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State Law Issues

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This outline and presentation are intended to address how state law is relevant in (1) delivery of the bond counsel opinion, (2) information that is disclosed in offering documents that may be material to a bondholder's investment analysis and (3) certain other deal matters.

I. The Bond Counsel Opinion.¹

A. Components of the Bond Counsel Opinion. Bond Counsel's opinion typically addresses the following matters:

- that the bonds have been duly authorized, executed and delivered by and are valid and binding obligations of the issuer;
- the source of payment or security for the bonds; and
- whether and to what extent interest on the bonds is exempt from federal income taxes and from other taxes, if any, imposed by the state of issue.

1. **Validity and Enforceability.**

Bond Counsel is traditionally engaged to provide an objective legal opinion as to *validity* and *enforceability*. Validity remains essential to a first step to both tax-exempt status and securities law exemption.

“... [I]t is clear from these cases discussing the purpose of that exclusion [Section 103 of the Internal Revenue Code] that the courts have recognized as an initial matter that the interest must be incurred through the exercise of state's borrowing power. Unauthorized exercise of such power would not invoke the Section 103(a)(1) exemption even when there is a reasonable probability that unauthorized contracts would be upheld by a state court on an implied contract theory.... The word “obligations” was not intended to extend to every obligation including the payment of interest but only to those obligations that were created

¹ For a summary of the evolution of Bond Counsel, see *The Function and Professional Responsibilities of Bond Counsel*, Third Edition (available at <https://www.nabl.org/resources/the-function-and-professional-responsibilities-of-bond-counsel-3rd-edition/>).

in the exercise of the state's borrowing power.” *Power Equipment Co. v. United States*, 748 F.2d 1130, 1137-38 (1984).

The validity opinion is the *sine qua non* of the Bond Counsel opinion. It is still of tremendous economic significance that the largest default in the history of public finance, by the Washington Public Power Supply System (“WPPSS”), was a state law validity case. *Chemical Bank v. Wash. Pub. Power Supply Sys.*, 666 P.2d 329 (Wash. 1983) (Although the court found the municipal participants had the authority to purchase electricity, it refused to imply the authority to enter into “take or pay” contracts to purchase the chance to obtain energy. As a result, the contracts which were to have provided the revenues to support the bonds were voided, and WPPSS defaulted on over \$2.25 billion in revenue bonds.)

There have been significant cases holding that *ultra vires* borrowings are void and unenforceable, placing the burden on the party contracting with a municipal entity to ensure validity. *Los Angeles Dredging Co. v. Long Beach*, 291 P. 839 (Cal. 1930). Note that there is no recovery in quasi contract or equity, so if the debt is void the municipality keeps the money and does not have to pay it back. Example: As part of its 1994 bankruptcy, Orange County, California, threatened to repudiate certain of its debt (claiming invalidity) as a part of its bankruptcy case and thus would not have to repay the debt.

2. State Tax Exemption

In addition, most Bond Counsel opinions also address the excludability of interest on the bonds with respect to taxation under state law in the state that the issuer is located. Inclusion of this component of the opinion may be less important, or entirely absent, in those states where there is no state income tax. In other states, the tax treatment under state law is tied to the treatment under federal tax law.

Many Bond Counsel opinions track the enabling legislation with respect to state tax exemption.

While some states will broadly provide that interest on bonds is exempt from taxation within the state of the issuer, the state may include interest on the bonds in the measure of corporate excise or franchise taxes. If bond interest is or may be includable in the measure of corporate excise or franchise taxes, the Bond Counsel opinion should include a qualification to such effect to avoid any confusion.

B. The NABL Opinion Standard.

It is critical to know all of the applicable law because as Bond Counsel, firms are expected to deliver an approving legal opinion in accordance with the “NABL Standard” which states in part:

Bond counsel “may render an ‘unqualified’ opinion regarding the validity and tax exemption of bonds if it is firmly convinced (also characterized as having a ‘high degree of confidence’) 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.”

See *Model Bond Opinion Report*, NABL Committee on Opinions and Documents, 2003 Edition (“2003 Report”), page 7 (available [here](#)). Prior to the 2003 Report, the accepted standard was “it would be unreasonable for a court to hold to the contrary”, *Model Bond Opinion Report*, NABL, 1997 Edition.

C. Becoming Firmly Convinced.

Bond Counsel must take many steps involving state law considerations to become “firmly convinced” and meet the NABL Standard:

1. Approval Process.

- a. Is the issuer or borrower properly in existence?
 - i. Was it duly created?
 - ii. Were its members correctly elected/appointed?
- b. Is the issuer authorized to issue the debt and is the borrower authorized to borrow the debt?
 - i. What is the source of the issuer’s authority?
 1. Home Rule: Local government’s right to rule itself cannot be taken away and is limited only by reference to state and federal constitutions.
 2. Dillon’s Rule: Local government’s authority comes only from the state and can be taken away by the state.
 - ii. What are the constitutional and statutory requirements for the issuance of debt and have they been met?
 1. Have required findings been made?
 2. Have approvals been properly received?
 - Open public meetings laws
 - Quorum requirements
 - Number of readings
 - Notice/public hearing requirements
 - Notice of passage requirements
 - Application of referendum
 - Election requirements (e.g., proper ballot measure, proper voter approval and validation)
 - Requirements for competitive sales
 - Debt policies (e.g., may impact authority and other related issues such as minimum savings targets for refunding obligations)
 - Any state level approvals
 - iii. Is the proposed financing structure authorized under state law? Is the pledge of security authorized under state law?

What state/local requirements must be satisfied prior to issuing the debt?

- iv. Are there practical considerations to keep in mind?
 - 1. Budgetary constraints.
 - 2. Debt management policies.
 - 3. Limited debt capacity.

2. Various Financing Structures.

- a. General Obligation Debt.
 - i. At its most basic level, a general obligation bond carries a pledge of the full faith and credit of the issuer. “Full faith and credit” of the issuer is a promise to use all available resources, including the power to raise/levy taxes, to pay debt service. (A good reference is the NABL paper on General Obligation Debt.)²
 - ii. There are three general categories of general obligation bonds: unlimited tax general obligation bonds, limited tax general obligation bonds, and general obligation bonds payable from the issuer’s general fund. In some states, it is possible that a general obligation bond may be secured by an additional defined source of revenues (e.g., water or sewer revenues or excise taxes). These types of bonds may be secured by the full faith and credit of the issuer and, depending upon the state and local law at issue, may require voter approval and be subject to a statutory requirement to budget and appropriate debt service. General fund bonds are not secured by a promise to levy *ad valorem* property taxes like the other two categories that are usually secured by such taxes, limited or unlimited as to amount. Accordingly, limited and unlimited tax general obligation bond issuers may be compelled to increase taxes to pay debt service.
- b. Revenue Bonds.
 - i. In special fund revenue bonds, the debt’s authorizing documents restrict repayment of the debt to funds deposited in a special fund, whether from specific taxes, utilities or other revenue-producing properties of the issuer. Frequently, the special fund is not supplemented by other funds of the issuer.
 - ii. Bond Counsel’s considerations with respect to pledging a specific revenue stream:

² See NABL’s 2014 Report, *General Obligation Bonds: State Law, Bankruptcy and Disclosure Considerations*, available on NABL’s webpage.

- When does the lien attach?
 - When is the lien perfected?
 - How is the lien perfected?
- iii. The pre-2001 UCC broadly excluded transactions involving states or the governmental entities of those states. The new UCC allows states to either continue the broad exclusion or narrow the exclusion so that it applies only to the extent that another statute expressly governs the creation, perfection, priority or enforcement of a security interest granted by a state or governmental entity of a state. (See Revised UCC Section 9-109.)
- c. Certificates of Indebtedness.
 - i. Bonds backed by an agreement to pay debt service from any available funds.
 - ii. The bond documents typically contain a promise to budget revenues and make payments regardless of budgetary or other constraints.
- d. Moral Obligations.
 - i. Bonds backed by an agreement to “request” appropriations annually to pay debt service.
 - ii. The bond documents typically contain “non-appropriation” language, meaning the issuer’s failure to appropriate funds does not cause a default.
 - iii. Issuer’s obligation will not be treated as a debt for statutory or constitutional debt limit calculations as long as there is no legal obligation on it to provide financial assistance to meet debt service requirements. See, e.g., *Harrison v. Day*, 202 Va. 967, 121 S.E.2d 615 (1961) (revenue bonds of port authority not general obligation debt even though authority required to “urgently request” appropriations to cover cost of project and there was an “expectation” of appropriations); *Baliles v. Mazur*, 224 Va. 462, 297 S.E.2d 695 (1982) (upheld authority created to finance public buildings from revenue bonds payable from lease payments from state agencies, citing “special fund” doctrine; where there is no pledge of full faith and credit, bonds are not general obligations even if special fund consists entirely of state appropriated money); *Dykes v. Northern Virginia Transportation Commission*, 242 Va. 357, 411 S.E.2d 1 (1991) (even though “practical effect” was that county would continue to make payments, no debt created where county’s payment obligation was expressly contingent upon county’s appropriation of funds for such payments). *Platte Cty. V. UMB Bank, N.A.*, 611 S. W. 3d 819 (2020) (a county

was not liable to pay a shortfall on bonds because the county did not promise to make such payments in the financing agreement, which provided for payment from sales tax revenues and expressed the county's intent to budget and appropriate such funds, but left the decision whether to accept the appropriation in the discretion of the county commission); *ACA Financial Guaranty Corp. v. City of Buena Vista*, 917 F.3d 206 (4th Cir. 2019) (failure by the City to make any payment required under a lease agreement or failure by the City to observe and perform any covenant, condition or agreement on its part to be observed or performed thereunder resulting from failure of the City to appropriate moneys for such purposes did not constitute an event of default..." and the City did not have an enforceable obligation to appropriate funds to make rental payments under the financing documents).

- e. Lease Obligations.
 - i. Can be closely related to moral obligations (such as obligations to pay lease payments that are subject to an annual appropriation), special fund doctrine (the revenues from lease payments are the "special fund" from which payments are made), or service contracts (obligation is a current expense for benefit provided).
 - ii. Important to distinguish operating leases from capital leases. A capital lease is characterized by:
 - The life of the lease is 75% or greater of the asset's useful life,
 - The lease contains a purchase agreement for less than market value,
 - The lessee gains ownership at the end of the lease period, or
 - The present value of lease payments is greater than 90% of the asset's market value.
 - iii. Many states require annual payments to be "fair market value" for facilities financed.
 - iv. Note the distinction between "leases subject to annual appropriation" and "leases subject to abatement." The first is usually "all or nothing" and in the second formulation a portion of the obligation (the part not subject to abatement) may be treated as debt.

- f. Real Estate.
 - i. Specific collateral may be pledged to secure the repayment of debt on a recourse or non-recourse basis. Specifically, housing bonds may be secured by a lien on land, buildings and equipment of a specific development or a mortgage pool.
- g. Short Term obligations.
 - i. Short-term (current fiscal year) borrowings in anticipation of current revenues or taxes or current tax revenue notes.
 - ii. Short-term obligations are typically excluded from debt limit calculations, or have their own statutory constraint. *See Davenport v. City of Rock Hill*, 432 S.E. 2d 451 (S.C. 1993). The general rationale is that these types of obligations are payable from currently levied taxes and, therefore, are not debt.
- h. Anticipation notes (BAN, TRAN, TAN, RAN, GAN).
 - i. Issued in anticipation of bonds, taxes, revenues, grants, etc.
 - ii. Depending on term of obligation and source of repayment and security, may, or may not, be considered debt for debt limit purposes, or the debt limit may be an assumed amortization schedule based on the anticipated long-term debt.
- i. Interfund Loans.
 - i. Limited and temporary transfers or “interfund loans” among the funds of a taxing district where the funds are not put at risk of insolvency may not constitute indebtedness of the taxing district.
 - ii. Procedural requirements may be required under state law (e.g., loan must be approved by official action of legislative body, term may not be longer than three years, must have plan in place for repayment, etc.).
- j. Service Contracts. Continuing service contracts where the municipality agrees to pay in installments for water, electric or other public services may be excluded from debt limitations depending on whether the payment is conditional and contingent on provision of service or an unconditional obligation which only postpones the time of payment. *See Armstrong v. County of Henrico*, 212 Va. 66, 182 S.E.2d 35 (1971) (county agreement to procure materials and services necessary to operate sewer system did not create “debt”); *Board of Supervisors v. Massey*, 210 Va. 253, 169 S.E.2d 556 (1969) (upholding contract for furnishing transit services as contract for services conditioned on performance and not a present liability).

for future payments); *McBean v. City of Fresno*, 112 Cal. 159 (1896) (holding that City incurs debt each year on five-year sewage disposal contract only to the extent of services provided during that year).

- k. Tax increment & special assessment financing. Forms of financing historically used to promote development in a particular geographic area. Procedures vary among states but to the extent that the general credit of the issuer also provides security for the TIF obligation, then the debt ceiling/limit and special procedures are likely to apply.

3. Debt Limits and Exceptions.

- a. Debt limit: a constitutional or statutory limit upon the incurrence of debt.
- b. Debt limits are intended to protect taxpayers from the burdens of excess taxation caused by “ruinous” debt levels. Across the states, there is a large variety of restrictions and no uniformity.
- c. Forms of debt limits:
 - i. Absolute amount (dollar figure).
 - ii. A percent of the value or assessed value of taxable property. Most common, this forbids indebtedness in excess of a certain percent of the value or assessed value of taxable property; some also depend on size of population in the unit or prior expenditure level (note that valuation methodology differences will affect the debt ceiling).
 - iii. Linked to income and/or revenue (a percentage of average general fund revenues, a percentage of total tax revenues, a percentage of state appropriations).
- d. Debt limit calculation is generally done at the time the bonds are issued or the obligation is incurred.
- e. In order to calculate debt, you must understand what is considered “debt” for purposes of such calculations and what may be an exception. Tests vary widely across the states.
- f. Offsetting Outstanding Debt.
 - i. Some states allow issuers to credit against their outstanding debt certain assets for purposes of statutory debt limitations.
 - ii. Assets may include taxes levied in the current year and cash on hand received for the purpose of paying obligations due in the current year (see, e.g., RCW 39.36.030 (Wash.)).

- g. Refunding Obligations.
 - i. Refundings that generate savings but with an increase in principal pose unique questions.
 - ii. The new principal amount in excess of the refunded principal amount may constitute new nonvoted “debt” for debt calculations, but some statutory exceptions may apply.

D. Use of Proceeds.

- 1. Use must be permitted under state law and within the scope of the authorizing documents.
 - a. Ballot measure, if applicable.
 - b. Ordinance, resolution or trust indenture.
 - c. Capital purpose vs. operating expense, if applicable.
 - d. Nexus with revenue producing enterprise.
- 2. Public Purpose.
 - a. This concept restricts public funding to activities that serve the interests of the public at large and precludes governmental participation in activities that solely benefit private interests. Sometimes this is not explicitly in the state constitution but courts have usually “found” it there.
 - i. There is no concrete or uniform definition of the public purpose doctrine, violation of which is sometimes expressed as (I) a public source of payment that benefits a private entity (thus basing the limitation on the need to protect the public treasury), or (II) an impermissible aid or franchise to one group over another with the blending of public and private roles, together with the concomitant concern that government should not be involved in the determination of which group to aid or benefit.
 - ii. Note the rapid evolution of the public purpose doctrine — today, the use of government debt or taxing power to finance economic development (jobs, housing, pollution control, sports facilities, student loans, mortgages, urban redevelopment, tourism) is common. This concept of financing private enterprise is derived from the anticipation that the entire community will benefit from job growth, higher education, home ownership and higher levels of private economic activity. Such expansion of the traditional

concept is often paired with a deferral by the courts to the government involved for the determination of “public benefit.”

Although upheld by the Supreme Court, state constitutional and statutory constraints may limit financing economic development:

In *Kelo v. City of New London et al.*, 545 U.S. 469, 125 S.Ct. 2655 (2005), the United States Supreme Court reviewed the condemnation powers of a local government under the Takings Clause of the Fifth Amendment of the United States Constitution. Property owners challenged the condemnations arguing that the development plan did not constitute a “public use” and that the plan was primarily for private benefit. The Connecticut Supreme Court upheld the condemnation on the grounds that the city had statutory authority to condemn the land as part of an economic development plan and that the Connecticut Legislature had expressed its intent that such a taking was a “public use” and in the “public interest.” The U.S. Supreme Court upheld the condemnations and held that the purposes articulated by the city satisfied the public use requirement of the Fifth Amendment. *Id.* at 485. In its reasoning, the Court deferred to the judgment of the local government and stated that the city had fulfilled the public use requirement by carefully formulating a program of “economic rejuvenation” that was thoughtfully designed to “provide appreciable benefits to the community, including – but by no means limited to – new jobs and increased tax revenue” in furtherance of clear statutory authority to engage in economic development. *Id.* at 483.

Board of County Commissioners of Muskogee County v. Lowery, 136 P.3d 639 (Okla. 2005) (holding that economic development alone does not constitute a public purpose and therefore does not constitutionally justify the County’s exercise of eminent domain. In light of *Kelo*, the case is decided under Oklahoma’s constitution).

City of Norwood v. Horney, 853 N.E.2d 1115 (Ohio 2006) (City failed to show the taking of blighted property for redevelopment was for public use as required under Ohio constitution).

In re Condemnation by Redevelopment Authority of Lawrence County, 962 A.2d 1257 (Penn. 2008)

(Pennsylvania law does not permit eminent domain to be used to foster economic development).

3. Lending of Credit/Gift of Public Funds.

- a. State law may prevent a local government from guaranteeing the debt of a private entity (e.g., lending its credit) or using its public funds (e.g., bond proceeds) for private purposes.
- b. *Board of Directors of the Industrial Development Board of the City of Gonzales v. All Taxpayers*, 938 So. 2d 11 (La. 2006) (City designated tract as an economic development district and its voters have approved rededication of sales taxes, of which there are as of yet none, to make them available to service sales tax increment bonds to be purchased by retail merchant, the proceeds to be used in part to construct a store for lease to the merchant, with an option to purchase it. Rival merchants challenge the financing, but “we conclude the Project does not constitute a prohibited loan, pledge or donation of public funds” as the arrangement is not “gratuitous.” Nor does the financing violate equal protection.)
- c. *State ex rel. Ohio Congress of Parents and Teachers v. State Board of Education*, 857 N.E.2d 1148 (Ohio 2006) (“(W)e hold that community schools, also known as ‘charter schools,’ in and of themselves, are not unconstitutional.” State’s guaranty of such schools’ loans doesn’t violate constitution’s restrictions on lending of the state’s credit and the state’s assumption of debt, as they bar lending of credit to private business enterprises, and the assisted charter schools are non-profit entities. Nor does the program violate the thorough and efficient test, though state aid is shifted to the charter schools based on a per pupil formula. And the result is not an unconstitutional diversion of school taxes, as state funds are at issue and “follow the student; [while] local funds do not.”)

E. Bond Counsel Opinion vs. Issuer Counsel Opinion

In *The Function and Professional Responsibilities of Bond Counsel*, published by the National Association of Bond Lawyers (2011) (link provided above), there is a brief history of the role of Bond Counsel and how the role of Bond Counsel came to be a standard practice. Before the role of Bond Counsel originated, counsel to the issuer would deliver the opinion as to the validity and enforceability of the bond. “In response to investor concerns, it became the practice for underwriters or purchasers to obtain an opinion regarding bond validity from lawyers whose expertise, objectivity, professional standing and independence from the issuer made their opinions acceptable to the bond underwriters through whom bond issuers were sold to investors.” *Id.*

Bond Counsel opinions as a matter of practice do not rely on or reference the issuer counsel's opinion, though many Bond Counsel opinions will reference or rely on the borrower's counsel opinion in a conduit financing. Since the Bond Counsel opinion is intended to be an independent opinion as to the validity and enforceability of the bonds, such reliance would be in contradiction with that position. References to opinions of other counsel are sometimes included in bond counsel opinions for informational purposes and to clarify that bond counsel is not rendering an opinion as to certain matters. However, there are some instances in which Bond Counsel may rely upon an opinion of separate counsel that are directly within such counsel's purview (e.g. reliance by bond counsel on an opinion of borrower counsel as to the 501(c)(3) status of a borrower).

While certain components of the issuer counsel's opinion overlap with Bond Counsel's opinion: validly existing, authority and power, duly authorization, it is important to have such opinions come from both Bond Counsel and issuer counsel. Bond Counsel provides the independent third party review and is an expert in the area of public finance, while issuer counsel generally has more ongoing knowledge of the issuer and its existence and power on a general basis.

II. Disclosure of State Law Matters.

A. Federal Law Securities Disclosure Requirements.

Rule 10b-5 (“Employment of Manipulative and Deceptive Practices”) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The U.S. Supreme Court has stated that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to

vote.” See *TSC Industries, Inc. v. Northway, Inc.* 96 S. Ct. 2126 (1976).

See SEC Release No. 10278, dated January 10, 2017, involving bond-financed road projects of the Port Authority of New York and New Jersey. The Authority entered into a settlement agreement with the SEC resulting in a Cease and Desist Order, upon admitting that their lawyers identified, but did not disclose, the risk of a successful challenge by the bondholders and investors relating to possible lack of authority to finance the road projects with bonds.

B. Security and Source of Payment.

1. General Obligation.

See prior discussion on the variation of general obligation bonds from state-to-state. The nature of the full faith and credit pledge, any procedural requirements necessary to enforce the pledge, and the limitations on the pledge are material to an investor’s analysis of the investment. Because of the variations state to state, it is critical to be familiar with and to accurately describe the nature of the pledge in the disclosure document.³ State law considerations to keep in mind include:

- a. Procedural and substantive components of the pledge.
 - i. Are there procedural steps that an issuer must take to generate sufficient revenue in the event of a shortfall? Such steps may include:
 - 1. Budgetary approval.
 - 2. Voter approval.
 - 3. Legislative approval to appropriate.
 - 4. Notice to State Regulators.
 - 5. Are any of the steps discretionary or conditional?
 - 6. Do any of the steps require action by another governmental entity?
 - 7. Timing of collections – will the revenue be collected in time to pay debt service?
 - ii. Is the full faith and credit pledge, in substance, a pledge of the general fund or a stream of restricted or unrestricted funds?
 - 1. Property taxes.
 - 2. Sales taxes.
 - 3. General fund may be comprised of multiple sources of revenue. Is that revenue available to pay debt service?
 - Property taxes.

³ See 2014 Report of the NABL General Obligation Disclosure Task Force, *General Obligation Bonds: State Law, Bankruptcy and Disclosure Considerations?* (<https://www.nabl.org/resources/go-bonds-report-2014/>)

- Utility taxes/revenues.
 - Sales taxes.
 - Hotel/motel (lodging) taxes.
 - Business and occupation taxes.
 - Real estate excise taxes.
- iii. What are the limitations on the ability to raise and/or collect taxes?
1. Statutory and constitutional limitations.
 2. Uniformity requirements.
 3. Assessed value – methodology used to determine assessed value of property subject to taxation may be important when determining property tax limitations.
 4. State statutes frequently control the method of giving notice of delinquency, the division of taxes among various taxing districts in the event of a delinquency, and the ability to collect past due payments.
- b. Does the bondholder have rights under state or local law to seek payment from another political subdivision? Disclosure documents frequently note that the debt does not constitute a debt or indebtedness of the state, any controlling entity, or other political subdivisions other than the issuer.
2. Pledge of and Security Interest in Revenues/Property and Applicability of UCC Provisions.
- a. Bondowners may or may not have a security interest in particular revenues or assets of the issuer. As noted by *The Report of the National Association of Bond Lawyers Opinions and Documents Committee Re: Revised Article 9 of the Uniform Commercial Code, July 17, 2000*, there is some variation among states regarding the treatment of security interests created by a government or governmental subdivision or agency.
- b. General obligation debt may be treated as “unsecured” without a security interest in particular revenues. State law may not permit a “priority” lien on tax proceeds. Alternatively, state statutes may grant a priority lien on tax collections without the necessity of making a UCC filing. For instance, Section 39:1430.1 of the Louisiana Revised Statutes of 1950, as amended, states in pertinent part as follows:

Any pledge of and grant of security interest in taxes, income, revenues, monies, ... or receipts ... made by a public entity in connection with the issuance of securities shall be valid, binding, and perfected from the time when the pledge is

made. The taxes, income, revenues, monies ... or receipts ... so pledged and then held or thereafter received by the public entity or any fiduciary shall immediately be subject to the lien of such pledge and security interest without any physical delivery thereof or further act, and the lien of such pledge and security interest shall be first priority and valid and binding as against all parties having claims of any kind in tort, contract, or otherwise against the public entity, whether or not such parties have notice thereof.... No filing with respect to such pledge and security interest made by a public entity need be made under Chapter 9 ... for the perfection or priority of such pledge and security interest.

- c. In revenue obligations, the concept of “lien position” (senior, parity and junior) becomes important primarily because of the limited source of revenues available for repayment. Some additional bonds tests are created by statute or regulation; others are the result of contractual bargains. State law may grant a statutory lien on revenues without the necessity of making a UCC filing.
- d. Note the interrelationship between general obligation bonds (subject to debt limit and can be considered unsecured) and revenue bonds (meeting the special fund exception with a perfected security interest)
- e. The authority to grant a security interest in real or personal property as collateral for an obligation is determined by state law. Many state constitutions limit or prohibit a seizure of public funds or property, so a mortgage may often be of limited utility. (See “Events of Default and Remedies – Seizure of Public Property” on the following page.)
- f. State law disclosure considerations:
 - i. Nature of the pledge.
 - ii. Unsecured or secured.
 - iii. Limitations on source of revenue.
 - iv. Whether a UCC filing is required.
 - v. Lien position.
 - vi. Authority for and limitations on foreclosure or liquidation of assets securing obligation.

C. Events of Default and Remedies.

Remedies available to bondholders in the event of a default depend on a number of factors, including the type of breach (payment default vs. technical default), the availability of remedies under constitutional, statutory, and contractual provisions, and the type of remedy being sought. State law, judicial actions and local rules may provide for and limit remedies

available to bondholders upon the occurrence of an event of default.

1. Seizure of Public Property.

“Remedies that are ordinarily available to reach the debtor’s assets do not generally apply against a governmental entity. So garnishment of public funds or seizure and sale of property devoted to public use are almost uniformly unobtainable. The immunity to execution process is predicated on express exemptions in some jurisdictions and on resort to policy considerations like the public use or public trust doctrine in others.” John Martinez, Bondholder Remedies—General Obligation Securities, 4 Local Government Law § 25:24 (October 2013) (citations omitted).

2. Acceleration.

Because the taxes or other rates and charges pledged to pay debt service on many governmental bonds cannot be accelerated, most non-private activity bonds are generally not subject to acceleration. In the event of a default, bondowners will generally not be able to declare all outstanding principal due and payable. In the event of multiple defaults in payment of principal or interest, bondholders would need to bring a separate mandamus or other enforcement action for each such payment not made.

Availability of this remedy varies state to state, issuer to issuer, and the nature of the security (e.g., conduit financing secured by general revenues of a private college may be subject to acceleration in the event of default).

3. Writ of Mandamus.

- a. The principal remedy available to governmental bondholders is to seek a writ of mandamus to compel performance of non-discretionary or ministerial duties (e.g., impose or collect taxes or rates and charges).
- b. Similar to other remedies, procedural steps to compel performance may be dictated by state or local law, and may be discretionary, conditional, or out of the control of the issuer (e.g., procedural steps that are required to be undertaken by governmental officers or entities other than the issuer).

4. Other Rights and Remedies.

- a. In many states, the power to appoint a receiver to undertake budgetary or other issuer functions may be available as a remedy under statute (legislative appointment) or compelled by a court (judicial appointment). The powers of receiver vary widely by state and may depend upon the source of the power of appointment. Depending on the powers granted to the receiver, the receiver may effectively supplant the powers, functions and responsibilities of some or all elected officials of the issuer. Alternatively, the receiver

may have a more limited role providing oversight (e.g., budgetary approval) of issuer actions. In some circumstances, a receiver may be legislatively granted with powers that go beyond those enjoyed by elected local officials. Note, however, that the powers of a receiver are likely very limited in a Chapter 9 bankruptcy context.

- b. Unless expressly authorized by statute, attachment and execution are not generally permitted against a municipality, but an exception may be made in some jurisdictions where the property is held in a proprietary capacity. And the same may apply with mechanics' liens. *See Manly Mfg. Co. v. Broaddus*, 94 Va. 547, 27 S.E. 438 (1897) (mechanics' lien laws do not apply to public buildings or structures erected by states, cities or counties for public uses, unless the statute creating the lien expressly so provides).
- c. "In some New England states where local inhabitants are personally liable for the debts of the local government unit, bondholders may execute process against private property. Consequently, the most effective remedy for the general obligation bondholder aims at the general taxing power of the issuer, whereas the revenue bondholder's best resort is the revenue-generating capacity of the project." *John Martinez, Bondholder Remedies—General Obligation Securities*, 4 Local Government Law § 25:24 (October 2013) (citing *Town of Bloomfield v. Charter Oak Nat. Bank*, 121 U.S. 121, 129, 7 S. Ct. 865, 30 L. Ed. 923 (1887) (noting that in Massachusetts and Connecticut, and some of the other New England states, the individual liability of the inhabitants is maintained, which is an exception to the general rule, being peculiar to their customs and laws)).
- d. State law often contains detailed statutory notice, timing and other requirements that must be fulfilled to exercise tax liens and other remedies. Protections are also frequently afforded to delinquent taxpayers that may impact the value of the remedy (e.g., homestead exemptions). The value of the property subject to the lien, competing rights to the proceeds of any sale and any limitations on a bondholder's right to seek a deficiency judgment against the property owners will also be material to an investor's decision.

D. Chapter 9 Bankruptcy.

- 1. Filing Considerations.
 - a. Municipal bankruptcy is much rarer than corporate bankruptcy. Several municipal bankruptcies between 2011 and 2013 (such as Jefferson County, Alabama; Harrisburg, Pennsylvania; and Detroit, Michigan) brought national attention to the issue.

- b. Bankruptcy is different than default.
- c. Many states either limit, or do not permit, Chapter 9 bankruptcy filings, and municipalities cannot be forced into involuntary bankruptcy.
- d. In many states, express authorization is required.

States that Authorize Municipal Bankruptcy Filings	AL, AZ, AR, ID, MN, MO, MT, NE, OK, SC, TX, WA
States that Conditionally Authorize Municipal Bankruptcy Filings	CA, CT, FL, KY, LA, MI, NJ, NC, NY, OH, PA, RI
States with Limited Authorization to File for Bankruptcy	CO, OR, IA, IL
Bankruptcy Filing is Prohibited	GA
Other states are unclear or do not have specific authorization	

See NABL's 2015 Report—*Municipal Bankruptcy: A Guide for Public Finance Attorneys* available on the NABL website [here](#).

- e. Even with authority to file for bankruptcy, municipal issuers must satisfy various procedural requirements to obtain bankruptcy protection.

2. The Automatic Stay.

- a. Application of the automatic stay provisions creates additional bondholder risk.
- b. Automatic stay provisions may force a municipality to stop paying debt service on its obligations once the bankruptcy petition is filed, but adherence to this rule is not universal. See Moody's Investors Service, Key Credit Considerations for Municipal Governments in Bankruptcy, January 19, 2012.

3. Special Revenue Pledge.

- a. Investors should be made aware that bankruptcy proceedings treat general obligation debt and revenue debt differently.
- b. "Special revenues" acquired by a municipality after the commencement of the Chapter 9 case remain subject to any lien resulting from any security agreement entered into by the municipality before the commencement of the case. Special revenues are defined in Section 902(2) of the Bankruptcy Code as:
 - i. receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide

- transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems;
- ii. special excise taxes imposed on particular activities or transactions;
- iii. incremental tax receipts from the benefitted area in the case of tax increment financing;
- iv. other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or
- v. taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.

E. State Tax Exemption.

1. Tax-exempt bonds may also be exempt from state income taxation. Whether or not the bonds are exempt from state income taxation would be material to an investor.
2. Not all states have an income tax.
3. Check local laws to determine if interest on the bonds is exempt from state or local income taxes. Best practice is to quote the relevant language of the law as closely as possible. See prior discussion regarding state tax exemption under The Bond Counsel Opinion section above.

F. Refunding/Defeasance of Bonds.

1. Rights of redemption, as provided for in the bond ordinance, resolution or indenture, are customarily disclosed to investors. Limitations under state or local law that may impact the availability of such rights should also be disclosed. For instance, state law, local law, or policies may only permit a refunding in the event that it results in savings, possibly at certain minimum levels.
2. State law may also limit eligible investments for an escrow fund, or alternatively, allow certain investments that are not unconditionally guaranteed by the United States.
3. Typically, bonds may be defeased prior to their redemption, either via current refunding (*i.e.*, issuance of refunding obligations within 90 days of the date the refunded bonds may be paid-off and retired) or other devices. In many states, a bondholder no longer has an interest in the original security following a defeasance, and the security becomes the investments

deposited in escrow to pay the debt service coming due on the bonds. The promises and covenants of the bond documents are released too. This is important to disclose to potential bondholders.

G. Post-Issuance State Law Consideration.

1. Post-issuance considerations and federal law requirements (e.g., Rule 15c2-12) are covered in depth in tax and securities law panels.
2. Many states have filing requirements and record retention requirements.
3. Change in use may impact federal tax law and state law.