proposed other rule amendments[11] to simplify and lessen the disclosure burden for public corporate issuers[12] to reverse the drift away from registered offerings to private transactions.[13] In response to the Amendments, and as predicted by commenters on the proposed amendments,[14] some municipal issuers and obligated persons may elect to follow the path trod by their corporate counterparts to private markets through offerings exempt under the Rule or means of financing not involving securities. Municipal issuers contemplating non-exempt offerings on or after the Compliance Date would be prudent to begin preparations to comply with the Rule as soon as possible.

[7] *See, e.g.* Rule 15c2-12(b)(5)(i)(C)(12) Bankruptcy, insolvency, receivership or similar event of the obligated person;
NOTE TO PARAGRAPH (b)(5)(i)(C)(12): For the purposes of the event identified in paragraph (b)(5)(i)(C)(12) of this section, the event is considered to occur when any of the following occur: The appointment of a receiver, fiscal agent or similar officer for an obligated person in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person.

[8] In the Matter of *City of San Diego, California*, Sec. Act Rel. No. 8751 (Nov. 14, 2006).

[9] See, e.g. SIFMA Rule 15c2-12 Whitepaper (April 2016), available at: https://www.sifma.org/resources/submissions/rule-15c2-12-and-potential-updates-to-the-rule/.

[10] Disclosure Update and Simplification, Release No. 33-10532 (Aug. 17, 2018).

[11] Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, Release No. 33-10526 (Jul. 24, 2018).

[12] *See* SEC Press Release, *SEC Proposes Rules to Simplify and Streamline Disclosures in Certain Registered Debt Offerings* (Jul. 24, 2018), announcing Release No. 33-10562, n. 7, supra.

[13] "Over the last year, the SEC has taken meaningful steps to reduce regulatory burdens on pre-IPO and smaller public companies, while maintaining and, in some cases, enhancing, investor protections. The importance of this focus is highlighted by the significant decline in public companies over the last two decades, particularly amongst emerging companies." Chairman Jay Clayton, R*emarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival* (Aug. 29, 2018).

[14] *See, e.g.*, Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, Securities Industry Financial Markets Association, to Brent J. Fields, Secretary, Commission, dated May 15, 2017, at p. 2; Letter from Clifford M. Gerber, President, National Association of Bond Lawyers, to Brent J. Fields, Secretary, Commission, dated May 15, 2017, at p. 23.

Amendments

The Amendments amend Rule 15c2-12(f), the definition section, by adding Paragraph 15c2-12(f)(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 paragraph (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.

The Amendments amend Rule 15c2-12(b)(5)(i)(C) to add the following events:

(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; and

(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; and

While removing "and" from Rule paragraph (b)(5)(i)(C)(14), the Amendments do not change the opening of Rule paragraph (b)(5)(i)(C), which continues to read "In a timely manner not in excess of ten business days after the occurrence of the event, notice of any of the following events with respect to the securities being offered in the Offering," nor does the Adopting Release discuss the interaction of the limiting phrase "with respect to the securities being offered in the Offering" with the two new events.

The two events are adopted as proposed. What has narrowed the scope of the events has occurred in the adopted definition of financial obligation, now reduced to three categories from five. Gone from the definition is "monetary obligation resulting from a judicial, administrative, or arbitration proceeding." "Lease" would appear to be gone as well, but that would be an inaccurate conclusion. Although removed from the proposed definition of *financial obligation* and no longer in the plain words of the Rule, to the extent leases would "operate as vehicles to borrow money," they are included as "debt obligations." "Debt obligation" is not defined in the text of the Rule, but in the guidance provided in the Adopting Release. As the Adopting Release explains, "the Commission believes that it is appropriate to (i) remove the term 'lease' from the definition of the term 'financial obligation;' and (ii) provide guidance that the term 'debt obligation' generally should be considered to include lease arrangements entered into by issuers and obligated persons that operate as vehicles to borrow money."[15] The broad term "derivative instrument" is narrowed in the adopted definition by addition of the words of limitation "entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation." Similarly the broad term "guarantee" is narrowed by the addition of the limiting words "of (f)(11)(i)(A) or (B)," presumably meaning a "guarantee of a financial obligation as described in paragraphs (f)(11)(i)(A) or (B)."

Guidance

The guidance provided in the Adopting Release is critical to understanding what the SEC considers "financial obligation," "material," "debt obligation," "derivative instrument," "guarantee," "default," "modification of terms" and "other similar events" to mean, in order to understand what issuers and obligated persons are expected to undertake to disclose and then to disclose, and what underwriters are expected to due diligence in order to form a reasonable belief in statements regarding the CDA and CDA compliance in offering documents of issuers and obligated persons.

[15] 83 FR 44711.

Event (15)

Materiality. "Material" is used twice in event (15) but is not used in event (16) or in the definition of financial obligation. As to commenters' concerns about use of materiality as a standard, the Adopting Release states "the Commission continues to believe that materiality determinations should be based on whether the information would be important to the total mix of information made available to the reasonable investor."[16] Under the heading "Guidance,"[17] this phrasing from *TSC Industries, Inc. v. Northway, Inc.*,[18] which may be referred to as "disclosure or Northway materiality," is distinguished by the Commission from what may be called "MCDC materiality." *Northway* materiality is the Commission's response to a commenter's concern as to how to determine the materiality of a "financial obligation" and "covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation."[19]

As to MCDC materiality, "[t]he Commission believes that the type of analysis undertaken in connection with the MCDC Initiative is distinct from the analysis required to determine whether a piece of information is material and must be publicly disclosed to investors in offering materials."[20] "The inquiry undertaken in connection with the MCDC Initiative required an assessment of whether the issuer or obligated person materially fulfilled its contractual obligations under its continuing disclosure agreement, which required a consideration of applicable state law and basic principles of contract law."[21] In a footnote, the Commission states "[t]he principles behind this [*Northway*] inquiry are consistent each time the question of whether a piece of information is material is presented, but the factors considered by issuers and obligated persons while undertaking such an inquiry are not uniform because it is a facts and circumstances driven analysis. This inquiry is distinct from the inquiry issuers, obligated persons, and underwriters conducted as part of the MCDC Initiative, which required an assessment of the issuer's or obligated person's performance of its contractual continuing disclosure obligations."[22]

After providing guidance purporting to clear up the MCDC confusion, the Commission affirms the Amendments are measured by *Northway* materiality: "Accordingly, under the Rule, as amended, an issuer or obligated person will need to consider whether a financial obligation or the terms of a financial obligation, if they affect security holders, would be important to a reasonable investor when making an investment decision."[23] The Commission acknowledges that when considering disclosure about financial obligations, opinions may differ as to what is material, but it "does not believe it is necessary to provide further guidance at this time."

As to the burdens of time and expense of the Amendments, "The Commission acknowledges that there will be costs incurred by issuers, obligated persons, and dealers when evaluating whether a financial obligation is material."[24] The Commission believes its narrower definition of financial obligation reduces the types of transactions to assess for materiality and, by planning ahead and beginning assessment in advance of incurrence, meeting the 10 business day notice requirement should not be a problem. Amended disclosure policies and procedures may ease the burden of summarizing the terms of material financial obligations and "in addition to industry practices that may develop, could help issuers and obligated persons streamline the process of disclosing material financial obligations to EMMA, and ease time and cost burdens associated with identifying, assessing, and disclosing material financial obligations."[25]

---

[16] Id, 44705-44706, adding in *67, See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, Exchange Act Release No. 34–33741 (Mar. 9, 1994), 59 FR 12748 (Mar. 17, 1994)
("1994 Interpretive Release").

[17] Id, 44706.

[18] 426 U.S. 438, 440 (1976).

[19] Id, n. 54.

[20] Id.

[21] Id, n.74.

[22] Id, n. 75.

[23] 83 FR 44706.

[24] Id, 44707.

As to materiality assessment in a series of related financial obligations, "Materiality is determined upon the incurrence of each distinct financial obligation, taking into account all relevant facts and circumstances." However, related transactions incurred closely in time might have to be evaluated for materiality in the aggregate,, unless separated for legitimate business reasons. "Relevant factors that could indicate that a series of financial obligations incurred close in time are related include the following: (i) Share an authorizing document, (ii), have the same purpose, or (iii) have the same source of security." Among possible legitimate business reasons to separate is to avoid an integration as one "issue" for tax purposes.[26]

Incurrence of a Financial Obligation. "The Commission believes that a financial obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person."[27]

Form of Event Notice. While acknowledging that "market participants are best suited to consider developing best practices … to assist issuers and obligated persons and their advisors in carrying out the objective of the amendments," the Commission repeats its proposing release description of the material terms of a financial obligation to be included in an event (15) notice:

> 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. A description of the material terms would help further the availability of information in a timely manner to assist investors in making more informed investment decisions. The Commission believes that, depending on the facts and circumstances, it could be consistent with the requirements of the Rule for issuers and obligated persons to either submit a description of the material terms of the financial obligation, or alternatively, or in addition, submit related materials, such as transaction documents, term sheets prepared in connection with the financial obligation, or continuing covenant agreements or financial covenant reports to EMMA. Any such related materials, if submitted as an alternative to a description of the material terms of the financial obligation, should include the material terms of the financial obligation.[28]

Financial Obligation

As discussed above, the surgery performed upon the proposed amendments to produce the Amendments was applied to the definition of "financial obligation."

Debt Obligation. The term "debt obligation" has increased importance in the Amendments' definition of "financial obligation." The guidance provided by the Adopting Release clarifies what is and is not a "debt obligation" under the Rule. While the term "lease" has been dropped from "financial obligation," leases operating as vehicles to borrow money are back in as "debt obligations." The guidance also clarifies that temporal consideration is not part of the analysis. "As adopted, the term 'debt obligation' includes short-term and long-term debt obligations of an issuer or obligated person under the terms of an indenture, loan agreement, lease, or similar contract."[29] Of course, the term of a debt obligation could affect whether it is material.

---

[25] Id.

[26] Id, text and n. 85.

[27] Id, 44708. In n. 89, the Adopting Release adds: This is consistent with similar concepts in Exchange Act Form 8–K. Specifically, the instructions for Item 2.03 of Form 8–K provide that "[a] registrant has no obligation to disclose information under this Item 2.03 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." See 17 CFR 249.308

[28] Id, 44708.

[29] Id, 44712.

Derivative Instrument. The formerly broad-reaching term "derivative instrument" is limited to those "entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation." The Commission explains: "The term … is not limited to derivative instruments incurred by issuers or obligated persons solely to hedge the interest rate of a debt obligation or to hedge the value of a debt obligation to be incurred in the future. Instead, the term covers any type of derivative instrument that could be entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation. … This includes, under certain circumstances, instruments that are related to an existing or planned debt obligation of a third party."[30]

The Adopting Release explains that "a debt obligation is 'planned' at the time the issuer or obligated person incurs the related derivative instrument if, based on the facts and circumstances, a reasonable person would view it likely or probable that the issuer or obligated person will incur the related yet-to-be-incurred debt obligation at a future date. In the Commission's view, it would be likely or probable … if, for example, the relevant derivative instrument would serve no economic purpose without the future debt obligation (regardless of whether the future debt obligation is ultimately incurred)."[31]

Like the elimination of "leases" from the definition of "financial obligation," the limitation of derivatives to those connected with or pledged to debt obligations may not have accomplished as much as is apparent on first blush. Fuel hedges and similar derivatives may be picked up, if part of the revenue pledge securing revenue bonds, unless excluded by the guidance relating to ordinary course obligations, discussed below.

Guarantee. As with "derivative instrument," the former, broadly reaching term "guarantee" has likewise been limited to guarantees of financial obligations that are either "debt obligations" or "a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation." The Adopting Release makes clear that the scope of the term "guarantee" includes "any guarantee provided by an issuer or obligated person (as a guarantor) for the benefit of itself or a third party, which guarantees payment of a financial obligation."[32] Such a guarantee "could raise two disclosure issues under the Rule – one for the guarantor and one for the beneficiary of the guarantee."[33] In such an instance, "the Commission believes that, generally, such beneficiary issuer or obligated person should assess whether such guarantee is a material term of the underlying debt obligation or derivative instrument and, if so (and if the underlying debt obligation or derivative instrument is material), disclose the existence of such guarantee under the Rule."[34]

Ordinary Course Obligations. As explained in the Adopting Release, "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."[35]

Any of Which Affect Securities Holders. The Adopting Release does not discuss or otherwise provide guidance as to the meaning of "any of which affect securities holders."

Event (16)

As noted previously, no materiality qualifier exists in event 16. The limiting factor for defaults and other listed events is whether or not they reflect financial difficulties. The Commission rejects narrowing "default" to "event of default" as it "believes that there are defaults that may reflect financial difficulties even if they do not qualify as 'events of default' under transaction documents."[36] The Commission also rejected suggestions to provide additional guidance or narrow

[30] Id, 44713.
[31] Id.
[32] Id, 44714.
[33] Id.
[34] Id.
[35] Id, 44709.
[36] Id, 44715.

the term, stating it "believes that the term is not vague, as the concept of 'reflecting financial difficulties' has been used in paragraphs (b)(5)(i)(C)(3) [unscheduled draws on debt service reserves reflecting financial difficulties] and (4) [unscheduled draws on credit enhancements reflecting financial difficulties] since the 1994 amendments to Rule 15c2-12, and, as such, market participants should be familiar with the concept as it relates to the operation of Rule 15c2-12. Furthermore, the Commission also believes that additional guidance on the term would be difficult to provide, due to the diversity of issuers and obligated persons as well as the financial conditions affecting them."[37]

Observations

Efficacy of the Amendments. This last sentence underscores a theme that runs throughout the Amendments: while some circumstances requiring filing of an event notice may be obvious, many will require the considered judgment of issuer or obligated person officials who are sufficiently familiar with the details of their financial obligations and materiality standards to identify the need to file, and do so with a proper notice, within 10 business days. Use of outside advisors or counsel may be required, particularly by those with minimal staff or familiarity with what is important to investors. Unlike in public offerings, they will not have the advice of experienced underwriters and their counsel. This task is complicated by the apparent simplicity of the events as presented within the CDAs with which they will seek to abide.

In the world of corporate public offerings, the answers to such questions are found in SEC regulations, such as Form 8-K and Regulation S-K, easily found in the Code of Federal Regulations. For purposes of the Amendments, the answers are found in guidance provided in the Adopting Release, of which the officials may or may not be aware and which may or may not be found in the CFR, but even then only to the extent that Rule guidance is relevant to the meaning of their CDAs.[38] Readers of a CDA incorporating the event notices as stated in the Rule would have no way of knowing the need to access interpretive materials unless they have disclosure policies and procedures providing the connection. For example, officials of a school district signing a CDA and in good faith seeking to comply with the undertaking might have no idea what they or their predecessors agreed to disclose after closing, such as certain lease financings entered to borrow money and a technical default under one such lease, until several years later when they go to market with a new borrowing, and an underwriter conducting due diligence tells them they failed to make required filings, unless they had controls and procedures in place and hired counsel or a municipal advisor to help them assess whether they need to disclose new financial obligations or related events as they arise.

Nothing in the Rule requires a CDA to state that terms used in the CDA shall have the meaning provided in the Adopting Release or future Commission guidance. As the Adopting Release reminds us when discussing materiality, obligations under a CDA require "a consideration of applicable state law and basic principles of contract law."[39] Under state contract law, the intent of a CDA obligor to enable its underwriter to comply with

---

[37] Id. 44716.

[38] For example, "Modifying and confirming the interpretation of municipal underwriter securities responsibilities" 54 FR 5603 (June 28, 1989) and "Amendment to Municipal Securities Disclosure" 75 FR 62973 (May 26, 2010) are found in 17 CFR. 241—Interpretative Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder, because the rulemakings expressly provide, as in the case of 75 FR 6293 by stating "Part 241 is amended by adding Release No. 34–62184A and the release date of May 26, 2010, to the list of interpretative releases." Nothing in the Adopting Release provides for amendment of Part 241 to include the guidance provided in the CFR. Similarly, Release No. 34-34961, Municipal Securities Disclosure, 59 FR 59590 (Nov. 17, 1994), the amendments originally providing for continuing disclosure, is not in 17 CFR 241. The consequences of exclusion or inclusion of guidance is beyond the scope of this article.

[39] Id at 44706, n.74.

the rule might be relevant to the meaning of CDA terms only if they are ambiguous, and a breach of a CDA might be "material" only if so substantial that it would excuse performance by the other party to the contract. While the SEC might argue that the Rule regulates broker-dealer conduct and as such underwriters should follow the guidance in the Adopting Release in due diligence review, such activity is after the fact and perhaps moot if there is no material breach as a matter of state law. Without express incorporation into the CDA, the guidance may not be enforceable as part of the CDA, with any assertion of failure to comply in a disclosure context open to dispute as a matter of state contract law and in an enforcement context of dubious merit. Importantly, it should be noted that some guidance in the Adopting Release narrows the Amendments, and some expands them, compared to the common usage of the express terms of the Amendments.

Should municipal market participants choose to agree that, as a matter of best practice, model CDAs will incorporate by reference guidance in the Adopting Release, this problem might be avoided, at least with regard to CDAs following the best practice. There is much to do for industry groups with regard to best practices. Perhaps a "NABL III" letter with the Office of Municipal Securities as well. Let's see where we are six months from now.

Through the Amendments the Commission continues to impose indirectly what it lacks authority to do directly: in this instance, to require, as a practical matter, an issuer to implement disclosure controls and procedures monitoring and assessing its financial obligations first on intake (and, if necessary, prepare and file the required extensive descriptive disclosure) and ongoing monitoring thereafter for default (in the case of default, for financial obligations in existence at the time of the first entry into a CDA on or after the effective date), assess their respective materiality, and report the same to the MSRB within ten business days of occurrence. The SEC expects issuers and obligated persons to plan in advance for the implementation of the amendments. The incentive to implement enhanced disclosure procedures, together with the attendant cost in applying them, might create a counterincentive to avoid the new requirements of the Rule by financing only through bond transactions exempt from Rule 15c2-12 or loans or other transactions that do not involve securities, mirroring behavior in the corporate market. The markets will respond as markets always do, through their behavior.

Materiality. Throughout the 1994 amendments to the Rule, when discussing interpretation or application of continuing disclosure undertakings, the Commission referenced state contract law. For example:

> Though a failure to comply with the undertaking would be a breach of contract, the rule does not specify the consequences of an issuer's breach of its undertakings to provide secondary market disclosure. As called for by the Joint Response, as well as other commenters, remedies for breach of any undertaking under applicable state law are a subject for negotiation between the parties to the Offering. To avoid uncertainties of enforcement, the parties to a transaction are encouraged to enumerate the consequences in the undertaking, including the available remedies, for breach of the information undertaking.

So, under MCDC materiality, an issuer or obligated person would assess the materiality of CDA noncompliance under state contract law, but any resulting disclosure required in the offering document would be measured under Northway materiality. That's at least what the Commission seems to be saying and was my understanding as an SEC staff member when working on the 1994 Amendments, but it is hard to discern in the text of the MCDC settlements.

The MCDC initiative involved self-reporting of potential violations by issuers, obligated persons and underwriters who, if selected and wished to take advantage of the terms offered, would then submit an offer to settle, which the staff then recommended the Commission accept. With respect to issuers and obligated persons, the resulting cease and desist orders summarized the Commission's findings regarding an issuer's misstatements and omissions in an official statement about compliance with continuing disclosure agreements and consequent violations of law, to which the issuer consented without admitting or denying the findings.

[40] Municipal Securities Disclosure, 59 FR 59590, 59602 (Nov. 17, 1994).

None of the MCDC orders reference the dichotomy between MCDC materiality and Disclosure materiality. Given the nature of the settlement process it is impossible to discern whether the process involved consideration of whether the allegedly undisclosed instances of material non-compliance with an undertaking were in the first instance a material breach of the undertaking under state contract law.

It is unfortunate that this dichotomy was not drawn before now, since as stated, it echoes the prior statements of the Commission without in any way intruding upon "Northway" or statutory materiality and could have as easily been stated prior to the filing deadlines when most of the municipal market was requesting just such guidance. As to whether this will quell the concerns of underwriters in assessing future non-compliance and issuers and obligated persons preparing statements regarding compliance in future offering documents, I suspect prudence will prevail and disclosure of non-compliance will continue to be influenced by the detailed findings of the MCDC settlements.

A Quarter Century (almost) of Continuing Disclosure. Twenty five years ago, the then recently sworn-in SEC Chairman sent a report to Congressman John Dingell, then Chairman of the House Committee of Energy and Commerce. The September 1993 Staff Report on the Municipal Securities Market had been prepared by the Division of Market Regulation at Chairman Dingell's request. The Staff Report noted that in "the Staff's view, comprehensive improvement of the existing system [of municipal issuer disclosure] would require Congressional action"[41] and discussed several options. The Staff report concluded with:

> If Congress chooses not to provide the Commission with full authority to address the adequacy and consistency of disclosure in this market, the Staff believes that the Commission could explore ways to improve initial and secondary market disclosure under its existing authority. Specifically, the Staff will prepare a memorandum and draft release recommending that the Commission use its interpretive authority to provide guidance regarding the disclosures required by the antifraud provisions of the federal securities laws. Similarly, the Staff will recommend amending Rule 15c2-12, or adopting similar rules, to prohibit municipal securities dealers from recommending outstanding municipal securities unless the municipal issuer makes available ongoing information regarding the financial condition of the issuer of the type required in initial offerings. Given these alternatives for increased disclosure, the Staff does not believe that the legislative grant of additional authority to the MSRB, which would enable the Board to establish offering document standards for municipal issuers, is necessary.
>
> The Staff strongly believes, however, that any Commission action in this area could not fully address the lack of complete disclosure in the municipal securities market. As noted above, comprehensive improvements to the existing system would require legislation.[42]

Shortly after the release of the Staff Report, in anticipation of the described Staff recommendations, representatives of municipal market participants coordinated dialogue with the Staff prior to the March 1993 proposed amendments to the Rule and subsequently filed comments on the proposed amendments referenced in the 1994 Adopting Release as the "Joint Response."[43] The dialogue among the market representatives, who were at the time referred to colloquially as "the gang of 10," produced general agreement among market participants on acceptance of the scope of continuing disclosure under the Rule as the "footprint." That is, the disclosure required under a CDA would not exceed the footprint of the offering document. "Thus, the information required to be provided annually was the 'financial and operating data' included by the issuer in the official statement for the primary offering."[44] Event notices were qualified by the addition of the phrase "with respect to the securities being offered" to the text in the proposing release.[45]

---

[41] Staff Report on the Municipal Securities Market, Division of Market Regulation U.S. Securities and Exchange Commission, p. 39 (Sept. 1993).

[42] Id, at 40.

[43] 59 FR 59590, 59591, n. 17 (Nov. 17, 1994).

[44] *See* NABL Letter p. 18, supra n. 15.

[45] *See* SIFMA Letter p. 8, supra n. 15.

Several commenters called the attention of the Commission to the bargain struck with the municipal market in 1994—limiting disclosure to the "footprint" of the official statement--and the failure of the proposing release to acknowledge the significant change to existing regulation that would result from adoption of the proposals,[46] as in effect a sub silentio change to Commission policy in effect for nearly a quarter century of a type subject to challenge under the Administrative Procedure Act.[47] The Commission ignored the comments. The Amendments may be vulnerable to challenge under the APA or other grounds, perhaps in some future enforcement action against a respondent with a pocket book and a reason not to settle.

Perhaps the Commission is pushing its authority as far as it can before turning to, and in support of, a legislative solution as described in its 2012 Report on the Municipal Securities Market:

> [t]o provide a mechanism to enforce compliance with continuing disclosure agreements and other obligations of municipal issuers to protect municipal securities bondholders, authorize the Commission to require trustees or other entities to enforce the terms of continuing disclosure agreements.[48]

Perhaps not. A good many people thought the Commission had reached that point in November 1994.

September 2018

---

[46] NABL Letter, SIFMA Letter, Tracy Ginsburg, Executive Director, Texas Association of School Business Officials (May 9, 2017), Kevin M. Burke, President and CEO, Airports Council International, North America (May 15, 2017).

[47] *See*, *e.g.*, *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 514-515 (2009) ("To be sure, the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it is changing position.").

[48] U.S. Securities and Exchange Commission, *Report on the Municipal Securities Market* (July 31, 2012).

Federal Tax Law: The Tax Microphone

Mike Bailey, Foley & Lardner LLP, Chicago, Illinois

New Form 8038-G and Form 8038

The IRS released new versions of Form 8038-G and Form 8038 in early September, along with draft instructions. For the most part, the new versions do not reflect a rethinking of the prior versions, but rather are in most respects the same as the prior versions. The new forms do, however, make a few notable changes.

First, references to advance refundings are removed to reflect the recent repeal of the authority to issue tax-exempt advance refunding bonds.

Second, the forms now require separate reporting of refundings of tax-exempt and taxable bonds. This revision makes sense in light of one of the primary original purposes of the information reporting requirement, which was to provide information to the Treasury Department to determine the volume of tax-exempt bonds issued and outstanding, and to estimate the tax expenditure relating to tax-exempt bonds.

Third, the new version of Form 8038 now includes a line to report whether the bonds are treated as issued pursuant to a reissuance for tax purposes.

In recent years, the IRS tax-exempt bond enforcement program has made increasing use of information returns to select bonds for examination. The revisions do not appear to be intended to further any enforcement-related use by the IRS.

Private Letter Ruling Concerning Indirect Private Business Use and Private Payments

In recent years the IRS Office of Chief Counsel has issued many fewer private letter rulings concerning tax-exempt bonds and other tax-exempt bonds than in past years. (I count only three private letter rulings in 2017 and two so far in 2018). Perhaps the recent substantial increase in IRS user fees for private letter rulings is to blame. In any event, we seem to have arrived at the point where any new tax-exempt bond private letter ruling is a notable event.

PLR 201830006 (Release Date July 27, 2018) sets forth an interesting application of the private business use and private payment tests to a particular fact pattern involving indirect private business use of bond-financed property. The private letter ruling concerns a governmental issuer that is a provider of public power. The issuer requires a source of water for processing and cooling purposes at its energy station. The issuer proposed to issue tax-exempt bonds to finance the acquisition and construction of an undivided interest in a reservoir. The issuer had previously participated with several other municipalities in the construction of a project to divert water from a river for their use. Water yields from this previous project fluctuate significantly from year to year due to the junior nature of water rights and inadequate infrastructure and storage.

The issuer had also entered into an agreement with a city for the exchange of water (the first agreement). Under this first agreement, the issuer will annually provide, when available, a specified amount of project water to the city on the upstream side of its municipal water system in exchange for the same amount of treated effluent at the tail end of its water system, plus the return flow of project water from the city. That is, the first agreement appears to provide for an exchange amount of clean water for an equal amount of effluent water, plus an amount of the original project water. Neither the issuer nor the city pays additional compensation for the water delivered to the other.

The second project (for the acquisition of an interest in the reservoir) enables project water from the first project to be stored for release and significantly improved the reliable annual yield of project water.

The issuer and the city then entered into an agreement with a private company to provide it with water to meet its needs (the second agreement). Under the second agreement, the city is obligated to deliver a specified amount of water to

the company. Under the second agreement, the issuer also agreed that the project water to be delivered to the city by the issuer under the first agreement may instead be designated by the city for delivery directly to the company to meet most of the company's water needs. Under a third agreement, the company pays the city for water acquired from the city, including project water, in the same manner as any other customer of city water. Because the first agreement remains in effect during the term of the second agreement, the issuer continues to be entitled to effluent from the city directly proportional to the amount of water delivered to the company plus the return flow of project water after the use of such water by the company. Under the second agreement, to the extent that project water is unavailable, the city must divert other amounts of its consumable water for use by the company. If the diversion results in insufficient effluent from the city (including the return flow of project water after use by the company) to meet the issuer's cooling needs, the company must reimburse the issuer for costs of obtaining alternative water. The reservoir project enhances the probability that the water delivered to the company will be project water.

Although the issuer is entitled to the return flow produced by the company from project water, the amount will be significantly less than that produced by the city from its previous use of the same amount of project water, so the second agreement will reduce the amount of water available to the issuer. To compensate the issuer for this reduction, the company further agrees in the second agreement to pay costs incurred by the issuer for the operation and maintenance of the pipes, canals and other facilities (variable costs) utilized by the issuer in the delivery, via the reservoir project or otherwise, of project water to the city for use by the company.

The second agreement appears to provide that the company has priority rights to use project water: the issuer will receive less water under its exchange agreement with the city, and the company will compensate the issuer for that difference.

In light of this complex fact pattern, it's not surprising that the issuer sought a private letter ruling regarding the impact of the second agreement on the tax-exempt status of bonds to be issued to finance the reservoir. The issuer entered into an arrangement that provided a private company with at least meaningful economic benefit from the reservoir financed with tax-exempt bonds. Moreover, private activity bond questions are often more challenging in the case of bond-financed property that is revenue-generating, because it is more difficult to avoid meeting the private payment test. In this case, the bond-financed reservoir is part of a revenue-generating public power system.

The private letter ruling basically concludes that the bond-financed property is treated as used for a private business use, but that the bonds do not meet the private security or payment test. Both parts of the IRS analysis take some twists and turns.

The private business use analysis first considers the special rules for output facilities under Treas. Reg. §1.141-7. The IRS states that the company's right to the delivery of an amount of consumable water, specifically project water, necessary to meet its requirements is derived from the second agreement. The IRS concludes, however, that the second agreement is not an "output contract" within the meaning of the regulations because the company is not treated as purchasing, either directly or indirectly, project water from the issuer. This conclusion turns on the IRS determination that neither of the two types of payments that the issuer receives under the second agreement are payments for project water. The IRS observes that the first payment occurs as a reimbursement to the issuer for its costs to find replacement water if the city's diversion to the company of consumable water other than project water cause a shortage of cooling water at the issuer's energy station. The second payment occurs because use by the company of project water results in significantly less return flow to the issuer than use by the city.

On the whole, this step of the analysis appears to be based on a view that the definition of "output contact" under the private activity bond regulations should not be expansively interpreted.

Having concluded that the second agreement is not an output contract and that, indeed, the company is provided with "no specific entitlement" to project water under the second agreement, however, the IRS concludes that the reservoir is treated as used for a private business use under other provisions of the private activity bond regulations.

Specifically, the IRS looks to the general rule in Treas. Reg. 1.141-3(b)(7). It provides that private business use can result from types of arrangements and circumstances not specifically listed in the regulations. The conclusion particularly turns on Treas. Reg. §1.141-3(b)(7)(ii), which provides that "[i]n the case of financed property that is not available to the general public . . . private business use may be established solely on the basis of special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property." The IRS concludes that the facts and circumstances are such that the company is provided with such a special economic benefit.

In order to apply the "special economic benefit" rule in Treas. Reg. §1.141-3(b)(7)(ii), the IRS necessarily needed to conclude that the reservoir is not properly treated as "available to the general public" within the meaning of the private activity bond regulations. The private letter ruling, however, contains no discussion or analysis of that point, which apparently is viewed as obvious by the IRS. There would appear to be at least an argument, however, that the reservoir should have been viewed as available to the general public, because it was part of a public power system that served the general public.

Another notable aspect of the IRS analysis is that the IRS determination that the company had "special economic benefit" is not based so much on general facts and circumstances as on the terms of the second agreement. In my view, the general "special economic benefit" rule was mostly intended to apply in cases where special economic benefit would exist in the absence of any private contract rights. The example applying this rule in the private activity bond regulations (Example 7) describes a city-owned pollution control facility constructed adjacent to a factory owned by a private corporation. In that example, the regulations conclude that private business use exists even in the absence of any contract between the city and the corporation. In other words, the IRS in effect concludes in the private letter ruling that the "special economic benefit" test can be largely based on contract rights, even though those contract rights in themselves would not ordinarily result in private business use.

This seems to me to be an expansive interpretation of the "special economic benefit" rule.

A different possible private business use analysis might have considered the other prong of the general rule in Treas. Reg. §1.141-7. Treas. Reg. §1.141-7(b)(i) provides that any arrangement for beneficial use of bond proceeds or of financed property results in private business use if the arrangement is "comparable to" one of the types of arrangements specifically listed as resulting in private business use (that is, an arrangement comparable to ownership, a lease, a management contract, a research agreement or an output contract that results in private business use). In this particular case, the IRS could have, for example, considered whether the second arrangement is sufficiently "comparable to" an output contract that it results in private business use, even though it is not exactly an output contract. The private letter ruling does not address that question.

Having concluded that the bond-financed reservoir is used for a private business use, the IRS then turns to considering whether the private payment test is met. The private letter ruling considers separately the company's two payment obligations to the issuer. The first is the company's obligation to compensate the issuer for costs it incurs for alternative cooling water if the city's obligation to deliver a specified amount of consumable water causes a reduction in the effluent available for the city to meet the issuer's cooling needs. The IRS notes that this contingent obligation "virtually disappears" after the reservoir comes on line, because of the increased reliability of the source of water. The private letter ruling concludes that, while the "disappearance" of this obligation enhances the economic benefit to the company, "the obligation cannot be considered a payment in respect of" the reservoir by the company.

This part of the analysis is not clearly framed. For example, what happens if, contrary to expectations, the company does indeed make such compensating payments to the issuer during the term the bonds are outstanding? One possible analysis is that the contingent payments should not be treated as private payments for purposes of the reasonable expectations test because they are not reasonably expected to be received as of the issue date, and that no contingent payments that are actually received in the future should be treated as private payments because the issuer would have taken no "deliberate action" resulting in their receipt. The private letter ruling, however, does not frame the analysis in that manner, but rather simply summarily concludes that such contingent payments cannot be private payments.

The company's second payment obligation is for variable costs related to delivery of project water for use by the company. These expenses include the costs of maintaining and operating the canals, ditches and other facilities that are to be used to deliver project water for use by the company via the reservoir project after it comes on line or otherwise. Although these expenses are not directly related to the operation of the reservoir project, without these supporting facilities to deliver the water from the first project to the reservoir, the reservoir project would not have been acquired.

In contrast to the first type of payments (that is, the payments for alternative water if project water is not sufficient), which are described as highly contingent and not reasonably expected, the second type of payments presumably are reasonably expected to be made. The IRS concludes, however, that the payments are not taken into account under the following exception in the private activity bond regulations: "Payments by a person for use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses . . . directly attributable to the operation and maintenance of the financed property used by that person." What is notable about this conclusion is that the expenses at issue in this particular case do not directly relate to the financed property at all (i.e., the interest in the reservoir), but rather to expenses that relate to other property (canals, ditches and other facilities) that were not financed with tax-exempt bonds. In effect, for purposes of the application of the rule that payments properly allocable to operating and maintenance expenses are not counted as private payments, the IRS appears to be taking the view issuer can look to the operating expenses of a system in part financed with a proceeds of a tax-exempt bond issue. That appears to be a somewhat expansive interpretation of the exception.

Accordingly, in my view, the private letter ruling reflects a narrow interpretation of the types of contracts properly treated as output contracts, a quite expansive interpretation of the rule that "special economic benefit" can result in private business use, a narrow interpretation of the types of contingent payments that are required to be counted under the private payment test, and an expansive interpretation of the rule that payments properly allocable to operation and maintenance expenses are not counted as private payments.

Whistleblower Litigation

The United States Tax Court issued a Memorandum Opinion on August 22, 2018, denying a claim for a whistleblower award under Section 7623(b) of the Internal Revenue Code. *William Mark Scott v. Commissioner*, T.C. Memo 2018-33. The decision describes the petitioner as the "former Director of the Internal Revenue Service (IRS) Office of Tax Exempt Bonds" who "worked for more than 19 years at the IRS and the IRS Office of Chief Counsel." (I add that part for new NABL members who may need an introduction to Mr. Scott.)

The whistleblower asserted that a particular issue of bonds issued by a municipal industrial development bond authority consisted of arbitrage bonds. The Tax Court granted declaratory judgment denying any award because it stated that the IRS had examined the bonds and closed the examination without adjustments. The IRS, via sworn affidavit, stated that no proceeds were collected from the issuer.

That may all seem entirely straightforward, but the opinion is informative (and, to some, perhaps even strangely entertaining) in a number of respects. Among other things, it provides a kind of window into the various procedures of the IRS whistleblowing program, particularly as it pertains to tax-exempt bonds. The whistleblower originally submitted a Form 211, Application for Award for Original Information, to the IRS on February 18, 2014. About two months later, the IRS acknowledged receipt, and about three months later, the IRS forwarded the claim for review by a tax-exempt bond subject matter expert. About six months later, the IRS agent prepared an evaluation report on the claim of award (Form 11369) stating that the bond issue "is not recommended for another examination since the 2012 examination addressed and tested arbitrage issues and did not identify an arbitrage issue." The report further noted that the whistleblower "did not provide any schedules, documents or bond yield calculation to show the bond yield was computed incorrectly." About nine months after the submission of the original claim, the IRS sent a preliminary denial letter to the whistleblower.

I describe this sequence of events in part because they indicate that the IRS actually does take whistleblowing claims seriously. Indeed, the period of time that the IRS took to respond was faster than many private letter ruling requests (and many IRS examinations of tax-exempt bonds, for that matter).

Shortly after receipt of the preliminary denial letter, in February 2015, the whistleblower responded by encouraging the IRS to reconsider its denial and proceeds with an examination of the bonds based on the information he provided. After the IRS Whistleblower Office sent the response to the IRS Tax Exempt Bond function ("TEB"), TEB assigned a *second* IRS agent to review the merits of the claim for a *second* time. About one year after the whistleblower response, in February 2016, the second IRS agent sent a second report to the IRS Whistleblower Office recommending that the IRS not open a new examination and that it deny the claim. The second report stated that an examination had previously been conducted and had determined that there was negative rebate liability and no indications or fraud, abusive transactions, or other tax law violations. The IRS Whistleblower Office then received additional information from the whistleblower in September 2016 and sent that information to the second IRS agent for review. In December 2016, the IRS Whistleblower Office sent to the whistleblower a final denial of his claim for a reward.

The whistleblower then filed in Tax Court to dispute the denial. It's at that point where the proceedings start to get really strange, because the whistleblower expressly accuses TEB of blatant malfeasance, both in connection with this particular matter and other matters. The whistleblower contends that the IRS in fact commenced an administrative action and collected proceeds related to the bond issues. The whistleblower states that he "obtained specific information and records regarding two separate attempts by TEB [Tax Exempt Bonds] to disguise the collection of proceeds on examinations initiated through submissions of Forms 211" (the whistleblower form). The whistleblower asserts that the IRS issued no-change letters to the issuer of the bonds but subsequently took administrative actions "so as to collect millions of dollars from the beneficial owners of the bonds." The whistleblower further claims that the reports prepared by TEB for the IRS Whistleblower Office were erroneous. Finally, the whistleblower generally states that "I have been told that the treatment of whistleblowers by TEB has been subject to active consideration of a possible review by the Treasury Inspector General for Tax Administration."

The Tax Court would have none of it, and granted summary judgment to the IRS. Among other things, the Tax Court held that assertions about conduct of the IRS in other matters were not relevant to this particular claim for an award.

It remains, however, somewhat remarkable to see a former Director of TEB assert that the current officials in that program are engaged in widespread misconduct. It is also informative to see how many IRS resources can be consumed by the actions of a single whistleblower, even if those actions are entirely without merit.

A Few Tax Notes on the Rule 15c2-12 Amendments

It's clear that, during this past quarter in public finance, new securities law developments have taken the thunder away from tax law developments, in light of the adoption of amendments to Rule 15c2-12. One may consider, however, what relationship, if any, the final amendments to Rule 15c2-12 have to federal tax questions. The answer appears to be not much, but there are a few tax-related observations that may be of interest.

Materiality and a Series of Related Obligations. The preamble to the new final rule notes that commentators have asked whether a series of financial obligations could be considered material due to their aggregate par amount, though none would be material on its own. The SEC states that materiality should be determined upon the occurrence of each obligation, taking into account all the facts and circumstances. If debt obligations are incurred at different times for legitimate business purposes, they would not be aggregated. If they are incurred at different times for no legitimate business purpose, but rather to avoid a single reportable transaction, they should be aggregated. When determining whether a series of related transactions is a single incurrence or should be assessed independently, all the relevant facts and circumstances must be considered. The

SEC then states that an "example of the type of facts and circumstances that could indicate that a series of related transactions were incurred separately for legitimate purposes would be if the series of financial obligations satisfy the requirements in the U.S. Department of Treasury Regulations and guidance concerning what constitutes a single issue of municipal securities under the IRC." 83 FR 44707. The preamble then cites in a footnote the familiar test regarding whether bonds are sold at least 15 days apart, sold pursuant to the same plan of financing and reasonably expected to be paid from the same source of funds. Among other things, this reference appears to accept the position in the Treasury Regulations that 15 days of market risk is sufficient to regard municipal bond transactions as separate, and to accept the view stated in the Treasury Regulations about the types of different bond issues that can be treated as issued pursuant to different plans of finance. It would seem unlikely, however, that the SEC intended to reference all of the special rules under the definition of "issue" in the Treasury Regulations (for example, the special rules for making separate issue elections).

In the same discussion the SEC "cautions issuers and obligated persons against entering into a series of transactions with a purpose of evading potential disclosure obligations." The SEC then compares this anti-abuse principle to the anti-abuse rule under the private activity bond regulations set forth in Treas. Reg. §1.141-14. That anti-abuse rule is focused on the particular purposes of the private activity bond restrictions, and it is difficult to see how making reference to it informs the application of the final amendments in any meaningful manner.

The Definition of "Debt Obligation" and Debt-for-Tax. The preamble discusses at some length what types of obligations may be treated as a "debt obligation" that is a "financial obligation". The position stated by the SEC is studiously vague, but the SEC does expressly state that state law characterization and financial accounting treatment are not determinative. Among other things, the preamble states that certain "debt-like" leases may be treated as debt obligations for this purpose. As an example, the preamble states that "the types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificate of participation transactions." 83 FR 44711. Of course, most certificate of participation transactions that are sold on the municipal market are treated as debt for federal income tax purposes, even though they may not be treated as debt for state law purposes. The preamble, however, does not expressly discuss whether treatment of an obligation as debt for federal tax purposes is an important factor in assessing whether an obligation is debt for purposes of the amended rule. For now, I merely raise that question.

I will note that an argument could be made that the inherently vague, facts and circumstances test for whether an obligation is properly treated as a debt obligation under the amendments to Rule 15c2-12 bears some resemblance to the inherently vague, facts and circumstances test that applies for whether an obligation is properly treated as debt for federal tax purposes.

References to Interest Rate Step-Ups Triggered by Tax Law Change. In discussing terms of debt obligations that could adversely affect the rights of existing security holders, the preamble uses as an important example the interest rate tax step-up provisions that are common in tax-exempt bonds held directly by banks:

> . . . the Commission believes that undisclosed debt obligations and their terms could adversely affect security holders. . . . Specifically, recent changes to federal tax laws have reportedly triggered provisions commonly found in direct placements relating to the rate at which the direct placement will bear interest. In the Commission's view, these tax-related provisions are illustrative of the types of terms to which issuers and obligated persons agree when incurring financial obligations that could impair an issuer's or obligated person's liquidity or creditworthiness and, thus, adversely affect existing security holders. . . . For these reasons, the Commission believes that the timely disclosure of both the incurrence of a debt obligation, if material, and the obligation's material terms that affect existing security holders, such as those related to the rate at which a debt obligation will bear interest, would provide important information . . .

83 FR 44710 (footnotes omitted).

Of course, there has been a great amount of discussion of the federal income tax treatment and consequences of such interest rate tax step-up provisions, and of modification of those provisions. One point that has become clear is that such tax step-up provisions have taken many different forms, and that some formulations are much simpler and clearer in application than others.

TE/GE "Issue Snapshots"

Without fanfare, the IRS Tax Exempt and Government Entities Division (TE/GE) continues to post "Issue Snapshots" on the IRS website. See https://www.irs.gov/tax-exempt-bonds. The website describes these as follows: "Issue Snapshots are employee job aids that provide analysis and resources for a given technical tax issue. They are developed through internal collaboration and may evolve as the compliance environment changes and new insights and experiences are contributed. Please visit this site periodically for new and updated Issue Snapshots."

The Issue Snapshots clearly are not formal public guidance. We are told by IRS officials, however, that the Issue Snapshots are being read and followed by IRS agents and may indicate technical issues that the IRS is currently focusing on.

As of the date of this writing, the IRS has posted 15 tax-exempt bond Issue Snapshots. The three most recent postings are as follows:

- "Deep Discount": Effect on Exempt Facility Bonds Compliance (June 15, 2018)
- Qualified Mortgage Bonds – Current Refunding/Replacement Refunding Structure (July 16, 2018)
- Excess Costs of Issuance for Private Activity Bonds (July 27, 2018)

An Issue Snapshot often ends with "Issue Indicators or Audit Tips," which may be of particular interest. For example, the Issue Snapshot for the costs of issuance limitation ends with the following tips for IRS agents:

- Verify the amount of actual issuance costs:
  - Request and review source documents (trustee statements, invoices, etc.) for costs of issuance.
  - Identify any additional costs that should be included as costs of issuance.
- Verify the amount of "Proceeds" for the issue:
  - Sale proceeds.
  - Investment proceeds (during the project period).
- Calculate the 2 percent allowable costs of issuance. If the limit is exceeded, the bonds could be taxable.
  - If the issuer asserts that excess costs of issuance has been paid by a conduit borrower, ensure the payment came from the conduit's funds and isn't traceable to bond proceeds.
- Compare the computed amount with the amount reported on Form 8038

For the most part, the Issue Snapshots appear merely to state the applicable law, but it may be only a matter of time before they stray further into interpreting the law in ways that may be concerning. In any event, the use of Issue Snapshots appears to be an important initiative for the TE/GE Division generally, and the postings can be expected to continue.

Federal Tax Legislation "Version 2.0"

On September 11, 2018 the Chairman of the House Ways and Means Committee introduced three new tax reform bills. This new legislation is not expected to be approved by the Senate. At this point, there is no indication that this legislation would touch on tax-exempt bond provisions, but of course any such legislation needs to be carefully monitored.

September 2018