The Workshop 2023
Session Outlines

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2023

THE WORKSHOP

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THE WORKSHOP 2023
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NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

ARBITRAGE AND REBATE

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Panelists:

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David Sutton — Raymond James – Saint Petersburg, FL
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This outline describes the arbitrage and rebate compliance rules set forth in Section 148 of the Internal Revenue Code of 1986, as amended, and related Treasury Regulations. The outline covers introductory matters such as the historical background of the rules, the process for determining whether funds are subject to the rules, basic yield restriction requirements and the procedure for determining the amount to be paid to the federal government. The outline also addresses more advanced topics, such as evaluating whether a transaction gives rise to replacement proceeds, determining how the yield restriction rules are applied, valuing investments, allocating proceeds to expenditures, anti-abuse provisions and the miscellaneous exceptions to the rebate requirement.

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ARBITRAGE-OVERVIEW[1]

This outline provides a broad overview of the arbitrage and arbitrage rebate principles of Section 148 of the Internal Revenue Code of 1986, as amended (the "Code").[2] Unless otherwise identified, Section references in this outline are to the Code or the applicable Treasury Regulations.

PART I —ARBITRAGE

I. ARBITRAGE—INTRODUCTION

The arbitrage restrictions of the Code, together with other Code restrictions, govern the investment and expenditure of "proceeds" of a tax-exempt bond issue.[3] Generally, the arbitrage restrictions limit the amount of interest or other return that can be made (or retained) from the investment of proceeds of tax-exempt bonds.

Interest on a bond is not tax-exempt if it is an "arbitrage bond" under § 103(b)(2). An "arbitrage bond" is defined under § 148(a) as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly: (1) to acquire higher yielding investments; or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) also provides that a bond will be treated as an arbitrage bond if an issuer intentionally uses any portion of the proceeds of an issue in a manner described in (1) or (2) of the preceding sentence.

II. THE LAW

A. The Code

Originally addressed solely in one subsection of Section 103 of the Internal Revenue Code of 1954, as amended (the "1954 Code"), the statutory provisions relating to arbitrage (and related matters) are now contained in Sections 148, 149(d) (relating to advance refundings, as in effect prior to the Tax Cuts and Jobs Act), 149(g) (relating to hedge bonds) and 150 (relating to reimbursement expenditures).

[1] This outline has been developed as a project of the faculties of the 1991 through 2023 NABL The Workshop conference, Bond Attorneys' Workshops and Tax and Arbitrage Seminars. Grateful acknowledgement is made for the contributions of prior workshop chairs and panelists.

[2] Part I discusses arbitrage principles; Part II discusses the rebate provisions of § 148(f) and Section 1.148-3. For ease of reference and understanding in context, certain concepts are discussed in both Parts I and II. Matters discussed in this outline relating to tax-exempt bonds generally also apply to qualified tax credit bonds and bonds providing for direct subsidy payments, as described in §§ 54A and 6431, each as in effect prior to Pub. L. No. 115-97, enacted December 22, 2017, sometimes referred to as the "Tax Cuts and Jobs Act." This outline presents an evolution of the provisions of the Internal Revenue Code and the Treasury Regulations governing arbitrage and rebate, including the exceptions to rebate. Prior versions of this outline provide greater detail with regard to earlier versions of the current Treasury Regulations.

[3] The arbitrage restrictions also apply to certain tax credit and direct pay tax advantaged bonds.

B. Regulations

Prior to 1989, the Treasury Regulations relating to the arbitrage provisions of Section 103(c) of the 1954 Code were contained in Sections 1.103-13, 1.103-14, and 1.103-15 (the "1979 Regulations"). Section 1.103-13 addressed the certification of reasonable expectations, the definition of "proceeds," the definition of "materially higher," the computation of yield, and "artifice and device." Section 1.103-14 addressed primarily temporary periods, working capital deficit financings, and refundings. Section 1.103-15 addressed certain issues in connection with advance refundings. In addition, Section 1.103-15AT addressed arbitrage matters related to the rebate provision that was enacted in 1985.

Commencing in 1989, the Internal Revenue Service (the "IRS") began issuing regulations under § 148. On June 18, 1993, the IRS published final arbitrage regulations (the "Regulations"). Included in the Regulations were provisions relating to compliance with the bond maturity limits, arbitrage rules, federal guarantees, limits on advance refundings, hedge bonds, a number of definitions, and reimbursement. The Regulations generally apply to all issues issued after June 30, 1993.[4] In 2016, the IRS published two sets of final arbitrage regulations (the "2016 Final Regulations"), including (a) regulations published July 18[5] related to working capital, yield, rebate and qualified hedges applicable to bonds issued, or qualified hedges entered into or modified, after October 16, 2016, and (b) regulations published December 9[6] concerning the definition of issue price applicable to bonds sold on or after June 7, 2017.

C. Other Guidance

The balance of the arbitrage restrictions is gleaned from case law, proposed regulations, revenue procedures, revenue rulings, notices, and private letter rulings, which are cited in the text where relevant.

D. General Yield Restriction Rules and Certification Requirements

The determination of whether a bond is an arbitrage bond is based in part on the reasonable expectations of the issuer at the time of issuance of the bond, as well as any intentional acts after issuance. Section 1.148-2(b)(2) requires, with some limited exceptions, an officer of the issuer responsible for issuing the bonds to certify in good faith as to the issuer's expectations, including the facts and estimates that form the basis of such expectations. Notwithstanding good expectations at the time of issuance, intentional acts after issuance can result in the bonds being treated as arbitrage bonds. *See* Section 1.148-2(c); Rev. Rul. 80-91; Rev. Rul. 80-92. This rule is also codified in the second sentence of § 148(a), as follows: "[A] bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in paragraph (1) or (2)" (*i.e.*, to acquire higher yielding investments or to replace funds that are directly or indirectly so used). In addition to "intentional actions" causing a bond to become an arbitrage bond, notwithstanding reasonable expectations to

[4] The chronology of the arbitrage regulations is discussed in greater length in versions of this outline from prior Workshops.

[5] 81 Fed. Reg. 46582 (July 18, 2016).

[6] 81 Fed. Reg. 88999 (December 9, 2016).

the contrary, a certification that is given in bad faith will not protect a bond from being an arbitrage bond. *See* Rev. Rul. 85-182.

III. PROCEEDS

A. Definitions

The first step in arbitrage compliance is generally to identify the "proceeds" of a tax-exempt bond issue, because it is the "proceeds" that may not be invested in higher yielding investments unless otherwise excused by a "temporary period" or special exception. Over time, the IRS has expanded the statutory concept of "proceeds" to include certain funds that, while not necessarily reflecting the generally understood meaning of the term proceeds, are treated as proceeds for arbitrage purposes. For example, Section 1.103-13(g) of the 1979 Regulations provided that amounts in a sinking fund were treated as proceeds of the bond issue, and Rev. Rul. 78-348 concluded that certain pledges of securities were also treated as proceeds of the bond issue. Under the Regulations, "gross proceeds" are defined as "proceeds and replacement proceeds of an issue" and "proceeds" are further defined as "sale proceeds, investment proceeds and transferred proceeds of an issue." Replacement proceeds include amounts reasonably expected to be used to pay debt service on a tax-exempt issue, amounts pledged to provide security on a tax-exempt bond issue and other amounts that have a sufficiently direct nexus to the bond issue.

A second step is to identify the "substantial beneficiaries" of a bond issue. As described below, only gross proceeds held by, derived from or for the benefit of a substantial beneficiary are subject to the arbitrage restrictions. A substantial beneficiary includes, but is not necessarily limited to, the actual issuer of the tax-exempt bonds as well as an entity that borrows the proceeds of a tax-exempt bond issue to carry out the purpose of that issue.

A third step is to identify investment property. The arbitrage restrictions apply to investment property of a substantial beneficiary that constitutes gross proceeds of a tax-exempt bond issue. As described below, investment property includes debt obligations, securities, annuity contracts, and "investment type property." Investment type property is property principally held for the passive production of income. Investment property excludes certain tax-exempt bonds and demand deposit SLGS.

1. *Sale Proceeds and Investment Proceeds.*

Sale proceeds are amounts received, actually or constructively, from the sale of the bonds, including amounts used to pay underwriter's discount and accrued interest (other than pre-issuance accrued interest[7]). Sale proceeds also include amounts derived from the sale of a right that is associated with a bond (*e.g.*, a call right). Investment proceeds are any amounts actually or constructively received from the investment of proceeds.[8]

[7] Section 1.148-1(b). Pre-issuance accrued interest is interest (i) that accrues for a period of not more than one year and (ii) is paid within one year after the issue date.

[8] Section 1.148-1(b).

2. ***Transferred Proceeds.***

Transferred proceeds arise in connection with refundings, and are unspent proceeds of a refunded issue at the time the principal of that refunded issue is paid from the proceeds of the refunding issue. These unspent proceeds of the refunded issue are "transferred" (usually pro rata) to the refunding bonds and subjected to a number of complicated rules in Section 1.148-9(b). No proceeds transfer until an actual payment or "discharge" of principal of the prior issue using proceeds of the refunding issue. There is no transfer of proceeds merely upon the establishment of an escrow fund when money is set aside for the future redemption of or payment of principal on the refunded bonds, and no transfer occurs when proceeds of the refunding issue is used to pay only interest on the refunded issue. Further, if there are amounts held in funds or accounts for the refunded issue that are not "proceeds"[9] of that refunded issue, such as equity contributed by the issuer to a reserve fund or debt service fund, those non-proceeds amounts do not become transferred proceeds of the refunding issue.

If only a portion of the outstanding principal of a refunded issue is refunded, only a portion of the unspent proceeds will transfer over to the refunding issue, based on the proportion of outstanding principal being refunded. Under 1.148-9(b)(1), there is a transfer on each date that principal of the refunded issue is discharged with proceeds of the refunding issue. Section 1.148-9(b)(1) goes on to provide that "[t]he amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction: (1) the numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge; and (2) the denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge."[10]

Section 1.148-9(b) defines the principal of a bond as, with respect to a "plain par bond,"[11] its stated principal amount, and, with respect to all other bonds, its present value. Section 1.148-9(b) also contains numerous technical rules relating to the selection of the investments that transfer.[12]

3. ***Replacement Proceeds.***

a. *General.*

"Proceeds" of an issue include only sale proceeds, investment proceeds, and transferred proceeds. The arbitrage and rebate requirements, however, apply to "gross proceeds" of an issue, which include not only proceeds but also any "replacement proceeds." Amounts are classified as "replacement proceeds" if the amounts have a "sufficiently direct nexus" to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that

[9] Proceeds of an issue include only sale proceeds, investment proceeds and transferred proceeds, <u>not</u> replacement proceeds. For certain private use purposes, disposition proceeds (i.e., any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition of property (other than investments) financed with the proceeds of an issue) are treated as proceeds (see Section 1.141-12(e)).

[10] Section 1.148-9(b)(1).

[11] Section 1.148-9(b)(2).

[12] In addition, transferred proceeds may be limited under the universal cap rules of Section 1.148-6(b)(2).

governmental purpose if the proceeds of the issue were not used for that governmental purpose. For these purposes, a governmental purpose includes the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for such purpose does not, however, in itself establish a sufficient nexus to create replacement proceeds.

Under Section 1.148-1(c), "replacement proceeds" include amounts in a sinking fund, a pledged fund, and "other replacement proceeds" to the extent that the funds are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary typically includes the issuer, any related party to the issuer or the state in which the issuer is located, and any conduit borrower of proceeds. A substantial beneficiary does not include any entity solely because the entity is a guarantor of the issue. Thus, collateral provided by a letter of credit bank (but not a borrower) to secure the bank's obligations under a letter of credit is generally not treated as replacement proceeds. In addition, if an organization solicits donations to fund construction of a particular facility, but then uses tax-exempt bond proceeds to pay for that facility, the funds raised may constitute replacement proceeds under the "nexus" theory, especially if such funds can only be used for that facility. *See* Section 1.148-1(c)(1).

b. *Sinking Funds.*

Under Section 1.148-1(c)(2), a sinking fund "includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue."[13]

It is possible to have an indirect sinking fund, such as where a bond issue is structured with a bullet maturity (*i.e.*, a term bond with no requirement that portions of the bond be retired in installments before the final maturity date) and in the years leading up to the maturity, the issuer accumulates amounts to pay the future operation and maintenance expenses in the year in which the bullet maturity comes due, thereby freeing all revenues earned in the final year for payment of debt service on the bonds. The amounts saved to pay operation and maintenance expenses are an "indirect" sinking fund and therefore "replacement proceeds" even though they will be used to pay operation and maintenance expense rather than debt service.[14] Similarly, where a fund was created simultaneously with the issuance of bonds (from a source other than sale proceeds), the interest on which was expected to be used "indirectly" to pay debt service (interest income on the fund was deposited into the issuer's general fund, and amounts in the general fund were used, among other things, for payment of debt service on the bonds), the IRS held that the fund was an indirect sinking fund for the bonds and amounts in the fund were "replacement proceeds."[15]

It is often difficult to tell whether a particular fund is a "sinking fund." The portion of an income fund or revenue fund into which all revenues of an enterprise of a city are deposited and out of which all expenses of the enterprise are paid (including transfers to a bond fund to pay debt

[13] *E.g., see* Section 1.103-13(g) of the 1979 Regulations and *City of Tucson v. Commissioner*, 820 F.2d. 1283 (D.C. Cir., 1987). For more discussion of the history of the "sinking fund" concept, see versions of this outline from prior Workshops.

[14] Rev. Rul. 78-302.

[15] Rev. Rul. 82-101.

service), and that is reasonably expected to pay debt service, is a "sinking fund." *See* Rev. Rul. 78-349. If an issuer maintains an investment fund funded with its tax revenues and also has outstanding general obligation bonds, the investment fund is generally not treated as a sinking fund unless the issuer reasonably expects to use such moneys to pay debt service on the bonds. *See* Rev. Rul. 78-302. If the size of the debt service payments due on the bonds are such that the issuer would be unable to make those payments if investment income from the investment fund was not available, the investment income generally would be considered part of a sinking fund.

Pursuant to § 54A(d)(4)(C), as it existed prior to the Tax Cuts and Jobs Act, a sinking fund established for qualified tax credit bonds is effectively disregarded for arbitrage rebate and yield restriction purposes if the fund satisfies certain requirements. This provision allows qualified tax credit bonds to remain outstanding to maturity to increase the availability of tax credits while providing for the security of a repayment fund.

c. *Pledged Funds.*

A "pledged fund" is any amount that is directly or indirectly pledged to pay principal or interest on the issue in such a manner that provides reasonable assurance that the amount will be available for that purpose if the issuer encounters financial difficulties, even if it is not reasonably expected that such amounts will be used to pay debt service on the bonds.[16] Under Section 1.148-1(c)(3)(i), a pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the bonds (*e.g.*, amounts pledged to a bank pursuant to a letter of credit reimbursement agreement relating to a letter of credit that secures payment of the bonds). A pledged fund can arise even where it is not the issuer who pledges the fund to the payment of bonds. For example, if a state pledges one of its funds to a local government's debt, this fund will be a pledged fund. *See* Rev. Rul. 78-348. This result is in part dependent on the IRS's perception that the state is an indirect beneficiary of a borrowing by one of its local governments. However, a pledge made by a party other than a substantial beneficiary of the financing does not give rise to "replacement proceeds."

In many instances it may be difficult to ascertain whether a fund constitutes a pledged fund. For example, a letter of credit bank may hold funds of a conduit borrower to be used for operation and maintenance, capital replacement and debt service. If, pursuant to the terms of the bank documents, the bank has complete discretion over withdrawals, the fund might be considered a pledged fund. Section 1.148-1(c)(3)(ii) provides an exception such that an amount held under an agreement to maintain the amount at a particular level of funds for the direct or indirect benefit of bondholders will not be treated as a pledged fund if (1) the issuer may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or (2)(a) the amount does not exceed reasonable needs for which it is maintained, (b) the level is tested no more frequently than every six months and (c) the amount may be spent without substantial restriction other than replenishment by the next testing date. An arrangement like this is often referred to as a "negative pledge."[17]

[16] Section 1.148-1(c)(3).

[17] *See* PLR 8334103, revoked by PLR 8841027.

Three private letter rulings provide insight into the IRS's analysis of replacement proceeds. In PLR 9243051, the IRS held under the arbitrage regulations effective on May 18, 1992 (and prior to amendment by TD 8476, 06/14/93) (the "1992 Regulations") that accumulated fees charged underground storage tank owners in connection with a state's arrangement of the clean-up costs for underground storage tanks would be replacement proceeds of long-term bonds issued to pay the costs of claims for property damaged by leaking storage tanks. In PLR 9509035, the IRS found that long-term bonds issued in connection with the refinancing of a city's pension arrangements with a state would produce replacement proceeds in the state's funds and accounts under the Regulations. Although the Tax Court held for the IRS in a declaratory judgment pursuant to § 7478, the D.C. Circuit Court of Appeals vacated and remanded that decision. In PLR 9534014, the IRS revisited underground storage tank bond financing structures and found under the Regulations that replacement proceeds would not arise if no significant balances of fees charged were accumulated during the life of long-term bonds issued to pay the costs of claims for property damaged by leaking storage tanks. *See also* PLR 9243051 and PLR 9233041 with regard to the 1992 Regulations.

In January of 2009, the Montana Facility Finance Authority issued a material-event notice stating that a series of bonds issued in 2002 for the Mission Ridge retirement community was under IRS audit, and that the IRS had issued a "Notice of Proposed Issue" in October 2008, concluding that the bonds were arbitrage bonds. The agent had determined that certain funds and accounts held by the borrower, including entrance fees contributed by residents, constituted replacement proceeds that should have been yield restricted, but were not. Almost three years later, in May of 2011, the IRS released a Technical Advice Memorandum[18] which concluded that the entrance fees were not, in fact, replacement proceeds of the bonds. Although there appeared to be a nexus between (1) the entrance fees and other facility revenues and (2) the bonds, the bond owners had no reasonable assurance that those entrance fees would be available to pay principal or interest on the bonds if Mission Ridge encountered financial difficulties.

d. *Other Replacement Proceeds.*

"Other replacement proceeds" or "ORPs" arise to the extent that an issue is outstanding longer than necessary, and the issuer expects there to be "available amounts," defined as described in Part I, Section V.C., below. The Regulations provide a safe harbor which clarifies that an issue does not give rise to ORPs if (1) it is a working capital issue that is outstanding no longer than 13 months, (2) the bonds (including a refunding bond) meet the bond maturity limit in § 147(b) relating to the economic life of assets financed, (3) in the context of a refunding, the weighted average maturity of the refunding bonds is not longer than the weighted average maturity of the refunded bonds (and the refunded issue satisfied one of the above two tests)[19] or (4) it is a working capital issue that meets the safe harbor for longer-term working capital financings which generally requires the issuer to determine the actual available amounts as of the first day of each fiscal year beginning with the year it expects to have such available amounts (with an outside limit that the first testing year must not be later than five years after the issue date) and apply such available amounts within 90 days of the beginning of the fiscal year to redeem bonds of the issue (or another

[18] TAM 201118012 (Jan. 19, 2011).

[19] *See* the anti-abuse rules under Section 1.148-10. See also PLRs 9424043 and 200306004, Notice 2001-49, and, more importantly, Rev. Proc. 2002-31.

issue) or to invest in eligible tax-exempt bonds. Prior to the 2016 Final Regulations, ORPs also would arise if a working capital reserve was directly or indirectly financed with the issue unless all the net proceeds of the issue were spent within six months or the bonds were exempt from rebate under § 148(f)(4)(D) (the small issuer exception), but the 2016 Final Regulations eliminated that restriction.

e. *Disposition Proceeds.*

In some situations, proceeds are created as a result of an event that was not reasonably expected at the time the bonds were issued. Under Section 1.141-12 and Rev. Proc. 2018-26, one requirement for taking remedial action in the event of a change in use of bond financed property (*e.g.,* a change that causes the private business or private loan tests to be met) is for the issuer to treat any "disposition proceeds" as "gross proceeds" for purposes of § 148.[20] These "disposition proceeds" are any amounts derived from the sale, exchange, or other disposition of property financed with proceeds of the issue. Remedial actions under Section 1.141-12 and Rev. Proc. 2018-26 may require disposition proceeds to be used to redeem or defease debt or to finance a new qualifying project. In the latter situation, the issuer may treat the date of receipt of the disposition proceeds as the issue date of the bonds for purposes of temporary periods (*see* Part I, Section IV.B.8.) and rebate exceptions (*see* Part II, Section VIII.). Further, the receipt of disposition proceeds will not disqualify the use of an expenditure exception (*see* Part II, Section VIII.) for rebate. *See* Section 1.141-12 and Rev. Proc. 2018-26.

f. *Exceptions from the Definition of Replacement Proceeds.*

The corpus and investments of certain perpetual trust funds of states and the investments of certain permanent university funds have been exempted from the definition of replacement proceeds. The fund must be described in Section 648 of the Deficit Reduction Act of 1984, Pub. L. 98-369. In PLR 20048022, the IRS recognized another class of state permanent funds as being exempt from the definition of replacement proceeds. However, under IRS Notice 2022-39, the IRS indicated that forthcoming proposed regulations are expected to be issued which will amend Section 1.148-11(d)(1)(i)(F) regarding whether certain perpetual trust funds created and controlled by states will be treated as replacement proceeds for purposes of the arbitrage investment restrictions on tax-exempt bonds under § 148.

B. Reserve Funds

Amounts held in a "reasonably required reserve or replacement fund" (or "4R Fund"), whether funded from proceeds or from other funds, qualify for certain exceptions from investment limits. Under § 148(d)(2) and Section 1.148-2(f)(1), no more than 10% of the stated principal

[20] Although the Regulations describe the amounts as being gross proceeds for purposes of § 148, for certain types of remedial actions, such as alternative use of disposition proceeds, the disposition proceeds are treated as "proceeds" for purposes of § 141 and the Regulations further describe modifications to temporary periods and effect of receipt of disposition proceeds on arbitrage compliance and rebate exceptions, therefore, for such purposes, the disposition proceeds are treated as "proceeds."

amount of a bond issue[21] of proceeds[22] may be deposited into a reserve or replacement fund, whether or not such fund is reasonably required without the bonds being "arbitrage bonds." Note that if that 10% limit is exceeded, the bonds will be arbitrage bonds even if the money in the reserve fund is invested at yields below the bond yield.[23] Amounts other than proceeds may be placed in a 4R Fund without regard to the 10% limit, but the investment of those amounts may be subject to yield restriction as discussed in the next paragraph.[24]

Regardless of how a 4R Fund is funded, § 148(d)(2) and Section 1.148-2(f)(2) imposes a limit on the amount that can be invested without regard to yield. This limit is equal to the least of: (1) the maximum annual principal and interest requirements on the issue; (2) 10% of the stated principal amount (or, for bonds with more than a *de minimis* amount of premium or discount, the issue price) of the issue; and (3) 125% of the average annual principal and interest requirements on the issue.[25] Amounts in excess of this limit may not be invested above the bond yield.[26]

IV. INVESTMENT OF PROCEEDS

A. General

The arbitrage rules are intended to prevent the perceived abuse whereby issuers and conduit borrowers of tax-exempt bonds, typically political subdivisions or 501(c)(3) organizations and hence not subject to income tax, borrow at tax-exempt rates, invest the bond proceeds at higher taxable rates, and use the arbitrage profit for discretionary purposes.

As previously described, the first step in the arbitrage analysis is to identify gross proceeds subject to arbitrage limits. The second step is to identify investments allocated to gross proceeds. Investments can include both "purpose investments" (*i.e.*, those acquired to further the governmental purposes of the issue, such as a conduit loan for a multifamily transaction) and "nonpurpose investments" (*i.e.,* investments that are not purpose investments, such as investments held in a project fund or debt service reserve fund). *See* definitions in Section 1.148-1(b).

Investments subject to arbitrage restrictions are referred to in § 148(b) as "investment property" and include any security, any obligation, any annuity contract, any investment-type property or, in the case of a bond other than a private activity bond, certain residential rental

[21] 10% of issue price minus pre-issuance accrued interest if the bonds have more than a *de minimis* amount of original issue discount or premium.

[22] While the Code section refers to "proceeds," the Regulations more specifically apply the restriction to sale proceeds.

[23] The IRS has taken an expansive view of the meaning of a reserve fund. For example, a project fund could be determined to be a reserve fund if the issuer did not have adequate expectations of rapid expenditure.

[24] Such other amounts may be subject to yield restrictions and eligible for "yield reduction payments" under Section 1.148-5(c).

[25] Under Rev. Proc. 84-26, the IRS suggests that a 4R Fund is also not ordinarily reasonably required if it secures general obligation bonds unless there are rare or unusual circumstances which would require such a fund.

[26] Such amounts, however, may be eligible for "yield reduction payments" under Section 1.148-5(c), discussed below in Part I, Section IV.B.7. Such amounts may also be eligible for the Minor Portion exception discussed in Section IV.G below.

property for family units not located within the jurisdiction of the issuer.[27] Investment-type property is defined in Section 1.148-1(e) as property that is held principally as a passive vehicle for the production of income, including production of income based on the time value of money. For instance, investment-type property can include a prepayment for property or services if a principal purpose of the prepayment is to receive an investment return. Section 1.148-1(e)(2) provides that certain qualifying prepayments will not be treated as investment-type property, including (1) customary prepayments (including prepayments for common types of equipment or software maintenance or extended warranty contracts), (2) prepayments within 90 days of date of delivery of property or services, and (3) certain narrowly defined prepayment contracts for natural gas and electricity.[28] Final regulations published April 9, 2019[29] added Section 1.148-1(e)(4), which provides that investment-type property does not include real property or tangible personal property (for example, land, buildings, and equipment) that is used in furtherance of the public purposes for which the tax-exempt bonds are issued. For example, investment-type property does not include a courthouse financed with governmental bonds or an eligible exempt facility under § 142, such as a public road, financed with private activity bonds.[30] Investments also include the investment elements of a hedge, if a payment by the issuer corresponds to a conditional or unconditional obligation by the hedge provider to make a payment on a later date (*e.g.*, a one-time upfront payment to purchase an interest rate cap).[31] Investment property excludes non-AMT tax-exempt bonds (and AMT Tax-exempt bonds for proceeds of AMT Tax-exempt bonds).[32] Investment property also excludes One Day Demand Deposit Series Certificates of Indebtedness of the State and Local Government Series ("Demand Deposit SLGS")[33] and an interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103(a), subject to the same limit on AMT/non-AMT as described in the preceding sentence, as they are also defined as tax-exempt bonds for purposes of Section 148.[34]

B. Yield Restriction

1. *General Rules.*

Yield restriction and rebate are different concepts under the arbitrage restrictions, although both may require repayment of investment earnings to the IRS. In general, unless eligible for a temporary period or other exception, gross proceeds cannot be invested at a yield "materially higher" than the yield on the bonds. However, (1) there are several temporary periods that may allow "gross proceeds" to be invested at higher yields, and (2) in some situations where a temporary period is not available, the issuer may be able to make "yield reduction payments" to

[27] This last category is really not an arbitrage provision in the traditional sense. It is simply a prohibition on the use of tax-exempt bonds to fund public housing outside the jurisdiction of the issuer.

[28] Section 1.148-1(e); see also Section 148(b)(4) (providing a separate safe harbor for certain prepayments for natural gas).

[29] 84 Fed. Reg. 14006 (April 9, 2019).

[30] Section 1.148-1(e)(4).

[31] *Id*. Section 1.148-4(h)(2)(ii).

[32] Sections 148(b)(3)(A) and 148(b)(3)(B).

[33] This exception does not apply to Time Deposit Series SLGS (with maturities from 15 days to 40 years).

[34] Section 1.150-1.

the IRS to reduce the yield on the investments (as described further below). The rebate rules apply in those situations where a temporary period allowed the issuer to invest at a higher yield and govern whether the issuer must repay those excess earnings to the IRS.

"Yield" is discussed below. To permit appropriate comparison, the same methods and compounding intervals must be used in calculating the yield on the investments and the bonds.[35]

2. ***Bond Yield.***

The yield on an issue is calculated under Section 1.148-4 both for the purpose of determining whether a bond is an "arbitrage bond" under § 148(a) and for computing rebate liability under § 148(f). The yield on a fixed yield bond issue is generally computed once, on the issue date, but it must be recomputed upon the transfer by the issuer of certain rights associated with the bonds (*e.g*., a call right) and upon termination of a qualified hedge. Yield on variable yield bond issues is calculated separately for each computation period (*e.g.*, every year or every five years), based on the actual (not expected) bond payments and payments for qualified guarantees and hedge payments. A variable yield issue is any issue that contains at least one variable yield bond.[36] The computation of bond yield, including the treatment of credit enhancement and interest rate swaps, is discussed in detail in Part II, Section VII below.

3. ***Issue of Bonds.***

Yield is calculated separately on each "issue" of bonds. Section 1.150-1(c) defines an "issue" for purposes of §§ 103 and 141 through 150, such that two or more bonds are part of the same "issue" if they are sold at substantially the same time (less than 15 days apart), sold pursuant to the same plan of financing, and are reasonably expected to be paid out of substantially the same source of funds.[37] Each type of tax-advantaged bond that has a different structure for delivery of a tax benefit that reduces the issuer's borrowing costs or different program eligibility requirements is treated as part of a different issue.[38] For example, tax-exempt bonds and tax credit bonds would be treated as separate issues, as they have different structures for delivery of a tax benefit. Taxable and tax-exempt bonds (or other tax advantaged bonds) are not part of the same issue but may constitute an abusive arbitrage device (*see* Part I, Section VI) or a device to avoid other limits in §§ 141 through 150.[39] Section 1.150-1(c)(4) addresses the single issue analysis for commercial paper and draw-down loans.[40] In addition, although separate bonds or series of bonds may be treated as a single issue, there are provisions that allow a single issue to be treated as separate issues for certain purposes—for example Section 1.150-1(c)(3) includes a special rule permitting an issue financing separate governmental purposes to be treated as separate issues for certain purposes (*e.g.*, facility qualification, Code Section 147 purposes), and Sections 1.141-13(d) and

[35] Section 1.148-4(a) and Section 1.148-5(b).

[36] Exceptions apply.

[37] Section 1.150-1(c).

[38] *Id.*

[39] *Id.*

[40] *See also* Section 1.150-1(c)(4)(iii) (special rule regarding general obligation bonds).

1.148-9(h) permit elections to allocate portions of an issue to separate purposes—but that separate issue treatment generally does not apply for purposes of determining yield on the entire issue.[41]

4. ***Materially Higher.***

"Materially higher" is not defined in § 148, but under Section 1.148-2(d)(2). Materially higher is generally 1/8 of 1 percentage point (0.125%). Special "materially higher" definitions apply for refunding escrows and replacement proceeds (1/1000 of 1%, or 0.001%), program investments (1.500%),[42] qualified mortgage bonds (1.125%) and student loan bonds (2.000%).[43] If some non-purpose yield restricted investments are subject to the 0.001% limit, then all yield restricted non-purpose investments are subject to that restriction.

5. ***Yield on Investments.***

Generally, the yield on investments is computed on the same basis as yield on bonds and is determined separately for each separate class of investments. Yields on investments in separate classes may not be blended for arbitrage purposes, although they may for rebate purposes. Separate classes of investments include each category of yield restricted purpose investments and program investments subject to a different yield limit, yield restricted nonpurpose investments, and all other nonpurpose investments. Section 1.148-5(b)(2). An issuer may waive temporary periods and other exceptions to yield restriction under Section 1.148-3(h). Note that yield reduction payments may be available (see below) to reduce yield. All investments in a refunding escrow must be treated as one investment.[44]

6. ***Yield Over the Term of Issue.***

It is the yield on investments "over the term of the issue" that is relevant under § 148(b)(1). Under this rule, it is permissible to have proceeds invested in higher yielding investments for a period of time so long as later (or earlier) investments in lower yielding investments offset the higher yielding investments and result in an overall investment yield over the term of the issue that is not materially higher than the bond yield.[45] An issuer that intends to blend after a rebate computation date (other than with respect to proceeds in a refunding escrow and a sinking fund expected on the issue date to reduce the escrow yield) may be required to actually make a rebate payment despite the intended future blending. The Regulations effectively allow yield blending to be broken up into 5-year computation periods for variable rate bonds. If investments within the same class have different "materially higher" standards, the lowest prevails.

[41] *See* Section 1.150-1(c)(3)(ii); Section 1.148-9(h)(1)(i). There is an exception that applies when different portions of a multi-purpose issue are related to different tax-exempt purpose investments.

[42] Program investments (defined under Section 1.148-1(b)) are investments acquired to carry out the governmental purposes of the issue pursuant to a loan program for the public, governmental units, 501(c)(3) organizations, or housing facilities.

[43] The materially higher spread is 1.125% for qualified mortgage loans under § 143(g) and 2.0% for student loans pursuant to Section 1.148-2(d)(2).

[44] This provision has little effect with respect to yield restriction but is extremely important with respect to rebate.

[45] *See* Section 1.148-2(d)(1).

7. ***Yield Reduction Payments.***

Although an issuer may not be allowed to invest gross proceeds above the bond yield, in certain cases, Section 1.148-5(c) allows an issuer to make a "yield reduction payment" to the United States to reduce the yield on yield-restricted investments to the appropriate rate. Not all "gross proceeds" are eligible for yield reduction payments. The major categories of investments or issues that are eligible for such yield reduction payments are (1) investments entitled to an initial temporary period (such as most new money construction funds), (2) investments allocable to most variable yield issues, (3) investments in a 4R Fund not meeting the size limit in Section 1.148-2(f)(2)(ii), but only to the extent that the amounts are less than or equal to 15% of the principal of the issue or are not (except for investment earnings) expected to pay debt service on the issue, and (4) certain transferred and replacement proceeds in the context of a refunding. The major categories of investments generally not eligible to use yield reduction payments are replacement proceeds and proceeds of an advance refunding issue (although the ability to issue tax-exempt advance refundings of other tax-exempt bonds was repealed effective Janurary 1, 2018). The yield reduction payment rules are particularly useful in three areas that historically have required yield restriction: (1) unexpended proceeds in a construction fund after the temporary period expires (*see* Part I, Section IV.B.8.a. below); (2) variable yield issues with yield restricted pledged funds; and (3) "transferred proceeds" held in a prior escrow as a result of a current refunding. *See also* Part II.

8. ***Temporary Periods.***

a. *New Money Issues.*

Generally, sale and investment proceeds of a new money issue will qualify for a three-year "temporary period" (*i.e.*, a three-year period during which the proceeds may be invested at a yield materially higher than the bond yield) if the issuer reasonably expects to satisfy (1) the expenditure test, (2) the time test, and (3) the due diligence test.[46] Under the expenditure test, the issuer must expect to spend at least 85% of the net sale proceeds (*i.e.*, sale proceeds minus any amounts deposited into a 4R Fund and any amount invested as part of a minor portion) by the end of the three-year temporary period. Under the time test, the issuer must expect to incur, within six months of the issue date, a substantial binding obligation to a third party to expend at least 5% of the net sale proceeds on capital projects. Under the due diligence test, the issuer must expect the completion of the capital projects and the allocation of the net sale proceeds to expenditures to proceed with due diligence. This three-year temporary period is not available for working capital financings. A five-year temporary period is allowed for construction issues if a certification of a licensed architect or engineer is obtained prior to issuance stating that a period of longer than three years is necessary.[47]

[46] Section 1.148-2(e)(2)(ii).

[47] *Id.*

b. *Refunding Issues.*

(i) General.

Section 1.150-1(d) defines "refunding issue" as an issue the proceeds of which are used to pay principal, interest, or redemption price on another issue, including issuance costs, accrued interest, a 4R Fund, or similar costs properly allocable to the refunding issue. An issue is not a refunding issue if the obligor[48] of the would-be refunding issue is not the obligor of the other issue (or a party related to the obligor of the other issue). Thus, if County X financed a water and sewage facility with tax-exempt bonds in 1994 and in 1998 sells it to unrelated County Y, which finances such purchase with a tax-exempt bond issue, that transaction will be treated as an acquisition of the facility and not as a refunding, even though County X used the proceeds from the sale to discharge its tax-exempt bond issue.

(ii) Current vs. Advance Refundings; Temporary Periods.

A current refunding issue is an issue that is issued not more than 90 days before the last payment of principal or interest on the prior issue paid with proceeds of the refunding issue. All other refunding issues are advance refunding issues.[49] Generally, the temporary period for an advance refunding issue is 30 days, and the temporary period for a current refunding is 90 days.[50] The temporary period for transferred proceeds of a current refunding is the temporary period for those proceeds if such proceeds had remained proceeds of the prior issue; however, the temporary period for transferred proceeds of an advance refunding terminates on the issue date of the advance refunding issue.[51] The Tax Cuts and Jobs Act repealed the ability to issue tax-exempt bonds after 2017 to advance refund other tax-exempt bonds, but the temporary period rules still apply to advance refunding bonds issued prior to the effective date of such repeal.

c. *Other Financings.*

The temporary period for a working capital financing, whether a restricted working capital financing or an extraordinary working capital financing, is 13 months.[52] Section 148(c)(2) limits the temporary period for pool bond proceeds (other than single family mortgage bonds) to six months (or two years for "construction issues," *see* Part II, below) in the hands of the issuer prior to being loaned to borrowers; the balance of the otherwise available temporary period for proceeds by the borrower is reduced by the amount of time the proceeds were held by the issuer.[53]

[48] In general, the actual issuer of a bond issue is treated as the obligor of such issue. However, with respect to refundings of a "conduit financing," the "conduit borrower" is treated as the issuer.

[49] Section 1.150-1(d)(3); see also Section 149(d)(5) (as in effect prior to the Tax Cuts and Jobs Act) ("a bond shall be treated as issued to advance refund another bond if it is issued more than 90 days before the redemption of the refunded bond.")

[50] Sections 1.148-9(d)(ii).

[51] Sections 1.148-9(d)(iii).

[52] Section 1.148-2(e)(3).

[53] Section 1.148-2(e)(4).

C. Rebate

Rebate, introduced first in the Mortgage Subsidy Bond Tax Act of 1980[54] for single family mortgage bonds and extended to virtually all tax-exempt bonds by the 1986 Act, has a similar economic effect for issuers as does yield restriction: investment return over the yield on the issue, if earned, is paid over, or rebated, to the U.S. Treasury. Failure to rebate arbitrage profits may result in taxability of the bonds (or loss of related tax credits or subsidies).[55] Further, compliance with the rebate requirement does not obviate the need for compliance with the yield restriction rules (through making yield reduction payments where available) and, to that extent, the two rules are duplicative. Thus, the rebate requirement primarily impacts proceeds that are entitled to a temporary period, such that the issuer was allowed to invest the proceeds at a higher yield than the yield on the bonds. For a comprehensive description of rebate and exceptions to rebate, *see* Part II, below.

D. Fair Market Value Rules

To address the concern that issuers would purchase investments with proceeds at artificially high prices (thus artificially lowering yields and reducing rebate or avoiding yield restriction), the IRS has issued rules relating to the fair market value of investments purchased with bond proceeds, contained in Section 1.148-5.

1. *Market Price Rules.*

The yield on an investment of bond proceeds must generally be based on a purchase price for the investment that does not exceed its "fair market value." Section 1.148-5(d) also contains some very specific valuation rules. Under Section 1.148-6(c), gross proceeds cannot be allocated to a nonpurpose investment in an amount greater than its fair market value (with any adjustments described below for qualified administrative costs). In other words, if an issuer accepts a below-market yield on a nonpurpose investment (by paying an above-market price), the investment will be deemed to have a yield based on the fair market price, and rebate will be due based on the excess of the market yield over the bond yield.

2. *Administrative Costs.*

When an issuer computes yield on an investment, costs or expenses paid directly or indirectly to purchase, carry, sell, or retire the investment (administrative costs) are generally *not* taken into account.[56] In other words, administrative costs generally do not increase the purchase price of the investment or reduce the receipts from the investment. However, certain "qualified administrative costs" may be taken into account in determining the yield of the investment. "Qualified administrative costs" are reasonable, direct administrative costs (other than carrying costs), such as separately stated brokerage or selling commissions, but not (a) legal, accounting,

[54] Pub. L. 96-499.

[55] *See Harbor Bancorp v. Commissioner*, 105 T.C. 260 (1995), aff'd, 115 F.3d 722 (9th Cir. 1997), *cert. den*. 118 S. Ct. 1035 (1998) (bonds issued by housing authority were deemed issued after December 31, 1985 and subject to the rebate requirement). Note that the regulations provide for intermediate sanctions (short of loss of tax-exemption) for late rebate payments.

[56] Section 1.148-5(e)(1).

recordkeeping, custody, or similar costs, (b) general overhead or similar internal, indirect costs, like employee salaries and office expenses, or (c) rebate computation costs. Special rules also apply to purpose investments (such as qualified mortgage loans and qualified student loans) and to shares in a regulated investment company or a "commingled fund." *See* the discussion of the safe harbor for qualified administrative costs in Part I, Section IV.D.4 below.

3. ***Safe-harbor for Guaranteed Investment Contracts and Investments for Defeasance Escrows.***

Section 1.148-5(d) sets forth criteria to establish a safe harbor that guaranteed investment contracts ("GICs") and United States Treasury obligations for yield restricted defeasance escrow, not purchased directly from the Treasury[57] or pursuant to regular way trading and traded on an established securities market under § 1273, are purchased at fair market value. The safe harbor rules are summarized below:

a. *Bona Fide Solicitation.*

The issuer must make a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation that satisfies all of the following requirements: (i) the bid specifications are in writing and are timely forwarded to potential providers; (ii) the bid specifications include all material terms of the bid; (iii) the bid specifications include a statement notifying potential providers that submission of a bid is a representation that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any other formal or informal agreement that the potential provider has with the issuer or any other person, and that the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the three-bid requirements described below; (iv) the terms of the bid specifications are commercially reasonable; (v) for purchases of GICs only, the terms of the solicitation take into account the issuer's reasonably expected deposit and drawdown schedule for the amounts to be invested; (vi) all potential providers have an equal opportunity to bid (for example, no potential provider is given the opportunity to review other bids that is not equally given to all potential providers (*i.e.*, no exclusive "last look") before providing a bid); and (vii) at least three reasonably competitive providers are solicited for bids; a reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

b. *Bid Requirements.*

The issuer must receive at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of paragraph a. above and that do not have a material financial interest in the issue;[58] at least one of the three bids described above must be from

[57] United States Treasury obligations purchased directly from the United States Treasury generally refers to U.S. Treasury Certificates of Indebtedness, Notes and Bonds of the State and Local Government Series (*"SLGS"*). While it is technically possible to purchase open market Treasuries directly from the United States Treasury in a Treasury auction, such purchases are generally not practical for gross proceeds of tax-exempt bonds.

[58] A lead underwriter in a negotiated underwriting transaction is deemed to have a material financial interest in the issue until 15 days after the issue date of the issue.

a reasonably competitive provider; and if the issuer uses an agent to conduct the bidding process, the agent cannot bid to provide the investment.

c. *Bid Selection Requirements.*

For a GIC, the winning bid is the highest yielding bona fide bid (determined net of any broker's fees). For a portfolio of securities for a defeasance escrow, the following requirements must be met: (1) the winning bid is the lowest cost bona fide bid, including any broker's fees;[59] (2) the lowest cost bona fide bid (including any broker's fee) is not greater than the cost of the most efficient portfolio of securities containing exclusively of SLGS;[60] and (3) if sales of SLGS are suspended on that day, the cost comparison to SLGS is not required.

d. *Other requirements.*

The provider of the investments or the obligor on the GIC must certify to the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment. In addition, the Regulations require that the issuer retain key records relating to the bid with the bond documents until three years after the last outstanding bond is redeemed. These would include, for example: a copy of the GIC itself or security confirmations; a record of the amount actually paid by the issuer for the investments, including administrative costs; the names of the persons and entities submitting the bids; the time and date of the bids and the bid results; and the bid solicitation form. Also, if the terms of the investment deviated from the bid solicitation form, or if a submitted bid is modified, a brief statement explaining the deviation should be retained.

4. ***Qualified Administrative Costs.***

For GICs and yield restricted defeasance escrow investments, direct administrative costs will be treated as "qualified" only if they are "reasonable" within the meaning of those regulations. If treated as qualified administrative costs, brokers' commissions and similar fees paid by the provider of the GIC or the securities are not treated as additional yield to the issuer. A safe harbor is provided under Section 1.148-5(e) which includes two components: a "per-investment safe harbor;" and a "per-issue safe harbor."

a. *Per-investment Safe Harbor.*

A broker's commission or similar fee with respect to the acquisition of a GIC or investments purchased for a yield restricted defeasance escrow is reasonable and not treated as additional yield to the issuer to the extent that the amount of the fee the issuer treats as a qualified administrative cost does not exceed the lesser of: (A) $46,000; or (B) 0.2% of the computational base, or if more, $5,000 (the "per-investment safe harbor" for calendar year 2023). *See* "Cost-of-living Adjustment" below. The computational base for a GIC is the amount of gross

[59] Any payment received directly or indirectly by the issuer from a provider at the time a guaranteed investment contract is purchased (*e.g.*, an escrow float contract) is taken into account in determining the lowest cost bid.

[60] Securities issued by the United States Treasury pursuant to the State and Local Government Series program described in 31 CFR part 344.

proceeds the issuer reasonably expects, as of the date the contract is acquired, to be deposited over the term of the GIC. For investments in a yield restricted defeasance escrow, the computational base is the amount of gross proceeds initially invested in the escrow.

b. *Per-issue Safe Harbor.*

For any bond issue, the issuer cannot treat as qualified administrative costs more than $130,000 (for calendar year 2023) in brokers' commissions or similar fees with respect to all GICs and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue (the "per-issue safe harbor"). *See* "Cost-of-living Adjustment" below.

c. *Exceeding the Safe-Harbor.*

This regulation does not restrict the ability of the issuer to pay a fee that exceeds the safe harbor amount. The portion of the fee that is within the safe harbor constitutes a qualified administrative cost, and any amounts in excess of the safe harbor are qualified administrative costs if they are "reasonable." The Regulations do not specify factors for determining the reasonableness of fees in excess of the safe harbor. Instead, the determination of whether a fee is reasonable is based on all the facts and circumstances, including whether the fee is comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

d. *Cost-of-living Adjustment.*

Section 1.148-5(e) provides for a cost-of-living adjustment for both the per-investment safe harbor and the per-issue safe harbor. The adjusted safe harbor dollar amounts are published by the IRS in an annual revenue procedure that sets forth inflation-adjusted items. The cost-of-living adjustment for calendar year 2023 allows $46,000 in qualified administrative costs per GIC and $130,000 per issue, with a floor of $5,000.[61]

E. Investment of Commingled Funds

1. ***Investment Rules.***

Special rules apply with respect to the investment of commingled funds. Fund earnings, gains and losses must be allocated among investors[62] on the basis of a "consistently applied, reasonable ratable allocation method." As described above, a "consistently applied" accounting method is a method that accounts (a) uniformly for amounts that are commingled with proceeds and (b) consistently for proceeds of the bonds for each fiscal year (or portion) during which the bonds are outstanding. *See* Section 1.148-6(e)(2).

[61] Rev. Proc. 2022-38.

[62] An investor means each depositor, or each different source of funds deposited. For example, bond proceeds and issuer tax revenues would be considered separate investors.

2. *Special Rules for Common Reserve Funds or Sinking Funds.*

Certain special rules apply to commingled funds that serve as common reserve funds or sinking funds. Under Section 1.148-6(e)(6), investments in such a fund must be allocated (after adjustment under the universal cap[63]) among the various issues the fund serves at least every three years and on each date that a new issue covered by the commingled fund is issued (or the date an issue is retired in certain cases the case of (iii) below) in accordance with one of three specified allocation methodologies: (i) the outstanding relative values of the issues as of the date of allocation;[64] (ii) the relative amount of the issues' remaining maximum annual debt service requirements; or (iii) the aggregate relative original principal amounts.

F. Minor Portion

Under § 148(e), an amount of up to the lesser of 5% of the sale proceeds or $100,000 may be invested in materially higher yielding investments; however, these amounts remain subject to the rebate requirement.

G. Limitation on Funding a Reserve

Section 148(d)(2) causes a bond to be an arbitrage bond if more than 10% of the proceeds of the issue of which it is a part are used to fund a reserve. It does not matter whether the reserve is otherwise reasonably required or not. While this clearly applies to funding a debt service reserve fund, the IRS has applied this provision to the funding of an account that is not reasonably expected to be spent in a reasonable time.[65]

H. Prohibition on Financing Out of Jurisdiction Housing Projects

In perhaps an oddly placed bond restriction included in §148(b)(2)(E), if proceeds of a non-private activity bond are used to finance a housing project located outside the jurisdiction of the issuer, such housing project is subjected to the arbitrage rules as though it were an investment. This provision basically prohibits such financings. Although it is under §148 of the Code and is couched as an arbitrage rule, it is really a separate restriction.

V. EXPENDITURE OF PROCEEDS

The "expenditure" of proceeds typically removes such proceeds from the realm of arbitrage. The rules for when proceeds are "spent" are generally simple, but special rules exist for determining an expenditure for working capital purposes, reimbursement purposes, and from a commingled fund.

[63] The "universal cap" rule provides an overall limitation on the amount of gross proceeds allocable to an issue. *See* Section 1.148-6(b)(2).

[64] *See* Section 1.148-4(e) for the determination of "value."

[65] *See* TAM 9749002 (Aug. 11, 1997).

A. Capital Expenditures

Proceeds may be treated as spent when applied to a "current outlay of cash for a governmental purpose"[66] and for a "capital expenditure," defined as "any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of 'placed-in-service' under Section 1.150-2(c) under general federal income tax principles)."[67]

B. Reimbursement

The expenditure rules are more complex in the context of reimbursement bonds. With limited exceptions, proceeds are not treated as allocated to an expenditure paid prior to the issuance of the bonds unless, (1) not later than 60 days after the expenditure the issuer (or, in the alternative, in a qualified 501(c)(3) bond financing, the conduit borrower) adopted or expressed an official intent (meeting the requirements of Section 1.150-2(e)(1)),[68] (2) the expenditure is a capital expenditure, a cost of issuance of a bond, an extraordinary working capital item[69] or a grant,[70] and (3) the reimbursement allocation is made not later than 18 months after the later of (a) the date of the expenditure or (b) the date the project was placed in service or abandoned, but not more than three years after the date of expenditure.[71] These requirements do not apply to certain *de minimis* amounts or to certain "preliminary expenditures". Furthermore, an issuer must not use the reimbursed amount such that the amount becomes replacement proceeds (other than a bona fide debt service fund) and must not employ an abusive device or attempt to avoid the rules of §§ 142 through 147. Reimbursement rules for restricted working capital expenditures are addressed in Section 1.148-6(d)(5); generally, in order for reimbursement bonds to be allocated to restricted working capital expenditures, there must be no other available amounts on the date such expenditure is made (as further described in C. below) and no other available amounts as of the date of the reimbursement.

C. Working Capital Purposes

1. *General.*

Section 1.148-6(d)(3) provides guidance on the expenditure of proceeds for working capital purposes. As a general rule, "proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed 'available

[66] A current outlay of cash is one reasonably expected to occur not later than five banking days after the proceeds are allocated to the expenditure. Section 1.148-6(d)(1)(ii).

[67] Section 1.150-1(b).

[68] Section 1.150-2(d). A special rule applies to certain preliminary expenditures such as architectural, engineering, surveying, soil testing and bond issuance costs.

[69] Defined in Section 1.148-6(d)(3)(ii)(B).

[70] Defined under Section 1.148-6(d)(4); Section 1.150-2(d)(3) also includes certain types of loans.

[71] Section 1.150-2(d)(2) includes a rule extending the 18-month limit to 3 years for small issuers (and relieving them of the 3-year limit) and to 5 years for long-term construction projects upon a certification similar to that for a 5-year temporary period.

amounts' as of that date." This rule also applies to replacement proceeds but is subject to some exceptions as described below.

Section 1.148-6(d)(3)(ii) excepts from the rule stated in the previous paragraph expenditures for the following specified purposes: (i) issuance costs and "qualified administrative costs;" (ii) "qualified guarantee" fees or payments for a "qualified hedge;" (iii) certain amounts paid to the United States, such as rebate payments; (iv) payment of debt service on an issue from (a) unexpected excess sale and investment proceeds, and (b) certain debt service reserve fund earnings; (v) working capital expenditures that "do not exceed 5% of the sale proceeds of an issue and . . . are directly related to capital expenditures financed by the issue;" (vi) extraordinary items (*e.g.*, casualty losses or an extraordinary legal judgments in excess of reasonable insurance coverage), provided that any available amounts in a reserve for that purpose have been expended; and (vii) interest on the issue for at least three years from the issue date.

For a discussion of the six-month spending exception for working capital financings, see Section VIII.B. herein.

2. ***Available Amounts.***

"Available amount" is defined as "any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue."[72] Generally, the available amount excludes proceeds of any issue but includes cash, investments and other amounts that may be used without "legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed." "Available amounts" may be held by the issuer or a related party. A reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures in the previous fiscal year.[73]

3. ***Long Term Working Capital Financing.***

Working capital financings are frequently done as short-term tax or revenue anticipation notes ("TRANs"). It is possible to issue long term working capital financings, subject to the restrictions against other replacement proceeds, which generally require that there be no available amounts during the period the bonds remain outstanding, or, if such available amounts do arise, that there is a proper unburdening action taken. *See* Sections 1.148-6(d)(3) and 1.148-1(c)(4). The 2016 Final Regulations added a safe harbor against the creation of replacement proceeds for longer-term working capital financings for issuers experiencing financial distress, contained in Section 1.148-1(c)(4)(ii), which requires the issuer to determine the actual available amounts (net of a reasonable working capital reserve) as of the first day of each fiscal year beginning with the year it expects to have such available amounts (and in no event no later than 5 years after the issue date) and to apply such available amounts to redeem or to invest in "eligible tax-exempt bonds."[74]

[72] Section 1.148-6(d)(3)(iii)(A).

[73] Section 1.148-6(d)(3)(iii)(B).

[74] Section 1.148-1(c)(4)(ii). Note that there is no reason to believe that the first day of the fiscal year will be a date on which even a very needy issuer would experience a deficit. Most issuers experience cyclical cash flow balances that are expected to be in excess of a reasonable working capital reserve on certain days in every fiscal year.

D. Grants

Under Section 1.148-6(d)(4), proceeds may be treated as expended when applied to the making of a grant.[75] The 2016 Final Regulations added Section 1.150-1(f), which did not change the favorable rule that bond proceeds are deemed spent on the date of the grant, but provides that the "character and nature" of the grantee's use of bond proceeds are taken into account in determining which rules apply to such bond proceeds. Accordingly, Section 1.150-1(f) clarifies that there is a look-through treatment for purposes of determining whether proceeds are used for capital or working capital expenditures, the temporary period to the issuer prior to making the grant and the useful life of the financed assets.

E. Allocation Methodology

An issuer may generally use any reasonable, "consistently applied" accounting method to determine when proceeds are expended, provided that proceeds must be accounted for in the same manner for purposes of both §§ 141 and 148. An issuer is not required to use the same accounting method for different issues of bonds, even if the issues finance the same project.[76] If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue, the specific tracing method is used. Further, Section 1.148-6(d)(1)(iii) provides that an issuer must account for the expenditure of proceeds not later than 18 months after the later of the date the expenditure is paid or the date the project financed is placed in service, provided that, in any event, this allocation must be made by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier.[77]

In many instances, issuers (and other governmental entities) enter into agreements regarding the usage of moneys, including intergovernmental loans and intergovernmental agreements for the construction of joint projects. In addition, borrowers in many conduit financings may enter into development or other agreements with parties having common ownership or board control, and expect expenditures related to such agreements be financed with proceeds of tax-exempt bonds. Under what circumstances are transfers between these parties treated as expenditures? Under Section 1.148-6(d)(7), any payment of proceeds to a related party is not an expenditure of those proceeds.[78] A "related party" with respect to governmental units

Presumably the requirement for the beginning of the testing is whether there are available amounts on the first day of the fiscal year. Even so, that may very well be the first fiscal year beginning after the issuance.

[75] The grantor may not impose any obligation or condition on the grantee to repay the grant if such repayment is anticipated to occur as a result of the obligation or condition, but conditions designed to ensure expenditure of the moneys for the desired governmental purposes are acceptable. If the grant is repaid, the moneys are treated as unspent proceeds unless expended within 60 days of receipt. Section 1.148-6(d)(4).

[76] However, an expenditure must not be double counted.

[77] *See* TAM 9723012 (March 21, 1997), in which the Service refused to permit the reallocation of proceeds to expenditures several years after the initial allocation. However, the Service concluded in PLR 200248002 (November 29, 2002) that Section 1.148-6(d)(1)(iii) permits issuers both to allocate and then to reallocate proceeds to expenditures as long as the reallocations are made within the time frame permitted by the regulation.

[78] A payment of bond proceeds by an issuer of the bonds to another department of the issuer is not an expenditure. For example, a city might issue bonds for a construction project and then need to obtain a city building permit as part of that project. The City may not allocate the cost of the building permit as an expenditure of proceeds of that issue. Moreover, a payment of bond proceeds by a conduit borrower to a related party to that borrower is also not an expenditure. For example, a payment by the borrower to a developer entity which is a related party to the

and 501(c)(3) organizations, are members of the same "controlled group" under Section 1.150-1(e) and, with respect to other persons, a "related party" is a "related person" as defined in § 144(a)(3). In certain instances, it may be possible to trace the expenditures of proceeds to "out-of-pocket" expenditures of the related party (i.e., payments made to a third party which is not a related party).

F. Certain Investment Proceeds

For governmental bonds and private activity bonds financing governmentally owned assets, investment proceeds (other than investment proceeds held in a refunding escrow) that are commingled with substantial tax and other revenues from governmental operations of the issuer may be treated as spent when commingled as long as the issuer reasonably expects the amounts to be expended for governmental purposes within six months of the date of commingling, using any reasonable accounting assumption.[79]

VI. ANTI-ABUSE RULES

A. Abusive Arbitrage Device

Under Section 1.148-10, if an "abusive arbitrage device" is employed in connection with the issuance of governmental obligations, the obligations will be considered to be arbitrage bonds. An abusive arbitrage device is a transaction or series of transactions that attempt to circumvent the provisions of § 148 by (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain material financing advantage, and (ii) overburdening the tax-exempt bond market. The 2016 Final Regulations revised Section 1.148-10 to add an issuer's bona fide need to finance "extraordinary" working capital items to the list of factors that could outweigh factors tending to show overburdening of the market.

B. Abusive Advance Refunding Transactions

Section 149(d)(4) as it existed prior to the Tax Cuts and Jobs Act prohibited use of a "device" in an advance refunding "to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates." Certain transactions are described as "devices" in the legislative history of such § 149(d)(4) and in the General Explanation of the Tax Reform Act of 1986, at p. 1215. In addition to giving the Commissioner fairly broad discretion to re-characterize perceived abusive transactions to reflect their economic substance, Section 1.148-10(d) also sets out five additional examples of transactions that are considered abusive. Finally, in Rev. Rul. 94-42, the IRS indicated that another type of transaction (one involving certain types of bond insurance arrangements under which the bond insurer was expected to pay the debt service on the bonds) would cause the interest on bonds to be taxable; interestingly, the IRS did not use the abusive device provisions of Section 1.148-10 to stop such transactions.

C. Clearly Reflect the Transaction

Under Section 1.148-10(e), the Commissioner "may exercise the Commissioner's discretion to depart from the rules of Sections 1.148-1 through 1.148-11 as necessary to clearly

borrower.

[79] *See* Section 1.148-6(d)(6).

reflect the economic substance of the transaction" if an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates. For an example of this situation, *see City of Columbus, Ohio v. Commissioner,*[80] which involved a state pension fund created to replace local plans, in exchange for agreements by the local entities to repay the state over a 65-year period with interest at 4.25%. The state had proposed that municipalities could "prepay" their "obligation" at a 35% discount, and the City of Columbus proposed issuing tax-exempt bonds for this purpose. The Tax Court concluded that-

> irrespective of the technicalities of the arbitrage regulations . . . , respondent was entitled to make the adjustment of the yield calculation to take the 35-percent discount into account and to reject petitioner's [the IRS] application for ruling under Section 1.148-10(e), on the ground that the *economic substance of the transaction clearly revealed a materially higher yield* . . . . Consequently, the interest on the proposed bonds will not be exempt under § 103(a). (Emphasis added).

The Tax Court did not treat the investments held by the pension fund as the "acquired obligation." Rather, the Tax Court determined that the "arbitrage" was the difference between the yield on the proposed bonds of 6% and the offered discount on the obligation to the state with a resulting "yield" of 7.57484%. After appeal and remand, the Tax Court determined that since there was no prepayment for property, the prepayment, in and of itself, did not constitute investment-type property. *City of Columbus v. Commissioner*, T.C. Memo. 1998-135 (1998). For an application of the "economic substance" doctrine to an advance refunding transaction, *see* PLR 200424003 (a technical advice memorandum), which required two bond issues to be treated as a single issue based upon the economic substance of the transactions.

PART II —REBATE AND EXCEPTIONS TO REBATE

VII. ARBITRAGE REBATE

A. Rebate Generally

1. *The Code.*

Under § 103(b)(2), the exclusion of interest pursuant to § 103(a) is not applicable to any arbitrage bond. Under § 148(f)(1), a bond that is part of an issue will be treated as an arbitrage bond unless the rebate requirements set forth in §§ 148(f)(2) and (3) are satisfied for that issue. §§ 148(f)(2) and (3) require timely payment of an amount to the United States (the *"rebate amount"*). The rebate amount to be paid is the sum of (i) the excess of the amount earned on all nonpurpose investments over the amount that would have been earned on those investments had those investments been invested at a rate equal to the yield on the issue, plus (ii) any income attributable to that excess.

Section 148(f)(3) specifies that rebate payments be made in accordance with an installment payment schedule over the life of the issue. A payment must be made at least once every five

[80] 106 T.C. 325 (May 14, 1996), supplemented by T.C. Memo. 1996-343 (1996), vacated and remanded 97-1 U.S.T.C. ¶ 50,424 (1997).

years in an amount such that at least 90% of the excess earnings amount at the time payment of the installment is required will be paid on such date, and a final payment of the balance must be made within 60 days of the final retirement of the issue.

2. ***Summary of Rebate Methodology under the Regulations.***

The history of the arbitrage regulations is discussed in versions of this outline from Bond Attorneys' Workshops in prior years.

a. *Computation and Payment Dates.*

(i) *Rebate Amount.* The rebate amount for an issue as of any computation date is the excess of: (a) the future value of all receipts on nonpurpose investments during the period ending on the computation date; over (b) the future value of all payments on nonpurpose investments during that same period. Future value is computed as of the computation date.[81] Future value is computed using the bond yield.

(ii) *Rebate Payment Dates.* Rebate computation payment dates must be selected by the issuer so that the first computation date is no more than five years after the issue date and each subsequent computation payment date is no more than five years after the previous computation payment date. The date that the bonds are paid in full is also a computation payment date (the *"final computation date"*). Each computation payment date must also be a computation date. No later than 60 days after each computation payment date (other than the final computation date), rebate must be paid in an amount that, when added to the future value as of the computation date of previous rebate payments made for the issue, equals at least 90% of the rebate amount as of that computation date. No later than 60 days after the final computation date, rebate must be paid in an amount that, when added to the future value of previous rebate payments made for the issue, equals 100% of the rebate amount as of that computation date.[82] For issues retired within three years of the issue date, the final payment need not occur before the end of eight months after the issue date or the end of the period in which the issuer reasonably expects that any spending exceptions will apply to the issue.[83]

(iii) *Late Payments; Interest Due.* Under Sections 1.148-3(g) and (h), a rebate payment is considered made only when paid at the place or places designated by the IRS and accompanied by the form provided by the IRS for payment purposes (Form 8038-T). For late payments, payment of a penalty and interest will normally be required, but the penalty is automatically waived if the rebate amount is paid (with interest) within 180 days after the discovery of the failure to pay, unless (A) the Commissioner determines the failure was due to "willful neglect," or (B) the issue is under examination by the IRS during the period beginning on the date the failure first occurs and ending on the date 90 days after the receipt of the rebate amount. Waiver outside these circumstances will only occur in unusual circumstances.[84] If not waived, the

[81] Sections 1.148-3(a) through (c) provide the general rules for determining the rebate amount.

[82] Section 1.148-3(f).

[83] Section 1.148-3(e)(2).

[84] Section 1.148-3(h)(3). Rev. Proc. 2005-40 also provides procedures for corrections of a failure to timely pay the proper amount of arbitrage rebate.

penalty will be 50% of the amount due for governmental or qualified 501(c)(3) bonds or 100% of the amount due for all other qualified private activity bonds. For late payments and underpayments, interest accrues at the underpayment rate defined by § 6621 beginning on the date the correct rebate amount was due and ending on the date 10 days before actual payment is made.[85]

(iv) *Computation Dates*. Under Section 1.148-3(e), a computation date means each date on which the rebate amount for an issue must be computed, which includes the first required computation date, subsequent required computation dates and the final computation date.

(1) For a fixed yield issue, the first required computation date is any date selected by the issuer that is not later than the fifth anniversary date of the issue. The subsequent required computation dates are any dates selected by the issuer that are not later than five years after a previous computation date for which a rebate installment was made. The final computation date is the date that an issue is retired (unless as may be extended as described in VII.A.2.a(ii) above).[86]

(2) For a variable yield issue, the first required computation date is the last day of any bond year selected by the issuer ending on or before the fifth anniversary date of the issue date. After the first required payment date, the issuer may not change previous computation dates and must consistently treat either the end of each bond year or the end of each subsequent fifth bond year as a subsequent required computation date. The selection of computation dates may be critical for these issues. The final computation date is the date an issue is retired (unless as may be extended as described in Section VII.A.2.a(ii) above).[87] After the first date payment is made the issuer may not change its choice of the first required payment date or its choice of subsequent required payment dates.[88]

(3) "Bond year" for these purposes is each one-year period selected by the issuer (with short first and last bond years permitted). If no day is selected by the issuer for these purposes before the earlier of the final maturity date of the issue or the date that is five years after the issue date, each bond year ends on the anniversary date of the issue date and on the final maturity date.[89]

b. *Investment Receipts.*

(i) *Relationship to Rebate*. The rebate amount as of any computation date is the excess of the future value of all receipts on nonpurpose investments ("nonpurpose receipts") over the future value of all payments on such nonpurpose investments ("nonpurpose

[85] Section 1.148-3(h)(2).

[86] Section 1.148-3(e)(2).

[87] Sections 1.148-3(e)(1) and (2).

[88] Section 1.148-3(e)(1).

[89] Section 1.148-1(b).

payments"). Significantly, there is no rebate obligation with respect to purpose investments (for example, in a conduit issue, the loan of proceeds by the issuer to the borrower).[90]

(ii) *Types of Receipts*. There are three classes of nonpurpose receipts: actual/constructive receipts; disposition receipts; and computation date receipts.[91]

(a) *Actual/Constructive Receipts*. Receipts include any amount that is actually or constructively received from a nonpurpose investment, including interest earnings, return of principal, and gain from the sale or retirement of the investment, with no adjustments for costs or expenses paid to purchase, carry, sell, or retire the investment (unless those costs are qualified administrative costs).[92] *See* the discussion of qualified administrative costs in Part I, Section IV.D.2. above.

(b) *Disposition Receipts*. Under Section 1.148-3(d)(2)(ii), a disposition receipt arises when a nonpurpose investment ceases to be allocated to an issue or ceases to be subject to the rebate requirements of an issue, other than by reason of a sale or redemption of the nonpurpose investment. This will occur, for example, when an investment becomes allocable to transferred proceeds of another issue, ceases to be allocable to the issue as a result of the operation of the universal cap rules of Section 1.148-6(b)(2), or is initially subject to a rebate requirement and subsequently qualifies for an exception to rebate (*e.g.*, an investment allocated to a fund initially subject to the rebate requirement but that subsequently qualifies as a bona fide debt service fund).[93] An investment that is de-allocated from an issue is generally treated as if sold for its fair market value on the date of de-allocation.

(c) *Computation Date Receipts*. Nonpurpose receipts also include computation date receipts.[94] Computation date receipts arise on the computation date in an amount equal to the value of all nonpurpose investments allocated to the issue at the end of the computation period.

(d) *Commingled Fund Receipts*. The rules of Section 1.148-6(e) control when receipts are allocated among the various investors of a commingled fund (as defined above). Section 1.148-3(d)(3) provides that the commingled fund rules control the required determinations of receipts and not the rules for actual/constructive receipts, disposition receipts, and computation date receipts stated above.

(e) *Value of Nonpurpose Investments*. The value of a nonpurpose investment on a date is generally determined by the consistent application (on that date) of one of the following three valuation methods: (1) outstanding stated principal amount plus accrued interest for "plain par investments;" (2) present value for fixed rate investments; and (3) fair market value for any investment.

[90] Section 1.148-1(b).
[91] Section 1.148-3(d)(2).
[92] Sections 148(f)(4)(A) and 1.148-3(d)(2)(i).
[93] Allocation of investments to gross proceeds is addressed under the Regulations in Sections 1.148-6(b), (c), and (e).
[94] Section 1.148-3(d)(2)(iii).

A plain par investment (1) is issued with no more than a *de minimis* amount of original issue discount or premium,[95] or acquired after issuance at no more than a *de minimis* amount of market discount or premium, (2) is issued for a price that does not include interest other than pre-issuance accrued interest, (3) bears interest that is unconditionally payable at least annually from the issue date at a single, stated, fixed rate, or is a variable rate instrument,[96] and (4) has a lowest stated redemption price that is not less than its outstanding stated principal amount. The present value of an investment on any date is defined, generally, as the present value as of that date of all future unconditionally payable receipts to be received from and payments to be paid for the investment, using the yield on the investment as the discount rate.[97] The determination of fair market value is governed by Section 1.148-5(d)(6). See Part I, Section IV.D above.

When valuing investments, certain restrictions apply. First, all yield restricted investments must be valued at present value.[98] Second, for an investment that is not yield restricted, it must generally be valued at fair market value on the date it is first allocated to an issue, or first ceases to be allocated to an issue, as a result of a deemed acquisition or disposition, except as described in the following sentence.[99] The fair-market-value rule does not apply if that disposition is the result of the transferred proceeds rules (Section 1.148-9(b)) or the universal cap rules (Section 1.148-6(b)(2)) or the investment is in a commingled fund.[100] These rules are complex; if you have to make these determinations, read the regulations carefully.

c. *Investment Payments.*

(i) *Relationship to Rebate*. Recall that the rebate amount as of any computation date is the excess of the future value of all nonpurpose *receipts* over the future value of all nonpurpose *payments*. Five different types of payments must be considered, as discussed below: actual/constructive payments; allocated payments; computation period payments; computation date credits; and yield reduction payments.

(ii) *Types of Payments*.

(a) *Actual/Constructive Payments*. Payments include the amounts of gross proceeds of an issue actually or constructively paid to acquire a nonpurpose investment or treated as paid to a commingled fund.[101] These amounts may not generally be increased by any brokerage commissions or administrative expenses, and the price paid may not exceed the fair market value as of the purchase date (Section 1.148-6(c)).[102]

[95] *De minimis* discount or premium means an amount that does not exceed the sum of 2% times the stated redemption price at maturity. Section 1.148-1(b).

[96] A bond, debenture, note or certificate of indebtedness under § 1275.

[97] Under Section 1.148-5(b)(2), all yield restricted investments of the same class are treated as a single investment, and investments held in a refunding escrow (no matter how funded) are treated as a single investment.

[98] Section 1.148-5(d)(2).

[99] Section 1.148-5(d)(3)(i).

[100] Section 1.148-5(d)(3)(ii).

[101] Section 1.148-3(d)(1)(i).

[102] However, qualified administrative costs may act to decrease the yield and rebate amount due with respect to a nonpurpose investment. *See* Section 1.148-6(c) and the discussion at Part I, Section IV.D. above.

(b) *Allocation Payments*. Payments include the value of nonpurpose investments on the date that a previously acquired nonpurpose investment first becomes allocable to an issue or becomes subject to the rebate requirements of an issue. Section 1.148-3(d)(1)(ii). For example, this type of allocation will arise (1) upon the pledge of a reserve or other fund of existing investments as security for an issue and (2) when proceeds of a refunded issue transfer to the refunding issue.

(c) *Computation Period Payments*. Payments include the value of an investment at the beginning of a computation period if the investment was allocated to an issue at the end of the preceding computation period. Section 1.148-3(d)(1)(iii). This rule provides symmetry for the determination of receipts and payments on an obligation that is held at the end of a computation period. The value of an investment for computation date receipt purposes should equal the value of an investment for computation period payment purposes.

(d) *Computation Date Credits*. Section 1.148-3(d)(1)(iv) provided a computation date credit of $1,000 on (1) the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to rebate requirements and (2) the final maturity date of an issue. The 2016 Final Regulations increased the credit to $1,400 and adjusts it for inflation. The computation credit is $1,960 for bond years ending in 2023.[103]

(e) *Yield Reduction Payments*. Finally, any amounts paid to the United States to reduce the yield on a nonpurpose investment, including rebate amounts, are treated as nonpurpose payments, Sections 1.148-3(d)(1)(v) and -5(c), and recoveries of overpayment of rebate pursuant to Section 1.148-3(i) are treated as negative yield reduction payments.[104] *See* the discussion at Part I, Section IV.B.7 above concerning yield reduction payments.

d. *The Future Value Method.*

The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when paid, received or treated as paid or received, plus interest assumed to be earned and compounded on such value over the period at a rate equal to the yield on the issue.[105]

B. Computation of Yield on Fixed Yield Issues

1. ***Introduction.***

The basic rule is that the yield on fixed yield issues, unlike variable yield issues, will not change over the life of the issue, with two exceptions as described in Section VII.B.3 below.

[103] Rev. Proc. 2022-38.

[104] Section 1.148-5(c)(2).

[105] Section 1.148-3(c).

2. ***Definitions.***

a. *Fixed Yield Issue.*

A fixed yield issue is any issue comprised exclusively of fixed yield bonds. A fixed yield bond is any bond whose yield is fixed and determinable on its issue date.[106]

b. *Issue Price.*

(i) *In General*. Under § 148(h), the yield on a fixed yield issue is determined on the basis of issue price (itself determined under §§ 1273 and 1274 as modified by Section 1.148-1(f) as discussed below). Issue price of an issue is generally the sum of the issue prices of all bonds in the issue. Under Section 1.148-1(f), the issue price of bonds issued for money is the first price at which a substantial amount (10%) of the bonds with the same credit and payment terms is sold to the public. "Public" means any person other than an underwriter or a related party[107] to an underwriter. "Underwriter" includes any person that agrees pursuant to a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to participate in the initial sale of the bonds to the public, and any person that agrees directly with such a person, pursuant to written contract, to participate in the initial sale of the bonds to the public. Issue price is not reduced by any issuance costs. The issue prices of bonds that do not have the same credit and payment terms are determined separately.[108] All bonds of an issue that have the same credit and payment terms (often referred to as bonds of a single maturity) have the same issue price.

(ii) *Private Placement Rule*. If a bond is issued for money in a private placement to a single buyer that is not an underwriter or a related party to an underwriter, the issue price of the bond is the price paid by that buyer. The price paid by the buyer typically includes the par amount of the bonds but may be reduced by any fees treated by the buyer as original issue discount.

(iii) *Special Rule for Competitive Sales.* For bonds issued for money in a "competitive sale," an issuer may treat the reasonably expected initial offering price to the public as of the sale date as the issue price of the bonds. The term "competitive sale" is defined as a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process that meets the following requirements: (A) notice of the sale is disseminated to potential underwriters in a manner designed to reach potential underwriters (*e.g.,* posting notice of sale in *The Bond Buyer* or on an internet based website or other electronic medium that is regularly used for such purpose and is widely available to potential underwriters); (B) all bidders have an equal opportunity to bid (*i.e.,* no last look); (C) the issuer receives bids from at least three underwriters with established industry reputations for underwriting new issuances of bonds; and (D) the bid is awarded to the bidder who submits the firm offer to purchase the bonds at the highest price (lowest interest cost).

[106] Section 1.148-1(b). A variable yield issue will automatically be treated as a fixed yield issue as of the first day on which it would qualify as a fixed yield issue if newly issued on such conversion date (or the next computation date at the option of the issuer). Section 1.148-4(d).

[107] *See* Section 1.150-1(b).

[108] Section 1.148-1(f)(4)(i).

(iv) *Hold the Issue Price Rule.* This rule provides that an issuer may, as of the sale date, treat the initial public offering price of the bonds as the issue price of the bonds, provided that the following two conditions are met: (A) the underwriter(s) offered the bonds to the public at the specified initial offering price on or before the sale date, with the (lead) underwriter certifying to such fact and providing supporting evidence of such offering price (*e.g.,* pricing wire or equivalent); and (B) each affected underwriter separately agrees, in writing, not to offer or sell the bonds to any person (including another underwriter) at prices higher than the initial public offering prices between the sale date and the earlier of the close of the fifth business day after the sale date or the date on which the underwriters have sold at least ten percent of the bonds to the public at a price not higher than the initial public offering price; with the latter ten percent alternative applying on a maturity by maturity basis.[109]

(v) *Choice of rule for determining issue price.* If more than one rule for determining the issue price of the bonds is available, at any time on or before the issue date, the issuer may select the rule it will use to determine the issue price of the bonds. On or before the issue date of the bonds, the issuer must identify the rule selected in its books and records maintained for the bonds. The issuer may choose to apply different rules to different bonds within the issue.

(vi) *Bonds issued for property.* The issue price of bonds issued for property other than money is determined under §§ 1273 and 1274. These include tax-exempt bonds (or leases) issued to acquire personal property such as vehicles or equipment. Also included are refunding bonds exchanged for refunded bonds of the issuer. In most cases, if such a bond has adequate stated interest (the rate is at least the adjusted applicable federal rate), the issue price will be par. If, however, the bond or the property for which the bond is issued is traded on an active market, the issue price will be determined based on fair market value.

3. ***Computation of Yield (Fixed Yield).***

a. *Basic Method.*

Yield on a fixed yield issue is defined as the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments over the life of the issue of principal of and interest and (in certain instances) stated redemption prices on the issue, qualified guarantee fees (both paid and reasonably expected to be paid), and payments made or received under a qualified hedge, produces an amount equal to the present value of the aggregate issue price of the bonds of the issue as of the issue date.[110] Yield is computed based upon the compounding of interest at the end of each compounding interval (a method referred to variously as the economic accrual method, constant interest method or actuarial method). Compounding intervals cannot exceed more than one year, yield is calculated to at least four decimal places, and reasonable standard financial conventions (*e.g.*, 30/360-day counts) may be used but must be consistently applied. Sections 1.148-1(b) and -4(a).

[109] In this context, a "maturity" refers to bonds with the same payment and credit terms. If some bonds have different coupons but the same maturity date, those are considered separate maturities for this rule. Insured bonds would be separate maturities from uninsured bonds or bonds with a different insurer.

[110] Section 1.148-4(b)(1).

b. *Redemption Provisions.*

(i) *Mandatory and Expected Redemptions.* If any bond is subject to mandatory early redemption or expected contingent redemption, it is treated as redeemed on its reasonably expected early redemption date at its value on that date. Section 1.148-4(b)(2)(i).

(ii) *Deep Discount: Mandatory Sinking Fund Redemption of Term Bonds*. In most cases, if the issue includes term bonds with mandatory sinking fund redemptions, bond yield is computed by treating those bonds as redeemed on their scheduled dates at a price of par plus accrued interest. But if those bonds are issued at a "deep" discount (discussed below), bond yield is computed by using the *value* of those bonds on the redemption date (not their stated principal amount), plus accrued interest.[111] This special rule applies to a term bond if the "stated redemption price of the bond at maturity" (usually the face amount), exceeds the issue price of the bond by more than the product of (A) 0.25% per year times (B) the number of years to the weighted average maturity of the expected mandatory sinking fund schedule. Section 1.148-4(b)(2)(ii).

(iii) *Yield-to-Call: Certain Bonds Subject to Optional Early Redemption*. This rule affects callable premium bonds, short-call bonds, and stepped coupon bonds. For certain fixed yield bonds subject to optional early redemption, the yield on the issue is computed assuming the bonds are redeemed at their stated redemption prices on the optional redemption dates that would produce the lowest yield on each of the bonds subject to optional redemption.[112] Stated redemption price for this purpose means the total redemption price of the bonds including any call premium. The three classes of fixed yield bonds subject to this yield-to-call requirement are: (A) bonds subject to optional redemption within five years of the issue date, but only if the yield on the issue computed by assuming those bonds are redeemed at maturity is more than 1/8 percentage point higher than the yield on the issue computed by assuming those bonds are redeemed at their earliest redemption date; (B) premium bonds when the premium is more than the product of (x) .25%, (y) the stated redemption price of the bonds at maturity and (z) the number of complete years to the first optional redemption date for the bonds; and (C) stepped coupon bonds when the bonds bear interest at increasing interest rates.[113]

Prior to the adoption of the 2016 Final Regulations, the calculation of bond yield on an issue with bonds subject to optional early redemption was complex, because it was often necessary to run multiple scenarios with different redemption dates for different bonds to determine which combination produces the lowest yield on the *issue*. The 2016 Final Regulations changed the Regulations to require that the issuer assume each callable bond would be redeemed on the optional redemption date that would produce the lowest yield *on that bond*.[114]

(iv) *Change in Bond Yield*. Yield on a fixed yield issue is computed under the Regulations as of the issue date (based on reasonable expectations) and is not affected

[111] This rule was written to force valuation of heavily discounted term bonds at the lower, accreted value, not par value, under the theory that, if the bonds are trading on the market at a significant discount, the issuer could simply purchase them at the market price and then cancel them.

[112] Section 1.148-4(b)(3)(i).

[113] Section 1.148-4(b)(3).

[114] Even under the 2016 Final Regulations, certain analysis or testing may be required to determine the lowest yield-to-call date in circumstances in which the bonds are callable at declining premiums.

by subsequent unexpected events, with two exceptions. First, yield must be recomputed for rebate purposes as of any date there is a transfer, waiver, modification or similar transaction of any right that is part of the terms of a bonds or otherwise associated with a bond in a transaction separate and apart from the original sale of a bond (such as sale or waiver of a redemption option). Second, if an issuer issued variable yield bonds and then entered into a qualified hedge that caused the issue to be treated as a fixed yield issue under Section 1.148-4(h)(4) (a "super-integrated hedge"), then it subsequently terminates that hedge within five years of the issue date of the bonds, the bond issue is treated as retired and reissued as a variable yield issue on the termination date.[115] *See also* Section VII.E. below (qualified hedges). The deemed new issue is apparently a new issue for purposes of triggering the final computation date provisions of § 148(f) for the "retired" issue.[116]

C. Computation of Yield on Variable Yield Issues

1. *Introduction.*

A variable yield issue is any issue that is not a fixed yield issue.[117] If interest on any or all of the bonds of an issue is determined by reference to market interest rates, the issue is a variable yield issue. Thus, all of the bonds of a variable yield issue may be variable yield bonds, but in many cases a variable yield issue will include some fixed yield bonds. Yield on a variable yield issue is computed separately for each computation period as of the first date of each computation period. *See* the discussion of rebate computation dates in Section VII.A.2 above.

2. *Computation of Bond Yield (Variable Yield).*

a. *General Rule*.

The yield on a variable yield issue for a computation period is computed as of the first day of the computation period and is the discount rate that, when used in computing the present value of all the payments of principal and interest, fees for qualified guarantees, and payments on a qualified hedge that are attributable to the computation period, produces an amount equal to the present value (using the same discount rate) of the aggregate issue price of all the bonds of the issue for the computation period.[118] For yield computation purposes, the bonds are treated as if retired and reissued at the end of each computation period.

b. *Issue Payments*.

These payments include: (a) principal (including for bonds redeemed during the computation period an amount equal to the greater of the bond value or actual redemption price including any call premium) and interest paid during the computation period; (b) amounts paid or deemed to be paid during the computation period for a qualified guarantee; (c) amounts paid or deemed to be paid during the computation period for a qualified hedge; and (d) for bonds

[115] Section 1.148-4(h)(4)(iii).

[116] Section 1.148-4(b)(4) and (h)(4)(ii).

[117] Section 1.148-1(b).

[118] Section 1.148-4(c).

outstanding at the end of a computation period, an amount equal to the bonds' value on the last day of the computation period.[119] See Section VII.C.2.d. below.

Up-front and other "non-level" payments for a qualified guarantee for variable yield bonds must be allocated to each computation period. The Regulations provide a safe harbor for an allocation of non-level payments if an equal amount is treated as paid as of the first day of each bond year over the term of the qualified guarantee. This amount is sometimes referred to as the "constant payment amount."[120]

c. *Issue Price*.

The issue price for both variable yield bonds and fixed yield bonds in a variable yield issue as of the issue date is based on the general issue price definition discussed at Part II, Section VII.B.2 above. Any bond (including a fixed yield bond) outstanding at the end of a computation period is treated as if it were immediately reissued at the end of the computation period for a deemed issue price equal to the value of the bond used as the issue payment immediately prior to such reissuance.

d. *Determination of the Value of a Bond.*

Section 1.148-4(e) sets forth two methods for valuing outstanding bonds:

(i) *Plain Par Bonds*. Plain par bonds are valued at their outstanding stated principal amount plus accrued unpaid interest. The value of a plain par bond that is actually redeemed or treated as redeemed is its stated redemption price on the redemption date, plus accrued, unpaid interest. A "plain par bond," as defined in Section 1.148-1(b), is a bond (a) with not more than a *de minimis*[121] amount of original issue discount or premium, (b) issued for a price that does not include accrued interest other than pre-issuance accrued interest, (c) that bears a single, stated fixed rate or that is a variable rate debt instrument (under § 1275), (d) that pays interest at least annually, and (e) that has a lowest stated redemption price not less than the outstanding stated principal amount.[122]

(ii) *Other Bonds*. Fixed yield bonds that are not plain par bonds are valued at their present value on a given date calculated using the yield on the bond as the discount rate (or for term bonds subject to mandatory tender, the yield on the term bond to maturity) and their expected remaining payments including fees to be paid for a qualified guarantee in connection with the issue.[123] Variable yield bonds that are not plain par bonds are valued at their present value on a given date calculated using the yield giving effect to the initial interest rate on the bonds and their expected remaining payments under such initial interest rate including fees for a qualified guarantee in connection with the issue.[124]

[119] Section 1.148-4(c)(2).
[120] Section 1.148-(f)(6).
[121] Section 1.141-1(b).
[122] Section 1.148-4(e)(1).
[123] Section 1.148-4(e)(2).
[124] Section 1.148-4(e)(2).

e. *Special Rules.*

As of the first day on which a variable yield issue would qualify as a fixed yield issue if it were newly issued, the variable yield issue is treated as if it were reissued as a fixed yield issue at an issue price equal to the aggregate values of all bonds on the conversion date. If such conversion date occurs on a date other than a computation date, the conversion date may be treated as occurring on the next succeeding computation date.[125]

D. Qualified Guarantees

1. *Elements of Qualified Guarantees.*

Bond yield is computed by taking into account payments made for a qualified guarantee, such as bond insurance or a letter of credit.[126] The Regulations contain a number of requirements regarding what constitutes a qualified guarantee, including the character of the entity that issues a credit enhancement device, the terms of the device and the fees paid for it. The following considerations are discussed below, in the order listed: (a) risk shifting; (b) fees for the credit enhancement; (c) non-guarantee element; (d) purpose investment guarantees; and (e) allocation of guarantee fees.

a. *Risk Shifting.*

The guarantee arrangement must create a guarantee in substance. The guarantee must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments on a bond, such as payments of principal, interest, and redemption or tender prices on the bonds. Thus, the guarantor may not be a co-obligor with respect to the bonds and the guarantor must not expect to make any payments (other than under a direct-pay letter of credit or similar arrangement for which the guarantor will be reimbursed immediately). Commercially reasonable limits on credit risk, limits on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor do not cause the guarantee to be conditional. The guarantor and related parties must not use more than 10% of the proceeds of the guaranteed bonds.[127]

b. *Fees for Credit Enhancement.*

The fees for a guarantee must not exceed a reasonable, arm's-length charge for the transfer of credit risk. In complying with this requirement, the issuer may not rely on representations of the guarantor.[128] The issuer must demonstrate expected savings as of the date the guarantee is obtained, and the issuer must reasonably expect that the present value of fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee.[129] A fee for a guarantee must not include any payment for any direct or indirect services

[125] Section 1.148-4(d).

[126] Section 1.148-4(f).

[127] Section 1.148-4(f)(3).

[128] Section 1.148-4(f)(4)(i).

[129] Present value for this purpose is computed using the yield of the issue (determined with regard to guarantee payments) as the discount rate.

other than the transfer of credit risk, unless the compensation for those other services is separately stated, reasonable, and excluded from the guarantee fee.[130]

c. *Non-guarantee Element.*

A qualified guarantee fee may not include fees for services other than the transfer of credit risk. Those fees, if any, must be separately stated and excluded from the yield computation. See Section 1.148-4(f)(4)(ii) for examples of these non-credit risk fees. Fees for the transfer of credit risk include, however, fees for the guarantor's overhead and other costs relating to the transfer of credit risk.[131]

d. *Purpose Investment Guarantees.*

The guarantee of a purpose investment, except for guarantees of qualified mortgage loans and qualified student loans, may be a qualified guarantee of the issue.[132] Purpose investments are investments including program investments that are acquired to carry out the governmental purpose of an issue.[133] In a typical conduit issue, the loan of the bond proceeds by the issuer to the borrower is the purpose investment, from the perspective of the issuer. All payments on the purpose investment must reasonably coincide with payments on the underlying bonds, and the payments on the purpose investment must be unconditionally payable no more than six months before the corresponding interest payments and twelve months before the corresponding principal payments on the bonds. The guarantee of the purpose investment must be, in substance, a guarantee of the bonds allocable to the purpose investment and to no other bonds.[134]

e. *Allocation of Fees for a Qualified Guarantee.*

The fee payments must be allocated in a manner that properly reflects the credit risk. Examples in the Regulations include allocating risk based on the ratio of total principal and interest paid and to be paid on a guaranteed bond to the total principal and interest paid on all bonds of the guaranteed issue. An allocation is not reasonable if a substantial portion of the fee is allocated to the construction portion of the issue. Reasonable letter of credit set-up fees may be allocated ratably during the initial term of the letter of credit.[135] If, as a result of an investment of proceeds of a refunding issue in a refunding escrow, there will be a reduction in, or refund of, payments for a guarantee, the savings must be treated as a reduction in the payments of the refunding issue.[136]

[130] Section 1.148-4(f)(4)(ii). Payments by a borrower for a credit enhancer's attorneys are qualified guarantee fees because such attorneys' fees are "other costs relating to the transfer of credit risk" within the meaning of Section 1.148-f(4)(ii). PLR 200813022.

[131] Section 1.148-4(f)(4)(ii).

[132] Section 1.148-4(f)(5).

[133] Section 1.148-1(b).

[134] Section 1.148-4(f)(5).

[135] Section 1.148-4(f)(6).

[136] Section 1.148-4(f)(7).

E. Hedging Transactions

1. *Introduction.*

Generally, payments made or received under a "qualified hedge," such as an interest rate swap or forward purchase contract, are taken into account in determining yield on an issue. This rule applies solely for purposes of §§ 143(g), 148, and 149(d). Except to the extent that a special fixed yield treatment rule applies, as described in paragraph 2.c. below, an issue covered by a qualified hedge is treated as a variable yield issue.

2. *Summary of Rules for Hedging Transactions.*

a. *Definition of a Qualified Hedge.*

For a bond issuer to treat a hedge as qualified, it must meet a number of very specific, technical requirements. These are summarized below.

(i) The contract is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond (a hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.[137] If a hedge provider makes a single payment to the issuer (*e.g.*, an acquisition payment for an off-market swap, where the rate the issuer pays is above the market) in connection with the acquisition of a contract, the issuer may treat a portion of that contract as a hedge, if the acquisition payment to the issuer and the issuer's payments under the contract in excess of the on-market rate are separately identified in a certification of the hedge provider and not treated as payments on the hedge.

(ii) The contract does not contain a "significant investment element," which would be the case if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date (*e.g.*, a payment for an off-market swap or prepayment of part or all of one leg of a swap, or an interest rate cap requiring the issuer's premium for the cap to be paid in a single, up-front payment).

(iii) The contract is entered into between the issuer and a hedge provider that is an unrelated party; the contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity, and terms); and the contract is primarily interest based.[138]

(iv) The payments received by the issuer under the contract correspond closely in time to either (A) the specific payments being hedged on the hedged bonds or (B) specific payments required to be made pursuant to the bond documents (regardless of the hedge) to a sinking fund, debt service fund or similar fund maintained for the issue of which the hedged bond is a part.

[137] If the contract modifies the issuer's risk of interest rate changes with respect to a bond that is part of an issue that, absent the contract, would be a fixed rate issue, the contract must generally be entered into no later than 15 days after the issue date (or the deemed issue date) of the issue. Section 1.148-4(h)(2)(i)(B).

[138] *See* Section 1.148-4(h)(2)(v).

(v) The issuer's payments to the hedge provider are reasonably expected to be made from the same source of funds that the issuer would expect to use to pay the hedged bonds.

(vi) The contract must be *identified* by the actual issuer on its books and records maintained for the hedged bonds not later than 15 calendar days after the date on which the issuer and the hedge provider enter into the contract. *See* Section VII.E.3 below. The Regulations are very specific as to what information must be included in the identification. Also, the issuer must indicate on its Form 8038 or 8038-G that it entered into a hedge.

b. *Accounting for a Qualified Hedge.*

Payments made or received by the issuer under a qualified hedge are generally treated as payments made or received on the hedged bonds and are taken into account in determining the yield on those bonds. Payments made or received include payments deemed made or received when a contract is terminated or deemed terminated. Payments reasonably allocable to the modification of risk of interest rate changes and to the hedge provider's overhead are included as payments made or received under a qualified hedge.

A termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer or the acquisition by the issuer of an offsetting hedge. A deemed termination occurs when the hedged bonds are redeemed (but see E.3 below regarding qualified hedge continuation in certain refundings) or when a hedge ceases to be a qualified hedge of the hedged bonds or if a transaction otherwise results in a deemed exchange of the hedge and a realization event under § 1001 to the issuer.

A payment made or received by an issuer to terminate a qualified hedge, including loss or gain realized or deemed realized, is treated as a payment made or received on the hedged bonds, as appropriate. The payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge. Except as provided below, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the fair market value of the qualified hedge on the redemption date is treated as a termination payment made or received on that date.

When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but not below zero, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The remainder of the payment, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess. To the extent that the hedged bonds are redeemed with a refunding issue, the termination payment is accounted for as a payment on the refunding issue, rather than the hedged bonds. To the extent that the refunding issue is redeemed during the period to which the termination payment has been allocated, the payment is treated as a payment on the redeemed refunding issue. Section 1.148-4(h)(3)(iv) provides a safe harbor for allocating a hedge termination payment.

c. *Special "Super-Integration" Rule Resulting in Fixed Yield Treatment for Certain Bonds.*

If the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if the hedge meets certain specific requirements set forth in Section 1.148-4(h)(4). This is often called a "super-integrated hedge." Special rules apply if the hedge is terminated. See Section 1.148-4(h)(iii).

d. *Anticipatory Hedges.*

Sometimes a bond issuer will enter into a hedge contract relating to an issue of bonds that the issuer expects to issue in the future, perhaps many months down the road. For example, an issuer may enter into a hedge in February to effectively lock in current market interest rates for an issue of bonds to be issued the following November. These hedges are commonly known as "anticipatory hedges." Section 1.148-4(h)(5) provides special rules for these hedge transactions, but this topic is beyond the scope of a basic arbitrage discussion.

3. ***Impact of 2016 Final Regulations on Hedges.***

The 2016 Final Regulations revised several rules relating to qualified hedges. The size and scope of a qualified hedge are limited to a level reasonably necessary to hedge the issuer's risk of interest rate changes on the hedged bonds. Hedge payments are treated as corresponding close in time to the payment on the hedged bonds if the payments are made within 90 calendar days of each other. The amount of any termination payment (for a deemed or actual termination of a hedge) is equal to the fair market value of the hedge on the termination date. The time limit for an issuer to identify a hedge increased from 3 days to 15 calendar days. The 2016 Final Regulations also require that, as part of the identification of a qualified hedge, the hedge provider certify that (1) the terms of the hedge were agreed to in a bona fide arm's-length transaction, (2) the rate payable by the issuer under the hedge was comparable to the rate that the hedge provider would have quoted in similar circumstances, (3) no payments to third parties are being made except as provided in the hedge documents, and (4) any amounts paid or received pursuant to the hedge do not include any payments other than payments reasonably allocable to the modification of risk of interest changes and the hedge provider's overhead.

In addition, the 2016 Final Regulations expanded the ability to make yield reduction payments under Section 1.148-5(c) by allowing those payments with respect to nonpurpose investments in an advance refunding escrow, if (1) the issuer has entered into a variable-to-fixed interest rate swap with respect to the variable yield bonds of the issue allocable to the advance refunding escrow, (2) the swap covers a period at least as long as the escrow, and (3) the issuer restricts the yield on the escrow to a yield not greater than the yield on the hedge bond issue, based on the fixed leg of the swap.

The 2016 Final Regulations also removed some complexity related to modifications of a hedge or the continuation of a hedge in the case of a refunding by providing that if the modified hedge or the hedge associated with the refunded bonds continues to be a "qualified hedge," then the "off-market" element of the hedge is disregarded and no deemed termination results. The modified hedge or continuing hedge in a refunding must be identified within the time period

measured from the date of the modification or date of issue of the refunding bonds and without regard to the requirement for a hedge provider's certification.

4. ***Reissuance; Notice 2008-41.***

IRS Notice 2008-41[139] provides that a qualified hedge will not be terminated under Section 1.148-4(h) upon a modification of the terms of the Bonds if (1) as of the date of the modification, the modification is not reasonably expected to change the yield on the affected hedged bonds by more than 0.25%, and (2) the payments and receipts on the qualified hedge, as modified, are fully taken into account as adjustments to the yield on those hedged bonds under § 148. The Notice also provides that, for purposes of § 148, any premium received by an issuer pursuant to a conversion of the interest rate on a qualified tender bond to a fixed interest rate will be treated as additional sale proceeds of the bonds.

VIII. EXCEPTIONS TO REBATE

The exceptions to rebate are presented in the following order:

SPENDING EXCEPTIONS

A. Six-Month Spending Exception

B. Six-Month Spending Exception for Working Capital Financings

C. 18-Month Spending Exception

D. Two-Year Construction Spending Exception

ISSUER/ISSUE EXCEPTIONS

E. $5 / $15 million Small Issuer Exception

OTHER REBATE EXCEPTIONS

F. Investments in Bona Fide Debt Service Funds

G. Investments in Tax-Exempt Obligations

H. Other Miscellaneous Exceptions (including yield restriction)

[139] 2008-15 I.R.B. 742, 745 (April 14, 2008).

SPENDING EXCEPTIONS

A. Six-Month Spending Exception

1. *General.*

If the gross proceeds of a bond issue are fully expended for the governmental purposes of the issue within six months of the issue date of the bonds, the bond issue will be treated as meeting the rebate requirements, as long as any gross proceeds that are not required to be spent, such as proceeds in a 4R Fund (other than earnings on amounts in any bona fide debt service fund), continue to meet the rebate requirement.[140] Use of the six-month exception is not mandatory. Amounts not required to be spent also include gross proceeds arising after six months that were not reasonably expected to arise as of the issue date, payments received on purpose investments and earnings on those payments, and amounts representing repayments of grants.[141] Expected future accumulations in an invested sinking fund other than a bona fide debt service fund or 4R Fund might prevent the use of a spending exception. The governmental purposes of the issue may include payment of interest, but not principal, on the issue. Section 148(f)(4)(B)(iv) and Section 1.148-7(b)(3). The *de minimis* rule contained in Section 1.148-7(b)(4) does not apply under the six-month exception.

2. *Additional Six Months.*

For governmental-purpose issues and qualified 501(c)(3) bonds, the six-month spending period is extended for an additional six months for an amount not exceeding 5% of the proceeds of the issue.[142]

3. *Refunding Issues.*

The only spending exception for which a refunding issue is eligible is the 6-month exception. A refunding issue meets the six-month exception only if all proceeds of the issue (other than transferred proceeds of the issue and proceeds not required to be spent, such as proceeds in a 4R Fund) are spent within six months of the issue date of the refunding issue. Proceeds of a prior tax-exempt issue that become transferred proceeds of the refunding issue continue to be treated as unexpended gross proceeds of the prior issue for purposes of the spending exceptions. Even if the refunding issue meets the six-month exception, transferred proceeds will be subject to rebate unless the prior issue meets its own spending exception. *See* Section 1.148-7(b)(1)(ii). Refunding and non-refunding portions of a multipurpose issue are analyzed separately. Most current refunding issues will meet this exception.

4. *Pooled Financings.*

For pooled financings, the general rule is that the six-month spending period begins on the issue date of the pool bonds (not on the date of the loan to the borrower), and the gross proceeds are not expended until the gross proceeds are spent for their ultimate purposes (rather than on the

[140] Sections 1.148-7(b), 1.148-7(c)(1), and 1.148-7(a)(3).
[141] Section 1.148-7(c)(3). A grant is defined in Section 1.148-6(d)(4).
[142] Section 148(f)(4)(B)(ii)(I). Also, the additional six-month exception cannot be used for TRANs.

making of a loan). But Section 1.148-7(b)(6) permits the pooled bond issuer to elect (on or before the issue date) to apply the spending requirements separately to each loan to a conduit borrower, as discussed below under the two-year construction spending exception. If the election is made and proceeds are lent to the ultimate borrower, the six-month spending period will begin for that loan on the earlier of (A) the date the loan is made or (B) the date 12 months from the issue date of the pooled bonds.

B. Six-Month Spending Exception for Working Capital Financings

1. *Only Spending Exception Applicable.*

The only spending exception available to a bond issue, a substantial portion of the proceeds of which will be used for non-capital expenditures, is the 6-month exception. This does not apply to working capital expenditures that are part of a capital project under a *de minimis* rule.

2. *Spending on Restricted Working Capital is on a Proceeds Spent Last Basis.*

Proceeds of a tax-exempt bond issue in general may only be treated as spent for non-capital purposes if at the time of the expenditure there are no other available funds from which the expenditure can be made. This rule does not apply to certain cases including extraordinary non-recurring expenditures and *de minimis* amounts that are treated as part of a capital project. If an exception does not apply, then the 6-month rebate spending exception is in general tested based on the restricted expenditure rule. The restricted expenditure rule means that expenditures occur only and to the extent of cash flow deficits on the day of the expenditure. Thus, to meet the 6-month expenditure rule, the issuer must experience a cumulative cash flow deficit in excess of the amount of proceeds of the issue as of a date no later than 6-months after the date of issue. In general, this will be satisfied if the balance of all available funds including the proceeds of the issue and the reasonable reserve is no greater than the applicable reasonable reserve amount. Also note that the issuer must not expect to have "other replacement proceeds" as a result of the bonds being outstanding longer than necessary without appropriate remediation.

3. *Tax and Revenue Anticipation Notes.*

One common type of tax-exempt restricted working capital bond issue is the tax or revenue anticipation note, often abbreviated TRAN, TAN or RAN. This term is used in the Code and there are special rules related to the 6-month exception for TRANs. Unfortunately, the term TRAN is not defined in the Code or in any regulations or other IRS authority. It is commonly understood to refer to a short-term instrument, generally no longer than 13 months (or perhaps in some situations, 2 years). A long-term bond issued for working capital purposes is generally not treated as a TRAN.

TRANs are not eligible for the extra 6-months allowed under the exception for the expenditure of the last 5% of an issue of governmental bonds. Also, there is a special statutory safe harbor for determining that an issue of TRANs meets the 6-month exception.

4. ***The Statutory Safe Harbor.***

For the purpose of applying the six-month spending exception to rebate to TRANs (but not long-term working capital financings), § 148(f)(4)(B)(iii) carves out a special safe harbor in which TRANs will be treated as meeting the six-month spending exception to rebate. If, as of the date six months after the issue date of the TRANs, the cumulative cash flow deficit of the issuer computed without regard to the reasonable working capital reserve exceeds 90% of the proceeds of the issue, all the net proceeds of the issue (proceeds less amounts deposited in a 4R Fund for the issue), plus investment earnings thereon, will be treated as spent for the governmental purposes of the issue in satisfaction of the six-month spending exception. The statutory safe harbor provides an alternative method of satisfying the six-month exception. The legislative history of the 1986 Tax Act makes it clear that the statutory safe harbor is optional, not mandatory.[143] An issuer would generally apply the statutory safe harbor if its reasonable working capital reserve was less than 10% of the amount borrowed.

5. ***Cumulative Cash Flow Deficit Definition.***

"Cumulative cash flow deficit" for this purpose means the excess of actual expenses paid during the period that would ordinarily be paid out of or financed by anticipated tax or other revenues, over the aggregate "amount available" (other than from the proceeds of the issue[144] but not excluding a reasonable working capital reserve) during such period for the payment of such expenses. Section 148(f)(4)(B)(iii)(II).[145] The defined deficit must actually occur within the six-month period. If the actual deficit is less than 90% of the proceeds of the issue for the full six months, the issue will not qualify for the statutory safe harbor. In such a case, the reasonable working capital reserve must be used to compute rebate or an exception to rebate.

6. ***Amount Available.***

The amount available to an issuer for this purpose includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type financed without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed, and, except as otherwise provided, available amount excludes proceeds of any issue. Section 1.148-6(d)(3)(iii)(A). For the purpose of the TRANs safe harbor, an otherwise permitted "reasonable working capital reserve" is specifically treated as part of the available amount. Section 1.148-6(d)(3)(iii)(D).

[143] This legislative history is found in a colloquy between senators Moynahan and Packwood (Congressional Record, Senate September 27, 1986 at 13960 and a soliloquy of Congressman Rostenkowski, Congressional Record, Extension of Remarks (October 2, 1986) at E. 3391.

[144] Although the statutory safe harbor references available amount as excluding proceeds of the issue, Section 1.148-6(d)(3)(iii)(D) provides that the definition of available amount under Section 1.148-6(d)(3)(iii)(A) applies, and generally excluded from available amount is proceeds of any issue.

[145] To distinguish this definition of deficit from the one used for other working capital expenditure purposes (taking into account a reasonable working capital reserve), this is often referred to as the "Safe Harbor Cumulative Cash Flow Deficit."

7. ***Allocation of Proceeds to Expenditures.***

Section 1.148-6(d)(3) provides that gross proceeds of an issue and available amounts may be allocated to working capital expenditures only under a "gross-proceeds-spent-last" method. Thus, gross proceeds are treated as spent for working capital expenditures only to the extent the expenditures exceed the available amounts as of that date.[146] If the safe harbor is not met, the available amounts for this purpose excludes the reasonable working capital reserve as defined in Section 1.148-6(d)(3)(iii)(B).

8. ***$5,000,000 Small Issuer Exception.***

TRANs are eligible for the small issuer exception to rebate discussed below.[147] Thus, small issuer TRANs may be sized for the deficit plus a reasonable working capital reserve, not to exceed 5% of the prior fiscal year's working capital expenditures. *See* Section 1.148-6(d)(iii).

9. ***Application of Traditional Six-Month Spending Exception.***

Section 1.148-6(d)(3) provides issuers of working capital financings with an alternative to the TRANs statutory safe harbor, which may be of particular interest for TRANs issuers that do not experience the requisite 90% deficit. Under Section 1.148-6(d)(3), bond proceeds may be spent for working capital purposes on a "proceeds-spent-last" basis, determined with respect to "available amount" (as described above). Under this rule, "available amounts" do not include a reasonable working capital reserve as defined in Section 1.148-6(d)(3)(iii)(B). *See* PLR 200446006.

An issuer will generally use this traditional version of the six-month spending exception if the total amount of the TRAN issue is less than 50% of prior fiscal year expenditures (whether capital or working capital expenditures) that are paid out of current revenues.

A reasonable working capital reserve may not exceed an amount equal to 5% of the issuer's actual working capital expenditures in the previous fiscal year.[148] In other words, unlike the TRANs safe harbor, in which the deficit must be measured assuming all available amounts are spent first, the six-month spending exception would allow an issuer to treat its bond proceeds as spent on working capital on a "proceeds-spent-last" basis while retaining a reasonable working capital reserve. Section 1.148-6(d)(3)(ii) sets out exceptions from the "proceeds-spent-last" rule in Section 1.148-6(d)(3)(i) for certain *de minimis* expenditures and for extraordinary, nonrecurring expenditures (*e.g.*, casualty losses).

[146] *See* PLR 8740027 (delinquent TRANs).

[147] By definition, TRAN proceeds are not used for public school construction and hence TRANs are not eligible for the $15,000,000 limit.

[148] *See* TAM 200413012 for additional guidance on how this 5% limit may be computed.

C. 18-Month Spending Exception

1. ***General Requirements.***

Under Section 1.148-7(d), the 18-month exception borrows elements of both the two-year construction spending exception discussed in Section VIII.D below and the six-month spending exception in VIII.B above. An issue will be treated as meeting the rebate requirement if the following requirements are met:

a. *Spending Schedule.*

The gross proceeds (including investment earnings) of the issue must be spent for the governmental purposes of the issue at least as fast as the following schedule: (i) 15% within six months of the issue date; (ii) 60% within one year of the issue date; and (iii) 100% within 18 months of the issue date. Section 1.148-7(d)(1)(i). For purposes of this exception, Section 1.148-7(d)(3)(i) provides that gross proceeds do not include amounts in a bona fide debt service fund, a 4R Fund, amounts that are not expected to be gross proceeds but arise after the end of the 18-month spending period, payments received under any purpose investment of the issue, and repayments of grants (the "gross proceeds exclusions"), and those amounts do not have to be spent within the 18-month spending period. For purposes of the six-month and twelve-month targets, the reasonably expected earnings as of the date of issue for the entire expenditure period must be included. This means that an issuer should certify as to its expected investment earnings in a document executed at the time of issuance. For purposes of the 100% requirement in 18 months, actual earnings are used, whether they are more or less than originally expected.

b. *Certain Proceeds Exempt; Temporary Period.*

The gross proceeds of the issue that need not be spent within the 18-month spending period, such as proceeds in a 4R Fund (other than earnings on a bona fide debt service fund), must comply with the rebate requirement. Section 1.148-7(d)(ii). All of the gross proceeds of the issue, other than the gross proceeds exclusions, must qualify for the initial three-year or five-year temporary period provided under Section 1.148-2(e)(2) for capital project financings to qualify for the 18-month exception. Section 1.148-7(d)(1)(iii).

2. ***Other Rules.***

The 18-month exception extends the 18-month spending period to 30 months for amounts that qualify as a "reasonable retainage," with the same meaning as provided for the two-year construction spending exception (Section VIII.D below). Section 1.148-7(d)(3). For purposes of determining compliance with the six-month and 12-month spending periods, the amount of investment earnings included is based on the issuer's reasonable expectations as of the issue date. Section 1.148-7(d)(4). The 18-month exception is not applicable to any portion of an issue if another portion of that issue is treated as meeting the rebate requirement under the two-year construction spending exception. Section 1.148-7(d)(4).

3. ***De minimis Rule.***

The 18-month exception has the same *de minimis* rule that applies to the two-year construction spending exception. Under the *de minimis* rule, the failure to spend an amount that does not exceed the lesser of 3% of the issue and $250,000 will not exclude an issue from qualifying for the 18-month exception, as long as the issuer continues to exercise due diligence to complete the project financed. Section 1.148-7(b)(4).

D. Two-Year Construction Spending Exception

1. ***General.***

Section 148(f)(4)(c) provides an exception to the arbitrage rebate rules for the "available construction proceeds" ("ACP") of "construction issues," if the proceeds are expended pursuant to a prescribed maximum time schedule, generally within a two-year period (the "two-year rule"). To qualify for the two-year rule, the bonds must be (A) governmental bonds, (B) qualified 501(c)(3) bonds, or (C) private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization. Section 1.148-7(f)(3)(i).[149] Obligations issued by "on-behalf-of" issuers can qualify as construction issues, with the issuer being treated as a governmental unit. Section 1.148-7(f)(3)(i).

If the expenditure schedule described below is met, the ACP are not subject to arbitrage rebate. Section 148(f)(4)(C)(i); Section 1.148-7(e). The two-year rule applies only to ACP; gross proceeds that are not ACP are, therefore, subject to rebate, unless another exception from rebate is applicable to them. Section 148(f)(4)(C)(xvii). If the construction issue qualifies for the six-month exception, then the two-year rule need not be used. Section 1.148-7(a)(2). Finally, even though the issue may qualify for this rebate exception, an issuer is not required to apply the exception, and may instead apply the arbitrage rebate requirement of § 148(f)(2), except where the issuer has elected to pay the penalty in lieu of rebate, as described below. *See* Section 1.148-7(a)(3).

2. ***Construction Issue.***

A "construction issue" is an issue that is not a refunding issue and with respect to which at least 75% of the ACP are to be used to finance construction expenditures. Section 148(f)(4)(C)(iv).[150] The Regulations provide, however, that for purposes of the two-year rule, the issuer may elect, on or before the issue date, to apply all of the provisions based on actual facts. Section 1.148-7(f)(2).

[149] The safe harbors provided by § 142(b)(1)(b), as augmented by § 146(h)(2) in the case of solid waste disposal facilities, may be applied to determine the ownership of bond-financed property. Section 148(f)(4)(C)(iv); Section 1.148-7(f)(3)(ii).

[150] Section 1.148-7(f)(1)(i) clarify the "to be used" language of the Code by providing that an issue will be a construction issue if, as of the issue date, the issuer reasonably expects that at least 75% of the ACP will be allocated to construction expenditures.

3. ***Construction Expenditures.***

The statute does not contain a definition of "construction" other than to provide that it includes reconstruction and rehabilitation. Section 148(f)(4)(C)(iv). The Regulations, however, define "construction expenditures" as capital expenditures[151] that are allocable to the cost of:

a. real property (other than expenditures to acquire any interest in land or other existing real property); *see* Section 1.148-7(g)(2) (turnkey contract);

b. constructed personal property (generally, tangible personal property built to an issuer's specifications, with several detailed requirements; *see* Section 1.148-7(g)(3)); or

c. specially developed computer software that is functionally related and subordinate to real property or constructed personal property; s*ee* Sections 1.148-7(g)(4) and 1.148-7(e)(3) (definitions of real property and tangible personal property).

4. ***Apportioning of Multipurpose Issues.***

The Regulations include detailed rules under which an issuer may divide a multipurpose issue into a refunding issue and a nonrefunding issue and may further divide the non-refunding portion of a multipurpose issue into two issues: a construction issue and a non-construction issue, in order for one of the issues to qualify for the two-year rule and, potentially, the other for another exception to rebate. Section 148(f)(4)(C); Section 1.148-7(j). If such a bifurcation election is made, the non-construction portion must not include any expected construction expenditures and the construction portion must be at least 75% for construction.

5. ***Available Construction Proceeds.***

ACP is defined as the sum of: (i) an amount equal to the issue price of the construction issue; (ii) earnings on amounts invested in a 4R Fund funded from other than bond proceeds; and (iii) earnings on (i) and (ii); minus (iv) the amount of the issue price on deposit in a 4R Fund; minus (v) the costs of issuance financed by the bond issue;[152] and (vi) minus earnings on amounts in a 4R Fund after the earlier of the close of the two-year period or the date construction is substantially completed. Section 148(f)(4)(C)(vi); Section 1.148-7(i)(1).[153] Earnings include earnings on any investment in tax-exempt bonds. Section 1.148-7(i)(1). Pre-issuance accrued interest and earnings thereon may be disregarded. *Id.* Amounts that are not gross proceeds because of application of the "universal cap" rules of Section 1.148-6(b)(2) are not ACP. *Id.*

6. ***Treatment of 4R Fund Earnings.***

Under the two-year rule, absent an election to the contrary by the issuer, investment earnings on amounts in a 4R Fund generally are not subject to rebate until the earlier of two years after the issue date and the date that construction is substantially complete, because those amounts

[151] *See* Part I, Section V.A above for the definition of capital expenditures.

[152] *See* Section 1.150-1(b) for the applicable definition of "issuance costs."

[153] ACP do not include amounts received as payments on purpose investments, earnings on those amounts, or repayments of grants financed by the issue. Section 148(f)(4)(C)(vi); Section 1.148-7(i).

are part of ACP. Instead, they are subject to the same spending schedule as other ACP of the issue. But after the earlier of the date construction is substantially completed or the end of the two-year period, those earnings become subject to rebate because they are no longer part of ACP. Section 148(f)(4)(C)(vi)(II) and Section 1.148-7(h)(2).

The issuer may also elect to rebate any arbitrage on amounts in a 4R Fund from the issue date. Section 148(f)(4)(C)(vi)(IV) and Section 1.148-7(h)(2). For example, this election may be desirable when the 4R Fund is net funded, so that earnings on the 4R Fund are to be retained in the fund (rather than expended for the governmental purpose of the issue) until the 4R Fund reaches its proper size. For purposes of determining compliance with the spending requirements for each of the first three spending periods, ACP includes future earnings that the issuer reasonably expects as of the issue date for the entire two-year period. Section 1.148-7(h)(3).

7. ***Spending Requirements.***

To utilize the two-year rule fully, ACP must be spent for the governmental purposes of the issue at least as fast as the following schedule: (i) 10% within the six-month period beginning on the date the bonds are issued; (ii) 45% within the one-year period beginning on the date the bonds are issued; (iii) 75% within the 18-month period beginning on the date the bonds are issued; and (iv) 100% within the two-year period beginning on the date the bonds are issued.

The 100% test at the end of the second year will be deemed met if no more than 5% of ACP is kept as a reasonable retainage, as defined below, and those proceeds are spent within the three-year period beginning on the issue date. Section 148(f)(4)(C)(ii) and Section 1.148-7(e)(2). The Regulations define "reasonable retainage" as amounts withheld for reasonable business purposes, such as to ensure or promote compliance with the terms of one or more construction contracts (*e.g.*, "punch list" items), where amounts are not yet payable, or in which the issuer determines that an actual dispute exists regarding either completion of construction or payment. Section 1.148-7(h). In addition to the exception for reasonable retainage, the Regulations contain a *de minimis* rule for failures to meet the final (24 month) spending target. Under this rule, which may be used in conjunction with the 5% "reasonable retainage," a failure to spend an amount that does not exceed the lesser of 3% of the issue price or $250,000 is disregarded if the issuer exercises due diligence to complete the project. Section 1.148-7(b)(4).

8. ***Special Rules for Refunding Bonds and Refunded Bonds.***

For purposes of the spending exceptions to rebate only, including the two-year rule (and including the penalty in lieu of rebate), the proceeds of the refunded issue never become transferred proceeds of the refunding issue, but rather retain their original characterization and temporary period (the latter for purposes of spend-down and election timing but not, in the case of advance refundings, for purposes of yield restriction). Any failure to pay a required penalty (discussed below) that results in loss of tax exemption relates both to the original bonds (to the extent within the statute of limitations) and to all refunding bonds. Section 148(f)(4)(C)(x). Transferred proceeds with respect to which either the 1.5% penalty or the 3 percent penalty has been paid are also not subject to rebate. Section 148(f)(4)(C)(xiii)(III).

9. ***Penalty In Lieu of Rebate.***

a. *In General.*

If the issuer fails to meet the spending rules specified above, absent an election to the contrary, the issuer will be obligated to pay rebate in accordance with the general rules of § 148(f)(2). Section 148(f)(4)(C)(i). The issuer is permitted, however, to elect to pay a penalty in lieu of rebate. Section 148(f)(4)(C)(vii); Section 1.148-7(k). The election to pay this 1.5% per 6 months penalty must be made by the issue date of the bonds and continues to apply unless terminated, all ACP are spent, or the final maturity of the issuer and any refunding issues is reached. Sections 148(f)(4)(C)(ix) and 148(f)(4)(C)(viii); Section 1.148-7(k)(1).

b. *Amount of Penalty.*

Section 148(f)(4)(C)(vii) and the Regulations provide that the penalty equals 1.5% of the amount of missed or under-spent expenditures for each six months during the two-year period. For example, if bonds with ACP (aside from investment proceeds) of $10 million are issued, investment proceeds at the end of the first six months are $300,000, and investment proceeds for the remainder of the construction period are expected to be $900,000 (for a total of $11,200,000), 10% or ACP in the amount of $1,120,000 is required to be spent by the close of the first six-month period. If only $800,000 is spent by the end of the first six-month period, the penalty would be $4,800 (($1,120,000 – $800,000) x 1.5%). Any penalty must be paid to the IRS within the 90 days following the six-month period for which the penalty applies. Section 148(f)(4)(C)(xvi).

Depending on interest rates and the amounts of unspent proceeds, the 1.5% penalty may be significantly more or less than any rebate that would be owed. Unless the running of the 1.5% penalty is tolled by payment of the 3 percent penalty described below, the penalty ceases to apply only after the bonds (including any refunding bonds) have been retired. Although the payment of interest is a governmental purpose constituting an expenditure for purposes of the two-year rule, the redemption or purchase of bonds is not, either for purposes of the expenditure rules or for purposes of the calculation of requisite penalties. Section 148(f)(4)(C)(xii); Section 1.148-7(b)(3). In PLR 9526002, the IRS ruled in technical advice that the 1.5% penalty cannot be reduced even if construction delays are encountered that are caused by natural disasters outside of the control of the issuer, and the penalty continues to accrue until the issuer elects to terminate the penalty as described below.

c. *Tolling the Penalty.*

The issuer may elect to toll the running of the 1.5% penalty by paying a separate three-percent penalty on unspent ACP. Section 148(f)(4)(C)(viii); Section 1.148-7(k)(1). The issuer must elect to pay the 3 percent penalty not later than 90 days after the earlier of (i) expiration of the initial temporary period applicable to the bonds or (ii) substantial completion of all or a portion of the construction to be financed with the bonds. Sections 148(f)(4)(C)(viii)(I) and 148(f)(4)(C)(ix); Section 1.148-7(l)(1).

d. *Payment of Penalties.*

The 1.5% and 3% penalties are the exclusive alternatives to the payment of rebate automatically available to the issuer. Each penalty payment is subject to the rules relating to payment of rebate under Section 1.148-3(g). Failure to rebate or pay such penalties is subject to the rules of Sections 1.148-3(h)(1), (2), and (3).[154]

10. ***Application to Pooled Bonds.***

The ACP of pooled bonds that are construction issues automatically qualifies for the two-year rule. To facilitate the use of the two-year rule for the ACP of pooled bonds, § 148(c)(2) was amended by the 1989 Act to provide that, if pooled bonds are issued and part of the issue is used to make or finance loans for construction expenditures, that portion of the bonds is entitled to a two-year temporary period, in the hands of the pooled issuer, rather than six months as provided under prior law. Section 148(c)(2)(C).

The Regulations provide that an issuer can elect, on or before the issue date, to apply the spending exceptions separately to each conduit loan. If this election is made, then (1) the spending requirements for a loan begin on the earlier of the date the loan is made or the first day following the one-year period beginning on the issue date of the pooled financing issue, and (2) the rebate requirement (and none of the spending exceptions) applies to the gross proceeds of the issue before the date on which the spending requirements begin. Section 1.148-7(b)(6)(ii). If an issuer makes this election, it may make all elections under the two-year rule separately for each loan, Section 1.148-7(b)(6)(ii)(C), and may pay rebate with regard to some conduit loans and the 1.5% penalty for other conduit loans from the same pooled financing issue. The 1.5% penalty is computed separately for each conduit loan. Section 1.148-7(b)(6)(ii)(B).

As is the case with other construction issues, if a borrower in the pool fails to meet the expenditure requirements, the issuer must pay rebate in accordance with the general rules of Code § 148(f)(2), unless it has elected to pay the 1.5% penalty in lieu of rebate. This election must be made on or before the date the pooled bonds are issued and is irrevocable. A pooled issuer, however, may elect to terminate the 1.5% penalty for a loan rather than for the entire issue.

ISSUER / ISSUE EXCEPTIONS

E. Small Issuer Exception

1. ***General.***

Section 148(f)(4)(d) provides that no rebate is required with respect to bonds issued to finance governmental activities of certain small issuers (the "Small Issuer Exception"). The only

[154] *See* Sections 1.148-7(m) and 1.148-3(h)(4). In addition, § 148(f)(4)(C)(x) and the Regulations provide that failure to pay all or a portion of a penalty (not due to willful neglect) may be cured, with the consent of the Secretary of the Treasury, by payment of the deficiency, plus 50% of the deficiency, plus interest on the deficiency from the due date to the payment date at the § 6621 underpayment rate. This provision is analogous to § 148(f)(7), which pertains to failure to make required rebate payments. *See also* PLR 9405018 (safe harbor for late payments of rebate for an innocent failure to pay rebate applies to a failure to pay the in lieu of rebate penalty).

regulatory guidance on this rebate exception is contained in Section 1.148-8. To be eligible for the small issuer exception, the following requirements must be met:

a. *General Taxing Power.*

The bonds must be issued by a governmental unit with general taxing powers, interpreted under Section 1.148-8(b) as the power to impose taxes of general applicability that, when collected, may be used for general purposes of the issuer. The taxing power may be limited to a specific tax, provided that its applicability is not limited to a small number of persons. The taxing power may be subject to procedural limits, such as voter approval requirements, but may not be contingent on approval by another governmental unit. An entity, such as a school district, that can cause a tax to be collected on its behalf, should generally be treated as qualifying even if the amounts and types of taxes are somewhat limited by State law.

b. *No Private Activity Bonds; Use for Local Activities.*

No private activity bonds qualify under this exception. Section 148(f)(4)(D)(i)(II). In addition, at least 95% of the net proceeds of the bond issue are "to be used" for the local governmental activities of the issuer or a governmental unit entirely within the jurisdiction of the issuer. Section 148(f)(4)(D)(i)(III). This test is a reasonable expectations test with respect to the use of proceeds. It appears that a governmental unit contained within the jurisdiction of a larger unit may have difficulty in lending the proceeds to the larger unit and still qualifying as having met this jurisdictional test.

c. *$5,000,000 / $15,000,000 Limit.*

Under the small-issuer exception, an issuer is a qualified small issuer if the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by the small issuer and all subordinate entities of the issuer during the calendar year of the issue is not reasonably expected to exceed $5,000,000. Section 148(f)(4)(D)(i)(IV). The $5,000,000 has since been increased to up to $15,000,000 in the case of bonds financing the construction of public school facilities. *See* Section VIII.E.1.d below. Current refunding bonds are excluded from this limitation as described below.

(i) For these purposes, the aggregation rule in § 148(f)(4)(D)(ii) and Section 1.148-8(c) treats an issuer and all subordinate entities, and an issuer and all entities that issue on behalf of the issuer, as one issuer. Referred to as an "upward attribution" or aggregation rule, this rule requires a review of the relationships an issuer has with other entities. An issuer is subordinate to another governmental unit if it is directly or indirectly controlled by another entity within the meaning of Section 1.150-1(e).[155] Mere geographic inclusion of one entity within another does not create subordination if the smaller entity derives its powers independently from the larger entity and is not subject to significant control by the larger entity. On-behalf-of entities are presumably defined by the concepts contained in Rev. Rul. 57-187, 1957 1 C.B. 65 (Alabama industrial development board); Rev. Rul. 63-20, 1963 1 C.B. 24; Rev. Proc. 82-26, 1982 1 C.B. 476, *etc*. For application of these concepts, *see* PLR 8821008 (February 22, 1988).

[155] Section 1.148-8(c)(2)(ii). *See* Section 1.150-1(e) for control factors.

(ii) Section 148(f)(4)(D)(ii)(III) and Section 1.148-8(c)(2)(iii) require downward attribution when a smaller entity is formed, or availed of, to avoid aggregation. But the aggregation rule of § 148(f)(4)(D)(ii) and Section 1.148-8(c)(2)(ii)(B) permit certain allocations and activities, as follows:

(a) An issuer with general taxing powers may allocate irrevocably its $5,000,000 cap to a subordinate entity (including an on-behalf-of issuer); the allocation must bear a reasonable relationship to the benefit to the subordinate entity from the bond issue, taking into account the manner in which (1) proceeds are to be distributed; (2) debt service is to be paid; (3) the facility is to be owned; (4) the use or output of the facility is to be shared; and (5) the costs of operation and maintenance are to be shared; and

(b) An issuer with general taxing powers may issue bonds to make loans to other entities with general taxing powers that are not subordinate to the issuer without using any of the issuer's $5,000,000 cap (although it should use the borrower's cap).

d. *Bigger "Small Issue" Bonds for School Construction.*

The Taxpayer Relief Act of 1997 (the "1997 Act") increased the $5,000,000 limit by the lesser of $5,000,000 or "so much of the aggregate face amount of the bonds as are attributable to financing the construction . . . of public school facilities" for bonds issued after 1997.[156] The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act")[157] replaced the "$5,000,000 school" amount with $10,000,000, effectively expanding the small issue rebate exception to $15 million (for public school construction issues). Section 148(f)(4)(D)(vii). The amendments made by the 2001 Act applied to bonds issued after December 31, 2001, but did "not apply to taxable, plan or limit years beginning after December 31, 2010."[158] The amendments made by the 2001 Act were extended through the end of 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[159] and were finally made permanent by the American Taxpayer Relief Act of 2012.[160]

2. ***Refundings.***

Current refunding bonds are not taken into account in determining whether the issuer is a qualified small issuer for the calendar year, but only to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. Section 148(f)(4)(D)(iii). Advance refunding bonds are fully included in calculating the $5,000,000 limit.[161] A refunding issue itself is not eligible for the small issuer exception unless the aggregate face amount does not exceed $5,000,000, the refunded bonds had qualified for the small issuer exception, the average maturity date of the refunding bonds is not later than the average maturity of the refunded bonds,

[156] Section 148(f)(4)(D)(vii), added by section 223(a) of the 1997 Act.

[157] Pub. L. 107-16, section 421(a).

[158] Section 901 of the 2001 Act.

[159] Pub. L. 111-312, section 101.

[160] Pub. L. 112-240, section 101.

[161] Only bond issues subject to the rebate requirement (such as tax-exempt issues or direct pay or tax credit bond issues) are included. Advance refunding bonds can no longer be tax advantaged, and therefore this inclusion of advance refunding bonds is no longer applicable.

and the maturity date of the refunding bond is not later than 30 years after original bond was issued. Section 148(f)(4)(D)(v). For refunding issues without reserve funds and without transferred proceeds and with a bona fide debt service fund, the limitations may be irrelevant because a current refunding generally will qualify for the 6-month exception to rebate.

3. ***Pooled Bonds.***

Under Section 1.148-8(d), in the context of a pooled financing in which the borrower otherwise meets the small issuer exception, the small issuer exception will be available to the proceeds of the pooled issue in the hands of the small issuer borrower. The pooled financing may mix large and small issuers and treat each borrowing separately for purposes of available rebate exceptions. A loan to a conduit borrower qualifies for the small issuer exception, however, only if the bonds of the pooled financing are not private activity bonds, none of the loans to conduit borrowers are private activity bonds, and the loan to the conduit borrower meets all the requirements of the Small Issuer Exception. The issuer of the pooled financing issue is, however, subject to the rebate requirement for any unlent gross proceeds.

4. ***TRANs.***

TRANs are eligible for this exception. *See* PLR 8740027 (July 7, 1987).

OTHER REBATE EXCEPTIONS

F. Bona Fide Debt Service Fund Exception

Amounts earned on a bona fide debt service fund are not taken into account in computing rebate if the gross earnings on the fund for a bond year are less than $100,000. For governmental bonds with an average maturity of at least five years and fixed interest rates during the term of the issue, the $100,000 limit is ignored, and all gross earnings on the fund are exempt from rebate.[162] In addition, an issue is treated as satisfying the $100,000 earnings limit if the average annual debt service does not exceed $2,500,000.[163] Private activity bonds (including qualified 501(c)(3) bonds) must observe the $100,000 earnings limit.

All bona fide debt service funds for a single bond issue are treated as a single fund. Conversely, a single fund serving two or more bond issues is treated as a series of separate funds. Section 1.148-6(e)(6) requires such a fund to be allocated ratably among the issuers in accordance with one of the following methods: (1) the relative values (determined in accordance with Section 1.148-4(e)) of the issues; (2) the remaining maximum annual debt service requirements of the issues; or (c) the original stated principal amounts of the issues.

G. Exception for Tax-Exempt Investments

Because the rebate requirement applies only to earnings on "nonpurpose investments," earnings on investments that are <u>not</u> nonpurpose investments are free from the rebate requirement. Section 148(f)(6) defines the term "nonpurpose investment" as any investment property that is

[162] Section 148(f)(4)(A)(ii).

[163] Section 1.148-3(k).

acquired with gross proceeds of an issue and that is not acquired to carry out the governmental purposes of the bond issue. Section 148(b)(3) excludes any "eligible tax-exempt bond" (including an interest in a regulated investment company to the extent that at least 95% of the income to the holder of the investment is interest that is excludable from gross income under § 103(a)(i) and Demand Deposit SLGS)[164] from the definition of "investment property," and thus from the definition of "nonpurpose investment."[165] But under § 148(b)(3)(b), "investment property" does include "specified private activity bonds" as defined in § 57(a)(5)(C) (any private activity bond other than a qualified 501(c)(3) bond, commonly referred to as an "AMT bond").

An interest in a regulated investment company (mutual fund) is treated as a tax-exempt investment if at least 95% of the income to the holder thereof is tax-exempt interest.[166] This test for mutual funds is quite restrictive because even if 100% of the assets of the mutual fund are non-AMT tax-exempt bonds, more than 5% of the income to the holder may be taxable capital gain.

H. Exception for Purpose Investments

The definition of "proceeds" under Section 1.148-1(b) states that an issuer's receipts from purpose investments under any of the permitted spreads found in Section 1.148-2(d) or for the recoupment of qualified administrative costs are not "proceeds" and, thus, are not subject to rebate. *See also*, PLR 8933045 (July 9, 1989). In a similar fashion, under Section 1.148-5(e)(3), administrative costs of purpose investments decrease the receipts from those investments. These amounts thus would also not be subject to rebate.

IX. RECOVERIES OF REBATE OVERPAYMENT

Under Section 1.148-3(i), issuers are entitled to recover any overpayment of rebate, defined as the excess of (1) the amount paid to the United States under § 148 over (2) the sum of the rebate amounts and yield reduction payments required to be paid on the date the recovery is requested. For recoveries of less than $5,000, recovery must wait until the after the final rebate computation date for the issue. To request a recovery, an issuer must file Form 8038-R with the IRS. An issuer is required to seek a recovery of rebate overpayment within two years of the final computation date (date issue is paid in full) for the issue to which the overpayment relates.

An example in the 2016 Final Regulations makes it clear that the "amount paid" means just the amount paid at that time, and not the future value of that payment on the computation date. *See* Example 2 in Section 1.148-3(j).

The IRS has concluded that an arbitrage rebate overpayment is a "sum" within the meaning of § 7422(a), which requires that administrative remedies be exhausted before a suit for recovery of a tax or penalty can be brought in court. *See* TAM 200750018. The IRS has not yet decided

[164] Section 1.148-1(c)(4)(ii)(E).

[165] Perhaps confusingly, the regulatory definition of "investment" includes tax-exempt bonds. Thus, a tax-exempt bond may be an investment but not a purpose investment and not a non-purpose investment.

[166] *Id.*

whether the future valuing of a rebate payment for purposes of computing a rebate overpayment constitutes the payment of statutory interest for purposes of the Code. *See* PLR 200512019.

X. EXCLUSION FROM INCOME

Under §148(f)(5), gross income does not include the amount to be rebated. Amounts paid as rebate are not deductible. This provision has no effect with respect to most governmental or 501(c)(3) bond issues. In the case of private activity bond issues, the investments of gross proceeds giving rise to rebate may be property of a taxpayer. Rebate is often not computed except with respect to five-year installment computation periods. Borrowers of tax-exempt proceeds may need to know the rebate amount applicable to each tax year in order to exclude such earnings.

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

ADVANCED ARBITRAGE

Chair:

Adam R. Baird Kutak Rock LLP – Spokane, WA

Panelists:

David J. Cholst Chapman and Cutler LLP – Chicago, IL
David Sutton Raymond James – Saint Petersburg, FL
Laurie Scott Integrity Public Finance – Jacksonville, FL

This outline is intended to be a higher-level discussion of arbitrage issues applicable to tax-exempt municipal bonds and the structuring of various transactions. The outline and panel will also focus on investment considerations and investment-related issues and opportunities arising in a higher yield environment, including strategies and approaches to investing without violating yield-restriction rules, as well as for minimizing any rebate or yield reduction payment liability through permitted elections made on the issue date or other permitted structuring tools. The outline will also focus on various issues and items common to rebate compliance and regular problems encountered in the computation of rebate.

I. Classes of Investments

1. Treas. Reg. 1.148-5(b)(2) states the following: "For purposes of the *yield restriction rules* of section 148(a) and § 1.148-2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, *whether or not held concurrently*, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended." What does this mean? It means all investments in the same class must be blended together regardless of when they are held, and despite the five-year computation date for rebate. The single yield is determined over the life of the investments. However, investments (other than escrows) are not treated this way for rebate purposes. For rebate, investments classes do not matter, and yield is computed for each computation period.

2. What are the different classes of investment?

   a. Each category of yield restricted purpose investment and program investment that is subject to a different definition of *materially higher* under § 1.148-2(d)(2)
      - Qualified student loans
      - Tax-exempt loans
      - Qualified mortgage loans
      - Program investments
      - Other purpose investments

      NOTE: The yield on investments in any of the above classes cannot be blended with each other. Only the yield on investments within the same class can be blended, and each purpose investment with a different "materially higher" limitation is considered to be in a separate class.

   b. Yield-restricted nonpurpose investments
      - Project fund money (after the expiration of the temporary period)
      - Sinking fund money (which does not qualify as a bona fide debt service fund or a reasonably required reserve or replacement fund)
      - Advance refunding escrow (to the extent any were/are outstanding)
      - Pledged funds or other replacement proceeds
      - Other amounts for which temporary periods were waived

      NOTE: In general, the yields on yield-restricted non-purpose investments are blended together for yield restriction purposes.

c. All other nonpurpose investments

- Amounts invested during the temporary period for capital projects (typically three years, but extended to five years in certain circumstances)
- Amounts invested during the 13-month temporary period for restricted working capital
- Amounts invested in a reasonably required reserve or replacement fund
- Amounts in a bona fide debt service fund
- Amounts making up the minor portion

NOTE: None of these investments can be blended with those of another class for purposes of yield restriction. If the issuer waives the right to invest in higher yielding investments, those investments are moved into the class of yield restricted nonpurpose investments.

3. Waivers of temporary period and right to invest in higher-yielding investments

a. What is it? Treas. Reg. 1.148-2(h) provides that an issuer may elect to waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve or replacement fund.

b. Why would you do it? If an issuer expects yields on other non-yield restricted investments will be lower and is concerned that the yield on certain yield restricted investments might be higher, a waiver might be desired in order to bring these investments into collective yield compliance.

c. When do you have to do it? In general, any waiver of a right to invest at a higher yield must occur on or before the issue date. At any time, an issuer may waive the right to invest higher yielding investments that are part of the minor portion.

4. Example 1 – Unspent project fund proceeds

a. Facts: In October 2020, City issued $100mm for a revenue bond project. The City funded costs of issuance and a reasonably required debt service reserve fund from its own cash. The City deposited all $100mm of the proceeds into the project fund. Now it is October 2023, and the City has not competed the project and approximately $14mm remain in the project fund and the project is expected to take 2 more years to complete (due to cost overruns and supply chain problems). Prior to this time, investments in the project fund and the debt service reserve fund earned significant amounts of negative arbitrage. The City anticipates that it may not have enough funds to complete the project and is contemplating issuing more

bonds. In addition to this, the City's financial advisor says the City should consider investing monies in the project fund at a higher level, and above the bond yield, in order to fund these additional cost overruns. The financial advisor states that positive arbitrage now should be offset by prior years' negative arbitrage, and should not result in violation of the arbitrage rules. What advice do you have for the City?

b. Potential Advice: Amounts in the project fund after the third anniversary are in a class of investments different from the class containing amounts in the debt service reserve fund and project fund that previously earned negative arbitrage. Consequently, positive arbitrage from the project fund now cannot be blended with prior negative arbitrage for yield restriction purposes. The City can earn above the bond yield, but unless there are proceeds which are in the same class of investment as the project fund, no other reduction of the proposed positive arbitrage or blending can occur to bring the yield into compliance. If the City earns above the bond yield now, it is able to make a yield reduction payment for amounts in the project fund. One thing the City could have considered at the outset is receiving the architectural or engineering certifications necessary to get the benefit of the five-year temporary period, if it expected that the project would take longer than 3 years. Finally, if the City was able to anticipate this potential issue at the closing date, the City could have considered waiving the temporary period for the project fund.

5. Example 2 – Defeasance escrow

a. Facts: In 2015 a County issued bonds in order to advance refund bonds originally issued in 2007 which were subject to optional redemption in 2017. The proceeds of the 2015 bonds generated a significant amount of negative arbitrage. In October 2023, the County desires to defease the 2015 bonds with its own cash and call the 2015 bonds in 2025, as is allowed under their underlying documents. The County's financial advisor suggests that any investment above the bond yield now can be blended with the negative arbitrage previously. As their legal counsel, you are nervous because amounts in the 2023 escrow would be treated as replacement proceeds of the 2015 bonds and you are being pressured to intentionally invest amounts pledged to the 2015 bonds above the bond yield. What do you do?

b. Potential Advice: In general, amounts in the 2015 escrow account and the 2023 defeasance account are the same category of investment, but bear in mind those amounts earned within the first 30 days of the advance refunding escrow were subject to a 30-day temporary period of no yield restriction (unless waived) and need to be taken into account. In any event, great

caution should be taken in structuring these investments and financial advisors and rebate analysts should be consulted. A current rebate calculation should be performed to identify all related amounts subject to yield restriction.

c. Important consideration. For yield restriction purposes, all categories need to be blended together.

6. Blending of investments in the context of rebate

a. For rebate, as distinguished from yield restriction, investments are generally blended without regard to classification. For example, consider an issuer with a reasonably required reserve or replacement fund and some other fund which is subject to yield restriction (e.g., additional required reserves or otherwise pledged funds which are subject to yield restriction). For rebate purposes, any positive arbitrage in the reasonably required reserve or replacement fund can be blended with negative arbitrage in the yield restricted fund.

7. Application of Anti-abuse rules. A potential sanction is a requirement that an issuer treat each investment as a separate class, and the issuer would lose the ability to blend low-yield investments with high-yield investments. See Treas. Reg. 1.148-10(b)(1)(i).

II. Investment Options and Considerations

1. Investment Options

a. Tax-exempt bonds – IRC 148(b), Generally, tax-exempt investments are not treated as investment property and are therefore not subject to arbitrage restrictions. For non-AMT bonds, specified private activity bonds are carved out of the investment exception.

b. Mutual funds (if 95% or more of the income is tax-exempt, considered to be a "tax-exempt bond" under IRC 148(b); but tax-exempt mutual funds present special problems because income could include capital gain distributions)

c. Money market funds (if 95% or more of the income is tax-exempt, considered to be a "tax-exempt bond" under IRC 148(b))

d. Local government investment pools (really external comingled funds)

e. United States Treasuries – directly purchased vs. open market purchases

f. Certificates of deposit, subject to special rules to determine fair market value.

g. Guaranteed investment contracts (GICs) – subject to special rules to determine fair market value

h. State and Local Government Series securities (SLGS) – See discussion below

i. Other – any investment of a type that is traded on an established market

2. SLGS and the use of demand deposit SLGS

a. SLGS securities are offered for sale to issuers of state and local government tax-exempt debt to assist with compliance of yield restriction or arbitrage rebate provisions of the Internal Revenue Code. Subscribers may invest in time deposit or demand deposit types of securities. All SLGS securities are issued in book-entry form and are non-marketable.

b. Closure of SLGS window and consequences (yield reduction payments)

When the federal government hits or nears the debt ceiling, the ability to acquire SLGS is suspended. When this happens, issuers are limited to other kinds of investments which may result in potential noncompliance with the arbitrage rules. It is key to remember that investments when acquired have to be acquired at their fair market value. If the fair market value of an investment is greater than the associated bond yield, this can be problematic. In scenarios where the sale of SLGS is suspended, an issuer is allowed to make yield reduction payments. See Treas. Reg. 1.148-5(c)(3)(viii). But note, importantly, that the ability to make a yield reduction payment appears to only apply to "nonpurpose investments allocable to the *proceeds* of an issue" which, on its face, appears to exclude replacement proceeds.

c. The Uses and Benefit of Demand Deposit SLGS

Two different regulation provisions add Demand Deposit SLGS to excluded tax-exempt investments. Neither regulatory provision mentions AMT treatment, but since the carveout separately excludes specified private activity bonds and SLGS are not specified private activity bonds, it is safe to apply the Demand Deposit SLGS treatment as tax-exempt investments to restrictions on non-AMT bonds.

The arbitrage regulations reference demand deposit SLGS (in both places) as "a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344."

When the United States Treasury takes extraordinary measures including the suspension of sale of new SLGS, they also convert outstanding Demand Deposit

SLGS into special 90-day Certificates of Indebtedness of the State and Local Government Series (*"Special 90-day Certificates"* see Attachment 1, Notice of Conversion to 90-day Certificates). A question has arisen as to whether a Special 90-day Certificate is itself a demand deposit SLGS certificate or more formally, whether a Special 90-day Certificate is a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344 (see Attachment 2, Chief Counsel Memorandum No. 202326019).

The answer seems to be clearly "yes" as further described below. Evidently, however, this is not clear to the IRS Chief Counsel, although they got the right answer pursuant to the broad powers of the IRS to deviate from the technical words of the arbitrage regulations under Treas. Reg. §1.148-10(g), which states:

> (g) Authority of the Commissioner to waive regulatory limitations. Notwithstanding any specific provision in §§1.148-1 through 1.148-11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under section 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of section 148.

Chief Counsel clearly reached the correct result, but employed a provision that probably should be reserved for situations where the technical regulations reach the wrong result.

First, Special 90-day Certificates are certificates of indebtedness issued pursuant to 31 CFR 344.7(b), which is part of 31 CFR part 344, Subpart (C) dealing with the Demand Deposit SLGS program. Second, special 90-day Certificates may be redeemed under the same provisions as other demand deposit SLGS (one-day notice). That certainly makes them demand deposit investments in any ordinary meaning of "demand deposit." Third, although it has only happened once, if the suspension of SLGS sales continues for more than 90 days, special 90-day Certificates are in fact reinvested in new Special 90-day Certificates. This must happen pursuant to 31 CFR 344.7(b), which only allows Special 90-day Certificates to be reinvested into Demand Deposit SLGS. Fourth, the Bureau of Fiscal Service treats Special 90-day Certificates as part of the Demand Deposit program in the statements they issue to investors.

3. Mixing of investments

a. Under regulations applicable to advance refunding bonds (which are no longer permitted), Treas. Reg. 1.149(d)(b)(3) provides that a transaction which has a mixed escrow, where a portion of the proceeds is invested in tax-exempt bonds and a portion is invested in other nonpurpose investments could be construed as an abusive transaction under prior Section 149(d)(4) of the Code. While this rule applies to advance refundings, the absence of a similar rule under the arbitrage rules suggests that the mixing of various types of investments (both taxable and tax-exempt) is permitted.

4. Current market trends and structuring investments options

a. Laddered Portfolio of U.S. Treasury Securities

- What is it? A portfolio of U.S. Treasury Securities which mature on different dates.
- Why do it? For issuers that may achieve IRS spending exception benchmarks, this is a vehicle with perceived least credit risk. For issuers that will likely fail or know they will fail IRS spend-downs, this is a vehicle that can enable them to invest a significant portion of proceeds at a fixed rate at least equal to or in excess of the arbitrage yield (expecting to rebate the difference). If an issuer failing spend-downs can exceed the arbitrage yield on investments, there is no need to take any credit risk in other instruments.

b. Laddered Portfolios of U.S. Treasury and Agency Securities

- What is it? A portfolio of U.S. Treasury Securities and Agency Securities (i.e., specific maturities issued by either Fannie Mae, Freddie Mac, Farm Credit System, or the Federal Home Loan Banks) which mature on different dates.
- Why do it? For issuers that have failed spend-downs and accrued negative arbitrage, this is a means to now potentially re-capture some or all of the previously accrued negative arbitrage, at least prior to the end of the temporary period. For issuers that anticipate achieving spend-downs, investing a significant portion of the bond proceeds in these instruments is a means to maximize potential retainable positive arbitrage.

c. Demand Deposit SLGS

- What is it? See discussion above.
- Why do it? For issuers that anticipate failing the IRS spend-downs and have a low arbitrage yield, these can be a means to earn exempt arbitrage.

d. Combination Taxable Investments and Demand Deposit SLGS

- Why do it? If a client has a lengthy draw schedule (i.e., 2.5 years or longer), may be viability in a combined taxable/demand deposit SLGS approach to hedge against a decline in market rates below the arbitrage yield over the anticipated lengthy expenditure period

e. Unsecured GIC's

- What is it? A GIC is a guaranteed investment contract and type of investment where the provider of the GIC (usually a highly rated bank or insurance company) receives bond proceeds (or other moneys) from a bond issuer and agrees to repay the principal at par, on a fixed date or upon request, with a fixed or floating rate of interest until repayment.
- Why do it? A GIC allows a bond issuer to invest bond proceeds without risk of adverse market rate liquidation loss (at least in the case of a project fund GIC) when the investment proceeds are needed to finance the issuer's project or program. These are utilized primarily in not for profit and structured transactions such as health care and state HFA financings, and are best utilized in transactions where the goal is to minimize negative arbitrage.
- Other Considerations? A principal challenge is the ability to meet the IRS 3 bid safe harbor, which is impacted by: the modest number of GIC market participants, and minimum rating requirements or other restrictions imposed by bond indentures (often "AA" category which can constrain the number of participants). It is easiest if developing a new bond indenture and can control the definition of "permitted investments" to maximize market participation. It is also typically easier to achieve the fair market value safe harbors for investment of reserve funds than project funds due to propensities of GIC market participants.

III. Rebate Considerations

1. The presence of IRC 148(f)(5) – "Gross income shall not include the [rebate amount]. Notwithstanding any other provision of this title, no deduction shall be allowed for any amount paid to the United States [for rebate]". How does this provision actually apply in practice and who would it apply to?

2. Allocations of Proceeds to Expenditures

   Three factors directly impact the amount of arbitrage rebate: 1) the amount of proceeds invested, 2) the size of the spread between the earnings rate and the

arbitrage yield, and 3) the length of time that the proceeds are invested. As a result, the allocation of proceeds to expenditures directly impacts the rebate liability.

Section 1.148-6(d)(2) states that "reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a gross proceeds spent first method, a first-in, first-out method or a ratable allocation method." Further, it states that "an allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue" (defined as no later than 5 banking days as of the date of which the allocation is made), and that the "issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service".

Example 1 – School District A plans to fund capital expenses for a new school with proceeds of a new bond issue as well as grants received from the State Department of Education. How should School District account for the grant monies once received? Should they be deposited into the Project Fund with the sale proceeds? Are they subject to rebate? What about yield restriction?

Example 2 – City A issues bonds to fund capital expenditures in connection with the improvement of a variety of city parks. Proceeds are invested at a rate in excess of the arbitrage yield. They are expended quickly, but not quickly enough for the issue to qualify for a Spending Exception to Rebate. Can City take any action whereby it would meet all of the Spending Exception benchmarks, allowing City to retain the positive arbitrage?

Example 3 – City B allocates proceeds to expenditures as they occur. In the process of preparing for the annual audit, B realizes that it paid for expenditures from bond proceeds that were not eligible for that purpose. A correcting entry is made to return the proceeds to the Project Fund. Does B need to take any additional actions?

3. Debt Service Funds

Section 1.148-1(b) defines a "bona fide debt service fund" as a "fund, which may include proceeds of an issue, that – (1) is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and (2) is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of: (i) the earnings on the fund for the immediately preceding bond year or (ii) one-twelfth of the principal and interest payments for the immediately preceding bond year.

Example 1 – Hospital A deposits revenues into the Principal and Interest accounts each month. The lowest aggregate balance of these accounts is greater than the

reasonable carryover amount. Are the P&I Accounts in total subject to rebate, or is a portion of the account a bona fide debt service fund, and only the excess is subject to rebate? If only the "excess", how is such amount identified?

Example 2 – City A issues bonds for capitalized interest equal to the first two interest payments on the bonds, which are paid 5 and 11 months after the issue date. These amounts are invested in a Cap I Fund, and the balance depletes to $0.00 after the 2nd interest payment. Is the Cap I Fund a bona fide debt service fund and exempt from rebate? Does your answer change if the Cap I Fund is a subaccount of the Project Fund?

Example 3 – City A issues bonds for capitalized interest sale proceeds sufficient to pay 3 interest payments and a portion of the 4th. The proceeds are deposited to a Debt Service Fund. City A starts depositing revenues into the Debt Service Fund during the 2nd bond year resulting in commingled proceeds and revenues. The Debt Service Fund does not deplete below the reasonable carryover during the 1st bond year due to unspent Cap I proceeds that remain, but the Debt Service Fund does deplete below the required limit during the 2nd bond year. Is the whole Fund exempt from rebate as a bona fide debt service fund?

Example 4 – Hospital B issues non-governmental bonds. To fund its debt service, B deposits 1/6th of the upcoming interest payment plus 1/12th of the upcoming principal payment each month and invests the funds in taxable instruments. After the P&I payment, the remaining balance in the account is $0.00. Earnings in the Debt Service Fund for the bond year are $101,000.00. Are amounts in the Debt Service Fund exempt from rebate? Are they subject to yield restriction? If B invested the amounts in the account in taxable securities to generate earnings of $99,999.99 and then invested only in demand deposit SLGS for the remainder of the bond year, are the funds subject to rebate?

4. Reducing Arbitrage

Arbitrage earnings are calculated for invested gross proceeds. Section 148(b)(3) states that the term "investment property" does not include tax-exempt bonds (with the exception that "with respect to an issue other than an issue a part of which is a specified private activity bond (as defined in section 57(a)(5)(C)), the term "investment property" includes a specified private activity bond (as so defined)". Section 1.150-1(c)(1) defines "tax-exempt bond" as any bond the interest on which is excludable from gross income under section 103(a). For purposes of section 148, tax-exempt bond includes:

(1) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103; and
(2) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Example 1 – City invests 50% of its Project Fund in U.S. Treasury securities and 50% in Demand Deposit SLGS. The Treasuries yield a return of 150 basis points above the arbitrage yield. The Demand Deposit SLGS are floating, but their average return is 100 basis points above the arbitrage yield. What, if any, excess must be rebated back? Can City A deposit funds into a non-interest-bearing checking account to offset positive arbitrage? Can City A invest proceeds in a money market equal to the arbitrage yield to avoid rebate?

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
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BANK PRODUCTS & DIRECT PURCHASES – GENERAL CONSIDERATIONS (NON-TAX)

Chair:

Katherine Gale	Partner, Chapman and Cutler LLP, Chicago, Illinois

Panelists:

Jonathan Casiano	Regional Manager, Senior Vice President, Public Finance, PNC Bank, National Association
Amy Condaras	Partner, Frost Brown Todd LLP, Charleston, West Virginia
Michael Thomas	Partner, Kutak Rock LLP, Denver, Colorado

In this panel, we will discuss structuring and legal considerations that arise with respect to bank products and in private placement bond issues and bank loans. Topics to be discussed include a brief overview of and trends in bank products, such as letters of credit, hybrid financings, liquidity and operational financings, and in bank loans and other direct-placement financings; securities law considerations; negotiation of covenants and other contract terms; use of forward delivery arrangements, "Cinderella" and other refunding tools; application of certain MSRB rules; roles and responsibilities of Municipal Advisors and Placement Agents; and considerations relating to continuing disclosure "financial obligation" filings. The session will emphasize general concepts which practitioners may face on direct purchase transactions and specific provisions that are frequently negotiated in such transactions.

Terminology/Terms of Convenience

In this outline, generic terms are used for convenience. It is intended that the meaning of such terms will be apparent to the reader. In this context, please see "Terminology" in the back of this outline.

I. DIRECT PURCHASE OF BONDS

A. EVOLUTION OF DIRECT PURCHASE BONDS

As used in this outline, the term "direct purchase" refers to the purchase of a bond, note or other obligation of indebtedness (tax-exempt or taxable) (a "Bond") by a commercial bank without an underwriting or public offering. The Bond may evidence of a loan from the bank to the Issuer or Borrower, which terms may be in the Bond certificate, or captured in another financing document, such as a loan agreement, financing agreement, continuing covenant agreement, note purchase agreement, or other instrument.

Prior to the 1986 Tax Act, direct purchase had been a popular method of tax-exempt financing. However, the 100% loss of the cost of carry instituted by the 1986 Tax Act[1] dissuaded commercial banks from providing this product, while the expansion of the tax-exempt mutual fund industry created a robust market for variable rate demand bonds ("VRDBs") enhanced or guaranteed by Letters of Credit. The combination of these factors tended to drive out of the tax-exempt arena all commercial banks with ratings less than those required by the mutual funds (at least A-1/P-1 for a short-term rating), unless a confirming Letter of Credit with the appropriate ratings could be obtained.

The 1986 Tax Act contained an exception to the 100% loss of cost of carry rule for "qualified tax-exempt obligations," which are commonly known as "bank qualified obligations" or "BQ obligations." However, the exception is narrow. For example, only certain tax-exempt obligations issued in a year in which the Issuer issued $10,000,000 or less in tax-exempt obligations may be designated as BQ obligations.

This exception was expanded briefly by the American Recovery and Reinvestment Act of 2009 ("ARRA"), which increased the $10,000,000 limit to $30,000,000 for 2009 and 2010 and by providing that, for qualified 501(c)(3) Bonds, the $30,000,000 would be measured per 501(c)(3) Borrower and not per conduit Issuer for 2009 and 2010. In addition, ARRA provided that tax-exempt items up to 2% of a bank's total adjusted assets could be ignored for the purpose of calculating the loss of cost of carry. These changes resulted in a flood of direct purchase deals in

[1] Section 265 of the Internal Revenue Code of 1986, as amended (the "IRC"), provides that taxable entities, such as commercial banks, lose a portion of the deduction to which they would have otherwise been entitled for the interest that the entities pay its depositors, CD-holders, etc. The portion disallowed is equal to the ratio that the entities' adjusted basis for its investments in tax–exempt obligations that are not bank-qualified bears to the entities' total adjusted basis for all assets.

2009 and 2010 for 501(c)(3) borrowers and brought many smaller banks into the direct purchase market.

Although the ARRA provisions expired on December 31, 2010, the market for the direct purchase of Bonds remained relatively strong through the end of 2017. The next hurdle in the direct placement of municipal bonds was the adoption of the 2017 Tax Cuts and Jobs Act ("TCJA"), which became effective January 1, 2018. The TCJA reduced the maximum federal corporate tax rate from 35% to a flat corporate rate of 21%, causing a reduction in most banks' return on tax-exempt investments and thereby causing indicative rates in proposed direct purchases to increase to levels that, in many cases, made direct purchases less attractive than a public market option. The TCJA also impacted the municipal market by eliminating the availability of certain tax-exempt advance refundings.

The volatility in the public markets that occurred in March 2020, at the outset of the COVID-19 pandemic, again increased levels of direct purchase activity. As the municipal markets were stressed after the emergency declaration, many municipalities were similarly stressed to obtain capital funding for projects and to react to lost revenue and costs of responding to the pandemic. This led to a rise in private placements for capital as well as lines of credit and other liquidity loans to reduce immediate capital needs and assist with cash flow.

Most of the discussion below will focus on the situation where a commercial bank is buying Bonds for its own portfolio. The financial terms of such a direct purchase of Bonds are limited only by the ingenuity of the parties. Some popular structures include:

- Long-term fixed rate transactions where the Bonds bear interest at a fixed rate for multiple years and the Bonds mature at the end of that period. Many banks or other lenders that purchase bonds or notes (referred to herein as "Lender") will not offer such products with a term of over 15 or 20 years, however, there are exceptions.

- Formula rate adjustment transactions through the life of the Bonds, in which the Bonds are issued for a 15-, 20-, 25- or 30-year term and the Lender agrees to hold to maturity, with successive periodic interest rate adjustments every five years based on an objective index (such as the Federal Home Loan Bank 10-year Classic Advance Rate).

- Variable rate transactions, historically based on a percentage of a one-month index rate plus a credit spread, with the Lender agreeing to hold the Bonds for a commitment period (typically 3 years, 5 years, 7 years or 10 years). This commitment period may coincide with the final maturity date of the Bond, or it may refer to an initial period that is short of the 25-year or 30-year maturity for the Bonds. In such case, at the end of the commitment period, there is typically a mandatory tender, and sometimes upon satisfaction of certain conditions on such tender date, the ability for

the Borrower to "term-out" over a set period during which the Bond is amortized.

B. POTENTIAL ADVANTAGES/DISADVANTAGES OF DIRECT PURCHASES TO THE ISSUER/BORROWER

1. **Potential Advantages**. Direct purchase transactions offer some potential advantages to Borrower:

(a) *Potential cost savings*. A direct purchase transaction can be structured so that the Borrower avoids certain costs, such as the costs of an underwriter, the costs (and time) of preparing an official statement, the fees of a remarketing agent (if the public option would have been a VRDO), rating agency fees (if the public option would have been rated), interest accrual (if structured as draw-down bonds), and bond trustee fees. These potential cost savings are offset by other Borrower costs applicable in direct purchase transactions, such as Lender origination fees, Lender counsel fees, placement agent fees, and other legal fees.

(b) *Potential time/schedule advantages*. Direct purchase transactions can typically be accomplished in a shorter timeframe than their publicly offered counterparts due largely to the elimination of the need for an official statement and, if the publicly sold bonds would have been rated, the rating process. While some direct purchases are straightforward and require minimal documentation, others (especially those with complex note purchase agreements or continuing covenant agreements) may take additional time to negotiate business points.

(c) *Continuing disclosure.* Direct purchases typically fall into an exception from the ongoing disclosure obligations required by SEC Rule 15c2-12 (the "Rule"). Depending on the Lender and the security for the Bonds, continuing disclosure in direct placements runs the spectrum from simply requiring delivery of audited financials each year, to contractually requiring reporting obligations that are more comprehensive than those provided for in the Rule. Continuing disclosure in bank direct placements exempted from the Rule are purely negotiated business terms. Further, unless required by the Bank, no EMMA postings are required.

(d) *"Financial Obligations" Event Notice under the Rule.* Separate from the reporting requirements provided for in the direct purchase documents themselves, if an Issuer has entered into a continuing disclosure undertaking after February 27, 2019, the direct purchase transaction itself (including a financing lease) and amendments to the direct purchase agreements may need to be disclosed on EMMA if such obligation is a material financial

obligation.[2] The Issuer may also need to keep track of and provide notice of certain defaults, events of acceleration, termination events, modification of terms, or other similar events under the terms of the direct purchase, any of which reflect financial difficulties. [3]

(e) *Amendments.* Direct access to the Lender for waivers, modifications, forbearance, restructurings, and other workout assistance can be a significant benefit, especially in times of financial distress. The nature of a direct purchase allows the parties to remain in dialogue during the term of the deal. Lenders often can also offer assistance and make accommodations in ways that the public market cannot, such as relief from financial or other covenants. [4]

(f) *Alternate Refunding Structures.* Alternate refunding structures, such as Cinderella (a taxable obligation that becomes tax-exempt at a point in the future), forward commitments (a contractual agreement to purchase the Bonds at a later date that is farther out in the future than the traditional pricing/closing period, upon satisfaction of certain conditions), or take-out bonds (issuing taxable Bonds now, with the agreement that tax-exempt take-out Bonds will be issued in the future to currently refund the taxable Bonds), which may not be readily marketable as a public offering, or short-term financings with short or no call features, may serve as alternatives to tax-exempt advance refundings.

(g) *Multiple Structures.* As different Lenders have different appetites for tenors and yields, it is possible for an Issuer to ask more than one Lender to purchase different tenors within the same offering, to obtain different bids along the yield curve, to more closely approximate what it is able to attain in terms of rates in the public market.

(h) *Debt Service Reserve.* Direct purchase transactions may possibly be structured with no debt service reserve or a smaller debt service reserve when a publicly offered transaction might otherwise require one, which would reduce aggregate borrowing costs. However, this varies significantly among Lenders and will be dependent on the credit rating of the Borrower and outstanding bond covenants. Further, many publicly offered transactions are now offered with reduced or no debt service reserve or,

[2] 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 clause (A) or (B) of this definition. The term financial obligation does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule.
[3] See “H.6. - Public Disclosure of Direct Purchases under Amendments to SEC Rule 15c2-12” herein for more information.
[4] Note that modification of terms reflecting financial difficulties may need to be reported under an Issuer’s outstanding continuing disclosure undertakings. See (d) above and “H.6. - Public Disclosure of Direct Purchases under Amendments to SEC Rule 15c2-12.”

perhaps, offered with only a covenant for a springing reserve if coverage drops below a required level.

(i) *Lien and Priority of Payment Flexibility.* Direct purchase Lenders may be willing to accept a pledge of revenues of an enterprise or Borrower on a subordinate basis from the pledge given to senior lien bond holders. This option gives the Issuer access to capital or liquidity without having to first pass the higher bar commonly associated with future parity bond tests. Lenders are on parity with other subordinate lien obligations, which may give rise to intercreditor or other considerations upon the occurrence of an event of default.

(j) *Downgrade Risk.* The Borrower does not bear the risk of a Lender downgrade as it might in a publicly traded VRDO. This risk was not taken seriously prior to 2008 but was impactful during the Great Recession and has again been a concern during the COVID-19 pandemic.

(k) *Basis Risk.* Direct purchase obligations might present an opportunity to avoid basis risk. In the past, there might have been an interest rate divergence between publicly marketed or remarketed floating rate debt and the rate formula on the variable rate leg of interest rate swaps hedging the debt. A direct purchase of the debt obligation by a bank might permit an issuer to achieve a closer matching of rates.

(l) *Access to Capital.* During certain periods of public market volatility and illiquidity, like the volatility that occurred during the early months of the COVID-19 pandemic, Lenders have sometimes played an important stop-gap and been the only means of accessing capital for certain Borrowers.

2. Potential Disadvantages.

(m) *Additional Negotiation.* There is often more direct negotiation with the Lender, including negotiation of terms that are viewed as standard practice for publicly offered transactions. The direct purchase market and the public market are very different, and Lenders often analyze credits and terms far differently than an underwriter would on a publicly offered transaction. In some cases, a Lender may expect the Borrower to move its lending and treasury management relationships to the Lender.

(n) *Different Covenants.* The terms of direct purchase transactions are often very different than publicly offered deals. These differences include, but are not limited to: (i) restrictive call features, sometimes involving make-whole calls; (ii) material adverse change provisions (see below); and (iii) restrictive and negotiated covenants such as Lender consent rights, default rates, tax gross-ups or financial covenants.

(o) *Higher Rates.* After the corporate tax rate was reduced to 21% by the TCJA, the interest rates in the private placement market typically increased for the

same credit than in the public market because of the greater economic benefit of the tax-exemption to the retail market than to the corporate market.

C. ADVANTAGES/DISADVANTAGES TO LENDER

1. Potential Advantages.

(a) Tax-exempt income for the Lender.

(b) Diversification of the loan portfolio and potentially higher (investment grade) credit quality loans that improve the overall loan portfolio credit quality.

(c) Entry into the customer for pitching other banking products and expanding the relationship and profitability, such as maintenance of deposit accounts and other treasury management relationships with the Lender, etc.

(d) Better capital risk-weighting for municipal obligations than commercial, private purpose obligations.

2. Potential Disadvantages.

Reduction in the corporate tax rate means the economic benefit of the tax-exempt nature of the interest is lessened for banks and corporations.

As noted above, IRC § 265 provides that the Lender loses a portion of the deduction to which it would have otherwise been entitled for the interest that the Lender pays its depositors, CD-holders, etc. The portion disallowed is equal to the ratio that the Lender's adjusted basis for its investments in tax–exempt obligations that are not bank-qualified bears to the Lender's total adjusted basis for all assets.

NOTE: For banks with a large asset base, the portfolio of tax-exempt obligations that are not bank qualified often is so small that the effect of IRC §265 is scarcely felt. Also, at the present time (as opposed to 1986), the rates paid by commercial banks to their depositors and CD-holders are so low that the loss of a portion of that deduction may not be particularly meaningful. Also, many banks that are active in this space have subsidiaries that buy non-bank qualified Bonds. The importance of bank qualified status in these transactions has diminished.

D. IS IT A SECURITY AND WHY DO YOU CARE?

One question frequently asked is whether or not the direct purchase bond is a "security" as opposed to a loan. To answer this question, it is helpful to determine why it is being asked. The distinction between a commercial loan and a security may determine, among other things, which division or group of the Lender

organization has primary responsibility for administration of the transaction, applicability of the Securities Act of 1933, as amended (the "Securities Act"), applicability of MSRB rules governing broker-dealers and municipal advisors, pledging to the Federal Reserve, use of the item to satisfy the Lender's capital requirements, applicability of the "Volker Rule," and applicability of "mark-to-market" requirements. The answer to the question is likely to vary depending on the purpose for which it is asked.

If accounting for the Bond as a "loan", among other things, Lenders typically do not want CUSIPs and typically want all references to DTC and book entry removed, and often want the Bond identified as a "loan," if at all possible.[5] More often than not, the Lender is stuck with the concept that their loan is represented by a bond, note, etc., as a result of state law or the naming convention for the Issuer. As a result, the parties must structure it in a fashion which allows the Lender to book the obligation as a loan for accounting purposes, assuming the Lender has a preference. However, practitioners should be cautious when giving advice on whether an obligation is a loan or security for accounting purposes, as the accountants may have their own criteria in making the determination.

For federal securities law purposes, under the Securities Act the analysis starts with the judicial recognition of a dichotomy between commercial loans and securities, despite the broad definition of "security" in Section 2(a)(1) of the Securities Act, which includes "any note [or] evidence of indebtedness… ." In determining where the dividing line should fall between securities and commercial loans for Securities Act purposes, the courts have not been able to give us more guidance than the "family resemblance" test, i.e., they know one when they see one. Reves v. Ernst & Young, 494 U.S. 56 (1990). Reves and its progeny point to four general factors to be considered: (i) motivation of the seller and buyer (or borrower and lender); (ii) plan of distribution; (iii) reasonable expectations of the investing public; and (iv) alternative means of regulation and risk reduction. In evaluating these factors, the courts give special attention to the protection of those members of the investing public for whose benefit the Securities Act was designed. (Contrast Resolution Trust Corp. v. Stone, 998 F.2d 1534 (10th Cir., 1993) (no "security" where purchaser of instruments was federal savings bank)) with SEC v. Wallenbrock, 313 F.3d 532 (9th Cir., 2002) (notes purchased by over 1,000 individuals, many of whom held the notes in their respective IRAs, held to be "securities").

[5] On June 14, 2018, amendments to MSRB Rule G-34 took effect. Rule G-34(a)(i)(F) includes an exemption from the requirement that underwriters (including placement agents) and municipal advisors obtain CUSIPs as follows: "A broker, dealer or municipal securities dealer acting as an underwriter of a new issue of municipal securities, or a municipal advisor advising the Issuer with respect to a competitive sale of a new issue, which is being purchased directly by a bank, any entity directly or indirectly controlled by the bank or under common control with the bank, other than a broker, dealer or municipal securities dealer registered under the Securities Exchange Act of 1934, or a consortium of such entities; or by a municipal entity with funds that are, at least in part, proceeds of, or fully or partially secure or pay, the purchasing entity's issue of municipal obligations (*e.g.,* state revolving fund or bond bank), may elect not to apply for assignment of a CUSIP number or numbers if the underwriter or municipal advisor reasonably believes (*e.g.,* by obtaining a written representation) that the present intent of the purchasing entity or entities is to hold the municipal securities to maturity or earlier redemption or mandatory tender."

For the plain vanilla middle market or lower middle market direct purchase transaction, the method of originating and approving the transaction by the Lender, the collateral, the amortization and the expectations as to transferability are little different from any Benchmark Rate-based conventional term loan. This could argue for placing these "plain vanilla" direct purchase transactions outside the definition of "security" for Securities Act purposes.

For the purposes of pledges to Federal Reserve Banks, municipal securities and commercial loans are subject to vastly different margin percentages and mechanics for pledging. (See, Federal Reserve Collateral Guidelines, 6/27/2011, and Federal Reserve Discount Window & Payment System Risk Collateral Margins Table, Effective Date: October 16, 2009 (updated January 3, 2011).) For a pledge of securities to the Federal Reserve, the Bonds would need to be held through DTC and the Lender would need to obtain a CUSIP number for the Bonds and typically an investment grade rating for the Bonds.

With respect to loan accounting treatment, there are different approaches among the commercial banks. Several of the major players in the direct purchase market appear to take the position that if a deal comes from the commercial loan floor then it must be a commercial loan and not subject to the mark-to-market requirements applicable to securities. Other banks will look to specific provisions of the instrument itself (for instance, one large commercial bank will book a direct purchase deal for accounting purposes as a commercial loan only if the Bonds are not rated by a rating agency, the Bonds are not held through DTC, the Bonds do not bear a CUSIP number, the Bonds carry high authorized denomination and significant transfer restrictions and the Bond Indenture for the Bonds permits no flexibility to convert out of a bank purchase mode to a variable rate mode). Other lenders suggest that the accounting treatment should turn not on the Securities Act definition of "security" but on the definition of "security" contained in Section 8-102(15) of the Uniform Commercial Code. This definition describes as a "security" an obligation of any Issuer: "(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the Issuer; (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and (iii) which: (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article." All tax-exempt bonds would satisfy clause (i) of the UCC definition (See, IRC, Section 149(a)) and most would satisfy clause (ii). Therefore, the pressure is on ensuring that clause (iii) is not satisfied. Restrictions on transfer (for instance, a requirement that transferees are limited to commercial banks or qualified institutional buyers) may be helpful for this purpose. Finally, it should be noted that some Lenders are comfortable with treating their direct purchases generally as securities subject to mark-to-market requirements.

Why do Issuers and Borrowers and other parties in the transaction care about whether the obligation is a loan or a security? The direct purchase as "security"

issue impacts the obligations and requirements of *placement agents and municipal advisors* in a transaction. If the Bond is a security for federal securities law purposes, then SEC, MSRB and FINRA rules and regulations would apply to a placement agent. This issue is noted in MSRB Notice 2011-52 (September 12, 2011) ("Potential Applicability of MSRB rules to Certain 'Direct Purchases' and 'Bank Loans'") and MSRB Notice 2016-12 (April 14, 2016) ("Direct Purchases and Alternatives to Public Financing in the Municipal Securities Market"). The MSRB, for this purpose, adopts the Reves tests and cautions that broker-dealers and municipal advisors (including a broker-dealer or advisor that is an affiliate of a lender or even a "separately identified department or division of the bank") may be subject to MSRB and FINRA requirements in connection with a direct purchase that is deemed to be a "security" as opposed to a "loan".

In an effort to address the financial stress on municipal Issuers and Borrowers caused by the COVID-19 pandemic, in June 2020 the SEC granted a temporary, conditional exception for registered municipal advisors from broker-dealer registration to the extent that the municipal advisor solicited Lenders and other qualified providers in the direct placement of securities. This conditional exception was used by some registered municipal advisors until it expired on December 31, 2020, and was objected to by many in the broker-dealer community.

E. BORROWER'S ALTERNATIVES AT THE END OF A LENDER'S HOLD PERIOD

1. Repay the Bonds with the Borrower's funds or with the proceeds of a conventional loan. This may implicate election and other state law requirements for municipal Borrowers.

2. Refinance the Bonds with a new issue. This may implicate election and other state law requirements for municipal Borrowers.

3. Convert into another mode (if applicable) then permitted under the Bond Indenture or (if so permitted) into a new bank purchase mode with a rate determined by index or by a remarketing procedure pursuant to the Bond Indenture. Note that such a conversion may result in a reissuance for federal tax purposes (particularly if the conversion results in a change in yield of 25 basis points or more). See the discussion in F.4. below.

4. Amend the Bond documents to reset the rate and the maturity date. Note that such an amendment may result in a reissuance for federal tax purposes (particularly if the amendment results in a change in yield of 25 basis points or more), which creates pressure for more complex arrangements relating to options of the Borrower to convert to other modes. For more detail, see the discussion in Section F.4. below.

F. ADJUSTMENTS TO RATE OR YIELD MAINTENANCE

The documentation for a direct purchase often contains one or more of the following adjustments to the interest rate or for yield maintenance:

1. **Taxable Rate, for use upon a Determination or Event of Taxability**. This is subject to negotiation. Some Lenders will agree that this only applies if taxability occurs as a result of actions or inactions of the Borrower and not changes in law.

2. **Default Rate/Late Fee**. Sometimes the imposition of these is at the option of the Lender. Sometimes it is not. Often bond counsel has legitimate state law concerns about these provisions. These concerns often include statutory limits on maximum rates, authorization limits for voted Bonds, etc. In addition, tax counsel may have concerns if the imposition of the rate adjustment is optional rather than mandatory.

3. **Downgrade Pricing**. As in the VRDB market, Lenders may impose downgrade pricing to increase the interest rate or spread component in the rate in the event of changes to the Issuer's rating or withdrawals or suspensions to the rate.

4. **Decrease in Maximum Marginal Statutory Corporate Tax Rate**. Increases in the tax-exempt rate often occur to compensate for a decrease in maximum marginal statutory corporate tax rate. As the corporate tax rate decreases, the tax-exempt nature of the interest does the Lender less "good," to the point that if there were no corporate taxes at all, the Lender should be receiving a taxable rate. NOTE: This can be a difficult provision to negotiate, because the Borrower will want the flip side, i.e., if the maximum marginal statutory corporate tax rate increases, then the tax-exempt rate should decrease, while the Lender may feel that it is already at a low rate and cannot get approval for anything lower no matter what happens to the corporate tax rate. Also note that any decrease in the multiplier used to determine the tax-exempt rate to 65% or below may lead to tax problems (including OID), as the rate may no longer be a "qualified floating rate." Practitioners should also be aware of state law concerns discussed in #2 above. For existing deals, where the corporate tax-rate gross-up provision is mandatory and the Lender decides to waive the interest rate increase, the waiver may cause a reissuance for federal income tax purposes (generally if there is more than a 25 bps change in yield for the remaining term of the Bond). Conversely if the corporate tax-rate gross-up provision is discretionary, imposing the interest rate adjustment could cause a reissuance for federal income tax purposes (generally if there is more than a 25 bps change in yield for the remaining term of the Bond). There are nuances to this, in that the exercise or nonexercise of a unilateral option is typically not a modification except in cases where the option is the holder's and the option results in a deferral or reduction in any scheduled payment of principal or interest. An option is not unilateral if the Issuer/Borrower has the right to refinance at the time the lender exercises its option. However, waiving or modifying the option would likely trigger a reissuance unless the change is "de minimis" (generally not more than a 25 bps change in yield for the remaining term of the Bond).

5. **Breakage Fee**. A breakage fee for financing based on a Benchmark Rate is often used in the case of a prepayment of a Bond on a date other than a rate reset date.

6. **Capital Adequacy/Change in Law**. This adjustment is not tied to a formula but typically seeks to reimburse the Lender for whatever loss of profitability or increase in costs that the Lender may suffer due to certain (or any) regulatory changes. Because the determination of loss of profitability or increase in costs is open-ended and somewhat subjective, some tax counsel have questioned whether such an adjustment would cause a reissuance for federal tax purposes.

7. A common resolution is to move this extra charge out of the bond documents and to include it in the Lender's Continuing Covenants Agreement as an extra fee that the Borrower would pay to the Lender on a taxable basis. This may also address state law concerns which bond counsel may have, though that is very fact and state law specific. This may also have implications for the collateral structure for the Bonds (e.g., if the Bonds themselves are secured by a Master Indenture while additional fees reflected only in the Continuing Covenants Agreement may not be entitled to the benefits of the Master Indenture).

8. Bond counsel may also wish to negotiate the terms under which such increased costs may be imposed through a limited look-back period or a right to prepayment. In some instances, the look-back limits the Lender's ability to recover for regulatory changes that occurred more than, say, six months prior. Another negotiated provision may allow for the Borrower to prepay the deal at par for a certain period of time if the Lender elects to impose increased costs.

G. TENDER OPTION BOND PROGRAMS

The discussion above has been limited to the situation where the Lender is buying the direct purchase Bond for its own portfolio and not as part of a wider distribution plan. There are also tender option bond programs in which a Lender (the "Sponsor Bank") buys the Bond and then places the Bond into a custodial trust. The custodian then issues participation interests bearing interest tied to SIFMA, the participation interests (other than a retained interest of the Sponsor Bank) are sold to bond funds and others looking for short-term variable rate instruments, and the Sponsor Bank issues its Letter of Credit supporting the payments coming due on the participation interests. Although this type of transaction begins with a direct purchase, it finishes by replicating a Letter of Credit backed "lower floater" financing. In terms of the commercial loan vs. security analysis, this product is generally considered to be a security. It can provide the Lender with a lower cost of funds.

H. SPECIAL ISSUES ARISING IN A DIRECT PURCHASE TRANSACTION

Direct purchase transactions range the spectrum from lower par amount issuances involving infrequent or unsophisticated Issuers, to sophisticated, frequent Issuers issuing hundreds of millions of dollars of Bonds in a single deal. Since the reduction in the corporate tax rate, the market has seen a migration of large issuances and/or middle of the road or high grade credits issuing in the public market, while forward commitments, Cinderella bonds, unique credits, smaller, less frequent Issuers largely remain in the private market. Specific covenants may be negotiated for a direct purchase transaction. In a lightly documented small issue (e.g., a lower principal amount borrowing), covenants also can be included in the note, bond, authorizing resolution, indenture or other key documentation. In more fully documented transactions, Lenders frequently request that they be included in a separate agreement, such as a "Continuing Covenant Agreement."

1. **Solicitation or Procurement Process**. The process to select a Lender varies depending on local requirements. Issuers/Borrowers may request a term sheet from a local lender that the Issuer/Borrower has a preexisting banking relationship with, to a more robust procurement process pursuant to a request for proposals. The process used raises a host of questions, such as who should prepare the request for proposals, what kind of documentation should be included the level of review to request, require, or expect from Lenders, and the role of the Issuer's municipal advisor.

2. **Covenants**. Covenants (affirmative and negative) are a heavily negotiated component of the direct purchase transaction. Often these agreements are separate from the indenture and are in the form of a "continuing covenants" agreement or appendix to a financing agreement and are usually direct covenants between the Borrower and the Lender. Lenders have to perform annual reviews of their loan portfolios and assign credit levels to each asset. In underwriting a deal for a particular Issuer or Borrower, the credit committee of the Lender may require specific covenants in the deal that are negotiated both at the term sheet stage and later in the loan documentation process. The typical affirmative covenants you might see in an RFP response or term sheet are requirements to maintain a specified debt service coverage ratio, a specific additional bonds test or, depending on the type of Borrower, a specified minimum level of unrestricted liquid assets or a loan to value ratio for loans secured by real estate or other tangible assets, etc. Bond Counsel must ensure that the Issuer or Borrower can reasonably expect to comply with, and understands the tax and state law implications of, these covenants.

> For example, to avoid yield restriction requirements resulting from characterization of funds as replacement proceeds, a test for unrestricted liquid assets can be tested only semi-annually and unrestricted liquid assets must be permitted to go to zero in the interim between testing dates. See Treas. Reg. §1.148-1(c)(3)(ii). Another way to measure the liquid assets that is less likely to result in a characterization of the funds as replacement proceeds is to require a certain multiple of operating expenses, rather than a set number.
>
> Depending on the Borrower, debt service coverage can be a sensitive negotiation. First, it is important to understand how the test is defined and whether the Borrower has ample margin for compliance. A common negotiated point is excluding balloon obligations from the definition of current maturities of long term indebtedness. Some Borrowers are more likely to hover around the limit and may try to negotiate relief for the first instance of noncompliance because any dip below would be a default incapable of cure.
>
> Some examples of relief include negotiating (i) that failure to maintain a DSCR is not a default unless, after the second testing, the Borrower fails to comply, thus making the initial noncompliance a "soft" default, or (ii) that, after the soft default, a "management consultant" be retained by the Borrower to make recommendations to make operating adjustments to meet the ratio in the future.
>
> One of the more contentious negative covenants is the prohibition on additional indebtedness. For certain credits, the Lender may prohibit any kind of additional indebtedness without Lender consent. Depending on the credit negotiations this

may result in compromises, including allowing indebtedness under a certain dollar limit, allowing additional purchase money indebtedness for assets the Borrower acquires, allowing additional indebtedness if the Borrower is above a higher debt service coverage ratio, and allowing lease financing for equipment purchases. It is less common to include such covenants in direct purchases of general obligation bonds. However, some covenants that arise in that context include maintenance of a specified rating category of the Issuer and financial reporting.

3. **Swaps**. Not infrequently, a commercial Lender may be reluctant to provide a long-term fixed rate for the Bonds but is willing to purchase the Bonds at a rate determined by reference to a Benchmark Rate and then sell the Borrower a swap to fixed rate. This has caused concern among some tax counsel, as it creates a question as to whether the swap and the bond need to be considered a single instrument or should be analyzed separately.

4. **Purchases by Non-Financial Institutions**. The 100% loss of cost of carry provided for by IRC § 265 applies, by its terms, to "financial institutions" and reduces the deduction from taxable income for federal income tax purposes that would otherwise have been available to the Bondholder for interest payments made to depositors, CD-holders and other creditors. Suppose, however, that the Bondholder doesn't take deposits and doesn't have any interest deductions at all? Such a Bondholder would not be affected by the 100% loss of cost of carry. Therefore, a number of Lenders have arranged for direct purchases to run through an entity such as a leasing company or a separate securities corporation. Such an entity typically is a subsidiary of the Lender's holding company, though not of the Lender, and is funded by equity contributed by the holding company. Will this really suffice to avoid IRC §265, assuming that the tax return is filed on a consolidated basis at the holding company level? This issue was decided in favor of the taxpayer in PSB Holdings, Inc. v. Commissioner, 129 T.C. No. 15 (2007).

5. **Transfer and Sale of Directly Held Bonds**. There are discrepancies in treatment of assignability depending on what the parties want to accomplish. If the goal is to avoid having to prepare an official statement and/or to enable the Lender to book the purchase as a commercial loan, then restrictions on transfer would be more common. At the extreme, there are some conduit Issuers who legend their Bonds with restrictions similar to "letter stock," including a requirement for an opinion of counsel upon each transfer. Often, however, subsequent transferees are limited to "accredited investors" and "qualified institutional buyers," and entities which are able to execute an investor or purchaser letter in substantially the same form as the one executed by the initial Lender.

6. **Public Disclosure of Direct Purchases under Amendments to SEC Rule 15c2-12**. On August 20, 2018, the SEC issued Release No. 34-83885 (the "SEC Release") adopting amendments to the Rule ("Amendments") that became effective on February 27, 2019. The Amendments add two new events to the list of reportable events for which an Issuer or obligated person must provide notice to the MSRB on EMMA. The Amendments are effective for continuing disclosure agreements or undertakings entered into on and after February 27, 2019. Accordingly, if a public offering is subject to the Rule, the additional listed events must be included in the continuing disclosure agreement or undertaking delivered in connection with the public offering. The SEC Release indicates: "The amendments are intended to address the need for timely disclosure of important information related to an Issuer's or obligated person's

financial obligations and cover a variety of obligations incurred by Issuers and obligated persons, including but not limited to direct placements." The Amendments added the following two new events (listed event Nos. 15 and 16) to the list of reportable events for which an Issuer or obligated person with publicly offered debt must provide notice to the MSRB's EMMA website within 10 business days:

> 15. (a) the incurrence of a financial obligation of the obligated person, if material, or (b) an 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. a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of an obligated person, any of which reflect financial difficulties.

Interpretative guidance from the SEC mentions that reportable event #15 extends to material amendments to existing financial obligations as well. Under the Amendments the term "financial obligation" means: "(i) a debt obligation; (ii) a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of (i) or (ii)".

These terms are broadly construed and include *both* short-term and long-term debt obligations of an obligated person under the terms of an indenture, loan agreement, financing lease, or similar contract regardless of the length of the repayment period of the debt obligation.

A "derivative instrument" includes a swap, a security-based swap, a futures contract, a forward contract, an option or similar instrument (or combination) to which an obligated person is a counterparty (keeping in mind that the derivative instrument also must be entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation).

A "guarantee" includes any guarantee provided by an obligated person (as a guarantor) for the benefit of itself or a third party, which guarantees payment of a financial obligation.

A "financial obligation" includes borrowings that might otherwise be exempt from statutory debt limits under state law. The SEC Release specifically notes that lease obligations, revenue bonds and certificates of participation may be considered "financial obligations" even though they are not "debt" under state law or state constitutional provisions. Leases that "operate as vehicles to borrow money" are debt obligations.

The materiality of a financial obligation or its terms is determined under general securities law standards (i.e., would the information be important to a reasonable investor in making an investment decision?), particularly with regard to any rights given to the holder of the financial obligation that are prior to the rights of the

holders of the obligated persons outstanding municipal securities. Beyond this general statement, the SEC has continued its approach of remaining vague in describing any materiality standard.

From pages 44705-44706 of the SEC Release: ". . . the Commission continues to believe that materiality determinations should be based on whether the information [disclosed in an offering document] would be important to the total mix of information made available to the reasonable investor." From page 44706: "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."

The SEC states in the SEC Release that the material terms of a financial obligation that should be disclosed under the new event include the following:

- date incurred,
- principal amount,
- maturity dates and amortization,
- interest rate, if fixed, or "method of computation," if variable,
- default rates, and
- such other terms as are "appropriate under the circumstances"[6]

For variable rate obligations, a question arises as to whether the Amendments permit the redaction of the interest rate spread similar to the redaction of commitment fees in the VRDB context under Rule G-34.[7] The SEC Release simply requires the disclosure of the "method of computation" for variable rate obligations. So long as the formula for interest rate computation is disclosed, query whether the spread could be redacted. Ultimately this would be a materiality determination by the Issuer.

New event #16 relates to "a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of an Issuer or obligated person, any of which reflect financial difficulties."

A default, acceleration, termination, modification or similar event under a financial obligation "reflects financial difficulties" of an obligated person and should be

[6] An issuer should consider what may be material to include when speaking to the market and whether a narrowly focused notice can be limited in scope with cautionary language. For example, if an Issuer obtains a bank loan to address a liquidity problem, e.g., to pay operating expenses such as payroll, additional disclosure regarding the issuer's financial condition may be necessary.

[7] Often commitment fees are set forth in a separate fee letter or fee agreement that is not posted on EMMA.

reported if the information is relevant to investors in making an assessment of the current financial condition of the Issuer or obligated person. In the SEC Release, the term "default" includes both payment and non-payment defaults, but distinguishes between those that do not reflect financial difficulties (such as failure to provide timely notice of a change in address) and those that do (such as a failure to replenish a debt service reserve fund).

There are different approaches that Issuers can take in disclosing financial obligations on EMMA. Some provide summaries of the obligations, others post full copies with certain information redacted.

The most efficient way to do this may be to post redacted documents for the prior private placements on EMMA. This approach seems to have become more common than posting summaries of the financial obligation terms, for the following reasons: Summaries are more time-consuming and expensive to produce than simply posting redacted copies of documents. Summaries make it harder for market participants to see all the terms of the deals. Summaries require the author of the summary to choose what to summarize and what to omit, and that judgment call invites potential errors and liability as to material omissions or misstatements.

7. Redaction of Information under Amendments to SEC Rule 15c2-12.

In an age of cybersecurity threats and identify theft concerns, participants in a direct purchase or other public finance bank product deals often are concerned about the posting of sensitive information. There are known instances of bad actors pulling financing documents from EMMA and trying to perpetrate financial or cybersecurity fraud. As such deal participants have a vested interest in protecting or redacting information that can be used fraudulently or nefariously.

The question is, what kinds of redactions are permitted under SEC rules?

Under the SEC Release, the SEC stated that "The [A]mendments **do not** require the provision of *confidential information* such as <u>contact information, account numbers, or other personally identifiable information to EMMA.</u>"

On February 27, 2019, the MSRB hosted a webinar with the SEC to discuss frequently asked questions related to the Amendments. At this webinar, in response to question as to whether certain proprietary information can be redacted from the event notice filings, an SEC representative noted that the SEC permits redaction of such information per the SEC Release, stating:

"In the Adopting Release, we specifically address what can be redacted and the Release states that the amendments do not require the provision of confidential information such as contact information, account numbers, or other personally identifiable information. As noted, an event notice filing should include all material terms of the financial obligation and we provided some examples of those: date of occurrence; principal amount; interest rate, and other terms may be appropriate as well. Notably, when discussing these redactions, the Commission made clear that

all necessary disclosures should be included in an event filing. In other words, Issuers should not redact event notice filings such that the notice does not contain all information about the financial obligation. If you want to make redactions, do so, but recognize that there is an expectation that all material information needs to be included in your event filing when you do so."

II. LETTERS OF CREDIT

A. OBJECTIVES: LOWER INTEREST COSTS THROUGH CREDIT AND LIQUIDITY SUPPORT

Letters of credit serve to provide access to public markets for Borrowers who could not achieve such access on their own credit. Letters of credit are also a useful financial tool for Borrowers that want to treat Bonds as long-term debt for financial statement purposes but want to enjoy the lower rates that come from the left-hand side of yield curve. The optional tender feature of VRDBs provides this opportunity to achieve lower rates and the Letter of Credit is there to make sure that Bondholders have the required liquidity.

B. NATURE OF LETTER OF CREDIT (NOT A GUARANTEE)

Letters of Credit are not guarantees.[8] A Letter of Credit is an independent, primary obligation of the issuer of the Letter of Credit to honor draws, up to an aggregate stated amount, presented in compliance with the terms of the Letter of Credit and prior to its termination. In contrast, a guarantee is a secondary obligation supporting a primary obligation of another person and, typically, does not have a limited term. Even more importantly, it may be a defense to the guarantor's liability on a guarantee that the primary obligor is not required to pay under the primary obligation. By contrast, if the beneficiary properly submits conforming documents under a Letter of Credit, the Letter of Credit issuer is bound to pay, whether or not the account party really owes the underlying obligation to the beneficiary. There is only the narrow exception for "fraud in the transaction" (or "material fraud," as UCC 5-109 describes it). The Comptroller's Office has issued a regulation with respect to the letters of credit (12 C.F.R. §7.1016) which, among other things, provides that (1) a national bank may issue letters of credit within the scope of

[8] Although technically speaking a Letter of Credit is a primary obligation and not a guarantee per se, for federal tax purposes letters of credit are regularly treated as "qualified guarantees" under Reg 1.148-4, which requires that they be a "guarantee in substance." "Treas. Reg. §1.148-4(f)(3) Guarantee in substance. The arrangement must create a guarantee in substance. The arrangement must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments, such as payments for principal and interest, redemption prices, or tender prices, on the guaranteed bonds. Reasonable procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional. In the case of a guarantee against failure to remarket a qualified tender bond, commercially reasonable limitations based on credit risk, such as limitations on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor, do not cause the guarantee to be conditional. The guarantee may be in any form. The guarantor may not be a co-obligor. Thus, the guarantor must not expect to make any payments *other than under a direct-pay Letter of Credit or similar arrangement for which the guarantor will be reimbursed immediately*. The guarantor and any related parties together must not use more than 10 percent of the proceeds of the portion of the issue allocable to the guaranteed bonds." (emphasis added).

applicable laws and rules of practice recognized by law (for instance, UCC Article 5, UCP 500, UCP 600 and ISP 98), and (2) as a matter of sound banking practice, in issuing a Letter of Credit a bank should consider the following:

1. The independent character of the Letter of Credit should be apparent from its terms (which includes, for this purpose, terms that subject the Letter of Credit to laws or rules providing for its independent character);

2. The Letter of Credit should be limited in amount;

3. The Letter of Credit should (i) be limited in duration, or (ii) permit the issuing bank to terminate the Letter of Credit either on a periodic basis (consistent with the Letter of Credit bank's ability to make any necessary credit assessments) or at will upon either notice or payment to the Borrower, or (iii) entitle the bank to cash collateral from the Borrower on demand (with a right to accelerate the Borrower's obligations, as appropriate);

4. The Letter of Credit bank either should be fully collateralized or have a post-honor right of reimbursement from the Borrower; and

5. In the event that the Letter of Credit provides for automatic renewal, the terms for renewal should be consistent with the Letter of Credit bank's ability to make any necessary credit assessments prior to renewal. In practice, "evergreen" provisions are frowned upon by many banks. Practitioners usually recommend that if an evergreen provision exists at all, there should still be a hard stop on a specified date in order to avoid the "asleep at the switch" problem.

C. PREFERENCE PROTECTION

1. **Object**. It is a major goal of rating agencies to ensure that the money paid to Bondholders is not subject to recovery as a preference in a bankruptcy of the Borrower. Accordingly:

(a) Principal of and interest on Bonds will be paid from draws on the Letter of Credit (i.e., it is the Bank's funds that pay the Bondholders, not the Borrower's money);

(b) Purchase price of tendered Bonds will be paid from remarketing proceeds or Letter of Credit draws upon failure to remarket;

(c) Alternatively, principal and interest or mandatory tender purchase price may be paid from aged money (on deposit with the Bond Trustee for the applicable preference period – generally 90 days under the United States Bankruptcy Code and four months, or 123 days, under some state insolvency laws). Aged money is not typically used as a source of payment (because it is not practical when you can make payment through a draw on a Letter of Credit and simultaneously reimburse the Bank without having to post funds with the Bond Trustee 90 days in advance); and

(d) Preference proof funds are segregated (not commingled with other funds).

2. **Preference Opinions**. Preference Opinions are not generally required anymore but see II.L. 2. Bank Counsel Opinions – Preference Opinions below.

D. DOCUMENTATION STRUCTURE

1. **Letter of Credit**. The Letter of Credit generally names the Bond Trustee as beneficiary. The Letter of Credit is issued in a stated amount equal to the aggregate principal amount of the Bonds, plus a stated number of days interest - typically determined by the rating agency to be the applicable interest period (usually one month), plus certain cushions (e.g., reinstatement period, weekends and holidays, and a reasonable time to assemble and present a draw request), usually for a total of 40 to 55 days interest at a stated maximum rate (usually 10% to 12% per annum). The Bond Trustee is authorized to make draws on the Letter of Credit by presentation of draw certificates in the forms prescribed by the Letter of Credit for (i) bond principal payments (which permanently reduce the amount available under the Letter of Credit), (ii) the current interest payment, a specified number of days (usually 5 to 10 days) after which the Letter of Credit amount is automatically reinstated with respect to such draw, unless prior to the expiration of such period the Bank notifies the Bond Trustee that such reinstatement shall not occur (but see II.E. 1. Reinstatement – Interest Draws below), and (iii) optional or mandatory tender purchase price of Bonds in the event and to the extent remarketing proceeds are not available to pay such purchase price (the principal component of such tender drawing, together with the appropriate interest component, is typically subject to reinstatement if the tendered Bonds are subsequently remarketed). Letters of Credit are generally issued for a stated term (typically, in the past, 3, 5 or 7 years, but more recently for shorter periods) and are subject to extension for additional periods at the option of the Bank upon request of the Borrower. If a Letter of Credit is not extended within a specified period prior to its stated expiration date, the Bond Indenture will typically require a mandatory tender of the Bonds and a corresponding draw on the Letter of Credit prior to its expiration.

2. **Reimbursement Agreement**. Usually, the Letter of Credit is issued pursuant to a Reimbursement Agreement between the Borrower and the Bank, pursuant to which (i) the Bank agrees to issue the Letter of Credit for the account of the Borrower and (ii) the Borrower agrees to reimburse the Bank for all draws honored under the Letter of Credit and to pay certain fees to the Bank, including quarterly fees calculated as a percentage of the amount available under the Letter of Credit. [PRACTICE TIP – In calculating availability for this purpose, the Bank should use the maximum drawable amount, but without giving effect to any temporary reduction that may be subsequently reinstated.] Reimbursement of a draw for payment of interest and/or principal is due the same day such draw is honored. Draws for purchase price of tendered Bonds are generally required to be reimbursed when the Bonds are remarketed or, in absence of remarketing, are treated as term loans which either amortize over the remaining term of the Letter of Credit or another specified period or become due as bullet maturities on the stated expiration date of the Letter of Credit. (At least one major Bank will permit the term loan to remain outstanding for 3 years after the stated expiration date of the Letter of Credit. Counsel may need to remind the Bank officer to obtain approval for an 8-year deal even if the Letter of Credit term is only 5 years.) In a more innocent age, outstanding tender draws had borne interest at conventional Bank rates (often Prime or Prime +1%). Today, many Banks (as the result of being

burned in 2008 by Remarketing Agents who failed to remarket and Borrowers who found that term loan rates were cheaper than SIFMA) insist on punitive rates for these term loans. (At a minimum, it should never be cheaper for the Borrower to force the Bank to purchase the VRDBs, rather than letting the interest rate on the VRDBs increase up to the rate necessary to remarket, right up to the Maximum Rate.) Reimbursement Agreements function as credit application/loan agreements between the Bank and the Borrower and set forth representations and warranties, covenants, reporting requirements, events of default and remedies. Remedies will include the right to direct a mandatory tender or an acceleration of the Bonds and to direct the Bond Trustee in the exercise of remedies under the Bond Indenture, the Loan Agreement and security documents.

3. **Bond Indenture**. A Bond Indenture should include the following provisions relating to the Letter of Credit:

(a) Mechanics and timelines for drawing on the Letter of Credit.

(b) Creation of segregated funds to hold proceeds of draws on the Letter of Credit and remarketing proceeds to be applied to pay (i) principal and interest on the Bonds and (ii) tender purchase price of Bonds. Failure to keep the funds properly segregated may result in the Bondholders being paid from Borrower’s money, not the Bank’s money, which could lead to a preference problem.

(c) Mandatory tender provisions triggered by (i) impending expiration of the Letter of Credit, (ii) non-reinstatement of the interest component of the Letter of Credit following an interest draw, or (iii) direction of the Bank because an event of default under the Reimbursement Agreement has occurred and is continuing.

(d) Mechanics for substitution of a new qualifying Letter of Credit for the existing Letter of Credit (which often includes mandatory tender).

(e) Provisions for declaration of an event of default, acceleration of the Bonds, draw on the Letter of Credit and exercise of remedies at the direction of the Bank because an event of default has occurred and is continuing under the Reimbursement Agreement. Note that some underwriters and financial advisors insist that the Bank’s remedy in this case is only the mandatory tender under (c) above. The idea is that an acceleration and redemption would kill off the Bonds for all time, while a mandatory tender preserves the possibility that the Borrower can find other credit and liquidity support and the Bonds can be remarketed.

(f) Provisions for the Bank to control the exercise of remedies under the Bond Indenture, the Loan Agreement and security documents (so long as the Bank is not in default of its obligation to honor conforming draws under the Letter of Credit) and requiring Bank consent to any proposed amendments to the Bond Indenture, the Loan Agreement or security documents.

4. **Construction Fund.** In the case of construction funds held by the Bond Trustee to pay Project construction costs, a provision requiring Bank approval of each draw of construction funds held by the Bond Trustee. The conditions under which the Bank will give such approval are typically set forth in the Reimbursement Agreement or in another agreement directly between the Bank and the Borrower.

E. REINSTATEMENT

1. **Interest Draws**. In order to maintain full coverage for the Bondholders and provide for the next scheduled interest payment, the amount available under the Letter of Credit to pay interest needs to be reinstated after each drawing to make a regularly scheduled interest payment (typically monthly). Reinstatement mechanics may include the following provisions:

(a) Usually, a Letter of Credit will provide for automatic reinstatement 5 to 10 days after a scheduled interest drawing, unless within such period the Bond Trustee receives notice from the Bank that a Reimbursement Agreement event of default has occurred and is continuing and such reinstatement shall not occur.

(b) Alternatively, a Letter of Credit may provide for immediate automatic reinstatement, with the understanding that the Bank is free to force a mandatory tender or an immediate acceleration of the Bonds if a Reimbursement Agreement default occurs. Immediate reinstatement permits the interest component of the Letter of Credit to be smaller (this gives rise to savings on letter of credit fees). ISSUE: If a Borrower files for reorganization and the Bonds remain outstanding in whole or in part, the Bank might be forced, because of the automatic stay, to watch its Letter of Credit reinstate without reimbursement and without the ability to collapse the transaction. Even absent bankruptcy, there would be a timing risk such that the Letter of Credit could be drawn upon and automatically reinstate at a time when the Bank has not been paid, leading to a possibility that the Bank will extend credit above its credit approval by an amount at least equal to a month’s interest.

2. **Purchase Price Draws**. The interest rate on Bonds is generally adjusted within the optional tender notice period as necessary to resell the tendered Bonds at par. Consequently, prior to the market collapse in September 2008, a failure to remarket upon an optional tender resulting in a purchase price draw was virtually unknown. Since September 2008, remarketing failure following an optional tender is now recognized as a very real possibility. Also, a purchase price draw may occur in the event of certain mandatory tenders. In the event of a draw on the Letter of Credit to pay purchase price of tendered Bonds that are not remarketed, such unremarketed Bonds are generally pledged to and/or held in the name of the Bank pending remarketing. If the Bonds are subsequently remarketed, the Bank is reimbursed with the remarketing proceeds and the Letter of Credit is reinstated.

F. PLEDGED BONDS/BANK BONDS

1. **Background**. If Bonds are purchased with the proceeds of a Letter of Credit draw upon an optional or mandatory tender, they are often deemed owned by the Borrower and pledged to the Bank pursuant to the Reimbursement Agreement or a separate pledge agreement pending remarketing of such Bonds and reimbursement of the Bank. For perfection of the pledge, the Bond Indenture should provide that ownership of such Bonds shall be registered in the name of the Bank as pledgee of the Borrower on the registration books of the Bond Trustee and on the records of the applicable DTC Participant. Alternatively, the Reimbursement Agreement may provide that such Bonds are deemed Bank Bonds owned by the Bank, in which case the Bank Bonds would bear interest at a Bank Rate (which needs to be provided for in the Bond Indenture). In the case of Bank Bonds and pledged Bonds that bear interest at a Bank Rate different from other Bonds, DTC requires a separate CUSIP number and compliance with certain procedures. Such CUSIP numbers are now generally being requested at closing instead of waiting for a failed remarketing.

2. **Purpose of Pledge**. Since the Bank would already hold the reimbursement obligation of the Borrower for the tender draw (secured by (i) any collateral and/or guarantees held by the Bank for the Borrower's obligations under the Reimbursement Agreement and (ii) any collateral held by the Bond Trustee), the tendered Bonds often add little intrinsic collateral value for the Bank. However, if the Bonds are secured by a significant trust estate (such as a construction fund, debt service reserve fund or other collateral), it is important for the Bank to block other creditors of the Borrower from acquiring an interest in the tendered Bonds and thereby acquiring an interest in the trust estate. Rights to pledged Bonds may also be important where only the Bonds (and not the Reimbursement Agreement) are secured by certain collateral.

G. RENEWAL

1. **Background**. Bond Indentures typically provide for a mandatory tender of the Bonds prior to the expiration date of the Letter of Credit, unless the Letter of Credit is renewed (extended) or replaced by another Letter of Credit meeting the terms of the Bond Indenture.

2. **Stated Expiration Date**. A Letter of Credit should have a stated expiration date or permit the Bank to terminate upon reasonable prior notice or payment. See ISP 98 §9.01, UCP 500 Article 42, UCP 600 Article 6, and 12 C.F.R. §7.1016.

3. **Prescribed Renewal Procedure**. Often a Letter of Credit or Reimbursement Agreement will set forth procedures and specific time periods for requesting and committing to future Letter of Credit renewals. ISSUE: While such procedures may be helpful in laying out how the parties intend to go about requesting and granting or denying Letter of Credit renewals in the future, they also create false deadlines that are often missed. It is usually best for the Borrower to start early well in advance of the deadlines and diligently pursue the renewal process with its Bank.

H. LETTER OF CREDIT REPLACEMENT

1. **Background**. Bond Indentures for Bonds supported by a Letter of Credit set forth various (sometimes elaborate) requirements to be met in replacing an existing Letter of

Credit with a new Letter of Credit issued by another Bank. Common requirements include (i) the new Letter of Credit must have substantially the same provisions as the old one (not very realistic unless the Bond Trustee is willing to take an expansive view of "substantially the same"), (ii) an opinion of counsel to the new Bank as to the validity and enforceability of the new Letter of Credit, (iii) confirmation by the applicable rating agency of the rating of the Bonds as enhanced by the new Letter of Credit, and (iv) an opinion of bond counsel as to no adverse tax consequences and compliance with the Letter of Credit replacement requirements of the Bond Indenture. Note that older Bond Indentures often provided that so long as the replacement of the Letter of Credit did not cause a reduction in rating level, then there would not be a mandatory tender, while more modern Bond Indentures typically provide for a mandatory tender and remarketing no matter what the rating for the replacement Letter of Credit. PRACTICE TIP: Provide expressly that the new Bank must purchase all Bank Bonds or pledged Bonds in order to take out the old Bank.

2. **Timing Problems**. The foregoing requirements are typically required to be satisfied at some period of time (often 30 days or more) prior to the expiration date of the existing Letter of Credit. This timing permits advance notice to the Bondholders and an orderly mandatory tender and remarketing (or, in some older Bond Indentures, an opportunity for Bondholders to optionally tender their Bonds for purchase prior to replacement of the existing Letter of Credit). If the existing Letter of Credit is about to expire and the replacement requirements are not met, the Bond Indenture will provide for mandatory tender or redemption prior to expiration of the Letter of Credit. Problems arise from Bond Indentures that suggest that somehow the new Letter of Credit needs to actually be in effect 30 days before the termination of the old Letter of Credit. Since this would prevent the new Bank from getting a first lien on the collateral, it creates an impossible situation unless the Bond Trustee can be persuaded to ignore the literal words of the Bond Indenture. PRACTICE TIP: In structuring a replacement transaction that involves a remarketing, remember that the existing Bondholders need to be paid with proceeds of a draw on the old Letter of Credit (i.e., the credit they originally signed up for), rather than the new Letter of Credit.

3. Suggestions.

(a) If Bank counsel has input on the drafting of the Bond Indenture, she should make sure that delivery of the actual replacement Letter of Credit is not required by the Bond Indenture until the interest payment date (or other date) on which the existing Letter of Credit is expected to be surrendered. Reasons: (i) Banks are often unwilling to issue a Letter of Credit unless the existing Bank is simultaneously relinquishing its rights with respect to collateral; and (ii) Banks are generally unwilling to issue a Letter of Credit prior to its effective date (from the Bank's point of view, the Bank is irrevocably committed when the Letter of Credit leaves its hands even if the effective date is at some later time).

(b) The time period for advance delivery of documents should be as short as possible. The Bond Indenture should set flexible timing requirements that will facilitate an effective replacement so long as there is no actual gap or potential shortfall in Letter of Credit coverage for the Bondholders.

I. NEW COLLATERAL TAKEN UPON LETTER OF CREDIT REPLACEMENT

1. **Problem**. If, upon issuance of a replacement Letter of Credit, the new Bank requires additional collateral that does not already secure the prior Reimbursement Agreement or the Bonds, there would be a potential for an indirect preference to the Bondholders in the event of a bankruptcy proceeding within the applicable preference period (generally 90 or 123 days) following the issuance of the replacement Letter of Credit and the concurrent delivery of the additional collateral. See In re Compton Corp., 831 F.2d 586 (5th Cir. 1987) (also known as the "Blue Quail" case); In re Air Conditioning of Stuart, Inc., 845 F.2d 293 (11th Cir. 1988). Consequently, the rating agencies will generally either prohibit the taking of such additional collateral or require an opinion of experienced bankruptcy counsel to the effect that there is no bankruptcy preference risk to the Bondholders in the event of the Borrower's bankruptcy.

2. **Solution**. The preference risk might be avoided if the Bank agrees that (1) the Bank will not foreclose or exercise any right to realize upon the new collateral for a period of 90 days (or 123 days, if applicable) following the date of execution and delivery of the new Letter of Credit and additional collateral documents and (2) if prior to the expiration of such 90-day (or 123-day) period the Borrower should become a debtor in a bankruptcy proceeding, then (i) the additional collateral documents shall be deemed void as of the date of execution and delivery thereof and (ii) the Bank will not claim or accept the benefits of the additional collateral. One sometimes sees a situation in which the new Bank takes over the old Bank's collateral at the date of substitution and then, 90 days later, when the rating agency has already issued its ratings letter and is no longer paying attention to the deal, the new collateral is added. The assumption is that in the event of the Borrower's bankruptcy within the following 90 (or 123, as applicable) days, the additional collateral grant to the Bank could be viewed as preferential, but rights of Bondholders to be paid under the new Letter of Credit would survive.

J. BOND DOCUMENT DRAFTING POINTS

1. Bond Counsel should take care that:

(a) Defined terms in the Bond Indenture, the Loan Agreement and security documents include the original Bank, Letter of Credit and Reimbursement Agreement, as they may be amended from time to time, and any substitute Bank, Letter of Credit and Reimbursement Agreement.

(b) The mechanics of drawings and payments generally work, are practical, and assure that payment of principal, interest and tender purchase price to Bondholders will always be made with Letter of Credit proceeds, remarketing proceeds (excluding any remarketing to the Borrower, its affiliates or the Issuer), or other money not subject to recovery as a preferential transfer in the event of a bankruptcy of the Borrower. In rating Bonds supported by a Letter of Credit, the rating agency will generally review and police these matters.

(c) The provisions governing replacement of an existing Letter of Credit with a new Letter of Credit are synchronized to not (i) allow a gap in the Letter of Credit coverage for the Bondholders or (ii) require an overlap of Letters of Credit such that the existing Letter of Credit and the new Letter of Credit are required to be outstanding at the same time (other than for an instant on the day of closing, such overlaps are virtually never acceptable to the exiting and incoming Banks).

2. Bank Counsel should consider the following in protecting the Bank's interests:

(a) Granting Clauses. The Bond Indenture granting clauses should secure (i) the payment of the Bonds for the equal and ratable benefit of the Bondholders and (ii) all of the Borrower's obligations under the Reimbursement Agreement for the benefit of the Bank. The "TO HAVE AND TO HOLD" and "PROVIDED, NEVERTHELESS" clauses should match the granting clauses in this respect. ISSUE: Sometimes the granting clauses of the Bond Indenture or other security documents state that the Bank is secured on a "subordinated" basis. This isn't exactly accurate; instead the various provisions of the Bond Indenture should specifically provide which money goes to whom and when. Thus, for instance, once the Bank has paid to the Bond Trustee a drawing in respect of a monthly interest payment on the Bonds, the Bank is entitled to be reimbursed from any monies deposited into the Bond Fund by the Borrower in respect of that monthly interest payment and this right is not "subordinated" to any claim of the Bondholders.

(b) Definitions. As a matter of exit strategy, the definitions of "Bank," "Letter of Credit" and "Reimbursement Agreement" should include any substitute Bank, Letter of Credit and Reimbursement Agreement to facilitate transition to a new Bank if the existing Bank declines to extend at the end of the term of its Letter of Credit.

(c) Draw Times. Should be reasonable and allow the Bank sufficient time to process and pay draws without undue risk of failure to timely honor conforming draw requests. The timing of a tender drawing for unremarketed Bonds is particularly sensitive when Bonds are in a daily mode; the fixing of the daily rate, the Bondholder's decision to tender, the remarketing and the draw times are all compressed into a few hours and the timing is further constrained by the DTC deadline governing the time by which the Trustee must remit payment to DTC for the Bondholders. During the troubled times in late 2008, when tenders were occurring with greater frequency than ever before, the compressed timetables for Bonds in daily mode led to mechanical problems in some deals. There simply was not enough time for all parties to perform their obligations smoothly.

(d) Mandatory Tender/Acceleration. The Bond Indenture should provide for a mandatory tender or acceleration as directed by the Bank if the Bank needs to collapse the financing due to an Event of Default under the Reimbursement Agreement. The advantage of mandatory tender over acceleration is that the potential for tax-exempt financing under the existing bond structure can be preserved as a workout option. Accordingly, (i) upon non-reinstatement of a Letter of Credit following a draw for regularly scheduled interest (non-reinstatement is usually conditioned upon a failure to reimburse the Bank for such draw or the existence of an ongoing Event of Default under the Reimbursement Agreement), and absent direction from the Bank to accelerate as described below, the Bond Indenture should provide for a prompt mandatory tender of the Bonds for purchase, and (ii) upon the occurrence of an Event of Default under the Reimbursement Agreement, the Bank should have the option under the Bond Indenture to direct either a mandatory tender or an acceleration of the Bonds.

(e) Control of Remedies. So long as the Bank is not in default of its obligation to honor conforming draws under the Letter of Credit, the Bank should have the right to direct and control the exercise of remedies (including acceleration) under the Bond Indenture, the Loan Agreement and security documents.

(f) Amendments. Amendments of the Bond Indenture, the Loan Agreement and the security documents should be subject to the Bank's consent. Bond Indentures often provide that the right to consent to amendments is conditioned on the Bank not being in default of its obligation to honor conforming draws under the Letter of Credit. ISSUE: The Bank is a direct beneficiary of the Bond Indenture. Should a defaulting Bank, like a defaulting Borrower, retain the right to consent to amendments of documents under which it is a direct beneficiary? ISSUE: Should the Bank be permitted to consent to amendments on behalf of Bondholders so long as it is not in default of its obligation to honor conforming draws under the Letter of Credit? The market will generally permit this, but Bondholders will typically also have consent rights as to their "sacred rights".

(g) Defeasance. Defeasance clauses should be conditioned not only on payment (or provision for payment) of the Bonds, but also on payment of all obligations owing to the Bank under the Reimbursement Agreement.

(h) Swaps/Cross-Default. Standard ISDA swap documents contain cross-default provisions and permit termination by the swap counterparty if there is a default permitting acceleration of debt under any credit agreement constituting Specified Indebtedness (including a Reimbursement Agreement). Bank counsel and Borrower's counsel should consider requiring that the ISDA Schedule modify the ISDA Master Agreement so that a cross-default gives rise to a right of termination of the swap agreement only if the cross-default debt is accelerated. Also, ISDA swap documents

often incorporate by reference the financial covenants of the Reimbursement Agreement as same existed on the closing date and without regard to future waiver or amendment. Obviously, the Bank would have a stronger hand in a work-out scenario if at the time of the closing it had required the swap documents to incorporate the financial covenants of the Reimbursement Agreement as the Bank and the Borrower may amend them from time to time.

3. **Security Structure**. In a Bond financing supported by a Letter of Credit where there is a mortgage or other collateral apart from the general obligation of the Borrower, the security structure usually takes one of the following paths:

(a) Bank Sole Secured Party.

- Advantages:
  - Bond documents and Bond Trustee duties are not complicated with collateral.
  - Letter of Credit Bank directly and solely controls the collateral.
- Disadvantages:
  - Upon substitution of a new Letter of Credit Bank, the collateral documents have to be transferred to the new Bank and, if necessary, modified, and additional title insurance expense may be incurred. This is particularly true in jurisdictions such as Pennsylvania where the ability to negotiate title insurance premiums is limited or nonexistent.
  - Upon a default of the Bank under the Letter of Credit, the Bondholders would not have the benefit of the collateral. Therefore, disclosure documents should stress that the Bondholders are looking only to the Letter of Credit as their source of payment.

(b) Bond Trustee Sole Secured Party.

- Advantages:
  - Facilitates transition to a substitute Letter of Credit Bank.
  - Bondholders will have the benefit of the collateral in the event of a failure of the Letter of Credit Bank.
- Disadvantages:

- The Letter of Credit Bank (which is taking all of the credit risk) does not have direct rights against the collateral and will have to work through the Bond Trustee in the event of an exercise of remedies.

(c) Both Trustee and Bank Secured Parties - Provides a combination of most of the advantages and some of the disadvantages noted in (1) and (2) above. The doubling up of security was popular in the bad old days of Twist Cap, a wrongly decided Florida bankruptcy case (Twist Cap, Inc. v. Southern Bank, 1 B.R. 284 (Bankr. M.D. Fla. 1979)) that treated the drawing under a secured Letter of Credit as giving rise to a preferential transfer at the time of the drawing unless the same security had been given to the holders of the underlying indebtedness secured by the Letter of Credit.

(d) Master Indenture Structure - All collateral held by a Master Trustee under a Master Indenture for the benefit of one or more Bond Trustees and one or more Letter of Credit Banks.

- Advantages:
  - Convenient and effective structure where multiple creditors and/or multiple bond issues are to be secured on a parity basis.
  - Can provide a uniform set of Borrower covenants for the benefit of all creditors. [But see Section II.P. 2. below.]
  - Functions, in part, as an intercreditor agreement.
  - Can also provide a convenient mechanism for securing swap providers.
  - Creditors can look to the Master Trustee to exercise remedies.
- Disadvantages:
  - Added layer of documentation and trustee expense.
  - Letter of Credit Bank does not have direct rights against the collateral and will have to work through the Master Trustee to exercise remedies.
- Bank Counsel Considerations:
  - Master Notes should be issued to both the Bond Trustee and the Bank (but should not be double counted for voting or payment rights).

- The Master Note issued to the Bank should not be limited to the stated amount of the Letter of Credit but should secure all reimbursement amounts, interest payments, fee payments and other amounts payable under the Reimbursement Agreement.

K. LETTER OF CREDIT GOVERNING LAW

Letters of Credit are generally issued under the laws of the state specified therein and are governed by and construed in accordance with Article 5 of the Uniform Commercial Code ("UCC Article 5") as in effect in such state, the Uniform Customs and Practice for Documentary Credits, Publication No. 500, 1993 Revision, adopted by the International Chamber of Commerce ("UCP 500"), the Uniform Customs and Practice for Documentary Credits, Publication No. 600, 2007 Revision, adopted by the International Chamber of Commerce ("UCP 600") or ISP 98 - International Standby Practices, ICC Publication No. 590, 1998 Edition, developed by the Institute of International Banking Law and Practice, Inc. and endorsed and published by the International Chamber of Commerce ("ISP 98"). UCP 600 is the most modern of these sources, but it is geared primarily toward international trade. ISP 98 is specifically oriented toward standby letters of credit (including "direct-pay" letters of credit) intended to support financial transactions. ISP 98 is, therefore, better suited for Letters of Credit supporting Bonds, but any of ISP 98, UCP 500 or UCP 600 will suffice. It should be noted that UCP 500, UCP 600 and ISP 98 are not statutes, but provide contract terms that only govern the Letter of Credit when incorporated therein by reference. Those incorporated terms constitute, in effect, a series of default rules that can be varied by the specific terms of a Letter of Credit. For instance, many Letters of Credit contain specific provisions as to transferability rather than relying on the default rules. As a drafting preference, one would like the Letter of Credit to be transferable in whole, but not in part, to any successor Bond Trustee and to permit successive transfers to successive Bond Trustees.

L. LETTER OF CREDIT BANK COUNSEL OPINIONS

1. **Letter of Credit Valid, Binding and Enforceable**. This is the core Letter of Credit bank counsel opinion. Generally expected and required by underwriter's counsel and bond counsel.

2. **Preference Opinions**. An opinion dealing with the consequences of Borrower's bankruptcy was once a common requirement of rating agencies. Now not usually required except in the case of addition of new collateral. See, Section II.I. above. In some cases, Moody's may still ask for an opinion relating to the consequences of the bank's insolvency, particularly with respect to a state-chartered bank organized in a jurisdiction where there is a question as to ability of the state regulatory authority to obtain a clawback of payments made by an insolvent bank.

3. **Bankruptcy Exception**. When the rating agencies were requiring preference opinions, they also required that the bankruptcy exception to bank counsel's Letter of Credit enforceability opinion be limited to a bankruptcy, insolvency or similar proceeding with respect to the bank, not the Borrower.

4. **Foreign Bank Counsel Opinions**. In the case of foreign banks, (1) domestic bank counsel will be required to deliver an opinion with respect to the validity, binding effect and enforceability of the Letter of Credit under the applicable domestic law, relying on the opinion of foreign bank counsel and (2) foreign bank counsel will generally be required to opine under the applicable foreign law with respect to (i) existence of the bank, (ii) authorization, (iii) enforceability of the Letter of Credit, and (iv) availability of remedies against the bank in its home jurisdiction.

5. **Section 3(a)(2) Exemption Opinions**. As separate securities in bond financings, Letters of Credit issued by domestic banks are exempt from registration under Section 3(a)(2) of the Securities Act. The Securities Act does not specifically address the availability of this exemption in the case of a branch or agency of a foreign bank which has been licensed to do business under the laws of a particular state. Nevertheless, the Securities and Exchange Commission (the "SEC") in Release No. 33-6661 effective September 23, 1986 (the "Release") has taken the position that, for purposes of Section 3(a)(2) of the Securities Act, a branch or agency of a foreign bank located in the United States will have the benefit of this exemption when (1) the extent and nature of the federal and/or state regulation and supervision of the branch or agency is substantially equivalent to that applied to a federal or state chartered domestic bank doing business in the same jurisdiction, (2) the business of the branch or agency is substantially confined to banking and (3) the branch or agency is supervised by a state banking commission or similar official. Although the Release is not dispositive of legal issues raised under the Securities Act, it does reflect the SEC's legal interpretation of the Securities Act. State of New York regulation of New York branches of foreign banks is well recognized as meeting the requirements of the Release. Sometimes, but not always, domestic counsel for foreign banks is asked to opine as to the exemption of the Letter of Credit from registration under the Securities Act.

M. DISCLOSURE

1. Letter of Credit Bank Disclosure.

(a) Historical Practice. In general, the disclosure regarding the issuing Letter of Credit bank in offering documents for Bonds supported by a Letter of Credit or a Standby Bond Purchase Agreement or other bank-provided liquidity facility has been brief, often limited to: (i) one or two paragraphs describing the Letter of Credit bank (and its holding company, if any), (ii) a few primary financial numbers for the most recent financial reporting period (typically, total assets, total deposits, total net loans and total shareholders' equity), (iii) an address where recipients of the offering document could write to obtain copies of current publicly available reports regarding the bank and/or its holding company; and (iv) more recently, websites where such information can be found. PRACTICE TIP: Consider whether any

such websites are incorporated into the offering for purposes of the Federal securities laws. Many practitioners have limited the websites in such disclosure to the SEC's EDGAR site. Beware of issues that pop up just prior to closing in the context of the certificate from the bank standing behind the limited Bank disclosure contained in the Official Statement. Bond counsel or underwriter's counsel may ask for Rule 10b-5 language to the effect that the Bank disclosure "does not omit to state a material fact." Question the intent of this certificate, as typical Letter of Credit bank disclosure omits to state just about everything. Consider whether the Letter of Credit bank should certify to the true and correctness (i.e., the disclosure isn't actually false).

(b) Rule 15c2-12. Previously, the Rule was not applicable to VRDBs supported by a "direct-pay" Letter of Credit because of the exemption for obligations issued in minimum denominations of $100,000 and subject to tender at par at least every nine months. The 2010 amendments to the Rule ended this exemption and provided that VRDBs are now subject to continuing disclosure requirements.

(c) References to Bank Reports. Most recent financial reports are frequently referenced (and incorporated by reference) in the disclosure (such as call reports and 10-Ks, 10-Qs and 8-Ks). Should there be an undertaking by the Letter of Credit bank to provide copies of such reports on request? Should such documents be formally incorporated by reference into the disclosure?

(d) Foreign Banks. Foreign banks often present additional difficult issues. Reports, in English, providing detailed information about the foreign bank in question are often, but not always, available; however, such reports are not necessarily prepared for the United States securities markets, are often prepared only annually and not available soon after the close of the relevant fiscal year, and are necessarily based on the accounting standards of the foreign bank's home country (and may or may not include some discussion of accounting principles). Moreover, obtaining current information from the principal office of the foreign bank in its home country may be impractical. What is the appropriate balance for disclosure regarding foreign banks in light of the foregoing? Should there be reference to (or incorporation by reference of) annual or interim financial reports produced by the foreign bank or to documents filed by the foreign bank with state or federal regulators in the United States?

(e) Disclosure Regarding Underlying Borrower. Disclosure regarding the underlying Borrower in the case of Bonds supported by a "direct pay" Letter of Credit has varied from complete to very limited (on the theory that the Bonds are being sold on the credit of the Letter of Credit bank and not the Borrower and are subject to tender for purchase at the option of the Bondholder and call at the option of the Borrower on short notice). Finance

teams will need to question what level of disclosure of the Borrower and its operations is necessary.

ISSUES: If the Bonds are subject to tender and call on short notice and are fully backed by the Letter of Credit (both as to debt service and tender purchase price) and if they are sold in large denominations to accredited investors, is disclosure regarding the underlying Borrower material to the Bondholder's investment decision? Borrower as an obligated party?

2. Summaries/Descriptions of Letter of Credit and Reimbursement Agreement.

(f) Letter of Credit. Official Statement descriptions of a Letter of Credit will generally include: (i) a statement that it is an irrevocable obligation of the Letter of Credit bank to honor draws presented by the Bond Trustee in compliance with the terms of the Letter of Credit; (ii) a statement of the Letter of Credit amount, the portion thereof available to pay principal of the Bonds or purchase price thereof corresponding to principal, and the portion thereof available to pay accrued interest (including a statement of the number of days interest and maximum rate at which such portion is determined) or purchase price corresponding to accrued interest; (iii) a brief description of the reduction and reinstatement mechanics of the Letter of Credit; and (iv) a thorough description of the expiration or termination provisions of the Letter of Credit. Sometimes the Letter of Credit itself is included as an appendix to the Official Statement.

ISSUES: In light of concerns regarding fraudulent draws on Letters of Credit by bad actors, what steps can be taken to ensure that draw forms cannot be taken from an Official Statement and manipulated for a fraudulent draw?

(g) Reimbursement Agreement. In the case of VRDBs, Official Statement descriptions of a Reimbursement Agreement usually include (i) a brief statement that the Letter of Credit is being issued, and (ii) a statement that the Reimbursement Agreement contains various representations, warranties and covenants of the Borrower. Official Statements typically include a description of the events of default and remedy provisions of the Reimbursement Agreement. If Bank counsel is being asked to give an opinion that the information contained in the Reimbursement Agreement contains "a fair and accurate summary of the substantive provisions of the Reimbursement Agreement," counsel will probably want to include in the Official Statement a more elaborate description of representations and warranties, covenants, reporting requirements, etc. In the case of Bonds in a long-term mode, special consideration should be given to disclosure of Borrower covenants that, if breached, may give rise to an early redemption of the Bonds and loss of the Bondholders' interest rate bargain.

N. RATING AGENCY/UNDERWRITER HOT BUTTONS

Some typical concerns of rating agencies and underwriters include:

1. **Day Count for the Interest Component of the Letter of Credit**. One would think this would be standardized (e.g., a 31-day month, plus a 3-day weekend, plus a 10-day reinstatement period = 44 days), but every rating agency analyst seems to count differently with conflicting results. One key factor is whether the remedy for non-reinstatement of an interest drawing is an acceleration (in which case interest stops accruing) or a mandatory tender (in which case interest continues to run during the notice period for the tender). If the latter, the notice period for that particular type of mandatory tender should be quite short (2 or 3 days should suffice); a 30-day notice period would lead to a sizing of the interest component of the Letter of Credit at 70+ days. PRACTICE TIP: When the underwriter is beating on the Bank about the sizing of the Letter of Credit, remember that for a $10,000,000 Letter of Credit covering Bonds with a Maximum Rate of 10% per annum and bearing an annual fee of 100 basis points, each additional day of interest coverage leads to an incremental $27.40 per year in Letter of Credit fees. This may help put things in perspective.

2. **Payable from Bank's Own Fund.** Making sure that the Letter of Credit is payable from the Bank's own funds. Note that if the Letter of Credit is governed by ISP 98, that term is deemed included whether or not specifically so stated. ISP 98, Rule 1.09.

3. **Notices to Trustee.** Making sure that notices to the Bond Trustee (particularly any notice of non-reinstatement) are stated to be effective only when received by the Bond Trustee, not when given by the Bank.

4. **The "Hurricane Hugo" Clause**. Note the disparate treatment under the various ICC documents. Under UCP 500, Article 17 and UCP 600, Article 36, if the Letter of Credit expires while the Bank is closed due to force majeure, the beneficiary is out of luck. Under ISP 98, Rule 3.14, if the presentment cannot be made in a timely manner due to closure of the Bank, the time for presentment is extended until 30 days after the Bank reopens. For this reason, UCP 500, Article 17 is often excluded by a Letter of Credit that otherwise adopts UCP 500 by reference and the force majeure situation is dealt by the express terms of such Letter of Credit.

O. CONFIRMING LETTERS OF CREDIT

If the Letter of Credit bank lacks (or loses) a sufficient rating to support the VRDBs, a Confirming Letter of Credit may be obtained. A Confirming Letter of Credit typically allows the Bond Trustee to draw on the Letter of Credit if (i) a proper drawing has been made on the underlying Letter of Credit, but the Letter of Credit bank has failed to pay or (ii) something has occurred (for instance, rejection by the Letter of Credit bank of its obligation to pay under the Letter of Credit or the insolvency of the Letter of Credit bank) that would make a drawing under the underlying Letter of Credit futile. Typically, the Letter of Credit bank enters into a reimbursement agreement with the Confirming Letter of Credit bank pursuant to which the Letter of Credit bank agrees to reimburse the Confirming Letter of Credit bank immediately for any drawing on the Confirming Letter of Credit. The

Confirming Letter of Credit bank may also seek direct recourse against the Borrower for this reimbursement and subrogation rights against collateral granted by the Borrower to the Letter of Credit bank. In other instances, the Confirming Letter of Credit bank regards the Letter of Credit bank as its customer and is not concerned with the Borrower.

A Confirming Letter of Credit may be drafted either (i) to permit reinstatement of interest drawings and/or tender drawings in the same way that a Letter of Credit typically would or (ii) as a one-time calamity call with no provision for reinstatement. In the latter case, the Bond Indenture needs to provide for acceleration or mandatory tender of the Bonds so that the Confirming Letter of Credit can be drawn upon in an amount sufficient to pay the Bondholders in full.

P. OTHER CURRENT LETTER OF CREDIT TOPICS

1. **Master Trust Indenture Covenants**. In many financings, particularly for hospitals, nonprofit entities, universities, and other conduit borrowers, the Lender may be stepping into a situation in which there are multiple series of existing long-term bonds held by others and secured by a Master Indenture. The Borrower and its municipal advisors will argue that the Letter of Credit bank should live with the Master Indenture covenants, because they are good enough for the long-term Bondholders. There are several problems with this argument, including: (i) the position of the long-term Bondholders and the Letter of Credit bank are markedly different; if the Bondholders have a problem with the Borrower they can always sell their Bonds, while the Letter of Credit bank is stuck with the contractual arrangement related to the Letter of Credit, (ii) Master Indenture covenants need to be written loosely, because they need to last for 30 years and the Bondholders may be hard to locate for waivers or amendments, while the bank's commitment is much shorter and the bank is more likely to be available to consider an amendment, consent, or waiver, (iii) if the bank doesn't give a requested waiver or consent, the Borrower can replace the bank as fast as it can find a replacement, while there is no way (short of actual refunding) for the Borrower to rid itself of recalcitrant long-term Bondholders and unwieldy or outdated Master Indenture covenants, and (iv) the Master Indenture covenants are typically written in a way that contemplates a large group of bondholders and are not necessarily what a bank credit committee would readily understand. In particular, note that Master Indenture covenants often calculate debt service coverage on the basis of "MADS" (maximum annual debt service). There are typically many pages of definitions, assumptions and exceptions for the MADS calculation. When commercial bankers refer to debt service coverage, they would more typically mean a retrospective actual-to-actual test. The latter at least has the virtue of being ascertainable from the Borrower's financial statements. Note that, even if the bank decides to live with the Master Indenture covenants as written for covenant definition and calculation purposes, the Bank may want a remedy for violation that differs from the Master Indenture's remedy. All too often, the Master Indenture will have a toothless remedy, such as requiring the Borrower to obtain a consultant's report, whereas the bank may want a more meaningful remedy, such as acceleration and/or a default interest rate (if permitted under local law).

2. **Material Adverse Change ("MAC") Attack**. There is increasing scrutiny of default clauses based on "material adverse change" ("MAC"). In particular, a rating agency may have concerns rating a VRDB issue if a MAC clause exists in the Reimbursement

Agreement. The rating agency's real objection doesn't relate to the VRDB issue that the rating agency is being asked to rate (since the holders of the VRDBs would be paid from the Letter of Credit if the bank accelerates), but the other unenhanced bond issues for the same Borrower that the same rating agency may have previously rated. Accountants have also joined in the attack on MAC defaults. In order to avoid a classification of VRDBs as short-term debt, Borrower needs to convince its accountants that the term-out of Bank Bonds will really work. Some accountants believe that a MAC default creates rights on the Letter of Credit Bank's part that are so subjective that the financing in essence becomes a demand loan.

III. STANDBY BOND PURCHASE AGREEMENTS

A. GENERAL

Liquidity facilities generally take the form of a Standby Bond Purchase Agreement but may take the form of a Letter of Credit or a dedicated line of credit. The purpose is to provide liquidity in the event of a tender and failure to remarket or in the event of a mandatory tender in anticipation of expiration of the existing Standby Bond Purchase Agreement. A Standby Bond Purchase Agreement may be used to provide liquidity for VRDBs that bear a long-term rating based on the credit of the Borrower.

In theory, a Standby Bond Purchase Agreement can be provided by a bank less expensively than a Letter of Credit because the associated capital maintenance requirement is less. One critical difference between a Standby Bond Purchase Agreement and a Letter of Credit is that the issuing bank may terminate, without any notice or cure period, its obligation to fund under the Standby Bond Purchase Agreement in certain circumstances (the "Immediate Termination Events") which are carefully limited by the rating agencies, and, if the Bonds are supported by a Bond Insurance Policy, by the Insurer. In addition, a Standby Bond Purchase Agreement may set forth various other events (including breach of financial or other covenants) (the "Notice Termination Events"), the occurrence of which will permit the bank to suspend or terminate its obligation to purchase Bonds under the Standby Bond Purchase Agreement after 30 days' notice to the Bondholders. Such a notice should trigger a mandatory tender under the Bond Indenture, so a 30-day termination notice will result in the bank funding the tender purchase price of all outstanding Bonds and holding such Bonds as Bank Bonds. Moreover, before a Borrower deteriorates to the point of tripping one of the Immediate Termination Events described below, the Bonds will probably have been tendered by the Bondholder under the optional tender provisions, not successfully remarketed, and ultimately purchased by the bank under the Standby Bond Purchase Agreement.

Bonds purchased by the bank under the Standby Bond Purchase Agreement become "Bank Bonds." Pursuant to the Standby Bond Purchase Agreement (and the Bond Indenture by reference to the Standby Bond Purchase Agreement), Bank Bonds will (i) bear interest at a Bank Rate (discussed in more detail in Section IV below) and be subject to full amortization over shorter period than that established for Bonds that are not Bank Bonds (typically 3 or 5 years for an uninsured deal and often

somewhat longer for an insured deal, in either case commencing after a six-month "hold period"). If an event of default has occurred and is continuing, the Bank Rate on the Bank Bonds may be increased to a stipulated default rate and the bank may have the right to direct a mandatory purchase, redemption or acceleration of the Bank Bonds.

B. IMMEDIATE TERMINATION EVENTS

A Borrower with high long-term credit ratings may typically use a Standby Bond Purchase Agreement for liquidity support of Bonds without a Bond Insurance Policy or any other long-term credit support. In such financings, the following is a list of events commonly permitted by the rating agencies that give rise to an Immediate Termination Event:

1. Borrower bankruptcy events or dissolution or termination of the existence of the Borrower;

2. Principal or interest payment default on the Bonds (including any Bank Bonds, other than as a result of an acceleration of the Bank Bonds);

3. Failure to pay scheduled debt service on senior or parity debt including, without limitation, any regularly scheduled payments on swap contracts (other than payments coming due solely through acceleration of Bank Bonds held by other lenders); or default with respect to senior or parity debt, the effect of which is to permit (determined without regard to whether any notice is required) such senior or parity debt to become immediately due and payable;

4. The downgrade by all rating agencies of the rating on the Bonds below investment grade, or withdrawal or suspension of the rating on the Bonds, unless such withdrawal or suspension is for non-credit reasons;

5. Failure to pay a final, non-appealable judgment of $5 million, which has not been stayed, within at least 60 days;

6. The Borrower legally contests or repudiates the validity of the Bond Indenture, the Loan Agreement or the Standby Bond Purchase Agreement or its obligation to pay principal or interest debt service with respect to the Bonds, including any Bank Bonds; or

7. Invalidity of Bond documents or any material provision thereof relating to principal or interest or the security therefor; or governmental declaration of a debt moratorium affecting the Bonds or affecting all parity debt.

C. SUSPENSION EVENTS

In addition to Immediate Termination Events and Notice Termination Events, some Standby Bond Purchase Agreements include events ("Suspension Events") that permit the bank to suspend its obligation to purchase tendered Bonds. For instance, a Standby Bond Purchase Agreement may provide that if a legal challenge is raised to enforceability of the Bonds, bond documents or bank documents or any provision

relating to the pledge or lien of the security for the Bonds or the Borrower repudiates its obligations with respect to the Bonds, bond documents or bank documents, the bank may suspend its obligation to purchase Bonds pending a final judicial resolution of the challenge; if a final judgment is entered within two years holding that the Bonds are enforceable, the bank's commitment would (subject to other expiration or termination provisions) automatically reinstate, otherwise the commitment would terminate without a requirement for notice or mandatory tender of Bonds.

B. BANK BONDS AS COLLATERAL FOR FRB LOANS

Liquidity draws on Standby Bond Purchase Agreements and Letters of Credit have created substantial liquidity needs for a number of Banks, including the U.S. branches of some foreign banks. One possible source of such liquidity is pledging qualified Bank Bonds to the Federal Reserve Bank as collateral for loans at its discount window. To qualify as eligible collateral, Bank Bonds must have an investment grade (Baa3 or BBB-) or higher rating from Moody's, S&P or another recognized rating service (exclusive of the Bank's Standby Bond Purchase Agreement or Letter of Credit) and must be transferred to the Federal Reserve Bank through DTC (for which purpose the Bank Bonds must have a CUSIP number distinct from the CUSIP numbers assigned to other Bonds of the same issue which are not Bank Bonds). Both the credit rating and the CUSIP number of the Bank Bonds must appear on the same Bloomberg screen. Moody's and Fitch (but not S&P) have been willing to issue ratings of Bank Bonds in advance instead of waiting for a failed remarketing. If a Bank Bond rating is not obtained in advance, the Bank may require the Borrower to covenant to obtain such rating promptly upon a failed remarketing.

IV. REMARKETING

A. RESETTING BOND INTEREST RATE UPON REMARKETING FAILURE

One of the lessons from the VRDB market dislocation in September 2008 is that Borrowers and Remarketing Agents had an incentive to stop remarketing VRDBs when the VRDB interest rate exceeded the applicable interest rate for draws on the Letter of Credit or Standby Bond Purchase Agreement (as the case may be). At the same time, many banks were experiencing liquidity shortages and/or funding expenses exceeding the interest rates they could receive under the relevant Reimbursement Agreement or Bank Bond (as applicable). Banks now include language (i) requiring express language in Bond Indentures and Remarketing Agreements requiring Remarketing Agents to remarket VRDBs up to the maximum rate for which there is credit enhancement coverage and (ii) setting applicable interest rates for unreimbursed draws on Letters of Credit or outstanding Bank Bonds at the highest of a menu of indices intended to cover the relevant bank's cost of funds plus a margin. One increasingly common provision requires that the Bank Rate will never be lower than the rate borne by any outstanding Bonds of the same issue (or, if no such Bonds are outstanding, the Maximum Rate).

1. **Remarketing up to Maximum Credit Enhanced Rate**. Most VRDB Bond Indentures provide for the Remarketing Agent to reset the interest rate for VRDBs daily, weekly or otherwise (as applicable) at the rate for which the VRDBs can be remarketed at par, but not in excess of the Maximum Rate.

2. Issues.

(a) In the absence of a provision in the Bond Indenture permitting the Borrower to direct the Remarketing Agent to cease remarketing Bonds, is the Remarketing Agent in breach of its obligations under the Remarketing Agreement if it fails to reset the interest on VRDBs up to the Maximum Rate as necessary to remarket any and all tendered VRDBs at par? More importantly, even if there is such a breach, what is the remedy?

(b) If most of the Bonds, but not all, remain outstanding or can be remarketed at a significantly lower rate, should the Remarketing Agent be required to set a higher interest rate to provide for full remarketing? Setting a significantly higher interest rate on all Bonds to successfully remarket a minor portion of the Bonds is not in the best interest of the Borrower and may not be in the best interest of the bank as long as the rate on the unreimbursed draw fully covers the bank's funds expense plus a negotiated margin. One solution may be to permit the Borrower, but only with the consent of the bank, to direct the Remarketing Agent not to remarket tendered Bonds.

B. UNREMARKETED BONDS

1. **Reimbursement Agreement Rates for Unremarketed Draws**. After the experience of September 2008, many banks now set the applicable interest rate for unreimbursed Letter of Credit draws at Base Rate plus a specified margin, where "Base Rate" is defined as the higher of (i) the bank's prime rate plus a spread, (ii) the Federal Funds Rate plus a spread, and (iii) 30-day Benchmark Rate plus a specified margin. Some banks also have added a fixed floor to the Base Rate or have specified that the rate for unreimbursed draws will not be less than the Maximum Rate. Note that these rate mechanics should be set forth at length in the Bond Indenture (and set forth in, or incorporated into, the Bond itself).

2. **Bank Bond Rates; Term-Out**. In like fashion, banks are also setting applicable Bank Bond interest rates to cover their funding expense and preserve their margins. Also, Bank Bond term-out terms offered by banks have been tightening.

3. **Borrower Ownership of Tendered Bonds**. In instances where Bonds are not remarketed, the Borrower may desire (or be required by the bank) to reimburse the bank for the draw on the Letter of Credit or Standby Bond Purchase Agreement (as applicable) and take ownership of the unremarketed Bonds. For a Borrower with available liquidity, reimbursement of the bank may avoid significant interest expense and/or term-out requirements while the Borrower pursues replacement credit support, refunding or other solutions.

ISSUES: (i) In the case of Bonds purchased with a draw under a Letter of Credit, if such ownership were expected to be for an extended or indefinite period, the Borrower may want to avoid reinstatement of the Letter of Credit and the associated Letter of Credit fee expense. (ii) At what point are the Borrower-owned Bonds deemed by the accountants and the bond lawyers to have been redeemed, thus defeating the Borrower's plan for eventual remarketing?

C. REMARKETING AGREEMENT/BOND INDENTURE PROVISIONS.

1. **Requirement to Remarket**. Banks are increasingly focusing on Bond Indenture and Remarketing Agreement provisions governing the obligations of the Remarketing Agent to remarket any and all tendered Bonds and resetting the Bond interest rate up to the Maximum Rate as and to the extent required to do so. At least one major commercial bank insists that the bank be included as an express third-party beneficiary of the Remarketing Agreement.

2. **Replacement of Remarketing Agent**. Since the experience of September 2008, banks are increasingly insisting on provisions in transaction documents permitting them to approve replacement Remarketing Agents and, in the case of a failure to remarket tendered Bonds, to direct the replacement of a Remarketing Agent.

V. TERMINOLOGY

In this outline, the following terms have the definitions indicated:

"Bank" or "bank" means the issuer of the Letter of Credit or Standby Bond Purchase Agreement, in each case as indicated by the context.

"Bank Bonds" means Bonds purchased by the bank under a Standby Bond Purchase Agreement or under a Reimbursement Agreement (if the Reimbursement Agreement provides for purchase of Bank Bonds in lieu of pledged Bonds).

"Bank Rate" means the interest rate borne by Bank Bonds.

"Benchmark Rates" refers to interbank reference rates such as SOFR and BSBY.

"Bond Indenture" means the trust indenture, trust agreement, resolution or other trust instrument or governing document under which the Bonds are issued and secured.

"Bond Insurance Policy" means an insurance policy issued by a regulated insurance company (typically a so-called monoline insurance company) that insures the payment of principal of and interest on a series of Bonds in accordance with the terms, and subject to the stated limitations, of such policy and any endorsements thereto.

"Bond Trustee" means the trustee, paying agent and/or tender agent acting for the benefit of the Bondholders under a Bond Indenture.

“Bonds” means bonds, notes, certificates of participation or other obligations supported by a Letter of Credit, a Bond Insurance Policy and/or a Standby Bond Purchase Agreement, or purchased in a direct purchase transaction.

“Borrower” generally refers to the conduit borrower or obligated group member(s) in a conduit financing and to the Issuer in a non-conduit financing.

“BSBY” means the Bloomberg Short-Term Bank Yield Index.

“Issuer” means the governmental entity issuing the Bonds.

“Lender” means the purchaser of Bonds in a direct purchase transaction.

“Letter of Credit” means an irrevocable direct-pay letter of credit issued to support principal, interest and purchase price of VRDBs, or similar product.

“Loan Agreement” means the loan agreement, installment sale agreement or lease agreement between the Issuer and a conduit Borrower, under which the Borrower agrees to make payments corresponding to the required payments of principal of and interest on the Bonds.

“Master Indenture” means a master trust indenture between the Borrower (and any other obligated group member(s)) and a Master Trustee, under which master notes or master obligations are issued to secure Bonds, Reimbursement Agreements and other obligations of the Borrower and any other obligated group members party to such master trust indenture.

“Master Trustee” means the trustee under a Master Indenture.

“Maximum Rate” means the maximum interest rate on the Bonds for which the respective Letter of Credit or Standby Bond Purchase Agreement provides the requisite number of days interest coverage.

“Reimbursement Agreement” means the agreement between the Borrower and the bank pursuant to which a Letter of Credit is issued for the account of the Borrower, and the Borrower agrees to reimburse the bank for draws honored under the Letter of Credit.

“Remarketing Agent” means, in the case of VRDBs, the institution that remarkets tendered Bonds pursuant to the terms of the Bond Indenture and the Remarketing Agreement.

“Remarketing Agreement” means, with respect to VRDBs, the agreement between the Remarketing Agent and the Borrower, pursuant to which the Remarketing Agent agrees (i) to set the daily, weekly or other periodic interest rate on the Bonds in accordance with the Bond Indenture and (ii) to remarket tendered Bonds.

“SOFR” means the secured overnight financing rate published each business day by the Federal Reserve Bank of New York.

"Standby Bond Purchase Agreement" means an agreement by and among a Borrower, a Bond Trustee and a Bank, pursuant to which the Bank agrees, subject to the terms and limitations thereof, to purchase unremarketed tendered VRDBs.

"VRDBs" or "VRDOs" means variable rate demand bonds or variable rate demand obligations; i.e., Bonds with a variable interest rate (usually daily or weekly) and a corresponding feature for optional tender, as well as provisions for mandatory tender upon the occurrence of certain events.

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

The Commissioner's Side: IRS Examinations, IRS Appeals, Voluntary Compliance Programs, and Outreach

Chair:

Todd L. Cooper — **Locke Lord LLP – Cincinnati, OH**

Panelists:

Allyson Belsome — **Internal Revenue Service**
Carol Lew — **Stradling Yocca Carlson & Rauth**
Rene Moore — **Butler Snow LLP**

This panel will focus on the IRS perspective on (1) current topics relating to IRS examinations of tax-exempt bonds and other tax-advantaged bonds, (2) current topics relating to appeals from examinations of tax-exempt and other tax-advantaged bonds to the IRS Independent Office of Appeals, (3) current topics relating to the IRS Voluntary Closing Agreement Program (VCAP) for tax-exempt bonds and other tax-advantaged bonds, and (4) other initiatives, activities and publications of the tax-exempt bond functions within the TE/GE Division of the IRS. The panel will include representatives of the IRS and private practitioners.

The outline reflects the work of numerous prior NABL Seminar and Workshop panel members on the subject matter.

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I. OVERVIEW OF THE IRS TAX-ADVANTAGED BOND PROGRAM

The establishment of an Internal Revenue Service ("IRS") compliance program, initially focused on tax-exempt bonds, was announced in 1995. The provisions of the Internal Revenue Code of 1986, as amended (the "Code") providing that certain bonds may qualify as tax-exempt or may qualify for tax credits has been administered by the Office of Tax-Exempt Bonds ("TEB") of the Tax-Exempt and Government Entities Division ("TE/GE") of the Internal Revenue Service ("IRS"). TEB was formally established in 2000.

TE/GE is under the jurisdiction of the IRS Commissioner, not the IRS Office of Chief Counsel. TEB's stated mission is to administer the federal tax laws applicable to tax-advantaged bonds and to provide its customers with top quality service by applying tax laws with integrity and fairness. TE/GE provides an annual workplan setting forth its priorities for the subject year, including for tax-advantaged bonds.

Many of the procedures and practices of TEB are set forth in the Internal Revenue Manual ("IRM"), *see* IRM Part 4. Examining Process and specifically IRM 4.81 Tax Exempt Bonds (TEB) Examination Program and Procedures. The provisions of the IRM are generally intended to provide for the internal procedures of the IRS and are not intended as published guidance on which taxpayers can rely. Nonetheless, the IRM contains information that explains how the IRS functions. TEB maintains a detailed section on the IRS website at https://www.irs.gov/tax-exempt-bonds. This website is a helpful resource for current information about TEB, including the relevant IRM provisions discussed in this outline. This outline discusses certain highlights of the TEB IRM provisions existing as of the date of this outline but does not purport to comprehensively describe all of those provisions. It is expected that certain of the IRM provisions discussed in this outline will be revised periodically. Also, readers are cautioned that the current procedures actually used by TEB may not always conform to the current IRM provisions.

The Office of Chief Counsel, Division Counsel (TE/GE) provides legal support to TEB. In turn, that office may seek support from the national office of the Associate Chief Counsel, Financial Institutions and Products, particularly Branch 5 (often referred to as the "Bond Branch"). Most interaction between TEB and Chief Counsel is through Division Counsel; however, the Bond Branch is responsible for responding to requests from TEB for technical advice. In the parlance of the IRS, the "Commissioner's side" is distinct from the Office of Chief Counsel.

This outline discusses the programs and procedures of TEB.

II. EXAMINATION PROCEDURES FOR TAX-ADVANTAGED BONDS

The IRS procedures for examining tax-advantaged bonds and resolving tax-advantaged bond cases are now primarily found in the Tax Exempt Bonds Examination Program and Procedures (the "Examination Procedures"), which are located at IRM 4.81.5 et seq. and in Rev. Proc. 2021-10, Internal Revenue Bulletin 2021-04, page 495 (which sets forth rules for administrative appeal of adverse determinations of tax-advantaged bond matters at the issuer level). Revisions to the IRM occur periodically and often have not been publicly announced. Portions of the IRM are posted on the TEB portion of the IRS website.

The Examination Procedures were last significantly revised on August 5, 2021. The August 5, 2021, revisions to the Examination Procedures reflect the most recent organizational structure of TE/GE and TEB, incorporate a number of items of interim guidance and also appear largely intended to make the Examination Procedures for TEB more consistent with the examination procedures used for other areas within TE/GE. Although many of the August 5, 2021, revisions are ministerial, some are significant and reflect a change from prior procedures.

Procedures generally applicable to taxpayers are also relevant, both because certain of these procedures may apply to issuers as "taxpayers" and because they apply in cases where enforcement is directed at conduit borrowers or other participants (such as in the case of application of section 150(b) change in use penalties against conduit borrowers and in the case of imposition of the section 6700 penalties against transaction participants).

A. The Issuer as "Taxpayer"

One of the foundational provisions in the Examination Procedures is the direction to treat governmental issuers as "taxpayers" for procedural purposes, even though governmental issuers do not have an obligation to pay income taxes. This position is consistent with the approach of IRS tax-advantaged bond enforcement from its inception. The IRS Restructuring and Reform Act of 1998 appears to have required this procedural approach. Section 3105 of the IRS Restructuring and Reform Act provides as follows:

> The Internal Revenue Service shall amend its administrative procedures to provide that if, upon examination, the Internal Revenue Service proposed to an issuer that interest on previously issued obligations of such issuer is not excludible from gross income under section 103(a) of the Internal Code of 1986, the issuer of such obligations shall have an administrative appeal of right to a senior officer of the Internal Revenue Service Office of Appeals.

This direction is reflected in the current Examination Procedures. In IRM 4.81.5.1.5.1(5), the definition of "Taxpayer" indicates that that the taxpayer is the issuer. See also IRM Part 25. Special Topics, as revised on October 7, 2022, and specifically 25.1.9.3.5(2). Although other provisions of the Code provide for examinations at a level different than the ultimate taxpayer, the approach of treating issuers of tax-advantaged bonds as taxpayers gives rise to many issues and questions that are unique to tax-advantaged bonds.

In addition, as is discussed below, the Examination Procedures contemplate that state and local government issuers of Build America Bonds and other "direct pay" qualified tax credit bonds are properly treated as taxpayers in a different, and more direct, manner.

B. Purpose of the Tax-Exempt Bond Examination Process

The Examination Procedures state that the "purpose of the Tax Exempt Bond examination program is to identify and correct noncompliance in tax-advantaged bonds with fairness, consistency and the highest level of integrity."

C. Scope and Phases of an Examination

The Examination Procedures provide for only one general type of TEB exam. However, IRM 4.81.5.4(1) provides: "Not all examinations are the same in scope, size, and complexity; therefore, portions of TE/GE examination guidance may be more applicable to some cases than others."

The Examination Procedures state that there are three phases to the examination process: planning, execution and resolution. IRM 4.81.5.4(2). After receiving a particular assigned case, the agent is directed to develop an examination plan, in which the agent uses its professional judgment to set the scope of the examination. IRM 4.81.5.4.1. In determining the scope of the examination, the agent is directed to consider the following minimal criteria: the reason the exam was selected, the materiality of the issue (dollar amount,

permanency and timing), impact on taxpayer compliance or taxpayer behavior, and a risk analysis of costs and benefits in pursuing.

D. Examination Selection

Pursuant to IRM 4.81.5.3, examinations are based on referral, claims review, and approved compliance strategies, with the IRS Compliance, Planning and Classification Office ("CP&C") generally developing the issues and classifying the cases based on issue criteria. Public statements by TE/GE officials have indicated that selection of cases for examination may rely on analysis of information reported in Forms 8038, Forms 990 Schedule K, other information returns, and other publicly available sources. The particular algorithms to be used in case selection continue to be developed and have not been publicly disclosed by TE/GE.

Generally, bond issues that have been redeemed are not selected for examination. There are exceptions, however. (For example, when arbitrage rebate is still owed on the issue). Bond issues that have been previously examined or subject to a voluntary closing agreement are not protected from future examinations. If the examination or voluntary closing agreement request was closed through a closing agreement, the agreement by its terms provides that the bondholders are protected from being taxed on the interest earned on the bonds only with respect to the particular violation covered by the agreement. Rules apply, however, that limit second examinations of the same tax return; these rules were crafted for the typical situation involving annual filings which is not ordinarily present with tax-advantaged bond issues; accordingly, it is unclear how these rules apply to tax-advantaged bonds.

E. Procedures for Opening an Examination

The Examination Procedures direct an agent to contact the issuer by mail when an examination is opened. TEB uses a letter similar to opening letters used by other TE/GE divisions. IRM 4.81.5.10.1.1. TEB sends an initial information document request ("IDR") with the opening letter. IRM 4.81.5.10.1.1(4)(d).

F. Examination Scope and Depth

The Examination Procedures contemplate that, throughout the examination, the agent should use judgment and risk-based decision-making in determining the scope, including any necessary modifications to the original scope.

The Examination Procedures list the following factors to help determine examination depth in IRM 4.81.5.7.2: (1) type of records available or expected to be made available for consideration of the issue; (2) complexity of the issue; (3) materiality of the issue; (4) whether the issue was identified in the assignment process as needing more in-depth review (e.g., a referral); and (5) whether the issuer or another entity with control over bond proceeds had "strong internal controls or post-issuance compliance procedures."

G. Power of Attorney and Taxpayer Information Authorization

The Examination Procedures set forth detailed rules relating to procedures for a taxpayer to appoint an attorney or other qualified person to represent it before the IRS. IRM 4.81.5.10.2.1. These procedures generally require a taxpayer representative to obtain a Power of Attorney (Form 2848). The Examination Procedures may require Taxpayer Information Authorization forms (Form 8821) in order for the IRS to meet its restrictions under the taxpayer confidentiality rules of section 6103 of the Code. For example, because the IRS treats a bond examination as the "taxpayer" information of the issuer, the issuer must execute a Form 8821 information authorization naming the conduit borrower as a person authorized to

receive its taxpayer information related to the examination in order for the IRS to communicate with a conduit borrower with respect to the conduct of the examination. Similarly, a conduit borrower is typically asked to execute a Form 8821 information authorization naming the issuer as a person authorized to receive its taxpayer information related to the examination. The IRS has issued a "Supplement to Instructions for Form 2848 and Form 8821," which, among other things, requires inclusion on the Form of the issue amount, CUSIP number, and the date the bonds were issued.

One important threshold question for any issuer or conduit borrower when a bond examination is initiated by the IRS is whether to retain counsel to represent it. The practice appears to vary. Many issuers and conduit borrowers may respond to examinations in early stages, without naming a representative, particularly if the examination is perceived to be routine. On the other hand, some issuers appear to have adopted the practice of retaining counsel to represent them in all bond examinations. In some cases, issuers have inadvertently complicated their positions by responding to questions without the input of counsel.

H. <u>Surveying a Case</u>

A TE/GE group may decide not to examine a case that has been selected for examination and close it by survey. IRM 4.81.5.7.3 provides instructions on the survey process. Generally, an agent must consider all the facts of the case, including, but not limited to, repetitive audit or compliance activity, if the returns have a short statute of limitations, and whether the issuer has already taken steps to correct an identified issue.

I. <u>Identifying and Addressing Conflicts of Interest in Examinations</u>

The Examination Procedures in IRM 4.81.5.10.2.2 contain detailed procedures regarding "identifying and addressing conflicts of interest" which primarily are intended to address the possibility that counsel representing the issuer in the examination may have a conflict of interest, particularly if the counsel served as bond counsel for the transaction under examination, and provided an approving tax opinion that might be challenged by the IRS.

The Examination Procedures state that, because bond attorneys provide opinions to their clients on whether a bond issuance will qualify for tax-preferred status, agents should be sensitive to conflict of interest issues in examinations. They acknowledge, however, that not all situations will present a conflict of interest and state that, for example, a conflict of interest does not necessarily arise because an attorney is representing the bond issuer after that attorney provided an opinion, such as when the focus of the examination is on post-issuance compliance.

If an examiner has reason to believe, based on the facts and circumstances available, that a representative has a conflict of interest, the examiner is directed to promptly raise the issue with the representative and request that the representative act to address the conflict of interest. If the examiner is persuaded that no conflict of interest is present, or the representative provides assurances that the conflict has been waived, the examiner may treat the matter as resolved. The Examination Procedures provide that TEB agents will not request copies of informed consent documents. The Examination Procedures provide that the IRS Office of Professional Responsibility ("OPR") has exclusive authority to enforce the rules governing practice before the IRS (Circular 230) and contemplate that TEB agents may consult with OPR about possible conflicts of interest.

Regardless of any determinations under the Examination Procedures or Circular 230, the representative must also turn to the applicable ethical rules in the relevant state as to whether a waiver is required.

J. Special "Bypass Procedures" Permitting TEB to Bypass a Taxpayer Representative

The Examination Procedures at IRM 4.81.5.10.2.4 contain detailed procedures for an agent to bypass a counsel or other representative appointed by an issuer or other taxpayer. Under these procedures, an examiner, with the manager's approval, may notify a taxpayer directly that the taxpayer's representative is responsible for unreasonable delay or hindrance of an examination. Under this procedure, the IRS may contact the issuer or other taxpayer directly to complete the examination. In particular, these procedures direct the examiner to document instances when the representative fails to submit records and information requested by the examiner, fails to keep scheduled appointments or fails to return telephone calls or correspondence. The Examination Procedures contemplate that the manager may issue a Form 4020-A, *Warning Letter for Bypass Procedures for Preparers,* to the representative and, if the issues are not resolved, may issue a Form 4020-C, *Final Bypass Letter.*

K. Review of Records and Record Retention

The Examination Procedures contain very detailed provisions relating to review of records and records retention. These provisions are relevant not only for providing insight into how TEB conducts its examinations, but also is informative for an issuer's own compliance procedures.

The Examination Procedures state that generally, when applicable to a particular case, the examiner should review records evidencing the following: (1) compliance with the requirements that applied when the bonds were issued; (2) sources and uses of bond proceeds; (3) allocations of bond proceeds to expenditures, investments or other uses; (4) how the financed facilities are used, (5) how the bond proceeds were invested before being used; (6) how payments were made on the bonds, including the source of payments; and (7) post-issuance changes to the bond documents, related contracts, or projects financed with bond proceeds. IRM 4.81.5.8.2(4).

The Examination Procedures describe detailed records that generally should be reviewed, including records of expenditures, records of investments, records related to the use of the financed facilities and records to establish issue price. IRM 4.81.5.8.2(5), (6) and (7).

Notably, the Examination Procedures contain detailed directions for "Evaluating and Documenting Internal Controls" of the issuer. IRM 4.81.5.9.1. Internal controls generally refer to the issuer's (or conduit borrower's) policies and procedures to monitor post-issuance compliance and other policies and procedures relating to the issuer's (or conduit borrower's) operations that impact on tax compliance.

The Examination Procedures also contain detailed provisions relating to review by an agent in an examination of summary records, rather than more detailed underlying records. In general, the Examination Procedures indicate that the review of an issuer's internal controls is a key factor in determining whether an agent should rely on summary records. (An examiner "may determine that an issuer's post-issuance compliance monitoring procedures and internal controls help to establish the accuracy and reliability of the summary records." IRM 4.81.5.9.1.7(3)). The Examination Procedures discuss reasonable types of summary records of expenditures, investments, and qualifying use of bond-financed facilities. IRM 4.81.5.9.1.5 to .7. For example, a summary record of expenditures may be a spreadsheet or other summary setting forth each separate project or purpose, the aggregate amount of bond proceeds and equity spent on that project, the date or range of dates of expenditures, the average reasonably expected economic life of each separate project, the placed-in-service date of each project, and a record of final allocations of bond proceeds.

The provisions in the Examination Procedures for summary records of qualifying use are of particular interest. IRM 4.81.5.9.1.6. These provisions contemplate that summary records of qualifying use

may consist of (1) a list of all contracts or arrangements for use of bond-financed property, including any contracts or arrangements that are identified as resulting in nonqualified use, (2) the issuer's confirmation that all such contracts or arrangements were reviewed by a party qualified to determine whether they result in private business use; and (3) a calculation of the total amount of nonqualified use of bond proceeds or bond-financed property. These provisions further state that, in general, an issuer's determination that all contracts were reviewed should be based on review by an official or consultant knowledgeable in tax requirements.

In other words, the Examination Procedures contemplate that, if an issuer can demonstrate adequate internal controls, an agent may reasonably rely on such a summary list of contracts, rather than review all of the underlying contracts.

The provisions that contemplate that reliance on a review of only summary records are practical for the IRS (to make best use of its limited resources), but also indicates that an issuer that has adopted adequate internal controls may have a much easier and streamlined review in examination. The Examination Procedures make clear, however, that an agent's determination to use summary records does not reduce the issuer's recordkeeping requirements.

The Examination Procedures contemplate that an agent may undertake a test sampling of summary records. IRM 4.81.5.9.2. This test sampling may be based on either an agent's judgment or statistical sampling.

The Examination Procedures further provide that, if the issuer's records are unreliable, lost, destroyed or not available due to circumstances beyond the issuer's control, the agent may allow the issuer to present reconstructed records under certain circumstances in which the agent believes the use of the reconstructed records to be reasonable. IRM 4.81.5.9.2.3.

L. Post-issuance Compliance Policies and Procedures ("PIC Procedures")

The Examination Procedures contain a robust discussion of PIC Procedures. IRM 4.81.5.9.1.1 and 2. Among other things, the Examination Procedures indicate that the adoption and implementation of PIC Procedures may indicate a lower level of risk. However, the opposite may not be true. The agent should not automatically find noncompliance when an issuer fails to provide documentation of PIC Procedures. An issuer is not required to implement PIC Procedures. An issuer that does not have PIC Procedures may demonstrate compliance. IRM 4.81.5.9.1.1(5).

The Examination Procedures provide that PIC Procedures "may" include the following: (1) procedures for conducting due diligence review at regular intervals; (2) identifying the official or employee responsible for review; (3) training of the responsible officer/employee; (4) procedures for retaining adequate records to substantiate compliance (e.g., records relating to expenditure of proceeds); (5) procedures reasonably expected to timely identify noncompliance; and (6) procedures for ensuring that the issuer will take steps to timely correct noncompliance. IRM 4.81.5.9.1.2 (1).

The Examination Procedures then describe in a much more detailed manner how certain of these important elements may be implemented, in particular "Due Diligence Review at Regular Intervals," "Identify the Official or Employee Responsible for Review," and "Retention of Adequate Records to Substantiate Compliance." IRM 4.81.5.9.1.2(2) to (4).

M. Third-Party Contacts

Section 7602(c) of the Code generally concerns IRS third-party contacts during an examination. Section 7602(c)(1) of the Code generally provides that an IRS employee may not contact any person other than the taxpayer in an examination unless such contact occurs during a period (not greater than one year) which is specified in a notice which informs the taxpayer that contact with persons other than the taxpayer is intended to be made during such period and, except as otherwise provided, is provided to the taxpayer not later than 45 days before the beginning of such period. IRM 25.27.1, Third Party Contacts-Third Party Contact Program, is the general reference for such contacts. This general Third Party Contract Program is incorporated for TEB at IRM 4.81.5.10.3.

N. Closing Examinations through Redemption

IRM 4.81.5.7.2.1 permits an agent to close an examination without further action in certain cases in which the issuer redeems 100% of the outstanding principal amount of the bonds during an examination. Factors for consideration by the IRS in whether to close the examination are the reasons for noncompliance, whether the transaction is abusive, whether interested parties were involved in aspects of the transaction that resulted in noncompliance, whether reasonable steps were taken by the issuer or borrower to ensure compliance and whether the issuer or borrower took steps to self-correct prior to the start of the examination. This resolution method to close an examination does not apply if the bonds are redeemed with proceeds of other tax-advantaged bonds, the bonds are direct-pay bonds, the issuer did not make appropriate rebate payments on the bonds, or the issuer asks to negotiate a closing agreement.

O. Closing Examination with No Change or Issuance of Advisory

If the agent concludes that the bonds are in compliance, it may close the examination with a "No Change Letter." IRM 4.81.5.17.2 (Letter 6049, Examination Closed - No Change). An agent may also decide to issue an "advisory" to the taxpayer if the agent determines that the bonds are in compliance but there is potential future noncompliance. For example, an agent may send an advisory to an issuer if it determines that there is private business use of a facility that, if continued, would result in noncompliance. IRM 4.81.5.17.3.

P. Procedures for Communicating Identified Noncompliance

When an agent identifies possible noncompliance in an examination, the examiner is directed to discuss that potential with the taxpayer or the taxpayer's representative as soon as possible. IRM 4.81.5.17.1. Depending on the violation, the appropriate resolution may require the examiner to secure and process a delinquent or amended return, assess penalties, issue a written advisory, enter into a closing agreement or adjust related income tax returns. If the taxpayer does not concur with the proposed resolution, the agent is directed to discuss the noncompliance with the manager. With the manager's concurrence, the examiner will provide the taxpayer or the taxpayer's representative with a written summary of the potential noncompliance in Form 5701B, *Notice of Proposed Issue* ("NOPI").

IRS agents and managers are directed not to initiate closing agreement discussions with the issuer or its representative and that closing agreement discussions are to be initiated solely at the request of the issuer or representative. The IRS agent may inform the issuer or its representative that closing agreements are to be used to resolve tax matters. If the issuer or representative requests a closing agreement, the IRS agent is directed to initiate the closing agreement process pursuant to IRM 4.81.6.

IRM 4.81.14 sets forth more detailed procedures for "Unagreed Issues" in an examination and for communicating identified issues. At each step when an examination proceeds towards an adverse

determination, the case is subject to a more rigorous, and higher-level, review within TEB. In addition, the procedures also contemplate possible assistance from the Office of Chief Counsel, but attorneys from the Office of Chief Counsel are not required to be involved and even when they are involved, final decisions on the case remain with TEB.

When an agent finds that a bond issue under examination may not comply with the Code, the agent is to discuss with the manager how to address the noncompliance. This may include preparing a NOPI and a Form 886A, Explanation of Items. IRM 4.81.14.2.

If the issuer's response to the NOPI indicates that the issue cannot be resolved through a closing agreement, the agent is directed to discuss with the agent's group manager the need for technical assistance or technical advice (which is the equivalent of a legal opinion from the IRS Office of Chief Counsel). An issuer may also request technical advice pursuant to the general IRS revenue procedure governing technical advice requests but has no right to obtain technical advice. If the issuer does not agree with the NOPI and has not indicated that it wants a closing agreement, and any technical review is complete, the agent is to issue a 30-day letter to the issuer, which notifies the issuer of its right to appeal the changes proposed by the IRS. IRM 4.81.14.4. The form of the 30-day letter depends upon the type of Form 8038 under audit. Before the case is submitted to Appeals, it is subject to mandatory review by TEB Technical. This review involves ensuring that the factual and legal matters in the case file support the proposed position and reviewing the issuer's protest to the Form 886-A, Explanation of Items, and the agent's rebuttal, apparently to ensure that the rebuttal sufficiently addresses the issuer's protest. If the issuer does not request an administrative appeal of the proposed adverse determination letter, the agent is directed to issue the appropriate final adverse determination letter.

If a Technical Advice Memorandum is requested, whether before or after issuance of a NOPI, the issuer is afforded certain procedural rights, including the right to receive notification of the request and the agent's arguments, the right to submit written materials in opposition to the agent's positions, and the right to an adverse conference. See Rev. Proc. 2023-2 (updated annually).

Upon issuance of a proposed adverse determination letter, the agent will follow the bondholder referral procedures set forth in IRM 4.81.7. When the final adverse determination is issued, a copy of the letter is sent to the Bondholder Referral Coordinator, if applicable. A more detailed description of the appeals process is set forth below.

In the case of a conduit financing resulting in a final adverse determination, the agent should determine whether the conduit borrower is under examination by another IRS division or function (such as Exempt Organizations). If the conduit borrower is under examination by another division or function, the agent will inform that other division or function and coordinate as needed. If the conduit borrower is not under examination, the agent is required to make a referral to the other appropriate IRS function or organization.

TEB may request a preconference with Appeals to discuss the case before Appeals begins consideration of the case. The issuer may attend this conference but cannot participate in the conference. These conferences may be used, for example, when Appeals has not previously considered the issue raised in the case.

The Examination Procedures contemplate that the case may take a number of different paths once sent to Appeals, depending on how Appeals handles the case. If Appeals is unable to settle the case, Appeals will issue the Final Adverse Determination Letter and close the case and return the case file, but not jurisdiction, to TEB to contact bondholders, if warranted. Alternatively, Appeals may, (i) return the case to TEB for further development or to concede the government position and close the case, (ii) return the case

to TEB to consider a new argument raised by the issuer, (iii) release jurisdiction, allowing TEB to re-engage in resolution actions or concede its position and close the case as agreed, or (iv) not release jurisdiction, in which case TEB should provide the response requested and return the case to Appeals. IRM 4.81.14.7.

Q. TE/GE Use of "Issue Snapshots"

Issue Snapshots are described as "employee job aids that provide analysis and resources for a given technical tax issue," and "are developed through internal collaboration and may evolve as compliance strategies and new insights are contributed." A TE/GE Issue Snapshot also contains a cautionary note that "Issue Snapshots are not official pronouncements of law or directives, and cannot be used, cited or relied upon as such."

Issue Snapshots can provide insight into what an agent is to consider when developing a particular issue. Issue Snapshots are posted on the IRS website.

R. IRS Secure Messaging

In 2021, TE/GE instituted a method for the taxpayer and its authorized representative(s) to communicate with the IRS in a secure manner through its "Secure Messaging" platform. For more information see: https://www.irs.gov/help/tege-secure-messaging. This allows for secure communication by email and allows for the attachment of documents. To implement this platform the taxpayer must enter into an agreement with the IRS by executing IRS Form 15314. The form can be found at: https://www.irs.gov/pub/irs-pdf/f15314.pdf. Form 15314 contains an Appendix A where the taxpayer can list its approved users of the Secure Messaging platform. The Secure Messaging platform allows expedited communication with an agent rather than the far slower methods of fax and regular mail permitted in the past. While Secure Messaging allows for faster communication and transmission of documents, it does not necessarily mean an examination will be resolved more quickly. But it can at least enhance that possibility.

III. CLOSING AGREEMENT PROCEDURES

The TEB procedures on closing agreements (the "Closing Agreement Procedures") are located in IRM 4.81.6. Special rules for voluntary closing agreements under the VCAP program are addressed under IRM 7.2.3. The Closing Agreement Procedures allow holders of the bonds, who generally don't know how the proceeds were used, to continue to receive tax benefits on the bonds and issuers of bonds to protect the subsidy associated with their bonds. Because the TEB program sets forth the general policy that includes encouraging issuers to voluntarily bring forward discovered noncompliance to the IRS and resolving those violations as quickly as possible, the provisions in the Closing Agreement Procedures setting forth the procedures and terms of closing agreements are particularly significant.

A. Execution of Closing Agreements

The Closing Agreement Procedures generally contemplate that a closing agreement must be signed by the governmental issuer, although other parties to a transaction, including a conduit borrower, for which the issuer has completed a Form 8821, may participate in negotiations and jointly execute the agreement. The Closing Agreement Procedures also contain provisions contemplating execution of closing agreements relating to section 150(b) "penalties" and section 6700 tax shelter penalties. In such cases, a separate examination generally would be opened and parties other than the governmental issuer generally would sign the closing agreement.

Examination closing agreements are executed by the Director of Government Entities. VCAP closing agreements are signed by the TEB Program Manager.

B. General Rules for Closing Agreements

The Closing Agreement Procedures acknowledge the general rule of section 7121 of the Code that closing agreements are final and conclusive and may not, in the absence of fraud, malfeasance or misrepresentation of material fact, be reopened as to matters agreed upon or be modified by the IRS. Closing agreements that cover any taxable period after their effective date are subject to any change in law subsequently enacted. IRM 4.81.6.2.

The Closing Agreement Procedures do, however, include provisions that contemplate closing agreements may be set aside or clarified in the limited circumstances permitted by section 7121. The Commissioner's signature is required to set aside a closing agreement. If a closing agreement provision is unclear or reasonably subject to more than one reasonable interpretation, TEB will generally clarify its understanding by issuing a letter to the issuer interpreting the unclear provision. IRM 4.81.6.7.

When there is an open examination of a case, the issuer may initiate closing agreement discussions at any time. Generally, TEB will require the issuer to use one of its model closing agreements. TE/GE has released separate form model closing agreements for examinations and voluntary closing agreements. The model agreements are set forth and discussed in an article posted on the TEB website. While changes to the model form closing agreements are possible for an issuer to negotiate, an explanation will be required and the change, if substantive, will likely require more approvals. The model closing agreements include a paragraph in which the particular violation being resolved by the agreement is to be set forth. This paragraph is particularly important because it sets forth the scope of what is covered by the agreement; any other legal issues that may arise are not protected by the closing agreement.

The Closing Agreement Procedures provide for a standardized review process within TEB for closing agreements. To ensure that all taxpayers are treated consistently and that all closing agreements are enforceable, a TEB Closing Agreement Committee has in the past been required to review all non-standard closing agreements. The Closing Agreement Committee consists of two representatives from TEB Technical. The Committee may consult with designated counsel from the Office of Associate Chief Counsel, Financial Institutions & Products (Branch 5) and the Office of the Associate Chief Counsel, Procedures & Administration. IRM 4.81.6.3. Notably, the TEB representatives on the Closing Agreement Committee have not been required to be senior managers within TEB.

C. Closing Agreement Terms

The Closing Agreement Procedures provide that, when negotiating a closing agreement, the TEB personnel will ensure that the terms: (1) are fair and equitable, (2) promote voluntary compliance and encourage due diligence in complying with all applicable federal tax laws and (3) recognize the difference between the enforcement and voluntary compliance programs established by the IRS. IRM 4.81.6.3.

The Closing Agreement Procedures provide that there will be certain violations covered by a special closing agreement program which is set forth in public announcement or notice that includes the closing agreement that is to be used. In those cases, TEB must use the applicable standard closing agreement.

If the issuer or other party that executes a closing agreement fails to comply with the terms of the agreement, TEB will consider the significance of that failure. Because the closing agreement covers only the specific noncompliance addressed therein, it is possible for other violations to require a subsequent closing agreement.

D. Bond Redemption

TEB may require as a prerequisite to entering into a closing agreement that the issuer redeem, retire or defease callable bonds of the issue at the earliest possible date. The Closing Agreement Procedures provide that if the issuer cannot redeem the bonds prior to the closing agreement execution date, the closing agreement must specify the redemption date, require the issuer to call the bonds on the redemption date, and require the issuer to provide the bondholders with an irrevocable call notice prior to the closing agreement execution date (and to provide this notice to TEB prior to execution of the closing agreement.) IRM 4.81.6.4.1. In addition, the Closing Agreement Procedures require that, for an examination closing agreement, if the bonds will not be redeemed or retired or purchased and cancelled prior to the date the closing agreement is executed by TEB, a fully funded irrevocable defeasance escrow or similar escrow satisfactory to TEB must be established to provide for payment of the bonds to the call date, and the issuer must provide written notice to TEB that it has established such an escrow. The issuer's written statement that the bonds have been irrevocably defeased is sufficient.

The requirement that an irrevocable escrow for redemption of bonds be established for examination closing agreements could be costly for certain issuers. However, the Closing Agreement Procedures are written in a manner that suggests that the establishment of such a defeasance escrow will not necessarily be required in the case of voluntary closing agreements.

E. Alternative Use of Proceeds or Facility

The Closing Agreement Procedures also provide that a closing agreement may require use of disposition proceeds of a facility for alternative qualifying uses, presumably in a manner the same or similar to "remedial actions" that are permitted in certain cases of the non-qualifying change of use of bond proceeds or bond-financed property. IRM 4.81.6.4.2. All arrangements and contracts for the alternative use must be finalized prior to the execution of the closing agreement. Presumably, the requirement to finalize arrangements in such a case is intended to minimize the future conditions of a closing agreement.

F. Resolution Amount

Perhaps the provisions of the Closing Agreement Procedures that are of most practical importance involve how the amount required to be paid by an issuer in a closing agreement (the so-called "resolution amount") is determined. The Closing Agreement Procedures provide that, generally, a closing agreement resolution amount for a tax-exempt bond issue is based on 100% of the present value of the taxpayer exposure of the bond issue, as computed pursuant to the method set forth in the Closing Agreement Procedures. However, as appropriate, closing agreement resolution amounts may also be based on the present value of an alternative minimum tax adjustment (referring to bonds issued as governmental bonds that could have qualified as exempt facility bonds), section 150(b) adjustment (referring to noncompliant change of use of certain types of qualified bonds), section 168(g) adjustments (referring to depreciation rules relating to tax-exempt bond financed property), any excessive arbitrage profits, or section 6700 penalties. Resolutions may also be based on a fee amount when provided for in guidance for a special closing agreement program. In addition, a closing agreement resolution amount for a Direct Pay Tax Credit Bond generally is based on 100% of the "credit maintenance amount" as further described below. IRM 4.81.6.4.3.

For many bond issues, and particularly for bond issues under examination, the determination of the "taxpayer exposure" is the starting point for negotiations of the resolution amount. The taxpayer exposure represents the estimated amount of tax liability the United States would collect from the bondholders if the bondholders were taxed on the interest they realized from the bonds during the calendar year(s) covered under the closing agreement. IRM 4.81.6.4.3.1.

The Closing Agreement Procedures set forth a detailed and specific method for determining the taxpayer exposure for examination closing agreements, which is also used for voluntary closing agreements. IRM 4.81.6.4.3.1. Although these methods are set forth in some detail, there remains some flexibility and ambiguity regarding the permitted methods of computations in certain cases. Particularly because the taxpayer exposure is of considerable practical importance in determining the amount an issuer may be required to pay to obtain a closing agreement, the specific methods merit discussion. The method for determining taxpayer exposure in the case of an examination closing agreement is as follows (IRM 4.81.6.4.3.1):

> Step 1. Determine the period to be covered under the closing agreement by identifying each past calendar year (as determined below) and each future calendar year during which the bonds were or will be outstanding. Bonds that have been called for redemption and defeased by a defeasance escrow are considered outstanding until their date of redemption. Past calendar years will generally include calendar years that have a tax payment date that falls within three years of the date TEB identified the compliance failure, assuming a tax payment date of April 15 following the conclusion of the calendar year.
>
> Step 2. Determine the amount of interest accrued or scheduled to accrue on the bonds in each calendar year within the closing agreement period based on the yield of such bonds. For bonds originally sold at a premium or discount of less than 5%, the actual amount of interest paid may be used for this purpose. For variable rate bonds, the examiner may determine the interest scheduled to accrue in future years by using the average of the interest rates paid to date, the last interest rate paid on the bond, or the appropriate fixed swap rate less up to 50 basis points, as appropriate under the facts of each case.
>
> Step. 3. Multiply each amount determined in Step 2 for each calendar year by the relevant tax percentage. The IRM has changed the method for determining the relevant tax percentage. Use the sum of (i) the backup withholding rate on interest payments under Code section 3406(a)(1), and (ii) the net investment income tax rate under Code section 1411(a)(1), in effect during the calendar year. For interest scheduled to accrue after the closing agreement is executed, assume no change to these tax rates from the rates then in effect.
>
> Step 4. Compute the present value of each amount calculated in Step 3 for each calendar year in accordance with IRM 4.81.6.4.3.8 by assuming it was due on April 15 in the following calendar year.
>
> Step 5. Total the present value amounts determined in Step 4 for all calendar years.

Present values are computed for prior periods by using the applicable IRS underpayment rate under section 6621 of the Code. Present values for future periods (when applicable), however, are determined using the applicable federal rates, which are lower than the underpayment rates and correspond to United States Treasury security rates.

The method for determining the taxpayer exposure for voluntary closing agreements follows the same framework as the method for examination closing agreements, with certain modifications. In general, as a matter of policy, TEB seeks to accept resolution amounts in VCAP that are less than the resolution amounts that it would require to close an examination with similar violations. The differences make the method for voluntary closing agreements somewhat more favorable to issuers. The taxpayer exposure for voluntary closing agreements is generally determined using the same method as for examination closing agreements, but it is generally based on only the nonqualified bonds, which will be allocated to the

maturities of the bonds outstanding on the date TEB identified the violation and the maturities that would have been outstanding on such date but for their early redemption to remove the nonqualified bonds from the market after the person responsible for compliance identified the noncompliance. The VCAP IRM also provides resolution standards for particular violations that can be significantly less than the resolution amount determined using nonqualified bonds. IRM 7.2.3.3.2.2.

Also, despite the considerable detail of the stated methods, the wording of the methods contains certain ambiguities and appears to allow for certain alternative computations.

First, the amount of interest used for the computation is "based on the yield of such bonds." This wording does not clarify whether the computation is based on the bond yield of the overall bond issue or the yield of substantially identical bonds of particular maturities. Because the method contains special rules for bonds issued at a substantial discount or premium, there is some basis for basing the computation on the yield of particular bond maturities. As a matter of simplicity and administrative convenience, however, it is reasonable to conclude that bond yield on the issue may also be used and, indeed, many agents appear to have used that simplified method. See, however, IRM Exhibit 7.2.3-2, which sets forth computational examples for taxpayer exposure for voluntary closing agreement purposes. This exhibit also suggests different methods may be permitted to allocate nonqualified bonds to different maturities.

Second, the method contemplates that adjustments to the interest "accrued" will be made in cases of bonds originally sold at a discount or premium of more than 5%. The method does not expressly state the method for amortizing bond premium, however.

Third, the method is not entirely clear on when the computation is to be based on interest "paid" during a calendar year, as compared to interest "accrued" during a calendar year. Literally, the method states that, if bonds are originally sold at a discount or premium, "the actual amount of interest paid may be used" but presumably is not required to be used. As a general rule, the method states that the computation is to be based on the "amount of interest accrued or scheduled to accrue on the bonds in each calendar year." As a practical matter, many agents have computed taxpayer exposure based on cash payments of interest during a calendar year, which appears to be a reasonable approach, even though the wording of the method is somewhat different.

Accordingly, even though the method is set forth with some specificity, an issuer should consider the different possible alternative approaches to the computation.

G. <u>Alternative Resolution Amount Terms</u>

Although the Closing Agreement Procedures contemplate that the general approach of TEB is to base resolution amounts on taxpayer exposure, they also contemplate a number of alternative approaches to determining resolution amounts.

In certain cases, the resolution amount may be based on payment of a "specified amount." In general, the specified amount will be set forth in a formal closing agreement program, in an IRS Notice or an IRS Announcement. The specified amount may be determined in different ways but may not be less than $5,000 for examination agreements and $2,500 for voluntary closing agreements. IRM 4.81.6.4.3.3.

For a closing agreement providing that interest on bonds will not be treated as an item of tax preference for the alternative minimum tax, the resolution amount is equal to an estimate of the federal income tax liability that all holders of the bonds during the closing agreement period will not be required to pay because the closing agreement provides that the interest is not a tax preference item. IRM 4.81.6.4.3.4. For this purpose, the "alternative minimum tax adjustment" is determined by multiplying the

outstanding principal amount of the bonds as of January 1 of each year by .0014 (that is, 14 basis points). Present value is determined according to the same method as taxpayer exposure. This method, like the method for determining tax exposure, is intended to be a rough estimate of tax that could otherwise be collected from bondholders. In practice, however, particularly for certain variable rate bonds, the result can far exceed actual taxpayer exposure. The method for determining the "alternative minimum tax adjustment" is set forth in somewhat less detail than the method for determining tax exposure. For example, there are no express provisions that contemplate refining the computation to reflect bonds sold at significant premium or discount. However, comfort can be drawn, at least for voluntary closing agreements, from the provision in the voluntary closing agreement procedures that limit closing agreement amounts to taxpayer exposure. IRM 7.2.3.3.2.2.

When a closing agreement addresses nonqualified private activity bonds, the closing agreement may require, in addition to taxpayer exposure, (1) a payment that recoups the tax benefit that a party to the transactions received for any deduction taken for interest paid on the tax-exempt financing that accrued during the nonqualified period, as provided in section 150(b) of the Code and/or (2) a payment that recoups the tax benefit that a party to the transaction received for a depreciation deduction on the financed property that was not allowed under section 168(g) during the nonqualified period. Accordingly, the Closing Agreement Procedures expressly contemplate that section 150(b) "penalties" and adjustments for depreciation improperly taken may be imposed in addition to taxpayer exposure payments. IRM 4.81.6.4.3.5 and 4.81.6.4.5.3.6. The Closing Agreement Procedures do not expressly indicate when, for example, the IRS will seek to impose section 150(b) penalties in addition to requiring payment of a resolution amount in a closing agreement.

The Closing Agreement Procedures also provide that a resolution amount may be based on "excessive arbitrage profit," which is "an estimated amount of the economic benefit realized by the issuer or other parties to the transaction in excess of the amount permitted to be realized under the arbitrage yield restriction and rebate rules." IRM 4.81.6.4.3.8.

In addition, closing agreements may be based on section 6700 penalties, as further discussed below.

H. Special Procedures for Tax Credit Bonds

The Closing Agreement Procedures contain special procedures for Tax Credit Bonds. These procedures mostly concern the differences in how the tax subsidy is provided; the general factors for closing agreement terms are the same as for tax-exempt bonds.

In the case of Tax Credit Bonds, the Closing Agreement Procedures generally provide that a closing agreement resolution amount will be based on "100% of the credit maintenance amount," rather than taxpayer exposure. The "credit maintenance amount" is "the present value of credit amounts that would have been allowable on each credit allowance date during the credit adjustment period if the violation had not occurred." Thus the "credit maintenance amount" is the equivalent of taxpayer exposure for Tax Credit Bonds. IRM 4.81.6.4.3.2.

The Closing Agreement Procedures provide that the credit adjustment period is the period from the date of the violation to the date the bonds are no longer outstanding. Depending on the facts, the date of the violation will generally either be the date of the deliberate action, the date of the intentional action, the issue date, or the date another action occurs that jeopardizes the tax-advantaged status of the bonds. The Closing Agreement Procedures contain a detailed method for determining the present value of the credit maintenance amount that is comparable to the method to determine taxpayer exposure.

For Direct Pay Bonds, the Closing Agreement Procedures also set forth an alternative approach to resolution which involves adjustments to direct pay credits. IRM 4.81.6.4.4. Because many Tax Credit Bonds have been issued as Direct Pay Bonds, this approach of adjusting direct pay credits may be of more practical importance than the approach based on a payment of a "credit maintenance amount." The approach basically entails entering into a closing agreement that provides for a reduction in a portion of or all of direct pay credit amounts. Such a closing agreement is required to describe the method for making adjustments, rather than specifying the amounts that are to be allowed. As discussed above, the resolution amount, at least for voluntary closing agreements, is limited to 100% of the credit maintenance amount. IRM 7.2.3.3.2.2,

Rev. Proc. 2018-26, among other things, provides for issuers to take remedial actions with respect to Direct Pay Bonds, including a provision that permits an issuer to reduce direct payments in an amount allocable to nonqualified bonds. IRM 7.2.3.1.4(4) provides that noncompliance eligible for the remedial actions set forth in Rev. Proc. 2018-26 will not be eligible for voluntary closing agreements for the same violation.

IV. PROCEDURES FOR IDENTIFYING BONDHOLDERS

The IRM contains detailed procedures for making bondholder referrals in the event of an adverse determination in a bond examination. IRM 4.81.7. The Examination Procedures state that as soon as the agent makes a proposed adverse determination (i.e., issues a NOPI) the agent should notify the Coordinator (as defined in the IRM in section 4.81.7.1.2) that it may be necessary to take actions to identify bondholders in order to protect the government's interest in connection with the case (Bondholder Case Notification). IRM 4.81.7.2. The Bondholder Case Notification must be forwarded by email through the agent's manager to the Coordinator and include, among other items, a copy of the proposed adverse determination, a copy of the explanation of items of the proposed adverse determination, a listing of all outstanding maturities of the issue, including all CUSIP numbers and a copy of the series 8038 information return filed by the issuer. IRM 4.81.7.2 (4).

V. ENFORCEMENT RELATING TO DIRECT PAY BONDS

The American Recovery and Reinvestment Act of 2009 authorized direct federal subsidies, characterized as refundable tax credits, to issuers for interest paid on certain taxable Build America Bonds ("BABs"). In the case of Direct Pay Bonds, the issuer, rather than bondholders, is liable for tax resulting from noncompliance, which dramatically affects the procedures and dynamics of IRS enforcement.

Section 3.3 of IRS Notice 2009-26 states refundable credits for Build America Bonds under section 6431 are treated as overpayments of tax. Accordingly, the issuer is the actual taxpayer and rules for overpayments of tax apply. As a result, limitations on credits or refunds of overpayments of tax under section 6511 of the Code also apply to credit payments with respect to BABs under section 6431 of the Code. Sections 6532, 7401, 7402, 7405 and 7422 of the Code, among others, establish rules for civil actions by the federal government to recover erroneous refunds and for civil actions by taxpayers to recover overpayments that the IRS fails or refuses to repay.

Section 301 of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111147, 124 Stat. 71 (2010) (the "HIRE Act") added subsection (o) to section 6431 of the Code, which authorizes issuers to elect irrevocably to receive Federal direct payments of allowances of refundable tax credits to subsidize a prescribed portion of their borrowing costs instead of the federal tax credits that otherwise would be allowed to holders of certain qualified tax credit bonds under section 54A of the Code. See Notice 2010-35; 2010-19 IRB 660, as reissued. Note that after the Tax Cut and Jobs Act, tax credit and direct pay bonds cannot be issued after December 31, 2018.

A. <u>Reporting Requirements</u>

Issuers seeking a payment of the refundable credit on direct pay BABs are required to file a Form 8038-CP, "Return for Credit Payments to Issuers of Qualified Bonds" with the IRS Service Center in Ogden Utah. Notice 2009-26, § 3.1. TEB has an interactive Form 8038-CP.

While there will still be review of the initial return by TEB, there will be fewer referrals on subsequent returns to TEB and those referrals will usually involve more complex and substantive issues. Other errors on the return, including possible errors in the refund amount arising from errors on the returns, will be handled under normal processing, which may mean written communications from the processing center instead of personal contacts from TEB.

In January 2022, the IRS released an updated Form 8038-CP. In addition to changing how some of the requested information is reported, the IRS indicated that the change was necessary, in part, to permit them to move to electronic filing of the Form 8038-CP. In December 2022 the IRS released an updated Schedule A to the Form 8038-CP and began permitting electronic filing of Form 8038-CP. More information about the changes to Form 8038-CP and electronic filing can be found on the IRS website: https://www.irs.gov/instructions/i8038cp#en_US_2022_publink1000105550 and https://www.irs.gov/tax-exempt-bonds/recent-updates-to-form-8038-cp-and-processing-changes.

B. <u>Examinations of Direct Pay Bonds</u>

Congress enacted special rules in sections 6401, 6431, and 6211(b)(4)(A) of the Code that create a deficiency when there is an excess of allowable direct pay credits. These changes permit the IRS to issue a notice of deficiency to the issuer for the amounts remitted as refundable credits on direct pay BABs if the IRS later determines such amounts were paid in error. After issuance of the notice of deficiency pursuant to section 6212, the issuer has the right to seek a review in U.S. Tax Court pursuant to section 6213. See Notice 2009-26, § 3.3.

The process for the issuer to litigate the withholding of a payment by the IRS is less clear. Notwithstanding the language in Notice 2009-26, a District Court has jurisdiction to review the withholding of a direct pay BAB refundable credit greater than $10,000 only if it determines that the withheld credit payment is statutorily treated in the same manner as a withheld tax refund. (See Notice 2009-26, § 3.3, which states that refundable credits for direct pay BABs will be "treated as overpayments of tax"; see also 28 U.S.C. § 1346(a)(1) and (2) (providing concurrent jurisdiction to District Courts for all tax claims and those contractual claims against the U.S. not exceeding $10,000); <u>Sorenson v. United States,</u> 475 U.S. 851 (1986) (treating a refundable credit as similar to a tax); section 6401(b) of the Code (providing distinction between refundable and nonrefundable credits)). Because Code provisions governing Build America and other direct pay credit bonds are found in the portion of the Code containing only nonrefundable credits, an "overpayment" may not exist for refund jurisdiction, preventing District Court jurisdiction, notwithstanding the wording of Notice 2009-26. See, however, section 7433 of the Code.

The IRS has asserted that it has the right to offset the BAB credit with amounts owed by the issuer to the United States, per section 6402 of the Code. If an "overpayment" does not exist, the IRS is not legally entitled to offset direct pay credits with prior tax or other debts. It is, however, unclear whether issuers who have had their credit offset by the IRS have any means to challenge the offset as being illegal, due to legal remedies available to the U.S. Government when sued in the U.S. Court of Federal Claims.

IRM Direct Pay Bond Procedures. In July 2021, TEB released revised IRM provisions on "Direct Pay Bond Procedures," which are set forth in IRM 4.82.3 (the "Direct Pay Bond Procedures"). The Direct Pay Bond Procedures generally follow the Examination Procedures that apply to tax-exempt bonds under

IRM 4.81.5 with appropriate modifications and additional procedures for Direct Pay Bonds. IRM 4.82.3.1.5.

As a general matter, an examination of Direct Pay Bonds is generally limited to one or more specific Direct Pay Bonds under examination (see, e.g., IRM 4.82.3.4.8). This approach appears to follow the historical and current approach of tax-exempt bond examinations, in which only a particular bond issue is normally the subject of an examination (and not all tax-exempt bonds of an issuer or borrower). It may be observed, however, that the question of whether an examination of Direct Pay Bonds normally should cover only particular bond issues, as compared to all Direct Pay Bonds of an issuer, does not necessarily raise all of the same considerations of whether an examination of tax-exempt bonds of an issuer should be limited to a single bond issue.

Direct Pay Bond Procedures Related to Statute of Limitations. The Direct Pay Bond Procedures devote significant attention to statute of limitations concerns and procedures. IRM 4.82.3.4 ("Statute Controls for Direct Pay Bonds"). The Direct Pay Bond Procedures continue to take the view that the period for assessment of tax on Form 8038-CP is three years from the date the return is filed (and that the normal application of section 6501(b)(1) of the Code does not apply because the due date of such return is not fixed by law or regulations, but is rather pursuant to instructions to the form). Section 7502 of the Code generally provides that the date of delivery of any return received after the prescribed filing date is deemed to be the postmark date.

The Direct Pay Bond Procedures set forth detailed provisions relating to obtaining statute extensions from an issuer. IRM 4.82.3.4.4. Note that similar procedures are not set forth in the IRM procedures for tax-exempt bonds, because an issuer would have no authority to extend the statutes of bondholders. The Direct Pay Bond Procedures provide that the "statute protection" for Direct Pay Bonds is similar to the IRS procedures for most types of assessments. Agents will generally use IRS Form 872-A to request an extension, which is the form used to extend an assessment period related to a return indefinitely. The procedures contemplate that such a consent to an extension generally will apply only to the particular bond issue under examination. IRM 4.82.3.4.8(1). The procedures provide that only the issuer of Direct Pay Bonds is permitted to extend the assessment period.

The Direct Pay Bond Procedures provide that when an examiner has identified one or more items that may result in an adverse determination, and the issuer has either refused to extend or terminated an extension and the periods will expire in less than one year, TEB will issue a notice of deficiency. IRM 4.82.3.9.2. See also, IRM 4.82.3.4.13 (which concerns the procedures an examiner is directed to follow if an issuer refuses to extend the assessment period).

Notably, the Direct Pay Bond Procedures do not acknowledge the difficult question of whether a governmental issuer has, or particular officials of a governmental issuer have, the legal authority to consent to an extension of the statute.

Direct Pay Bond Procedures Related to Agreed Adverse Determinations. An agent may use Form 4549-T to present a proposed tax adjustment for changes in the credit amount paid on Form 8038-CP. If the agent determines that the bonds are not qualified bonds, the agent is directed to discuss the issues with the issuer. If the issuer agrees the bonds are not qualified bonds and requests a closing agreement to resolve the matter, the agent is directed to follow standard closing agreement procedures. IRM 4.82.3.5.1.

Closing agreements resolving examinations of Direct Pay Bonds (i) generally follow the procedures for tax-advantaged bonds (currently in IRM 4.81.6, as described below); (ii) cover the subject bond issue and all related Form 8038-CP returns; and (iii) have a closing agreement resolution amount generally based upon the refund previously received, penalty, and interest that would be due to adjust all related Form 8038-

CP returns where the period for assessment is not barred by statute. Note that complexities arise in determining the excess refund because sequestration reduces the amount of tax refund and the sequestration rates have been subject to change, generally annually.

Direct Pay Bond Procedures Related to Unagreed Adverse Determinations. If the issuer doesn't agree with adjustments made by the agent, the Direct Pay Bond Procedures direct the agent to follow deficiency procedures for claims made on an original return. IRM 4.82.3.5.2(1). The agent is directed to follow the normal TEB procedures for proposing issues and proposed adverse determinations: (1) list the proposed adjustments to the credit amounts of the related Form 8038-CP amounts on Form 4549-T; (ii) attach a copy of the Explanation of Items (Form 5701-B or Form 886-A) prepared for the Proposed Adverse Determination Letter to Form 4549-T supporting the proposed adjustments; (iii) prepare letter 5871-A, TEB Proposed Adjustments to Credits Under IRS 6432, 30 Day Letter, to include all related Form 8038-CP periods listed on Form 4549-T; and submit the letter with enclosures for group manager review. Upon group manager approval, the Proposed Adverse Determination Letter is executed by the group manager and sent to the issuer. IRM 4.82.3.5.2.

Direct Pay Bond Procedures Related to Appeals. The Direct Pay Bond Procedures include detailed provisions regarding appeals. IRM 4.82.3.6. For cases where the only potential noncompliance involves the qualification of Direct Pay Bonds, no separate protest is required apart from an adequate protest of the related Proposed Adverse Determination Letter. If adjustments relate to the computation of the credit or the allowance of any specific credits, not involving the overall qualification of bonds for which a separate explanation of items is required, then the issuer's protest must identify and address the specific adjustments to which it does not agree.

The IRS continues to process Form 8038-CP returns until a final adverse determination. IRM 4.82.3.6.

Direct Pay Bond Procedures Related to Taxpayer Penalties. The Direct Pay Bond Procedures include detailed provisions regarding taxpayer penalties. They note that the Protecting America from Tax Hikes Act of 2015 changed the definition of an underpayment to which section 6662 and 6663 of the Code apply to include credits under section 6431 of the Code for returns filed after December 18, 2015. Accordingly, accuracy related penalties and fraud penalties may be applicable to deficiencies determined for such returns. IRM 4.82.3.11.

The Direct Pay Bond Procedures continue to state that the penalty for erroneous claims under section 6676 of the Code may be considered in all examinations of Direct Pay Bonds resulting in a proposed adjustment to tax. The penalty that can be imposed under Section 6676 is an amount equal to 20 percent of the "excessive amount." The "excessive amount" is the amount by which the amount of the claim for refund or credit exceeds the amount of credit allowable for a taxable year. The Direct Pay Bond Procedures note that the defense to the penalty imposed by Section 6676 of the Code was changed from "reasonable basis" to "reasonable cause" in the 2015 legislation. The Direct Pay Bond Procedures state that, when penalties under Section 6676 are dependent on the determination of a deficiency, as defined in Section 6211, the penalty is subject to deficiency procedures, but when the penalty relates to a claim disallowance and is not dependent on a determination of deficiency, the penalty is not subject to deficiency procedures. The "reasonable cause" exception, however, does not apply to a transaction lacking "economic substance" under section 6662(b)(6).

The Direct Pay Bond Procedures contain no statement or acknowledgement that such penalties should only be considered in extraordinary circumstances, but rather are framed in a manner that contemplates that the penalty could be routinely considered.

VI. COMPLIANCE CHECK QUESTIONNAIRES

A compliance check is not treated by the IRS as an audit. Instead, it is viewed as a "soft contact" to ascertain the levels of adherence to certain requirements. There is no legal requirement to respond to a compliance check questionnaire. Nevertheless, the IRS may use compliance checks to identify potential audit targets. TEB has launched a few separate compliance check questionnaire programs since 2007: (1) exempt organization borrowers of qualified 501(c)(3) bonds, (2) governmental issuers of tax-exempt governmental bonds, (3) governmental issuers of direct pay Build America Bonds, (4) issuers of qualified tax credit bonds, and (5) governmental issuers of advance refunding bonds and exempt organizations borrowers benefitting from advance refunding bonds.

VII. ADMINISTRATIVE APPEAL PROCEDURES FOR ISSUERS OF TAX-ADVANTAGED BONDS

Special procedures for administrative appeal from a proposed adverse determination by the IRS for an issuer of tax-advantaged bonds are set forth in Rev. Proc. 2021-10, which updated and expanded Rev. Proc. 2006-40, which, in turn, implemented Section 3105 of the Internal Revenue Service Restructuring and Reform Act of 1998. Rev. Proc. 2006-40, which implemented the concept of the issuer as a taxpayer, only applied to tax exempt bonds. Rev. Proc. 2021-10 expanded the procedures in Rev. Proc. 2006-40 to include other forms of tax advantaged bonds.

A. The Issuer as "Taxpayer"

Rev. Proc. 2021-10 states that the IRS generally treats an issuer as the taxpayer for the bond issue under examination. Bondholders do not, however, lose their status as taxpayers, and they retain separate appeal rights. This means that a bondholder is not estopped from going to the IRS Independent Office of Appeals ("Appeals") because the issuer went to Appeals. Conduit borrowers and other interested persons may inspect or receive confidential information during the Appeals process, if authorized by the issuer, by submitting a duly executed Form 8821, Taxpayer Information Authorization, to the Appeals officer.

B. Procedures for Requesting an Appeal

Rev. Proc. 2021-10 provides that an issuer may request an appeal upon the receipt from the TEB Examination Office of a (1) proposed adverse determination that an issue of bonds fails to qualify for the exclusion of the interest on the bonds from the gross income of the bondholders under section 103; (2) proposed adverse determination that an issue of bonds fails to qualify for the tax credits for the bondholders or direct payments to the issuer with respect to the bonds under provisions of the Code applicable to tax-advantaged bonds; or (3) proposed adverse determination that denies a claim for recovery of an asserted overpayment of arbitrage rebate under section 148 with respect to tax-exempt bonds or under section 148 as modified by relevant provisions of the Code with respect to other tax-advantaged bonds.

An issuer's appeals request must be submitted in writing to the TEB Examination Office within 30 days of the date of the proposed adverse determination or arbitrage rebate claim denial, subject to possible extension by the IRS. After a case file is sent to Appeals, Appeals has jurisdiction over the issues raised in the proposed adverse determination. If the issuer fails to submit an appeals request within the required time, a Proposed Adverse Bond Determination or arbitrage rebate claim denial will become final.

C. The Administrative Appeal Process

An appeal is assigned to an Appeals officer. Appeals will consider the case a priority assignment and will resolve the case as expeditiously as possible. If the issuer provides additional information not

previously given to TEB, Appeals may forward such information to TEB for comment, or Appeals may return jurisdiction over the case to TEB if it determines that the significance of any new information warrants further case development by TEB Field Operations.

If Appeals and the issuer agree that no action is necessary with respect to the issues raised in a proposed adverse determination, Appeals will provide written notification to the issuer that the proposed adverse determination has been withdrawn. If Appeals and the issuer reach an agreement with respect to the bond issue, Appeals will generally prepare a closing agreement using a model closing agreement.

If Appeals and the issuer cannot reach an agreement, Appeals will provide written notification to the issuer that TEB's Proposed Adverse Determination has become final. Appeals then returns the case to TEB, which may initiate procedures to impose tax on the bondholders.

D. Special Appeals Procedures for Conduit Borrowers

Rev. Proc. 2021-10 provides that, in appropriate circumstances Appeals may consider issues that relate to the tax liability of a conduit borrower at the same time as the issuer's appeal. Appeals will consider using this procedure only if the conduit borrower is under examination with respect to the issue, the resolution of the issue is affected by the Proposed Adverse Bond Determination, and the conduit borrower agrees to resolve the issue at the same time as the issuer's appeal.

VIII. THE VOLUNTARY CLOSING AGREEMENT PROGRAM

On September 25, 2001, the IRS issued Notice 2001-60, announcing the establishment of a voluntary closing agreement program known as the TEB VCAP. TEB VCAP had been administered by the CPM group, but after the TE/GE reorganization, the program is under the TEB Technical group. Since 2001, the IRS and issuers have resolved a substantial number of compliance issues through VCAP closing agreements. However, the number of VCAP closing agreements in the past several years have significantly declined. It is within the power of the IRS to send an unresolved VCAP request, once closed, to the examination function.

Notice 2001-60 provides that TEB VCAP is intended to encourage issuers and conduit borrowers to exercise due diligence in complying with the Code and applicable regulations by providing a vehicle to correct violations thereto in furtherance of the IRS' policy of taxing bondholders as a last resort.

TEB Voluntary Closing Agreement Procedures have been modified many times since 2001, including revisions made in Notice 2008-31 and IRM provisions released in 2008, 2011, 2015 and 2018. Notice 2008-31 and guidelines released in 2008 (1) added Tax Credit Bonds to VCAP, (2) provided for electronic submission of VCAP requests, (3) established roles for a TEB VCAP inventory coordinator, a CPM team leader, and the TEB Closing Agreement Committee, (4) provided details regarding the internal briefing requirements necessary to resolve a VCAP, (5) established the requirement to pay the closing agreement amount through the official electronic payment system, and (6) created a streamlined closing agreement process for certain identified violations. Voluntary Closing Agreement Procedures in the IRM released in late 2015 made a number of significant revisions to the existing VCAP procedures but continued the general themes of the program. IRM 7.2.3. One significant development is increased emphasis on making the process of obtaining a VCAP more streamlined and efficient through increased use of provisions such as standardized closing agreements and "streamlined" closing agreement terms. The IRM moved certain VCAP provisions from the general closing agreement IRM to the VCAP IRM, increased the minimum required payment for a VCAP from $1,000 to $2,500, removed a resolution standard that was no longer applicable, and made certain other changes to reflect the reorganization.

A. Scope of TEB VCAP

TEB VCAP generally may be used for violations applicable to tax-exempt bonds under section 103 or related provisions of the Code or applicable regulations. Absent extraordinary circumstances or specific IRS instructions to the contrary, TEB VCAP is not available if the violation can be remedied under other remedial action provisions or tax-exempt bond closing agreement programs contained in the Regulations or published guidance or by filing of a corrected return, when permitted. IRM 7.2.3.1.4. Thus, for example, TEB VCAP is generally not available if an issuer can take a remedial action under provisions such as Sections 1.14112, 1.142-2, 1.1442, 1.145-2, and 1.147-2 of the Treasury Regulations, or if the issuer can remedy an arbitrage problem through paying rebate. In the same manner as for tax-exempt bonds, for tax credit and direct pay bonds, "absent extraordinary circumstances or specific IRS instructions to the contrary," TEB VCAP is not available if the violation can be remediated under other remedial actions of the Code and the Regulations. Thus, TEB VCAP is not available for a failure to expend 100 percent of available project proceeds of qualified tax credit bonds for qualified purposes as of the close of the expenditure period if the issuer can redeem nonqualified bonds within 90 days after the close of such period. TEB VCAP also excludes the remedial action for qualified zone academy bonds for excess proceeds set forth in the regulations, when applicable. Further, TEB VCAP is not applicable to Build America Bonds in cases when an issuer can take a remedial action for change of use or when an issuer is able to correct prior clerical or computational errors in Form 8038-CP. Under this same general approach, TEB VCAP is not available for corrections of mistakes relating to carryforward of volume cap that can be corrected under Rev. Proc. 2005-30. Revenue Procedure 2018-26, which provides for additional remedial actions, also applies to limit the application of VCAP.

TEB VCAP is not available if the bond issue is under examination or the tax-advantaged status of bonds is an issue in any court proceeding or is being considered by Appeals. For this purpose, a bond issue is generally treated as under examination beginning on the date a letter opening the examination is mailed to the issuer. IRM 7.2.3.1.4(6)(b).

The Voluntary Closing Agreement Procedures provide that TEB VCAP is not an appropriate forum to conclusively resolve matters relating to future events or actions that may affect tax-exempt bonds. Note, however, that an issuer is permitted to take anticipatory remedial actions. See Treas. Reg. §1.141-12(d)(3).

TEB VCAP is not available if the issuer has not filed a Form 8038 series information return with respect to the bond issue.

TEB VCAP is not available if TEB determines that the violation was due to "willful neglect."

B. "Anonymous Requests"

The Voluntary Closing Agreement Procedures provide that an issuer may cause to be submitted a request to TEB for an indication of how TEB would resolve a compliance issue pursuant to VCAP, without a requirement that the issuer identify either itself or identifying information about the bond issue (a so-called "Anonymous Request"). IRM 7.2.3.1.7. The Voluntary Closing Agreement Procedures provide that Anonymous Requests are intended to be available only in those instances where the standards set forth in the Voluntary Closing Agreement Procedures do not provide guidance on how a particular violation may be resolved and is generally intended for situations that are novel or unique. An Anonymous Request is not treated as a formal request for a voluntary closing agreement and provides the issuer with no protections for an issuer against an IRS examination that commences before the issuer submits a voluntary closing agreement with the required identifying information. Moreover, TEB's response to an Anonymous Request is intended only "to describe a general resolution framework based on its described facts" and does not represent a TEB settlement offer. IRM 7.2.3.1.7. Nonetheless, if TEB determines to respond, it will follow

procedures to obtain the concurrence of managers and the Closing Agreement Committee and may send a letter describing likely settlement terms. Notwithstanding the limitations of the Anonymous Request procedures, the submission of an Anonymous Request may be a useful option for an issuer in many circumstances, particularly those that are not similar to the resolution standards for particular "Identified Violations" that are set forth in the Voluntary Closing Agreement Procedures.

C. Information Required in Submission Request

The Voluntary Closing Agreement Procedures require that a VCAP request submit a Form 14429 and provide detailed statements under penalties of perjury. These statements include basic information identifying the bond issue, but also must include a detailed description of the violations for which resolution is requested, the issuer's proposed resolution terms, and other express representations (including representations to the effect that the request is within the scope of TEB VCAP, as described above). IRM 7.2.3.2. Specialty template agreements, such as those found in Announcement 2015-02, provide their own procedures that should be followed.

The description of the violation must include a clear statement of the specific federal tax requirement violated and a statement as to how the facts surrounding the violation were discovered. If the issuer requests that TEB consider the lack of clarity about a legal answer as a factor in determining an appropriate resolution, the issuer must include a discussion of "established law supporting a determination that there is a credible basis for finding that a violation has occurred." IRM 7.2.3, Exhibit 7.2.3-1. This requirement is based on the TEB view that it has authority under TEB VCAP to resolve only violations of applicable federal tax requirements. An issuer is not required to represent or concede that a violation necessarily has occurred but is required to provide the basis for an IRS determination that there is at least a "credible basis" that a violation has occurred.

The description of the proposed resolution terms must describe the method used to compute the resolution amount or a description of an alternative method and the funds that will be used to pay the closing agreement amount (which cannot be derived from proceeds of tax-advantaged bonds).

The Voluntary Closing Agreement Procedures provide that TEB generally will rely on the issuer's representations of facts as true and accurate and not review books or records to confirm or verify such facts and may rely on representations of another party (such as a conduit borrower) made under penalties of perjury. In connection with any such reliance on representations of another party, TEB will require that the issuer certify under penalties of perjury that, to the best of the issuer's knowledge, such facts are true and accurate.

D. Form Closing Agreement Generally Required

The Voluntary Closing Agreement Procedures generally require that a proposed form of closing agreement be included in any VCAP request. The Voluntary Closing Agreement Procedures state that TEB generally will not deviate from its form, and that any proposed deviations from the form must be identified and explained in the request. IRM 7.2.3.2.1(5).

E. TEB Processing of VCAP Requests

One important feature of the Voluntary Closing Agreement Procedures is that they contemplate a distinctly different approach for the processing of "streamlined" VCAP requests (that is, requests for the "Identified Violations" described below) as compared to other requests for which TEB has not stated resolution standards. In general, in the case of "streamlined" VCAP requests, the Voluntary Closing Agreement Procedures provide for a more summary review that contemplates less review by managers.

IRM 7.2.3.3.2. Further, if the proposed closing agreement does not substantively differ from the TEB VCAP model closing agreement, the agreement does not require review by the TEB Closing Agreement Committee.

In the case of other voluntary closing agreements, however, the agent is generally required to provide a more detailed briefing memoranda, and in addition to receiving the group manager approval, to obtain the approval of the Technical Program Manager, and in all cases, to submit the agreement to the TEB Closing Agreement Committee.

The TEB Closing Agreement Committee consists of two representatives from TEB Technical who may consult with a designated person from the Office of the Associate Chief Counsel, Financial Institutions & Products (Branch 5) and the Office of the Associate Chief Counsel, Procedures & Administrative.

One important trend in the development of the Voluntary Closing Agreement Procedures is the development and expansion over time of these "Identified Violations" eligible for streamlined and standardized resolution terms. A common theme is that the resolution standards for these Identified Violations are intended to be proportionate to the violation, even though failure to comply with eligibility requirements generally causes an entire bond issue to fail to qualify as tax advantaged. The standard resolution standards for Identified Violations are important not only to provide guidance on how the IRS will resolve Identified Violations, and how it is likely to resolve violations that are similar to an Identified Violations, but also provide benchmarks to consider in resolving other violations.

The current "Identified Violations" (IRM 7.2.3.4.3) are as follows:

1. *Excessive nonqualified use.* This refers to a violation of required uses of proceeds of both governmental bonds under section 141(b) and various types of qualified private activity bonds and other bonds.

2. *Ownership of qualified 501(c)(3) bond-financed property.* This refers to violations of the requirement of section 145(a) that all property financed with proceeds of a qualified 501(c) bond issue must be owned by a section 501(c)(3) organization or a State or local governmental unit.

3. *Failure to provide notice of defeasance.* This refers to a violation of the technical requirement in the regulations that a notice must be sent to the IRS in the event that a defeasance escrow is established as a remedial action.

4. *Failure to call defeased bonds within 10.5 years of issuance.* This also refers to a technical requirement in the regulations that the remedial action of redeeming or defeasing bonds is permitted only if the bonds are subject to optional redemption not later than 10 $^{1}/_{2}$ years after the issue date.

5. *Alternative minimum tax adjustment.* This generally applies to a violation of use-of-proceeds requirements that apply to governmental bonds for a bond issue that could have otherwise qualified as a type of permitted exempt facility bond issue.

6. *Capital expenditure limitation failure.* This applies to failures of "qualified small issue bonds" issued under section 144(a) of the Code to meet the $10 million limitation on the face amount of the issue and certain capital expenditures of the conduit borrower.

7. *Maturity exceeding 120% of economic life.* This applies to failures of qualified private activity bonds to meet the requirement that the weighted average maturity of the bonds cannot exceed 120% of the reasonably expected weighted economic life of the property financed by a bond issue.

8. *Impermissible advance refunding.* This refers to a violation of the limitations under section 149(d) of the Code, as it existed prior to 2018, on the number of permitted advance refundings. The standard could apply either to any qualified private activity bond issue other than a qualified 501(c)(3) bond issue (in which case no advance refunding is permitted) or to a governmental bond issue or qualified 501(c)(3) bond issue (in which case only one advance refunding was generally permitted prior to 2018). This standard would apply, for example, if refunded bonds are actually redeemed more than 90 days after the issue date of the refunding bond issue, in an instance where advance refunding is not permitted.

9. *Failure to timely reinvest proceeds into SLGS.* This refers to a violation of the yield restriction requirements of section 148 of the Code as they apply to an advance refunding escrow. Specifically, it refers to an instance where an advance refunding escrow requires the bond trustee to reinvest maturing escrow securities in United States Treasury Securities State or Local Government Series having a zero yield. Note that the resolution amount for cases in which an alternative investment was not acquired is based on the highest SLGS rate at the date of the investment failure for a SLGS investment with a maturity on the scheduled maturity date under the escrow agreement for the 0% SLGS that were to be acquired or an earlier date that the 0% SLGS were actually purchased. This is a change from the implied overnight fed funds rate that had been used in certain instances in the past.

10. *Failure to satisfy TEFRA public approval requirements in connection with status of applicable elected representative.* This also refers to a violation of the requirement that an issue of qualified private activity bonds meets the public approval requirement of section 147(f) of the Code. Specifically, it refers to a bond issue that was approved by an individual that was mistakenly thought to meet the requirements of an "applicable elected representative" eligible to provide the public approval.

11. *Extinguishment, merger.* This refers to a violation that occurs because tax-exempt bonds or Direct Pay Bonds purchased by the issuer itself may be treated as extinguished in certain circumstances.

12. *Failure to satisfy information reporting requirements after a remedial action.* This refers to a violation of the requirement to file an additional Form 8038 in the case of certain remedial actions. This violation mostly occurs in the case of a remedial action relating to qualified 501(c)(3) bonds in which the remedial action is an alternative qualifying use of bond proceeds.

The Voluntary Closing Agreement Procedures set forth a number of resolution standards for Identified Violations involving the particular requirements that apply to Build America Bonds and other Direct Pay Bonds. IRM 7.2.3.4.4.

13. *Excessive nonqualified use or failure to expend within the permitted period.* This refers to a violation of the private activity bond, capital expenditure, or speed of expenditures requirements as applied to Build America Bonds and Recovery Zone Economic Development Bonds, which are generally required to meet the same use-of-proceeds restrictions as tax-exempt governmental bonds or a failure of qualified tax credit bonds to meet use-of-proceeds or speed of expenditure requirements. IRM 7.2.3.4.4 (2).

14. *De minimis premium violation (Build America Bonds, Recovery Zone Economic Development Bonds, and specified tax credit bonds).* This refers to the requirement that the issue price of Build America Bonds, Recovery Zone Economic Development Bonds and specified tax credit bonds not have more than de minimis premium. IRM 7.2.3.4.4(3).

In addition, the IRS has implemented certain voluntary closing agreements in Announcements and other types of published guidance, so that not all resolution standards for the VCAP program are set forth in the IRM. The following is an example.

Announcement 2015-2 (Relief from violation of qualified ownership and use requirements for qualified 501(c)(3) bonds). This announcement sets forth a closing agreement program for a 501(c)(3) organization that has lost its status as a 501(c)(3) organization because of failure to file required Form 990 information returns for three consecutive years. The closing agreement applies if the organization has obtained a reinstatement letter regarding its 501(c)(3) status under IRS Rev. Proc. 2014-11. The closing agreement provides assurance that the temporary loss of status of the organization as a 501(c)(3) organization will not cause qualified 501(c)(3) bonds benefiting the organization to violate the ownership or other use-of-proceeds requirements of section 145(a) of the Code. If a request is submitted in a timely manner after the receipt of a reinstatement letter, the required resolution amount ($500 per year) is fairly modest. This Announcement is in part notable because it sets forth a required closing agreement form, and in some respects is an early example of TEB's trend towards more streamlined closing agreements.

A general theme of the resolution standards for Identified Violations is that they reflect TEB's intent to provide an incentive to issuers to identify a violation shortly after it occurs, by providing more favorable resolution terms. For example, for many Identified Violations, the resolution terms are more favorable if the issuer submits a VCAP request within 6 months of the violation; in such cases an issuer qualifies for somewhat less favorable resolution terms if it submits a VCAP request between 6 months and one year of the violation. For many of the Identified Violations, an issuer does not qualify for the streamlined VCAP resolution standards if the VCAP request is not submitted within one year of the violation. The intent of the resolution standards for Identified Violations is to streamline the VCAP process and to provide issuers with a high degree of confidence that the resolution standard will be proportionate (at least in a rough way) to the violation.

For example, some of the most commonly used resolution standards are for the Identified Violations that involve excessive nonqualified use or failure to meet a requirement relating to ownership of bond-financed property. In those cases, the resolution standard generally requires a payment based on the taxpayer exposure on the "nonqualified bonds" for the period of noncompliance. The "nonqualified bonds" are basically the portion of the bonds of an issue that would fail to comply because of the noncompliant use or ownership. If the VCAP request is submitted within 6 months of the violation, the resolution standard is 100% of the taxpayer exposure on the nonqualified bonds; if the VCAP request is submitted after 6 months but not more one year after the violation, the resolution standard is 110% of the tax exposure. In the case of Build America Bonds and certain other Direct Pay Bonds, a comparable approach is used based on the "credit maintenance amount" rather than taxpayer exposure. The same resolution standard applies to other information reporting requirements after a remedial action (that is, failure to fail a supplemental Form 8038, when required under the regulations).

Certain of the Identified Violations do not as readily lend themselves to an obvious standard for a resolution standard proportionate to the violation. In those cases, the IRS has developed resolution standards based on certain dollar amounts or percentages of taxpayer exposure. Certain of these resolution standards appear to be somewhat arbitrary, but they at least provide benchmarks for consistent treatment by TEB of similar violations. These resolution standards are subject to the minimum payment requirement of $2,500 set forth in the IRM. For example, the resolution standard for a failure to timely file a notice of defeasance relating to a remedial action is a settlement payment of $2,500, if the VCAP request is made within 6 months of the violation, and $5,000, if the VCAP request is more than 6 months after but not more than one year after the violation, presumably reflecting TEB's view that this is a relatively minor violation of a technical reporting requirement. In the case of a failure to meet the public approval requirement because of a mistaken view that a person providing the approval was properly authorized, the comparable resolution standard provides for a settlement payment equal to 5% (or 5.5%) of taxpayer exposure.

Computing the settlement amounts under the resolution standards. The resolution standards for Identified Violations appear to strive for settlement payments that are computed in a uniform, and almost

automatic, manner. Also, Exhibit 7.2.3-2 provides for computational examples which clarify certain points. In fact, notwithstanding the considerable level of detail setting forth the method for determining settlement payments, the resolution standards do not expressly address every aspect of the computation, and often there may be some ambiguity regarding the correct computation. For example, many of the resolution standards are based on the amount of "nonqualified bonds." The exact method of determining the nonqualified bonds generally references the applicable regulations, but there is some lack of clarity in the resolution standards regarding how this method is actually applied. In particular, many counsel interpret the applicable regulations as contemplating that the amount of nonqualified bonds is a percentage of the outstanding bonds of an issue; in many cases, however, TEB has taken the view that the amount of nonqualified bonds is a fixed principal amount of bonds, determined once on the date that a violation occurs. The differences in the resulting computation may be significant. There also may be some room for interpretation of the exact date on which a violation occurs and, as set forth above, different methods of determining taxpayer exposure may lead to somewhat different results.

F. Implications for Requests not Meeting the Requirements for Streamlined Resolution Standards for Identified Violations

The Voluntary Closing Agreement Procedures generally contemplate that TEB will follow the resolution standards for Identified Violations. The Voluntary Closing Agreement Procedures also provide, however, that if the violation is not described in the streamlined resolution standards or if the issuer requests TEB to consider factors to arrive at a different resolution, the violation will be resolved through the TEB VCAP general procedures on "such terms as are determined appropriate under the facts and circumstances." IRM 7.2.3.4.2.

As a practical matter, however, TEB often appears to look to the resolution standards as benchmarks to resolve violations that are not expressly covered under the resolution standards. For example, TEB has received many VCAP requests for violations involving excessive nonqualified use of bond proceeds made more than one year after the date of the violation. In such instances, TEB has in many instances resolved the VCAP request by requiring a settlement payment of 120% of taxpayer exposure on nonqualified bonds for the period of noncompliance. This 120% factor appears to be an extrapolation from the resolution standards in the streamlined VCAP. (That is, if 100% of tax exposure is the standard for a VCAP request made within 6 months of the violation, and 110% of tax exposure is the standard for a VCAP request made more than six months after but not more than one year after the violation, a reasonable extrapolation may be to require a settlement payment of 120% in the case of closing agreements submitted even longer after the violation).

IX. SECTION 150(b) CHANGE IN USE "PENALTIES"

The provisions of section 150(b) of the Code present the IRS with an alternative, or additional, enforcement approach in the case of noncompliance relating to use of proceeds of qualified private activity bonds. In general, section 150(b) denies users of the proceeds of qualified private activity bonds an interest deduction in cases where proceeds are not used as required under the tax-exempt bond rules. Section 150(b) assessments are not technically "penalties" under the Code, but are commonly referred to as penalties, and are so described in this summary.

The IRS has not issued comprehensive regulations under section 150(b). The IRS has issued regulations addressing how "remedial actions" taken to protect the tax-exempt status of bonds affect imposition of the section 150(b) penalties. Treas. Reg. § 1.150-4. In general, these regulations provide that the section 150(b) penalties will not apply if the remedial action is taken to redeem bonds within 90 days of a "change of use" or if the remedial actions of alternative qualifying use of a facility or alternative use of disposition proceeds are taken, as permitted by applicable "use-of-proceeds" regulations. Notably,

however, the regulations literally state that section 150(b) penalties may continue to apply if noncompliant bonds are defeased rather than redeemed. See also PLR 9406028 for an analysis of certain interpretive issues not addressed in the regulations.

Reliance on section 150(b), rather than on enforcement approaches directed at issuers or bondholders, has several obvious advantages: (1) it avoids disruption of the tax-exempt bond markets; (2) unlike the "all or nothing" rule for qualification as a tax-exempt bond, the statutory remedy under section 150(b) is proportional to the violation, both because it applies to only the noncompliant portion of a bond issue and because it applies only during the period the noncompliant use occurs; and (3) conduit borrowers have more direct procedural means to contest adverse determinations of the IRS without implicating bondholders. One disadvantage of section 150(b) is that the IRS has adopted the position that section 150(b) provides an additional set of penalties, not an approach that should necessarily be used instead of questioning the tax-exempt status of bonds.

As is discussed above, the Closing Agreement Procedures expressly contemplate that section 150(b) "penalties" may be imposed in addition to payment of a closing agreement resolution amount to protect the tax-exempt status of bonds, but the IRM does not provide an indication of the circumstances under which the penalty will be imposed.

It is understood that some closing agreements relating to qualified small issue bonds and other qualified private activity bonds have included an agreement that the IRS will not seek to apply section 150(b)(6). Accordingly, it may be appropriate to request that a closing agreement addressing use-of-proceeds requirements for qualified private activity bonds should cover the possible imposition of section 150(b) penalties.

X. SECTION 6700 - TAX SHELTER PENALTIES

A. Background for Application of Tax Shelter Penalties; GAO Recommends Application of Section 6700

A seminal General Accounting Office report on tax-exempt bond enforcement published in 1993 encouraged the IRS to apply section 6700 of the Code, which provides for a penalty for promoting a tax shelter, to the tax-exempt bond area. Section 6700 can provide the IRS with a vehicle for direct recourse against transaction parties. Section 6700 provides for a penalty on any person who directly or indirectly participates in the sale and who furnishes or causes to furnish a statement with respect to the excludability of income which the person knows or has reason to know is fraudulent or false. Thus, the section 6700 penalty may only be applied in cases of actual or constructive fraud.

B. Development of Section 6700 and Section 6700 Actionable Conduct

1. Persons Subject to 6700 Penalties. Section 6700 provides for the imposition of a penalty upon:

(a) Any person who organizes (or assists in organizing), or participates (directly or indirectly) in the sale of an entity, investment plan or any other plan or arrangement or any interest therein; and

(b) Makes or furnishes or causes another person to make or furnish (in connection with such sale) a statement with respect to securing a tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the

person knows or has reason to know is false or fraudulent regarding any material matter; or

(c) Makes or furnishes or causes another person to make or furnish a gross valuation overstatement.

C. Section 6700 Terminology

1. “Plan” or “Arrangement” Defined. Generally, a plan or arrangement is any “tax avoidance scheme.” See Legislative History 1982 Act, Staff of Jt. Comm., General Explanation of TEFRA at 211. Under case law, the term has been interpreted broadly and has been applied to tax protester organizations that market family trusts, U.S. v. Smith, 657 F. Supp. 646 (W. D. La. 1986), aff’d per curium, 814 F.2d 1086 (5th Cir. 1987), and cassette tapes outlining dubious constitutional attacks on the federal income tax, U.S. v. White, 583 F. Supp. 1118 (D. Minn. 1984), aff’d 769 F.2d 511 (8th Cir. 1985).

2. Tax-Exempt Bonds. The legislative history of Pub. L. 101-239 (the “1989”) Act explicitly provides that an “investment plan or arrangement” and “other plan or arrangement” includes tax-exempt bonds and states:

> The Committee wishes to clarify that under present law, `investment plan or arrangement’ and `other plan or arrangement’ as those terms are used in section 6700 of the Code, include obligations issued by or on behalf of State or local governments which are represented to be described in section 103(a) of the Code. Therefore, the penalty imposed by section 6700 may apply to bond counsel, investment bankers and their counsel, issuers (and beneficiaries of `conduit’ bonds), financial advisors, feasibility consultants and engineers, and other persons, who (1) are involved in the organization or sale of such State or local government bonds and (2) know or have reason to know that their opinions, offering documents, reports or other statements (or material on which they relied in making such statements) are false or fraudulent as to any matter material to the tax exemption of the interest on the bonds.”

3. Any Person. Any “person” includes individuals, estates, trusts, corporations, and partnerships. See section 7701(a)(1) of the Code.

4. Penalties Imposed on Person-by-Person Basis. Because section 6700 penalties are imposed on a person-by-person basis, multiple penalties may be imposed on each party involved in a single transaction such as an incorporated legal practice and each of its lawyers who worked on the financing. See Autrey v. U.S., 889 F.2d 973 (11th Cir. 1989) rehearing denied en banc, 897 F.2d 537 (11th Cir. 1990).

5. Corporations. A corporation acts through agents, therefore, liability may accrue to the agent and the corporation for the agent’s actions.

6. Pass-through Entities. Does the penalty apply to both the entity and the equity holder receiving the income? With respect to S-corporations, case law treats them as distinct legal entities. Thus, separate penalties may be assessed against the S-corporation and its shareholders. See In re MDL-73 I Tax Refund Litigation, 989 F.2d 1290 (2nd Cir.), cert. denied sub nom. Madison Library, Inc. v. U.S., 510 U.S. 964 (1993). If the S-corporation is legally distinct from its shareholders, should corporate income flowing to the shareholders count as income derived from the promotion of a tax shelter? One court says yes - See Id. Two opinions split on whether the IRS may assess penalties against both a partnership and its partners. Unlike S-corporation shareholders, partners are liable for any penalty imposed on the partnership (aggregate approach). See Id. However, partnerships and their individual partners are both “Persons” as defined in the Code and there is no express statutory restriction (entity approach). See Bailey Vaught

Robertson & Co. v. U.S., 828 F. Supp. 442 (N.D. Tex. 1993). Is a limited liability corporation (LLC) treated like a partnership or an S-corp.?

7. Service Providers. Penalties may be imposed on accountants or lawyers whose opinions are used as part of an offering. See Staff of Jt. Comm., General Explanation of TEFRA at 211.

8. "Make or Furnish Fraudulent Statement." Making or furnishing a fraudulent statement means that a person must actually make or furnish a statement to an investor. See U.S. v. Turner, 601 F. Supp. 757 (E.D. Wis. 1985), aff'd 787 F.2d 595 (7th Cir. 1986). However, "[o]f importance is the fact that the actions of the promoter that gave rise to the penalty, and whether or not the potential purchaser enters into the transaction, relies on the advice, or underreports his income is of no consequence to the imposition of the penalty." Gardner v. Commissioner, 145 TC 6 (2015). Statements are not imputed from one individual to another, although employee actions may be imputed to entities. See In re Tax Refund Litigation, 989 F.2d at 1290. Examples of furnishing a statement include offering materials, tax forms, contracts, price quotes or extension of credit. Review of offering materials to be sent to investors by a third-party may be legally sufficient grounds that such party made the statement. See U.S. v. Philatelic Leasing Ltd., 794 F.2d 781 (2nd Cir. 1986).

9. "False or Fraudulent Statements." False or fraudulent statements means that the maker must know or have reason to know the statement is false. The legislative history of the 1982 Act states that this does not impose duty of inquiry beyond a person's role in the transaction, (i.e., salesman presumed to know information in the sales material; S. Rept. No. 97530, 97th Cong., 2nd Sess. (Aug. 17, 1982)). One court has held that this language may impose a duty of inquiry on lawyers. See Gard v. U.S., 92-1 USTC 50, 59 (N.D. Ga. 1992). There are two types of statements: statements that directly address tax benefits and statements regarding factual matters relevant to determining tax benefits. The statements must be material. Statements affecting tax benefits are material; e.g., statements regarding the tax-free status of interest to be paid on bonds is material. See U.S. v. Buttorff, 761 F. 2d 1056 (5th Cir. 1985). The New York State Bar Association's Tax Section issued a Report No. 1075, "Report on Application of Section 6700 Penalties to Lawyers: The 'Reason to Know' Standard" on January 10, 2005.

10. Gross Overvaluation Statements. A statement is a gross overvaluation statement if the stated value of property or services exceeds the correct value by 200% and such value is directly related to an investor's tax benefit. Knowledge of the overvaluation is not required. See Gates v. U.S., 874 F.2d 584 (8th Cir. 1989). The correct value is the fair market value which is the price a willing buyer would pay a willing seller in an arm's-length transaction and, in this regard, appraisals are not conclusive. See U.S. v. Music Masters, Ltd., 621 F. Supp. 1046 (W.D. N.C. 1985), aff'd sub nom. U.S. v. Masters, 816 F.2d 674 (4th Cir. 1987). The IRS may waive the penalty if statement is made in good faith and upon reasonable basis. See section 6700(b)(2) of the Code.

D. Amount of Penalty

1. Calculation. The penalty imposed with respect to false statements appears to be limited to 50% of the gross income derived. Section 6700(a) of the Code (last sentence).

2. To Be Derived. "To be derived" is a forward-looking test, and therefor income does not have to be, in fact, earned at a later time. Thus, the government may assess a penalty on the income it reasonably expects the person to earn. See In re Tax Refund Litigation, 766 F. Supp. 1248 (E.D.N.Y. 1991), aff'd sub nom. In re MDL-731 Tax Refund Litigation, 989 F.2d 1290 (2nd Cir.), cert. denied sub nom. Madison Library, Inc. v. U.S., 510 U.S. 964 (1993).

E. Procedural Aspects

1. Statute of Limitations. Arguably there is no statute of limitations under section 6700, although the doctrine of laches might be available. See Sage v. U.S., 908 F.2d 18 (5th Cir. 1990). Filing Form 8038 may start the statute. See also Groves v. U.S., 199 AFTR 20171730 (DC IL 2017), holding that no statute of limitations applies and the doctrine of laches is not available.

2. Deficiency Procedures. Deficiency procedures do not apply (section 6703(b)). A taxpayer may make a refund claim after paying 15% of the penalty (section 6703(c)(1)). Historically, the IRS assessed the penalty on a per-transaction basis. See, e.g., Johnson v. U.S., 677 F. Supp. 529 (E.D. Mich. 1988), appeal dismissed, 875 F.2d 862 (6th Cir. 1989). Thus, the penalty is treated as divisible (i.e., the taxpayer would only have to pay $150 to get refund jurisdiction, Id.).

3. Forum. A person must bring an action in the District Court within 30 days after the day on which his claim for refund is denied. The Service must stop collection procedures after filing of a refund claim, although the Service may still be able to offset refund claims for other time periods (section 6703(3)(1)). Compare Belloff v. C.I.R., 996 F.2d 607 (2nd Cir. 1993) (setoff allowed) with In re Tax Refund Litigation, 725 F. Supp. 140 (E.D.N.Y. 1989), appeal dismissed, 915 F.2d 58 (2nd Cir. 1990) (set-off not allowed).

4. Burden of Proof. The Government has the burden of proof on the issue of liability. Case law is unclear whether the standard is "clear and convincing" or "preponderance" of the evidence. See In re MDL-731Tax Refund Litigation, 989 F.2d at 1302 03 n.4; but see Barr v. U.S., 67 F.3d 469 (2nd Cir. 1995) (Government's burden is preponderance of evidence). The Taxpayer has the burden of proof on the amount of the penalty. See In re Tax Refund Litigation, 766_F. Supp. at 1248.

F. Enforcement of Section 6700 Penalties

The TEB program has actively used section 6700 examinations. Among other things, the IRS asserted that section 6700 penalties could be applied in certain "yield burning" and pooled financing bond cases. For example, see the article entitled "Valuation of Government Securities - Yield Burning" contained in the TEB "Continuing Professional Education Technical Instruction Program for Fiscal Year 2003." In recent years it appears that the section 6700 program of TEB has not been as active as in certain prior years, but section 6700 remains an important part of the TEB program.

The TEB Examination Procedures include procedures relating to section 6700 examinations. IRM 4.81.5.18. These procedures generally provide that TEB will make a referral to a lead development coordinator and that another IRS function will make the determination on whether the IRS pursues a section 6700 examination. A section 6700 examination is a separate examination from an examination of the underlying bonds.

G. Application of Section 6700 Penalties against Bond Counsel: FSA 200129011

In FSA 200129011 (April 16, 2001), the IRS concluded that the IRS does not need to open or pursue an audit on the bond issue under section 103 of the Code to assert the section 6700 penalty against bond counsel. However, the burden of proof with respect to each element of the section 6700 penalty is on the IRS.

The FSA emphasized that the imposition of the section 6700 penalty is highly factual and can only be done on a case-by-case basis. The IRS concluded that in the case under consideration the IRS must establish that (1) bond counsel organized and participated in the sale of the bonds; (2) bond counsel made

or furnished a statement with respect to the allowability of deduction or credit, the excludability of income, or the securing of any other tax benefit by reason of holding an interest in the bonds; (3) the statement is false or fraudulent as to any material matter; and (4) bond counsel knew or had reason to know that the statement is false or fraudulent.

Of particular interest is the discussion in the FSA of the requirement that bond counsel's statements be false or fraudulent:

> [T]he Service will need to determine whether bond counsel knew or had reason to know that the statements bond counsel made or furnished regarding the excludability of interest earned on the bonds were false or fraudulent. I.R.C. section 6700(a)(2)(A). The Service is not required to prove actual knowledge. Rather, the Service may rely on objective evidence of the bond counsel's knowledge of the transaction. S. Rep. No. 97-530, 97th Cong., 2d Sess., at 572 (1982). See also United States v. Campbell, 897 F.2d 1317, 1321-22 (5th Cir. 1990). The Service may not, however, impute knowledge to bond counsel beyond the level of comprehension required by bond counsel's role in the transaction. S. Rep. No. 97530, supra, at 572. Thus, for example, bond counsel "would be able to rely, as to matters of fact or expectation relevant to his or her opinion, on information provided by other parties (including the issuer) absent actual knowledge or a reason to know of its inaccuracy or the use of statements not credible or reasonable on their face. On the other hand, bond counsel must draw [his or her] own legal conclusions from that information." H.R. Rep. No. 101-247, supra, at 1398 (1989). Consequently, whether bond counsel in the present case knew or had reason to know that statements contained in the bond documents were false or fraudulent depends upon bond counsel's role. The greater bond counsel's knowledge of the bond-financed project and involvement in the issuance, marketing, and sale of the bonds, the more likely it is that bond counsel knew or should have known that the bonds would not meet the requirements of section 103(a) of the Code.

Questions raised by FSA 200129011 include the following:

- The FSA does not focus on the tax opinion of bond counsel as the "false or fraudulent statement" made by bond counsel, but the opinion of bond counsel appears to be the most likely focus of a 6700 examination. Are there any other statements that bond counsel could make that could also trigger imposition of the section 6700 penalties?

- The FSA plainly states that the greater the bond counsel's role in an abusive transaction, the more likely it is that the section 6700 penalties could be imposed against bond counsel. Does this mean that section 6700 is more likely to be a concern if a bond counsel has a longstanding relationship with the issuer or if the bond counsel serves multiple roles (e.g., bond counsel and conduit borrower's counsel)?

- Given that the "false or fraudulent" standard is very high, should the IRS adopt procedures to be particularly cautious about sending preliminary determination letters under section 6700?

XI. SELECTED LITIGATION RELATING TO TAX-EXEMPT BOND ENFORCEMENT

In part because the interest received by bondholders has only rarely been taxed under the Tax-Exempt Bond Program, little litigation has arisen from the program. Many of the litigated cases concerning tax-exempt bonds have arisen from declaratory judgment actions relating to prospective bond issues under section 7478 of the Code. The most significant case law arising from the Tax-Exempt Bond Program

concerns an IRS challenge to multi-family housing bonds issued by the Riverside County Housing Authority, California.

A. Harbor Bancorp/Riverside County

In June 1994, the IRS concluded a Tax Court bench trial involving the holders of the multifamily housing bonds issued by the Riverside County Housing Authority. After the Authority and the IRS were unable to reach agreement with respect to the bonds, the Authority sued the IRS in United States District Court to prevent the IRS from taxing the bondowners on the interest on the bonds. The district court dismissed the case for lack of jurisdiction over the subject matter. The IRS declared the interest on the bonds taxable and assessed the tax against two of the bondowners. The bondowners then filed a petition in Tax Court to contest the tax assessment.

The key issues in the trial were whether the bonds were issued in 1985 or 1986; whether the arbitrage certificate was based on reasonable expectations; and, if the bonds did not meet federal tax requirements for tax-exempt bonds, whether the IRS can now tax the innocent bondowners. The Tax Court upheld the tax assessed by the IRS. See Harbor Bancorp v. Commissioner, 105 T.C. 260; aff'd, 115 F.3d (9th Cir. 1997), cert. denied, 522 U.S. 1108 (1998). For the most part, the Court viewed the matter as one of straightforward statutory interpretation and held that the issuer's intent was not relevant to the determination of whether a rebate payment was owed. The Court rejected the taxpayers' argument that the Commissioner's sole remedy was to disqualify the issuer under former Treas. Reg. § 1.103- 13(a)(2)(iv), noting that the Commissioner also has a concurrent duty to collect tax on income from the bonds that are not tax-exempt. The Court further stated that it is not uncommon for the Commissioner to have a variety of ways to carry out her duties. On appeal, the Ninth Circuit, like the Tax Court, held that the bonds were not tax-exempt because they were not issued until they were remarketed to the public.

B. Central Bank of Denver

Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), precludes one remedy for bondholders. Following a default by a public building authority on its bonds, certain of the bondowners sued the underwriter, the issuer, the private developer, and the trustee under § 10(b) of the 1934 Act. The district court granted summary judgment to the trustee because the complaint alleged only that the trustee was secondarily liable. The Court of Appeals reversed the district court's judgment in light of prior cases within the Second Circuit allowing private aiding and abetting actions under § 10(b) of the 1934 Act. The Supreme Court held that a private plaintiff may not maintain an aiding and abetting cause of action under § 10(b). Until Central Bank, many wondered whether private plaintiff aiding-and-abetting lawsuits would provide another avenue for bondholders to pursue transaction parties following a determination of taxability. After Central Bank, such lawsuits will not prevail; issuers and other transaction parties continue to be subject to § 10(b) liability for primary violations of the securities laws.

C. Kline v. First Western Government Securities

Case law has developed as to the meaning of the Central Bank of Denver decision. In Kline v. First Western Government Securities, Inc., 24 F.3d 480 (3d Cir.), cert. denied sub nom. Arvey, Hodes, Costello & Burman v. Kline, 513 U.S. 1032 (1994), the Third Circuit upheld a U.S. district court finding that allowed investors to claim reliance on counsels' tax opinions under the antifraud provisions of § 10(b). The investors had claimed that they had been misled by brokers and their counsel about the brokers' trading practices in forward delivery securities contracts and about the validity of counsel's tax opinions concerning the deductibility of certain losses upon termination of the forward contracts. The IRS had disallowed the investors' deductions taken upon termination of the contracts. The case thus allows certain § 10(b) actions against professionals who deliver opinions in securities transactions.

D. City of Columbus v. Commissioner

In City of Columbus, Ohio v. Commissioner, 106 T.C. 325, supplemented by T.C. Memo. 1996-343 (1996), vacated and remanded, 97-1 USTC ¶ 50,424 (D.C. Cir. 1997), the Tax Court denied declaratory relief with respect to a reviewable private letter ruling request. The issue in this case was whether the bonds used to prepay a pension obligation were arbitrage bonds. The case is significant mostly because the Tax Court concluded the bonds were taxable by applying the general anti-abuse rules in Treas. Reg. § 1.148-10(a) and (b). On remand from the D.C. Circuit, the Tax Court held for the City and rejected application of the arbitrage anti-abuse rules in that context. See City of Columbus v. Commissioner, T.C. Memo. 1998-135 (1998).

E. Strategic Housing v. Commissioner

In Strategic Housing v. Commissioner, the Court of Federal Claims dismissed an arbitrage rebate refund action against the U.S. by concluding that the issuer should have first filed a claim under the provisions of section 7422(a) of the Code, regardless of how arbitrage rebate is defined. The Court further found that the IRS had non-reviewable discretion to demand an early computation of arbitrage rebate, notwithstanding the standards set by Treas. Reg. § 1.148-10(f).

In 2010, the Court of Appeals for the Federal Circuit affirmed the dismissal of the rebate suit but vacated the portion of the lower court's decision finding that the IRS had non-reviewable discretion to demand an early computation of arbitrage rebate. Strategic Housing v. Commissioner, 608 F. 3d 1317 (Fed. Cir. 2010).

NATIONAL ASSOCIATION OF BOND LAWYERS

The Workshop 2023
October 18-20, 2023

Deal Gone Bad

Panel Chair: Rod Kanter - Bradley Arant (Birmingham, AL)

Faculty:

Kenneth R. Artin — Bryant Miller Olive – Orlando, Florida
Ann D. Fillingham — Dykema – Lansing, Michigan
Poonam Patidar — Mintz – Boston, Massachusetts

This panel will focus on three phases of a "deal gone bad". The first phase, the default and mobilization stage, includes issues such as the standard for notice to the public market under Rule 15c2-12, the effect of cross-default provisions and "most favored lender" provisions, and mobilization efforts by the bond trustee and other creditors. The second phase, the workout phase, includes issues such as the trustee's duties under the prudent creditor standard, communication strategies for informing bondholders, the use and effect of waivers and forbearance agreements, bond document provisions for control of remedies and reissuance issues. The third phase, bankruptcy, will focus on eligibility for Chapter 9, some key differences between Chapter 9 and Chapter 11 and practical aspects of navigating through bankruptcy for the issuer or borrower and the creditors (including recent rulings that could further impact how revenues and other funds pledged to a transaction and generated post-petition are treated in the Chapter 9 context).

INTRODUCTION

Bond issues, generally, are carefully tailored transactions that are the product of good faith, collaborative efforts by all participants—including those that have interests considered legally adverse to others on the deal. Analysis and focus is devoted over a period of weeks, months, and sometimes years to get everything just right. Unlike other commercial transactions where one party seeks to "win" (and, naturally, others are felt to "lose"), in a municipal bond transaction parties generally work collaboratively towards the common goal of a borrowing that can withstand the test of time.

Yet despite all the long hours, tedious conference calls, painstaking document review and good faith efforts, things don't always play out as planned. Obligors experience unexpected financial difficulties, enterprise systems hit operational problems, legal issues arise from unexpected sources and a host of other unexpected issues can emerge during the years following a closing. In some cases these events have disgruntled bondholders holding defaulted or troubled securities (a situation referred to herein as a "distressed debt situation").

This outline addresses the essentials of which any lawyer should be aware when facing a distressed debt situation. Part One addresses the initial stage of a distressed debt situation, including the process by which investors or lenders are notified that a default exists and important threshold issues that will influence the course of the events that follow. Part Two addresses the remedies available during the workout phase—the period between default and a solution, which may be bankruptcy. Part Three addresses the structure of bankruptcy, including the differences between Chapter 9 and Chapter 11, and various features of bankruptcy that might make it a preferred solution or an outcome to be avoided.

PART ONE
DEFAULT AND MOBILIZATION

A. Impact of Rule 15c2-12

The amendments to Rule 15c2-12 ("Rule 15c2-12") of the Securities Exchange Commission ("SEC") that became effective in 2019 have effectively reformed the process by which bondholders learn of a developing distressed debt situation. Before these amendments were effective, a bank that had made a loan to the borrower might have learned about a default through a default notice provision in the loan documents, a compliance certificate or some other reporting requirement. Holders of publicly offered bonds might have learned about a default through various other means, including notes in the annual audit, a notice from the bond trustee or a request for bondholder votes in favor of a waiver. Rule 15c2-12 now acts as the likely early-warning signal.

Rule 15c2-12 causes an underwriter to obtain an agreement (a "continuing disclosure agreement") requiring the obligated person[1] to (i) provide specified annual operating and financial data and (ii) report the occurrence of certain enumerated events (e.g., debt service delinquencies,

[1] In general, a conduit borrower is the obligor in a conduit financing, and the issuer of the bonds is the obligor in a non-conduit financing. Rule 15c2-12 defines an "obligated person" in paragraph (f)(10).

unscheduled draws on debt service reserve funds, non-payment related defaults, etc.). This is more particularly addressed in other portions of the seminar.

Two additional listed events were added to the required list of event notices for continuing disclosure agreements entered into after February 27, 2019[2]:

> "(15) The incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; 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; . . ."

An obligor under a continuing disclosure agreement must report defaults and events of default not only with respect to publicly-traded bond issues, but, due to these new requirements, for any other "financial obligations"[3] of the obligor, which covers transactions like bank loans and other types of non-public debt.

Default vs. Event of Default. The SEC's interpretation of these new reporting requirements makes it clear that a "default" must be reported whether or not that default has become an "event of default" under the debt documents.[4] Most debt documents have specified events that constitute an "event of default" that entitle a lender or bond trustee to seek specific remedies. The debt documents may require that notice or the lapse of time, or both, are required before those events become an "event of default" that would give the lender or trustee the right to enforce remedies. Rule 15c2-12's use of "default," rather than "event of default," is intentional. It requires notice to investors before an event matures into an "event of default" under the related bond documents.

Typically, more tailored and complex operating covenants and non-payment related default terms exist under bank and other non-public financing instruments than in debt instruments issued through the public bond market. Absent these Rule 15c2-12 changes, there could be any number of defaults arising under non-publicly traded debt that might not become known to creditors. In practice, these Rule 15c2-12 changes should alert creditors of an obligors' defaults sooner and more reliably than in the past.

B. Threshold Issues After a Default Occurs

[2] *See* Rule 15c2-12(b)(5)(i)(C)(15), (16).

[3] "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)." Rule 15c2-12(f)(11).

[4] *See* SEC Release No. 34-83885, § III.A.3.i (Aug. 20, 2018).

Once the existence of a default becomes known, there are a number of threshold issues to be addressed that can have an important effect on the future course of the distressed debt situation. These issues include the following:

1. **Effect of Cross-Default and Most-Favored Lender Provisions.** The effect of any particular default and the number of creditors who have rights to enforce as a result of that default might be increased by cross-default or most-favored-lender provisions. A cross-default provision in bond documents or loan documents provides that the existence of a default with respect to debt (the original defaulted debt) held by one lender or group of bondholders becomes a default under the bond or loan documents with respect to the debt (the cross-defaulted debt) held by a separate lender or group of bondholders. The concept is relatively simple, but the application of the specific terms of each cross-default provision varies significantly. For example, the cross-defaulted debt might provide that the original defaulted debt exceed some minimum threshold amount before the cross-default becomes effective. Some cross-default provision apply only if the original defaulted debt is accelerated. Other cross-default provisions may apply if the original defaulted debt could be accelerated, whether or not an acceleration has actually been declared.

Many bank loan agreements provide that the lender automatically accrues the benefit of any more stringent financial covenants agreed to by the borrower with another lender (a most-favored-lender provision). For example, if a borrower enters into a line of credit with a minimum rating requirement, that same rating requirement may also apply to another lender who has the benefit of a most-favored-lender provision.

When a borrower enters into a distressed debt situation it should identify any creditors with cross-default or most-favored-lender provisions in order to determine which creditors are directly affected and have immediate rights or remedies to consider.

2. **Identifying Bondholders.** Issuers or borrowers facing trouble over debt issues may desire or need to work with outstanding bondholders and lenders to negotiate forbearance or other credit modification agreements or otherwise "work out a deal." It is relatively easy to know who the creditors are in a bank loan transaction, a derivative transaction or a private placement transaction. It is not easy for securities publicly held through the DTC book-entry system. And the holders of publicly offered bonds are usually a critical part of the default and work-out process. Even though holders regularly receive debt service payments under the securities through the DTC book-entry system, it comes as a surprise to many issuers or borrowers that it is very hard to contact specific holders or even know who they are. This difficulty arises from the nature and mechanics of the DTC book-entry system.

What is DTC? The Depository Trust Corporation ("DTC") is a U.S.-registered clearing agency for securities that provides depository, custody, book-entry transfer and related asset servicing for U.S. and non-U.S. securities that satisfy the eligibility requirements provided in DTC operational arrangements. DTC is a subsidiary of DTCC. DTCC is the holding company for DTC, NSCC, and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTC

rules and procedures are required to be filed with, and approved by, the SEC, and they are publicly available.[5]

Before the creation of DTC (and certain of its predecessors), banks and brokers typically held and exchanged physical securities certificates. The delivery and exchange of these certificates occurred upon initial original issuance and for subsequent trades. Brokers' mechanisms to record and transfer physical securities relied heavily on hundreds of delivery messengers, pen and paper, the U.S. mail and overnight delivery systems. The associated process of exchange, transfer, registration and custody of physical certificates was often inefficient, time-consuming, expensive and sometimes subject to loss or theft. In-person bond closings were customary, and most law firms with active bond practices were, by necessity, located in the New York Wall Street area, within walking distance of the custodian banks.

Against this backdrop, the U.S. securities industry experienced a dramatic surge in volume in the late 1960s (daily trading volume almost tripled between 1965 and 1968), creating a crisis in paperwork processing. Back offices could not keep pace with the volume of paperwork—closings were delayed, errors increased, and brokerage firms became overwhelmed. Stock exchanges were forced to shorten hours each day, closing one day each week to handle the volume.

DTC was created in 1973 by the securities industry as a direct response to this logistical and paperwork problem. DTC, by offering a single source for the deposit and electronic transfer of interests in securities, facilitates the distribution of public bond offerings by means of electronic delivery and settlement.[6] The creation of DTC effectively eliminated the need for physical movement of securities for trading. It also simplified payments, the processing of redemptions and bond calls, and the administration of corporate actions. In each case, the DTC system reduces or eliminates costs of shipping and insurance associated with transporting certificates, risk of loss or delay in shipment, risk of theft, and associated replacement costs in the event of loss.

Eligibility of Securities in DTC – Participants and Beneficial Owners. Securities may be made eligible for DTC's full range of depository services (known as the "full book-entry service") or the limited custody service offered by DTC in which DTC can, subject to its procedures, act as a custodian for securities on behalf of a transaction. Central to an understanding of DTC and its involvement in the municipal securities industry is the role played by Participants and Beneficial Owners.

Participants. Participants consist of banks, broker-dealers, clearing corporations and other

[5] *See* http://www.dtcc.com. For the purposes of the Uniform Commercial Code ("UCC") DTC is a "clearing corporation" and a "securities intermediary," as defined therein.

[6] A wide range of security types may be made eligible for deposit with DTC. These include, among others, equities, warrants, rights, corporate debt and notes, municipal bonds, government securities, asset-backed securities, collateralized mortgage obligations, equity and debt derivatives, variable-rate demand obligations, money market instruments, American/global depositary receipts, shares of closed end funds, retail certificates of deposit, unit investment trust certificates, shares of exchange traded funds and insured custodial receipts.

financial organizations approved by DTC to maintain an account in its system.[7] DTC will only accept deposits of eligible securities from Participants.[8]

Eligibility of Securities for Deposit with DTC. As explained in greater detail below, Participants may deposit and hold interests in securities at DTC for their own account or for the accounts of others. Those for whom a Participant holds an account may, in turn, be holding for their own account or acting as intermediaries (i.e., holding for the accounts of others).[9] Only Participants may request that DTC make a security eligible for deposit. It is therefore necessary that an issuer have a relationship with a Participant (typically an underwriter) or an institution directly associated with a Participant willing to sponsor the eligibility process for the issuer's securities. A Participant may submit an eligibility request through DTC at the time a security is initially being offered, or at a later time (such as securities issued as private placements that are later to be DTC-registered for ease in public trading).

When eligible securities are deposited with DTC, DTC credits the account of the appropriate Participant with an interest in those securities. As such interests are subsequently transferred, DTC debits the account of a delivering Participant and credits the account of a receiving Participant.

Title to the Security and Related Interests. Participants do not hold title to a specific security. Rather, each Participant to which an interest in securities of that CUSIP is credited holds a ratable interest in the entire inventory of that security held by DTC. For purposes of Section 8-503 of the Uniform Commercial Code ("UCC"), the Participant owns a securities entitlement[10] to a *pro rata* interest in the interest in that security held by DTC. Correspondingly, each customer of a Participant with respect to a particular security, for whom that Participant acts as a securities intermediary[11] (sometimes referred to herein simply as an "intermediary"), owns a securities entitlement to a *pro rata* interest in such security held by the Participant and credited to such customer's account with the Participant.[12] A Participant tracks this ownership by crediting an interest in the relevant CUSIP to the account it maintains for that customer. The customer essentially holds a ratable interest in the aggregate amount of that CUSIP held by that Participant (in the nature of a securities entitlement in a securities account). Participants have the legal relationship with DTC. The customers, direct or indirect, of the Participants do not. For such customers, legal privity—and thus legal recourse—is solely to their own securities intermediary.

7 See DTC Rules 2 and 3, available at: http://www.dtcc.com/legal/rules-and-procedures.aspx. A financial institution that meets the requirements set forth in DTC Rule 2 may, subject to Rule 3, apply for membership. The application is subject to evaluation by the DTC Risk Group, including analysis of the applicant's business model and credit condition, among other factors.

8 Most large U.S. broker-dealers and banks are Participants, holding one or more accounts through which they deposit and hold securities at DTC.

9 Participant accounts at DTC constitute "security accounts," as defined in the UCC. DTC, as a "securities intermediary," holds its deposited securities in "fungible bulk" meaning that there are no specifically identifiable securities directly owned by any single Participant.

10 "Security entitlement" is defined in UCC § 8-102(a)(17).

11 "Securities intermediary" is defined in UCC § 8-102(a)(14).

12 Under UCC Sections 8-501 and 8-503, a customer of a securities intermediary having a security credited to its securities account does not have an ownership interest in the security itself, but holds a securities entitlement in the securities account, representing a *pro rata* interest in the security held by the intermediary. *See generally* UCC §§ 8-501 through 8-511.

Receipt of Payments and Other Rights. As title holder to the securities, DTC is entitled to receive all payments of principal and interest. It also possesses all other "bondholder" rights for the securities in question, such as voting rights and the right to receive notices of redemption. In turn, DTC treats any Participant having securities credited to its DTC accounts as entitled to the full benefits of ownership with respect to such securities, including the right to receive debt service payments, voting rights, notices of redemption, etc.[13] The process by which such payments and other rights flow from DTC to the Participant and the ultimate Beneficial Owner is explained below.

Immobilization. Simply stated, the DTC system physically immobilizes securities deposited with it. Through this electronic deposit system, securities (or interests therein) no longer need to be physically held by the bondholder or physically transferred in the secondary market.[14]

Beneficial Owners. In layman's terms, the Beneficial Owner is the actual purchaser of the security in question. If a Participant is acting on behalf of customers, the interest acquired by the Beneficial Owner must be credited to an account on the Participant's records. If the customer of the Participant is itself a securities intermediary holding for a customer, the customer of the Participant would credit an interest in the securities to an account it maintains for its customer, and so on until reaching the Beneficial Owner of the securities. In this context it is noteworthy that, at any particular point in time, none of DTC, the trustee, the issuer, or the Participant (in most circumstances) will know the identity of a Beneficial Owner. The identity of a Beneficial Owner of a particular security exists solely on the books and records of the last securities intermediary in the chain that starts with the issuer and ends with the ultimate Beneficial Owner.

DTC's Legal Relationship. Securities held by DTC are registered in the name of Cede & Co., as nominee of DTC. This is the only ownership interest of which the issuer and the trustee/paying agent have direct knowledge.[15] Within DTC, the aggregate principal amount of a security is divided among (and allocated in DTC's books and records to) the Participants. Allocable portions of a security credited to a Participant's account are referred to as "positions" in the bond issue.[16]

Identifying the Beneficial Owners. Anyone that has been charged with identifying the Beneficial Owners of a class of securities will attest to how difficult and frustrating that task can

[13] Participants are also entitled to receive any security certificates evidencing securities to the extent so credited if such security certificates are to be issued in the event of a withdrawal of the securities from DTC, which can happen under certain circumstances not addressed in this outline.

[14] Subject to applicable state law requirements, eligible securities held at DTC may be certificated (i.e., represented by one or more physical certificates) or un-certificated (i.e., not represented by any physical certificate), so long as the registered holder is noted as such on the registration books of the issuer, or so long as it is Cede & Co., the nominee of DTC, which was created for the purpose of being the registered holder of securities.

[15] Governing bond documents (indenture, bond resolution, etc.) commonly provide that the trustee and the issuer are entitled to recognize only the record owner for all purposes.

[16] DTC maintains a list of the Participants holding a position in the issuer's securities as of a specific date. These are referred to as a "Participant List," a "Security Position Report" ("SPR"), or a "Security Position Listing" ("SPL"). DTC charges a fee for providing each listing (per CUSIP number), and each request must be made for specific securities listed by CUSIP number. Information regarding these listings, including pricing, can be obtained from DTC's website.

be. Each Participant involved with a series of securities may or may not be the Beneficial Owner, and may or may not know the Beneficial Owner of the securities. As mentioned above, each Participant maintains accounts for its customers to which it credits applicable interests in the security. If that customer is not itself the Beneficial Owner, it is a securities intermediary that credits its customers, and so on down to the Beneficial Owner (i.e., the last customer holding against the last securities intermediary). Each intermediary in the chain of ownership is responsible for keeping track of its holdings on behalf of its customers. Thus, for any particular security only the last intermediary in the chain of custody knows the identity of the Beneficial Owner as of any particular inquiry date.[17]

Complicating this process further is the fact that beneficial ownership can change on a frequent basis. These changes can be reflected at the Participant level on DTC's system (e.g., transfers of positions in the bond issue from one Participant account to another Participant account), or on the books and records of one or more intermediaries. In each case, neither the issuer nor the trustee will have direct knowledge of these movements. In fact, when securities are held indirectly in this manner, there are no means by which the issuer or trustee can unilaterally force disclosure of the identity of a Beneficial Owner or its holdings. Likewise, intermediaries will not disclose the identity or holdings of their customers without consent, so when securities are held indirectly through intermediaries, there is no way to identify a Beneficial Owner without its consent.

Evidence of Ownership Received by Beneficial Owners. In DTC-held transactions, Beneficial Owners do not receive physical certificates. They only receive written confirmation from the Participant or intermediary with which the Beneficial Owner has its account providing details of the transaction, and periodic statements of their holdings. Indeed, DTC's operational agreements require issuers to expressly acknowledge that: (i) DTC has no obligation to communicate to its Participants or any other person having an interest in the securities any information contained in the certificates representing the securities, (ii) and neither DTC's Participants nor any other person having an interest in the securities are deemed to have notice of the provisions of the security certificates by virtue of their deposit with DTC.

Working Around DTC Limitations. As a result of the issues discussed above, the book-entry system makes communications with holders of publicly held debt and verification of ownership for voting and direction purposes in a work-out situation more difficult. The communication problem may be reduced to some extent by the Municipal Securities Rulemaking Board's Electronic Municipal Markets Access ("EMMA") system. Issuers, borrowers and trustees can communicate with existing holders through EMMA notices. But, an EMMA notice does not typically substitute the notice provisions of the debt documents, which still must be followed (and wind their way through the DTC procedural layers). And for directions, consents, approvals or other similar communications from bondholders, signed documents from the beneficial owners and verification of beneficial owner status are significant mechanical issues that can frustrate or delay the work-out process.

[17] The trustee has no direct means to know the identities of the intermediaries or owners who may exist in the chain of ownership beneath the Participants.

3. Bond Insurance. Although bondholders in a publicly offered debt issuance are ultimately the beneficial owners under the DTC book-entry system, for a distressed debt situation in which some portion of the issuer's or borrower's debt is insured, the insurer, rather than the insured bondholders, may be the party that will be the primary player with respect to the insured bonds.

History of Bond Insurance. Municipal bond insurance first came onto the scene in 1971 when the American Municipal Bond Assurance Corporation (Ambac) became the first company to issue such insurance. While bond insurance seems like a wonderful idea for bond issuers or borrowers, it took a while for the concept of bond insurance to catch on. In fact, in 1980, only 3% of bonds issued were insured. However, as time went on bond insurance became more popular, and soon a majority of bonds issued were insured. This was evident in 1983 when the Washington Public Power Supply System defaulted on $2.25 billion in revenue bonds; most bondholders lost 60 to 90 cents on the dollar. The small amount of bonds issued that were backed by insurance saw full repayment from the bond insurer, Ambac. This was a watershed moment in the history of bond insurance, and the practice became more popular. By 2007, approximately 60% of bonds were insured.

How a Municipal Bond Insurance Policy Works from the Perspective of the Bondholder and Issuer. Municipal bond insurance is obtained to guarantee the payment of debt service on the insured security. While this concept appears fairly simple and straight forward, municipal bond insurance works very differently than many common forms of insurance that people are more familiar with, such as homeowner's insurance or automotive insurance. The three key distinctions concerning municipal bond insurance are as follows:

> (1) *Bond Insurance Only Covers Scheduled Payments of Debt Service*. Under a classic municipal bond insurance policy, a bond insurer will agree to essentially guarantee payment of principal and interest when due on the insured bonds, in accordance with the original payment schedule. As such, debt service coming due earlier or on a calendar different than scheduled at the time of issuance is not covered by bond insurance. For example, assume a bond issue matures over 10 years, with $100.00 of principal maturing on August 1 of each year. If the issuer or borrower commits a payment default in March of year 3 causing the trustee to accelerate all debt service (making the same immediately due and payable), the bond insurance policy would continue only to cover $100 each August during bond years 3 to 10. Likewise, under the policy the insurer would cover interest at the original rate, on the originally scheduled payment dates and at the originally set amounts.
>
> (2) *Bond Insurer Acts as the Holder of Securities Insured*. One of the benefits of bond insurance is that the insurer is treated as the holder of the insured indebtedness. As a result, most policies and bond insurance terms provide that, so long as the insurer is not in default of its obligations, the insurer is vested with the right to act as the true holder of the bonds for purposes of the indenture. These rights most often come into play when exercising indenture rights, such as consents to modifications or amendments of terms of the indenture, or to change the trustee or other financing participants. For a troubled transaction these rights become more important as they enable the insurer to act as the

holder of the bonds insured for purpose of directing the trustee to accelerate debt service, appoint a receiver and similar actions.

(3) *Subrogation*. Subrogation is perhaps the biggest (and to some issuers or borrowers most surprising) distinction of bond insurance. Payment under a bond insurance policy does not relieve the original issuer or borrower for that payment obligation. It merely shifts the obligation from the true bondholder (who has been paid under the policy) to the insurer. Put another way, the issuer or borrower is not "off the hook" for the debt service payment that it failed to pay, even though payment to the true holder was made by the bond insurer.

Typically, as a condition of the issuance of a bond insurance policy, bondholders are required to assign their rights to the missed payment to the bond insurer. As such, the bond insurer is fully subrogated to the bondholders' rights to the missed payment. The insurer essentially becomes the holder of that security. This is in stark contrast to more common insurance coverage, like automobile insurance, where the insurer pays and the insured driver owes no further sums (other than increased insurance premiums in the future).

4. State Law Intervention. In some jurisdictions, state law mandates preliminary steps or actions be taken in connection with a distressed debt situation. Thus, state agencies, in addition to bondholders, other lenders and bond insurers, may be potential players who should be identified early in a distressed debt situation.

State Imposed Oversight. As described in Part Three, a Chapter 9 municipal bankruptcy action may be commenced only when authorized by state law. Many states require some form of state or court imposed oversight as an alternative to or a precursor of the right for a government to file a Chapter 9 proceeding. These statutes vary in the breadth of power given to the person overseeing the municipality. For instance, under Pennsylvania's Municipalities Financial Recovery Act, Act 47 of 1987[18] (as amended, "Act 47"), once a fiscally distressed community is identified, an Act 47 coordinator is appointed and paid by the Commonwealth of Pennsylvania. The Act 47 coordinator has general powers and authority to assist the governmental unit and require development of a fiscal plan enabling it to remedy its distress. Contracts negotiated by the governmental unit prior to the commencement of the Act 47 proceeding are unaffected, but those negotiated under Act 47 cannot violate the terms of the recovery plan. The coordinator assists with implementation of the plan, but the governmental unit continues to be responsible for day-to-day operations. A similar system exists in Michigan, whereby the governor can appoint an Emergency Manager for a municipality or school district with a "financial emergency."[19] The Emergency Manager assumes the power and duties of the chief administrative officer and legislative body, and in addition, is the sole person authorized under Michigan law to file a Chapter 9 bankruptcy proceeding for a Michigan municipality or school district.

[18] P.L. 246, No. 27

[19] Michigan Local Government and School District Fiscal Accountability Act, Public Act 4 of 2011, as amended, MCL §§ 141.1501 *et seq.*

State Takeovers. State takeovers occur most frequently in the school context, such as the well-publicized takeover of the Philadelphia schools. These state takeovers may be the result of financial or academic issues, or some combination of the two. State takeovers of cities, such as the takeover of New York City in 1975, are also possible, though less common, and generally require special legislative authority. States have generally limited their omnibus legislation to some form of oversight.

State Receivership Actions. Most states have some statutory authorization for state level receiverships as an alternative to federal bankruptcy. Some statutes authorize appointment of a receiver to administer matters only with respect to certain types of project finance, such as utility systems. Others, such as a since-repealed statute in Rhode Island, empowered municipalities such as Central Falls, Rhode Island with the ability to declare itself insolvent and request the appointment of a receiver to oversee its general affairs (subsequent to the Central Falls receivership, the Rhode Island Legislature amended its laws to limit access to state law receivership). As in Rhode Island, the powers of state-appointed receivers can be limited. Almost all receivers have the ability to approve and reject purchases and payments, and in some situations, such as in Rhode Island, with court approval, to change contracts with labor unions and other parties, and hire and fire municipal employees.

5. Sovereign Immunity. In certain jurisdictions, states enjoy significant protection from claims in court under the doctrine of sovereign immunity. Other states do not recognize this doctrine or only recognize some limited version of the doctrine compared to others. It is important to know if the state law at hand for a distressed debt situation recognizes this doctrine and whether the same pertains to the issuer. In such cases this doctrine greatly alters and improves the negotiating leverage of the issuer and changes many aspects of the workout effort.

Sovereign immunity involves various legal doctrines and statutes that provide federal, state and other governments immunity from certain legal claims. Under the doctrine of sovereign immunity, a state of the United States of America cannot be sued by its own citizens. Under the Eleventh Amendment to the United States Constitution, a state cannot be sued by citizens or subjects of any foreign state. Local governments, municipalities, and political subdivisions of the state are immune from tort suits by virtue of governmental immunity, when the state grants them immunity—usually in its constitution.

The doctrine of sovereign immunity varies state-to-state. In most states the doctrine has been greatly limited or eliminated. In others, the doctrine is broad and absolute.[20] For example, under Section 14 of the Alabama Constitution, "the State of Alabama shall never be made a defendant in any court of law or equity." Section 14 provides the State of Alabama and its "arms or agencies" with absolute immunity from lawsuits.[21] The Alabama Supreme Court, "construing said Section 14, has held almost every conceivable type of suit to be within the constitutional prohibition."[22] On the other hand, in many jurisdictions there is case law holding that the doctrine

[20] For example, the State of Alabama's absolute immunity extends to "suits for relief by way of mandamus or injunction, no less than suits for any other remedy." *Ex parte Troy Univ.*, 961 So. 2d 105, 108 (Ala. 2006) (citation omitted)).

[21] *Ex parte Tuscaloosa Cty.*, 796 So. 2d 1100, 1103 (Ala. 2000).

[22] *Ex parte Town of Lowndesboro*, 950 So. 2d 1203, 1206 (Ala. 2006).

of sovereign immunity does not preclude a suit for collection if the amount due is clearly ascertainable and there is no dispute that the amount is due and payable. The application and scope of sovereign immunity must be carefully considered in each state to determine the available rights of action against entities subject to the doctrine.

Negotiations of distressed debt situations change dramatically if the issuer can invoke the doctrine of sovereign immunity. Indeed, the lack of a clear litigation path to enforce the debt obligation greatly changes the negotiating dynamic of a creditor.

6. Other State Law Limitations. State law can be the most critical, and to creditors in a distressed debt situation, the most aggravating, part of the distressed debt process. This is because in certain jurisdictions a state or local government is limited by the types of covenants and provisions to which it can be obligated. This can be particularly frustrating for creditors when terms of an indenture are challenged as being unenforceable under applicable state law. Counsel must gain a firm grasp on the local laws at issue in order to navigate a distressed debt situation..

This starts by understanding the source of the issuer's or borrower's authority, which typically fall within the concept of either (i) home rule or (ii) Dillon's rule.[23] Under home rule, a local government's right to rule itself is embedded in its existence. This right cannot be taken away and is limited only by reference to state and federal constitutions. Conversely, Dillon's rule provides that local government's authority comes only from the state, and can be taken away by the state. Under Dillon's rule, a local government only has those powers that are: (1) granted by the state legislature in the express words of the statute, private act, or charter creating the municipal corporation; (2) necessarily or fairly implied in, or incident to the powers expressly granted; or (3) otherwise implied as essential to the declared objects and purposes of the local government in question.

The applicability of state law in a Dillon's Rule jurisdiction requires careful examination of statutory authority as well as applicable case law. By way of example, in the State of Alabama, a Dillon's rule jurisdiction, debt obligations issued as "bonds" may only be issued upon a favorable public referendum, while debt obligations issued in the form of "warrants" do not require a public vote. While on their face a bond and a warrant look <u>almost</u> identical, the holder of a debt obligation issued as a bond not approved through a public referendum will face great difficulty enforcing that payment obligation in court.[24] Similarly, under Alabama law, utility rates may not be so high as to be deemed confiscatory or unreasonable.[25] In the case of Jefferson County, Alabama, creditors were unable to cause the county to comply with the rate maintenance covenant in its indenture requiring rates to be increased as necessary to timely pay maturing debt service on its sewer revenue warrants—which would have resulted in an increase of over 420%—on the grounds that such an increase violated this principle of Alabama law.

[23] Dillon's rule is named after Iowa Supreme Court Justice John F. Dillon and is based on a philosophy articled in an 1868 case that local governments are considered an extension of the state and power is distributed to those local governments according to the state constitution. *Clinton v. Cedar Rapids & M. R. R. Co.*, 24 Iowa 455.

[24] *See O'Grady v. City of Hoover*, 519 So. 2d 1292 (Ala. 1987).

[25] *See Mitchell v. City of Mobile*, 13 So. 2d 664 (Ala. 1943).

7. Understanding Whether Bankruptcy is an Option. For a conduit borrower that is a private business or nonprofit corporation, the ultimate solution may lie in Chapter 11, and the borrower generally has discretion whether to seek protection under Chapter 11. The consequences and governing principles for Chapter 11 are generally understood in the creditors' rights arena.

For issuers that are governmental entities, public corporations or other quasi-governmental entities, the ultimate solution may lie in Chapter 9, which is similar to Chapter 11 in a number of ways, but quite different in a number of ways. A fundamental difference is that an issuer otherwise eligible for Chapter 9 protection cannot seek that protection unless authorized to do so by the state where that issuer is located. Whether bankruptcy is available to such issuers may be a critical factor in the exercise of remedies against such issuers and the structuring of a solution. For example, bondholders and their trustee may conclude that the most effective remedy available is to seek a court appointment of a receiver. If that issuer is eligible for Chapter 9, it might file for bankruptcy protection in order to prevent the receiver from taking control of its operations.[26] Counsel for the various parties will want to determine early in the process whether Chapter 9 is available.

8. Verifying the Expected Security Position. At the very beginning of a distressed debt situation the lenders and bond trustees usually take steps to verify that the expected security position is in place and all proper filings are up to date. For example, a lien on equipment or other personal property may, under a state's UCC provisions, require periodic continuation statements to keep that lien in effect with the priority perfected by the initial filing. A creditor who has not filed the required continuation statements may find itself in the unenviable position of being second lien to an intervening creditor with proper perfection or even unsecured if the curative filing is not made in time (e.g., before bankruptcy is filed).

PART TWO
REMEDIES AND WORKOUT OPTIONS

Of course the parties to a troubled transaction would prefer to remedy the situation without resorting to bankruptcy. Indeed, various realistic solutions will be explored or at least discussed before bankruptcy is considered. The solutions often involve transactional tools not dissimilar to those applied in the corporate context.

As noted below, creditors cannot force municipalities into bankruptcy. Similarly, liquidation of a public issuer through the bankruptcy process is not an option (for either the debtor or the creditor). Accordingly, a municipality often has more bargaining power (or at least its creditors have less) than might originally be assumed when negotiating a workout/restructuring. That does not mean a pre-bankruptcy workout is without substantial pain or cost to the borrower, but compared to a bankruptcy, a workout is typically more efficient, less costly, and presents less headline and similar risk to the borrower.

The search for a solution starts with an understanding of the role played by the trustee for debt issued pursuant to a trust indenture. Of course, there may be other creditors other than an indenture trustee, such as a bank that served as lender in a direct loan, a swap provider or a bond

[26] *See In re Jefferson Cnty., Ala.*, 474 B.R. 228 (Bankr. N.D. Ala. 2012).

insurer, as well as various general creditors, but most distressed debt situations involve one or more debt issuances pursuant to a trust indenture.

A. The Trustee

For debt issued pursuant to a trust indenture, the trustee plays an essential role in a distressed debt situation. The trustee not only administers the payment process and other mechanics of the indenture, but typically exercises rights and remedies on behalf of bondholders. In the eyes of the borrower, a trustee can quickly shift from a friendly banker who sends helpful reminders and answers general bond questions during times of prosperity, to an adversarial party sending default notices, insisting on performance of covenants and filing contentious litigation.

Due Diligence. As a borrower becomes troubled, the prudent trustee will take the time to review the status of its own files and make certain that it has all of the appropriate certificates and other documentation to support its administration of the trust to date as well as confirming that the responsible party has filed appropriate continuation statements and made other filings necessary to protect any claims in UCC and non-UCC collateral.

General Exercise of Remedies. Frequently, after default, the initial reaction of the bondholders, trustees and their counsel is to contemplate acceleration, possessory actions, foreclosure on collateral or receivership (each of which is discussed in the following section concerning enforcement of rights and exercise of remedies). Typically, bond documents permit access to the books and records of the borrower or the issuer, inspection of collateral and other remedies, all of which should be considered as initial steps before the parties are locked into more adversarial processes. Particular attention should be given to other obligations of the debtor that may have a significant impact on the value or availability of the collateral. Particular attention is also warranted for tax and insurance payments, participation agreements in government programs such as Medicare or Medicaid, and valuable licenses or franchises that require compliance or affirmative actions to maintain. Well drafted bond documents should contain covenants that are sufficiently detailed to permit actions for specific performance or mandamus to require the borrower or the issuer to take actions to preserve the value of the collateral or the revenue producing capacity of an enterprise. The trustee initiates all of these actions on behalf of the bondholders.

Accepting Bondholder Directions. In most cases of default, some group of bondholders can be expected to come forward and offer their input to the trustee about the most desirable course of action to pursue. The motives of the bondholders can be quite diverse, with some having a genuine belief in the value of their judgments, some having ulterior motives in positioning themselves for a subsequent suit against the trustee for breach of its duties, and some having only an immediate economic interest in obtaining the maximum return on a troubled investment in the shortest period of time. The American Bar Association's Model Debenture Indenture[27] (the "Model Debenture Indenture") provides, in Section 603(e), the trustee with some latitude in this regard:

[27] American Bar Foundation Corporate Debt Financing Project, *Commentaries on Model Debenture Indenture Provisions* (1971) ("Model Debenture Indenture").

"[T]he Trustee shall be under no obligation to exercise any of the rights or powers vested in it by this Indenture at the request or direction of any of the bond holder pursuant to this Indenture, unless such bond holder shall have offered to the Trustee reasonable security or indemnity against the costs, expenses and liabilities which might be incurred by it in compliance with such request or direction; . . ."

The Model Debenture Indenture pairs this protection for the trustee with a provision in Section 507 that forbids the bringing of suit by a bondholder unless first, among other things:

(1) such Holder has previously given written notice to the Trustee of a continuing event of default;

(2) the Holders of not less than 25% in principal amount of the Outstanding [bonds] shall have made written request to the Trustee to institute proceedings in respect of such event of default in its own name as Trustee;

(3) such Holder or Holders have offered to the Trustee reasonable indemnity against the costs, expenses and liabilities to be incurred in compliance with such request;

(4) the Trustee for 60 days after its receipt of such notice, request and offer of indemnity has failed to institute any such proceeding; and

(5) no direction inconsistent with such written request has been given to the Trustee during such 60 day period by the Holders of a majority in principal amount of the Outstanding [bonds].[28]

The NABL Model Conduit Indenture[29] has a similar limitation on actions by the bondholders in Sections 7.10 and 8.2. Although the trustee is absolved from liability for good faith actions taken in accordance with the direction of the holders of a majority of the bonds relating to the time, place and method of conducting any proceeding or any remedy available to the trustee, or exercising any trust or power conferred upon the trustee under the Model Debenture Indenture by Section 601(c)(4), there remain cases where the indemnity to the trustee may imply indemnity for successful actions by the non-directing bondholders. This is a sobering implication for most bondholders who wish to direct the trustee.

Acting Without Bondholder Direction. In most cases the trustee would prefer to act only with directions from bondholders and after receiving indemnity. However, most indentures provide that after an event of default exists, the trustee shall exercise the rights and powers vested in it by the indenture, and use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.[30] This provision

[28] *Id*.
[29] *See* National Association of Bond Lawyers, *Form Conduit Indenture* (2nd Ed. 2019).
[30] *See* § 6.1(b) of the Model Debenture Indenture.

is mandatory for indentures subject to the Trust Indenture Act.[31] It reflects the general philosophy of the Trust Indenture Act: namely that under ordinary circumstances the duties of the trustee are largely administrative, but under the special circumstances of a default the function of the trustee may become active and executive as circumstances require in order to protect the interests of bondholders.

It is important to note that a trust indenture requirement to obtain the consent of the bondholders may mean dealing with or going through DTC and its processes. It may be helpful to build in to the trust indenture consent rights based on percentages of the holdings of the beneficial owners.

There is a certain inescapable tension between the prudent man standard after default and the typical provisions of an indenture that allow bondholders to direct the trustee after default and the provisions giving the trustee the right to receive indemnity before taking certain actions, or pursuing remedies under the indenture. A trustee must be careful in a default scenario to balance or apply these provisions properly on the bondholders' behalf.

B. Waivers, Forbearance Agreements and Debt Modifications

Waivers/Forbearance Agreements. Before true cash insolvency is reached, a borrower will often default on one or more covenants in its bond documents. This may or may not result in an event of default under the bond documents. It will almost inevitably result, however, in candid discussions with trustees, bondholders, rating agencies, bond insurers, swap providers and other parties regarding the causes of the default and the borrower's plan to remedy the situation. If the crisis is expected to be short-lived, or a mutually-agreeable fix can be identified, the parties can enter a simple waiver agreement (most often used for a one-time covenant breach).

When the default is a result of prevailing economic conditions or there is little to gain from pursuing default remedies a longer period of time may be required to take corrective action. At such time, the parties may consider entering into a forbearance agreement. This may be the case, for example, when market conditions indicate that a foreclosure sale of a project would produce little value or when a special purpose facility, such as a hospital or power plant, is involved, and current management appears to be reasonably honest and competent or substitution of management can be effected by other means.

In these circumstances, a more detailed forbearance agreement with a longer duration may become necessary. With a forbearance agreement, the party with the rights to exercise or direct remedies agrees to forbear exercise such rights so long as the obligor or borrower agrees to a course of corrective action. For example, in the case of Jefferson County, Alabama, extensive forbearance agreements among the county and several standby bond purchase agreement providers, trustees, bond insurance companies, and other parties were entered during the years leading up to that county's filing for bankruptcy protection. Those agreements kept over $2.0 billion of that county's sewer revenue debt from acceleration, and forestalled considerable litigation for a period of time following initial issues with that debt. The forbearance allowed time for Jefferson County, its creditors, and numerous other financing participants and lawyers to identify solutions to that

[31] *See* § 315(c) of the Trust Indenture Act of 1939, 15 U.S.C. § 77ooo(c).

county's debt crisis. When those efforts failed, that county ultimately declared bankruptcy (from which it emerged roughly four years later).

Like their corporate kin, forbearance agreements on the municipal side are generally heavily negotiated and vary significantly from deal to deal. Terms one might see in a forbearance agreement include, among many others:

- A limited period of forbearance known as a "forbearance period." This period typically has a specified end date, but can end sooner if certain terms or milestones are not satisfied. Forbearance agreements are not used to restructure the debt rather at the end of the forbearance period the default needs to have been cured.

- Express agreement by creditors not to exercise remedies (such as directing the trustee to accelerate) or to pursue remedies available under the bond or other collateral documents during the forbearance period. As noted above, this permits "breathing room" for parties to work-out solutions.

- Reservations of rights so creditors and/or the bond trustees can apply all their rights and remedies after the forbearance period if the corrective action does not result in curing the defaults.

- Provisions for special or modified interest rates (e.g., that a "default rate" not go into effect), and possible other payment terms (e.g. that principal payments can be deferred, but not eliminated) during the forbearance period.

As mentioned above, these agreements can vary greatly, and creditors/other participants will seek other terms and provisions based on the specific factors at play. A forbearance agreement can be (but is not always) an interim step to the workout/restructuring of one or more of an issuer's outstanding bond issues. The financing agreement can be crafted to allow the requisite percentage of beneficial owners may direct that the bond trustee enter into the forbearance agreement instead of the registered bondholder which mostly is DTC.

It is also important to point out there may be tax consequences relating to forbearance agreements with a duration longer than 24 months.

Amendments/Debt Modifications-Reissuance. Mutually agreeable terms are typically memorialized in amendments to the primary bond documents. For example, if an issue is in default due to a borrower failing to satisfy a rate covenant, the parties can amend that violated provision, provided the requisite percentage of bondholders concur with the change.

Debt modifications can include changes to interest rates, principal forgiveness, changes in amortization, or early repayment and restructured reissuance. These types of changes can trigger federal tax issues, such as a reissuance, which will be considered in more depth at a separate panel at the Workshop; however, the following are some general principles of the reissuance analysis

that are of special interest to counsel in a distressed debt situation where payment terms and other changes are considered in a work out:

- The general reissuance principles of Section 1.1001-1 through 1.1001-4 of the Treasury Regulations[32] and Notice 2008-41[33] are the primary focus of the analysis.
- Under Section 1.1001-3 of the Regulations a "significant modification" of the debt documents can result in a reissuance.
- If a reissuance occurs, the changes are treated as a "deemed refunding" of the original debt, which requires a determination whether the "refunding debt" can be tax exempt under the law applicable at the time of reissuance and compliance with certain procedural steps, such as the filing of a new 8038.
- Failure to perform and temporary forbearance may not result in a reissuance if the safe harbor provisions of Section 1.1001-3(c)(4) are met.
- Changes to the terms of the documents as a result of a bankruptcy plan are deemed to occur when the plan is effective.[34]
- A significant modification may occur if, among other things, (a) the yield on the debt is changed by more than the de minimis amount specified by Section 1.1001-3(e)(2) of the Regulations, or (b) the timing of the payments due is changed in a material manner.[35]
- Changes in security that result in a change in payment expectations may cause a reissuance.[36] If the debt was below investment grade before the change and above investment grade as a result of the change, a reissuance may occur.[37]
- The cumulative effect of changes may result in a reissuance.[38]

C. Enforcement of Rights and Exercise of Remedies in Default

Municipal bond defaults confront trustees with a series of strategic issues that must be carefully considered as trustees seek to best serve the interests of bondholders. These include the economic and competitive conditions in which the borrowers or issuers operate, the availability of

[32] 26 Treas. Reg. §§ 1.1001-1 *et seq.* (the "Regulations").
[33] Reissuance Standards for State & Loc. Bonds, 2008-1 C.B. 742 (2008).
[34] Regulations § 1.1001-3(c)(6)(iii).
[35] Regulations § 1.1001-3(e)(3).
[36] *See* Regulations § 1.1001-3(e)(4).
[37] *See* Regulations § 1.1001-3(e)(4)(vi) and IRS Notice 2008-41, § 7, Example 1 (Mar. 25, 2008).
[38] *See* Regulations § 1.1001-3(f)(3).

accurate financial data, the value and condition of collateral, the ability, credibility and stability of management, the nature and materiality of the default, the likelihood that a default can be cured and, if curable, when the cure can be achieved, and, of course, the provisions of the indenture that may either allow or require certain actions by the trustee. The considerations may be different depending on whether the borrower is the governmental issuer or a conduit borrower.

The primary resource for the trustee navigating these often uncertain waters is the indenture.[39] Navigation of a distressed debt situation may involve, among other things, meetings or other communications with bondholders, guarantors and the issuers of credit enhancements, confirmation that liens are duly perfected, requests by the trustee for indemnity from bondholders, extraordinary administrative fees and an analysis of all licenses or franchises of the borrower that are required for its ongoing business operations. Once the trustee investigates both the nature of the default and the viability of the borrower's business, it must then identify those remedies that are available to it, determine which remedies are most suitable under the circumstances and the manner in which those remedies can be best implemented. The discussion below offers a brief summary of some of the significant remedies that a trustee may choose to exercise upon an event of default.

Acceleration. Most indentures empower either the indenture trustee or a percentage of the bondholders to declare the entire principal amount of the outstanding bonds to be immediately due and payable. Although acceleration is often left to the discretion of the trustee or the bondholders, bond documents may mandate acceleration in some circumstances. Acceleration by the bondholders may generally be required upon the direction of the holders of at least 25% of the outstanding bonds. Direction by the bondholders to accelerate is generally subject to the requirement that security or indemnity be provided to the trustee. Upon acceleration by the bondholders, such action may be rescinded, but rescission may require the consent of a much higher percentage of the bondholders, typically 50% or more, as well as the curing of all defaults. Accordingly, once the bond indebtedness is accelerated, it may be difficult, if not impossible, to reverse that action. This may prove to be particularly problematic when the parties desire to engage in meaningful workout negotiations that require maximum flexibility by all interested parties.

Acceleration is an appropriate remedy when the indenture trustee elects to pursue a money judgment for the principal amount of all outstanding bonds, plus interest, penalties and fees. An indenture may also require acceleration as a condition to the application of a default rate of interest, or in conjunction with a foreclosure action, or to affect a mandatory redemption of bonds by drawing upon a credit support device.

Money Judgment. Upon default of a municipal conduit issue, the trustee may decide to institute a lawsuit against the owner of the project and any guarantors of the issue in order to obtain a money judgment. Of course, the trustee must decide if the proposed defendants have sufficient assets to pay all or a substantial part of a potential judgment. Absent the maturity or acceleration of the indebtedness evidenced by the bonds, a lawsuit for a money judgment will be limited to the principal, interest and fees due and payable as of the date of the judgment. Actions at law for

[39] *See U.S. Bank Nat'l Ass'n. v. U.S. Timberlands Klamath* Falls, *L.L.C.,* 2004 WL 1699057 at *2 (Del. Ch. July 29, 2004) ("An indenture trustee derives its powers and rights from the indenture itself").

damages may also be instituted in appropriate circumstances against issuers, underwriters and other participants in the issuance of the bonds.

A judgment may enable the trustee to perfect and enforce a judicial lien on the real and personal property of the judgment debtors. A judicial lien may be particularly valuable if the judgment debtors are not in bankruptcy and the lien is perfected more than 90 days prior to the filing of a bankruptcy petition.[40] Once perfected, enforcement of a judicial lien is dependent upon strict compliance with the procedures prescribed by the state in which the lien is perfected. Enforcement may implicate a variety of statutory remedies including levy, attachment, garnishment or seizure.

Mandamus. The term "mandamus" is derived from Latin and means "we command."[41] It is a judicial remedy issued by a court of superior jurisdiction to a private or municipal corporation commanding the performance of an official act required by law. Mandamus is appropriate to compel a government official or entity to comply with law when the claim is clear and there is a duty to act.[42] In the context of municipal finance, a trustee may request a writ of a court of competent jurisdiction compelling an issuer, its officers or other government officials to perform their duties. For example, a writ of mandamus may order the assessment and collection of a tax,[43] increase the rates charged by a utility board, enforce a city ordinance,[44], compel the collection and payment of a special assessment,[45] or compel the payment of improvement bonds from available funds.[46]

Since mandamus is an extraordinary remedy, courts will issue the writ only as a last resort. Therefore, its application is more restricted than the similar remedy of specific performance. The issuance of a writ of mandamus rests within the sound discretion of the court and is therefore never ordered as a matter of right. Many jurisdictions require a person seeking a writ of mandamus to show (1) a clear legal right to the order that is sought, (2) an imperative duty upon the respondent to perform and a refusal to do so, (3) the absence of another adequate remedy and (4) the properly invoked jurisdiction of the court.[47]

Equitable Principles. The Model Bond Opinion Report published by NABL[48] calls for the customary bond opinion to provide that "[t]he rights of the owners of the Bonds and the enforceability of the Bonds are limited by bankruptcy, insolvency, reorganization, moratorium, and other similar laws affecting creditors' rights generally, and by equitable principles, whether considered at law or in equity." This emphasis on equitable principles is very important on both a federal and state law level.

[40] *See* 11 U.S.C. § 547 (a judgment lien perfected within 90 days prior to a bankruptcy petition may be avoided as a preferential transfer).
[41] 52 Am. Jur. 2d Mandamus § 1 (2d ed. 2000).
[42] *Eugster v. City of Spokane*, 76 P.3d 741, 753-54 (Wash. Ct. App. 2003).
[43] *See City of Guymon v. Butler*, 92 P.3d 80 (Okla. 2004).
[44] *See Engster,* 76 P.3d at 41.
[45] *See Foote Co. v. City of McAlester*, 197 Okla. 440, 172 P.2d 617 (Okla. 1946).
[46] *See Town of Shattuck v. Barcafer*, 137 P.2d 238 (Okla. 1943).
[47] *See, e.g., Nicholson v. Moates*, 159 F. Supp. 2d 1336 (M.D. Ala. 2001).
[48] NABL Committee on Opinions and Documents, *Model Bond Opinion Report*, p. 21 (Feb. 14, 2003).

One example of the possible adverse exercise of equitable principles is judicial permission to pay essential operating expenses ahead of debt service.[49] Indeed, many states have cases holding that revenues from taxes must first be used to pay the ordinary and necessary expenses of operating the government, even though such taxes may be pledged for payment of debt service.[50]

Receiverships. A receiver is an impartial person that is appointed by a court of competent jurisdiction to receive rents, manage property and to otherwise act as a custodian of some or all of the assets of another. In most jurisdictions, a receivership is an ancillary remedy in aid of the primary object of litigation.[51] In other words, a court will appoint a receiver prior to the adjudication on the merits of an action for another remedy, such as a judicial foreclosure, and the receiver will possess and preserve property pending the determination of the litigation.[52] Conversely, when the bond documents or the relevant enabling legislation prescribe the appointment of a receiver upon default, it is arguable that a receivership is not an ancillary remedy but, rather, is a principal remedy for bondholders.

When an indenture default has occurred or is imminent, it may be critical that the trustee or someone other than the project owner control either the project assets, the disposition of income produced by the mortgaged property or the revenues received by the obligor. This may be particularly beneficial if the trustee files a judicial foreclosure proceeding which may involve considerable delay before the trustee or its assignee can take possession of the relevant collateral.

In such circumstances, there is also the danger that revenues will be diverted to other creditors or that an income-producing property will be "milked" by collecting revenues in advance and at a discount. By the time that the trustee gets possession of the property through foreclosure, both past and future revenues may be compromised.

Another instance when a receivership may be particularly beneficial is when a borrower is not eligible to be a debtor under the Bankruptcy Code. For example, upon the occurrence of a payment or covenant default by a utility board or similar issuer which has breached indenture covenants by, among other things, failing to maintain adequate rates, providing free service, refusing to maintain adequate reserves for system maintenance and repairs, allowing waste of system assets or gross mismanagement, the appointment of a receiver to oversee the day-to-day operations of the issuer may be appropriate. Under the laws of some states, a receiver will be appointed if there has been a default and the bond documents and/or the organizational statutes of the issuer provide for a receivership. In some instances, a receiver may be appointed upon *ex parte*

[49] *See Borough of Fort Lee v. United States,* 104 F.2d 275, 284 (3rd Cir. 1939).

[50] *See Johnson v. City of Sheffield*, 183 So. 265 (Ala. 1938) ("We see nothing in the ordinance per se, calling the election, and the proposed pledging of the taxes, ad valorem and license, which would stamp the ordinance as being illegal or ultra vires, or as being inconsistent with any provisions of the municipal charter, or any law of the state. However, into this ordinance, and into the contract pledging the specified taxes, **must be read the law imposed limitation that, if necessary, out of this revenue accruing from said taxes, the necessary and legitimate governmental expenses in operating the municipality must be first paid**. The municipality must function, without funds to defray the operation of its governmental agencies, the municipality would be destroyed. The police power of the municipality cannot be abridged, nor its existence destroyed, which would result if all its entire revenue was consumed in the payment of bonded debts, and nothing left to defray operating expenses.") (emphasis added).

[51] *See C.E. Development Co. v. Kitchens*, 264 So.2d 510 (Ala. 1972).

[52] *See In re Willows of Coventry Ltd. Partnership*, 154 B.R. 959 (Bankr. N.D. Ind. 1993).

application. The laws of most jurisdictions, however, provide that the appointment of a receiver is within the discretion of the court and is not automatic.

Due to the time, expense and uncertainty of obtaining a receiver, a trustee may wish to consider other alternatives that are permissible under governing state law. Such alternatives may include a sequestration order or a stipulated order for the collection of revenues, payment of expenses and application of net proceeds. Also, care must be taken in so-called "single action" states to make sure that a receivership action will not preclude a subsequent action for foreclosure.

Foreclosure of Real Property. When a defaulted bond issue is secured by a mortgage or deed of trust on real property, the trustee will often enforce those rights through foreclosure. The procedures for foreclosure vary from state to state. In most cases, the law of the site of the real estate will be applied to determine the nature of the lien created and the procedures for and consequences of foreclosure. In a number of states, non-judicial foreclosure by exercise of a power of sale is permitted.[53] This type of foreclosure depends upon a power of sale clause in the indenture or other mortgage instrument. Such a sale is conducted after advertising, serving and/or posting of a notice of sale as specified in the indenture and applicable state law. Some states authorize foreclosure only upon compliance with prescribed judicial procedures.

Not surprisingly, judicial foreclosure involves more time and expense than a power of sale foreclosure. These judicial procedures are generally designed to protect the interests of the mortgagor. On the other hand, a judicial foreclosure sale is confirmed by an order or judgment of a court which may be particularly important to a trustee. A party to a judicial foreclosure action must appeal an unfavorable ruling within a specified (and generally short) period of time. Therefore, so long as the judicial foreclosure action is filed in the appropriate court, in the proper jurisdiction, and all necessary parties are joined and served, the order or judgment of the court should be conclusive of the rights of all interested parties. Conversely, a power of sale foreclosure may be attacked on a variety of grounds over a longer period of time. Such grounds may include allegations of a defective notice of default, the absence of a default, inadequate notice of sale, defects in the foreclosure sale, collusive bidding, fraud or realization of a grossly inadequate purchase price.

In a few states, a debt that is secured by a mortgage may be enforced only by a judicial foreclosure action in which a judgment for a deficiency may be obtained. This requirement may not be waived by agreement at the time that the mortgage is executed. In those jurisdictions, if a mortgagee sues initially for a money judgment, it will lose the right to later foreclose the mortgage. Similarly, enforcement of a security interest in personal property collateral may bar a later foreclosure on a real estate mortgage. This is often referred to as the "single action rule." A number of states have appraisal statutes that require an appraisal of the value of the mortgaged property before a foreclosure sale can be conducted. Most appraisal statutes specify a percentage of the appraised value that must be paid by a purchaser in order for a sale to be confirmed. In some states,

[53] States in which the normal method of foreclosure is by power of sale include Alabama, Arizona, Arkansas, California, Colorado, Georgia, Idaho, Maryland (if deed of trust), Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska (if deed of trust), Nevada, new Hampshire, North Carolina, Oregon, Rhode Island, Tennessee, Texas, Utah (if deed of trust), Virginia, Washington (if deed of trust), West Virginia and Wyoming.

appraisal statutes are applicable to situations where the mortgagee desires to obtain a deficiency judgment against the obligor and any guarantors. In most states with appraisal statutes, however, a mortgagor may waive its appraisal rights.

Of great concern to a trustee is the potential for liability if the mortgaged property does not comply with governing federal and state environmental laws. For example, the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) imposes liability for cleanup costs and consequential damages attributable to the presence of the hazardous substances that are subject to the legislation. Trustees should exercise extreme caution before foreclosing on any real property since such action could create significant liabilities for the trustee.

PART THREE
BANKRUPTCY

Any workout situation, from finding an early solutions to the process implemented through bankruptcy, requires a fundamental understanding of the role, rights and responsibilities of the indenture trustee. Also critical is an understanding of certain key elements of an indenture and state law relating to the enforcement of remedies.

A. General

Municipalities (as defined below) seeking bankruptcy protection may file only under Chapter 9 (applicable to municipalities) of the Bankruptcy Code.[54] Chapter 11 (reorganization) and Chapter 7 (liquidation) of the Bankruptcy Code do not apply to municipalities. Chapter 9 is the only source of bankruptcy relief for municipalities.

Municipalities may voluntarily[55] file petitions under Chapter 9 of the Bankruptcy Code. The purpose of Chapter 9 is to permit a financially distressed municipality to seek protection from its creditors while it formulates and negotiates a plan for adjustment of its debts, typically by extending debt maturities, reducing interest or principal or refinancing its debt by obtaining a new loan to pay off some or all of its existing debt. Because municipalities are controlled by the state, there is no provision in the Bankruptcy Code for the liquidation of a municipality or for a municipality to involuntarily be put into Chapter 9.

This is a key distinction between Chapter 9 and the other provisions of the Bankruptcy Code pertaining to private and other non-governmental entities. Indeed, the inability of a creditor to put a municipality into bankruptcy dramatically impacts the bargaining power and negotiations between a municipal borrower and its creditors.

Similarly, the Bankruptcy Court is generally not as active in managing Chapter 9 cases as it is in managing Chapter 11 cases. Bankruptcy Court functions are generally limited to approval of the petition and confirmation and implementation of a plan of adjustment, although municipalities may consent to additional jurisdiction of the Bankruptcy Court in order to obtain the protections that come along with Bankruptcy Court authorized actions. The Bankruptcy Court

[54] 11 U.S.C. §§ 101 *et seq.* (the "Bankruptcy Code").
[55] 11 U.S.C. §§ 109(c)(1), 303, 901(a); *see also United States v. Bekins*, 304 U.S. 27, 51 (1938).

has no control over a municipal debtor's expenditures for municipal services or other activities during the case.

B. Eligibility of Municipalities for Bankruptcy Protection

Section 109(c) of the Bankruptcy Code prescribes five eligibility standards for a Chapter 9 debtor[56]. An entity[57] qualifies as a Chapter 9 debtor if it:

(1) Is a municipality;

(2) Is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by state law, or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under such chapter;

(3) Is insolvent;

(4) Desires to effect a plan to adjust such debts; and

(5) The municipality (a) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (b) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (c) is unable to negotiate with creditors because such negotiation is impracticable; or (d) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of the Bankruptcy Code.[58]

1. What is a "Municipality". The Bankruptcy Code broadly defines a "municipality" as a "political subdivision or public agency or instrumentality of a State."[59] Political subdivisions can include counties, parishes, cities, townships, towns and villages. Public agencies or instrumentalities are "state-sponsored or controlled" authorities, boards, commissions, districts, and independent corporations that raise revenues through taxes (e.g., public improvement districts, school districts) or user fees (e.g., public utility boards and bridge and highway authorities).[60] Applying the definition of municipality requires care in analysis of the statutory definition and of the character of the particular debtor seeking to proceed under Chapter 9. This is

[56] The debtor bears the burden of proof on proving eligibility. *See In re Jefferson County*, *Alabama*, 469 B.R. 92, 99 (Bankr. N.D. Ala. 2012). *In re New York City Off-Track Betting Corp.*, 427 B.R. 256, 264 (Bankr. S.D. N.Y. 2010).

[57] "Entity" is defined at 11 U.S.C. § 101(15), and that term includes a "governmental unit," defined in 11 U.S.C. § 101(27). A municipality is a governmental unit, but not all governmental units are municipalities.

[58] 11 U.S.C. § 109. "A chapter 9 petitioner must satisfy each of the mandatory provisions of § 109(c)(1)-(4), and one of the requirements under §109(c)(5) to be eligible for relief under the Code." *In re Boise County*, 465 B.R. 156, 166 (Bankr. D. Idaho 2011); *see also In re City of Vallejo*, 408 B.R. 280, 289 (B.A.P. 9th Cir. 2009).

[59] 11 U.S.C. § 101(40).

[60] *Compare In re County of Orange*, 183 B. R. 594, 599 (C. D. Cal. 1995) with *2 Collier on Bankruptcy* (*16th ed.*) (Alan N. Resnick & Henry J. Sommer, eds.), ¶109.04[3][b], p. 109-26, and fns. 22-24. Also note the definition of "governmental unit" found in 11 U.S.C. §101(27).

particularly illustrated in three bankruptcy court decisions. The court in the 1995 *Orange County* case found that one of the debtors, an investment pool operated by the county, did not meet the "municipality" definitional requirements of Section 101(40), a decision that has received criticism. The debtor in *In re New York City Off-Track Betting Corp*., a public benefit corporation operating a pari-mutuel betting system, was determined by the court, and conceded by creditors, to be a "municipality" that could proceed in Chapter 9. And finally, after a thorough review of cases on the meaning of "municipality" in *In re Las Vegas Monorail Company*, the court held that the debtor was *not* a municipality for purposes of Chapter 9.[61]

States are not municipalities by definition; they are neither included nor contemplated in the definition of a municipality. "State" is defined to expressly include "the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under [Chapter 9 of the Bankruptcy Code]."[62] Thus, a State may not be a debtor in a Chapter 9 case. *In re Las Vegas Monorail Co*. analyzed whether a private, non-profit corporation that owned and operated a public transportation system was a state instrumentality. When the debtor filed under Chapter 11, a creditor moved to dismiss the case, arguing the debtor was a municipality eligible to file only under Chapter 9. The debtor had declared itself an instrumentality in a tax certificate, but the court found the declaration did not control the eligibility determination because "instrumentality" has a different meaning for tax purposes and the debtor did not make the declaration in connection with the bankruptcy. The debtor lacked the traditional powers of government, such as eminent domain, taxing authority or sovereign immunity, so the court examined whether the debtor had a public purpose and the necessary level of state control, focusing particularly on day-to-day activities. Although the debtor offered a public service traditionally supplied by government, private corporations often provide public services in areas such as transportation, utilities and education. The state's control over the debtor was strategic and periodic rather than operational and constant. The debtor ran its day to day business without the direct oversight of the state, whose power over the debtor was a matter of regulation rather than control. Moreover, the state generally did not treat non-profit public benefit corporations as municipalities. Accordingly, the debtor did not exhibit the characteristics of a municipality and was eligible for Chapter 11.

2. Specific Authorization to be a Chapter 9 Debtor. State law must specifically authorize a municipality to file for bankruptcy.[63] States take different approaches as to how they authorize a municipality to file for bankruptcy. Some states, like Idaho, grant a municipality direct access to bankruptcy protection and do not place restrictions on its filing. In Idaho, any "taxing district" is authorized, without restriction, to file a bankruptcy petition.[64] Many states place preconditions on its authorization of a Chapter 9 filing. They may only allow particular municipalities to file or allow filing only in certain circumstances. Montana, for example, allows

[61] 429 B.R. 770 (Bankr. D. Nev. 2010).

[62] 11 U.S.C. § 101(52). In addition, as noted in *2 Collier on Bankruptcy* (16th ed.) (Alan N. Resnick & Henry J. Sommer, eds.), ¶ 101.52 at p. 101-205: "The inclusion of the District of Columbia and Puerto Rico within the meaning of state does not apply for purposes of determining eligibility for a Chapter 9 bankruptcy. This limitation has the effect of preventing political subdivisions, agencies and instrumentalities of the District of Columbia and Puerto Rico from being debtors in Chapter 9 cases."

[63] 11 U.S.C. § 109(c)(2). Some courts have held "that the authorization must be written, 'exact, plain, and direct with well-defined limits so that nothing is left to inference or implication.'" *In re New York City Off-Track Betting Corp.*, 427 B.R. at 267; *see also In re Jefferson County*, 469 B.R. at 92.

[64] Idaho Code § 67-3903.

a “local entity” to file for bankruptcy, but specifically excludes counties from this definition.[65] Some states give a state appointed official or body the power to approve a filing. In Connecticut, a municipality cannot file without the governor’s prior consent.[66] A Pennsylvania municipality must obtain the written approval of the State Department of Internal Affairs.[67] California, which previously permitted direct access to bankruptcy by its municipalities, now requires communities to undergo a mediation except in cases of immediate financial crisis.[68] Lastly, some states, including New York and Pennsylvania, have enacted “municipal distress statutes” containing “bankruptcy” procedures that parallel federal bankruptcy laws.[69] New York’s statute created an Emergency Financial Control Board and authorizes the municipality or the board to file a petition in the New York Supreme Court for approval of a repayment plan.[70] Pennsylvania’s Municipalities Financial Recovery Act[71] provides:

- The criteria for identifying distress;
- The powers and duties of the Department of Community and Economic Development in assisting a community to alleviate its distressed status;
- A procedure for declaring a municipality as distressed and subsequently authorizing the appointment of a distressed municipality coordinator;
- A requirement that a distressed municipality develop a fiscal plan to remedy its distress status;
- The option for a distressed municipality to formulate its own fiscal plan;
- A requirement that the state withhold all nonessential state funds when a distressed municipality refuses to adopt a fiscal solvency plan; and
- Authorization for a distressed municipality to file under Chapter 9.[72]

Twenty-one states have no authorizing statute and, therefore, do not allow municipalities to file bankruptcy. Many states limit, to varying degrees, access. Georgia expressly prohibits a

[65] Mont. Code. Ann. § 7-7-132.
[66] Conn. Gen. Stat. Ann. § 7-566.
[67] 53 P.A. Cons. Stat. Ann. § 5571.
[68] Effective January 1, 2012, California Government Code Section 53760 provides that to be eligible to file Chapter 9, California municipalities must either complete a sixty-to-ninety-day mediation process or face an immediate financial crisis that threatens the health and welfare of its residents.
[69] Public Law Research Institute, *Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code*, http://gov.uchastings.edu/public-law/docs/plri/muniban.pdf (last visited August 23, 2015).
[70] N.Y. Local Fin. Law §§85.00–85.90, Title 6-A, Art. 11, Ch. 33-A, N.Y. Cons. Laws.
[71] 53 P.S. §§11701.101 *et seq*.
[72] Pennsylvania General Assembly, Local Government Commission, Pennsylvania Legislator’s Municipal Deskbook 185-86 (3rd ed. 2006).

municipality from filing for bankruptcy.[73] Municipalities in the states without an authorization statute must seek the enactment of a statute specifically authorizing that particular municipality to file for bankruptcy. This is a difficult and time-consuming process that puts a major roadblock in front of a municipality's ability to seek bankruptcy protection. The exact scope of the authorizing statute, as well as other state laws in effect at the time of adoption of the authorizing statute, can make a difference in eligibility determinations. In the Detroit bankruptcy, the Bankruptcy Court noted that the state had a bankruptcy authorizing statute when it enacted the constitutional protections in 1986, but also noted that it did not take any steps in 1963 to protect pensions from bankruptcy, and accordingly concluded that the pensions were merely contractual obligations under Michigan law.[74]

3. Insolvency. The term "insolvent," as used in Section 109(c), is defined in 11 U.S.C. § 101(32). That definition for municipalities differs from the "balance sheet tests" of insolvency applied, when the term is relevant, to most other entities and partnerships. Municipal insolvency is defined as a "financial condition" in which a municipality is:

> (1) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or
>
> (2) unable to pay its debts as they become due.[75]

Part one of the definition looks to current, general nonpayment of debts as they become due.[76] Part two of the definition is an equitable, prospective test looking to inability to pay in the near future.[77] A municipality's projections of insolvency must be based on the current or upcoming fiscal year.[78] Merely an anticipated inability to pay debts in later years does not satisfy the definition of insolvency. Furthermore, bankruptcy courts have found that a municipality does not meet the insolvency requirement if it is merely economically distressed or, although distressed, remains in a favorable cash position.[79] Upon the filing of an objection to a Chapter 9 petition, Section 921(c) provides that the municipality bears the burden to prove its insolvency.[80] Under both components of the definition, insolvency should be determined as of the petition date.[81]

[73] Ga. Code Ann. § 36-80-5.

[74] *In re City of Detroit,* 504 B.R. 191 (Bankr. E.D. Mich. 2013).

[75] 11 U.S.C. § 101(32)(C). The insolvency tests are applied as of the time of the filing. *In re Hamilton Creek Metro. Dist.*, 143 F.3d 1381, 1384 (10th Cir. 1998).

[76] *Hamilton Creek*, 143 F.3d at 1384; *see also In re Town of Westlake*, *Texas*, 211 B.R. 860, 864 (Bankr. N.D. Tex. 1997).

[77] *Id.*

[78] *See In re Pierce County Housing Authority*, 414 B.R. 702, 711 (Bankr. W.D. Wash. 2009); *In re City of Vallejo*, 408 B.R. at 294; *In re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Conn. 1991).

[79] *In re Boise County*, 465 B.R. at 172-73 (county with surplus funds and borrowing capacity failed to show inability to pay debts and failed to demonstrate reserves were restricted or unavailable to pay judgment debt); *In re Hamilton Creek Metro Dist.*, 143 F.3d at 1386 (debtor not eligible for relief simply because it was severely economically distressed); *In re City of Bridgeport*, 129 B.R. at 337 (unbalanced budget not sufficient to establish insolvency); *see also In re City of Vallejo*, 408 B.R. at 290-291 (analyzing debtor's ability to pay general obligations when due where restrictions apply to use of certain funds).

[80] 11 U.S.C. § 109(c)(3). *See In re Valley Health Sys.*, 383 B.R. 156, 161 (Bankr. C.D. Cal. 2008) ("The burden of establishing eligibility under § 109(c) is on the debtor.").

[81] *See In re Slocum Lake Drainage Dist. of Lake City*, 336 B.R. 387, 391 (Bankr. N.D. Ill. 2006).

4. Desire to Effect a Plan. A municipality must "desire to effect" a debt adjustment plan.[82] There is no specific test that a municipality must fulfill to satisfy this requirement.[83] This is essentially a good faith requirement–the municipality must demonstrate it wants to put a plan in place through Chapter 9. Having such a plan in place is not a precondition to filing. In determining whether this requirement is met, the bankruptcy court will not look "behind the petition" for an improper purpose.[84] Rather, it will look at the financial situation of the debtor and whether the case serves the purpose of Chapter 9.[85] A court will find that a municipality does not, in good faith, seek to adjust its debts if it filed only to "buy time or evade creditors."[86] Courts that have analyzed this requirement have held that a written declaration of the debtor stating its intent to affect a plan, combined with actual efforts to negotiate and prepare a plan, fulfill this requirement.[87]

5. Negotiation with Creditors; Impracticability. The municipality must show that it satisfies at least one of the "creditor negotiation" tests of Section 109(c)(5), which include requirements that the municipality has made efforts to negotiate with its creditors regarding the impairment of their claims or that such an effort is impracticable.[88] The purpose of this requirement is to show that the municipality has attempted to find ways to avoid filing for bankruptcy and that Chapter 9 is its last resort.[89] Courts have read this section in conjunction with the "desire to effect a plan" requirement to conclude that a municipality must actually engage in negotiations concerning the possible terms of the plan.[90] Nevertheless, "[c]ourts agree . . . that no formal complete plan is required for negotiations."[91] An outline, term sheet or similar writing is satisfactory.[92]

There are four alternative ways to satisfy these requirements of Section 109(c)(5). First, the debtor may obtain the agreement to a plan for adjustment from a majority of the creditors that the debt adjustment plan will impair.[93] Second, it may demonstrate that it attempted to negotiate terms of a plan with the creditors in good faith and was unable to reach an agreement.[94] When a municipality did not acknowledge all of its creditors and liabilities in its plan, never utilized its assessment powers, and failed to present a realistic repayment plan in a timely manner, this

[82] 11 U.S.C. § 109(c)(4).

[83] *In re New York City Off-Track Betting Corp.*, 427 B.R. at 272; *In re City of Vallejo*, 408 B.R. at 295.

[84] *In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 81 (Bankr. D. N.H. 1994).

[85] *Id*.

[86] *See In re City of Vallejo*, 408 B.R. at 295.

[87] *See e.g. In re Pierce County Housing Auth.*, 414 B.R. 702, 710 (Bankr. W.D. Wash. 2009).

[88] 11 U.S.C. § 109(c)(5)(A)–(D).

[89] *Sullivan County*, 165 B.R. at 82.

[90] *In re Cottonwood Water and Sanitation Dist.*, 138 B.R. 973, 975 (Dist. Colo. 1992); *but cf. 2 Collier on Bankruptcy* ¶109.04[3][(e)][ii] (To require that pre-filing negotiations include a proposed plan "is an overly restrictive view").

[91] *In re New York City Off-Track Betting Corp.*, 427 B.R. at 274, quoting *In re City of Vallejo*, 408 B.R. at 297.

[92] *See In re City of Vallejo*, 408 B.R. at 297 ("[W]e emphasize that while a complete plan is not required, some outline or term sheet of a plan which designates classes of creditors and their treatment is necessary"); *see also In re Mendocino Coast Recreational and Park Dist.*, 2012 WL 1431219 *2 (Bankr. N.D. Cal.) (The proposal of a plan in concept does not require specific references to provisions of the Bankruptcy Code).

[93] 11 U.S.C. § 109(c)(5)(A). When a majority of creditors have accepted a plan, bankruptcy may be necessary to bind the non-accepting minority.

[94] 11 U.S.C. § 109(c)(5)(B).

requirement was not met.[95] The mere presentation of a "take-it-or-leave-it" plan to creditors without discussing the material terms is insufficient to meet this requirement.[96] The municipality must express a willingness to compromise and make a good-faith effort to use available revenues to resolve its financial crisis.[97] Third, the municipality may demonstrate that negotiations are impracticable.[98] One way to prove this is by demonstrating that there are a large number of claimants and no practical way to negotiate with them individually or through a representative.[99] In *In re Villages at Castle Rock Metropolitan District No. 4*, for example, the debtor had four classes of bondholders but negotiated only with one class.[100] The court found that the "creditor negotiation" requirement was met because negotiating with all of the classes of bondholders would have been impracticable.[101] This conclusion was also reached by the Bankruptcy Court in Detroit, which concluded that the City did *not* negotiate in good faith, but referenced Section 109(c)(5)(C) of the Bankruptcy Code, and concluded that such negotiations were impracticable, stating "It is impracticable to negotiate with a group that asserts that their position is immutable," and further that "[n]egotiations with retirees and bondholders were impracticable due to the sheer number of creditors, and because many of the retirees and bondholders have no formal representatives who could bind them, or even truly negotiate on their behalf."[102] Negotiations might also be impracticable because a municipality must act to preserve its assets.[103] In *In re County of Orange*, local agencies deposited their excess funds in the debtor county's treasury, which were commingled in an investment fund.[104] The fund had hundreds of participants and accounts.[105] The fund could not meet the lenders' demand for additional collateral. Liquidation of the lender's portfolio was threatened, thus prompting the Chapter 9 filing.[106] Negotiations were impracticable as the fund "had no time to enter into negotiations with its participants before acting to protect its portfolio assets."[107] Finally, a municipality can satisfy the fifth requirement by proving a creditor may attempt to gain a transfer of assets that would be avoidable as a preference.[108] Such a situation may exist when a municipality demonstrates that a creditor is seeking a transfer that would unfairly disadvantage other creditors. Examples include a demand for collateral or a setoff of funds. A municipality can file for Chapter 9 without negotiations to prevent this from occurring. Not all municipalities will meet the eligibility requirements for a Chapter 9 debtor. In extreme instances, it has taken a year or more for a municipality to establish it is eligible for Chapter 9.[109] Other cases have only taken a few months.[110] If a creditor objects to the filing, the municipality bears the

95 *Sullivan County*, 165 B.R. at 78.
96 *In re Ellicott School Building Authority*, 150 B.R. 261, 266 (Dist. Colo. 1992).
97 *Id.*; *Sullivan County*, 165 B.R. at 83.
98 11 U.S.C. § 109(c)(5)(C). Impracticality of negotiations requires a fact-sensitive analysis that must be addressed on a case-by-case basis. *In re City of Vallejo*, 408 B.R. at 298.
99 *In re City of Vallejo*, 408 B.R. at 297-98.
100 *In re Villages at Castle Rock Metro Dist. No. 4*, 145 B.R. 76, 85 (D. Colo. 1990).
101 *Id.*
102 In re *City of Detroit, Eligibility Opinion*, *supra* at fn. 117, pp. 124-125.
103 *In re Valley Health Syst.*, 383 B.R. 156, 163 (Bankr. C.D. Cal. 2008).
104 *In re County of Orange*, 183 B.R. 594, 607 (Bankr. C.D. Cal. 1995).
105 *Id*. at 608.
106 *Id.*
107 *Id.*
108 11 U.S.C. § 109(c)(5)(D).
109 *Vallejo*, *supra*; *Hamilton Creek*, *supra*.
110 *Valley Health Syst.*, *supra*; *In re New York City Off-Track Betting Corp.*, 427 B.R. 256 (Bankr. S.D. N.Y. 2010); *City of Bridgeport*, *supra*.

burden of proving it is eligible by a preponderance of the evidence.[111] In making this determination, the court should "provide access to relief in furtherance of the Bankruptcy Code's underlying policies."[112] If the court concludes that the filer is ineligible, it must dismiss the case.[113] A case may also be dismissed if the petition is not filed in good faith, so the municipality should be prepared to prove it filed the petition in good faith, apart from the good faith negotiation component of the eligibility requirements.[114] The "good faith" requirement for a municipality's petition is not defined by the Bankruptcy Code and there is no legislative history for Section 921(c) on this issue.[115]

C. Payment Considerations in Chapter 9

Revenue Pledges. Bonds secured by "special revenues" (as defined by the Bankruptcy Code)[116] have traditionally been viewed as receiving favorable treatment in Chapter 9 cases because they continue to be secured by the liens established at the outset of the bond transaction.[117] Section 902(2) of the Bankruptcy Code defines special revenues as revenues derived from (1) the operation or ownership of transportation or utility projects, (2) special excise taxes, (3) incremental taxes attributable to a special project, (4) certain municipal functions and (5) taxes levied to finance a specific project.[118] Section 928(a) specifically provides that special revenues received by a municipal debtor after the commencement of a Chapter 9 case remain subject to a prepetition pledge.[119] However, in March 2019, a three-judge panel of the First Circuit Court of Appeals upended this long-standing view by ruling that payments on special revenue bonds may not be enforced during bankruptcy proceedings.[120] This ruling arose out of the Commonwealth of Puerto Rico bankruptcy. In the ruling, the panel found that 928(a) merely permits, but does not require, the debtor to make payments secured by special revenues during a bankruptcy proceeding.

In March 2023, some market players were further surprised by another ruling arising out of the Commonwealth of Puerto Rico bankruptcy, this one an Order by Judge Swain related to the

[111] *See Valley Health Syst.*, 383 B.R. at 161; *Vallejo*, 408 B.R. at 289, 289 n.14; *Sullivan County*, 165 B.R. at 75.
[112] *Vallejo*, 408 B.R. at 289 (quoting *Valley Health Sys.*, 383 B.R. at 161).
[113] *See County of Orange*, 183 B.R at 599.
[114] 11 U.S.C. § 921(c). Dismissal for lack of good faith is permissive, but not mandatory. *In re Pierce County*, 414 B.R. at 714.
[115] *In re County of Orange*, 183 B.R. at 608.
[116] 11 U.S.C. § 902(2).
[117] 11 U.S.C. § 928.
[118] 11 U.S.C. § 902(2).
[119] *See In re County of Orange*, 179 B.R. 185 (Bankr. C.D. Cal. 1995) where the court reasoned as follows: Prior to 1988, when a municipality filed Chapter 9, a risk existed that § 552(a) could strip revenue bondholders of their liens on post-petition property of the debtor. Bankruptcy Code § 928 was enacted to remedy this problem by making § 552(a) inapplicable to revenue bonds. Section 928 was narrowly crafted to apply only to special revenue bonds. Congress could have made § 928 applicable to all municipal bonds, but it chose to limit its application. 179 B.R. at 191-92 (footnotes omitted). This is a significant exception to Section 552(a), which provides that property the debtor acquires after filing bankruptcy is not subject to any lien resulting from a pre-petition security agreement, notwithstanding an after-acquired property provision in the grant of the security interest.
[120] *See In re The Financial Oversight and Management Board for Puerto Rico*, 919 F.3d 121 (1st Cir. Mar. 26, 2019) and *In re The Financial Oversight and Management Board for Puerto Rico*, 931 F.3d 111 (1st Cir. Jul. 31, 2019) (collectively, "*In re The Financial Oversight and Management Board for Puerto Rico*").

Puerto Rico Electric Power Authority ("PREPA").[121] Judge Swain rejected an assertion of PREPA bondholders that they had a secured lien on system revenues, concluding that (i) while the pledge language of the applicable trust agreement constituted a legal covenant, the lack of any associated lien or charge language meant no legal security interest was created in "Revenues" by the Agreement and (ii) only those monies deposited in certain accounts, which the Trust Agreement expressly subjected to *"a lien and a charge in favor of the holders,"* which lien was perfected by control under the Commonwealth's version of UCC Article 9, were subject to a lien. These decisions collectively underscore the need to pay close attention to both the provisions of applicable local law and the specific language of applicable bond documentation when assessing potential treatment in a Chapter 9 bankruptcy.

Another advantage to the holders of revenue bonds is that Section 922 provides that the automatic stay imposed by Section 362(a) does not stay the application of pledged revenues to the payment of the bond indebtedness.[122] Municipal debtors have argued that while pledged revenues held or received by an indenture trustee can continue to be applied by the trustee to pay down bond debt without court approval, a municipal debtor is not required by the Bankruptcy Code to turn over special revenues to the trustee during the Chapter 9 case despite the retention of the trustee's security interest in such revenues.[123] The bankruptcy court in *Jefferson County* rejected this argument and ruled Section 922(d) required the debtor to pay over net revenues during the life of the case.[124] In either event, the trustee does not need stay relief to apply net revenues in its possession whether the trustee obtains possession before or after the debtor files Chapter 9. Further, if a municipal debtor chooses to turn over special revenues (which, in some cases, may help facilitate the debtors' ultimate exit from bankruptcy and future access to the capital markets), it can do so without first obtaining court approval or notifying other creditors. Similarly, a municipality may elect to pay or not pay unsecured debt, including GOs, after the commencement of the Chapter 9 without first obtaining court approval.[125] Some State Legislatures, including California, have taken action to create state law statutory lien protection which is intended to also constitute statutory lien protection under the Bankruptcy Code.[126] Statutory liens do not constitute consensual liens (security interests) under the Bankruptcy Code,[127] but are not subject to the same express protections as bonds backed by "special revenues" under Section 928.

[121] See In Re Financial Oversight and Management Board for Puerto Rico, 2023 WL 2589708.

[122] 11 U.S.C. § 922(d) provides: "Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues."

[123] *In re Jefferson County,* 465 B.R. at 285-286. Note, however, that in *Jefferson County*, the Bankruptcy Court concluded that the debtor could not deduct funds from its operating revenues for the purpose of establishing a reserve for professional fees, depreciation, amortization, and capital expenditures because the indenture did not contemplate those deductions.

[124] For a discussion of "special revenues," the "pledge" of those revenues, and the implications of 11 U.S.C. §§ 362(a) and 922(d) on those funds, *see generally In re Jefferson County, Alabama*.

[125] 11 U.S.C. § 904(2) provides: "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order or decree, in the case or otherwise, interfere with . . . any of the property or revenues of the debtor".

[126] *See, e.g.*, Cal. EDC § 15251, applicable to certain school district general obligation bonds, and Michigan's Public Act 17 of 2015, amending M.C.L.A. § 117.36a, applicable to certain home rule city financial recovery bonds.

[127] 11 U.S.C. § 101(53).

Gross Pledge Versus Net Pledge. The revenues pledged as security for revenue bonds may be subject to either a gross pledge or a net pledge. A gross pledge in an indenture requires the issuer to first apply revenues to the bond issue debt service costs. Once the pledged revenues are used for that purpose, operating costs may be paid from the balance. Conversely, a net pledge allows the issuer to first pay operating expenses from the projects receipts prior to any payment for the benefit of bondholders. However, this distinction is of little consequence during the pendency of a Chapter 9 of the issuer since Section 928(b) provides that a lien on special revenues is subject to the payment of operating expenses, even if the revenues are subject to a gross pledge.[128]

Preference Exception. Section 926(b) provides that a transfer of property of the debtor to or for the benefit of a bondholder on account of a bond (either general obligation or revenue) is not subject to avoidance as a preference pursuant to Section 547.[129] Bondholders therefore are generally exempt from the threat of preference liability with respect to pre-petition payments on account of bonds.

Preservation of Nonrecourse Status. Section 927 suspends the operation of Section 1111(b) and prevents the creation of a recourse claim by the holders of revenue bonds should the dedicated revenues prove to be insufficient.[130] Thus revenue bonds will remain nonrecourse obligations throughout a Chapter 9 case. In the absence of Section 927, it might be possible for a revenue bond issue to become a GO bond issue, raising major issues with respect to debt limitations and authority to incur a general obligation debt under state law.

Automatic Stay Exception. As previously addressed, the filing of a Chapter 9 petition results immediately in the imposition of a stay against most actions against the municipality and its properties. Previously, it was widely established that a Chapter 9 petition does not stay the application of special revenues that are pledged as security, subject to the provision made in Section 928(b) for the payment of necessary operating expenses. However, in a March 2019 ruling, the First Circuit Court of Appeals found that debt payments on special revenue bonds may not be enforced during bankruptcy proceedings.[131]

Subordination. The provisions of Section 510 of the Bankruptcy Code, which deal with the enforceability of subordination agreements, are incorporated into Chapter 9 via Section 901. Accordingly, contractual and equitable subordination apply in Chapter 9. Without limitation, agreements subordinating termination claims and other swap obligations to the payment of bond debt should be enforceable in Chapter 9.

[128] "Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system shall be subject to the necessary operating expenses of such project or systems, as the case may be." 11 U.S.C. § 928(b).

[129] "A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under 547 of this title." 11 U.S.C. § 926(b).

[130] "The holder of a claim payable solely from special revenues of the debtor under applicable nonbankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant to section 1111(b) of [the Bankruptcy Code]." 11 U.S.C. § 927.

[131] *See In re The Financial Oversight and Management Board for Puerto Rico*.

NATIONAL ASSOCIATION OF BOND LAWYERS

The Workshop 2023

October 18-20, 2023

Recent Trends in Energy Finance

Panel Chair:
Elizabeth Columbo — Nixon Peabody LLP – New York, NY

Panelists:
Mason Baker — Utah Associated Municipal Power Systems – Salt Lake City, UT
James C. Burr — Chapman and Cutler LLP – Salt Lake City, UT
Christopher Fink — BofA Securities, Inc. – New York, NY
Chris Lover — PFM Financial Advisors LLC – Charlotte, NC

On this panel, we will discuss two major recent developments in energy finance.

First, the number of tax-exempt electric and gas prepayment transactions has increased dramatically over the past five years due to structural innovations in the market and rising interest rates. Prepayment transactions afford municipal utilities the ability to make long-term purchases of gas or electricity at a discount to the applicable index price. You might be thinking: "Aren't there complicated tax rules that make it difficult to finance the prepayment of expenditures on tax-exempt basis?" Indeed. We will provide an overview of the structures of these transactions and the tax laws that make them possible.

Second, the Inflation Reduction Act of 2022 (the "IRA") created new opportunities for entities that aren't subject to federal income tax, such as governmental entities and municipal utilities, to participate in the benefits of various energy tax credits even though they don't pay federal tax by allowing these entities to receive cash payments in lieu of the tax credits. The U.S. Treasury and the Internal Revenue Service ("IRS") have been releasing guidance on these provisions since late 2022, and more is to come. This outline will address certain of the key provisions of the IRA that allow tax-exempt entities to receive cash instead of tax credits.

I. PREPAYMENT TRANSACTIONS

A. INTRODUCTION

Prepayment transactions allow municipal utilities to issue tax-exempt bonds and use the proceeds to prepay the cost of long-term future purchases of natural gas or electricity at prices below the applicable market price. Specifically, if a municipal utility enters into a commodity purchase agreement where it reasonably expects to purchase the prepaid gas or electricity during the term of the agreement and expects to use the gas or electricity for qualifying uses, the utility can use the proceeds of tax-exempt bonds to prepay a commodity supplier for a fixed amount of gas or electricity.[1]

Tax-exempt prepayment transactions can generate a discount of 5-10% off of the forward price of natural gas or electricity for a municipal utility and are structured to be non-recourse to the municipal utility. They are highly structured financings requiring the performance of numerous parties and certain structural features to insulate bondholders from the risks in the transaction from non-performance of such parties. The credit ratings of the various parties are important because ratings on prepayment bonds are based on the "weak-link" approach, meaning that the rating of the transaction will either be higher than or equal to the weakest credit involved in the transaction, depending on the size of the weakest credit and the amount of the credit enhancement of higher-rated credits among the underlying obligors.[2]

Most of the early transactions completed between 2003 and 2008 were for the prepayment of natural gas, and the gas supplier was usually the commodity unit of a large bank or investment bank. The same bank or investment bank would guarantee the performance by the supplier unit, allowing the bonds to have the same (stronger) credit rating as the bank providing the guarantee. A number of electricity prepayment deals were also done around this time using the gas prepayment structure. These prepayment transactions provided municipal utilities with several significant benefits in addition to the expected cost savings over the life of the transaction, including that the municipal utility generally had to pay only for the gas or electricity that was actually delivered, and the bonds were excluded from the municipal utility's debt metrics.

These early gas prepayment transactions were typically funded by an upfront payment from the issuer for the twenty to thirty-year term of the transaction. The amount of this payment was based on the gas price curve. The bonds were fixed-rate bonds issued by a municipal issuer, often a special purpose entity created for the prepayment transaction. There was a fixed discount to the monthly index prices for the term of the transaction. Between 2008 and 2012, a few prepayment transactions were executed, which were funded with the proceeds of variable rate demand bonds

[1] Although not discussed in this outline, a number of prepayments for natural gas were completed in the 1990s. Several of those transactions were audited by the IRS. Although those audits were closed without change, the IRS revised the Treasury Regulations in 2003, and the Internal Revenue Code (the "Code") was subsequently amended to permit prepayments for natural gas and electricity under specific sets of rules.

[2] See Fitch Ratings, U.S. Public Finance Prepaid Energy Transaction Rating Criteria, June 13, 2023 (https://www.fitchratings.com/research/us-public-finance/us-public-finance-prepaid-energy-transaction-rating-criteria-13-06-2023) and Moody's Investors Service, US Gas Prepayment Bonds Methodology, July 1, 2019 (https://ratings.moodys.com/api/rmc-documents/60900).

that were supported by a direct-pay letter of credit and swapped to a fixed rate of interest through an interest rate swap agreement.

The volume of prepayment transaction deals slowed significantly between 2009 and 2016 due to interest rates. Many of the outstanding prepayment bonds at this time suffered credit downgrades due to the downgrades of the ratings of the banks and investment banks.

The original natural gas transaction structures have evolved in the last few years to address the changing needs of municipal utilities and lessons learned from the impact of the credit crisis on the economics of these transactions. Transactions beginning in 2016 have been executed with a segmented structure under which the interest rate on the bonds is reset periodically after the initial rate period and bonds are remarketed when the interest rates are reset.

As renewable energy resources have become important in future resource planning for municipal utilities, some transactions now provide the municipal utility with the ability to designate whether to receive deliveries of an equal value of natural gas or electricity or renewable natural gas during the term of the transaction. Prepayment transactions solely for renewable energy have also become common.

B. PREPAYMENT STRUCTURES

1. <u>Prepayments Transactions Generally</u>

In a modern prepayment transaction, a municipal conduit issuer issues tax-exempt bonds on behalf of one or more municipal gas or electric utilities to prepay for a future supply of natural gas or energy at a discounted price to be delivered over a twenty to thirty-year period. The issuer of the tax-exempt bonds pays the bond proceeds to a gas or energy supplier in exchange for the delivery of gas or energy over the life of the bonds pursuant to a commodity purchase agreement ("Prepaid Commodity Purchase Agreement"). The supplier of the gas or electricity (the "Commodity Supplier") is usually, but not always, a commodity-trading subsidiary of an investment bank. The municipal issuer sells the gas or energy it purchases under the Prepaid Commodity Purchase Agreement to one or more municipal gas or electric utilities (each a "Participant" and collectively, the "Participants") at a discount to first-of-the-month market prices through individual supply agreements. The price paid by the Participants under the supply agreements is equal to the monthly index price minus the discount. The Participants then distribute the gas or electricity within their systems to their customers as required by the tax regulations governing prepayment transactions.

As highly structured financings, the municipal conduit issuer depends on the performance of a number of different parties to pay principal and interest to bondholders. The transactions are typically structured so that there are sufficient funds on hand for the issuer to make debt service payments regardless of movements in gas prices, provided that all parties to the transaction perform in accordance with the terms of the transaction documents. If an issuer does not receive sufficient payment from any one of the transaction parties, and there is no alternative source of available funds to cover the nonpayment, there may not be enough funds to pay debt service. As a result, the transactions are structured with a number of features intended to protect the bondholders.

2. Parties to a Prepayment Transaction

The parties involved in a prepayment transaction generally include the following:

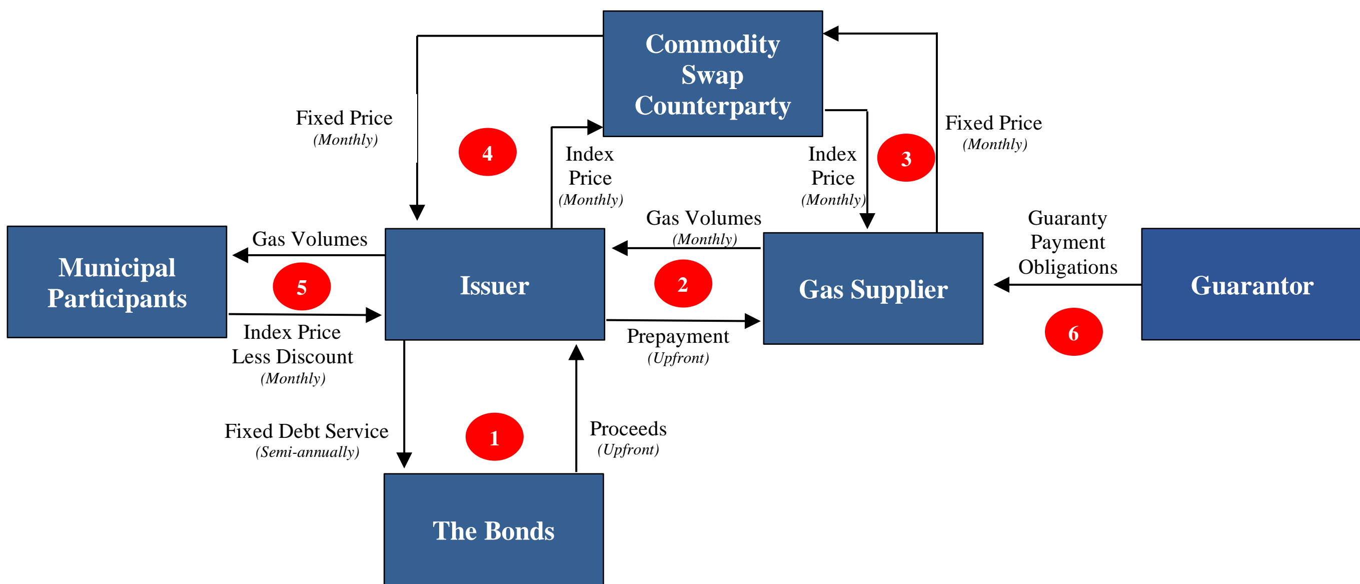
Issuer:	A political subdivision or other state or local governmental entity with the authority under state or local law to issue tax-exempt bonds to finance the acquisition of long-term natural gas or electricity supplies. This may be a special purpose entity whose primary purpose is to enter into and manage transactions of this type on behalf of member municipal utilities. This issuer often has limited assets of its own and functions like a conduit issuer.
Commodity Supplier:	The entity, typically a commodity-trading entity affiliated with a bank or investment bank, responsible for delivery of the prepaid gas or electricity to the specified delivery points and for making payments in the event of undelivered prepaid gas or electricity (subject to force majeure) and for the remarketing to qualified users of the prepaid gas or electricity at the request or direction of the Issuer or the Participants. The Commodity Supplier is also responsible for making any termination payment resulting from a termination of the Prepaid Commodity Purchase Agreement.
Participants:	Any electric and natural gas utility system that is owned by a state or local government and which is duly authorized under applicable state law to participate in the prepayment transaction and satisfy the requirements of the Internal Revenue Code (the "Code") and Treasury Regulations thereunder (the "Regulations"). The Participants in a prepayment transaction are the ultimate purchasers of the supply of gas and/or electricity.
Guarantor of Commodity Supplier:	A third party, typically the parent company of the Commodity Supplier, who agrees to guaranty the Commodity Supplier's on-going payment obligations under the Prepaid Commodity Purchase Agreement, including any termination payment.
Trustee:	A financial institution with requisite trust powers to serve as trustee for the bonds (the "Prepay Bonds") under the Trust or Bond Indenture.
Interest Rate Swap Provider:	For prepayment transactions that use variable rate bonds, the entity with whom the Issuer enters into an interest rate swap agreement to swap the fixed payment received under the commodity swap into a floating-rate to pay the floating-rate debt service on the Prepay Bonds.
Commodity Swap Counterparty:	The entity which enters into a matching commodity swap agreements with the Issuer (the "front-end swap") and with the Commodity Supplier (the "back-end swap").

3. <u>Prepayment Structures</u>

a. *Full Term Prepayment Structures*

Early gas prepayment transactions that were done in the 2003-2008 timeframe were typically funded by an upfront payment in amount of the gas to be purchased over a twenty to thirty-year period with the proceeds of fixed-rate bonds. There was a fixed discount to the variable monthly index prices for gas for the entire twenty to thirty-year term. A diagram and description of the key provisions of a fully funded prepayment structure is set forth below:

Prepaid Natural Gas Structure
(Fixed Rate Bonds)



The numbered paragraphs set forth below relate to the numbers shown in the preceding chart:

(1) The issuer issues fixed-rate bonds to fund the prepayment for natural gas and to pay financing costs and fund certain reserve funds.

(2) The issuer transfers the bond proceeds to the gas supplier to prepay the supplier for a fixed amount of natural gas to be delivered over twenty to thirty years. Under a prepaid natural gas sales agreement, the gas supplier will be obligated to (a) deliver specified daily quantities of gas each month to the issuer for twenty to thirty years; (b) make payments for any gas not delivered based on replacement cost or the monthly market index price, whichever is higher; and (c) make a termination payment upon any early termination of the prepaid natural gas sales agreement.

(3) The gas supplier enters into a commodity swap with the commodity swap counterparty to facilitate its ability to purchase at market prices the specified gas

volumes required to be delivered each month throughout the term of the prepaid natural gas sales agreement.

(4) The issuer enters into a commodity swap with the commodity swap counterparty ("Issuer Commodity Swap"), creating the economic effect of fixing the discount below the market price at which gas is sold to the Participants under gas supply contracts. The Issuer Commodity Swap enables the Issuer to sell prepaid volumes to the Participants at discounted monthly prices while ensuring that the net funds from Participant payments and the swap always equal or exceed debt service regardless of the price of natural gas at the time. Volumes, term, pipelines, and delivery points for the Issuer Commodity Swap mirror those of the swap between the same counterparty and the gas supplier (the "Gas Supplier Commodity Swap"). In the event of an early termination of the prepayment transaction, under the circumstances permitted by the IRS the swaps will terminate with no termination payment required.

(5) Under the gas supply contracts, the issuer has agreed to sell to the participants 100% of the gas delivered by the gas supplier on a pay-as-you-go basis at a price equal to the applicable monthly market index less a discount determined to ensure that the month's net proceeds under the gas supply contract (net of swap payments and receipts and investment income from the debt service account) will enable the issuer to make scheduled deposits to pay debt service.

(6) The payment obligations of the gas supplier are unconditionally and irrevocably guaranteed by its parent company and provides a higher rating for the transaction and increasing the discount.

The cumulative effect of the structure described above is to ensure that the issuer receives dependable natural gas supplies at a discount below current market prices and the resulting monthly net revenues, regardless of fluctuations in gas prices, are adequate, together with investment income on amounts deposited under the bond indenture, to pay the debt service requirements on the bonds and on-going fees and expenses when due. The terms of the documents were drafted to mitigate certain risks, including, among others, a failure of the gas supplier to deliver gas, a failure of the municipal issuer to take delivery of the prepaid gas, a failure by the participants to take and pay for the gas, a failure by a swap counterparty to make a required payment, the occurrence of a force majeure event that would prevent delivery or receipt of the prepaid gas, or failure of the bonds to qualify as tax-exempt debt.

A handful of prepayment transactions were executed that were funded with the proceeds of variable rate demand supported by a direct-pay letter of credit and swapped to a fixed rate of interest.

b. Segmented Prepayment Structures

As described above, the early prepayment transactions were typically long-term fixed-rate bond transactions and the savings (the amount of the discount to the index price) was locked in for the term of the transaction. As a result of changing interest rate environments, prepayment structures have been developed that included bonds with interest rate resets and mandatory tender provisions after a period of five to seven years, breaking the interest rate periods over the life of

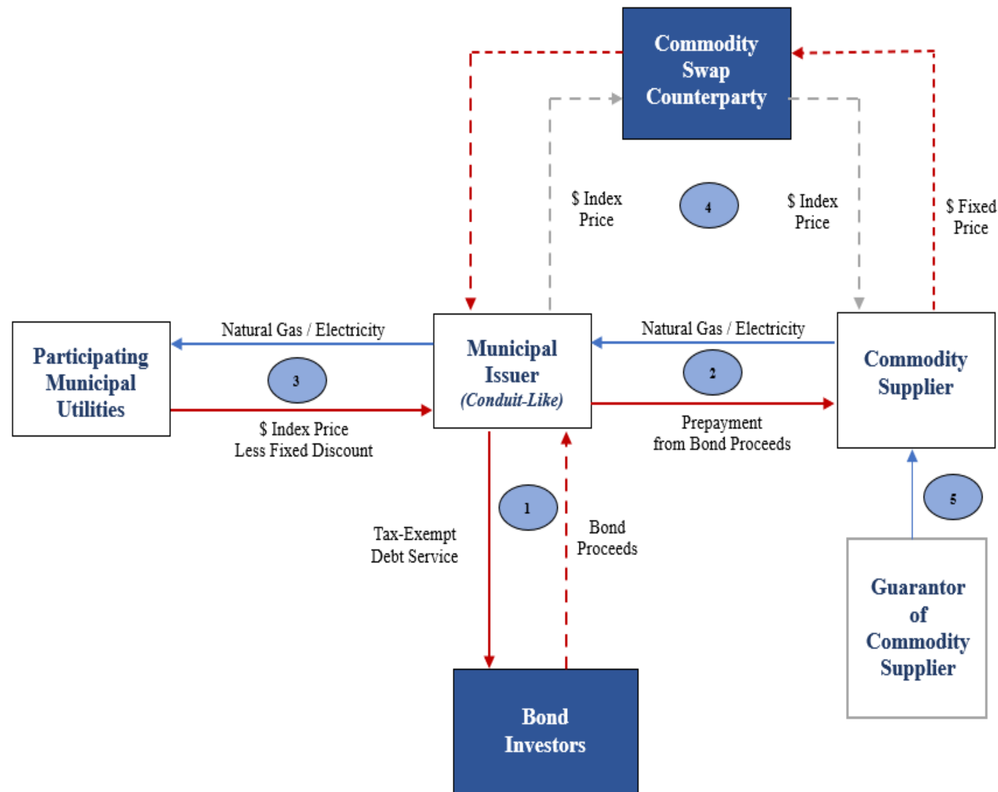
the bonds into different "segments." While the municipal issuer and participants still enter into long-term commodity purchase and sale agreements, the interest rate on the bonds and the commodity price are reset at the end of each period through a remarketing process to maximize the savings from the transaction and to create the opportunity for improved overall savings going forward. The Issuer and the Commodity Supplier will enter into an agreement that establishes the procedures for the determining the interest rates on the Prepay Bonds for the future interest rate periods or "segments" during the twenty to thirty-year term of the prepayment transaction after the initial interest rate period for the Prepay Bonds ends as well as for setting the discount and the resulting savings for the Participants for such future interest rate periods. This structure has been used to prepay for gas or electricity (including renewable energy) or gas switching to electricity.

c. Innovations in Prepayment Structures

Prepayment transactions in recent years have further evolved to address the increasing importance of renewable energy resources in the future resource planning of municipal utilities. The structure of the prepayment transactions for renewable energy remains similar to the structures for natural gas prepayments with some modifications to address differences between natural gas and renewable energy supplies, including the use of a utility's existing power purchase agreements for renewable energy as part of the prepayment transaction. As a result, the Commodity Supplier will acquire all or a portion of the renewable energy supply to be delivered under the prepay transaction through an assignment or novation of certain of the Participants' existing power purchase agreements ("PPAs"). As renewable energy resources have become important in future resource planning for municipal utilities, some transactions now provide the participant with an opportunity to switch the natural gas deliveries to the delivery of an equal value of electricity or renewable natural gas during the term of the transaction so that the cashflows remain unharmed. This provision allows a municipal utility to prepay for seven to ten years of natural gas today and then electricity for the subsequent reset periods thereafter.

C. KEY DOCUMENTS IN A PREPAYMENT TRANSACTION

As described above, a municipal prepayment transaction structure involves a number of contractual undertakings among the parties. As shown in the diagram above, there are four contractual relationships and documents common to almost every prepayment transaction and provide the basic underlying framework for these financing structures.



The numbered paragraphs set forth below relate to the numbers shown in the preceding chart and identify and describe the key documents in a prepayment transaction. They are as follows:

(1) *The Trust or Bond Indenture*. The municipal entity that issues the tax-exempt prepayment bonds (the "Issuer") will issue the Prepay Bonds pursuant to the terms of a trust or bond indenture (the "Indenture"). The Indenture sets forth the terms of the Prepay Bonds and conditions for the issuance of additional bonds and refunding bonds. The Indenture also establishes the trust estate and the funds and accounts that will secure the payment of debt service on bonds and the commodity swap payments, including redemption of the Prepay Bonds prior to maturity or mandatory tender if required due to an early termination of the prepay transaction. The Indenture also appoints a trustee with requisite trust powers to serve as trustee for the Prepay Bonds under the Indenture and to hold and administer the trust estate established for the Prepay Bonds.

(2) *The Prepaid Commodity Purchase Agreement*. This agreement is between the Issuer and the Commodity Supplier and establishes the terms and amount of the prepayment (the "Prepayment") to be made by the Issuer to the Commodity Supplier, payable from the Prepay

Bond proceeds, for delivery and taking of natural gas and/or electricity by Issuer from the Commodity Supplier for a twenty to thirty-year delivery period.

(3) *The Commodity Supply Agreement*. Under the Commodity Supply Agreement, each municipal utility ("Participant") agrees to purchase, and the Issuer agrees to deliver and sell at a floating price that includes a fixed discount, all or a portion (depending on the number of Participants in a particular transaction) of the natural gas and/or electricity that the Issuer acquires under the terms of the Prepaid Commodity Purchase Agreement. If the Participant cannot take the natural gas or electricity that it agreed to purchase (for example, because of loss of load on its utility system or adverse changes of law, among other reasons), the Participant may remarket, request the Issuer to remarket, or arrange with the Commodity Supplier to remarket such commodities. In order to maintain the tax-exempt status on the Issuer's Prepay Bonds, the Participant covenants to sell or use commodities only for a "qualifying use" consistent with IRS regulations.

The Participant's payments for the commodities are payable from revenues as an operating expense of the Participants' municipal utility system. While the payments received by the Issuer from the Participant in accordance with the terms of the Commodity Supply Agreement are "revenues" for the purpose of the Indenture and will be deposited by the Issuer with the trustee and used to pay debt service on the Prepay Bonds, the Participant has no obligation to pay debt service on the Prepay Bonds.

(4) *The Commodity Swap Agreements*. As described above, the Commodity Supplier, the Issuer, and the Participant each seek a price for the gas or electricity (each a "commodity") based on current prices (e.g., index prices for gas). Because the price paid under Prepaid Commodity Supply Agreement is based on a fixed price for the applicable commodity, a mechanism is needed to convert the price to a variable, market-based price. Therefore, the Issuer will enter into a floating-to-fixed commodity swap with a swap provider (the "Commodity Swap Provider") to receive a fixed payment while it pays the monthly market price (the "Issuer Commodity Swap") and the Commodity Supplier and the Commodity Swap Provider will also enter into a swap (the "Supplier Commodity Swap") pursuant to which the Commodity Swap Provider will be required to pay a floating amount each month and the Commodity Supplier will be required to pay a fixed amount each month. Volumes, term and delivery points for the Supplier Commodity Swap mirror those of the Issuer Commodity Swap.

Under the Issuer Commodity Swap, the Issuer will be required to pay a floating amount each month based on the first-of-the-month index price or prices applicable to gas or electricity at the delivery point or points for such month, and the Commodity Swap Provider will be required to pay a fixed amount each month based on the forward price or prices for such gas or electricity used to determine the amount of the Prepayment for such month.

In order for the commodity swaps to function as an effective hedge, payments from the Participant(s) must be sufficient to make the required payment by the Issuer under the Issuer Commodity Swap. The payments from the Commodity Swap Provider must be sufficient, together with interest earnings when applicable, to pay the interest and the principal due on the Prepay Bonds as well as any other transaction expenses.

(5) *The Guarantee.* The payment obligations of the Commodity Supplier are usually guaranteed by a parent or affiliate of the Commodity Supplier. The payment obligations of the Commodity Supplier may include payments under the Prepaid Commodity Sales Agreement (e.g., obligation to make payments upon failure to deliver commodities, obligation to make a termination payment), the obligation to purchase certain receivables of the Issuer, and obligation to make interest rate swap payments if an interest rate swap is used. Guarantee obligations are usually capped at a specified amount. It is important to note that the guarantee is a guarantee only of the Commodity Supplier's payment obligations under various transaction documents, and not a guarantee to deliver commodities, and is not a guarantee to pay debt service on the Prepay Bonds.

D. TAX CONSIDERATIONS FOR PREPAYMENT TRANSACTIONS

In general, the use of tax-exempt bond proceeds to prepay an expense is often treated as the acquisition of investment property rather than an expenditure of bond proceeds.[3] In other words, in that situation, the prepayment would be treated as an investment of bond proceeds that the issuer has to continue to monitor to determine whether it complies with the applicable arbitrage yield restriction and rebate requirements. (This will often mean that the prepayment simply can't be financed with tax-exempt bonds.) There are certain exceptions to this general rule, however. The rules regarding Prepay Bonds are an example of such an exception.

In August of 2003, the IRS released final regulations (the "2003 Final Regulations") relating to the application of the arbitrage rules to prepayments for natural gas and electricity.[4] These regulations confirmed that a prepayment for natural gas won't be treated as investment property as long as the municipal utility uses at least 90% of the gas to supply retail customers in its historic service territory or to make wholesale sales to other municipal utilities that use the gas to supply their own retail loads. A utility's historic service territory is the area it served at all times during the five years leading up to when the tax-exempt bonds were issued.

The 2003 Final Regulations also effectively extended the rules for prepayments for natural gas to prepayments for electric capacity or energy by permitting prepayments to purchase a supply of electricity provided that at least 90% of the electricity is consumed in the municipal utility's service area. The definition of service area for electric utilities is the same as for gas utilities. In addition, the IRS eliminated the requirement that the service area include only areas in which the utility has an obligation to serve its customers. For purposes of the 90% test, qualifying sales of electricity are defined as electricity: (i) furnished to retail customers of the issuing municipal utility located in its service area; and (ii) sold to a governmental utility and furnished to retail customers in the service area of the purchaser.

[3] See Code Section 148(b)(1) (providing that "higher yielding investments" means "any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue"); Code Section 148(b)(2)(D) (providing that "investment property" includes "investment-type property"); Treas. Reg. Section 1.148-1(e)(2)(i) ("Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made.").
[4] See Treas. Reg. Section 1.148-1(e)(2)(iii).

The 2003 Final Regulations were followed by the Energy Policy Act of 2005 (the "2005 Act") which provides a safe harbor from arbitrage restrictions under Section 148 of the Internal Revenue Code for prepayments for natural gas that are part of a qualified natural gas supply contract.[5] The 2005 Act also provides that such prepayments are not treated as private loans for purposes of the private business tests.

Section 1327 of the 2005 Act[6] creates a safe harbor exception to the general rule that tax-exempt bond-financed prepayments violate arbitrage restrictions. The term "investment type property" does not include a prepayment under a "qualified natural gas supply contract." Section 1327(b) provides that such prepayments are not treated as private loans for purposes of the private business tests. Thus, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility would not be treated as the acquisition of investment-type property. The safe harbor provisions do not apply if the utility engages in intentional acts to render the volume of natural gas covered by the prepayment to be in excess of that needed (a) for retail natural gas consumption and (b) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility.

Sizing limitation. The 2003 Final Regulations apply the 90% sizing limitation on an aggregate basis over the term of the bond issue that financed the prepayment and require that the issuer monitor the amount of gas or electricity sold outside its service area. The application of this limitation over the term of the bonds permits issuers to average years in which significant amounts are sold off system with years in which on system sales exceed the average. Since, however, the greatest amount to be purchased in a year is likely not to exceed approximately 110% of expected use within the service area, this is the maximum amount that could be averaged with years in which significant amounts were sold off system.

Requirement to redeem or defease bonds. To the extent that the 90% requirement is not satisfied over the term of the bonds, the issuer and the participant must take a qualifying remedial action to cure this violation. Qualifying remedial action is for the issuer to use its revenues or taxable debt to redeem or defease the portion of the bonds that corresponds to the excess gas or electricity sold outside its service area to the first call date for the bonds. In addition, the 2003 Final Regulations also provide that a qualifying remedial action includes using the cash sale proceeds received from nonqualifying sales of gas or electricity for a purpose for which the issuer could have issued tax-exempt bonds. Under this rule, an issuer could use the cash from "off-system" sales in excess of the 10% limit to finance capital improvements to its system (in lieu of redeeming bonds).

[5] Unless indicated otherwise, all section references for tax matters are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. Section" references are to the Treasury Regulations promulgated under the Code.

[6] Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005).

E. SECURITIES LAW ISSUES IN PREPAYMENT TRANSACTIONS

1. Exemption from Registration

The Securities Act of 1933 (the "1933 Act") governs the primary offering of securities and requires registration of securities with the Securities and Exchange Commission (the "SEC") unless such securities are specifically exempt from registration.

Most municipal securities are not registered with the SEC because they are "exempt securities." Section 3(a)(2) of the 1933 Act exempts from the registration requirement any security "issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any state of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of one or more states or territories."[7]

However, also subject to registration are what are known as "separate securities" which are instruments embedded in, or related to, the financing structure for an issue of municipal securities, and may, in and of themselves, be a "security" for purposes of the 1933 Act and subject to registration. Under SEC Rule 131, "[a]ny part of an obligation evidenced by any bond, note, debenture, or other evidence of indebtedness issued by any governmental unit specified in section 3(a)(2) of the Act which is payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, shall be deemed to be a separate security within the meaning of section 2(l) of the 1933 Act, issued by the lessee or obligor under the lease, sale or loan arrangement."[8]

In order for a security to constitute a "separate security" under Rule 131, the instrument generally needs to form "part of the obligation" represented by the municipal bonds. Prepayment transactions involve a more complex analysis of "separate security" considerations than most municipal bond transactions. The transaction is carefully structured to ensure that any instruments do not consist of "separate securities." This analysis will need to be undertaken by counsel on these transactions to confirm that the applicable contracts, considered individually and considered collectively, do not constitute a "security" within the meaning of the 1933 Act or a "separate security" within the meaning of Rule 131.[9]

2. Disclosure Considerations

The offering document for the Prepay Bonds should clearly identify the amounts that are pledged to pay debt service and the structure of the transaction clearly and in a way that will not be subject to misinterpretation, including that only the Issuer is obligated to pay debt service on the bonds. Careful consideration should be given to the drafting of a "risk factors" or "investment considerations" section. As highly structured transactions, the Prepay Bonds do not have recourse to an ongoing operating fund and thus the transaction will contain numerous potential structural vulnerabilities that should be fully disclosed to investors. Careful review and consideration should

[7] Securities Act of 1933, 15 U.S.C. § 77a.

[8] 17 CFR Sec. 230.131(a).

[9] For additional information, see Fippinger, The Securities Law of Public Finance, (3rd ed. vol. I Practicing Law Institute, NY 2011), § 2:7.2[B] at 2-104 to 2-106.

be given to disclosure of the events and conditions in a particular prepayment transaction that could result in a failure to pay debt service on the Prepay Bonds, an early termination of the transaction leading to a mandatory redemption of the Prepay Bonds or the loss of tax exemption on the Prepay Bonds.

The offering document for the Prepay Bonds will contain financial and operating data relating to the Participants and the continuing disclosure undertaking of the issuer will provide that annual financial and operating data and event notices with respect to the Participants will be filed on EMMA. To make certain that the issuer of the Prepay Bonds can obtain the information required to maintain compliance with the continuing disclosure undertaking there is a provision in the Commodity Supply Agreement requiring the Participant to provide to Issuer: (a) such financial and operating information as may be requested by Issuer, including a Participant's most recent audited financial statements, for use in Issuer's offering documents for the bonds; and (b) annual updates to such information and statements to enable the underwriters of the offerings of the bonds to comply with the continuing disclosure provisions of the SEC's Rule 15(c)2-12. Failure by the Participant to comply with its agreement to provide such annual updates is not a default but provides the Issuer or bondholder with the ability to take such actions and to initiate such proceedings as may be necessary and appropriate to cause the Participant to comply with such agreement.

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II. INFLATION REDUCTION ACT

A. INTRODUCTION

On August 16, 2022, President Biden signed into law HR 5376, the Inflation Reduction Act of 2022 (the "IRA").[10] The IRA, among other things, substantially expands federal tax benefits and subsidies for energy projects. For example, it extends or increases a number of existing tax credits for renewable and other green energy projects, creates new energy tax credits and creates new ways for taxpayers to monetize tax credits. The IRA has the potential to impact multiple aspects of governmental activities, such as affordable housing, nonprofits, education, transportation, and public power. The most significant aspect of the IRA for issuers of tax-exempt bonds is that it allows entities that aren't subject to federal income tax (such as municipal utilities)[11] to benefit from various energy tax credits. The IRA does this by enacting Code Section 6417, which makes those credits "refundable," which means that the tax-exempt entities who qualify will receive direct payments in lieu of tax credits.[12]

As further described below, the IRA extended and changed the rules for (i) the production tax credit ("PTC") for, among other things, wind, solar, biomass facilities, geothermal facilities, and existing nuclear projects and (ii) the investment tax credit ("ITC") for, among other things, wind, solar, stand-alone energy storage, combined heat and power (co-generation facilities), geothermal heat pumps, clean hydrogen, waste energy recovery, and biogas projects. The IRA also provides for new "technology neutral" PTCs and ITCs (which will replace the existing credits by 2025), for electric generation facilities that produce zero greenhouse gas emissions.

In addition to extending and enhancing various tax credits, the IRA fundamentally changes the way tax credits are calculated and the factors that boost the amount of the tax credit (and, thus, the amount of the direct payment for a tax-exempt entity that elects to receive it). Now tax credits start with base credit, which in some cases is 1/5 of what the tax credits were historically. That base credit may be increased by a 5X multiplier if certain "prevailing wage" requirements (under the Davis-Bacon Act) and apprenticeship requirements are met. That amount may be further increased by certain "bonuses" or "adders" to the tax credit where the project satisfies certain key goals of the IRA. For instance, if the energy project uses enough "domestic content" in its construction then there is a bonus/adder of 10%, and if the project is located in what is called an "energy community," there is an additional bonus/adder of 10%. In addition, certain solar and wind projects located in low-income communities or tribal land may be able to receive an

[10] Public Law 117-369, 136 Stat. 1818.

[11] This outline will refer to these entities in various places as "tax-exempt entities;" this is intended to refer to a much broader classification of entities than what might be the common usage of that term (referring to, e.g., 501(c)(3) public charities).

[12] A tax credit is an amount of money that a taxpayer can subtract, dollar for dollar, from the income taxes they owe, historically tax credits have had value for tax-paying organizations only to the extent the taxpayer otherwise owes federal income taxes. Since tax-exempt organizations generally do not have any federal tax liability they were not able to benefit from energy tax credits before the IRA.

additional 10% or 20% if the owner of the project applies for and is awarded that "environmental justice" bonus/adder.

In contrast, the amount of the credits is reduced by the lesser of (a) 15% and (b) the portion of the project financed with tax-exempt bonds, if the related project is financed with tax-exempt bonds. However, this 15% maximum reduction is a sharp decrease from the rule that formerly governed tax credit projects financed in part with the tax-exempt bonds, which provided for an up to 50% reduction in the amount of the credit if the property was financed with tax-exempt bonds.

You may be thinking to yourself: "Direct payments from the federal government in lieu of tax credits . . . where have I heard that before?" The direct payment provided by IRA in lieu of these various energy tax credits is governed by the same principles as the direct subsidy payment provided for Build America Bonds ("BABs") and other direct pay bonds[13] under the American Recovery and Reinvestment Act of 2009.[14] Accordingly, it would face the same threat of reduction through budget sequestration. Importantly, the IRA provides protection for these direct payments from sequestration, which would otherwise reduce the value of the credits in the same way that it reduced the direct subsidy payment for BABs. These provisions of the IRA are described in greater detail below, although it is important to note that the new rules are complex and contain a number of additional requirements, exceptions, and limitations. This summary does not reflect the many other tax credits and energy provisions contained in the IRA, including those related to tax credits for manufacturing, energy efficiency, clean vehicles, and fuels.

B. OVERVIEW OF THE TAX CREDITS – PTC AND ITC

1. Prior to the IRA - Power Purchase Agreements

Prior to the enactment of the IRA, only tax-paying entities could benefit from renewable energy tax credits. Tax-exempt entities would enter into an agreement with a tax-paying developer with the developer agreeing to construct, own and operate the project. The tax-exempt entity would agree to purchase energy at an agreed-upon rate over the term (e.g., fifteen to twenty years), which would generally be adjusted annually for inflation. The developer receives several incentives, including a PTC or an ITC as well as the benefit of accelerated depreciation of the asset as the tax owner of the facility. The developer would embed some of these incentives into the contracted cost of energy and the tax-exempt entities' cost of energy would also reflect the developer's investment return objectives.

However, while these structures result in savings for the tax-exempt entities, there are tax consequences and other issues requiring careful consideration with these structures. Tax-exempt proceeds can only be used to make the fixed-price prepayment for the fixed amount of energy. Use of the prepaid energy is limited to retail use through government-owned utilities/customers in qualified service areas. Also, the term of the power purchase agreement cannot exceed 80% of the estimated life of the facility. The municipal utility cannot control operations of the facility, has no right of foreclosure for a breach by the developer and any purchase option for the facility must be a fair market value at the time of exercise of the option. Further, any tax-exempt bonds issued to

[13] Code Section 6431.

[14] Public Law 111-5 (Feb. 17, 2009).

acquire the facility would need to obtain volume cap in accordance with Section 141(d)(2) which defines "nongovernmental output property" generally as any property (or interest therein) that before such acquisition was used (or held for use) by a person other than a governmental unit in connection with an output facility (within the meaning of § 141(b)(4)) (other than a facility for the furnishing of water).

With the enactment of the IRA, private ownership of renewable energy projects is no longer necessary for local governments to obtain any benefit from available federal tax credits -- local governments can now own renewable energy projects and finance them with tax-exempt bonds and receive direct payments of in lieu of tax credits.

2. Production Tax Credit ("PTC")

PTCs are provided for under Code Section 45.[15] The PTC is a per-kilowatt-hour ("kWh") credit for producing energy from a qualifying resource. The PTC is paid over the ten-year period beginning on the date the facility is placed in service. The amount of the "base" credit is 0.3 cents per kWh but is indexed for inflation so that the rate for 2022 is 0.52 cents per kWh. The credit increases to 1.5 cents per kWh, 2.6 cents per kWh as adjusted for inflation for 2022 if the prevailing wage and apprenticeship requirements described below are met or are not applicable. The rates are adjusted annually for inflation.

The types of projects eligible for the PTC are energy projects under Section 45 of the Internal Revenue Code, including those using wind, closed and open-loop biomass, solar, geothermal energy, and hydropower to generate electricity. The IRA extends to December 31, 2024, the construction start deadline for otherwise eligible projects, but these credits are to be replaced thereafter with the new "tech neutral" PTC (described below).

The IRA creates a new PTC for electricity sold after 2023 and through 2032 from existing nuclear projects that never received federal tax credits. The base credit is 0.3 cents per kWh (0.52 cents per kWh for 2022), increasing to 1.5 cents per kWh (2.6 cents per kWh for 2022) if the prevailing wage and apprenticeship requirements are met. The credit is, however, reduced by 80% of the gross receipts from sales of electricity at a price in excess of 2.5 cents per kWh.

In addition, a new PTC will apply to qualifying clean hydrogen projects. The IRA also extends and enhances the PTC for carbon sequestration projects. As with the other PTCs, there are base credit amounts for hydrogen and carbon sequestration projects and increases for projects that satisfy the prevailing wage and apprenticeship requirements and potentially additional bonus credits and requirements described in Part E below.

[15] To allow for new technologies that are not currently enumerated in Section 45, beginning in 2025, the Section 45 PTC will be replaced with the "technology neutral" Section 45Y PTC. Instead of having a list of qualified technologies, credit will be based on "greenhouse gas emissions rate" that is expressed as grams of CO_2e per KWh, and the IRS will publish tables showing rate for different types of facilities.

3. <u>Investment Tax Credit ("ITC")</u>

ITCs are provided for in Section 48 of the Code. The ITC is a one-time credit after the facility is placed in service. In contrast to the PTC, which is calculated based on the amount of energy that the project produces, the ITC is calculated based on a percentage of the *cost* of qualifying energy property. For most ITC projects the base rate is 6% and the full rate is 30% (subject to further increase by potential bonus/adders described in Part E below). The ITC vests 20% each year over 5 years.

There are two types of ITC. One is limited to certain types of energy property. The other is "technology neutral." The types of projects eligible for the ITC are those under Section 48 of the Code, which include energy projects, which begin construction before 2025 using solar, geothermal energy, combined heat and power systems, qualified small wind projects, and waste-energy recovery, as well as those described in Section 45 (related to PTCs) that elect to take the ITC. The IRA also extends the ITC to standalone energy storage projects and certain other types of facilities. The amount of the base ITC is 6% for certain projects like solar, wind, combined heat and power (co-gen), geothermal heat pumps or energy storage. The credit increases to 30% if the prevailing wage and apprenticeship requirements described below are met or are not applicable (subject to further increase by potential bonus/adders described in Part E below).

4. <u>New "Tech Neutral" ITC and PTC for Zero Emission Projects.</u>

The IRA creates a new ten-year PTC (Section 45Y) and an ITC (Section 48E) for property that generates electricity with a greenhouse gas emission rate of zero, and is placed in service after 2024. These credits also apply to retrofits placed in service after 2024. These credits have the same base rates as the PTCs and ITCs under Sections 45 and 48 (that is, 0.3 cents per kWh (prior to the inflation adjustment) and 6% or 2% for ITC) and the same increases for satisfaction of the prevailing wage and apprenticeship requirements, if applicable (that is, 1.5 cents per kWh (prior to the inflation adjustment) and 30%) and potential bonus credits described in Part E below.

C. PTC OR ITC – THAT IS THE QUESTION

Many factors will influence whether to use the PTC or the ITC for a particular project and tax-exempt or taxable financing for a given project. A final decision on which credit is likely to apply is likely to be project- and utility-specific. The ITC is one-time tax credit that does not vary by system performance, whereas the PTC provides a cash flow, as the tax credits are earned over time. Whether to choose the ITC or the PTC depends largely on whether the facility owner will utilize the energy or if there is a third-party off-taker, the amount of renewable resources available, and whether it is eligible for any bonus tax credits. Smaller-scale photovoltaics ("PV") projects and concentrated solar power ("CSP") projects generally receive more value utilizing the ITC, particularly if they can utilize a low-income bonus, which is not available with a PTC. As described above, the PTC is a per-megawatt hour ("MWh") payment based on actual production over the first ten years of project operation (adjusted each year for inflation) and payable annually

based on the preceding year's production while the ITC is a one-time payment (that vests 20% over five years), equal to a percentage of project costs, from the date the facility is placed in service.

The following chart highlights certain of the key differences between the PTC and the ITC:

Incentive Considerations	Production Tax Credit ($26.00 MWh)	Investment Tax Credit (30% of qualified costs)
• Can elect to take one of the incentives (not both) • Each project is unique in terms of which incentive and form of debt provides the highest benefit	• Incentive is based on the energy produced from the renewable facility • Received annually for first ten years of operation • Adjusted for inflation each year so maintains buying power • Can finance with tax-exempt debt but incentive reduced by 15% • Dependent upon continuing project performance and dispatch • Payment processing and continuing receipt of annual payments • Adherence to fair wage and apprenticeship requirements for ten-year period	• Incentive is based on the installed cost of the renewable energy facility • Received once the facility produces energy and is interconnected with the grid • Requires initial filing with the US Treasury and IRS (qualified costs as well as engineering reports) • Can finance with tax-exempt debt but incentive reduced by 15% • Dependent on construction completion and interconnection to grid • Qualifying cost calculation • Asset ownership versus power purchase agreement benefits

Sources: Inflation Reduction Act, Congressional Research Service, "Tax Provisions in the Inflation Reduction Act of 2022", August 10, 2022; https://crsreports.congress.gov/product/pdf/R/R47202;https://home.treasury.gov/system/files/136/Fact-Sheet-IRA-Equitable-Clean-Energy-Economy.pdf.

D. CREDIT MULTIPLIER: PREVAILING WAGE AND APPRENTICESHIP REQUIREMENTS

Under the IRA each of the PTCs and ITCs has a base tax credit rate that is multiplied by a factor of five if the rules related to prevailing wages and apprenticeships are satisfied or are not applicable. Importantly, the prevailing wage and apprenticeship rules apply only to projects with a capacity of at least 1 MW that begin construction sixty days after Treasury publishes guidance on these requirements, which occurred on November 30, 2022. Projects that are less than 1 MW still receive the 5x credit multiplier even if they do not satisfy the prevailing wage or apprenticeship requirements. In the event the taxpayer fails to satisfy the prevailing wage or apprenticeship requirements, the IRS provides procedures to cure the failure.

On May 12, 2023, the IRS and Treasury issued Notice 2023-38 (the “Notice”),[16] which provides initial guidance for developers and investors seeking to qualify projects for the domestic content bonus credit available under Sections 45, 45Y, 48, and 48E (the “Domestic Content Bonus Credit”).

[16] IRS Notice 2023-38 (https://www.irs.gov/pub/irs-drop/n-23-38.pdf).

a. *Prevailing Wage*

The prevailing wage rule piggybacks off the Department of Labor's Davis-Bacon rules and requires that laborers and mechanics are paid prevailing wages for the locality in which the project is located during the construction of a qualifying project (and, in some cases, the alteration and repair of the project) for a defined period after the project is placed into service. A prevailing wage is the combination of the basic hourly wage rate and any fringe benefits rate paid to workers in a specific classification of laborer or mechanic for all hours that work is performed in the construction, alteration, or repair on the work site of a qualified project.

For purposes of showing compliance with the IRA's prevailing wage provisions, the tax-exempt entity must maintain records sufficient to establish that the entity and the entity's contractor and subcontractor paid wages not less than such prevailing wage rates. These records could include documentation identifying the applicable wage determination, the laborers and mechanics who performed construction work on the project, the classifications of work they performed, their hours worked in each classification and the wage rates paid for the work.

The IRA's prevailing wage provisions became effective on January 29, 2023, so in order to receive the available enhanced tax credits for a project with a capacity of 1 MW of more, unless the project is less than 1 MW, tax-exempt entities must meet the prevailing wage requirements for facilities where construction began on or after January 29, 2023.[17]

b. *Apprenticeships*

The apprenticeship rule relies on the U.S. Department of Labor and state apprenticeship agencies and requires that qualified apprentices perform no less than the "applicable percentage" of total labor hours of the project. A qualified apprentice is an apprentice that participates in an apprenticeship program that is registered with the U.S. Department of Labor or a state apprenticeship agency. The applicable percentage depends on the year in which construction begins: 10% for 2022, 12.5% for 2023, and 15% thereafter. Failure to hire an apprentice is excused if there is a good faith effort to request qualified apprentices from a registered program.

The IRA's apprenticeship provisions also became effective on January 29, 2023 (sixty days after the guidance of November 30, 2022, was published); so, in order to receive the available enhanced tax credits for a project with a capacity of 1 MW or more, unless the project is less than 1 MW, tax-exempt entities must meet the apprenticeship guidelines for projects or facilities where construction began on or after January 29, 2023.

E. BONUS CREDITS

a. *Domestic Content Rules*

The IRA provides that a "bonus credit" applies to a PTC or ITC facility that meets the domestic content rules. The PTC will be increased by 10%t (excluding any energy community

[17] IRS Notice 2022-61; 87 FR 73580.

bonus described below under "Energy Communities" or low-income bonus described below under "Low-Income Communities"), and the ITC will be increased by ten percentage points if the prevailing wage and apprenticeship requirements described in Part D above are satisfied with respect to the facility, if applicable, and by only two percentage points if they are not. In the case of tax-exempt entities (including governmental, non-profits, tribal entities and rural electric co-ops) with projects of 1 MW or more, if the domestic content rules are not satisfied, the PTC and ITC will be reduced by 10% if construction of the facility begins in 2024, by 15% if it begins in 2025, and by 100% if construction begins after 2025. These reductions do not apply to entities that are not able to elect for direct-pay. A project that is less than 1 MW that fails to meet domestic content requirements will not lose its direct payment (it will simply not receive the 10% bonus credit for domestic content).

The domestic content rules differentiate between subcomponents and components and require that any steel, iron, or manufactured product that is part of a project is produced in the United States. The domestic content rules apply differently to two different categories of components: (a) steel or iron components, which are subject to a more stringent test, and (b) "manufactured products" (defined as any item produced as a result of a manufacturing process). Subcomponents do not need to be manufactured in the United States. For steel or iron components, the rules are satisfied with respect to a project component if all manufacturing processes with respect to the project component (other than metallurgical processes involving refinement of steel additives) take place in the United States. With respect to manufactured products, the domestic content rule is satisfied if specified percentages of the total cost of a project's components are mined, produced, or manufactured in the United States.[18] The percentage is calculated by dividing the cost of all domestically manufactured products and components by the total cost of all manufactured products.

PTC and ITC projects that are 1 MW or more that started construction after 2023 must meet domestic content requirements, or be excepted from them to qualify for certain direct payments. For projects starting construction in 2024 or 2025, the otherwise-available direct payments are reduced to 90% or 85% of their value, respectively, unless the project meets or is excepted from the domestic content requirements or is less than 1 MW.

For projects 1 MW or more that begin construction after 2025, direct payments are not available unless domestic content requirements are met or an exception applies. As noted, these reductions do not apply to PTC and ITC projects with a maximum net output of less than 1 MW (AC).

The IRA directs the Treasury to provide exceptions for projects if the inclusion of US-made steel, iron, or manufactured products would increase overall construction costs by more than 25% or the relevant steel, iron or manufactured products are not produced in the United States in sufficient and reasonably available quantities or of a satisfactory quality. Additional Treasury guidance will be necessary to clarify the domestic content bonus requirements and any waiver process.

[18] The percentages required are as follows: (i) 40% for projects with construction starting in or before 2024; (2) 45% for projects with construction starting in 2025; (3) 50% for projects with construction starting in 2026; (4) 55% thereafter; and (6) 20% for offshore wind in 2024, increasing to 55% by 2028.

b. ***Energy Communities***

The IRA provides a bonus credit for a PTC or ITC facility located in an "energy community" for tax credits described in the following Code sections, all as amended by the IRA: Section 45 (the current PTC) and Section 48 (the current ITC") and their successor provisions: Section 45Y (the technology neutral PTC) and Section 48E, (the tech neutral ITC).

For the PTC, the bonus is 10% of the otherwise-applicable direct payment (excluding any domestic content or low-income bonus). For the ITC, the bonus is an additional 10 percentage points (10% adder) if the facility meets wage and apprenticeship requirements, if applicable, and only an extra two percentage points if it does not.

A project is in an energy community and eligible for the "energy communities" bonus credit if it satisfies any one of the following three tests:

(a) ***The Brownfield Rule*** – Project is in a brownfield (as defined in §101(39)(A), (B), and (D)(ii)(III) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 U.S.C. §9601(39)), subject to certain exceptions.

(b) ***The "MSA/NMSA Rule"*** – Project is located in one of the following:

(x) A metropolitan statistical area or a non-metropolitan statistical area with BOTH (a) at least .17% (that's 1 in 600) people employed in fossil fuels and (b) an unemployment rate at or above the national average OR

(y) A metropolitan statistical area or a non-metropolitan statistical area with BOTH (A) more than 25% of its tax revenue derived from fossil fuel businesses and (B) an unemployment rate at or above the national average.

(c) ***The Coal Closure Census Tract Rule*** – Project is in a census tract with a coal mine shut down after 1999 or a coal-fired electrical generator shut down after 2009 or any census tract that is adjacent to such census tract.

IRS Notice 2023-29[19] provided guidance on the IRA provisions relating to energy communities and provides special rules for each of the three tests set forth above, including safe harbor provisions.

c. ***Low-Income Communities***

The IRA provides potential bonus credit for a ITC facility for either a solar or wind project that has a maximum net output of less than 5 MW (as measured in alternating current) that is located in one of the following four categories and that has been allocated part of the available environmental justice solar and wind capacity limitation described below for the bonus credit:

a. ***Category 1 – NMTC low-income community***: The facility is located in a low-income community described in under §45D(e)(1) (relating to new market tax credits (NMTCs)), with certain modifications described elsewhere in §45D(e), as any population census tract if the poverty rate for such tract is at least 20%, or, in the case of a tract not

[19] IRS Notice 2023-29, April 4, 2023 (https://www.irs.gov/pub/irs-drop/n-23-29.pdf).

located within a metropolitan area, the median family income for such tract does not exceed 80% of statewide median family income, or in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.

b. ***Category 2 – Tribal lands***: The facility is located on Indian land as defined in §2601(2) of the Energy Policy Act of 1992 (25 U.S.C. 3501(2)).

c. ***Category 3 – Qualified Low-Income Residential Building Project***: The facility is part of a qualified low-income residential building project if such facility is installed on a residential rental building that participates in an affordable housing program, and the financial benefits of the electricity produced by such facility are allocated equitably among the occupants of the dwelling units of such building. For a qualified low-income residential building project, §48(e)(2)(D) provides that electricity acquired at a below-market rate will be considered a financial benefit. Forthcoming guidance will further clarify the parameters of financial benefit.

An affordable housing program includes any of the following: (i) a covered housing program (as defined in § 41411(a) of the Violence Against Women Act of 1994 (34 U.S.C. 12491(a)(3)); (ii) a housing assistance program administered by the Department of Agriculture under title V of the Housing Act of 1949, (iii) a housing program administered by a tribally designated housing entity (as defined in § 4(22) of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4103(22)); and (iv) such other affordable housing programs as the Secretary of the Treasury may provide.

d. ***Category 4 - Qualified Low-Income Economic Benefit Project***: The facility is part of a qualified low-income economic benefit project if at least 50% of the financial benefits of the electricity produced by such facility are provided to households with income of less than 200% of the poverty line (as defined in §36B(d)(3)(A)) applicable to a family of the size involved, or less than 80% of area median gross income (as determined under §142(d)(2)(B)). For a qualified low-income economic benefit project, §48(e)(2)(D) provides that electricity acquired at a below-market rate will be considered a financial benefit. Forthcoming guidance will further clarify the parameters of financial benefit.

d. *Environmental Justice Solar and Wind Capacity Limitation*

In order to receive the bonus credit for a solar or wind project that is less than 5 MW located in one of the four categories described above, the owner of the facility must apply for an allocation of "capacity limitation" from the Department of Treasury and the IRS ("Capacity Limitation"). For each facility owned by an applicant, the applicant may apply for an allocation of Capacity Limitation in only one category for calendar year 2023. Applicants that do not receive an allocation of Capacity Limitation will be permitted to apply for future allocations after calendar year 2023. Facilities placed in service prior to being awarded an allocation of Capacity Limitation are not eligible to receive an allocation.

F. ELECTRIC VEHICLES

The IRA Section 45W created a new credit effective for "qualified commercial clean vehicles" placed in service after December 31, 2022, and before January 1, 2033. To be a qualified commercial clean vehicle, the vehicle must meet the following requirements: (a) the vehicle must be acquired for use or lease by the business; (b) the vehicle must be a depreciable asset; (c) the vehicle must be manufactured for use on streets, roads and highways or must be mobile machinery; (d) the vehicle's battery capacity must be at least 7 kWh (15 kWh for vehicles weighing more than 14,000 pounds); (e) the vehicle must be charged by an external electricity source; and (f) the vehicle must made by a qualified manufacturer[20].

The amount of the credit is equal to the lesser of (i) 15% of the vehicle's cost (30% for vehicles not powered by a gas or diesel engine) or (ii) the "incremental cost" of the vehicle over the cost of a comparable vehicle powered solely by a gas or diesel internal combustion engine and which is comparable in size and use. The credit is capped at a maximum credit of $7,500 for vehicles with a gross vehicle weight rating (GVWR) of less than 14,000 pounds or $40,000 for vehicles over 14,000 pounds.

The IRS will be tracking the credits by vehicle identification number ("VIN") and so there is one credit available per VIN. Taxpayers seeking to claim the credit will be required to provide the VIN on the tax form used to claim the credit. In addition, once the credit has been claimed, the cost basis of the vehicle must be reduced by the amount of the credit before depreciation is taken.

G. DIRECT CASH PAYMENT OF CREDITS AND SEQUESTRATION PROTECTION

1. Elective Direct Payments

Historically, tax credits have only been available to entities with taxable income. A major goal of the IRA is to expand access to tax credits across sectors to the public sector, non-profits and, for some of the energy credits in some cases, taxable entities.[21] Now municipal public power systems (and other tax-exempt entities22) can own qualifying projects and obtain the benefit of

[20] The term "qualified manufacturer" means: any "manufacturer" within the meaning of the Environmental Protection Agency's regulations with respect to the Clean Air Act (a generally broad definition incorporating automobile manufacturers), which enters into a written agreement with the U.S. Treasury Department (Treasury Department) pursuant to which the manufacturer agrees to make periodic written reports to the Treasury Department providing vehicle identification numbers and any other required information related to each clean vehicle manufactured. A list of qualified manufacturers can be found at: https://www.irs.gov/credits-deductions/manufacturers-for-qualified-commercial-clean-vehicle-credit.

[21] The IRA also permits monetization of tax credits by taxable entities through transfer and sale under Section 6418 of the Internal Revenue Code.

[22] Section 6417 of the Internal Revenue Code introduces the concept of an "applicable entity," which is an entity that is eligible to elect the direct payment of certain tax credits. In general, an applicable entity is (1) any tax-exempt organization, (2) any state or political subdivision thereof including District of Columbia or a political subdivision thereof, (3) the Tennessee Valley Authority, (4) any Indian tribal government, (5) any Alaska Native Corporation, or (6) any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas. Applicable entity includes an agency or instrumentality of any applicable entity described in clauses (2) or (4).

most of the investment and production tax credits through direct cash payments from the IRS.23 The direct payment election would be available to States and political subdivisions with respect to (a) the PTCs for renewable energy projects eligible under Section 45 (as described above), and carbon sequestration, nuclear energy, and hydrogen projects, (b) the projects eligible for the ITC under Section 48, including storage (as described above), and (c) the new tech neutral ITC and PTC for zero emission energy projects. The IRA includes an anti-abuse provision under which, if Treasury determines that an excessive payment has been made, the recipient would be required repay the excess plus a 20% penalty unless a showing of "reasonable cause" is made. Taxpayers that are not applicable entities would be able to transfer specified tax credits to an unrelated party for cash, and would be eligible to elect direct payment for a limited subset of the IRA tax credits (e.g., PTCs for clean hydrogen and carbon sequestration projects). In order to be eligible for direct payments, projects must be placed in service after 2022.

Guidance issued by the IRS clarified that the direct payment rules apply to co-ownership structures commonly used in public power projects, so that two or more entities can each own a portion of a project, and their interests will be respected as separate ownership interests for purposes of the direct payment rules. The regulations also clarify that agencies and instrumentalities of political subdivisions are eligible for direct payments of credits. However, an applicable entity is not permitted to purchase a tax credit from a taxable entity and then apply for a direct payment in lieu of that credit.

2. Process for Receiving Direct Payments

On June 14, 2023, the IRS released temporary and proposed regulations on direct payments, including the process for making the election for elective payments.24 Taxpayers can rely on the proposed regulations for tax years beginning after December 31, 2022, as long as the proposed regulations are followed in their entirety and in a consistent manner. Under this most recent guidance, obtaining direct payments is a three-step process that begins with a project owner complying with a registration process. Registering does not guarantee eligibility for the tax credit or commit an entity to ownership of the related project or electing to receive direct payments and completing registration does not mean that the entity is eligible for the tax credit or is able to transfer or elect direct payment of the tax credit.

a. ***Registration Process Required***

The regulations state that registration is to be effectuated through an online "portal." This portal does not exist as of yet, but the rules say that the IRS will open the portal in fall 2023. On completion of the registration process, a registration number will be provided that relates to the specific project that produces the tax credit. Each separate property that is eligible for tax credits must have a unique registration number. In addition, a registration number is valid only for

[23] Section 6417 of the Internal Revenue Code permits governmental entities and tax-exempt organizations to effectively receive cash payments from the government even if the governmental entity or tax-exempt organization has no tax liability against which one of the specified tax credits can be offset.

[24] NABL provided comments to these regulations regarding the mechanics of the direct payment election, available here: https://www.nabl.org/resources/comments-proposed-section-6417/.

single taxable year and must be renewed annually. Credits cannot be claimed for a property without a registration number.

To obtain the registration number, the portal will require information about the operations of the entity and the property that will generate the credits. The regulations specify some of the required information but defer to "portal instructions" (which haven't yet been published) any further information that could be required. The required information that the IRS has specified in the regulations includes information about the applicable entity (name, address, employer identification number, type of entity, etc.). In addition, specific information about the tax credit property must be provided, including physical location (including geographic coordinates), supporting documentation to demonstrate eligibility for the credits (such as operating permits, deeds or other evidence of ownership; etc.), the date on which construction commenced, and the placed-in-service date of the property.

In the case of production tax credits and each vesting year of an investment tax credit, the registration will have to be renewed each year (separately for each project). Again, it is difficult to know precisely what the renewal process will entail until the IRS provides more information and publishes the instructions for the online portal. The regulations also make clear that the registration will have to be updated to include any changed facts and an attestation that the facts giving rise to the credit for the particular tax year are still true.[25]

b. *Process and Timing for Direct Payment Claims.*

Once a registration number is obtained (and only after if it is obtained), an applicable entity can then elect to receive direct payments and submit a claim for direct payments. Both the election and the claim for direct payments are to be made on IRS Form 990-T, which is the tax return form that nonprofit corporations file with the IRS to report and pay tax on unrelated business taxable income. The IRS has not indicated whether this form will be modified to make it more user friendly for tax credits. In addition to Form 990-T, the entity must also file IRS Form 3800, the form for general business tax credits, and the form that specifically applies to the tax credit being claimed (that is, Form 3468 for the investment tax credit and Form 8835 for the production tax credit). Links to these forms are provided below.

Form 990T: https://www.irs.gov/pub/irs-pdf/f990t.pdf
Form 3800: https://www.irs.gov/pub/irs-pdf/f3800.pdf
Form 8835: https://www.irs.gov/pub/irs-pdf/f8835.pdf
Form 3468: https://www.irs.gov/pub/irs-pdf/f3468.pdf

The election to receive direct payments must be made by an applicable entity by the 15th day of the fifth month after the end of the taxable year in which the related facility is placed in service on an original return (subject to extension) and not an amended return. A governmental entity's taxable year for this purpose is likely its fiscal year. Specifically, the rules say that the taxable year is based on its annual accounting period (that is, the annual period on which it

[25] Updates to the registration are also required if, after receipt of a registration number, there are changes to the project that occur prior to filing a claim for the credit, such as a change of ownership.

computes its income in keeping its books), which would normally be the entity's fiscal year. The rules on making the election are very strict; for example, they prohibit revoking or revising an election after it has been made. An election to receive direct payments that does not include a valid registration number for the credit property will be treated as ineffective.

The somewhat quirky way that the direct payment statute was drafted may lead to lengthy delays between the time the energy credit property is placed in service and the tax-exempt entity's ability to claim the direct payment, particularly for facilities that are placed in service early in an entity's fiscal year. Specifically, the theory of the direct payment is that the tax-exempt entity is treated as having made a payment of tax (which of course it did not actually make), and then the federal government "refunds" that fictional payment (leaving the tax-exempt entity richer in the amount of the payment). Because of this oddity, the fictional payment (which is then refunded in the real world) is not treated as having been made until a date that is no earlier than the due date of the tax return for the period when the credit is generated. As a result of this timing requirement, there could be a significant period of time before the tax-exempt entity can claim the direct payment, particularly for facilities placed in service early in the year.

3. <u>Sequestration Protection</u>

The IRA provides a mechanism to prevent direct payments of tax credits from the same reductions due to sequestration that have applied to Build America Bonds and other direct pay bonds. The current sequestration rate is 5.7% and is scheduled to continue through the end of the Federal government's 2030 fiscal year. Specifically, the IRA provides that any direct payment tax credit is automatically increased by 6.0455% and this "gross-up" mechanism will result in 100 percent of the direct pay tax credits being paid. This adjustment is fixed at 6.0455% and as long as the sequestration rate is not changed, the gross-up should protect direct payments of tax credits from being impacted by sequestration.

H. POTENTIAL TAX-EXEMPT FINANCING IMPLICATIONS

A further limitation on the entities eligible to benefit from tax-exempt financing is that the tax credits are reduced if a project is financed by tax-exempt bonds by 15% or, if less than 15% of the project is tax-exempt financed, by the percentage of the project that is financed with tax-exempt bonds. This provision could encourage these tax-exempt entities to consider using taxable bonds or revenues on hand to finance all or nearly all of the cost of projects eligible for tax credits. However, under prior law, the reduction in the tax credit for projects financed with tax-exempt bonds could be up to 50%, which may encourage more of these projects to be done. Although the reduction in the credit sounds simple enough, it can raise some complicated issues, which are beyond the scope of this panel and outline, but are discussed in more detail in NABL's comments submitted to Treasury.[26]

[26] NABL submitted two rounds of comments on this provision and others, available here: https://www.nabl.org/resources/response-to-irs-requests-on-ira-implementation/ (dated Nov. 4, 2022), and here: https://www.nabl.org/resources/suppl-comments-ira-notices/ (Mar. 9, 2023).

I. ADDITIONAL GUIDANCE

There are many open questions at this time as to the implementation of many provisions of the IRA for tax-exempt organizations and while a number of these tax credits have been in effect for some time with respect to other taxpayers, there are rules and procedures that still need to be adopted for tax-exempt organizations to take advantage of these new credit provisions. Treasury and the IRS have been issuing guidance on the IRA since late in 2022 but additional guidance is expected and must continue to be monitored.

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18 – 20, 2023

Ethics – Conflicts, Competence and Confidentiality

Speaker's Outline

1. Introduction
    a. Outsourcing this presentation to artificial intelligence tools
2. AI/LLM Overview
    a. Key terms and concepts
        i. "Artificial Intelligence": the use of technology to mimic human intelligence to perform tasks
        ii. "Machine Learning" use of large data sets to "train" AI on patterns.
        iii. "Generative AI" Artificial intelligence tools that can be used to create content (text, video, graphics, etc.)
        iv. "Large Language Models (LLMs)" – Type of artificial intelligence trained on massive dataset of text and code that is able to generate human-like text, translate languages, write different kinds of creative content, and answer questions.
        v. General purpose generative AI (chatGPT) vs. context specific tools (Harvey)
    b. ChatGPT/Generative AI limitations
        i. "May occasionally generate incorrect information. May occasionally produce harmful instructions or biased content. Limited knowledge of world and events after 2021." - ChatGPT disclaimer
        ii. "ChatGPT is incredibly limit, but good enough at some things to create a misleading impression of greatness. [I]t's a mistake to be relying on it for anything important right now. [I]t's a preview of progress; we have lots of work to do on robustness and truthfulness. - Sam Altman, CEO of Open AI
    c. Cautionary Tales and AI in the Wild
        i. ChatGPT and LLMs hallucinate –
            1. Lawyers in airline suit sanctioned for citing fake cases (hallucinated by ChatGPT) in a filing.
            2. Colorado attorney reprimanded for including fake cases (hallucinated by ChatGPT) in a filing.
        ii. Texas Judge: No ChatGPT in this Court! –
            1. https://techcrunch.com/2023/05/30/no-chatgpt-in-my-court-judge-orders-all-ai-generated-content-must-be-declared-and-checked/
            2. https://www.txnd.uscourts.gov/judge/judge-brantley-starr
                a. "…These platforms are incredibly powerful and have many uses in the law: form divorces, discovery requests, suggested errors in documents, anticipated questions at oral argument. But legal briefing is not one of them. Here's why. These platforms in their current states are prone to hallucinations and bias. On hallucinations, they make stuff up—even quotes and citations.

Another issue is reliability or bias. While attorneys swear an oath to set aside their personal prejudices, biases, and beliefs to faithfully uphold the law and represent their clients, generative artificial intelligence is the product of programming devised by humans who did not have to swear such an oath. As such, these systems hold no allegiance to any client, the rule of law, or the laws and Constitution of the United States (or, as addressed above, the truth) …."

iii. Tech company bans employee use of generative AI tools over confidentiality concerns regarding company data.
iv. Internal, proprietary software code submitted to ChatGPT subsequently incorporated into an unrelated ChatGPT answer.

d. Thomson Reuters survey of attorneys
    i. 15% of respondents – firms issued warnings about generative AI
    ii. 82% said generative AI could be used in legal work
    iii. 50% said generative AI should be used
    iv. Reasons for reluctance to proscribe usage
        1. Accuracy (most cited)
        2. Privacy
        3. Confidentiality of client info
        4. Data security
        5. Bias

3. Competence Rule 1.1 requires lawyers to provide competent representation to clients.
    a. Comment 8 obligates lawyers to be aware of changes affecting the law and law practice, including benefits and risks of relevant technology.
    b. Competent usage of LLM complicated in current iterations of the technology
        i. Information not accurate and complete
        ii. No sourcing of information to assess quality
    c. Rule 1.4 – requires lawyers to reasonably consult with their clients about the means by which the clients' objectives are to be accomplished.
        i. Must Artificial Intelligence be disclosed?
    d. Rule 8.4 – states that conduct involving dishonesty, fraud, or deceit is professional misconduct.
        i. Is using Generative artificial intelligence without disclosure dishonest or deceitful?
    e. Rule 1.5 – requires that lawyers only charge reasonable fees and expenses.
        i. Can time spent using generative AI be billed to a client? If work becomes more efficient, must fees come down?
    f. Rules 5.1 and 5.3 impose supervisory responsibilities on other lawyers. Supervising lawyers would need to carefully monitor any use of generative AI tools to ensure compliance with other rules and overall competence of representation.
4. Confidentiality
    a. Rule 1.6 – requires that lawyers protect information relating to the representation and take steps to prevent unintended disclosure or unauthorized access to that information. Will asking a client-specific question reveal client information?
        i. Entering confidential information into a generative AI platform immediately places that information outside of the firm's secure systems and onto third-party

services where the firm can no longer ensure that appropriate safeguards are in place to protect the information.

ii. Platforms use prompts and other information to further train and improve the systems.

1. Amazon software developers included proprietary Amazon code in a prompt and later discovered that code regurgitated by ChatGPT in other contexts.

b. Generative AI can be used in cyberattacks – enhanced need to safeguard client information and protect systems in light of increasing cyberattacks and use of generative AI to launch increasingly sophisticated attacks.

5. Conflicts
    a. Personal Interest Conflict
    b. Confidential Information Conflict
    c. Rule 1.8(b) Conflict
    d. Duties to former clients
6. Sample AI Policy for law firms may require that attorneys:
    a. Educate themselves on terms of use, benefits, and risk of tools
    b. Scrutinize output for accuracy, reliability, and legal and regulatory compliance
    c. Consider obligations to communicate with clients about use of tools.
    d. Continue to exercise independent professional judgment in representing and providing advice to firm's clients
    e. Prohibit entering client information, confidential firm data, or personally identifiable information into generative AI platforms.
7. AI Products for Lawyers
    a. Harvey AI
    b. CoCounsel (Casetext/Thomson Reuters)
    c. Microsoft 365 Copilot
    d. Spellbook
    e. HighQ
    f. Litera
    g. Contract Express
    h. More every day…
8. Benefits of AI
    a. Efficiency
    b. Effectiveness
    c. Elimination of menial tasks

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18 – 20, 2023

NABL 2023 Workshop - Ethics Panel

Dealing With Stress, Mental Illness, Addictions and Substance Misuse in the Legal Profession

Chair:

Allison Dyer	Holland & Knight LLP, Atlanta, Georgia

Panelists:

Dr. Diana Uchiyama, JD, PsyD, CAADC	Executive Director, Lawyers' Assistance Program, Illinois State Bar
Christine P. Anderson	Director of Probation and Lawyer Deferral Services, Attorney Registration & Disciplinary Commission of the Supreme Court of IL

Panel Description:

This panel will explore mental health and substance misuse issues affecting practicing lawyers. The statistics have become depressingly familiar: attorneys have significantly higher levels of problem drinking, substance abuse, anxiety and depression when compared with the general population and these levels increased significantly during the pandemic and continue to rise. During this presentation we will review the current statistics on these issues, how they may impact your practice, various approaches that law firms have taken to address these issues and attempt to provide practical tips on managing stress. Topics of discussion will include examining the ABA Model Rules of Professional Conduct that may be impacted by these issues and practical tips on managing stress for the individual practitioner.

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I. OVERVIEW OF MENTAL HEALTH STATISTICS IN THE LEGAL PROFESSION

Attorneys should take care of their mental health, as it is arguably their greatest asset. The legal industry should be supporting this effort in every way possible. Yet reports on the latest data conclude that the "situation remains grave."[1] There are many professional and ethical reasons why we, as individuals and an industry, should put more value on our mental health. While we wait for the larger legal culture to change, this outline contains ways you can start your self-care practice, include some things attorneys are already doing that they may not realize actually contribute to better mental health.

As lawyers, while we take our mental capacity seriously, our actions don't typically reflect it. We know we aren't hired for our physical strength or cardiovascular endurance. We are hired by employers and clients for how well we think, communicate, and concentrate on complex matters for long periods of time. Our mental fitness - strength, capacity and endurance - sets us apart. It's our mind that matters.

While mental health awareness may be growing, stigma and existing legal and corporate culture continue to have negative effects on our most precious asset, to the extent that these concerns have made their way into popular culture (for example, the television show *Suits*). Headlines assessing Law.com's and ALM's Intelligence's 2022 Mental Health and Substance Abuse Survey read "Lawyers Mental Health Remains in Crisis"[2] and "Pandemic Anxiety Wanes, but Legal Industry's Mental Health Struggles Persist".[3]

That's not surprising given the data. Per Law.com and ALM's Intelligence 2022 Mental Health and Substance Abuse Survey: "Thirty-five percent of respondents said they personally feel depressed, and two-thirds reported having anxiety. Three-quarters reported that the profession has had a negative effect on their mental health over time. Sixty-four percent reported that their personal relationships have suffered as a result of being a member of the legal profession. Nineteen percent answered yes to the question: "In your professional legal career, have you contemplated suicide?"

A 2020 survey of 3,800 legal professionals conducted by ALM Intelligence and Law.com revealed:

- 74% feel the profession has had a negative impact on their mental health
    - 64% feel they suffer from anxiety
    - 31% feel they are depressed
        - 62% know a colleague who is depressed
    - 18% have contemplated suicide at some point in their careers

- 44% use alcohol to deal with stress
    - 10% feel they have an alcohol issue

[1] Above the Law, Marlow, K., June 17, 2022.
[2] Ibid. https://abovethelaw.com/2022/06/lawyers-mental-health-remains-in-crisis-but-awareness-is-growing/.
[3] Law.com ALM, Smith, M., May 10, 2022.

    - 50% know a colleague with an alcohol problem

- 74% feel their work environment contributes negatively to their well-being
    - 36% use 100% of their vacation time (63% do NOT)
    - 35% do not feel safe discussing their mental health at work

II. EXAMINATION OF THE ABA MODEL RULES OF CONDUCT IMPACTED BY MENTAL HEALTH AND SUBSTANCE MISUSE

A. Rule 1.1: Competence

"A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

B. Rule 5.1 Responsibilities of a Partner or Supervisory Lawyer

"(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if: (1) the lawyers orders or, with knowledge of the specific conduct, ratifies the conduct involved; or (2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or had direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action."

C. Rule 8.3 Reporting Professional Misconduct

"(a) A lawyer who knows that another lawyer has committed a violation of the Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority. . ."

D. Rule 1.16(a)(2): Declining or Terminating Representation

". . . a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if: . . . (2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or . . ."

E. Additional Relevant Rules of Professional Conduct That May Be Impacted by Lawyer Wellness

1. Rule 1.3: Diligence.
2. Rule 1.4: Communications
3. Rule 1.5 Fees
4. Rule 1.6: Confidentiality of Information
5. Rule 4.1: Truthfulness in Statements to Others
6. Rule 5.2: Responsibilities of a Subordinate Lawyer
7. Rule 8.1: Bar Admission and Disciplinary Matters
8. Rule 8.4: Misconduct

F. ABA Formal Ethics Op. 03-429 (June 11, 2003) – Obligations of a Law Firm

In Formal Opinion 03-429 (June 11, 2003), the ABA considered the obligations of a law firm when a member of the firm is or becomes mentally impaired. The measure of the firm's obligations is how well the lawyer and/or the law firm are able to comply with the Model Rules relating to competent representation of the client.

The opinion by its terms deals only with mental impairment, both temporary and permanent. Physical impairment is relevant only if it results in mental impairment. Mental impairment can be caused by Alzheimer's Disease and other age-related mental conditions or by alcoholism or substance abuse. (The Opinion noted that lawyers are prone to substance abuse at a rate at least twice that of the general population.) Some conditions (e.g., Tourette's Syndrome) may cause conduct that is overtly erratic but that does not interfere with the lawyer's ability to render competent representation.

A law firm's main obligation is to take steps to ensure the interests of its clients. Under MR 5.1(a) all partners in a law firm and all lawyers with direct supervisory authority over another lawyer are required to make reasonable efforts to establish policies and procedures that encourage compliance with the Model Rules. "The measures required depend on the firm's size and the nature of its practice."

When a partner or a supervising lawyer is confronted with a lawyer's mental impairment, the first step may be to confront the lawyer and insist upon steps that will assure that the impairment does not prejudice the interests of any client. These steps may include insisting that the lawyer accept assistance, restricting the lawyer from handling certain matters, or preventing the lawyer from dealing directly with clients.

If possible without injury to the client, the mental impairment may be accommodated. For example, a lawyer who is unable to meet deadlines or to work under pressure may be assigned unpressured research. A lawyer who is unable to handle a jury trial or a hostile takeover competently may be competent to draft transaction documents. Depending on the severity of the impairment, the law firm has an obligation to supervise the lawyer's performance. In an appropriate case, this may include preventing the lawyer from rendering legal services to clients of the firm.

If reasonable efforts have been made to institute procedures designed to assure compliance with the Model Rules, neither the partners in the firm nor the lawyer with direct supervisory authority are responsible for the impaired lawyer's violation of the rules unless they knew of the conduct at a time when its consequences could have been avoided or mitigated and failed to take reasonable remedial action.

Firm's Responsibilities to Report Rules Violation

What are the obligations of a law firm or a supervisory lawyer when the mental impairment of a lawyer results in a violation of the Model Rules? Under MR 8.3(a), partners in the firm and supervisory lawyers are required to report violations that raise "a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer."

Before a report is made, judgment must be exercised to determine whether the violation is one that "a self-regulatory profession must vigorously endeavor to prevent." In some instances, the reporting lawyer need report only the violation which has occurred, without disclosing the cause, but in most cases, disclosure of the impairment will be appropriate.

If the mental condition that caused the violation has ended, no report is required. If the lawyer has resolved a psychiatric condition that caused temporary impairment, no report is required. "Similarly, if the firm is able to eliminate the risk of future violations of the duties of competence and diligence under the Model Rules through close supervision of the lawyer's work," no report is required. But the partners and supervising lawyers have an affirmative obligation to report the violation if the lawyer's impairment continues to make them unable to represent clients competently and diligently.

If the matter which manifested the violation is still pending, the law firm must do more than simply remove the impaired lawyer and substitute another lawyer. Under MR 1.4(b)[4], the firm may have an obligation to discuss the change in lawyers with the client in candor. At the same time, the firm should preserve the privacy rights of the impaired lawyer. Even if the matter in which the violation occurred is no longer pending, the firm may have an obligation to mitigate "any adverse consequences of the violation."

What are the continuing obligations of the law firm if the impaired lawyer resigns or is terminated by the firm? Clients of the firm may wish help in deciding whether to shift their representation to the departing (though impaired) lawyer. MR 1.4 requires a lawyer to explain a matter to the extent necessary to permit the client "to make informed decisions regarding the representation." This would require the law firm to advise its existing clients of the lawyer's withdrawal to the extent it deemed the advice reasonably necessary to prevent prejudice to the clients. "In doing so, the firm must be careful to limit any statements made to ones for which there is a reasonable factual foundation."

If a client has already shifted his loyalty to the departing impaired lawyer, the law firm has no obligation to advise the client of the impairment or that it believes the lawyer is unable to handle

[4] Model Rule 1.4(b) requires that "[a] lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

the client's matters competently. But the firm should avoid any act that may be construed as an endorsement of the lawyer's ability to handle matters competently. For example, the law firm should refrain from sending the client a joint letter announcing the lawyer's departure.

The law firm should consider whether it has an obligation to report the departed lawyer's impairment to the disciplinary authorities to prevent his representation of clients. No obligation arises [under MR 8.3(a)] unless the impairment has resulted in a violation of the Model Rules. "Thus, if the firm reasonably believes that it has succeeded in preventing the lawyer's impairment from causing a violation of a duty to the client by applying the necessary support and supervision, there would be no duty to report…" But, subject to the constraints against disclosures protected by MR 1.6[5], partners in the firm may voluntarily report to the authorities their concern that the departing lawyer will not be able to perform competently without adequate supervision and support.

G. Real-Life Example

Board of Professional Responsibility, Wyoming State Bar v. Anderson, 261 P.3d 695 (2011).

> An initial proceeding was instituted in 2006 due to a report that Respondent had appeared in court under the influence of alcohol. Respondent acknowledged that he had an alcohol problem and entered into a diversion contract. In the event of a breach of such contract, Respondent agreed to an immediate six-month suspension.
>
> In 2010, the Respondent was twice convicted of driving under the influence of alcohol. Also in 2010, court staff reported that Respondent was not adequately representing his client in court proceedings. Similar concerns were received by Bar Counsel from clients of Respondent.
>
> **Discipline: Respondent retired from the practice of law and did not contest the formal charge. Respondent agreed to a one-year license suspension.**

H. Forms of Lawyer Discipline and Diversion

Private discipline for lawyers can range from a letter of caution to a private censure. Public discipline can range from a brief suspension to disbarment.

Many states now have diversion programs[6] for impaired attorneys. Diversion usually consists of the respondent attorney agreeing to a set of requirements, such as drug treatment,

[5] Model Rule 1.6(a) states that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b)" of such Model Rule relating to the safety of the client or other people.

[6] From Wikipedia: A diversion program, also known as a pretrial diversion program or pretrial intervention program, in the criminal justice system is a form of pretrial sentencing that helps remedy behavior leading to the arrest. Administered by the judicial or law enforcement systems, they often allow the offender to avoid conviction and include a rehabilitation program to avoid future criminal acts. Availability and the operation of such systems differ in different jurisdictions.

mental health treatment, law practice management education and/or monitoring of the aforementioned concerns. Diversion programs often require that the respondent attorney make an application for diversion. In addition, the attorney must demonstrate some causal connection between the mental health or substance misuse issue and the misconduct in question.

III. LAW FIRM SOLUTIONS TO SUPPORT LAWYER MENTAL HEALTH AND WELLNESS

Corporate legal culture promotes the importance of physical health and prevention much more openly and easily than mental health. It encourages healthy eating, exercise and annual flu shots. But it still has a 911 mentality with regard to mental health. Hotlines and helplines are available for individuals to navigate alone while in crisis. Yet we don't similarly prioritize the prevention of our most valuable asset from illness and injury. As an industry, we aren't convinced yet of how crucial mental health is to creating and sustaining thriving individuals and businesses. In fact, our priorities reflect a culture that treats our minds as expendable and our human capital as replaceable.

Surveys point to a ripple effect of these cultural and generational changes. Clio's *2022 Legal Trends* report found that nearly 1 in 5 lawyers had left their jobs, with better pay and work-life balance cited as the top reasons. The 2022 Thomas Reuters Institute report, *Law Firms Competing for Talent 2022: Will Lawyers Stay or Go?*, suggests junior associates are "more apt to cite things like culture and work-life balance" over compensation when talking about what they like about their firms.

While unconvinced, we can't ignore that even stakeholder and institutional clients have recently become publicly critical of the practices attorneys and clients alike equate with a "competitive edge" and success.[7] Yet, when asked what factors negatively impact attorney's mental well-being, 72% of respondents selected "always on call/can't disconnect," 59% selected "billable hour pressures," 57% pointed to "client demands," and 55% selected "lack of sleep."[8]

We also can't ignore that the world has changed drastically over the last few years. Where smart phones blurred the lines maintaining a work-life balance, the pandemic erased any trace of them. Work and life are now one and imbalance is our new reality. There is no exit strategy from our stressful day because it seemingly never ends. We sleep and wake to its continuation. With no clear boundaries, there is no space for our minds to rest and recharge.

It's important to recognize that attorneys are not just stressed out by work. We are uniquely trained to perpetuate our stress if not careful. From the first day of law school, we are taught to "issue spot," or "identify potential danger." When this skill is utilized professionally, the stress it causes may be contained. But when this skill seeps into every corner of our lives, so does the stress is causes.

[7] LegalDive, Moran, L., June 13, 2022, https://www.legaldive.com/news/USBank-wellbeing-guidelines-outsidecounsel-lawfirms-MorganLewis-communication/625374/.
[8] Above the Law, Marlow, K., June 17, 2022.

Recent historic events have challenged attorneys' ability to contain this skill and their mental health continues to suffer as a result. Events like a global pandemic, social and political unrest and a highly politicized society continue to unfold at an intense clip. We issue-spot every time we look at our phone, turn on the TV or talk to a friend. It is a constant barrage of threats to ourselves, our children, clients, livelihood, personal rights, freedoms, democracy, and the world as we know it. If that felt like more direct objects than one sentence could hold, that was the point.

Constant threats trigger uncomfortable emotions. We feel out of control, frustrated, afraid, anxious, depressed, lonely, angry, even enraged, and a profound sense of loss. While these emotions are a normal human response to these events, we aren't well-equipped or encouraged to recognize and release them. Law school curriculums don't teach us how to issue-spot our own mental health struggles. When left unaddressed, they can intensify. We are taught by example to hide these issues or take care of them ourselves because to seek help would suggest our biggest asset - our source of worth and value - is broken or may be compromised forever. This is perpetuated by a culture that doesn't prioritize mindfulness and help-seeking behaviors.

Worried about a fellow lawyer? According to the American Addiction Centers[9], these five signs may be indicative of substance misuse:

1. Changes in or problems with performance at work.
2. Frequent conflicts with co-workers.
3. Erratic behavior or change from usual behavior.
4. Declining or absent personal hygiene.
5. Using any excuse to incorporate drugs or alcohol into ordinary activities.

The data on partner and associate attrition is a great indicator of what attorneys are now demanding in the workplace. The NALP Foundation for Law Career Research and Education "reports that associate attrition reached an average rate of 26% in 2021, up from 16% in 2020. Nearly half of those departing associates left to take a job at another law firm, a stunning 149% year-over-year increase in the number of associates switching firms."

"This was the highest average rate reported since the update on associate attrition studies began in 2006," said the NALP report. This phenomenon was not limited to associates. "There were a total of 14,534 combined lateral partner and associate moves within the largest 200 firms in the U.S. last year, nearly double the amount in [2020] and a 23% increase since the previous high in 2019…"

What's striking is that of the top ten factors these attorneys said they wanted to see reflected in a firm's culture, having policies that support attorneys' well-being ranked number three. Training and mentoring and diversity where the only factors that ranked above it.[10]

The good news is that Bloomberg Law's most recent Workload & Hours Survey showed the largest jump in hours lawyers spent on self-care since the survey's inception. Female attorneys reported 5.9 hours a week, still lagging behind male attorneys, who reported 7.2 hours. This is still

[9] Addiction in Lawyers: 5 Signs to Look For (americanaddictioncenters.org)
[10] 2022 Law Firm Culture Survey, Major, Lindsey & Africa, published by Law360 Pulse.

just one hour per day or less. With all of the categories that fall under "self-care," this is shockingly low.

The majority of self-care reported was exercise (66%), family time (57%), and outdoor activities (48%), while "attending to my mental health" came in at 14%.[11] This is actually positive news given these activities are some of the best ways to improve and preserve our mental health. But it's clear that attorneys may not be aware that they fall under "attending to my mental health," otherwise that category would have ranked just as high.

The pervasive "always on" and "always available" culture where lawyers feel pressure to be accessible to clients at all times and under all circumstances is also a large source of concern. In order to address these concerns, in 2022 U.S. Bank partnered with seven outside counsel law firms to lay out guidelines setting forth expectations for communication between internal and external counsel, as well as highlight the importance of attorneys maintaining work-life balance.[12] The guidelines specific to communications place a strong emphasis on attorneys being considerate of others when working during off hours. For example, they encourage delaying non-urgent communications until work hours, as well as including expectations for the time when a response is needed. In addition, they also recommend lawyers communicate clearly about when they will be taking time off to avoid unnecessary interruptions. Efforts along those lines could include identifying a backup contact or suggesting other arrangements for any urgent matters that arise. Urgent matters should be the exception and not the rule, according to the guidelines. They also suggest resisting the temptation to "over-deliver" if doing so would sacrifice work-life balance. As for project management, the guidelines convey that the bank will consider alternatives to the traditional billable hour arrangement, where appropriate, to reduce the impact of billable hour demands on lawyer well-being.

Other suggestions to consider for your law firm in order to promote health and wellness of your lawyers:

- Improve the workplace culture with things such as:
    - Increase awareness and conversations about well-being issues
    - Address issues and poor behavior when they arise, don't ignore them

- Provide direct support such as:
    - Resource to therapists, counselors, advisors and/or coaching
    - Provide mentoring and sponsorship programs for new lawyers or lawyers who may be struggling or need some guidance

- Prioritize work/life balance such as:
    - Provide and encourage remote work – thanks to Covid this option is available for many.

[11] Bloomberg Law's Workload and Hours Survey, conducted from July 27, 2022 to August 19, 2022 - https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-lawyer-self-care-is-getting-its-moment-in-the-sun.
[12] LegalDive, Moran, L., June 13, 2022, https://www.legaldive.com/news/USBank-wellbeing-guidelines-outsidecounsel-lawfirms-MorganLewis-communication/625374/.

- Ensure that attorneys have help from other team members to cover their matters so they can actually take time off and rejuvenate on vacation
- Look at workloads to see if they are too heavy/too light and adjust with regular (at least weekly) check-ins (red light, yellow light, green light e-mails from team members regarding workload).

- Supervisory support such as:
  - Increasing feedback from supervising partners and coaching supervising partners on how to provide feedback (such as "compliment sandwich" offering praise as well as constructive feedback)
  - Provide training about well-being issues and resources

- Workplace benefits such as:
  - Look at your firm's vacation policies and improve them if necessary (see above)
  - Does your firm have adequate staffing?
  - Health benefits that cover substance abuse and mental health assistance
  - Back-up childcare support and resources for parents

- Social and physical health benefits and activities such as:
  - Regularly scheduled or recorded wellness programs in house (including on topics such as managing stress and anxiety, finding work-life balance, confidence, and purpose)
  - Affinity groups for different categories of attorneys (attorneys of color, LGBTQ+ attorneys, women attorneys, first generation attorneys, attorneys with disabilities, attorneys of different faiths)
  - Social activities
  - Resources that allow your lawyers to take time for meditation or exercise (subsidized gym memberships, access to gym, access to meditation classes or recorded sessions)
  - Sports and recreational activities outside of the office
  - Community service activities

IV. PRACTICAL TIPS FOR MANAGING STRESS FOR THE INDIVIDUAL PRACTITIONER

Consider the perspective of other professionals who protect their most precious commodity. While still playing soccer professionally, David Beckham insured his legs with Lloyd's of London for $140 million. Mariah Carey insured her vocal chords for $35 million before touring in 2016 and Daniel Craig insured his entire "007" body for $9.5 million before filming "Quantum of Solace."[13]

These professionals know the source of their worth and value. Not only do they take great care of it, they actually put a dollar value on it and insure against its loss. While attorneys and the culture we work in, do the opposite. Much of the industry continues "business as usual" –

[13] https://www.gobankingrates.com/net-worth/celebrities/10-celebrities-insured-body-parts-for-big-money/?utm_campaign=1064210&utm_source=yahoo.com&utm_content=3.

glorifying and rewarding over-working, increasing billable hour requirements, promoting alcohol use, and ignoring the detrimental financial impacts of attrition, burn-out, and malpractice risk. Attorneys are afraid to admit they are struggling to meet unrealistic requirements for fear they will be told they aren't cut out for this profession. Is that what they told David Beckham and Kobe Bryant when they tore their Achilles tendons?

Law school taught us to "argue against yourself" and "think like a lawyer," promoting pessimism and rigidity. Transactional lawyers are taught to identify all possible risks and work to mitigate against those risks in drafting in order to provide their clients excellent service. This style of thinking may be useful in legal practice but can have damaging effects on a lawyer's mental health. "Although research has shown a positive correlation between pessimism and success in law school" or as a lawyer, that does not usually result in a happy, healthy human being.[14] Having a more flexible, positive way of thinking can enormously benefit one's mental health; not all scenarios will result in catastrophe. Below are five science-based steps to combat catastrophizing:[15]

1. Describe the stress-producing event factually.
2. Write down all the worst-case scenario thoughts you're having.
3. Create a best-case scenario (make one up to induce a surge of positive emotion).
4. Analyze the most-likely scenario.
5. Develop a plan to address the most-likely scenario.

Similarly, consider ways to increase your mental resilience, the "ability to overcome negative emotional experiences and difficult life experiences by adapting to the demands of stressful experiences."[16] "Resilience has been shown to positively influence work satisfaction and engagement, as well as overall wellbeing, and can lower depression levels."[17] Depending on others and cultivating a support system can dramatically increase one's resilience. Other perspectives on situations will help turn pessimism to optimism. Begin nurturing relationships with those around you, cultivating a support system of people to turn to in stressful times. Have a daily a "gratitude practice," taking time to name things, experiences or otherwise that you are thankful for.

Dealing with difficult clients has become the norm for many lawyers, which can have an outsize impact on their mental well-being. Compounding a negative interpersonal relationship with time and intellectual demands can lead even the most resilient lawyers into a downward spiral. Below are five tips "to consider if you have a client with whom you find it difficult to communicate or interact:"[18]

1. Prepare for the conversation. Reflect on your position and try to see the client's perspective.

[14] Keeva, Steven. "The Bounce-Back Factor." 89 A.B.A. J. 66 (2003).
[15] Davis-Laack, Paula. "Think This Way and That Way: Developing Mental Resilience." 87-MAR. Wis. Law. 41. March, 2014.
[16] Vandenak, Mary E. "Deliberate Wellness – The Resilient Lawyers." 36 PROB. & PROP. 52 (2022).
[17] Cross, Rob et al. "The Secret to Building Resilience. It's a Team Sport." Published on HBR.org on January 29, 2021.
[18] Browning, Nicole. "Maintaining Resilience in Stressful Situations: Self-Care Techniques and Tips for Dealing with Stressful Clients." 27 TYL 8 (2022).

2. Avoid communications barriers, such as preconceived notions, not listening and engaging in power struggles.
3. Practice active listening and avoid interrupting a client. Feeling "heard" may help defuse the tension in a difficult interaction.
4. De-escalate. Do not respond to anger with anger, instead working to empathize with where a client is coming from and respond in a rational, neutral maner.
5. Be aware of body language.

Here are some other ways to "attend to your mental health" that attorneys are already trained to do:

> *Issue-spotting.* We can use our "issue-spotting" skills on ourselves. This is also known as "mindful awareness." We do it every day as lawyers. We identify red flags, solutions and preventative measures. Doing this on a personal level can be a form of self-care. Bringing awareness to our thoughts and behaviors can help you identify when we've reached a tipping point and need to take a breath, a break, or maybe reach out for support. Try to spot thoughts like "what if" rumination and catastrophizing narratives. If these aren't clear, watch for behaviors that are reactive, impulsive, indulgent and/or not typical. Over-working or drinking, getting triggered, rage, or trouble sleeping are warning signs.
>
> *Vulnerable vocabulary.* There is theory known as "name them to tame them" - speaking of our emotions. We learn an entirely new vocabulary as young lawyers (i.e. et al.). Yet when shame researcher and bestselling author Dr. Brené Brown's data revealed that when over 7,000 people were asked to list emotions they could recognize when they felt it, they came up with only three on average - happy, mad and sad. Naming our emotions while we feel them is an incredibly powerful tool to disarm them. If we familiarize ourselves with a more extensive list of emotions, adopting a more vulnerable vocabulary, we can better identify and express precisely how we are feeling.
>
> *Journaling.* Writing is essential to most lawyers' practice. If we use this skill to give our uncomfortable emotions a voice, we are releasing them in a healthy way rather than pushing them down, numbing them or hiding from them in our work. A popular technique used is known as "rage on the page" where you can express your deepest anger without a filter if you decide before you start to destroy the page when done. The key is start writing before you know what you want to write. This may be counter-intuitive to a lawyer, but essential for letting your emotions speak for themselves.

These and other simple techniques can be discussed, promoted and even rewarded as part of a cultural shift that stops jeopardizing our most precious resource. As individuals, we can prioritize our mental wellness without compromising our career, our relationships or our values. And as an industry, we can prioritize the mental wellness of our human capital without compromising there productivity and our profitability. When we prioritize prevention and promote well-being, we thrive rather than barely survive, increasing productivity and satisfaction. And when we show up for our clients, colleagues and families as our best self, it's not just good for business, it's good for humanity.

A. Resources

- National Task Force on Lawyer Well-Being Report & Recommendation https://lawyerwellbeing.net/

- Well-Being Template for Legal Employers https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/well-being-template-for-legal-employers-final-3-19.pdf

- Well-Being Toolkit for Lawyers & Legal Employers https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/ls_colap_well-being_toolkit_for_lawyers_legal_employers.pdf

- Well-being Toolkit Nutshell: 80 Tips for Lawyer Thriving https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/ls_colap_Well-Being_Toolkit_Flier_Nutshell.pdf

- ABA Well-Being Pledge Campaign https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/ls_colap_working_group_pledge_and_campaign.PDF

- ABA Well-Being Pledge Commitment Form https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/ls_colap_working_group_pledge_commitment_form.pdf

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023
October 18-20, 2023

Ethics: DEI: Making the Paradigm Shift

Chair:

Latasha R. Thomas	**Clark Hill PLC – Chicago, IL**
Richard H. Chapman	**Clark Hill PLC – Chicago, IL**
Steven Washington	**Chapman and Cutler LLP – Chicago, IL**

"I get it… Some of my best friends are…"

ETHICS: Diversity & Implicit Bias: A Discussion of Implicit Bias, Its Effects on the Practice of Law, Including Costs and Practical Solutions for Taking Control: From the early years of our nation, America has been heralded as the great "Melting Pot" of many cultures. Moreover, *"E Pluribus Unum"* ("out of many…one") is one of our most treasured national mottos. Despite that, and notwithstanding our cultural diversity, bias has always been a troubling aspect of American culture. In fact, implicit or unconscious bias is particularly unsettling because many Americans have biases that they are not even aware of. It has been studied and proven that we all have biases that unintentionally affect every aspect of our dealings with others. Is bias an unfortunate and inevitable part of our history and "DNA" as Americans?

In its seventh year, this panel will give practitioners invaluable insight into implicit bias, as well as a forum to explore this timely and sensitive issue. The session will illuminate such biases, discuss the hidden financial disincentives of such biases, and, through "transformative learning," provide strategies for how to take control, to the benefit of your practice, of your professional relationships and your organization. The ABA Model Rule 8.4(g) regarding anti-discrimination will be reviewed, as well as the National Association of Bond Lawyers' Diversity Initiative.

It is highly recommended that participants take <u>any one</u> (or more) of the Implicit Association Tests at (https://implicit.harvard.edu/implicit/takeatest.html) **as a companion to this panel and the associated materials.**

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I. INTRODUCTION

From the early years of our nation, America has been heralded as the great "Melting Pot" of different races, languages, beliefs, and cultures, which have blended into one "American" persona. In fact, this ethos is part of the standard curriculum taught in American elementary schools. Moreover, *"e pluribus unum"* ("out of many…one"), with the ideal of unity arising out of diversity, is a longstanding national motto. Over the years, however, there has been a growing awareness of diversity in American culture, and as a result, the "Melting Pot" paradigm has gradually shifted to a "Salad Bowl" model, which recognizes diversity and sees America is one big amalgamation of unique, distinct cultures.

Notwithstanding our dynamic and multifaceted diversity, bias has always been a problematic aspect of American culture and society. Derived from the French word "bias" which means angle or slant, bias has been firmly entrenched in our history and it has filtered through to every aspect of American life.

In recent years, it has been argued consistently and convincingly that the practice of law is one of the least diverse professions in the United States, and moreover, that lack of diversity is most profound in law firms. Part of this lack of diversity has its roots in the scarred history of the United States and many lingering issues that are beyond the scope of this outline. However, another aspect of this lack of diversity stems from well-intentioned professionals who have implicit biases of which they are unaware and who unwittingly allow those implicit biases to affect personnel decisions and professional relationships.

The National Association of Bond Lawyers ("NABL"), the American Bar Association (the "ABA"), various governmental entities, and various private entities have all adopted rules and have created policies and procedures in an attempt to combat discrimination and unintentional bias, and to promote all types of diversity and inclusion within the practice of law. The main purpose of this outline is to demonstrate that we all have implicit biases and how certain biases can lead to unintentional discrimination. In addition, through "transformative learning" and other methods, this outline will seek to provide lessons on how to abate unintentional discrimination and implicit bias to the benefit of your practice, your professional relationships and your organization. This outline will also review ABA Model Rule 8.4(g), regarding anti-discrimination and NABL's Diversity Initiative.

II. THE ABA MODEL RULES, PARTICULARLY ABA MODEL RULE 8.4(g)[1]

<u>What are the ABA Model Rules and Why Does the ABA Adopt Model Rules?</u>

The Model Rules of Professional Conduct (the "Model Rules") were first promulgated in 1983 by the ABA to address, among other things, criticism concerning the Model Code of Professional Responsibility's focus on litigation.[2]

According to the introduction to the Model Rules, they are:

> . . . rules of reason. They should be interpreted with reference to the purposes of legal representation and of the law itself. . .. The Rules are thus partly obligatory and

> disciplinary and partly constitutive and descriptive in that they define a lawyer's professional role. . .. Comments do not add obligations to the Rules but provide guidance for practicing in compliance with the Rules.[3]

The Model Rules are invoked as governing standards in the context of disciplinary or disqualification proceedings, and not as the basis for a separate cause of action. Comment [20] to the Scope of the Model Rules states that "[n]evertheless, since the Rules do establish standards of conduct by lawyers, a lawyer's violation of a Rule may be evidence of breach of the applicable standard of conduct."[4] Violations of the Model Rules are considered by courts as evidence of standards of care in civil actions based on allegations of malpractice, misrepresentation, and other common law or statutory concepts.[5]

Pre-Model Rule 8.4(g)

Prior to the adoption of the ABA's Model Rule 8.4(g) ("Model Rule 8.4(g)"), anti-harassment and anti-discrimination provisions existed only as Comment [3] to ABA Model Rule 8.4, which read in pertinent part:

> A lawyer who, in the course of representing a client, knowingly manifests by words or conduct, bias or prejudice based upon race, sex, religion, national origin, disability, age, sexual orientation, gender identity, marital status, or socioeconomic status, violates paragraph (d) when such actions are prejudicial to the administration of justice . . . [6]

Proponents of an amendment to Model Rule 8.4 advanced two primary critiques of Comment [3]: that the comment (1) had too narrow a scope; and (2) existed only as guidance regarding enforcement of Model Rule 8.4(d),[7] which only covered "conduct prejudicial to the administration of justice."[8] After years of drafting and negotiations, constituents of the ABA succeeded in amending Model Rule 8.4 to adopt a revised version of Comment [3], which moved the anti-discrimination provision to the black letter of the rule as Model Rule 8.4(g).[9]

History of Adoption of Model Rule 8.4(g)

Based on a widespread concern about the effects of bias, discrimination, and harassment in the practice of law and the justice system, ABA efforts to adopt Model Rule 8.4(g) extend as far back as 1994.[10] The ABA Young Lawyers Division first recommended an amendment that included an anti-bias and anti-discrimination provision, but withdrew it due to opposition from other groups within the ABA.[11] Opponents of the amendment thought the drafts were too broad and too vague to have any legitimate enforceability.[12] That same year, the ABA Standing Committee submitted a similar proposed amendment but withdrew it for similar reasons.[13]

In 1998, the ABA Criminal Justice Section attempted to correct problems in the previous proposed amendments to Model Rule 8.4 by narrowing the scope of the rule and including comments clarifying the terms to which lawyers were to adhere.[14] Again, the proposal was withdrawn before it reached the ABA House of Delegates.[15]

In the same year, the ABA Standing Committee sought to add only a comment (rather than a black letter rule as previous groups had attempted to do) to Model Rule 8.4.[16] The ABA Standing Committee noted the need to consider race, gender, and other factors in the legal process.[17] The ABA Standing Committee also noted the prior controversial and divisive attempts at amendments.[18] Again, this proposal was withdrawn before consideration, but importantly, acted as the precursor to Comment [3] (*supra*).[19]

At the 1998 ABA Annual Meeting, the House of Delegates adopted Comment [3] after debate and a voice vote.[20] Until the adoption of Model Rule 8.4(g), this Comment was the only anti-bias provision in the Model Rules.[21]

After 16 years of existing as a comment to Model Rule 8.4, sponsors within, as well as outside of, the ABA began advocating for the elevation of the comment to a rule.[22] Proposed in 2015, the first version of the amendment expanded the conduct of lawyers to be covered by the rule, added the bases of characteristics on which discrimination was barred, adopted Comment [3]'s "knowingly" qualifier, and eliminated the connection to Model Rule 8.4(d) so that the new rule would stand on its own.[23] This version also modified the previous Comment [3] to Model Rule 8.4 (*supra*) and would eventually become the adopted model rule, but not without subjection to several revisions.[24]

A change in the second version, to cover "conduct related to the practice of law," would eventually be included in the final version.[25] However, at the public hearing, the second version drew criticism for lack of definitions of key terms within the proposal, lack of an applicable knowledge qualifier, and vagueness.[26] The ABA Standing Committee on Professional Discipline also questioned whether there was a need for the change at all.[27]

A third version was drafted in response to the criticisms that the second version received.[28] This version expanded conduct covered to virtually anything a lawyer may encounter while practicing law.[29] Also, it did not attempt to define key terms, but expounded upon the principles of discrimination and harassment and what they included.[30] Significantly, this version added a diversity exception: "Paragraph (g) does not prohibit conduct undertaken to promote diversity," and an advocacy exception: "Paragraph (g) does not prohibit legitimate advocacy that is material and relevant to factual or legal issues or arguments in a representation."[31] Finally, this version added at the end of the rule an exception: "This Rule does not limit the ability of a lawyer to accept, decline, or withdraw from a representation in accordance with Rule 1.16."[32]

A fourth version of the proposal re-introduced the "reasonably should know" standard that exists in the provision today.[33] The addition of this knowledge qualifier proved to be a major factor in finalizing the adoption of Model Rule 8.4(g). This version also expanded the "diversity exception" and "advocacy exceptions" that existed in the third version.[34]

Bargaining over the fourth version yielded yet another version that left much of the previous version intact, but elevated the "legitimate advice or advocacy" exception from a comment to a rule.[35] Further negotiations and bargaining to smooth over any differences among constituencies within the ABA resulted in the new rule being passed on August 8, 2016.[36] The ABA Standing Committee on Ethics and Professional Responsibility noted that many jurisdictions across the United States had already adopted similar language to the Rule 8.4 revision.[37] Moreover, the great

majority of the 598 member ABA House of Delegates approved the amendment, with only a few opposing via voice vote; none spoke in opposition from the floor.[38]

ABA Model Rule 8.4(g)

Important groups within the ABA that led the charge for the adoption of Model Rule 8.4(g) include the ABA Commission on Racial and Ethnic Diversity, the ABA Commission on Sexual Orientation and Gender Identity, the ABA Commission on Disability Rights, and the ABA Commission on Women in the Profession. Until the ABA's recent amendment to the Model Rules, there were no anti-bias, anti-prejudice, or anti-harassment black-letter rules. These groups achieved a substantial victory for the legal profession with Model Rule 8.4(g), which provides that it is professional misconduct for a lawyer to:

> . . . engage in conduct that the lawyer knows or reasonably should know is harassment or discrimination on the basis of race, sex, religion, national origin, ethnicity, age, sexual orientation, gender identity, marital status or socioeconomic status in conduct related to the practice of law.[39]

Importantly, the new rule reaches conduct that a lawyer knows or "reasonably should know" is discrimination.[40] The ABA states that this knowledge requirement acts as a safeguard protecting lawyers from prosecution for conduct they could not have known was discrimination or harassment.[41] This requirement doubly acts as a safeguard against lawyers attempting to evade prosecution for conduct that any reasonable lawyer would and should know was discrimination or harassment.[42] Further, Model Rule 8.4(g) extends to cover any "conduct related to the practice of law" instead of the narrower conduct covered under 8.4(d).[43]

The ABA also included three new comments relating to Model Rule 8.4(g).[44] Comment [3] provides an explanation and examples of what discrimination and harassment include.[45] Comment [4] provides an explanation and examples of what conduct the rule is intended to cover, including representation of clients, managing a law firm, and participating in bar association or social activities "in connection with the practice of law."[46] Finally, Comment [5] provides exceptions that do not constitute a violation of Model Rule 8.4(g), including those for peremptory challenges on a discriminatory basis and limiting one's practice to members of underserved populations.[47]

Adoption of Model Rule 8.4(g) by States

Since its inception, Model Rule 8.4(g) has been met with some controversy regarding adoption by the states.[48] Fourteen states still have neither a rule nor a comment,[49] and thirteen states have adopted only a comment.[50] However, in the seven years since the ABA's formal adoption of Model Rule 8.4(g), 24 states and Washington, D.C. have adopted Model Rule 8.4(g) in some capacity.[51] However, in each of these jurisdictions, Model Rule 8.4(g) exists in varying forms, none of which is as all-encompassing as the pure ABA iteration of Model Rule 8.4(g).[53] For example, no state has adopted Model Rule 8.4(g)'s "legitimate advocacy exception," only a few states include all 11 protected classes and characteristics listed in Model Rule 8.4(g), several states limit rules to

“conduct in the course of representing a client,” and some require the conduct be “prejudicial to the administration of justice,” as explained in Rule 8.4(d).[54]

Challenges to Model Rule 8.4(g)

Thirteen states have declined to adopt the amended Model Rule outright, citing constitutional implications.[55] For example:

- In 2017, the Montana State Legislature passed a joint resolution vehemently condemning the amended Model Rule, stating that it violates the First Amendment and “seeks to destroy the bedrock foundations and traditions of American independent thought, speech, and action.”[56]
- In 2017, Louisiana’s Attorney General also weighed in and rejected the amended Model Rule, stating — among other reasons — that the expansive phrase “conduct related to the practice of law” is “unconstitutionally broad as it prohibits and chills a substantial amount of constitutionally protected speech and conduct.”[58] Subsequent to that pronouncement, the Louisiana State Bar Association Rules of Professional Conduct Committee voted not to proceed with Rule 8.4(g).[59]

Moreover, augmenting the unconstitutionality claims after the ABA’s adoption of Rule 8.4(g), the United States Supreme Court rendered two decisions regarding free speech, wherein the Court held that certain government restrictions on free speech were unconstitutional. In *Matal v. Tam*[60] the Supreme Court held a federal statute unconstitutional *prima facie*, because it allowed the punishment of “disparaging” speech.”[61] Specifically, the *Matal* Court unanimously agreed that a provision of a longstanding federal law allowing government officials to deny trademarks for terms that may “disparage or bring into contempt or disrepute” living or dead persons was unconstitutional, because “[i]t offends a bedrock First Amendment principle: Speech may not be banned on the ground that it expresses ideas that offend.”[62] Additionally, writing for a plurality of the *Matal* Court, Justice Alito noted that “[s]peech that demeans on the basis of race, ethnicity, gender, religion, age, disability, or any other similar ground is hateful; but the proudest boast of our free speech jurisprudence is that we protect the freedom to express ‘the thought that we hate.’”[63]

National Institute of Family and Life Advocates v. Becerra[64] (“NILFA”) dealt specifically with restrictions on legal speech. In *NIFLA*, the Supreme Court held that government restrictions on lawyers’ professional speech are subject to strict scrutiny, because they are content-based restrictions, and “such laws are presumptively unconstitutional and may be justified only if the government proves that they are narrowly tailored to serve compelling state interests.”[65] Further, the *NILFA* Court observed that “[t]his stringent standard reflects the fundamental principle that governments have ‘no power to restrict expression because of its message, its ideas, its subject matter, or its content.’”[66] Moreover, the Court added “[T]his Court has not recognized ‘professional speech’ as a separate category of speech subject to different rules. Speech is not unprotected merely because it is uttered by ‘professionals.’”[67]

Notwithstanding these constitutional challenges, the ABA Commission on Racial and Ethnic Diversity, the ABA Commission on Sexual Orientation and Gender Identity, the ABA Commission on Disability Rights, and the ABA Commission on Women in the Profession, among others, argue that no First Amendment rights are being infringed upon, and that Model Rule 8.4(g)

is intended to give underserved groups a weapon with which to combat unprofessional and unethical conduct that would cast lawyering in a negative light.

Another frequent argument against the adoption of Model Rule 8.4(g) is that gray areas exist in considering what conduct is covered and not covered by Model Rule 8.4(g). For example, South Texas College of Law professor Josh Blackman has argued that the text of Rule 8.4(g) is not specific enough to exclude the harassment or discrimination it seeks to preclude, and instead could make "[a] single 'harassing' comment . . . result in discipline."[68] UCLA School of Law Professor Eugene Volokh raised similar sentiments, pointing to several hypothetical situations wherein attorneys may be at risk for disciplinary action for engaging in social activities where their "'verbal . . . conduct' [may be seen as] 'manifest[ing] bias or prejudice' and thus as 'harmful.'"[69] The crux of this argument is that lawyers may not know what form of conduct could offend another person. Notwithstanding these ambiguity-based attacks, the ABA has countered this argument by noting that Rule 8.4(g) calls for lawyers to *educate themselves* about reasonable standards of acceptable conduct; the rule prohibits conduct "the lawyer knows or reasonably should know is harassment or discrimination."[70] If nothing else, the rule is an invitation for lawyers to consider another person's viewpoint *before* speaking or acting.[71]

Like NABL and its Diversity Committee (the "Diversity Committee") and the NABL Diversity Initiative (the "Diversity Initiative"), the ABA has chosen to confront the issue of diversity and inclusion head on. The ABA has adopted certain goals to guide its actions and desired outcomes. In 1986, the ABA adopted Goal IX as one of such goals. That goal supported "the full and equal participation in the legal profession by minorities, women, persons with disabilities, and persons of differing sexual orientations and gender identities."[72] In 2008, the ABA identified and revised a series of goals to serve its mission as an organization, and Goal IX became Goal III, "to eliminate bias and enhance diversity."[73] According to the ABA, "[i]ts objectives are to promote full and equal participation in the association, our profession, and the justice system by all persons and to eliminate bias in the legal profession and justice system."[74] The ABA established commissions for each of its goals, including the following for Goal III: Commission on Racial and Ethnic Diversity, Commission on Women in the Profession, Commission on Sexual Orientation and Gender Identity, and Commission on Disability Rights.[75] The efforts of these Goal III Commissions ultimately culminated in Model Rule 8.4(g) and its related comments years later.

Similarly, the Diversity Initiative, adopted by the NABL Board of Directors (the "NABL Board") at its March 2017 NABL Board meeting, has the stated purpose, among others, "[t]o encourage and facilitate active long-term participation in NABL by diverse NABL members and to minimize implicit bias within NABL on the basis of gender, gender identity, race, ethnic background, religion, age and sexual orientation."[76] Consequently, in many ways NABL and the ABA are aligned in their goals regarding diversity and inclusion within their respective organizations and the practice of law as a whole.

III. IMPLICIT BIAS: IS IT IN OUR DNA?

What is Implicit Bias?

"We don't see things as they are, we see things as we are" - Anaïs Nin

Baseball, Apple Pie and Bias

Racial bias, stereotyping and discrimination are as old as America itself, and are well documented throughout American history. Moreover, biases may be held by an individual, group, or institution and have been institutionalized in education, the news media and journalism, entertainment, politics, law enforcement, healthcare and other social strata. In recent years, bias has even manifested itself in artificial intelligence and website algorithms for such cyber giants as Google and Amazon. Is bias an unfortunate and inevitable part of our history and DNA as Americans?

What is implicit bias? In short, "implicit bias" is an unconscious attitude or stereotype that affects how people view and interact with other people. The Kirwin Institute for the Study of Race and Ethnicity at The Ohio State University, one of the nation's leading experts/institutions on implicit bias, has created the following comprehensive definition of "implicit bias":

> Also known as implicit social cognition, implicit bias refers to the attitudes or stereotypes that affect our understanding, actions, and decisions in an unconscious manner. These biases, which encompass both favorable and unfavorable assessments, are activated involuntarily and without an individual's awareness or intentional control. Residing deep in the subconscious, these biases are different from known biases that individuals may choose to conceal for the purposes of social and/or political correctness. Rather, implicit biases are not accessible through introspection.
>
> The implicit associations we harbor in our subconscious cause us to have feelings and attitudes about other people based on characteristics such as race, ethnicity, age, and appearance. These associations develop over the course of a lifetime beginning at a very early age through exposure to direct and indirect messages. In addition to early life experiences, the media and news programming are often-cited origins of implicit associations.[77]

Types of Unconscious Cognitive Biases

We all have unconscious biases that can, and often do, interfere with our interactions with others. Unconscious bias can manifest itself in many different ways. Here are some common types of bias that often affect decision-making and interactions at work.

Confirmation Bias

Confirmation bias is a particularly troubling type of unconscious bias that causes people to pay more attention to information that confirms their existing belief system and assumptions, while disregarding that which is contradictory. Of particular relevance to this outline, this type of bias can "skew your evaluations of others' work and potentially disrupt their careers."[78] For example, in 2014, lawyer and sociologist Dr. Arin Reeves released results of a study she conducted to probe whether practicing attorneys make workplace decisions based on confirmation bias.[79] Specifically, this incisive study tested whether attorneys unconsciously believe African Americans produce inferior written work and that Caucasians are better writers. In the study, Reeves created a research memo that contained 22 errors (spelling, grammar, technical writing, factual, and analytical). The memo was distributed to 60 partners working in nearly two dozen law firms who thought they were participating in a "writing analysis study" to help young lawyers with their writing skills. All of the participants were told the memo was written by a (fictitious) third-year associate named Thomas Meyer who graduated from New York University Law School. Half of the participants were told Thomas Meyer was Caucasian and the other half were told Thomas Meyer was African American. The law firm partners participating in the study were asked to give the memo an overall rating from 1 (poorly written) to 5 (extremely well written). They were also asked to edit the memo for any mistakes. The results are truly compelling:

> The results indicated strong confirmation bias on the part of the evaluators. African American Thomas Meyer's memo was given an average overall rating of 3.2 out of 5.0, while the exact same memo garnered an average rating of 4.1 out of 5.0 for Caucasian Thomas Meyer. Incredibly, the evaluators found twice as many spelling and grammatical errors for African American Thomas Meyer (5.8 out of 7.0) compared to Caucasian Thomas Meyer (2.9 out of 7.0). They also found more technical and factual errors and made more critical comments with respect to African American Thomas Meyer's memo. Even more significantly, Dr. Reeves found that the female and racially/ethnically diverse partners who participated in the study *were just as likely* as white male participants to be more rigorous in examining African American Thomas Meyer's memo (and finding more mistakes), while basically giving Caucasian Thomas Meyer a pass.[80]

It is a safe bet that the law firm partners who participated in this study were shocked by the results, especially those who did not view themselves as having any biases. For Kathleen Nalty, a lawyer and leading consultant who specializes in diversity and inclusion, which is the insidious nature of unconscious bias — people are completely unaware of implicit biases they may harbor and how those biases leak into their decision-making and behaviors.[81]

Attribution Bias

Another type of unconscious cognitive bias — attribution bias — causes people to make more favorable assessments of behaviors and circumstances for those in their "in groups" (by giving second chances and the benefit of the doubt) and to judge people in their "out groups" by less favorable group stereotypes.[82]

Availability Bias

Availability bias interferes with good decision-making because it causes people to default to "top of mind" information.[83] So, for instance, if you automatically picture a man when asked to think of a "leader" and a woman when prompted to think of a "support person," you may be more uncomfortable when interacting with a female leader or a man in a support position, particularly at an unconscious level.[84]

Affinity Bias

The adverse effects of many of these cognitive biases can be compounded by affinity bias, which is the tendency to gravitate toward and develop relationships with people who are more like ourselves and share similar interests and backgrounds.[85] According to Attorney Nalty, this leads people to invest more energy and resources in those who are in their affinity group while unintentionally leaving others out.[86] Attorney Nalty further argues that, due to the prevalence of affinity bias, the legal profession can best be described as a "mirror-tocracy"—not a meritocracy.[87] For Nalty, a genuine meritocracy can never exist until individual lawyers and legal organizations come to terms with unconscious biases through training and focused work to interrupt biases.[88]

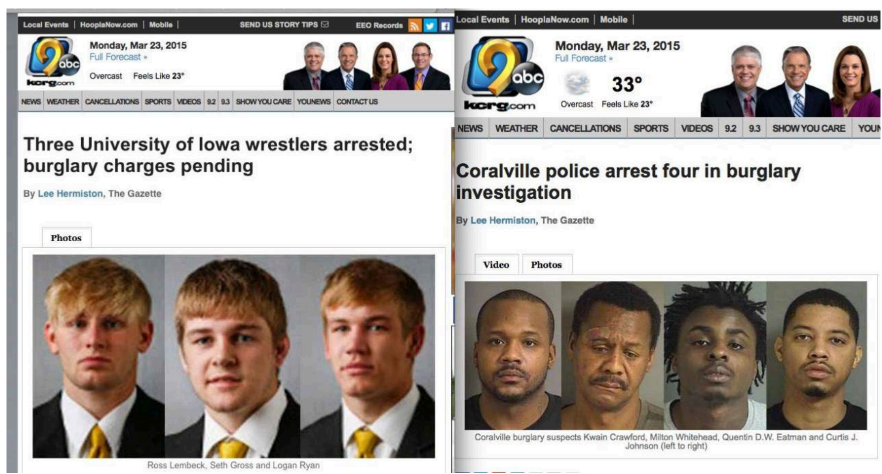
Implicit Bias in the Our Everyday Environment

Human beings certainly are not born with biases and prejudices, but rather, these negative impulses are basically learned behavior from one's environment over time. Typically, biases are picked up from family and friends, but they are also absorbed from negative images of groups and individuals that have been consistently presented to the American public by the news media and entertainment industry, often on a nightly basis.

Race and Ethnicity

The news media is a vitally important American institution that is the very backbone of a free and democratic society. It has also been integral to shaping American public perception and opinion. There are many examples of bias in the news media, some of which follow below. The first is an AP photograph and news report below regarding a young black male walking through flood waters after allegedly "*looting* a grocery store" in the wake of Hurricane Katrina in New Orleans. Looting has obvious negative connotations because it involves a criminal act of stealing or taking something illegally during a crisis. This is in stark contrast to a photograph and news report of a white couple, taken the same day walking through the same flood waters, whose actions were innocently characterized as "*finding* bread and soda from a local grocery store."[89]

In another striking example of unbalanced and biased news reporting along racial lines, the photograph below is a side-by-side comparison of two 2015 crime reports from the same reporter of a local newspaper (The Gazette) in Coralville, Iowa concerning the same alleged crime — burglary — that occurred on the same day.[90]



The story regarding the black suspects, who were arrested in connection with a single burglary, uses mug shots (i.e., photos taken at the time of booking), which are inherently suggestive of criminality, and have long been held by US courts to be highly prejudicial because they create an almost automatic "inference that the person involved has a criminal record, or has at least been in trouble with the police…"[91] Moreover, mug shots typically do not show suspects in their best light, as many appear disheveled and/or despondent under the stress of an arrest. By stark contrast,

the story on the white suspects uses their official school yearbook photographs (with each in a suit and gold tie), and the reporter emphasizes that the white suspects are University of Iowa student-athletes, which taken together with the official school photographs, creates an inference that the white suspects are educated, clean cut and basically "good kids." This inference is drawn despite the fact that these "good kids" were arrested for *seven* burglaries, and one of the suspects fought with police officers at the time of his arrest.[92] Mug shots were taken of all three white suspects, but those pictures were not used in the initial news story, and were used to swap out the original school yearbook photographs in follow up reports *only* after the unbalanced nature of the two crime reports had caused quite a firestorm on social media.[93]

The news media's use of mug shots to depict people of color who are suspected of criminal activity has been pervasive over the years, but it has finally begun to be acknowledged and recognized as part of an overall awakening and recognition of systemic racism following the uproar over the shocking death of George Floyd at the hands of Minneapolis police officers on May 25, 2020. For example, in July of 2020, the San Francisco Police Department ("SFPD") announced that it would no longer release mug shots for use in news reports.[95] SFPD Police Chief William Scott, who is African American, said that SFPD's new policy is based on:

> [c]ompelling research suggesting that the widespread publication of police booking photos in the news and on social media creates an illusory correlation for viewers that fosters racial bias and vastly overstates the propensity of black and brown men to engage in criminal behavior.[96]

SFPD joins a growing movement by newspapers and broadcasters (including GateHouse Media, Gannett, The Orlando Sentinel, The Houston Chronicle, and WRCB-TV in Chattanooga, TN) that have decided to curtail the use of mug shots as well.[97] This is definitely a very positive step, but it could be argued that the many decades of this repetitive practice has already caused damage and has generated significant racial bias that may take generations to undo.

In addition to the unbalanced depictions and descriptions of black and white criminal suspects, it has been found that news coverage has also *over-represented* African American people as perpetrators of criminal activity. As an example, a 2015 Media Matters for America and Color of Change joint study of crime coverage found that in 2014, the four major network affiliate stations in New York City (WABC/7, WNBC/4, Fox/5 and WCBS/2) reported on murder, theft, and assault cases in which black people were suspects at a rate that far outpaced their actual arrest rates for these crimes.

Specifically, the joint study found the following:

> According to [2010-2014] averages of arrest statistics from the New York City Police Department (NYPD), African American suspects were arrested in 54 percent of murders, 55 percent of thefts, and 49 percent of assaults. However, between August 18 and December 31, 2014, the suspects in the four stations' coverage of murders were 74 percent African-American, the suspects in coverage of thefts were 84 percent African-American, and suspects in assaults were 73 percent African-American….For WABC, where the problem was at its worst, 82% of the people they

present as perpetrators of crime are African American, an exaggeration of 31 percentage points.[98]

This is a significant level of distortion. As *The Color of Change News Accuracy Report Card* notes, the exaggerated amount of black faces linked to crime undoubtedly breeds suspicion and hostility toward black people, as does the practice of inaccurately under-representing white people in crime coverage.[99] This in turn substantially intensifies negative stereotypes about black people and significantly contributes to the development of implicit biases against them.

Latinos have been similarly disparaged in the news media. For example, a study found that 66 percent of the time, news coverage between 1995 and 2004 showed Latinos in the context of either crime or immigration rather than in other contexts.[100] According to the Center for American Progress, more recent analysis confirms these findings, and moreover, this treatment of Latinos as criminals and outsiders is especially concerning given that Latinos are otherwise rarely represented in the news media.[101] For example, one of the more recent studies found that between 2008 and 2014, stories focused on Latinos and issues concerning Latino communities composed just 0.78 percent of coverage on national evening network news.[102] To put this in perspective, CBS, NBC, ABC, and CNN dedicated an average of *just 87 seconds* of coverage on Latinos per day — combined — from 2008 to 2014.[103]

In the same way that it over-represents black people in its coverage of crime, the news media's overrepresentation of Latinos as lawbreakers and outsiders is particularly troubling considering the overall lack of coverage of Latinos. In addition, the Center for American Progress argues that, similar to the coverage of black people, coverage of Latinos often "speaks in generalities when the story is unfavorable."[104] Positive coverage, meanwhile, is likely to focus on individuals, which allows positive attributes to be seen as "the exception, not the rule."[105] In comparison, the Center for American Progress notes that coverage of white suspects "rushes to emphasize the humane aspects of the offender," even in instances when the crime is far more horrendous than a crime committed by blacks or Latinos.[106]

When media outlets are so erroneous in this regard, they reinforce a culture in which we see a hostility and distrust for some, and privilege for others.[107] Media-driven biases limit the empathy people feel for African Americans, Latinos and other racial and ethnic groups, and "adversely influence the behavior of employers conducting job interviews, juries and judges evaluating guilt and sentencing, and countless other discriminatory encounters with doctors, teachers, landlords, lawmakers, prosecutors and everyday people on the street."[108] Basically, the effect of these unbalanced portrayals is all-encompassing.

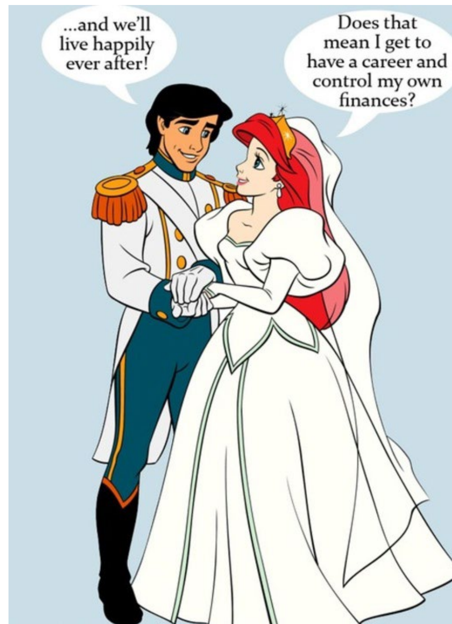
Gender

Women also have been traditional targets of implicit bias, which is present in every facet of American society. Gender bias is one of the most commonly discussed and observed forms of unconscious bias, which is often used to refer to "the preferential treatment men receive — specifically white, heterosexual males."[109] Gender bias is often labeled as "sexism" and describes the prejudice against women solely on the basis of their sex. Gender bias is most prominently visible within professional settings, where female employees must constantly battle the omnipresent "Glass Ceiling," which is a "metaphor for the evident but intangible hierarchical impediment that prevents minorities and women from achieving elevated professional success."[110]

To further illustrate the problem, Built In, a Seattle-based technology company, assembled a number of statistics related to gender bias in the workplace from such prominent sources as the U.S. Equal Employment Opportunity Commission, the Pew Research Center, the International Labour Organization and the Harvard Business Review, among others. The statistics show the following:

- 42% of women report having experienced gender discrimination at work.
- In 2017, 25,000 sex-based discrimination claims were filed and in 2018, victims of sex-based discrimination received more than $148 million in payouts from the complaints.
- 5 of the 14 top barriers women face in the workplace are related to discrimination and gender bias.
- Both men and women are twice as likely to hire a male candidate.
- Women are 79 times more likely to be hired when there are a least two female candidates in the finalist pool.
- Women are 25-46% more likely to be hired with blind applications or auditions.
- Half of men believe women are well-represented at their company, when 90% of senior leaders are men.
- 40% of men and women notice a double standard against female candidates.
- Men view unconscious bias as the number one barrier women face in their careers.
- 34% of men and women believe male executives are better at-risk assessment.
- Men are 30% more likely to obtain managerial roles.
- Women receive pay raises 5% less often.
- Men and women ask for pay raises at the same rate.
- 23% of CEOs are women
- 4% of C-Suite roles are held by women of color.
- 6.6% of CEOs at Fortune 500 companies are women.
- 0.2% of CEOs at Fortune 500 companies are women of color.[111]

There are many societal and historical causes of gender bias. Ironically, one of the main offenders in this category has been one of the most cherished American institutions, the iconic Walt Disney Company ("Disney"). Disney has influenced American culture in more ways than many people realize or acknowledge, and the iconic Disney princess movies (the "Disney Princess Movies") have contained subliminal gender roles and negative female stereotypes* for decades. For example, the renowned "classic" Disney Princess Movies (*Snow White and the Seven Dwarfs, Cinderella* and *Sleeping Beauty*) are three of the most watched Disney productions of all time, and all had three dominant themes based on negative gender roles for women: (1) the heroine was a weak "damsel in distress" character, (2) the worth of the heroine, and in the case of *Snow White*, the main antagonist as well, was based solely on her beauty and appearance ("...mirror, mirror on the wall, who is the fairest one of all…?) and (3) the heroine's fate was completely dependent upon her being rescued by the brave male hero. As one commentator observed, "Disney's depiction of females as young and delicate, wearing gowns, being admired for their beauty and as damsels-in-distress waiting for a heroic knight to rescue them, reinforced society's long-held views of women."[112]



The themes in the classic Disney Princess Movies, which have been watched by millions of American families for generations, have served as a catalyst to reinforce and perpetuate negative gender stereotypes that women cannot be leaders, cannot be assertive, must rely on others for their safety, and can only depend on their physical appearance (beauty and sexuality) — and invariably a man — to "live happily ever-after."

Although the "Disney Renaissance" period (post 1989) has seen Disney playing "catch-up" with more positive female leads and doing away with many of the blatant gender-based stereotypes of the classic era, the important takeaway from this is that Disney actively promoted and reinforced negative gender stereotypes for almost 60 years in the production of its classic Disney Princess Movies, and those stereotypes have gone far beyond that timespan due to the frequency in which they have been viewed by new generations of young male and female viewers over the past 30 years. Moreover, because Disney has been such a significant influencer on American culture for decades through its movies, theme parks and paraphernalia, its use of gender stereotypes has undoubtedly had a significant effect on America's social landscape and by extension, the workplace environment. Notwithstanding the foregoing, Disney is merely one of many generators of implicit gender bias that exists in our society.

Although racial and gender biases are the most documented forms of inequality in American history, it is important to recognize that biases, explicit and implicit, are not limited to race, ethnicity and gender. Indeed, such biases exist toward social groups based on sexual orientation, gender identity, age, physical abilities, religion, weight, and many other characteristics.

Implicit vs. Explicit

To understand implicit bias, it is essential to distinguish it from explicit bias, which is essentially a prejudice known to the believer that generally judges one group of people to be superior

to another. In many cases relevant to the practice of law, explicit bias is both against the law and contrary to professional ethics rules (see discussion of Model Rule 8.4(g) above). In the United States, many of the laws and policies forbidding explicit bias have to do with righting subjugation of minorities throughout the history of both the United States and other countries. While explicit bias is abhorrent and typically violative of laws and a host of policies and procedures, implicit bias is treated differently, and for good reason.

The National Center for State Courts articulately explains that implicit bias results from subtle cognitive processes that often operate at a level below conscious awareness and without intentional control.[113] Most researchers agree that we all have implicit biases.[114] However, as suggested in the title "implicit," unless people make a conscientious choice to explore their implicit biases, they tend to operate without actual knowledge that implicit bias is unintentionally affecting their dealings with others. The following paragraph from a May 2017 article in *The Atlantic*, backed up by scientific references, is particularly illuminating:

> In fact, studies demonstrate bias across nearly every field and for nearly every group of people. If you're Latino, you'll get less pain medication than a white patient. If you're an elderly woman, you'll receive fewer life-saving interventions than an elderly man. If you are a man being evaluated for a job as a lab manager, you will be given more mentorship, judged as more capable, and offered a higher starting salary than if you were a woman. If you are an obese child, your teacher is more likely to assume you're less intelligent than if you were slim. If you are a black student, you are more likely to be punished than a white student behaving the same way.[115]

<u>The Implicit Association Test ("IAT")</u>

Scientists have long known that it is difficult to identify implicit bias through reporting. There are two primary reasons for this. First, the reporting person may not be aware of the bias. Second, even if the reporting person is aware of the bias, the reporting person may be too embarrassed to disclose it. One of the latest tools used in the identification of implicit bias is the Implicit Association Test ("IAT"). The IAT is an online test housed on a Harvard University domain and run by a non-profit entity called Project Implicit.[116] According to Project Implicit, the IAT measures attitudes and beliefs that people are either unwilling or unable to report. To do so, the IAT measures strength of associations between concepts (e.g. race or sexual orientation) and evaluations (e.g. good or bad) or stereotypes (e.g. athletic or smart). In simple terms, the idea of the IAT is to get the person taking the test to move through the test as quickly as possible before that person's brain has the ability to make a politically correct response as opposed to following his or her underlying instinct. Project Implicit describes the process more specifically, as follows:

> When doing an IAT you are asked to quickly sort words into categories that are on the left- and right-hand side of the computer screen by pressing the "e" key if the word belongs to the category on the left and the "i" key if the word belongs to the category on the right. The IAT has five main parts.

> In the first part of the IAT you sort words relating to the concepts (e.g., fat people, thin people) into categories. So, if the category "Fat People" was on the left, and a picture of a heavy person appeared on the screen, you would press the "e" key.
>
> In the second part of the IAT you sort words relating to the evaluation (e.g., good, bad). So, if the category "good" was on the left, and a pleasant word appeared on the screen, you would press the "e" key.
>
> In the third part of the IAT, the categories are combined, and you are asked to sort both concept and evaluation words. So, the categories on the left-hand side would be Fat People/Good and the categories on the right-hand side would be Thin People/Bad. It is important to note that the order in which the blocks are presented varies across participants. So, some people will do the Fat People/Good, Thin People/Bad part first and other people will do the Fat People/Bad, Thin People/Good part first.
>
> In the fourth part of the IAT, the placement of the concept switches. If the category "Fat People" was previously on the left, now it would be on the right. Importantly, the number of trials in this part of the IAT is increased in order to minimize the effects of practice.
>
> In the final part of the IAT, the categories are combined in a way that is opposite what they were before. If the category on the left was previously Fat People/Good, it would now be Fat People/Bad.
>
> The IAT score is based on how long it takes a person, on average, to sort the words in the third part of the IAT versus the fifth part of the IAT. [Project Implicit] would say that one has an implicit preference for thin people relative to fat people if they are faster to categorize words when Thin People and Good share a response key and Fat People and Bad share a response key, relative to the reverse.[117]

Project Implicit reports that millions of people have taken the IAT since its inception and researchers agree that no other measure of implicit bias has been more influential in the conversation about implicit bias than the IAT. Part of this lies in the ability to pull such statistics; for example, seventy percent of people who take the race version of the IAT have a moderate preference for white faces over black faces.[118] As a result of this ability, the IAT has been cited in thousands of peer review papers regarding implicit bias and countless more presentations (like this one). In a legal context the IAT has been used, among other purposes, to provide more context to determinations by statisticians that prove judges and juries still value some lives over others. For example, judges and juries tend to incarcerate those who kill whites longer than those who kill blacks, those who kill women longer than those who kill men and those who kill old victims longer than those who kill young victims.[119]

However, despite its champions, the IAT is not without detractors. One of the most frequent and biting criticisms of the IAT is that a test taker's score on the very same test (e.g. gay versus straight) can vary significantly depending upon when the test is taken. For example, in January 2017, the *National Review* published an article directly challenging the IAT's results and

relevance.[120] Among other things, the author suggested that the IAT is "a Ouija board of the mind conjuring up the ghosts of our own bigotry . . .."[121] Project Implicit acknowledges this problem on its website and responds that:

> Although the IAT is a well-validated measure of implicit attitudes, no test is perfectly accurate, and some variation is to be expected. We encourage you to take a test more than once. If you get similar feedback more than once, you can be more certain about the accuracy of your results. If you get somewhat dissimilar feedback two times you can simply average the results. It is somewhat unusual for someone to get very different feedback but, if you do, you can think of your test results as being inconclusive.[122]

Nevertheless, Project Implicit' s response, provided in many different forms over the years, has been insufficient to quiet a very vocal minority of scholars who argue that it is a poor method for judging implicit bias. Recently, this resulted in an article in *The Chronicle of Higher Education* entitled "Can We Really Measure Implicit Bias? Maybe Not."[123]

The article in *The Chronicle of Higher Education* was spurred by a paper from researchers who examined nearly five hundred case studies over twenty years involving over 80,000 people who had used the IAT and similar other tests. The researchers concluded that there is little correlation between implicit bias and discriminatory behavior, and that there is very little evidence to support the conclusion that changes in implicit bias will change one's behavior. Interestingly, based upon the data available, Project Implicit agrees with the researchers that the statistical effect linking bias to behavior is slight. They only disagree about how slight. A minority of researchers see the connection to be so trivial that it is irrelevant. However, proponents of the IAT argue that "statistically small effects" can still have "societally large effects."[124]

Irrespective of the scientific value of the IAT, in light of Model Rule 8.4(g), the NABL Diversity Initiative and the lack of diversity in the legal profession, those seeking to adhere to Model Rule 8.4(g) and to advance the goals of the NABL Diversity Initiative are encouraged to take the IAT as one of many tools toward that end. At a minimum, the IAT is still a means to begin an open and honest dialogue regarding the root causes of a lack of diversity in our society and the legal profession.

Implicit Bias and its Application to the Practice of Law

In 2020, workplaces across the world reassessed their traditional operating procedures, following the COVID-19 pandemic, the violent murders of George Floyd and Breonna Taylor by police, and the sharp rise in violent hate crimes against Asians. But law firms have not made noticeable changes in advancing diversity, equity and inclusion (DEI) strategies.[125] In her 2015 *Washington Post* article entitled "The law is the least diverse profession in the nation. And lawyers are not doing enough to change that," Stanford University Law Professor Deborah L. Rhode makes a very convincing argument regarding the legal profession's diversity woes.[126] In considering Professor Rhode's conclusions, consider 2021 statistics from The Bureau of Labor, 87.8% of lawyers are white, while other professions do a bit better (i.e. 76.5% of architects and engineers are white, and 76.1% of accountants are white).[127] Professor Rhode goes on to point out that:

> Women constitute more than a third of the profession, but only about a fifth of law firm partners, general counsels of Fortune 500 corporations and law school deans. The situation is bleakest at the highest levels. Women account for only 17 percent of equity partners, and only seven of the nation's 100 largest firms have a woman as chairman or managing partner. Women are less likely to make partner even controlling for other factors, including law school grades and time spent out of the workforce or on part-time schedules. Studies find that men are two to five times more likely to make partner than women.
>
> Although blacks, Latinos, Asian Americans and Native Americans now constitute about a third of the population and a fifth of law school graduates, they make up fewer than 7 percent of law firm partners and 9 percent of general counsels of large corporations. In major law firms, only 3 percent of associates and less than 2 percent of partners are African Americans.[128]

As an aside, please note the use of "chairman" above in the quotation from Professor Rhode's article. Even experts on diversity and inclusion have implicit biases. Although Professor Rhode's statistics are from 2015, as further discussed below, those numbers have barely changed in the seven years since the publication of her article.

Professor Rhode is not alone in her concerns regarding the lack of diversity within the legal profession. Dr. Arin N. Reeves views implicit gender bias in the legal profession in what he has coined the: "Two Leaks."[129] Dr. Reeves points out that, in 2016, women were 60% of college graduates, 45% of law school graduates and 40% of business school graduates. Initially, that resulted in women being 45% of junior law firm associates and 47% of junior attorneys in corporate legal departments. That was prior to what Dr. Reeves describes as the "1st Leak: Work Life Balance." After the first leak, there was a significant drop in the presence of women to 30% - 35% of senior lawyers. Then comes the "2nd Leak: Implicit Bias." After that, women were only 10% - 20% of partners, general counsel and senior (C-Suite) executives. Dr. Reeves and Professor Rhode appear to be in agreement on this phenomenon, including the 2nd Leak's effects on other historically underrepresented groups.

The issues identified by Professor Rhode and Dr. Reeves, among others, are significant. They also show that the practice of law tends to become less diverse at the more senior and more

highly compensated levels. This is due in large part to attrition in law firms, which is evidenced by the most recent available statistics. The National Association for Law Placement ("NALP"), a national association of over 2,500 legal career professionals, has conducted extensive research on the lack of diversity and the issue of attrition in U.S. law firms.[130]

Partnership

Law firm partners sit at the top of any firm's hierarchy as they share in the ownership and management of the firm, and make determinations on personnel, compensation and firm policies. It is at this level that the lack of diversity is most profound. NALP reported in its *2022 Report on Diversity in U.S. Law Firms* (the "2022 NALP Report") the following:

All Partners [131]			Partners by Race or Ethnicity					
			Asian		Black or African American		Latinx	
Total #	% People of Color*	% Women of Color*	Total %	% Women	Total %	% Women	Total %	% Women
42,061	11.40%	4.39%	4.57%	1.85%	2.32%	0.94%	2.97%	0.97%

Associates

In terms of associates, the 2022 NALP Report found the following:

All Associates [132]			Associates by Race or Ethnicity					
			Asian		Black or African American		Latinx	
Total #	% People of Color*	% Women of Color*	Total %	% Women	Total %	% Women	Total %	% Women
42,697	28.32%	16.51%	12.12%	7.29%	5.77%	3.45%	6.55%	3.57%

Summer Associates [133]			
Total #	% Women	% People of Color*	% Women of Color*
7,011	55.11%	43.03%	26.10%

	Lawyers with Disabilities [134]		LGBTQ Lawyers [135]	
	# Reported	% of Total	# Reported	% of Total
All Lawyers	996	1.41%	4,006	4.17%
Partners	330	1.08	999	2.46
Associates	492	1.63	2,549	6.14
Summer Associates	114	2.43	616	9.37
Other Lawyers+	174	1.79	458	3.27

*Refers to race/ethnicity and includes Asian, Black or African American, LatinX, Native American or Alaska Native, Native Hawaiian or other Pacific Islander, and multiracial lawyers.

+Data for counsel and non-traditional attorneys combined

The statistics noted above show a continuing trend where diverse attorneys - particularly women and people of color - are best represented among the lower-tier summer associates, and somewhat well-represented among associates, but then leave the lawyer ranks each year thereafter at a higher rate than white males, culminating in dramatic underrepresentation among equity partners, with just 12.6% equity partners being women and only 5.1% of equity partners being people of color.[136]
Moreover, the 2022 NALP Report also found that there have been only modest gains made in the area of law firm diversity over the past ten years. James G. Leipold, NALP Executive Director, remained positive and noted that law firms are in a unique position to help their firms make real change to ensure true inclusiveness. Leipold stated "[T]here is much that should give the industry pause and continue to challenge all of us to do better, but on balance I'm going to take an uncharacteristically upbeat approach in describing the most important findings that I see in this year's data analyses. Chief among those findings are the gains made at the summer associate level in the representation of women, summer associates of color, and LGBTQ summer associates…Many are the challenges that remain. In 2020 NALP called on its members and the legal profession as a whole to address more directly and more forcefully the many ways that the profession has failed Black lawyers and the Black community. Although the percentages of Black partners, associates, and lawyers overall increased in 2021, the representation of Black lawyers in law firms still trails that of Asian and Latinx lawyers and those gaps have widened over time. The share of associates who are Latinx women surpassed the percentage of Black women associates for the first time in 2021, and the rate of growth in the share of Black associates' overall lags behind that of Latinx and Asian associates."[137]

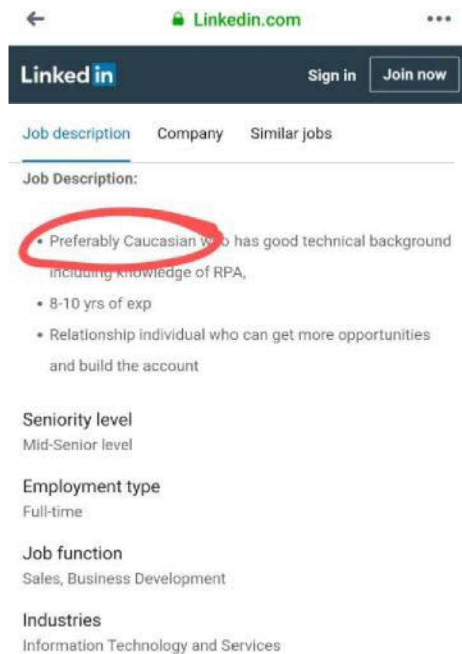
This is the current and traditional legal landscape. The numbers are stark and, in the context of law already being one of the least diverse professions in the United States, this is a serious problem. In this context, every single historically underrepresented lawyer lost is significant.

<u>Effects in the Management of Firms</u>

The effect of bias on hiring decisions has been studied and accepted by most researchers for many years. The following paragraph from Kathleen Nalty's *"Strategies for Confronting Unconscious Bias"* sums up the effect certain names have on hiring decisions:

> If you are named John, you will have a significant advantage over Jennifer when applying for a position, even if you both have the exact same credentials. If your name is Jose, you will get more callbacks if you change your name to Joe. And if you're named Emily or Greg, you will receive 50% more callbacks for job interviews than equally qualified applicants named Lakeisha or Jamal.[138]

There are other sources indicating bias in the workplace. One recent example is the LinkedIn job posting below from late April 2019:



To its credit, Cynet Systems, the recruiting firm responsible for posting the job advertisement, apologized for "the anger & frustration caused by the offensive job post" and wrote that the responsible employees were terminated.[139] Whether the actions of those responsible employees were the result of implicit bias or something else is unknown, but the bias is clear, nonetheless. In another 2019 example, two members of a city council in Georgia reported to the city attorney that the city's mayor rejected an African-American city manager applicant because the city had a minute black population and she didn't believe the city was "ready for" a black city manager.[140] These recent examples may support prior research in this area.

Many agree that the lack of diversity in the practice of law is attributable to hidden barriers that disproportionately impact and disrupt the career paths of historically underrepresented lawyers. Sometimes these barriers are known to senior and supervising lawyers, while other times they are the result of unconscious bias. These biases typically lead to disproportionally less access to critical components for success, such as: (a) networking opportunities; (b) insider information; (c) decision-makers; (d) mentors and sponsors; (e) meaningful work assignments; (f) candid and frequent feedback; (g) social integration; (h) training and development; (i) client contact; and (j) promotions. [141] Moreover, the double-whammy of a lack of diversity in the practice of law is that applicants and people in a position to hire them are less likely to have direct social or familial connections. This too has the effect of placing diverse candidates at a hiring disadvantage. In addition, even when hired, there is a host of data to show that diverse candidates, particularly women, tend to earn less than their counterparts for doing the same jobs and are less likely to be invited to join management. It is with that backdrop that DEI is addressed with more interest in the practice of law and in other professions.

The Costs to Law Firms of Unintentional Discrimination & Implicit Bias

It is well established that law firm attrition is costly to law firms.[142] Some estimate the costs to be as high as a collective $9.1 billion each year for the 400 largest law firms in the U.S.[143] Some of those costs include training costs and financial incentives that may never be recouped as well as the loss of profitable client relationships. In addition, there are other less obvious costs. New generations of lawyers are coming online with more exposure to diversity and a greater appreciation of its benefits. Studies have shown that these new lawyers, particularly "millennials," are focused as much, or more, on firm "culture" than anything else.[144] A lack of diversity could result in a lack of an ability to hire the best new candidates, which will ultimately adversely affect succession planning and client retention. Also, the United States Census Bureau has confirmed that the United States is becoming more ethnically diverse.[145] Consequently, clients will likely become more diverse over time as well. Law firms who hire and retain racially and ethnically diverse lawyers will be at an advantage as they will be able to draw from the cultural experiences of those lawyers as well as train and promote those lawyers; they will be ready to be the direct client contacts for clients who will no doubt demand diversity within the law firms that they hire.

Client-driven diversity initiatives are already a reality. Given the public nature of our law practice, many NABL members primarily represent governmental entities. For years, many of those governmental entities have had diversity and inclusion policies that require bond counsel and disclosure counsel to demonstrate a diverse workforce or to partner with a diverse law firm.[146] At the same time, in many cases the client decision makers have become more diverse and are increasingly aware of a lack of diversity within their public finance law firm or firms. There have been many cases where failure of a qualified law firm to identify a minority law firm with which to partner has caused the loss of a client and a profitable relationship.[147] The same holds true for qualified law firms who do not have diverse attorneys with significant responsibilities on their proposed legal team. Moreover, clients are not immune to implicit bias themselves and can be affected by an unintentional desire to have a direct relationship with a lawyer who is from the same diverse background.[148] This would fall under affinity bias and is analogous to the phenomenon explained by Dr. Beverly Tatum in her famous text *"Why Are All the Black Kids Sitting Together in the Cafeteria?"*[149] In current planning and succession planning, it is recommended that law firms consider this in their hiring decisions.

Further, in addition to governmental clients, many large, private entities are stepping up their demands on their outside counsel to be more diverse and requiring training regarding the same. For example, in April 2017, MetLife held a seminar for its outside counsel titled *"Creating a Diverse Leadership Pipeline Workshop – Ideas and Initiatives That Work."* Topics for discussion included, among others: (a) specific ways law firms can hold partners accountable for the retention and promotion of diverse talent; (b) specific ways in-house legal departments can hold senior leadership of their outside counsel accountable for retention and promotion of diverse talent; (c) financial incentives and other tools available to drive accountability; and (d) the role non-diverse men must play in successfully retaining and promoting diverse talent. Also, in 2017, through Kim Rivera, its Chief Legal Officer and General Counsel, Hewlett Packard ("HP") advised its outside counsel that the company would be withholding invoiced fees from law firms that do not meet or exceed HP's minimum diverse staffing requirements.[150] In pertinent part, Ms. Rivera wrote about HP, "[w]e

have invested in diversity at all levels, and I expect no less from our outside law firm partners. I believe we can all do better."[151]

Other large companies like Microsoft Corp., Wal-Mart Stores Inc., Allstate Corp., GlaxoSmithKline, PayPal Inc., Google Inc., Viacom Inc., McDonald's, Eli Lilly and Co., MasterCard and Abercrombie & Fitch Co. are also stepping up their initiatives to require their outside counsel be more diverse. Additionally, the Wall Street Journal's analysis of companies in the S&P 500 concluded that "Diverse and inclusive cultures are providing companies with a competitive edge over their peers".[152]

Actual Examples of Encounters with Implicit Bias Experienced by Diverse Lawyers

The following are actual examples of situations where diverse lawyers have encountered implicit bias in the practice of law. Specifics have been omitted to protect confidentiality. For purposes of this exercise and outline, put yourself in the shoes of the diverse lawyer. In addition, while doing so, try to imagine a time when you have been a minority in a meeting, dinner or setting. This is the backdrop behind which all of these incidents occurred.

1. The City Council Meeting. In this situation, an African American bond partner appeared at a small-town council meeting in lieu of his law partner who had a conflict. During the discussion of the approval of a tax-exempt forward delivery bank loan, but following the conclusion of public comment, the Mayor of the Town began to suggest modifying the terms of the loan, which had been previously agreed to pursuant to an executed and delivered forward delivery agreement. In connection with his duty to ensure the client did not modify the loan in a manner that would result in adverse consequences, the covering lawyer, in a gray business suit, approached the podium and asked to be heard. He was met by the Mayor's response, "[s]on, the time for public comment has closed." For many African American men in, being referred to as "son" by a white man with whom the African-American man does not have a close personal relationship is offensive. This has to do with the use of terms such as "boy" and "son" during the U.S. slave trade, the Civil Rights Movement and elsewhere in U.S. history as a manner of belittling and subjugating African American men. Why do you think the Mayor assumed the bond partner was not approaching the podium to speak on the bond issue as bond counsel?

2. The Closing. This is an all too common situation. Multiple racially/ethnically diverse bond lawyers and female bond lawyers have experienced arriving at a closing only to be told to sit and wait. Ultimately, when the time for commencement of the closing either drew near or expired, the bond lawyer would go back to whoever originally seated him or her and request to meet with the relevant governmental signatories. The bond lawyer would then be met with the response that such signatories were busy in a bond closing. In each case, the host would appear shocked that the female or racially/ethnically diverse lawyer was in fact leading the bond closing. Why do you think the person greeting the bond lawyer automatically assumed the bond lawyer was not there for the bond closing?

3. The Partner Meeting. In a partner meeting at a local office of a large, global firm, an older white male senior partner was sitting next to a younger male partner, who is of color and identifies as LGBTQIA+. Following the partner meeting, the older partner said to the younger

partner “you know, I didn’t know they were now allowing *paralegals* to attend these partner meetings.” As incredulous as this may sound, it did in fact happen…in New York City…in 2018!

4. Baby on Board. This is a story of bias and success, typically told by a bond partner who has had one or more children and has still excelled in the practice of law. Almost universally, it revolves around a female lawyer advising her managing partner that she is pregnant, but that she would like to remain at the law firm and take a brief maternity leave, work remotely until the child is ready for daycare or do some combination of both. In these cases, the female lawyer’s pregnancy and request are ultimately met with a loss of projects at the firm and other career stunting events. That results in the lawyer leaving the law firm and ultimately, but not always immediately, finding a new law firm that is supportive of the flexibility often required of new motherhood. How does this phenomenon relate to the disparity between men and women in the highest level of law firm leadership? Could it be both a cause and an effect?

5. The Drink. With the near parity of female and male law school graduates, many law firms and lawyers are admirably hiring young female lawyers as first year associates. Unfortunately, this can result in a common unintentional bias. In this situation, the older male senior partner regularly meets other older male clients for happy hour without inviting the female associate or discussing with her why she is not invited. This continues even after the female associate and the client know each other well through business interactions. Typically, the younger female associate is uncomfortable asking why she has not been included in the happy hours, but her expectation is that it has to do with her age and gender. Are there better, more direct, ways to handle this problem?

6. The Club. This story is less about the practice of law and more about implicit bias in general. In this case, an African American male attorney arrived at his business club for a client lunch prior to the rest of the party arriving. While collecting his thoughts for the lunch meeting, he was met by a request from a female member of the social club for her check. When questioned, the woman responded that she thought he was a club employee. Employees of the social club are primarily African American men but they dress in black uniforms with name tags, not business suits like the bond lawyer was wearing. Why do you think the female club member assumed the attorney was a member of the wait staff rather than a member of the social club?

Ways to Interrupt the Effects of Implicit Bias, Generally

Vernã Myers, a renowned diversity and inclusion speaker, has famously summed up in one sentence what many diversity and inclusion experts have been trying to say for years: “diversity is being invited to the party; inclusion is being asked to dance.” While there is an ongoing debate regarding the degree of effect, most scientists agree that bias can predict behavior.[153] However, according to Project Implicit, there is not yet enough research to say for certain whether or not implicit bias can be reduced, let alone eliminated, or whether implicit bias reduction will ultimately lead to behavioral change.[154] Project Implicit goes on to encourage people not to focus on strategies for reducing implicit preferences, but to focus instead on strategies that deny implicit biases the chance to operate. Despite a dearth of research to determine whether implicit bias can be eliminated entirely and whether that would ultimately change behavior, there are still many good reasons to attempt to eliminate one’s implicit bias. For example, following a 2018 incident in which two black men were arrested for merely sitting in a downtown Philadelphia Starbucks, the City of

Philadelphia's former Police Commissioner Richard Ross addressed implicit bias head on, explaining:

> But when they're busy doing their job, they're distracted. The biases are still going to be operative and influence them unless you change the practices and the policies.
>
> The bottom line is we don't know how to change the biases in a meaningful, lasting way, because they're...the way we think normally, and they're based on years of exposure. So, in the absence of being able to change them, we need to change the way people make decisions and the way that they act.[155]

For bond lawyers, two good reasons to employ strategies that prevent the chance for implicit biases to operate are Model Rule 8.4(g) and NABL's Diversity Initiative.

General Approaches to Address Implicit Bias

The following are some approaches one might use to interrupt the effects of implicit bias and perhaps, ultimately, eliminate all or a portion of it:

1. Blind Evaluations: As discussed in this outline, even the appearance of diversity in a candidate's application can result in a negative evaluation of that application. One way to eliminate the opportunity for implicit bias or unintentional discrimination to affect the outcome of an evaluation is to scrub the hiring process of all personal details that might reveal a candidate's diverse nature.

2. Education, Awareness & Mindfulness: Even if being aware of implicit bias and unintentional discrimination only has a slight effect on ultimate behavior, education and awareness on the topic for people who have decision making authority can have a significant effect for both small and large law firms. For a large law firm, this could mean a few handfuls of diverse lawyers who are hired or retained; for a small law firm it could mean one or two. Ultimately, for both, it could also influence the ultimate survival of their law firms through recruitment and client retention.

3. Exposure: Purposefully exposing oneself to people of different backgrounds can have the effect of providing additional information about diverse people that can help to counter implicit bias, unintentional discrimination and stereotypes. Using this exposure to consider differing views can also create transformative learning opportunities.

4. Making a List of Evaluation Characteristics First: This approach might be used in tandem with blind evaluations. The creation of a list, in conjunction with other strategies, could have the effect of leveling the playing field in evaluations.

5. Focus on Results, Not Style or Processes: Law is a nuanced profession and sometimes the manner in which counsel is delivered is just as important as the substantive counsel that is being delivered. Managing lawyers should be mindful that diverse lawyers may have a different style from them, but that style is not *automatically* incorrect. In fact, the diverse lawyer's style might be more appealing to a client than the managing lawyer's style. This might also result in a better connection between the firm and the client.

6. Create an Environment that Encourages Candid Disclosure of Diversity: Even when it cannot be hidden (e.g. race), some lawyers feel uncomfortable openly disclosing or discussing their diverse nature. Creating a safe environment for disclosure of diversity may boost morale and create opportunities for others within a law firm or company to have a transformative learning experience through their interaction with openly diverse attorneys.

7. Alter Feedback/Guidance/Mentoring Delivery Methods to Adjust for Your Biases: Once you identify your biases, you can alter your own feedback, guidance and mentoring delivery methods to adjust for them. For example, if you have a moderate bias for men over women or you grew up with women being homemakers more so than working professionals, you can take that information into account in preparing for feedback and mentoring situations.

8. Promote Diversity: For decades people have been attempting to address the lack of diversity in the legal profession and there is much work still to be done. Having a passive approach to diversity is unlikely to aid in the goal of increasing diversity and inclusion. Instead, actively recruiting and hiring diverse lawyers, mentoring and promoting diverse lawyers from within and championing diverse lawyers externally to clients, colleagues and professional publications, are all better ways to achieve the goal. [156]

9. Allyship: A key concept and practice of diversity and inclusion in the workplace is Allyship. What is "Allyship?" Sheree Atcheson, international award-winning lecturer and author on diversity and inclusion, provides a succinct definition and pertinent guidelines for application. According to Ms. Atcheson, Allyship is:

> [a] lifelong process of building relationships based on trust, consistency, and accountability with marginalized individuals and/or groups of people. It is not self-defined—work and efforts must be recognized by those you are seeking to ally with. It is an opportunity to grow and learn about ourselves, whilst building confidence in others.[157]

Moreover, an ally is any person that actively promotes and aspires to advance the culture of inclusion through intentional, positive and conscious efforts that benefit people as a whole.[158] According to Ms. Atcheson, everyone has the ability to be an ally as privilege is "intersectional" - white women can be actionable allies to people of color, men can be allies to women, cis people can be allies to members of the LGBTQI+ community, able-bodied people can be allies to those with different abilities, economically privileged people can be allies to those who are not and so on.[159] In terms of action steps, to be a true ally, Ms. Atcheson notes that one should:

- Lift others up by advocating,
- Share growth opportunities with others,
- Not view venting as a personal attack,
- Recognize systematic inequalities and realize impact of micro-aggressions,
- Believe underrepresented people's experiences, and

- Most importantly – listen, support, self-reflect & change.[160]

IV. TRANSFORMATIVE LEARNING/PRACTICAL SOLUTIONS

In addition to the valuable approaches to implicit bias interruption and abatement noted above, Transformative Learning may also offer some helpful and practical solutions. The "Transformative Learning" theory was developed by American sociologist and Columbia University Emeritus Professor Jack Mesirow in 1978.[161] It is an approach designed to change a person's perspective through experience rather than more traditional approaches to learning and has been applied in academics, with increasing frequency, over the last 20 years. In his article, *"It's Time to Change Our Minds: an Introduction to Transformative Learning,"* Dean Elias explains transformative learning as follows:

> Transformative learning is the expansion of consciousness through the transformation of basic worldview and specific capacities of the self; transformative learning is facilitated through consciously directed processes such as appreciatively accessing and receiving the symbolic contents of the unconscious and critically analyzing underlying premises.[162]

Another definition of transformative learning was put forward by Edmund O'Sullivan, Director of the Transformative Learning Centre at the University of Utah:

> Transformative learning involves experiencing a deep, structural shift in the basic premises of thought, feelings, and actions. It is a shift of consciousness that dramatically and irreversibly alters our way of being in the world. Such a shift involves our understanding of ourselves and our self-locations; our relationships with other humans and with the natural world; our understanding of relations of power in interlocking structures of class, race and gender…[163]

An important part of transformative learning is for individuals to "change their frames of reference by critically reflecting on their assumptions and beliefs and consciously making and implementing plans that bring about new ways of defining their worlds."[164] This reflection of one's assumptions and redefinition of one's worldview are two goals in the battle against implicit bias, but does the Transformative Learning theory have practical applications?

A powerful example of Transformative Learning in practice is the groundbreaking "Constitutional Law and the Civil Rights Movement" course taught at Stetson University College of Law.[165] Since 2006, more than 300 Stetson students have participated in this thought-provoking transformative learning experience.[166] After receiving approximately one week of extensive classroom instruction regarding the American civil rights movement (the "Civil Rights Movement"), students embark on a six-city bus tour through the southern United States, retracing the steps of the "Freedom Riders"* and meeting some of the most prominent surviving figures of

* The Freedom Riders were black and white civil rights activists who rode interstate buses together into the segregated southern United States to challenge the federal government's non-enforcement of United States Supreme Court decisions that ruled that segregated public buses and stations were unconstitutional. The Freedom Rides, and the violent reactions they provoked, bolstered the credibility of the Civil Rights Movement by calling national attention to the

the Civil Rights Movement at some of the most famous locations, for an experience that has been described as "life-changing."[167] One such stop is a chilling, single file silent march over the Edmund Winston Pettus Bridge. This bridge, named after a Confederate general and leader of the Ku Klux Klan[168], was the site of "Bloody Sunday" on March 7, 1965. On that date, peaceful Civil Rights protesters, led by the late Representative John Lewis (D. Ga.) and other civil rights leaders, were attacked with tear gas, billy clubs and whips by Alabama state troopers and county deputies, who were led by the infamous Montgomery police chief Eugene "Bull" Connor and Selma Sheriff Jim Clark. Another stop on the tour is Kelly Ingram Park in Birmingham, where in 1963, schoolchildren were "attacked by police dogs, knocked down by water cannons and arrested (and jailed) for marching for equal treatment."[169] One particularly poignant stop is the 16th Street Baptist Church in Birmingham, where students stand at the very spot where a bomb was placed by Ku Klux Klan members that killed four young black girls who were preparing to participate in church youth activities.[170] The effect of this transformative learning experience is profound. As one May 2020 law graduate stated, "[I]t's something that, one, I never can forget….And two, it just opened my eyes up to so much more than I think just the normal population has."[171] Moreover, the impact of this historical tour reaches both Stetson students and staffers alike, as a white assistant vice president for parent and alumni engagement noted:

> [Y]ou get to the point where you feel it's safe to cry because you do cry…. when we walked up to the very spot where Martin Luther King was killed, an audible sob came out of me. I mean, it was so powerful. We just stood there together in silence.[172]

Clearly, this course teaches life lessons that are instrumental in changing perspectives, assumptions and world views. As such, this Stetson course epitomizes the word "transformative."

With regards to workplace diversity and inclusion, a critical factor in the Transformative Learning approach is the focus on the transformation of attitudes of dominant group members. Generally termed the "pedagogy of the privileged," the goal of research in this area is to determine what kinds of experiences lead socially dominant group members to recognize their dominance, choose to see inequity, and choose to act to end inequity.[173] In her seminal work on the subject, Dr. Ann Curry-Stevens, conducted extensive research with this focus on "transforming the lenses" of those who were privileged by virtue of their race, gender, or socioeconomic status to glean insights about what worked in facilitating transformation for the privileged. [174] Dr. Curry-Stevens came up with six-steps for facilitating the transformation of the privileged, which are as follows:

- Understanding that oppression exists
- Understanding oppression as structural
- Locating oneself as oppressed
- Locating oneself as privileged

disregard for the federal law and the local violence used to enforce segregation in the southern United States. Police arrested riders for trespassing, unlawful assembly, violating state and local Jim Crow laws, and other alleged offenses, but often they first let white mobs attack them without intervention. *See, e.g.,* https://en.wikipedia.org/wiki/Freedom_Riders.

- Understanding the benefits of privilege
- Understanding oneself as implicated in the oppression of others and understanding oneself as oppressor.[175]

More recently in 2017, authors Diether Gebert, Claudia Buengeler, and Kathrin Heinitz acknowledged support for the Curry-Stevens approach, and asserted that a "dogmatic" stance in diversity training is one of the reasons for its low success.[176] Instead, Gebert et al. encouraged diversity trainees to "foster a tolerance than allows for unpopular and politically incorrect statements to be shared and listened to without judgment."[177] According to these authors, "constructively" dealing with diversity is dealing with diversity "in ways that serve the mutual growth of those involved and increase the chance that people will be able to engage in a dialogue — even in the case of opposing values that are highly salient to people's identities — as a means of preventing conflict."[178]

The goal for these Transformative Learning studies is a change in behavior arrived at through a change in one's worldview, which is triggered by a critical reflection on assumptions that had been previously unexamined or taken for granted as truth. This critical reflection on assumptions is a vital component in combatting some of the types of unconscious cognitive biases that were previously discussed in this outline, such as Confirmation Bias, which is based mainly on assumptions or pre-conceived notions about a group that are taken as truth. Therefore, it appears that Transformative Learning can be an effective tool in the arsenal to help reduce implicit bias and bring about the intended results of workplace diversity training.

V. THE NABL DIVERSITY INITIATIVE

NABL's Diversity Committee is one of its standing committees and is of great importance to the NABL Board. The Diversity Committee was created in 2006 with the stated goal to "[f]acilitate increased participation by culturally diverse individuals in NABL and its activities."[179] To further that goal, events have been held each year in connection with NABL conferences to generate awareness of the opportunities for participation in NABL activities and to provide networking opportunities for diverse individuals. A high priority of the NABL Board and the Diversity Committee over the past several years has been to identify diverse members of NABL interested in participating in the work of NABL committees, serving as panelists at NABL seminars and teleconferences, and writing for NABL publications. These efforts have resulted in increased involvement of diverse members in these activities and will continue to be a key element of the work of the Diversity Committee. In the past four years, NABL has become even more proactive in its pursuit of diversity within NABL.

In an effort to gain a better understanding of the diversity and make up of its membership, NABL began actively collecting demographic information in 2015. Based upon voluntary self-identification by members, NABL is 67% male and 33% female, 87% white/Caucasian and over half of NABL's membership has been practicing law for more than 26 years.

Through its Diversity Committee in 2016, NABL used interactive voting software at its Fundamentals of Municipal Bonds seminar* and its Bond Attorneys' Workshop to query its

* The Fundamentals of Municipal Bonds seminar was renamed "NABL U Presents The Essentials" in 2019.

members regarding their positions on diversity and inclusion. The result was an overwhelming response by those attendees, most of whom were NABL members, that diversity and inclusion is important and that it is lacking within the practice of public finance law. In addition, respondents overwhelmingly chose, from various definitions of diversity, the following expansive definition of "diversity" espoused by Queensborough Community College in New York City and the University of Oregon:

> The concept of diversity encompasses acceptance and respect. It means understanding that each individual is unique and recognizing our individual differences. These can be along the dimensions of race, ethnicity, gender, sexual orientation, socio-economic status, age, physical abilities, religious beliefs, political beliefs, or other ideologies.[180]

In 2017, with this backdrop and in consultation with the Diversity Committee, the NABL Board adopted the Diversity Initiative. The Diversity Initiative is a policy passed down from the NABL Board to the Diversity Committee and its other committees. In addition, the Diversity Initiative is a lighthouse for all of the NABL membership to see NABL's stated goals regarding diversity and inclusion, which are as follows:

> To encourage and facilitate active long-term participation in NABL by diverse NABL members and to minimize implicit bias within NABL on the basis of gender, gender identity, race, ethnic background, religion, age and sexual orientation.
>
> To create and maintain an atmosphere of inclusion around all NABL committees, projects and programs by taking steps (1) to inform leadership of NABL committees, projects and programs of diverse members who have expressed an interest in participating in committees, projects and programs, and (2) to encourage and welcome diverse member participation in those committees, projects and programs.[181]

In addition to its stated goals, the text of the Diversity Initiative includes nine steps to inclusion. The primary purpose of the steps to inclusion is to ensure coordination and collaboration among the NABL Board, the various NABL committees, the various NABL seminar chairs and the NABL membership with the Diversity Committee. The steps to inclusion also include guidance regarding continuity within the Diversity Committee from year to year and reporting requirements from the Diversity Committee to the NABL Board so that performance may be monitored and improved. The full text of the Diversity Initiative is available on NABL's website.[182]

VI. CONCLUSION

The practice of law is one of the least diverse professions in the United States. Historically, overt and intentional discrimination have played an undeniable role in that. Model Rule 8.4(g) speaks to this issue. However, another explanation for this lack of diversity is unintentional discrimination and implicit bias, which all people have. Both implicit and explicit biases are deep-rooted in American history and culture, but as American society continues to evolve into a more diverse paradigm, these biases appear more and more to be out of place and dysfunctional.

One of the keys to remedying this problem is identifying one's implicit biases and then modifying behavior to either limit the effects of implicit bias or, where possible, remove it entirely from the decision-making process. The Diversity Initiative attempts to do just that with respect to NABL's business. In addition, many governmental entities, businesses and law firms have successfully adopted diversity and inclusion initiatives, which will become increasingly important as both the consumers and providers of legal counsel become more diverse.

Lastly, although profitability should not be the reason to aggressively address DEI matters, it should be emphasized, again, that there is a strong business case for both gender diversity and ethnic and cultural diversity in leadership (both in the law firm and corporate)—and the analysis and data shows that this business case continues to strengthen. The most diverse companies are now more likely than ever to outperform less diverse peers on profitability.[183]

ENDNOTES AND REFERENCE MATERIALS

1 This outline focuses on the ABA's version of the Model Rules, which has been adopted in various forms throughout the states. Each jurisdiction has its own rules, and a minority of states (such as Minnesota and Tennessee) still use the Model Code of Professional Responsibility. To the extent Bond Counsel practices in different states with differing rules, it is generally suggested that Bond Counsel comply with the stricter rules of a particular jurisdiction.

2 *See generally*, MODEL RULES OF PROF'L CONDUCT (AM. BAR ASS'N 2016).

3 MODEL RULES OF PROF'L CONDUCT (AM. BAR ASS'N 2016).

4 MODEL RULES OF PROF'L CONDUCT pmbl. cmt. 20 (2016).

5 Gary A. Munneke & Anthony E. Davis, *The Standard of Care in Legal Malpractice: Do the Model Rules of Professional Conduct Define It?*, 22 J. LEGAL PROF. 33, 52 (1998).

6 MODEL RULES OF PROF'L CONDUCT r. 8.4 cmt. 3 (2010).

7 *See generally* Andrew Taslitz & Sharon Styles-Anderson, *Still Officers of the Court: Why the First Amendment Is No Bar to Challenging Racism, Sexism, and Ethnic Bias in the Legal Profession*, 9 GEO. J. LEGAL ETHICS 781 (1996).

8 MODEL RULES OF PROF'L CONDUCT r. 8.4(d) (2010).

9 MODEL RULES OF PROF'L CONDUCT r. 8.4(g) (2016).

10 *See* Taslitz, *supra* note 7**.**

11 ABA, A LEGISLATIVE HISTORY: THE DEVELOPMENT OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT, 1982-2005 812 (2006) [hereinafter A LEGISLATIVE HISTORY].

12 ABA Memorandum from Standing Comm. on Ethics and Prof'l Responsibility, Draft Proposal to Amend Model Rule 8.4 (December 22, 2015).

13 ABA Memorandum from Standing Comm. on Ethics and Prof'l Responsibility, Draft Proposal to Amend Model Rule 8.4 (December 22, 2015).

14 A LEGISLATIVE HISTORY, *supra* note 11, at 813.

15 A LEGISLATIVE HISTORY, *supra* note 11, at 814.

16 A LEGISLATIVE HISTORY, *supra* note 11, at 816.

17 A LEGISLATIVE HISTORY, *supra* note 11, at 816.

18 A LEGISLATIVE HISTORY, *supra* note 11, at 817.

19 A LEGISLATIVE HISTORY, *supra* note 11, at 817.

20 A LEGISLATIVE HISTORY, *supra* note 11, at 817.

21 A LEGISLATIVE HISTORY, *supra* note 11, at 817.

22 ABA Working Discussion Draft: Amendment to Model Rules 8.4 and Comment [3] (July 2015), *available at*

https://lalegalethics.org/wp-content/uploads/2015-07-16-ABA-Proposed-Amendment-to-Rule-8.4-re-Harassment.pdf?x54129

23 The first version added subsection (g) which made it professional misconduct for a lawyer to: "knowingly harass or discriminate against persons, on the basis of race, sex, religion, national origin, ethnicity, disability, age, sexual orientation, gender identity, marital status, or socioeconomic status, while engaged [in conduct related to] [in] the practice of law"; ABA Working Discussion Draft: Amendment to Model Rules 8.4 and Comment [3]

https://lalegalethics.org/wp-content/uploads/2015-07-16-ABA-Proposed-Amendment-to-Rule-8.4-re-Harassment.pdf?x54129

24 The new comment entirely eliminated the first 3 sentences of the old comment and added: "Conduct that violates paragraph (g) undermines confidence in the legal profession and our legal system and is contrary to the fundamental principle that all people are created equal. A lawyer may not engage in such conduct through acts of another. See Rule 8.4(a). Legitimate advocacy respecting any of these factors when they are at issue in a representation does not violate paragraph (g). It is not a violation of paragraph (g) for lawyers to limit their practices to clients from underserved populations as defined by any of these factors, or for lawyers to decline to represent clients who cannot pay for their services. A trial judge's finding that preemptory challenges were exercised on discriminatory basis does not alone establish a violation of paragraph (g). Paragraph (g) incorporates by reference relevant holdings by applicable courts and administrative agencies."

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47 MODEL RULES OF PROF'L CONDUCT r. 8.4 cmt. 5 (2016) ("A trial judge's finding that peremptory challenges were exercised on a discriminatory basis does not alone establish a violation of paragraph (g). A lawyer does not violate paragraph (g) by limiting the scope or subject matter of the lawyer's practice or by limiting the lawyer's practice to members of underserved populations in accordance with these Rules and other law. A lawyer may charge and collect reasonable fees and expenses for a representation. Rule 1.5(a). Lawyers also should be mindful of their professional obligations under Rule 6.1 to provide legal services to those who are unable to pay, and their obligation under 6.2 not to avoid appointments from a tribunal except for good cause. See Rule 6.2(a), (b) and (c). A lawyer's representation of a client does not constitute an endorsement by the lawyer of the client's views or activities of law.").

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NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

HEALTH CARE FACILITIES – NON-TAX MATTERS

Chair:

Jessica Zaiger **Polsinelli PC – Kansas City, MO; Milwaukee, WI**

This panel will examine non-tax issues for financings of 501(c)(3) health care providers, with the panel addressing hot topics in health care finance. The primary focuses are expected to be developments in public disclosure for health care providers; managing the post-COVID-19 ongoing covenant and disclosure issues, the continuing market turmoil impact on health care borrowers; and addressing default and potential default scenarios, including for financially troubled health care providers (including senior living providers). Within disclosure considerations, the panel will discuss recent disclosure trends, including around environmental, social, and governance (ESG) investing standards; green bonds and social bonds; cybersecurity; diversity, equity, and inclusion; disclosure of material financial obligations; disclosure of major transactions; the fine line between disclosure and marketing; and interim period disclosure. Time permitting, the panel may also address additional topics including continued lessons learned from the COVID-19 public health crisis, considerations for forward delivery issuances, the impacts of mergers, acquisitions and joint ventures (including non-acute care facilities and providers); and varied financing structures and products.

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HEALTH CARE FACILITIES - NON-TAX MATTERS

This outline discusses topics that may be of interest to participants in tax-exempt financings that benefit health care institutions. Tax issues are not discussed here, but are handled separately in the outline titled "Tax Issues in 501(c)(3) Financings." For retirement community health care institutions, see also the outline titled "Multifamily Housing."

PART A – SECURITY

I. GENERAL

The most common types of security for health care financings are joint and several obligations among related entities and/or guarantees from related entities; "negative pledges" pursuant to which the borrower agrees not to grant liens on its assets in favor of other creditors; security interests in gross revenues; and mortgages on and security interests in health care facilities. . Depending on market conditions, reserve funds and credit enhancement may be part of the security package for particular debt instruments.

II. GROSS REVENUES OR UNRESTRICTED RECEIVABLES PLEDGE

Health care financings are often secured by a security interest in gross revenues, frequently referred to as a pledge of gross revenues, gross receipts, or unrestricted receivables. The security interest is typically granted in all revenues, receivables and contract rights of the borrower other than donations and grants that are restricted to purposes inconsistent with their use to pay debt service. Sometimes the revenues are to be deposited in a lock box or gross revenue fund held by the trustee or a depository with those moneys being made available to the borrower to pay its expenses and obligations unless a default has occurred and is continuing. In most instances, however, the revenues are collected and retained by the borrower for its use absent an event of default.

A security interest in many of the elements of gross revenues cannot be perfected by filing a financing statement and, even if it can be perfected by filing, may be subject to a prior security interest of another secured party that has control or possession of that property (i.e. cash) or a statutory priority. Deposit account control agreements are sometimes used to perfect a security interest in funds held in bank deposit accounts. A security interest in a health care institution's gross revenues may also be limited by law in other ways such as limitations on the assignment of Medicare and Medicaid receivables or the imposition of a charitable trust in funds of a nonprofit health care provider under applicable state law. These limitations on perfection and priority should be disclosed in the offering document for any debt instruments that have the benefit of such security interests; including in a bondowners' risks section and in the section that describes the security for the debt.

III. Mortgages and Negative Pledges

Most health care financings include a covenant that restricts the borrower from granting or permitting to exist liens on its assets, other than permitted liens enumerated in the applicable documents. This covenant is often referred to as a "negative pledge" or "negative lien." The scope of permitted liens varies depending on the credit quality of the borrower, but typically includes encumbrances that occur in the ordinary course of business, certain statutory liens that do not materially impair the security of the bondholders, purchase money security interests, and a "basket" clause. Basket amounts are often measured based on a percentage of assets, revenues, outstanding debt, or a specified dollar amount of secured liabilities.

After the experience of bond insurers in 1998 with the bankruptcy filing of Pittsburgh-based Allegheny Health, Education, and Research Foundation (*"AHERF"*) in which the bonds were not secured by a mortgage, some credit enhancers and investors began requiring a mortgage on the health care borrower's core health care facilities. As the financial performance of health care organizations grew stronger and the memory of the AHERF bankruptcy grew fainter, the demand for mortgages decreased, especially in financings for stronger credits. In some cases, financing documents have provided for the release of these liens if certain ratings or financial ratios are maintained. In other instances, it has been sufficient for the borrower to covenant to place a mortgage upon its core health care facilities if it fails to meet certain rating or financial ratio criteria (sometimes called a "springing lien").

IV. Pledged Funds

Banks providing credit support for bonds (such as letters of credit and standby bond purchase agreements), or directly purchasing bonds often seek additional security in the form of pledged funds. Sometimes this is an agreement to have funds pledged to secure the borrower's obligations to the bank in a specified amount or to agree not to pledge funds of the borrower or a guarantor to another creditor. Pledged funds arrangements require input from tax counsel, as they can create arbitrage rebate and other tax issues.

V. Guarantees by Related Institutions

The most prevalent type of credit support by a related entity is the master indenture, which is discussed later in this outline. In other instances, a related entity may enter into a guarantee agreement or other support agreement. Under a guarantee agreement, the related entity guarantees the health care borrower's obligations on the bonds. Under a support agreement, the related entity agrees to provide financial support for the financing or the operations of the health care borrower or both (often referred to as a "liquidity support agreement"). Guarantee agreements and support agreements are often used for start-up financings; *i.e.,* financings for new facilities. In these instances, sometimes the agreement provides that the related entity's obligations terminate if the borrower demonstrates positive financial and operating performance over a period of time.

Guarantee agreements and support agreements are often used in circumstances in which a related entity wants to limit its guarantee to the particular financing or does not want to be subject to master indenture covenants.

PART B – MASTER INDENTURES

I. THE CONCEPT

Master Indentures are frequently entered into by health care institutions with a master trustee to create a flexible financing and security structure. The master indenture provides for the issuance of master indenture notes or obligations at different times that are secured on a parity basis with one another. Such notes or obligations are issued from time to time to evidence and/or secure various indebtedness and other obligations (i.e. swap transactions, leases, and guarantees).

Master Indentures create an obligated group or credit group, which can be comprised of a single member, or multiple members. Typically, members of an obligated group or credit group are related or commonly controlled entities. Unrelated entities can also take advantage of this structure, but expose themselves to greater risk in doing so. Pooling the credit of multiple entities can result in greater credit strength for the group than for its individual members because of the increased size and diversity of the operations behind the credit. In addition, it can be a means of affording smaller or weaker entities access to the credit markets that would not exist if they were to act alone. The greater strength of the group can also result in fewer and less onerous covenants for the borrowers.

The master indenture structure provides a uniform borrowing framework for the credit group and consistency in the terms and covenants applicable to the indebtedness secured thereby. Covenant uniformity can enhance managerial efficiency and certainty and reduce the burdens and potential for unintended covenant violations for those operating complex health care operations. Non-uniform covenants applicable to a particular debt instrument can be addressed in a supplemental indenture, or in other documents that govern such indebtedness, without modifying the master indenture covenants.

Master indenture covenants permit assets of one group member to be freely transferred to another member, whereas in a single health care institution borrowing, the institution's covenants ordinarily will make such a transfer more difficult and sometimes even impossible, which does not reflect the reality of today's health care system organizational structures. Master indenture covenants do not address other restrictions on transfer of assets of a nonprofit corporation to a for-profit member of the group imposed by state or federal non-profit laws and regulations or, in the case of assets financed with tax-exempt bonds, by federal income tax law. See more detailed discussion of state law limitations on nonprofit corporations under "Enforceability of Master Indentures" later in this outline.

The master indenture provides the basic framework governing all indebtedness of the credit group members and can accommodate the full range of debt financing options. It allows flexibility for various types of financings, including multi-issuer bond issuances and financing or refinancing improvements in various locations. This structure allows each financing to have its own bond indenture, loan agreement and security agreements as applicable. In addition, master indenture notes or obligations can be used for direct borrowings by credit group members and to evidence or secure other contractual obligations such as reimbursement agreements, lines of credit, leases,

and interest rate swap obligations. Additional debt can be incurred or assumed on a parity basis with existing debt under a master indenture without limiting the character of the individual debt.

The master indenture format accommodates the growth and development of a multi-institutional system, allowing the system to adapt to developments and changing environments within the health care industry. For example, master indentures provide for the admission or withdrawal of members of the credit group upon meeting certain tests and conditions contained in the master indenture, mergers and consolidations among members of the credit group, and the transfer of assets among members of the credit group.

The financial tests contained in the master indenture, such as debt service coverage ratios and additional debt tests, are computed on an aggregate basis for all members of the credit group, and sometimes at a broader consolidated system level if certain operating revenue thresholds are met.

II. Master Indenture Structures

The most frequently used master indenture structure is an "obligated group" approach. Under an obligated group structure, all members of the pooled credit group are parties to the master indenture and members of an obligated group. Each obligated group member may be the primary obligor of its own indebtedness or other obligations evidenced and/or secured by notes under the master indenture and all such obligated group members will be jointly and severally liable for all notes issued under the master indenture. In some instances, the liability of various obligated group members for the master indenture indebtedness incurred by others may be limited by provisions in the master indenture.

Another master indenture structure is modeled after corporate borrowings. In this structure, the master indenture obligations are obligations of a parent corporation, which is often a non-operating corporation. The operating entities are affiliates of the parent and are not directly obligated to pay the master indenture indebtedness. Instead, the parent is the sole obligor for the debt incurred for the system. The parent typically causes the indebtedness to be paid by its affiliates, usually through its control of the affiliates or through contractual arrangements. The affiliates are not parties to the master indenture, but the parent agrees to cause them to comply with certain covenants in the master indenture. The credit group under this type of master indenture is often referred to as a "restricted group." The restricted group may include only certain designated affiliates of the parent, with other affiliates left out of the restricted group.

Some master indentures combine the features of the obligated group and restricted group structures by providing for joint and several obligations of members of an obligated group and the inclusion of other affiliates that are not directly obligated to pay master indenture indebtedness in the credit group as members of the restricted group.

III. Enforceability of Master Indentures

Master indenture financings have raised the issue of the susceptibility of cross-stream or upstream guarantees to avoidance under the United States Bankruptcy Code (Title 11, U.S.C.) or

under the Uniform Fraudulent Transfer Act or other state fraudulent conveyance laws. Section 548(a)(1) of the United States Bankruptcy Code (11 U.S.C. § 548(a)(1)) provides as follows:

> The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor . . . (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (B)(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation . . .

Section 5(a) of the Uniform Fraudulent Transfer Act is as follows:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

Although slightly different in the two acts, two similar tests must be met under each act to avoid a master indenture guarantee obligation. Using the language of the United States Bankruptcy Code, these tests are normally referred to as the "insolvency" test and the "reasonably equivalent value" test. In master indenture financings, attention has centered on the insolvency test. For purposes of the United States Bankruptcy Code, "insolvent" is defined in Section 101(32) thereof (11 U.S.C. § 101(32)) and for purposes of the Uniform Fraudulent Transfer Act is defined in Section 2 thereof. Insolvency is determined at the time the obligation is incurred. With respect to a guarantee, the obligation is incurred at the time the indebtedness guaranteed is issued if it is issued at or after the time the guarantee is given. *Rubin v. Manufacturer's Hanover Trust Company,* 661 F.2d 979 (2d Cir. 1981).

There is a lack of clarity in the case law regarding how the insolvency test would be applied in the context of corporate cross-guarantees, which has resulted in considerable confusion. See Rosenberg, *Intercorporate Guarantees and The Law of Fraudulent Conveyances*, 125 U. Pa. L. Rev. 235 (1976), and the cases cited therein.

Some have analyzed *Rubin v. Manufacturer's Hanover Trust Company, supra,* to be susceptible to an interpretation that solvency is determined by treating the full amount of the debt that is guaranteed as a liability, but not treating any portion of the right of contribution from the other members for payments made on the guarantee as an asset. Those who have adhered to this analysis have addressed the insolvency problem in a variety of ways. In one approach, each group member's guarantee is conditioned so that it is in force only so long as and to the extent that payment thereunder will not render that member insolvent. In another approach, the amount of

indebtedness guaranteed by each group member is limited to a specified portion of the indebtedness at the time of its incurrence. Both of these approaches are subject to the criticism that they weaken the strength of the obligated group guarantee and run afoul of the concept that the entire credit of the obligated group is to stand behind its master indenture indebtedness. They are not widely used today. Others have resorted to the restricted group master indenture structure discussed above under "Master Indenture Structures" in which the restricted group members are not guaranteeing the master indenture debt.

Most believe that the preceding analysis of *Rubin* is not the best reading of that case. In addition, other cases support the proposition that the guarantor's right of contribution from others liable on the indebtedness guaranteed should be counted as an asset to the extent of its value. *In the Matter of Ollag Construction Equipment Corp.,* 578 F.2d 904 (2d Cir. 1978); *Schwartz v. C.I.R.,* 560 F.2d 311 (8th Cir. 1977); *Syracuse Engineering Co. v. Haight,* 97 F.2d 573 (2d Cir. 1938); *Wingert v. President, Directors and Company of Hagerstown Bank,* 41 F.2d 660 (4th Cir. 1930), *cert. denied* 282 U.S. 871 (1930); *In Re Knox Kreations, Inc.,* 474 F.Supp. 567 (E.D. Tenn. 1979), *aff'd in part, rev'd in part on other grounds,* 656 F.2d 230 (6th Cir. 1981); and *In re Bowers,* 215 F. 617 (N.D. Ga. 1914). Sometimes the contribution rights under common law are bolstered by contractual subrogation or reimbursement rights contained in the master indenture. In addition, a covenant by each obligated group member to prevent the bankruptcy of any other obligated group member is sometimes included in master indentures.

In a typical master indenture financing, the obligated group must demonstrate its ability to pay the indebtedness being incurred, together with any outstanding indebtedness, by meeting certain debt service coverage requirements dictated by the market or the master indenture itself. See "Covenants—Limitations on Indebtedness" below. In addition, those following the analyses of the preceding paragraph often require that each member of the obligated group provide evidence of its solvency each time master indenture debt is issued. In these instances, the asset value of each member's right to contribution normally should offset the amount of its contingent liability under its guarantee.

A second set of legal issues raised in the context of master indenture financings is the power of nonprofit entities to make contributions to a parent corporation or another related entity member of the group for the payment of its debt or to guarantee debt of others. These issues are often addressed in the organizational documents of each member of the credit group, which include among the purposes of the entity the furtherance through financial assistance and otherwise of the nonprofit purposes of the other members of the credit group. Similar purposes among the members that are furthered by master indenture financings or other purposes that are furthered by participation in the master indenture financings may also provide a basis for the powers of nonprofit entities to participate in master indenture financings.

The nonprofit corporation laws of many states prohibit the distribution of dividends or profits to members. See, for example, the Model Nonprofit Corporation Act (Rev. 1964) § 26. The Model Nonprofit Corporation Act, after prohibiting the payment of dividends and distribution of income by a nonprofit corporation to its members, provides that a nonprofit corporation "may confer benefits upon its members in conformity with its purposes." *Id.* The purpose of these laws is generally to prevent the inurement of any income derived by a nonprofit corporation to an

individual or for-profit entity for private benefit. It seems that the obligation of a nonprofit subsidiary corporation to make contributions to a nonprofit parent corporation that is its member should not run afoul of these prohibitions where the obligation was incurred in furtherance of the subsidiary's nonprofit corporate purposes. In a master indenture financing, the obligations usually are incurred by the members of the credit group to make available to them the advantages of group financing for their respective nonprofit purposes and to further benefit in other ways their respective nonprofit purposes and the nonprofit purposes of the parent.

Even if the participation in the joint and several liability or contribution arrangements of a master indenture financing is within the scope of a nonprofit entity's powers under its organizational documents, state law must still be examined for possible impediments. For example, in some jurisdictions the ability of a nonprofit entity to divert property committed to charitable purposes is limited. This raises the issue of the ability of a for-profit entity to participate in a master indenture financing where its borrowings are guaranteed by nonprofit entities. If all of the stock of the for-profit entity, however, is owned by one or more nonprofit entities, particularly if they are members of the credit group, and if the for-profit entity exists to further the proper purposes of those nonprofit entities, a good case can be made for inclusion of the for-profit entity because no assets are diverted for the benefit of any private individuals or for a purpose that is not a part of the nonprofit entity's purposes. In addition, the nature, extent, and value of the benefits received by the nonprofit entities in return for their guarantees may be relevant.

One court has held that the articles of incorporation of a nonprofit corporation create a "charitable trust." *Queen of Angels Hospital v. Younger,* 66 Cal.App.3d 359, 136 Cal.Rptr. 36 (1977). It is difficult, though, to see why this interpretation should affect the ability of a nonprofit corporation to guarantee debts of other nonprofit corporations if the purpose of the guarantee is within the scope of its corporate purposes and if the guarantee is within its corporate powers. There has also been an increasing willingness of some state attorneys general to use the charitable trust doctrine to challenge business strategies of nonprofit corporations and systems, especially in transactions involving sales or transfers of facilities between systems and board decisions to close individual hospitals within a system. Similar challenges could be brought in cases where an in-state obligated group member was called upon to transfer money to an out-of-state affiliate to satisfy the affiliate's obligations.

Legal opinions regarding the enforceability of master indentures generally contain customary exceptions for limitations imposed by bankruptcy, insolvency and similar laws affecting the enforcement of creditors' rights. These opinions are often further qualified by noting that the obligation of a member to pay any master indenture indebtedness issued by another member may not be enforceable (i) if that master indenture indebtedness was issued for a purpose that is inconsistent with the charitable purpose of the member from which payment is sought or is issued for the primary benefit of an entity other than a nonprofit corporation exempt from federal income taxes as described in Section 501(c)(3) of the Internal Revenue Code, (ii) to the extent payment is sought from moneys or assets that are donor-restricted or subject to a trust that does not permit the use of the moneys or assets for such a payment or (iii) if enforcement would result in the cessation or discontinuation of a material portion of the health care related services provided by the member from whom payment is sought. In addition, these matters are generally discussed

in the bondholders' risks and security sections of the offering document for a indebtedness secured by a master indenture.

IV. VOTING OF MASTER INDENTURE OBLIGATIONS

As is the case for bondholders under a bond indenture, noteholders under a master indenture have voting rights in certain situations. In bond issuances secured by a master indenture note, the bond trustee is the holder of the master indenture note and is the party voting the interest of the master indenture noteholder absent a provision to the contrary. Some master indentures or bond indentures provide that the bondholders are deemed to be the owners of the master indenture note securing a bond issue for voting purposes. If the bonds are widely held, this provision may make it more difficult to obtain master noteholder consents or directions required by the master indenture. In instances in which the bonds secured by a master indenture note are enhanced by bond insurance or a letter of credit, the master indenture or the bond indenture often provides that the credit enhancer is deemed to be the owner of the master indenture note for voting purposes. Much like similar provisions in a bond indenture providing that the credit enhancer is deemed to be the owner of the bonds for voting purposes, this provision may facilitate amendments to the master indenture. Certain voting rights are sometimes withheld from the credit enhancer, making it important to review the provisions whereby the credit enhancer obtained those rights (often the bond indenture).

Most master indentures permit master indenture notes to be issued to secure a wide variety of obligations, not just bonds. Examples include interest rate hedging products such as swaps, revolving lines of credit or credit facilities with commercial banks, continuing covenant agreements used in direct placements of bonds with commercial banks, and certain types of leasing arrangements. Because of the unique nature of some of these products, issuing master indenture notes to secure them may raise interesting questions when it comes to obtaining consents from noteholders. See "Part D—INTEREST RATE HEDGES AND INVESTMENT CONTRACTS" below.

V. SUBSTITUTE/REPLACEMENT MASTER INDENTURES

The consolidation of two or more health care systems with separate master indentures in place can present difficult problems for the consolidation. To alleviate these, some bond indentures and master indentures provide for the replacement of the master indenture note securing outstanding bonds with a new master indenture note issued under a different master indenture if certain conditions are met. These conditions typically include a rating requirement applicable to the new credit, and sometimes require satisfaction of certain financial covenants. Any such provision should be prominently disclosed in the security for the bonds and bondowners' risks sections of the offering document. In recent years, there has been widespread acceptance of these provisions, especially in higher rated credits.

VI. MEMBERSHIP

Master indentures provide for changes in the credit group over time with provisions for entry of new members into the credit group, withdrawal of members of the credit group if certain

conditions are met, and mergers (or similar corporate restructurings) of members with other entities. The investor community, credit enhancers and liquidity providers may require that the strongest entity or controlling entity in a credit group not be allowed to withdraw. This type of requirement is generally called a "flagship covenant."

PART C – COVENANTS

I. GENERAL

Health care transactions normally include covenants by the health care borrower relating to the borrower's organization, financial condition, operations and property, and tax-exempt status . These covenants may appear in a master indenture, a loan agreement, or in an agreement with a credit enhancer or liquidity provider. Some, but not all, of the more common significant covenants are discussed in this outline. In the discussion of these covenants, "borrower" is used to refer to the borrowing institution or, for master indenture financings, the credit group or the members of the credit group.

II. RATE COVENANT

The most prevalent financial covenant is a covenant to maintain rates, fees, and charges at a level sufficient to result in a specified debt service coverage ratio. The debt service coverage ratio is the number determined by dividing the borrower's net income available to pay debt service by either the debt service for the calculation period or the maximum annual debt service of the borrower. Net income available for debt service is typically calculated by adding back non-cash items (such as depreciation and amortization expenses, unrealized investment gains or losses, other noncash investment losses, noncash charitable pledge income and impairment charges), nonrecurring items, and interest expense so that the ratio renders a true picture of the cash generated to pay debt service without regard to nonrecurring items. If the borrower operates a senior living facility with entrance fees, adjustments from the entrance fee income shown in accordance with generally accepted accounting principles are also necessary to correct for long-term accrual accounting treatment.

If the borrower fails to meet the required debt service coverage ratio, the rate covenant typically requires the borrower to engage a health care consultant to make recommendations to achieve the required ratio in the future and requires the borrower to follow those recommendations to the extent feasible and permitted by law. If the borrower engages the health care consultant and follows its recommendations to such extent, the rate covenant provisions typically provide that no default under that covenant exists unless, in many cases, the ratio is less than 1.00. Credit enhancers and liquidity providers do not always allow for a consultant in their documents and may require an immediate event of default if the rate covenant is not met. These provisions increasingly include exceptions if the failure to meet the covenant is the result of force majeure, and/or provide that an event of default shall exist only if the failure happens for consecutive fiscal years.

The debt service included in the ratio is usually the debt service on all long-term debt of the borrower. If the ratio measures maximum annual debt service, provisions are included that allow the use of certain assumptions in calculating debt service on balloon debt or debt with a put

option to smooth out the annual debt service, that specify how interest is to be calculated for variable rate debt, that require guaranteed debt to be included (but sometimes at a reduced level depending on the financial strength of the guaranteed entity), and that require or permit swap arrangements to be taken into account.

Debt service for debt incurred to finance capital projects is often not included until the project is completed, or in some long-term care financings until the project is projected to reach stabilized occupancy, if the financing is structured so that the borrower's revenues and expenses from such project are not required to pay that debt service during that period.

As described above, the debt service coverage ratio may be computed on an aggregate basis for all members of the credit group, and sometimes at a broader consolidated system level. System level testing can be at the discretion of the credit group or only permitted if certain financial thresholds are met that measure the materiality of the credit group compared to the system as a whole.

III. LIQUIDITY COVENANT

Another common covenant is a requirement for health care institutions to maintain certain levels of liquidity. These covenants characteristically require the borrower to have an amount of unrestricted cash, cash equivalents and marketable securities on hand at or above a specified level once or twice each year. A covenant that requires cash, cash equivalents and marketable securities to be maintained at a specified level more frequently than at six-month intervals may result in that amount being treated as a pledged fund for tax purposes, regardless of whether the requirement is contained in a master indenture, a loan agreement or an agreement with a bank, if the related indebtedness is tax-exempt.

Often the borrower is required to have a certain number of "days cash on hand" (*i.e.,* the amount of unrestricted cash, cash and equivalents and marketable securities divided by the average daily operating expenses, excluding depreciation and amortization), but sometimes another measure, such as the "cushion ratio" (*i.e.,* the amount of unrestricted cash, cash equivalents and marketable securities divided by maximum annual debt service), is used. If the borrower does not maintain the required level of liquidity, the liquidity covenant generally requires that the borrower engage a consultant to make recommendations for the borrower to achieve the required liquidity level in the future, and the borrower is required to follow those recommendations to the extent feasible (although in some instances the provisions provide that a default will nevertheless exist if the ratio is less than certain levels). Sometimes an initial failure to meet a liquidity covenant may require only a report by the borrower's management, with a consultant required to be engaged if the required liquidity level is not met for two consecutive test dates or is below an even lower threshold. If the borrower complies with the requirement for a consultant's report or management report and follows the actions or recommendations set forth therein to the extent feasible and permitted by law, the liquidity covenant typically provides that no default under that covenant will exist. Banks do not always allow for a consultant in their documents and may require an immediate event of default if the liquidity covenant is not met.

These provisions are sometimes drafted to exclude proceeds of short-term borrowings from the amount of cash, cash equivalents and marketable securities for purposes of meeting the liquidity covenant. Otherwise, the borrower could borrow to meet the liquidity covenant shortly before the relevant date and repay the borrowing shortly after the relevant date.

IV. Occupancy and Marketing Covenants

Financings for new senior living facilities or significant additions to those facilities often include covenants requiring the borrower to achieve or use its best efforts to have reached occupancy levels or certain marketing levels (*i.e.,* levels of signed residency contracts with nonrefundable deposits) by certain times. These levels are frequently established from projections in the financial feasibility study for the project to provide some assurance that the financial performance projected in the feasibility study will be obtained.

If the borrower does not achieve these levels, these covenants normally require the borrower to engage a consultant or file a report of the borrower's management and to follow the consultant's recommendations to the extent feasible and permitted by law or to follow the actions in the report of the borrower's management and provide that, if the borrower does so, no default under those covenants will exist.

V. Limitations on Indebtedness

Health care financings usually include covenants limiting additional indebtedness that may be incurred by the borrower. These covenants prohibit the incurrence of additional indebtedness with permitted exceptions. Additional long-term indebtedness is normally permitted if certain financial tests are met. These financial tests are ordinarily debt service coverage ratio tests that demonstrate either a specified debt service coverage ratio for the maximum annual debt service on all debt that will be outstanding (including the proposed debt); on a historical basis; or a historical debt service coverage ratio not including the proposed additional debt and a projected debt service coverage ratio for all debt that will be outstanding after the issuance of the proposed debt (including the proposed debt). Sometimes a "capitalization ratio" test (*i.e.,* the ratio of long-term debt to long-term debt plus unrestricted net assets) is used in addition to or in lieu of debt service coverage ratio tests. Other common categories of permitted indebtedness are completion indebtedness (*i.e.,* indebtedness incurred to complete a project for which indebtedness was previously incurred) within limits, refunding indebtedness (sometimes if the maximum annual debt is not increased by more than a specific amount), non-recourse indebtedness, subordinated indebtedness and, within certain limits, purchase money indebtedness and short-term indebtedness. There often also is a "debt basket" where a certain amount of debt is permitted without meeting any tests (such a percentage of revenues or of property, plant, and equipment).

VI. Limitations on Sale or Transfer of Property

Another commonly used covenant limits the borrower's ability to sell, lease or otherwise transfer its assets (including cash), subject to certain exceptions. These exceptions typically include transfers in any year up to an amount that is a percentage of some line item from the

borrower's financial statements (such as the value of its property or the amount of its revenues), transfers to other members of the credit group, transfers in the ordinary course of business, transfers for fair and adequate consideration, transfers of obsolete or worn-out property, loans of cash if there is a reasonable expectation of repayment and fair market terms, and transfers of property restricted by the donor or grantor for purposes inconsistent with the payment of indebtedness. Additional permitted transfers may include transfers of property that is designated as excluded property and transfers if certain financial ratios are satisfied. In addition, transfers of cash, cash equivalents, and marketable securities are permitted so long as the transfer would not reduce the borrower's unrestricted cash, cash equivalents and marketable securities below a certain level.

VII. MERGERS AND CONSOLIDATIONS

The borrower or any credit group member is normally prohibited from entering into mergers, consolidations or transfers of substantially all of its assets unless specified conditions are met. These conditions normally include the assumption by the surviving entity of the borrower's obligations in connection with the financing, an opinion of counsel regarding those obligations and the continued exemption of the bonds from registration under the Securities Act of 1933, as amended, an opinion of bond counsel that the transaction will not cause the interest on applicable bonds to be included in gross income for federal income tax purposes, rating confirmations, and the satisfaction of one or more financial tests. Mergers or consolidations between members of the credit group are excepted from this prohibition.

VIII. INSURANCE

Historically, master indentures required maintaining various kinds of insurance at certain specified levels. This created problems for health care institutions in some periods as types of coverage have evolved and when insurance at those levels was no longer available or was no longer available at reasonable rates. The insurance covenants that are most often used today require that the borrower maintain insurance with respect to its property and operations covering risks that are of an insurable nature and of a character customarily insured against by health care organizations operating similar properties and engaged in similar operations in such amounts as in the judgment of the borrower, or in some instances an insurance consultant, are adequate to protect the borrower and its property and operations. The insurance provisions also frequently permit self-insurance and other alternative risk programs. Some documents require periodic insurance consultant review of the insurance and self-insurance and other alternative risk management programs (such as captive insurance companies or mutual or other cooperative or risk management programs with other health care institutions), with the borrower agreeing to comply with the recommendations of the insurance consultant unless compliance is not feasible or not permitted by applicable law.

IX. FINANCIAL REPORTING

The borrower is commonly required to furnish its audited financial statements to the master trustee and the bond trustee on an annual basis, along with a "no-default" certificate and debt

service coverage calculation certification from an appropriate officer of the borrower. Historically, compliance certificates were sometimes required from the borrower's auditors, although these provisions have been removed where possible as auditors have refused to provide such certificates in recent years

Master indenture financial disclosure tends to be more limited, with enhanced disclosure obligations being included in continuing disclosure agreements entered into pursuant to SEC Rule 15c2-12. In addition to the borrower's annual report provided pursuant to SEC Rule 15c2-12, the trend is toward increased disclosure, with many investors also requiring quarterly unaudited financial statements, operating data, and financial ratios in addition to required financial covenants.
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The combined or consolidated financial statements of the credit group often include financial data pertaining to entities that are not members of the credit group as permitted or required under generally accepted accounting principles. Master indentures often permit those entities to be included provided that (i) the combined or consolidated financial statements include schedules consolidating the financial data for the credit group that is necessary or appropriate to determine compliance with the requirements of the master indenture, or (ii) if the consolidated revenues and the consolidated assets of the entities that are not part of the credit group in the aggregate do not exceed a designated percentage (*e.g.,* 20%) of the total combined revenues and total combined assets as reflected in the consolidated or combined financial statements. If these combined or consolidated financial statements are used in an offering document, there should be clear disclosure of the financial performance of only the members of the Credit Group.

X. Covenants Required by Credit Enhancers and Direct Purchasers

Bond insurers or banks providing credit or liquidity support or directly purchasing bonds often require additional covenants or modifications to the above-described covenants. It is usually advisable to isolate these covenants or modifications in a supplemental master indenture, an insurance agreement, a bank agreement or in some other manner and to provide that they are for the benefit of the credit enhancer or bank and may be modified or waived with the consent of the credit enhancer or bank, as the case may be, and without bondholder or trustee consent.

XI. "Covenantless" Transactions

In the pre-AHERF bankruptcy era, "covenantless" master indentures were becoming more common in financings for health care systems with very good credit ratings (usually *"AA"*). These master indentures use the corporate debenture/corporate parent form described above under "Master Indentures—Master Indenture Structures." They are not completely without covenants; routine covenants, such as covenants regarding maintenance of corporate existence, 501(c)(3) status, maintenance of properties, insurance, and financial reporting, are normally included. A rate covenant is also typically included, but at very low level (sometimes, even at a 1.00 level). There is often no limitation on the incurrence of additional debt or the transfer of assets or, if limitations exist, the required debt service coverage tests are set at the same low level as the rate covenant. These are rarely seen today and, when they still exist, additional covenants are often required to sell the bonds and obtain bank financing.

XII. MSRB RULE G-34(c)

Rule G-34(c) of the Municipal Securities Rulemaking Board (*"MSRB"*) relating to variable rate security market information requires that, among other things, brokers, dealers and municipal securities dealers submit to the MSRB certain documents associated with auction rate securities and variable rate demand revenue bond transactions. The purpose of the rule is to provide a centralized source of documents that define critical aspects of liquidity provisions and auction procedures and interest rate setting mechanisms. Dealers in auction rate securities are required to submit documents defining current auction procedures, while dealers in variable rate demand revenue bonds are required to submit documents relating to letters of credit, reimbursement agreements, standby bond purchase agreements and any other documents that establish an obligation to provide liquidity (including any amendments to such documents). Health care providers sometimes are required to covenant to provide such documents to the dealers in a timely fashion.

Part D – Interest Rate Hedges and Investment Contracts

Some governmental and nonprofit health care borrowers use interest rate hedging transactions and derivatives as part of their financing structures, giving consideration to market experience with collateral posting requirements and the mark to market effects on the operating statement, and the benefits of integration as a "qualified hedge" for tax purposes. Transactions involving derivatives often move quickly based on market opportunity, so where a borrower is considering these, it is important to pay early attention to whether a health care entity has appropriate corporate approval to enter into a derivative transaction, and whether their existing master indenture (and other debt documents) contains language contemplating the use of such products.

I. SECURING THE INTEREST RATE SWAP ON PARITY WITH BONDS

Most swap providers are requiring that governmental and nonprofit health care borrowers secure their obligations under a swap (or at least the regularly scheduled payments) on a parity basis with the bonds to which the swap relates. For both the governmental and nonprofit health care borrower, this will usually require an analysis of whether the revenue stream that is being pledged to the payment of the bonds can be tapped to make payments due under the swap as well. In the context of a financing that includes a master trust indenture, it can be significant as to how the master indenture defines the types of obligations that may be incurred by the members of the credit group and how such obligations may be secured, as obligations under a swap, do not fit neatly into the normal legal concepts of debt. Many master indentures provide for the issuance of a master indenture note or obligation solely to secure "indebtedness," which defined term is usually drafted to include only debt obligations or to specifically exclude derivative products. Also, many master indentures do not permit the Termination Payments (as defined below) under a swap obligation to be secured on parity basis with bonds and other debt under the master indenture. Care should be taken to confirm that the document allows the borrower to issue a master indenture note to secure its payment obligations for non-traditional debt items such as a swap.

II. Rights of Counterparty in Relation to Other Debt

If the governing document does allow a swap to be secured on a parity basis with the related bonds, another issue to address is how the swap counterparty, either as a holder of a master indenture note or as a party with an interest in the revenue stream that supports the bonds, is treated vis-à-vis the other master indenture noteholders or the bondholders. Unlike debt, in which a stated principal amount is outstanding and owing on which interest accrues, a swap transaction is merely a trading of payment streams based on a "notional amount" or fictitious principal amount bearing interest at a fixed or floating rate. In addition, swap transactions have certain payment obligations that may be owing to either party upon the early termination of the swap transaction (a *"Termination Payment"*). The amount of a Termination Payment and to which party it is owed will depend on the direction and magnitude that interest rates have moved since the swap transaction was completed and may fluctuate daily. All of these factors lead to the potential for wide movements in the amounts that may be owed by a party to a swap. With this in mind, there is a question of what is the "principal amount" of a note issued to secure a swap transaction for the purpose of exercising voting and consent rights of the holder of such note. While using the notional amount of the swap transaction provides some certainty in the outstanding amount, it will usually greatly overstate the amounts due the swap provider under the swap, even including any potential Termination Payment. Using the payments that may be due under the swap, on the other hand, is also not practical because it fluctuates. Master indentures increasingly try to create a solution for these issues, sometimes specifying that notes securing derivatives are not deemed outstanding for voting and consent issues, only for the rights to receive payments.

III. Collateralizing Payment Obligations under a Swap or Investment Contract

Depending on the creditworthiness of the borrower and other factors, some swap transactions will include a Credit Support Annex (part of the standard ISDA swap documentation), which requires either party to deliver cash and/or securities to collateralize its potential obligation to make a Termination Payment. Some investment contracts may also require to the counterparty to collateralize the trade if a ratings downgrade is received. Market volatility can present a situation where borrowers reach their collateralization threshold and actually have to post collateral. These collateralization requirements raise issues under covenants restricting liens on existing assets or on transferring assets outside of the credit group. If the covenants do not provide for specific exceptions allowing collateralization of a swap transaction or investment contract, then the borrower may be put in the awkward position of violating the master indenture covenant or violating the swap or investment documents if it is required to post collateral.

PART E – HEALTH CARE INDUSTRY REGULATION

I. General

The health care industry is highly regulated. The federal government has enacted laws and promulgated rules designed to reduce perceived fraud in the Medicare and Medicaid programs and is devoting more resources to investigations and audits in recent years. This increased regulation and supervision has affected the profitability of most health care institutions due to reductions in

reimbursements and increases in administrative expenses needed to comply with these rules and to respond to these investigations.

The Stark (self-referral prohibition) laws, general fraud and abuse statutes and privacy regulations under the Health Insurance Portability and Accountability Act of 1996 *("HIPAA")* all complicate the wording of opinions and make due diligence investigations more difficult and important. A health care provider's failure to comply with these laws and regulations can have serious consequences. As a result, the bondowners' risks section of the offering document for a health care transaction needs input from various members of the finance team and other attorneys with specialization in health care regulatory matters to disclose adequately the material facts regarding these laws and regulations as they affect the borrower. In addition, many borrower counsel are unwilling to give a blanket "compliance with all laws" opinion because of the difficulty of complying with rules and regulations that are often inconsistent or because proposed regulations may impose new duties that are ill-defined.

Regulation issues remain challenging in the wake of the Patient Protection and Affordable Care Act and the Reconciliation Bill (collectively, the *"Health Care Reform Act"*). Since its passage in 2009, the Health Care Reform Act has imposed substantial new statutory and regulatory requirements on the health care providers and third-party payors. As a result, the health care industry has undergone significant structural and operational changes and challenges in recent years. Such changes and challenges are likely to continue for the foreseeable future, notwithstanding efforts to waive, defer, grant exemptions from, or delay the implementation of the Health Care Reform Act and efforts by many members of Congress to repeal and/or replace the Health Care Reform Act. The ultimate effect of the Health Care Reform Act, on the one hand, and legislation that might revise, repeal and/or replace it, on the other, on current and projected operations, financial performance and financial condition of health care organizations is unclear at this time.

II. MEDICARE, MEDICAID, HIPAA, FRAUD AND ABUSE AND OTHER FEDERAL REGULATION

The principal federal health care regulations that are covered in a regulatory section or in the bondowners' risks section of offering documents include the following major topics:

1. *Medicare and Medicaid Programs.* Many health care providers derive a significant portion of their revenues from Medicare, Medicaid and other federal and state third party payor programs that are subject to governmental regulation applicable to health care providers. (Medicaid is a federal and state program that is administered by the states, resulting in state laws and regulations that vary from state to state.) It is common practice to discuss in the offering documents changes that have been and are likely to continue to be made in these programs that have had and are likely to continue to have a material impact on the financial condition of the borrower.

2. *Medicare and Medicaid Anti-Fraud and Abuse Statutes ("Anti-Kickback Laws").* The Medicare and Medicaid Anti-Kickback Laws provide for civil monetary and criminal penalties and expulsion from the Medicare/Medicaid programs for acts that add unnecessarily to the costs of the programs, such as knowing or willful over-utilization of services, or the offering,

solicitation, payment or receipt of remuneration for the referrals of patients. The scope of the Anti-Kickback Laws is generally discussed in the offering document, along with disclosure that there has been an apparent increase in high profile fraud and abuse investigations, which suggests that the federal government is devoting greater resources to scrutinizing arrangements and relationships among health care providers and referral sources to determine if those arrangements and relationships are in violation of the Anti-Kickback Laws.

3. *Federal False Claims Act/Qui Tam Actions.* Medicare requires that extensive financial information be reported on a periodic basis and in a specific format or content. Under the Federal False Claims Act ordinary course errors or omissions may result in liability. Additionally, HIPAA prohibits (1) the practice or pattern of presenting a claim for an item or service on a reimbursement code that the person knows or should know will result in greater payment than appropriate, *i.e.,* upcoding, and (2) engaging in a practice of submitting claims for payment for medically unnecessary services. Violation of prohibited practices under HIPAA could result in potential liability for over-reimbursements under the Federal False Claims Act.

Federal False Claims Act actions may be brought directly against a health care provider by the United States Attorney. In addition, the False Claims Act provides that an individual may bring a civil action for a violation of the Federal False Claims Act. These actions are referred to as *qui tam* actions. In a *qui tam* action, a health care employee is able to sue on behalf of the United States government if the employee believes that the health care provider has violated the Medicare reimbursement rules, including the HIPAA provisions described above. Many providers have experienced actual or threatened false claim or *qui tam* actions. If so, disclosure of past or pending claims may be appropriate in the official statement.

4. *Federal Self-Referral Prohibitions.* The Stark laws prohibit a physician who has a financial relationship, or whose immediate family member has a financial relationship, with an entity (including a hospital), from referring a Medicare or Medicaid patient to the entity for certain designated health services, including inpatient and outpatient hospital services. The Stark laws also prohibit the entity receiving the referral from filing a claim or billing for the services arising out of the prohibited referral. The types of financial arrangements between a physician and an entity that would trigger the self-referral prohibition are broad, and include investment interests, joint ventures, space and equipment rentals, management and personal service contracts and employment arrangements. Offering documents often state that the borrower has no reason to believe that its arrangements with physicians and others are in violation of the Stark laws.

5. *Patient Privacy Regulations*. HIPAA also requires that certain health care providers, including hospitals, establish distinct privacy and security protections for individually identifiable health information. Most health care providers are now disclosing in offering documents that they are spending and anticipate that they will continue to spend substantial amounts in complying with the medical privacy rules under HIPAA. HIPAA also mandates the establishment of security regulations.

6. *Patient Transfers.* In response to concerns regarding inappropriate hospital transfers of emergency patients based on the patient's inability to pay for the services provided, Congress has enacted an "anti-dumping" statute. Failure to comply with the law can result in exclusion from

the Medicare or Medicaid programs, as well as civil and criminal penalties. Hospitals receive inquiries about the appropriateness of certain patient transfers in the ordinary course. It should be noted in the offering document if the hospital has had any significant violations of the anti-dumping statute in the past.

7. *Medicare and Medicaid Retroactive Audit Adjustments.* Health care providers are subject to audits and retroactive audit adjustments with respect to the Medicare and Medicaid programs. These adjustments may exceed the health care provider's reserves and may be substantial.

8. *Physician Alliances and Affiliations*. Many health systems are pursuing strategic alliances and joint ventures with physicians that may be capital intensive and may create certain business and legal liabilities for the related hospital or health system. These integration strategies take many forms, including management service organizations (*"MSOs"*) or physician-hospital organizations (*"PHOs"*), which may provide a combination of financial and managed care assistance, as well as management, facilities, and equipment to groups of physicians. Other integration structures include hospital-based clinics or medical practice entities, which may purchase and operate physician practices. These integrated delivery developments carry with them the potential for financial, legal, or regulatory risks in varying degrees, including certain regulatory risks outlined above.

9. *Hospital Affiliation, Merger, Acquisition and Disposition.* Many multi-hospital systems plan for, evaluate and pursue potential merger and affiliation candidates as part of their overall strategic planning and development process. Discussions with respect to affiliation, merger, acquisition, disposition, or change of use are held on a confidential basis with other parties. Analysis of a borrower's obligation to disclose a potential affiliation, merger, acquisition or disposition that is not yet public in connection with a planned bond financing can be complex, although substantial guidance is provided in the public-company/corporate arena as to when such disclosure is required.

10. *Other Acquisitions and Affiliations.* In addition to relationships with hospitals and physicians, hospital systems frequently consider investments, ventures or affiliations involving other health care-related entities or development and acquisition of other health care-related entities. These may include home health care, long-term care entities or operations, infusion providers, pharmaceutical providers and other health care enterprises that support the overall operations and mission of the system. All these initiatives may involve significant capital commitments or operating risk (including, potentially, insurance risk) in a business in which the hospital system may have less expertise than in hospital operations.

11. *Antitrust.* Antitrust liability may arise in a wide variety of circumstances, including medical staff privilege disputes, payor contracting, physician relations, joint ventures, merger, affiliation and acquisition activities and certain pricing or salary setting activities, as well as other areas of activity. Another potential area of liability is merger and affiliation activity if a provider's market power in a particular inpatient market or related health care business line becomes too great. The application of the federal and state antitrust laws to health care is still evolving, significant issues exist in connection with initiatives set out in the Health Care Reform Act and

enforcement activity by federal and state agencies has increased. In recent enforcement actions, the federal government has taken fresh looks at mergers that had originally received pre-merger governmental approval. Violators of the antitrust laws may be subject to criminal and civil enforcement by federal and state agencies, as well as by private litigants in certain instances.

III. Medicaid, Certificates of Need, Licensure and Other State Regulation

See "*Medicare, Medicaid, HIPAA, Fraud and Abuse and Other Federal Regulation—Medicare and Medicaid Programs*" above for a discussion of the Medicaid programs administered by the states.

During the time that Medicare reimbursed health care institutions for capital costs, many states enacted "certificate of need" or other health care planning laws as a means of limiting the construction of health care facilities to contain health care costs. Several states have repealed these laws, but they remain in effect in several other states. Certificate of need laws prohibit the acquisition or construction of certain health care facilities unless the appropriate state health planning review body has granted a "certificate of need" for that facility. These laws specify the capital expenditures that require certificates of need, usually requiring certificates of need for new health care services, an increase in beds or capital expenditures above a specified threshold amount. If a certificate of need is required for facilities to be financed, financing participants usually require that the certificate of need be obtained before the financing takes place unless they have determined that its issuance is virtually certain or unless the certificate of need is required for only a small portion of the property to be financed and other property that qualifies under applicable state law and federal income tax law for inclusion in the financing can be substituted in the financing if the certificate of need is not issued.

In addition to certificates of need, other governmental approvals may be required in connection with the acquisition or construction of the project being financed. These may include approval of plans and specifications by state licensing authorities, building permits, planning and zoning approvals, environmental approvals, or historic preservation approvals.

Hospitals and nursing homes generally are required to be licensed by state law, and assisted living or residential care facilities are required to be licensed in many states. Several states also have laws pertaining to resident contracts, entrance fees and escrowed funds for various senior living arrangements.

IV. Operating for "Charitable" Purposes

The basis for a nonprofit hospital obtaining 501(c)(3) status has long been rooted in demonstrating that the entity is organized and operated exclusively for charitable or other exempt purposes. The IRS first articulated its criteria for this test in Revenue Ruling 56-185. Revenue Ruling 56-185 created a fairly narrow criteria of "operat[ing] to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able or expected to pay." Treasury Regulations interpreting Section 501(c)(3) of the Code were then adopted in 1959 which broadened the concept of "charitable" and paved the way for Revenue Ruling 69-545 which set forth a five part test for a nonprofit hospital to be considered "charitable":

(1) operate an emergency room open to all regardless of ability to pay, (2) provide care to all who can afford to pay, including through federal and state insurance programs, (3) dedicate surplus funds to support programs that further its exempt purpose, (4) have a medical staff open to all qualified physicians and (5) have an independent board of community leaders. These five tests are generally referred to as the "community benefit standard."

The exemption granted to nonprofit hospitals and health care systems under federal and state laws and the question of what is a "charitable" purpose and what are the appropriate levels of charity care is frequently scrutinized. For example, several states have adopted minimum charity care levels that nonprofit health care providers must meet to avoid revocation of state nonprofit status. In addition, in certain areas, local governments have denied property tax exemption for nonprofit hospitals based on a determination that the "non-charitable activity" by the hospitals was great enough to override its not for profit status. Class action plaintiff lawyers have also filed federal civil class action lawsuits filed against many major nonprofit hospitals and health care systems across the country targeting the nonprofit's billing and collections practices. Both houses of Congress have held hearings to investigate the operations of nonprofit corporations and to look into levels of executive compensation at nonprofit organizations. Such scrutiny, and others, may lead to legislation targeted to directly impact the existing standards applied to nonprofit hospitals in order to maintain 501(c)(3) status. The Form 1023 Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code and the Form 990 include several new and/or expanded areas of investigation, including governance practices, compensation arrangements, and community benefit.

From this increased focus on the 501(c)(3) exempt status of hospitals and health care providers, it appears that in addition to monitoring changes in the legislative landscape under the federal and state reimbursement programs, nonprofit hospitals should also be focusing on some of the basic issues underlying their 501(c)(3) exempt status and potential increased oversight and reporting requirements.

PART F – RELIGIOUS USE

Many health care institutions have religious affiliations. These affiliations may impact the ability of certain facilities to be financed with tax-exempt bond proceeds because of the establishment clause of the First Amendment to the United States Constitution ("Congress shall make no law respecting an establishment of religion . . .," which is also applicable to the states as a result of the Fourteenth Amendment to the United States Constitution), similar provisions of state constitutions and provisions in enabling bond legislation that address the use of bond proceeds to finance facilities used for sectarian purposes.

A health care institution's religious affiliation alone generally will not disqualify it from engaging in tax-exempt conduit bond financings for its facilities. Most counsel believe, however, that the financing of facilities that are used for sectarian instruction or places of religious worship or that restrict their patients or residents to persons meeting certain religious qualifications may run afoul of these provisions even though the courts have become more reluctant to find that governmental programs violate the establishment clause and recent judicial activity has further complicated analysis of these issues.

PART G – HEALTH CARE FINANCING STRUCTURES

I. DIRECT PURCHASE BONDS

Taxable or tax-exempt bonds purchased directly by commercial banks (or their affiliates) have become a popular option for health care providers to finance new facilities or equipment purchases or to refinance existing debt. Many financial institutions offer this structure as an alternative to traditional letter of credit-backed variable rate bonds or taxable term loans. Health care providers may be able to reduce their overall cost of capital by utilizing this structure. In addition to potentially lower interest rates, this structure substantially reduces costs of issuance when compared to a fixed rate or letter of credit-backed variable rate bond transaction since there are no underwriting and remarketing fees or fees associated with the preparation of an offering document (*e.g.,* fees of disclosure counsel and auditor's fees related to agreed-upon procedures).

While the direct purchase bond structure provides certain benefits to health care providers, there are certain hurdles to be overcome and risks to be examined before entering into this type of transaction. Since financial institutions typically are not interested in holding bonds to maturity, they are typically granted a "put" option at the end of the period they are willing to hold the bonds (typically in the one- to seven-year range, although longer hold periods have become more common in recent years). As noted above under "COVENANTS—Rate Covenant," master indentures often include a provision which allows a health care provider to smooth out the annual debt service requirements on debt with this type of a put option. Without the ability to smooth this put debt over a longer period of time, the health care provider may be unable to incur this type of debt under its master indenture or to meet its on-going rate covenant. In addition, in the event the health care provider fails to comply with the covenants imposed by the bank, a significant amount of liquidity would be required if payment of the bonds is accelerated.

Public disclosure of direct purchase bond transactions has not also been required, although rating agencies have focused on the potential impact of the repayment risk on the health care provider's liquidity for many years. Following the market trend of increased disclosure, and the SEC's focus in this year, beginning February 2019, borrowers with outstanding debt subject to Rule 15c2-12 are required to disclose direct purchase bonds and other non-public financings, if material.

II. VARIABLE RATE DEMAND BONDS AND PUT BONDS

Health care providers that seek to diversify their debt portfolios often utilize variable rate demand bonds ("VRDBs") and put bonds. Variable rate demand bonds are publicly-offered debt instruments that bear interest at a floating rate, which resets on an interval selected by the borrower at its issuance. The most common intervals are daily and weekly resets. Borrowers engage a remarketing agent to reoffer the VRDBs on each reset date, at a market rate on such reset date. With VRDBs, Borrowers are exposed to interest rate risk and remarketing risk, as investor demand drives what the interest rate will be on each reset date, and whether the VRDBs can be resold to investors on each reset date. If no investors can be identified to purchase any VRDBs on a particular reset date, the borrower is obligated to purchase the VRDBs from the then-current

holder. As such, VRDB issuances are frequently coupled with a form of credit support, pursuant to which a bank agrees to backstop the borrower's obligation to purchase unremarketed VRDBs, and often agrees to issue a letter of credit to support the payment of principal and interest on such VRDBs. Such VRDBs receive a joint-criteria rating; i.e. a rating that is based on the credit of both the borrower and the bank issuing the credit support. Some highly-rated health care providers that issue VRDBs have sufficient financial resources that investors are comfortable purchasing VRBDs issued for their benefit without such third-party credit support, this being referred to in the market as "self-liquidity." Notwithstanding these risks, VRDBs are an attractive instrument because they typically bear interest at a much lower short-term interest rate than traditional fixed rate bonds.

Put Bonds are another publicly-offered instrument by which health care providers diversify their debt portfolios. Put Bonds are issued at a fixed interest rate to particular holders, who agree to hold the bonds for a selected period of time, typically 1, 3, 5, or 7 years. Put Bonds allow borrowers to take advantage of an interest rate that is lower than a traditional fixed rate bond, without the interest rate risk or remarketing risk of a VRDB. However, the borrower is required to either pay the Put Bonds in full at the end of the hold period, remarket them to a new holder for a new term and at a new interest rate, or purchase the Put Bonds and convert them to bear interest in a new interest rate mode. If the purchase price of the Put Bonds is not paid at the end of the hold period the borrower will be in default. This obligation to purchase Put Bonds at the end of their hold period can also be supported by a credit facility similar to that described above for VRDBs.

To further mitigate the risks to health care borrowers associated with VRDBs and Put Bonds, these bonds are typically issued under a multi-modal indenture, which gives the borrower flexibility to convert them to a different product, within a relatively short-time frame for VRDBs and at the end of (or shortly before) their hold period for Put Bonds.

III. Forward Delivery Transactions

The elimination of tax-exempt advance refundings, coupled with a historically low interest rate environment for health care providers borrowing funds, has driven a resurgence in forward delivery bond issuances in recent years. In a forward transaction, the bonds are priced and sold, but not issued and settled, until a date farther in the future than a typical bond issuance. There may be a rate lock required and there is usually a premium in their pricing, because these bonds are not as liquid during the forward period in the hands of their holders. In addition to a rate lock or premium, health care borrowers also need to carefully consider contingencies in the purchase contract for forward delivery bonds (otherwise known as "underwriter outs", given the extended period of time in which such contingencies could occur.

IV. Federal Housing Administration/Office of Housing and Urban Development Programs

Certain health care providers may utilize mortgage insurance issued under various programs offered by the Federal Housing Administration and the Office of Housing and Urban Development as credit enhancement for tax-exempt bonds. The FHA's Section 242 program is generally available to stand-alone hospitals, including community and critical-access hospitals,

and may be used to refinance existing debt and to complete renovations as long as 20% of the mortgage proceeds are spent on construction or renovation projects, including equipment purchases. Loans insured by the Section 242 program are typically secured by a mortgage and pledge of revenues related directly to the project financed, and collateral pledged for this type of loan may not be part of an obligated group or be used as collateral for other debt. Other FHA/HUD programs are available for refinancing existing 242-insured mortgages.

V. Tax-Exempt Operating Leases/Off-Balance Sheet Financing

Some health care providers have used tax-exempt operating leases to finance new facilities or equipment purchases. These transactions have historically been treated as operating leases for accounting purposes, but as installment purchase obligations (*i.e.,* debt) for federal income tax purposes. Health care providers engaged in these transactions for a variety of reasons, including a desire for the off-balance sheet accounting treatment, the exclusion of the transaction from existing covenants restricting incurrence of debt, the exclusion of the transaction from debt service coverage ratio and other financial ratio calculations and the attractiveness of their payment schedules. For more information on tax-exempt lease financing generally, see The Workshop outline entitled "Tax-Exempt Leasing."

Recent changes to generally accepted accounting principles require that, with very limited exceptions, both financing leases and operating leases be recognized on the balance sheet. Accounting Standards Update No. 2016-02, February 2016. This requirement, which became effective for fiscal years beginning after December 15, 2018, for nonprofit health care providers that are conduit bond obligors, eliminates disparate accounting treatment as motivation for these transactions. If the health care provider desires that a lease transaction result in off-balance sheet treatment, its accountants should review the transaction and provide their assessment of this treatment very early in the financing process. (In some cases, off-balance sheet treatment is not important to the health care provider; management simply likes the payment schedule that results from the structure.)

There is an inherent tension between the desire to have one of these transactions treated as an operating lease for accounting purposes and to have it treated as debt for tax purposes. Just as it is important to have the health care provider's accountants review the transaction early in the process, it is also important for bond counsel to review the transaction at the beginning of the process to determine whether the transaction results in debt for federal income tax purposes.

If the health care provider has covenants in outstanding bond issues or other financings regarding debt restrictions, asset acquisitions or encumbrances, those covenants need to be examined to determine their applicability to the transaction. "Indebtedness," as used in these covenants, is defined in some cases by reference to a transaction's treatment under generally accepted accounting principles, but in other cases is defined more broadly to include additional obligations such as operating leases as well. The security interest in the facilities or equipment financed must also be permitted. The rating agencies will normally take off-balance sheet financings into account regardless of their treatment under the hospital's financing covenants. In addition, many banks, other direct placement purchasers and credit enhancers require that off-

balance sheet leases be included in computations of debt service coverage and other financial ratios.

VI. EXTRA-TERRITORIAL ISSUERS

Most multi-state health care systems continually evaluate their bond transactions to try to reduce the issuance costs related to their borrowing. One way these systems reduce costs is to reduce the number of issuers that are involved in transactions that finance projects in multiple states. Several state authorities have amended their authorizing statutes to include the power to finance facilities outside the boundaries of the authority's state. In addition, issuing authorities have been created in various states that have the power to finance facilities across the country. These issuers have been issuing bonds for health care, senior living, and other ancillary health care service providers to finance a facilities outside the boundaries of the issuer's state of formation.

For an issuer to issue bonds, it must have the power to do so. Typically, this power must be granted by the state legislature (unless it is derived from constitutional charter or home rule powers granted by the state constitution). Secondly, the power must not run afoul of state constitutional limitations. State constitutions normally serve to limit legislative power rather than to grant it. See, for example, *Kansas City v. Fishman,* 241 S.W.2d 377 (Mo. 1951) at 379, which provides "a State Constitution is not a grant of power as is the Constitution of the United States but, as to legislative power, it is only a limitation; and therefore, except for the limitations imposed thereby, the power of the State Legislature is unlimited and practically absolute."

State constitutional limitations will vary from state to state. A common, but not universal, constitutional limitation is a requirement that the bonds be issued for a public purpose. Illustratively, the Missouri constitution has provisions that prohibit the granting of public money or the lending of the credit of the state or its political subdivisions in aid of a private corporation. The Missouri Supreme Court has held on several occasions that these provisions are not violated in conduit financings where there are no public moneys involved and the bonds are not payable from taxation or where the bonds are issued for a public purpose.

If a public purpose is required, it may be helpful if the legislature has included public purpose findings in the enabling legislation. In addition, it may also be helpful if the issuing authority finds that the issuance of the bonds serves a public purpose. It is important to carefully review the appropriate legislation and to talk to the issuer and its counsel to ensure that any specific requirements or policies developed to demonstrate the benefit to the state of issuance of financings for facilities in other states are met.

Some have expressed concern that the use of bond proceeds to finance projects outside the state in which an issuer is located may violate the sovereign powers of another jurisdiction. The concept of state sovereignty is derived from Amendment X of the Constitution of the United States which provides that "[t]he powers not delegated to the United States by the constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people." U.S. Const. Amend. X. A "state possesses exclusive jurisdiction and sovereignty over persons and property within its territory." 81A C.J.S. States §17. "The jurisdiction of a state is restricted to its own

territorial limits and does not extend beyond its boundaries." *Id.* This limit on extraterritorial powers prevents a state from exercising sovereign powers beyond its borders. Consequently, if a governmental issuer is acting outside its state and those actions are of a sovereign nature, those actions may violate Amendment X of the Constitution of the United States by infringing upon the sovereignty of another state. The courts have found sovereign powers to be powers associated with governing, such as police powers, the power to tax, the power of eminent domain and the power to regulate the conduct of its citizens, and have distinguished these powers from other powers exercised by governmental entities. See, for example, *State ex rel. Landis v. Board of Commissioners of Butler County*, 115 N.E. 919, 920 (Ohio 1917), *Speas v. Kansas City,* 44 S.W.2d 108, 113 (Mo. 1931), *The City of Colorado Springs v. Colorado City,* 94 P. 316, 319 (Co. 1908), *Langdon v. Walla Walla,* 193 P. 1, 3-4 (Wash. 1920), *Sabaugh v. City of Dearborn,* 185 N.W.2d 363, 366 (Mich. 1971), and *Birge v. Town of Easton,* 337 A.2d 435, 440 (Md. 1975). The Supreme Court of Missouri in *Menorah Medical Center v. Health and Educational Facilities Authority,* 584 S.W.2d at 73 (Mo. 1979), held that the Health and Educational Facilities Authority of the State of Missouri "does not raise or receive its funds in connection with any sovereign powers of the State."

From the foregoing, it does not appear that lending the proceeds of a bond issue to finance facilities outside the bond issuer's state is prohibited by limitations on sovereign powers. There is some question, moreover, whether the issuance of bonds by an issuing authority that loans its money to an entity in its state is engaging in extraterritorial action even when the borrower uses those proceeds in another state.

Under federal tax law, a tax-exempt private activity bond issue must be approved, after published notice and a public hearing, by the governmental unit issuing the bonds (an *"issuer approval"*) and by each governmental unit having jurisdiction over the site of the financed facilities (a *"host approval"*). When a portion of the project is outside the jurisdiction of the governmental unit that is granting the issuer approval, a public hearing and host approval are required for each governmental jurisdiction in which the project is located. Thus, multiple public hearings and approvals are required in financings for projects in more than one state. Public hearings must be conducted by an individual or entity authorized by the appropriate governmental unit (the issuer or the host) to conduct the public hearing. This authorization is typically implied if the hearing is held by the issuing entity or by an employee or official of the issuing entity. For a host approval in another state, the person or entity holding the hearing must be authorized to do so by the host governmental unit. In some instances, this authorization may already be in place. The act establishing and governing the Health and Educational Facilities Authority of the State of Missouri, for example, authorizes that authority to conduct public hearings for Missouri projects that are to be financed by other issuers. In other instances, it may be necessary to have the elected governmental official who will approve the project authorize an individual or entity to hold the hearing.

PART H – CORPORATE GOVERNANCE ISSUES FOR 501(C)(3) ORGANIZATIONS

I. FALLOUT FROM THE SARBANES-OXLEY ACT

The American Competitiveness and Corporate Accountability Act of 2002 (commonly referred to as the Sarbanes-Oxley Act) (*"SOX"*), became law on July 30, 2002. Passed in response to the corporate and accounting scandals occurring in 2001 and 2002, SOX is applicable to publicly traded companies and, therefore, for the most part does not directly govern entities such as 501(c)(3) organizations participating in securities offerings that are exempt from the registration requirements of the securities law.[1] Even so, many 501(c)(3) organizations have voluntarily adopted some of the basic corporate practices outlined under SOX. States have also shown a willingness to legislate SOX type standards for nonprofit organizations (*e.g.,* California's Nonprofit Integrity Act of 2004).

The SOX and enforcement proceedings under SOX may also have an impact on what is considered material for purposes of disclosures regarding corporate governance policies and procedures. Is the fact that a nonprofit does not have an "independent" audit committee that would be required for a registered company under the SOX something that should be disclosed to potential investors? While 501(c)(3) bonds are not subject to the registration requirements of the federal securities laws, they are subject to the application of Rule 10b-5.

II. AREAS OF SOX THAT MAY IMPACT GOVERNANCE POLICIES

1. *Independent and Competent Audit Committee.* Under SOX, each member of the company's audit committee must be a member of the board of directors and be independent. SOX defines independence as not being part of the management team and not receiving any direct or indirect compensation from the company as a consultant for other professional services. Companies must also disclose whether they have at least one "financial expert" on the audit committee, or if they don't, they must disclose the reasoning behind that decision.

2. *Auditor Responsibilities.* SOX requires that the lead and reviewing partner of the auditing firm rotate off the audit every five years, prohibits the auditing firm from providing most non-audit services to the company while they are acting as auditors and requires the auditing firm report to the audit committee concerning "critical accounting policies and practices".

3. *Certified Financial Statements.* SOX requires the chief executive and chief financial officers to certify as to the appropriateness of financial statements and that they fairly present the financial condition and operations of the company.

III. IRS GUIDANCE FOR 501(c)(3) ORGANIZATIONS

The IRS has published a "Compliance Guide for 501(c)(3) Public Charities," which includes guidance on corporate governance procedures and practices for 501(c)(3) organizations.

[1] There are two provisions of the Sarbanes-Oxley Act that are applicable to both for profit and nonprofit corporations alike: (1) prohibition on retaliation against any individual who reports suspected illegal activity and (2) prohibition against altering, concealing, destroying or falsifying litigation-related documents (or persuading others to do it) to prevent their use in official proceedings (*e.g.*, federal investigation).

While not mandatory requirements, these recommendations do offer a look into what issues may be important to the IRS when dealing with financial transactions involving 501(c)(3) health care organizations. The guide can be found online at (www.irs.gov/pub/irs-pdf/p4221pc.pdf).

PART I – 15c2-12

Under SEC Rule 15c2-12, an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more is prohibited from purchasing or selling such municipal securities unless the underwriter has reasonably determined, among other things, that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement, has undertaken in a written agreement or contract for the benefit of holders of such securities to provide to the MSRB updated annual financial information and operating data presented in the final official statement and notice of certain events listed in Rule 15c2-12. Underwriters comply with this provision of Rule 15c2-12 by requiring that an issuer of municipal securities or an obligated person undertake in a written agreement or contract (i.e., a "continuing disclosure agreement") to provide certain financial information, operating data and event notices to the MSRB in a manner that is consistent with the requirements of Rule 15c2-12.

Rule 15c2-12 was amended effective February 27, 2019, to require timely (within 10 business days) notice of two additional sets of "events":

1. Incurrence of a financial obligation (defined to include a (i) debt obligation, (ii) derivative instrument, or (iii) a guarantee of (i) or (ii), other than municipal securities for which a final official statement has been provided to the MSRB) of the obligated person, if material (not defined), 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

2. Default, event of acceleration, termination event, modification of terms, or other similar events (not defined) under the terms of the financial obligation of the obligated person, any of which reflect financial difficulties.

# # #

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

HOT TOPICS IN SECURITIES LAW

Chair:

Daniel Deaton Nixon Peabody LLP, Los Angeles, California

Panelists:

David Cohen RBC Capital Markets, New York, New York
Dave A. Sanchez Director, Office of Municipal Securities, U.S. Securities and Exchange Commission

Panel Description*: This panel will include practitioners and securities regulators discussing the latest federal securities law issues facing the municipal bond market, with a focus on how lawyers may assist their clients in addressing these issues. While the final topics are subject to change based upon current events, expect to hear updates about (i) analysis concerning the application to the municipal securities market of the recent SEC actions, initiatives and developments concerning ESG disclosure, and (iii) recent enforcement actions and pending rule changes impacting securities laws and transactions in the municipal market.*

I. MUNICIPAL SECURITIES LEGAL & REGULATORY LANDSCAPE

A. Securities Act of 1933 – The Securities Act of 1933, as amended (the "Securities Act") is the foundational securities law governing securities offerings, which is generally inapplicable to municipal securities other than the anti-fraud provisions

> Securities Act Section 17(a)(2) – "*It shall be unlawful for* ***any person*** *in the offer or sale of any securities ... or any security-based swap agreement ... by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.*"

This statutory provision formed the basis for the settlements with underwriters, municipal issuers and obligated persons in the SEC's Municipalities Continuing Disclosure Cooperation ("MCDC") Initiative.

B. Securities Exchange Act of 1934 – The Securities Exchange Act of 1934, as amended (the "Exchange Act") created the Securities and Exchange Commission (the "Commission" or the "SEC"), and establishes regulatory authority and jurisdiction of the Municipal Securities

Rulemaking Board (the "Board" or the "MSRB") and other self-regulatory organizations and market utilities, requires registration of broker-dealers, municipal securities dealers and municipal advisors with the SEC, establishes certain securities-related reporting and related requirements inapplicable to municipal securities, and includes anti-fraud provisions that are applicable to municipal securities.

(1) Exchange Act Section 10(b) – "*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 … [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.*"

This statutory provision provides authority for SEC Rule 10b-5: "*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) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o 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)[t]o 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.*"

(2) Exchange Act Section 15(c)(1)(B) – "*No* ***broker, dealer, or municipal securities dealer*** *shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security or any security-based swap agreement involving a municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance.*"

(3) Exchange Act Section 15(c)(2)(B) – "*No* ***broker, dealer, or municipal securities dealer*** *shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in connection with which such broker, dealer, or municipal securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.*"

This statutory provision provides authority for SEC Rule 15c2-12, establishing requirements on underwriters with respect to municipal issuers' primary and continuing disclosures, derived from this section and Section 15(c)(2)(D).

(a) Current text of Rule 15c2-12: https://www.ecfr.gov/cgi-bin/text-idx?SID=eb2c65d80de644ceac78502b5fb51b3d&mc=true&node=se17.4.240_115c2_612

(b) SEC Office of Municipal Securities page on Rule 15c2-12 and related disclosure matters: https://www.sec.gov/municipal/municipal-securities-disclosure.html

(4) Exchange Act Section 15B(a)(5) – "*No **municipal advisor** shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products, the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, in connection with which such municipal advisor engages in any fraudulent, deceptive, or manipulative act or practice.*"

(5) Registration requirements:

(a) Broker-dealers must register with the SEC as broker-dealers under Exchange Act Section 15(a)(1).

(b) Non-broker-dealer banks effecting, inducing or attempting to induce transactions in municipal securities must register with the SEC as municipal securities dealers under Exchange Act Section 15B(a)(1)(A).

(c) Municipal advisors (including broker-dealers or municipal securities dealers already registered as described in (i) and (ii)) must register with the SEC as municipal advisors under Exchange Act Section 15B(a)(1)(B).

This statutory provision provides authority for SEC Rules 15Ba1-1 through 1-8, defining who is a municipal advisor.

(6) Exchange Act Section 15B(c)(1) [first sentence] – "*No **broker, dealer, or municipal securities dealer** shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security, and no broker, dealer, municipal securities dealer, or **municipal advisor** shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products, the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, in contravention of any rule of the Board.*"

This statutory provision is what requires broker-dealers, municipal securities dealers and municipal advisors to comply with MSRB rules.

(7) Exchange Act Section 15B(c)(1) [second sentence] – "*A **municipal advisor** and any person associated with such municipal advisor shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice, or course of business which is not consistent with a municipal advisor's fiduciary duty or that is in contravention of any rule of the Board.*"

This statutory provision is what establishes the federal fiduciary duty of municipal advisors to their municipal entity clients.

(8) Rulemaking authorities:

(a) MSRB Rulemaking – Exchange Act Section 15B(c)(2) – "*The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by* ***brokers, dealers, and municipal securities dealers*** *and advice provided to or on behalf of municipal entities or obligated persons by* ***brokers, dealers, municipal securities dealers, and municipal advisors*** *with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by* ***brokers, dealers, municipal securities dealers, and municipal advisors****. The rules of the Board, as a minimum, shall … [sets out 12 specific areas for rulemaking]*"

(i) MSRB Rules and Interpretations: http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx

(ii) MSRB's EMMA website: https://emma.msrb.org/

(b) SEC Rulemaking

(i) Exchange Act Section 15B(c)(7) – "*Nothing in this section shall be construed to impair or limit the power of the Commission under this title.*"

(A) *e.g.*, MSRB rulemaking authority does not foreclose SEC from adopting rules under the Exchange Act, such as SEC Rule 15c2-12

(ii) Exchange Act Section 19(c) – "*The Commission, by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as "amend") the rules of a self-regulatory organization … as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this title and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this title….*"

This provision provides the SEC residual rulemaking authority to add to, amend or override MSRB rules on broker-dealers, municipal securities dealers and municipal advisors under Exchange Act Section 15B(c)(2)

(c) "Tower Amendment"

(i) Limitation on SEC and MSRB rulemaking authority – Exchange Act Section 15B(d)(1): "*Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities,*

directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities."

(ii) Further limitation on MSRB rulemaking authority – Exchange Act Section 15B(d)(2): "*The Board is not authorized under this title to require any issuer of municipal securities, directly or indirectly through a municipal securities broker, municipal securities dealer, municipal advisor, or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: Provided, however, that the Board may require municipal securities brokers and municipal securities dealers or municipal advisors to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title.*"

(A) The inapplicability of subsection (2) of the Tower Amendment to the SEC allowed the SEC, but not the MSRB, to adopt the requirements set out in SEC Rule 15c12-12.

(B) The proviso clause in subsection (2) allowed the MSRB's requirements for underwriters to provide official statements, if produced and made available, to the MSRB and to customers.

(9) Examinations for compliance with, and enforcement of, MSRB rules conducted by:

(a) For broker-dealers:

(i) the Financial Industry Regulatory Authority ("FINRA"), with:

(A) examination authority under Exchange Act Section 15B(c)(7)(A)(i)

(B) enforcement authority under Exchange Act Section 15A(b)(7)

(ii) the SEC, with:

(A) examination authority under Exchange Act Section 17(b)(1)

(B) enforcement authority under Exchange Act Section 15(b)(4) and Section 15B(c)(2)-(4)

(b) for non-broker-dealer municipal securities dealers:

(i) the US Treasury Department's Office of the Comptroller of the Currency, the Federal Reserve Board or the Federal Deposit Insurance Corporation, depending on the type of bank (as prescribed in Exchange Act Section 3(a)(34)(A)), with:

(A) examination authority under Exchange Act Section 15B(c)(7)(A)(ii)

(B) enforcement authority under Exchange Act Section 15B(c)(5)

(ii) the SEC, with:

(A) examination authority under Exchange Act Section 17(b)(1)

(B) enforcement authority under Exchange Act Section 15B(c)(2)-(4)

(c) for municipal advisors:

(i) the SEC, with:

(A) examination authority as primary examiner for non-broker-dealer municipal advisors under Exchange Act Section 15B(c)(7)(A)(iii) and for all municipal advisors under Exchange Act Section 17(b)(1)

(B) enforcement authority under Exchange Act Section 15B(c)(2)-(4)

(ii) FINRA, for municipal advisors that are broker-dealers, with:

(A) examination authority derived from the SEC's designation under Exchange Act Section 15B(c)(7)(A)(iii) and Exchange Act Release No. 70462 (September 20, 2013), 78 FR 67468 (November 12, 2013), Section IV ("Municipal Advisor Registration Order")

(B) enforcement authority under Exchange Act Section 15A(b)(7)

C. Trust Indenture Act of 1939 – inapplicable to municipal securities pursuant to Trust Indenture Act Section 304(a)(4)(A)

D. Investment Company Act of 1940

(1) governs mutual funds and other fund-based investment vehicles, even when vehicles invest in municipal securities

(2) fund products issued by municipal entities (*e.g.*, 529 plans, ABLE Act plans and local government investment pools) are exempt pursuant to Investment Company Act Section 2(b)

E. Investment Advisers Act of 1940

(1) regulates provision of investment advice with respect to all types of securities investments

(2) no exemption for municipal securities

II. IMPLEMENTATION OF 2017 "FINANCIAL OBLIGATIONS" EVENT DISCLOSURES IN SEC RULE 15c2-12

A. Overview of implementation of the financial obligations event disclosures

(1) Documenting the new events in new continuing disclosure undertakings – what to say in the undertaking itself

(2) Understanding how issuers and obligated persons identify, track and disclose:

(a) incurrence of a material financial obligation

(i) what is a "financial obligation"?

(ii) when is it "material"?

(iii) when is it "incurred"?

(b) agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation

(i) what are "covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation"?

(ii) which "affect security holders"?

(iii) when is there an "agreement to" covenants *et al.*?

(c) occurrence of a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation

(i) what is a "default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation"?

(ii) when do they "reflect financial difficulties"?

(iii) are defaults *et al.* reflecting financial difficulties with respect to non-material financial obligations covered?

(d) are standard processes or approaches for issuers and obligated persons emerging so far?

(3) Understanding how underwriters comply with their obligation to:

(a) "reasonably determine" that the issuer or obligated person have made a compliant continuing disclosure undertaking – do underwriters expect more than just an undertaking with the right language?

(b) undertake "due diligence" regarding official statement disclosure of material non-compliance with financial obligation disclosures – what steps do underwriters take, and how do they expect issuers/obligated persons to back up their official statement disclosures

(c) are standard processes or approaches for underwriters emerging so far?

(4) General discussion of the good, the bad and the ugly of financial obligation disclosure so far

B. Elements of the 2017 disclosure obligations – teasing out the open questions

B.1 – What is a financial obligation?

(1) Definition of "financial obligation" in Rule 15c2-12(f)(11):

(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 any financial obligation described in (i) or (ii) above;

but excludes municipal securities as to which a final official statement has been provided to the MSRB consistent with Rule 15c2-12.

(2) Excerpts from the SEC discussion in Exchange Act Release No. 83885 (August 20, 2018), 83 FR 44700 (August 31, 2018) ("15c12-12 Amendment Order"), Section III.A.2:

(a) general nature of financial obligation:

(i) "*... 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*"

(ii) "*... is not limiting the term "debt obligation" to debt as it may be defined for state law purposes, but instead is applying it more broadly to circumstances under which an issuer or obligated person has borrowed money*"

(iii) "*... any short-term or long-term debt obligation of an issuer or obligated person under the terms of an indenture, loan agreement, lease, or similar contract [such as a line of credit] is covered by the term 'debt obligation' regardless of the length of the debt obligation's repayment period*"

(b) direct purchases and loans

"*... a direct purchase of municipal securities by an investor and a direct loan by a bank would be debt obligations of an issuer or obligated person*"

(c) leases

(i) "*... generally should be considered to include lease arrangements entered into by issuers and obligated persons that operate as vehicles to borrow money*"

(ii) "*... the types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions*"

(iii) "*... leases entered into in the ordinary course of an issuer's operations do not represent competing debt and should be excluded from the definition of financial obligation*"

(iv) "*... leases that are typically not vehicles to borrow money that are common among issuers and obligated persons include, but are not limited to: commercial office building leases…, airline and concessionaire leases at airport facilities…, and copy machine leases….*"

(d) derivatives

(i) "*… 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.*"

(ii) "*... the definition captures any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument to which an issuer or obligated person is a counterparty ... provided that such instruments are related to 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.*"

(iii) "*To determine whether a derivative instrument that relates to an existing or planned debt obligation of a third party is covered ... it would be reasonable to distinguish derivative instruments designed to hedge against the risks of a related debt obligation (i.e., debt-related derivatives) from derivative instruments designed to mitigate investment risk. ... the former generally would be covered ..., while the latter would not.*"

(iv) "*... 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. ... it would be likely or probable that an issuer or obligated person will incur a future debt obligation 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).*"

(v) "*Factors relevant to whether an issuer's or obligated person's debt obligation is "planned" might include, but are not be limited to, whether: (1) the documents evidencing the relevant derivative instrument explicitly or implicitly assume a future debt obligation; (2) the legislative body of the issuer or obligated person has taken any preliminary (e.g., preliminary resolution) or final (e.g., authorizing resolution) action to authorize the related future debt obligation; or (3) the issuer or obligated person has hired any professionals (e.g., municipal advisor, bond counsel, rate consultant) to assist or advise the issuer or obligated person on matters related to the future debt obligation.*"

(vi) "*Determinations by issuers and obligated persons of whether a derivative instrument contemplates a future debt obligation should prioritize substance over form. In addition, whether a debt obligation is "planned" is based*

on an objective assessment of the facts and circumstances prevailing at the time of incurrence of the derivative instrument, and is not a bright-line test."

(e) guarantee

(i) "*... the term "guarantee" is intended to capture 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.*"

(ii) "*A guarantee provided for the benefit of a third party or a self-liquidity facility or other contingent arrangement would be a guarantee under the amendments.*"

(iii) "*...guarantee may assume different forms including a payment guarantee or other arrangement that could expose the issuer or obligated person to a contingent financial obligation. For example, an issuer that is a county could agree to guarantee the repayment of municipal securities issued by a town located in the county. In this instance, the county could be required to use its own funds to repay the town's municipal securities. Furthermore, an issuer or obligated person may provide a guarantee with respect to its own financial obligation. For example, an issuer or obligated person could, in connection with the issuance of variable rate demand obligations, agree to repurchase, with its own capital, bonds that have been tendered but are unable to be remarketed. In this instance, the issuer or obligated person uses its own funds to purchase the bonds instead of a third party liquidity facility.*"

(iv) "*A guarantee ... could raise two disclosures under the Rule – one for the guarantor and one for the beneficiary of the guarantee. Specifically, if an issuer or obligated person incurs a material guarantee, such guarantee would be subject to disclosure under the Rule, as amended. For an issuer or obligated person that is the beneficiary of a guarantee provided in connection with a debt obligation 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 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.*"

(f) excluded municipal securities as to which a final official statement has been provided to the MSRB consistent with Rule 15c2-12

(i) "*... for this exclusion to apply, whether the final official statement is submitted voluntarily or not, the issuer or obligated person must submit the final official statement to the MSRB subject to the requirements of Rule 15c2-12(b). This exclusion from the definition of "financial obligation" covers only "municipal*

securities as to which a final official statement has been provided to the [MSRB] consistent with this rule" and does not extend to instruments or obligations (contingent or otherwise) related to such municipal securities. Under a continuing disclosure agreement, an issuer or obligated person will need to disclose any such derivative instrument or guarantee if it is material and affects security holders for purposes of new paragraph (b)(5)(i)(C)(15) of the Rule and make any related disclosures required under new paragraph (b)(5)(i)(C)(16) of the Rule."

(ii) With regard to bond offerings that qualify for one of the exemptions from Rule 15c2-12, it should be noted that "final official statement" is defined in Rule 15c2-12(f)(3) to mean, in relevant part, "*a document ... that sets forth ... a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section,* ***if applicable*** *....*"

(A) A literal reading of the Rule suggests that a final official statement for an issue to which the continuing disclosure provisions are not applicable (for example, a "limited offering" under Rule 15c2-12(d)(1)(i)), and therefore does not include a description of such an undertaking, would be consistent with section (b) of the Rule, so long as such final official statement has been provided to the MSRB.

(B) The SEC staff position, however, appears to be that such a final official statement must effectively commit the issuer or obligated person to provide continuing disclosures in order to qualify for this exclusion.

If continuing disclosure provisions must apply, which version is sufficient? Must the issuer/obligated person agree to provide:

(1) annual financial information as included in the official statement, audited financial statements, and event notices, as would be required under paragraph (b)(5)(i) of the Rule?

(2) annual financial information as is customarily prepared and made publicly available and event notices, as would be required under paragraph (d)(2)(ii) of the Rule?

(3) solely event notices, as would be required under paragraph (d)(2)(iii) of the Rule?

(iii) With regard to any "*instruments or obligations (contingent or otherwise) related to*" a bond offering (including a related swap or guarantee for a bond offering subject to Rule 15c2-12's continuing disclosure requirements), the 15c2-12 Amendment Order states that the exclusion applies only to the bonds offered and not to these related obligations.

It appears that swaps, guarantees and other financial obligations related to a new issue offering, even if disclosed in the official statement and already likely to trigger a continuing disclosure for that issue if drawn upon or if they fail to perform, are now expected to trigger separate clause 15 and 16 disclosures to the issuer's other outstanding bonds as well.

B.2 – What must be reported?

(1) Incurrence event under Rule 15c2-12(b)(5)(i)(C)(15):

(a) Incurrence event consists of:

(i) "*Incurrence of a financial obligation of the obligated person, if material, ...*" or

(ii) "*... 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*"

(b) Excerpts from the SEC discussion in 15c12-12 Amendment Order, Section III.A.1:

(i) materiality

(A) "*... not every incurrence of a financial obligation or agreement to terms is material. For example, an issuer or obligated person may incur a financial obligation for an amount that, absent material terms that affect security holders, would not raise the concerns the amendments are intended to address. Utilizing a materiality standard permits an issuer or obligated person to assess its disclosure obligation in the context of the specific facts and circumstances.*"

(B) *"... What constitutes materiality can vary by entity based on the size of the overall balance sheet, the size of existing obligations or the size of the overall bond portfolio ..., [but] these are not the only factors that are relevant in evaluating the particular facts and circumstances.... For example, it may be appropriate for issuers and obligated persons to consider not only the source of security pledged for repayment of the financial obligation, but also the rights associated with such a pledge (e.g.,*

senior versus subordinate), par amount or notional amount (in the case of a derivative instrument or guarantee of a derivative instrument), covenants, events of default, remedies, or other similar terms that affect security holders to which the issuer or obligated person agreed at the time of incurrence, when determining its materiality."

(C) "*In the materiality inquiry that issuers, obligated persons, and dealers must regularly undertake when preparing disclosure documents in connection with an Offering, they must assess whether a piece of information at the time of issuance is of a character that there is a substantial likelihood that, under all the circumstances, 'the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available.'*"

(D) "*... the determination by an issuer or obligated person of whether to submit an event notice under subparagraph (b)(5)(i)(C)(15) requires the same analysis that is regularly made by such parties when preparing offering documents. 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.*"

(E) "*Materiality is determined upon the incurrence of each distinct financial obligation, taking into account all relevant facts and circumstances. For example, if the issuer or obligated person enters into a series of transactions that, though related, are incurred at different points in time for legitimate business purposes – e.g., to satisfy the necessary conditions for the debt to be considered tax-exempt under provisions of the Internal Revenue Code of 1986, as amended ('IRC') – the issuer or obligated person would need to assess the materiality of each transaction at the time it was incurred.... 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.*"

(F) "*When an issuer or obligated person is considering whether a series of related transactions is a single incurrence or has been incurred at different points in time for legitimate business purposes for determining materiality under the amendments, such issuer or obligated person must consider all relevant facts and circumstances. An example of the type of facts and circumstances that could indicate that a series of related transactions were incurred separately for legitimate business purposes would be if the series of financial obligations satisfy the requirements set forth in the U.S. Department of Treasury regulations and guidance*

governing what constitutes a single issue of municipal securities under the IRC.… The Commission cautions issuers and obligated persons against entering into a series of transactions with a purpose of evading potential disclosure obligations established by paragraphs (15) and (16) of the Rule in a manner that is inconsistent with the purposes of the Rule."

(ii) when incurred

"*... a financial obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person…. For example, if an issuer or obligated person enters into an agreement providing for a material drawdown bond, or such agreement contains material terms that affect security holders, the issuer or obligated person generally should provide notice at the time the terms of the obligation are legally enforceable against the issuer or obligated person, instead of each time a draw is made.… The Commission likewise believes that a financial obligation is incurred with regard to a derivative instrument when the derivative instrument is enforceable against an issuer or obligated person.*"

(iii) agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation

(A) "*...agreement to covenants, events of default, remedies, priority rights, ...or other similar terms of a financial obligation, any of which affect security holders, may result in, among other things, contingent liquidity and credit risks that potentially impact the issuer's or obligated person's liquidity and overall creditworthiness and reduce value for existing security holders.*"

(B) Discussion of the meaning of this clause in the15c12-12 Amendment Order is extremely limited – instead, the clause is discussed in Exchange Act Release No. 80130 (March 1, 2017), 82 FR 13928 (March 15, 2017) ("15c12-12 Amendment Proposal"), Section III.A.1.

(1) "*... a list of events—specifically, covenants, events of default, remedies, priority rights, or other similar terms—which are typically agreed to in connection with the incurrence of a financial obligation and analyzed by market participants. These terms of a financial obligation could result in, among other things, contingent liquidity and credit risks, refinancing risk, and reduced security for existing security holders.*"

(2) "*... there are other material terms similar to covenants, events of default, remedies, and priority rights that an issuer or obligated person may agree to that could, among other things, create liquidity, credit, or refinancing risks that could affect the liquidity and creditworthiness of an issuer or obligated person or the terms of the securities they issue. For example, an investor may make an investment decision without knowing the issuer or obligated person has entered into a financial obligation structured with a balloon payment at maturity creating refinancing risk that could compromise the issuer or obligated person's liquidity and creditworthiness and their ability to repay their outstanding municipal securities*"

(iv) content of notice

(A) "*... a material event notice for the events described in paragraph (b)(5)(i)(C)(15) generally should include a description of the material terms of the financial obligation. Examples of some material terms may be the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates); other terms may be appropriate as well, depending on the circumstances.*"

(B) "*... 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.*"

(C) "*The amendments do not require the provision of confidential information such as contact information, account numbers, or other personally identifiable information to EMMA. Provided the necessary disclosures are made, the formatting of such disclosures tailored to avoid disclosure of such confidential information would be consistent with Rule 15c2-12.*"

(2) Financial difficulty event under Rule 15c2-12(b)(5)(i)(C)(16):

(a) A financial difficulty event consists of the following types of events, "*any of which reflect financial difficulties*":

(i) "*Default*",

(ii) "*event of acceleration*",

(iii) "*termination event*",

(iv) "*modification of terms*", or

(v) "*other similar events under the terms of a financial obligation of the obligated person*".

(b) Excerpts from the SEC discussion in 15c12-12 Amendment Order, Section III.A.3:

(i) reflect financial difficulty/no materiality standard

(A) "*A modification of terms would be reported under a continuing disclosure agreement only if the modification "reflect[s] financial difficulties of the issuer or obligated person." This qualifier is included to help target the disclosure of information relevant to investors in making an assessment of the current financial condition of the issuer or obligated person. Accordingly, because the modification of terms already is subject to a qualifier, the Commission believes there is no need to also include a materiality qualifier.*"

(B) "*... the concept of "reflecting financial difficulties" has been used in paragraphs (b)(5)(i)(C)(3) and (b)(5)(i)(C)(4) 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…. For example, ... an issuer or obligated person may covenant to provide the counterparty with notice of change in its address and may not promptly comply with the covenant. A failure to comply with such a covenant may not reflect financial difficulties; therefore, absent other circumstances, this event likely does not raise the concerns the amendments are intended to address. On the other hand an issuer or obligated person could agree to replenish a debt service reserve fund if draws have been made on such fund. In this example, if an issuer or obligated person fails to comply with such covenant, then such an event likely should be disclosed to investors and other market participants…. Issuers and obligated persons may consider disclosing the occurrence of events that do not reflect financial*

difficulties as a matter of best practice if they believe investors would find those occurrences important."

(ii) default

"*…there are defaults that may reflect financial difficulties even if they do not qualify as "events of defaults" under transaction documents. This may constitute important information related to an issuer's or obligated person's material financial obligations that could impact an issuer's or obligated person's liquidity, overall creditworthiness, or an existing security holder's rights. Accordingly, the Commission believes the concept of "default" should be retained ….*"

(iii) waiver

"*Additionally, "modification of terms" is broad, and as such, a written or verbal waiver of a deal provision would be a modification of the terms of an agreement because such waivers are a departure from what was agreed to under the terms of the agreement.*"

(iv) other similar events

"*… paragraph (b)(5)(i)(C)(16) covers not only defaults, events of acceleration, termination events, or modifications of terms that reflect financial difficulties of the issuer or obligated person, but also events arising under the terms of a financial obligation that similarly reflect financial difficulties of the issuer or obligated person…. in order to be subject to disclosure under the Rule, the term "other similar events under the terms of a financial obligation of the obligated person reflecting financial difficulties" must necessarily share similar characteristics with one of the preceding listed events (a default, event of acceleration, termination event, or modification of terms).*"

B.3 – When did the 2017 financial obligation events begin to apply for a particular offering?

(1) Amendment to Rule 15c2-12 became operative on February 27, 2019.

(a) Continuing disclosure undertakings for offerings on and after that date that are subject to the continuing disclosure provisions of the Rule must include the two new events:

(i) Does not apply to pre-existing continuing disclosure undertakings, and no obligation for an issuer or obligated person to amend pre-existing continuing disclosure undertakings to incorporate the new

events or to otherwise provide notice of such events with respect to the corresponding prior offering.

While not required to do so, an issuer or obligated person may voluntarily provide event notices for outstanding bonds for which the corresponding continuing disclosure undertaking does not include the two new events

(ii) Thus, issuers and obligated persons may have some outstanding bonds for which the new event notices apply and some outstanding bonds for which the new event notices do not apply, and this status is likely to continue for many years.

(b) So long as an issuer or obligated person does not have a new offering that becomes subject to the two new events, the amendment to Rule 15c2-12 has no impact on such issuer or obligated person.

(2) Incurrence events (clause 15) are required to be provided only for events triggering that clause that occur on or after the effective date of a continuing disclosure undertaking; that is, an issuer or obligated person is not required to "back fill" incurrence event notices under clause 15 for incurrences that occurred prior to the effectiveness of the continuing disclosure undertaking.

(3) Notice of financial difficulty (clause 16) must be provided only for events triggering that clause that occur on or after the effective date of a continuing disclosure undertaking.

(a) Thus, an issuer or obligated person is not required to "back fill" financial difficulty event notices under clause 16 for an event reflecting financial difficulty that occurred prior to the effectiveness of the continuing disclosure undertaking.

(b) However, clause 16 requires disclosures relating to any existing financial obligation of an issuer or obligated person, regardless of whether the financial obligation was incurred before or after the effectiveness of the continuing disclosure undertaking; that is, even if an incurrence of a financial obligation did not require disclosure under clause 15, an event reflecting financial difficulty with respect to such financial obligation is still required to be disclosed under clause 16, regardless of whether such non-disclosure under clause 15 was due to the fact that:

(i) the financial obligation was incurred prior to the effectiveness of the continuing disclosure undertaking, or

(ii) the financial obligation was deemed not to be material and therefore its incurrence did not require a disclosure under clause 15.

B.4 – What is the impact of a "materiality" standard applicable to incurrence events under clause 15 but not to financial difficulty events under clause 16?

(1) Even if an incurrence of a financial obligation did not require disclosure under clause 15 because the financial obligation was determined to be not material, a disclosure of the occurrence of an event reflecting financial difficulty with respect to such financial obligation is still required under clause 16.

Thus, the amendment to Rule 15c2-12 effectively requires the issuer or obligated person to be able to monitor all of its financial obligations it has previously incurred and that remain outstanding, or that it incurs in the future, for compliance with clause 15, including financial obligations that are not material for purposes of triggering clause 16.

(2) An adverse event of the type listed in clause 16 that does not reflect financial difficulties is not required to be disclosed, even if the size, nature or impact of such adverse event is material.

For example, a clerical error that results in non-payment on a financial obligation, even if it results in material financial or other consequences, is not required to be disclosed if that error does not reflect financial difficulties – this would appear to be true, even if the adverse event reflects gross negligence or malfeasance of an individual employee, or poor internal procedures or supervision, or other reasons that do not reflect financial difficulty.

In the context of a real-world occurrence of such a scenario, however, depending on the specific facts, it would not be surprising if the regulators were tempted to view these types of causes as arising from a lack of resources to properly carry out or supervise the obligations relating to such financial obligation, which in turn might be characterize by the regulators as potentially reflecting financial difficulty.

B.5 – How are the 2017 event disclosures made on EMMA?

(1) The MSRB provides detailed submission instructions in its EMMA Dataport Manual for Continuing Disclosure Submissions on its website at http://www.msrb.org/msrb1/EMMA/pdfs/EMMACDManual.pdf .

(2) Under Rule 15c2-12, the new event disclosures consist of events that have an impact on outstanding municipal bond offerings that are subject to the Rule; that is, Rule 15c2-12 does not treat the incurrence of such financial obligation as triggering required disclosures for the benefit of the holder(s) of such financial obligation, but instead for the benefit of holders of outstanding bonds subject to the Rule.

(3) Consistent with Rule 15c2-12's treatment of financial obligations, the MSRB provides for the new financial obligation disclosures to be indexed to outstanding bonds

for which the disclosures are provided under the Rule through the CUSIP numbers (with very limited exceptions) of such bonds.

Thus, incurrence event disclosures under clause 15 and financial difficulty disclosures under clause 16 are both indexed to the CUSIP numbers of outstanding bonds, not as standalone disclosures pertaining to the financial obligation itself.

(a) That is, financial obligations are available as a disclosure attached to another debt offering's disclosure page on EMMA, not as its own disclosure page.

(b) As a result, a financial difficulty disclosure under clause 16 is not attached directly to the incurrence disclosure under clause 15 for the corresponding financial obligation, but instead both such notices (along with incurrence and financial difficulty disclosures for other financial obligations) are attached to outstanding bonds subject to Rule 15c2-12.

(4) Searches for the new financial obligation disclosures can be conducted on EMMA through:

(a) the "Search" link at https://emma.msrb.org/MarketActivity/RecentCD; or

(b) for a more precise search function, the "Disclosures" filter (which can be used in combination with the other available filters) at https://emma.msrb.org/Search/Search.aspx

(5) EMMA's new incurrence notice category under clause 15 has effectively replaced its prior voluntary bank loan disclosure category, which is no longer available for new submissions

The MSRB has indicated that issuers and obligated persons that wish to disclose on a voluntary basis the incurrence of a bank loan or other obligation that is not otherwise required to be disclosed by operation of Rule 15c2-12 may be disclosed, as a voluntary disclosure, through this new clause 15 category

B.6 – What do Issuers and Obligated Persons need to do?

(1) Overview – Rule 15c2-12 creates no direct obligations on issuers and obligated persons – instead, the Rule applies to underwriters. How it applies to underwriters has an indirect, but significant, impact on issuers and obligated persons, as outlined below.

(2) Prior to issuing its first issue of municipal securities subject to the new financial obligations disclosure, an issuer or obligated person have no new obligations as a result of the Rule 15c2-12 amendment; however, if they anticipate such an issuance in the future, they should consider familiarizing themselves with the new requirements ahead of such

issuance and take appropriate preparatory steps to facilitate compliance once the new disclosures take effect for them.

(3) For a new issue that is to be underwritten (including in a "private placement") and that is subject to the continuing disclosure provisions of Rule 15c2-12(b)(5) or (d)(2)(ii)(B), the issuer and/or applicable obligated persons will be expected to enter into a continuing disclosure undertaking that includes the two new financial obligation disclosures.

(4) For a new issue that is not subject to the continuing disclosure provisions (for example, a limited offering under Rule 15c2-12(d)(1)(i)), the issuer/obligated person will need to consider whether to:

(a) Voluntarily enter into a continuing disclosure undertaking as if the issue were subject to the Rule requirements and include a description of such undertaking in an official statement that is then submitted to EMMA.

(i) In this case, the issuer/obligated person would treat this issue just like a typical issue subject to the Rule for all purposes of continuing disclosures.

(ii) Note that this notion of voluntarily subjecting an issue to a continuing disclosure undertaking arises from Rule 15c2-12(f)(11)(ii), which provides that "*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.*" – see the discussion above regarding this exclusion; or

(b) Maintain the status as not being subject to the Rule's continuing disclosure requirements but instead disclose the incurrence of the new issue, if material, in an incurrence event notice under clause 15 and make any necessary financial difficulty event disclosures under clause 16, to the extent that the issuer/obligated person has other offerings that are subject to the two new financial obligation disclosures

(5) The issuer/obligated person should consider what existing financial obligations exist, including, but not limited to, outstanding municipal bond issues exempt from Rule 15c2-12 that are now subject to financial difficulty event disclosures under clause 16 (incurrence notices are not required for incurrences that occurred in the past).

Because financial difficulty event disclosures under clause 16 are not limited to only material financial obligations, but to any financial obligation whatsoever (so long as the event reflects financial difficulties), this consideration of existing financial obligations cannot be limited solely to material financial obligations.

(6) The issuer/obligated person should understand and develop processes for ensuring that it will be able to identify when it is incurring a material financial obligation (for purposes of clause 15) or when a financial difficulty event with respect to any financial obligation has occurred (for purposes of clause 16), what to include in the disclosure submission, how to make sure the submission is made in a timely manner, and how to ensure that the submission is indexed to all outstanding CUSIPs to which the disclosure applies.

While a formal written procedure for complying with continuing disclosure undertakings, including specifically clauses 15 and 16, is not technically required, issuers and obligated persons should expect that underwriters will increasingly expect to review such written procedures and to consider their likely effectiveness as they seek to fulfill their "due diligence" obligations in connection with underwriting new issues.

(7) Official statement disclosures regarding past instances of material non-compliance with Rule 15c2-12 would not cover the new financial obligation event disclosures in clauses 15 and 16 until the issuer's or obligated person's second new issue subject to the amended Rule. The issuer/obligated person must issue a first new issue subject to the requirement to make such financial obligation disclosures, and then must issue a second new issue subject to that requirement for which the issuer/obligated person is required to disclose in the official statement any material non-compliance with the first issue's financial obligation disclosure requirement.

B.7 – What do Underwriters need to do?

(1) Rule 15c2-12(b)(5)(i) obligates the underwriter to reasonably determine that the issuer or obligated person has entered into a continuing disclosure obligation that meets the requirement of the paragraph (b)(5)(i).

(a) At a minimum, underwriters will expect to see that the continuing disclosure undertaking for new issues now include the new financial obligation event disclosures under clauses 15 and 16.

(b) Practices vary among underwriters regarding the level of confidence they expect to develop in the ability of an issuer or obligated person to achieve substantial compliance with the new financial obligation event disclosures.

(i) in many cases, underwriters will expect to conduct heightened diligence to establish its reasonable determination – and perhaps receive written representations to the effect that – the issuer/obligated person has established written procedures to identify and disclose continuing disclosures, including in particular financial obligation event disclosures under clauses 15 and 16, in part due to the heightened difficulties arising

from the nature of such disclosures as compared to the other types of disclosures traditionally required under Rule 15c2-12.

(ii) There is no explicit legal obligation, however, to determine the likelihood of compliance at the time of entering into a continuing disclosure undertaking, other than ensuring that the undertaking includes all of the required elements and is not illusory or entered into without any expectation of performance.

(c) Underwriter "due diligence" with regard to the disclosure of any material non-compliance with past continuing disclosure obligations with respect to second and subsequent issues occurring after the Rule 15c2-12 effective date, when such disclosures could apply with respect to the new financial obligation event notices under clauses 15 and 16, can be expected to be more exacting in many cases.

(i) Because of the heightened difficulties arising from the nature of such disclosures, as described above, underwriters will seek varying levels of confidence that the issuer/obligated person has been able to identify all relevant financial obligations, disclose all material incurrences in a timely manner, and disclose all adverse events reflecting financial difficulty (regardless of materiality) in a timely manner, to the point that the underwriter has an adequate basis to reasonably determine that the disclosure in the official statement is not materially misleading.

(ii) There is a more substantial legal basis for concern regarding the issuer/obligated person's ability to perform, or to identify instances of non-performance, under a continuing disclosure undertaking in the context of the necessary due diligence in connection with the official statement disclosure, as compared to the potential legal exposure in connection with determining whether the issuer/obligated person has entered into a continuing disclosure undertaking, so long as the terms of the undertaking match the Rule requirements.

B.8 – How Can Investors and the Public View Financial Obligation Event Information?

(1) Investors and members of the public can search for the new financial obligation disclosures on EMMA through:

(a) use of the "Search" link at https://emma.msrb.org/MarketActivity/RecentCD; or

(b) for a more precise search function, use the "Disclosures" filter (which can be used in combination with the other available filters) at https://emma.msrb.org/Search/Search.aspx

(2) New financial obligation disclosures are viewable on EMMA as continuing disclosure, based on the indexing information provided to EMMA at the time of submission of such disclosure, as investors and members of the public view information about:

(a) a specific issuer under the "Event-Based Disclosures" tab, which accumulates all event disclosures for all outstanding issues of such issuer

(b) a specific bond issue under the "Continuing Disclosure" tab, which accumulates all financial and event notices, by specific disclosure category, for all maturities of such issue

(c) a specific maturity of an issue under the "Disclosure Documents" tab, which accumulates all primary market and continuing disclosure documents, by specific disclosure category, for such maturity

(3) Since the financial disclosure event notice requirement was designed to provide additional relevant information not previously available on EMMA, investors and members of the public seeking a more complete understanding of this type of information about all existing obligations that may have an impact on a particular bond issue should use the available search and navigation tools on EMMA to find and review disclosures for other bond issues of the issuer available on EMMA under the traditional primary market and continuing disclosure obligations under Rule 15c2-12.

(a) Investors and members of the public should understand that disclosures submitted as financial obligation event notices under clauses 15 and 16 will usually represent only a portion of all potentially relevant outstanding obligations that may have an impact on a particular issue of municipal securities.

(b) More generally, investors and members of the public seeking to obtain the most comprehensive view of an issuer's or obligated person's outstanding material obligations should also be reviewing any financial statements or other financial information for such issuer or obligated person posted on EMMA.

In particular, for obligated persons that may borrow through multiple municipal issuers and for which no assured manner of searching for related municipal bond issues has yet been developed, the financial statements likely will continue to be the primary source for understanding their full range of outstanding obligations, supplemented by the new financial obligation event notices.

C. The Rest of Rule 15c2-12 – what are the key sticking points of the "legacy" provisions of the Rule that challenge issuers, obligated persons, underwriters and investors?

(1) Timeliness of disclosures and availability of interim information

(a) Benefits and risks of voluntary disclosures

(b) Understanding practical considerations in producing disclosures and in confidently assessing quality and timeliness of disclosures

(2) Ability to manage the continuing disclosure obligation over the course of a multi-decade commitment

(a) Are undertakings too brittle, or are there ways to amend or otherwise conform disclosures made under different circumstances than existed at the time of the undertaking many years earlier?

(b) Is it clear what post-issuance actions (remarketings, tender offers, restructurings, modifications of terms, etc.) may trigger a new continuing disclosure obligation under the Rule?

(3) How do new concepts of disclosable information fit into the Rule 15c2-12 construct?

(a) COVID-19 risks, impacts and mitigation efforts

(b) Exposure to risk of LIBOR demise

(c) climate change/resiliency, other ESG

(d) cybersecurity policies and procedures/incident disclosures

(e) other issues

(4) Are issuers with multiple outstanding issues incurred under different versions of Rule 15c2-12 facing increasing complexity in their overall management of their disclosure obligations?

III MUNICIPAL ADVISORY VS. UNDERWRITING (VS. INVESTMENT ADVISORY VS. SWAP ADVISORY VS. ENGINEERING VS. ACCOUNTING VS. BOND LAWYER) ACTIVITIES … NOT TO MENTION IRMAs

A. Are the lines between being a municipal advisor and being someone else involved in a bond transaction becoming any clearer?

B. Some key points of ambiguity between municipal advisors and:

(1) Underwriters [underwriter exclusion under Exchange Act Rule 15Ba1-1(d)(2)(i)]

(a) when does the underwriting relationship begin and end?

(b) is the breadth of activities within the underwriting exclusion just right, too broad, or to narrow?

(c) if an underwriter qualifies for the underwriter exclusion (or otherwise qualifies for an exclusion or exemption from being treated as a municipal advisor under Rule 15Ba1-1(d), such as by application of the IRMA exception), is that underwriter automatically also not a "financial advisor" under MSRB Rule G-23 for the duration of such exclusion or exemption?

(i) or are there situations where a broker-dealer can be treated as a financial advisor under MSRB Rule G-23 but not as a municipal advisor under SEC Rule 15Ba1-1?

(ii) is the MSRB considering merging Rule G-23 with Rule G-42, or are there reasons for keeping the two rules separate?

(d) Given that a municipal advisory regulatory regime exists today that did not exist when the SEC issued the Dominion Resources no-action letter, relating to certain placement activities of financial advisors, and then revoked it (Dominion Resources, Inc., SEC No-Action Letter (July 23, 1985), withdrawn March 7, 2000), is it time to revisit whether to revoke the revocation of the Dominion Resources no-action letter?[1]

(2) Investment advisers [investment adviser exclusion under Exchange Act Rule 15Ba1-1(d)(2)(ii)]

Given that a municipal advisory regulatory regime exists today that did not exist when the SEC's Division of Investment Management published its Staff Bulletin No. 11 (Applicability of the Advisers Act to Financial Advisors of Municipal Securities Issuers (September 19, 2000)), under which most instances in which financial advisors advised their issuer clients were viewed as being subject to investment advisory regulation, is it time to revisit Staff Bulletin No. 11?

[1] There continues to be ongoing concern and confusion surrounding when a municipal advisor can be involved in a direct placement of securities with investors and avoid the broker-dealer registration requirements. This led to a temporary exemptive order by the SEC in 2020 that provided an exemption from broker-dealer registration for covered activities, which has now expired. (https://www.sec.gov/files/rules/exorders/2020/34-89074.pdf).

(3) Swap advisors [commodity trading advisor exclusion under Exchange Act Rule 15Ba1-1(d)(2)(iii)]

(a) When is a swap advisor acting as a municipal advisor subject to the MSRB municipal advisor rules vs. acting as a commodity trading advisor (CTA) subject to the rules of the Commodity Futures Trading Commission (CFTC)? Is the status as municipal advisor vs. CTA something that the swap advisor can elect, or is it determined by law/regulation without the opportunity to make an election?

(b) If a swap advisor is acting as a CTA under CFTC rules, can that swap advisor effectively serve as an "independent registered municipal advisor" (IRMA) for purposes of the IRMA exception? Or must a CTA serving as swap advisor also be registered as a municipal advisor in order for the IRMA exception to be available?

(4) Engineer [engineer exclusion under Exchange Act Rule 15Ba1-1(d)(2)(v)]

(a) Are there recognized categories of engineers, or a minimum requirement for licensing or other customary qualification for engaging in engineering services, needed in order for this exclusion to apply?

(b) Or, does this exclusion apply more generally to any person undertaking the types of analytic activities described in the SEC discussion in Section 3.A.1.c.vii of the Municipal Advisor Registration Order and in Section 12 of Registration of Municipal Advisors Frequently Asked Questions (updated September 20, 2017) ("MA FAQs")?

(c) Are there some types of analytic activities that are excluded from being treated as municipal advisory activities only if such activities are undertaken by an "engineer"?

(5) Accountants [accountant exemption under Exchange Act Rule 15Ba1-1(d)(3)(i)]

(a) Are there any ambiguities around what is covered and what is excluded?

(6) Bond lawyers [attorney exclusion under Exchange Act Rule 15Ba1-1(d)(2)(iv)]

(a) is it clear what services "*of a traditional legal nature with respect to the issuance of municipal securities or municipal financial products to a client of such attorney that is a municipal entity, obligated person, or other participant in the transaction*" are included as permitted non-municipal advisory activities of an attorney?

(i) the Municipal Advisor Registration Order provides several examples of activities that constitute an attorney representing itself "*as a*

financial advisor or financial expert regarding the issuance of municipal securities or municipal financial products", including where "*the attorney provides advice that is primarily financial in nature, such as: (1) the financial feasibility of a project or financing; (2) advice estimating or comparing the relative cost to maturity of an issuance of municipal securities depending on various interest rate assumptions; (3) advice recommending a particular structure as being financially advantageous under prevailing market conditions; (4) advice regarding the financial aspects of pursuing a competitive sale versus a negotiated sale; and (5) other types of financial advice that are not related to the attorney's provision of legal advice and services of a traditional legal nature*"

(ii) Would any of these types of activities be viewed as traditional business counselling outside of the context of the municipal securities market? If so, does this create ambiguities or dislocations where the client is an obligated person to which differing ranges of advice may be available from their attorneys depending on such client's status?

(b) What lessons are there to be learned from the Barcelona Strategies, LLC settlement order (https://www.sec.gov/litigation/admin/2018/34-83191.pdf)?

(c) When does it make sense for a law firm to register as, or to form an affiliate as, a municipal advisor?

(7) Other municipal advisors [IRMA exemption under Exchange Act Rule 15Ba1-1(d)(3)(vi)]

(a) May a municipal advisor rely on the IRMA exemption? For example:

(i) In a complex new issue, can an issuer's municipal advisor engaged to advise on traditional bond issuance matters rely on the IRMA exemption in connection with swap advice where the issuer has engaged another municipal advisor with expertise in derivatives matters?

(ii) Where there are co-financial advisors on a new issue, could the "lead" financial advisor serve as an IRMA so that the other financial advisor does not formally serve as a municipal advisor?

(iii) Can an issuer that has engaged a municipal advisor use the IRMA exception to seek a second opinion from another municipal advisor firm without subjecting the second firm to formal municipal advisor liability?

C. What are the impacts – positive, negative or ambiguous – of the municipal advisory regulatory regime as it has taken shape since 2010?

(1) for issuers

(2) for obligated persons

(3) for the regulated entities

(4) for investors

D. What areas touching on municipal advisory activities still need to be dealt with, either for the first time or to better focus matters previously addressed?

IV. DUTIES AND ROLES IN THE NEW ISSUE PROCESS, THROUGH THE PRISM OF MSRB RULE G-17 AND RETAIL INVESTOR PROTECTION RULES

A. Underwriter role disclosures under MSRB Rule G-17 as a roadmap for new issue obligations of the various new issue transaction participants – underwriters, municipal advisors, issuers, obligated persons and others

(1) General fair practice principle – "*Rule G-17 requires an underwriter to deal fairly at all times with both municipal (b) For a more detailed discussion of post-issuance compliance procedures, see Session #22 – Post Issuance Compliance issuers and investors*"

(a) Fair dealing obligation is above and beyond the notion of the federal anti-fraud provisions and specific rule-based obligations

(b) Goes to core of the "intermediation" role of an underwriter between the issuer and the investor

(c) While the duty is only mentioned in the context of the issuer and investors, it applies to all parties, including obligated persons, municipal advisors, etc.

(d) What was the unfairness in:

(i) *In the Matter of Edward D. Jones & Co., L.P.* and related matters [misrepresentation regarding bona fide offering; honoring priority of orders] – https://www.sec.gov/news/pressrelease/2015-166.html

(ii) the line of "flipping" and retail order period abuse cases, described at https://www.sec.gov/news/press-release/2021-179, with links to cases from August 2018 through September 2021*Securities and Exchange Commission vs. Core Performance Management, LLC et al.* and

related matters [flipping; kickbacks] – https://www.sec.gov/news/press-release/2018-153

(iii) *In the Matter of First Midstate Inc. and Paul D. Brown* [misrepresentation to issuers of underwriter's distribution capability where underwriter sold bonds primarily to broker dealers] – https://www.sec.gov/litigation/admin/2020/34-90783.pdf

(iv) *In the Matter of Crews & Associates, Inc.* and related matters [broker-dealer recommended tender offer to issuer while having undisclosed interest in tendered bonds] – https://www.sec.gov/news/press-release/2021-166

(v) *In the Matter of IFS Securities* [new issue pricing not fair and reasonable to the issuer] – https://www.sec.gov/litigation/admin/2019/34-86210.pdf

(vi) *Securities and Exchange Commission v. Rhode Island Commerce Corporation (f/k/a Rhode Island Economic Development Corporation* [lack of disclosure regarding adequacy to complete project; inadequate disclosure of fees] – https://www.sec.gov/litigation/litreleases/2019/lr24428.htm

(vii) *In the Matter of City Securities Corporation and Randy G. Ruhl* [undisclosed donations, entertainment expenses as cost of issuance] – https://www.sec.gov/news/press-release/2013-136

(viii) *Securities and Exchange Commission vs. City of Victorville et al.* [misleading valuation and debt service ratio; undisclosed fees] – https://www.sec.gov/news/press-release/2013-2013-75htm

(ix) *In the Matter of Goldman, Sachs & Co.* & *In the Matter of Neil M.M. Morrison* [undisclosed political contributions and conflicts of interest] – https://www.sec.gov/news/press-release/2012-2012-199htm

(e) Do any other parties to a new issue have parallel "fairness" duties to each other or to investors? – Issuer? Obligated person? Municipal advisor? Counsel? Other parties?

(2) Conflicting interests in a commercial transaction – "*the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer*"

(a) Does this generalized disclosure of the conflicting interests of the underwriter and the issuer (that is, the underwriter has its own interests that differ from the issuer's) affect the level of particularity of conflicts disclosures required to the issuer?

(b) This disclosure is only to the issuer – does not reach the question of conflicting interests with other parties

(c) Municipal advisors have own conflicts disclosure obligations under MSRB Rule G-42

(d) Do any other parties to a new issue have parallel "conflicting interest" disclosure obligations to the issuer? – Obligated person? Counsel? Other parties?

(3) Fair dealing vs. best interest – "*unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests*"

So what is the difference between "fair dealing" (Rule G-17) and "best interest" (fiduciary duty)? Is this a distinction that will survive broader regulatory evolution?

What is the impact of Regulation Best Interest ("Reg BI") on underwriter activity and enforcement actions? Imposing a fiduciary duty on underwriters as it relates to retail investors?

(4) Pricing a new issue – "*the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable*"

(a) Pricing duty to issuer under Rule G-17:

(i) "*... implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced*"

(ii) "*... a dealer purchasing bonds in a competitive underwriting for which the issuer may reject any and all bids will be deemed to have satisfied its duty of fairness to the issuer with respect to the purchase price of the issue as long as the dealer's bid is a bona fide bid (as defined in MSRB Rule G-13) that is based on the dealer's best judgment of the fair market value of the securities that are the subject of the bid*"

(iii) "*In a negotiated underwriting, the underwriter has a duty under Rule G-17 to negotiate in good faith with the issuer*"

(b) Pricing duty to investors under MSRB Rule G-30:

(i) "*No broker, dealer or municipal securities dealer shall purchase municipal securities for its own account from a customer, or sell municipal securities for its own account to a customer, except at an aggregate price (including any mark-up or mark-down) that is fair and reasonable*"

(ii) "*A 'fair and reasonable' price bears a reasonable relationship to the prevailing market price of the security*"

(iii) "*Reasonable compensation differs from fair pricing. A dealer could restrict its profit on a transaction to a reasonable level and still violate this rule if the dealer fails to consider market value.*"

"*For example, a dealer may fail to assess the market value of a security when acquiring it from another dealer or customer and as a result may pay a price well above market value. It would be a violation of fair-pricing responsibilities for the dealer to pass on this misjudgement to another customer, as either principal or agent, even if the dealer makes little or no profit on the trade.*"

(iv) "*The most important factor in determining whether the aggregate price to the customer is fair and reasonable is that the yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market.*"

(c) How does the fair pricing obligation to the issuer constrain the pricing offered to investors?

(d) How does the fair pricing obligation to investors constrain the pricing of the offering to the issuer?

(e) How much difference is there between the fair price to the issuer and the fair price to the investor?

(f) How does all of this interact with Reg BI?

(5) Issuer disclosure and underwriter due diligence – "*the underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction*"

(a) Do issuers understand that, when it comes to disclosures in the official statement, the federal securities laws expect the underwriter to stand on the side of the investors as opposed to the issuer?

(b) The MCDC settlements with underwriters, together with certain pre- and post-MCDC individualized enforcement actions, represent the most prominent recent set of examples of this obligation.

(i) The SEC alleged that municipal securities dealer firms sold municipal bonds with offering documents that contained "materially false statements or omissions about the bond issuers' compliance with the continuing disclosure obligations." Additionally, the SEC charged that the firms had neglected to conduct sufficient due diligence and therefore failed to identify the omissions or misstatements before offering and selling the bonds.

(ii) The settlements with underwriters under the MCDC represented 96% of the municipal market's underwriting community; as an offshoot of these settlements, this 96% of the municipal market's underwriting community is now legally committed to having in place policies and procedures that have been vetted by the SEC with regard to their due diligence obligation.

(c) Beyond the question of whether the underwriters have engaged in adequate due diligence to develop a reasonable basis for believing the truthfulness of material statements in the official statements is the question of the obligation of the "speaker" itself to speak truthfully in the official statement, as outlined below.

(6) Of retail investors and new Regulation Best Interest – Regulators have been focused in recent years on potential abuses related to retail investors in the new issue process, as seen in the flipping/retail order period cases. The SEC has adopted its new Regulation Best Interest, which supplants the MSRB's suitability under Rule G-19 with respect to retail investors. Enforcement actions under Regulation Best Interest as just begun – will this have an impact on municipal new issue retail sales? – see *SEC v. Western Int'l. Sec. et al* [alleging violation of Regulation Best Interest by offering certain unrated bonds to retail investors] – https://www.sec.gov/litigation/complaints/2022/comp-pr2022-110.pdf

B. Issuer/obligated personal liability with regard to disclosure

(1) The MCDC-era settlements with issuers and obligated persons addressed their direct obligations under the federal anti-fraud provisions with regard to materially false statements or omissions about their compliance with continuing disclosure obligations.

(2) Other relevant cases:

(a) *Securities and Exchange Commission vs. City of Rochester, New York, Rosiland Brook-Harris, Capital Markets Advisors, LLC, Richard Ganci, and Richard Tortora* [misleading investors and breaching fiduciary duty by including outdated financial statements and not disclosing imminent financial distress related to overspending on teacher salaries] – https://www.sec.gov/news/press-release/2022-108

(b) *Securities and Exchange Commission v. Anthony Michael Holland* [false financial statements and audit report posted to EMMA] – https://www.sec.gov/litigation/litreleases/2022/lr25426.htm

(c) *In the Matter of Town of Sterlington, Louisiana* and related matters [false financial projects used to obtain state approval for bond offering] – https://www.sec.gov/news/press-release/2022-97

(d) *In the Matter of Crosby Independent School District* and related matters [false and misleading financial statements in the offering documents] – https://www.sec.gov/news/press-release/2022-43

(e) *In the Matter of Sweetwater Union High School District* and related matters [misleading budget projections in offering document] – https://www.sec.gov/news/press-release/2021-178

(f) *Securities and Exchange Commission vs. Keith Borge* [false statements in financial information distributed by obligated person as continuing disclosure] – https://www.sec.gov/news/press-release/2019-46

(g) *Securities and Exchange Commission vs. David Webb, Jr.* [failure to disclose to investors pay-to-play scheme involving bond proceeds] – https://www.sec.gov/litigation/complaints/2017/comp23998.pdf

(h) *Securities and Exchange Commission vs. Dwayne Edwards et al.* [failure to disclose to investors commingling and misuse of funds intended to secure bondholders] – https://www.sec.gov/news/pressrelease/2017-28.html

(i) *In the Matter of the Port Authority of New York and New Jersey* [failure to disclose risks regarding authority to fund financed project] – https://www.sec.gov/news/pressrelease/2017-4.html

(j) *Securities and Exchange Commission vs. Town of Ramapo, et al.* [fraudulent financial information in official statement] – https://www.sec.gov/news/pressrelease/2016-68.html

(k) *In the Matter of Westlands Water District* [use of undisclosed extraordinary accounting principles to meet debt service coverage ratio] – https://www.sec.gov/news/pressrelease/2016-43.html

(l) *Securities and Exchange Commission v. Rhode Island Commerce Corporation (f/k/a Rhode Island Economic Development Corporation* [lack of disclosure regarding adequacy to complete project] – https://www.sec.gov/litigation/litreleases/2019/lr24428.htm

(m) *In the Matter of City of Allen Park, Michigan* [failure to disclose deteriorating conditions affecting viability of project and ability to service debt] – https://www.sec.gov/news/press-release/2014-249

(n) *Securities and Exchange Commission vs. City of Harvey, Illinois et al.* [misstatements and omissions regarding misuse of bond proceeds] – https://www.sec.gov/news/press-release/2014-122

(o) *Securities and Exchange Commission vs. United Neighborhood Organization of Chicago et al.* [failure to disclose breach of agreement potentially affecting ability to repay bonds] – https://www.sec.gov/litigation/complaints/2014/comp-pr2014-110.pdf

(p) *In the Matter of the Greater Wenatchee Regional Events Center Public Facilities District et al.* [failure to disclose consultant reports calling into question viability of project and ability to service debt] – https://www.sec.gov/news/press-release/2013-235

(q) *In the Matter of Public Health Trust of Miami-Dade County, Florida* [misstatement of revenues and misrepresentation that financial statements prepared according to generally accepted accounting principles] – https://www.sec.gov/news/press-release/2013-181

(r) *Securities and Exchange Commission vs. City of Miami, Florida and Michael Boudreaux* [false and misleading disclosures regarding interfund transfers to mask deteriorating financial condition] – https://www.sec.gov/news/press-release/2013-130

(s) *In the Matter of South Miami, Florida* [failure to disclose use of proceeds of tax-exempt bond issue in a manner that jeopardized tax-exempt status] – https://www.sec.gov/news/press-release/2013-2013-91htm

(t) *In the Matter of the City of Harrisburg, Pennsylvania* [misleading statements regarding financial condition made to the public in light of failure to

make required continuing disclosures] – https://www.sec.gov/news/press-release/2013-2013-82htm

(u) *Securities and Exchange Commission vs. City of Victorville et al.* [misleading valuation and debt service ratio] – https://www.sec.gov/news/press-release/2013-2013-75htm

C. Municipal advisor's role in the new issue process

(1) Where are the municipal advisor's duties in connection with specific new issues defined?

(a) Solely in the contract with the issuer/obligated person client under MSRB Rule G-42(c)?

(b) Or are there "inherent" duties that the municipal advisor is deemed to have if it is engaged to work in some capacity on a new issue?

That is, although (in the case of a municipal entity client), a municipal advisor has a fiduciary duty, to what activities does that duty run?

(2) What is the relationship between a municipal advisor's fiduciary duty to its municipal entity client and its Rule G-17 fair dealing duty to all other persons?

(a) Fair dealing with direct transaction participants with which the municipal advisor interacts

(b) Is there a fair dealing duty to investors, even where the municipal advisor does not interact directly with the investor?

(i) Potential duty through the underwriter, as "representative" of investors?

(ii) Potential duty to investor as a key participant of the overall financing transaction (a "duty to the transaction")?

(c) Does the fiduciary duty outweigh the fair practice duty?

(d) Do the disclosures that municipal advisors are required to make to their clients relevant to other parties? Is there a duty to provide a subset of such disclosures to others, including to investors in the official statement? If so, where does that legal duty arise?

See *Securities and Exchange Commission vs. City of Rochester, New York, Rosiland Brook-Harris, Capital Markets Advisors, LLC, Richard Ganci, and Richard Tortora* [alleging principals of municipal advisor were aware of financial

distress but did not inquire further about school district's financial condition or inform investors of risk] – https://www.sec.gov/litigation/complaints/2022/comp-pr2022-108-city-of-rochester.pdf

See also *Securities and Exchange Commission vs. Aaron B. Fletcher and Twin Spires Financial LLC* [alleging preparation of false financial statements in connection with bond offering approval and acting as unregistered municipal advisor] – https://www.sec.gov/litigation/complaints/2022/comp-pr2022-97-fletcher.pdf

See also *Securities and Exchange Commission vs. Choice Advisors, LLC and Matthias O'Meara* and related matters [alleging violation of municipal advisor duties and engaging in unregistered municipal advisory activities] – https://www.sec.gov/news/press-release/2021-188

See also *Securities and Exchange Commission v. Comer Capital Group, LLC and Brandon L. Comer* [alleged violation of municipal advisor's fiduciary duty in connection with engagement of underwriter and pricing of new issue] – https://www.sec.gov/litigation/litreleases/2019/lr24520.htm

See also *In the Matter of Central States Capital Markets, LLC et al.* [persons acting in dual role of underwriter and financial advisor failed to make disclosures of roles, including in the official statement] – https://www.sec.gov/news/pressrelease/2016-54.html – with regard to official statement disclosure, was liability incurred as underwriter or as municipal advisor?

V. WHAT IS MATERIAL?

A. Preview: the standard characterization of materiality in the context of disclosure looks to "*facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision*" [Municipal Securities Disclosure, Securities Exchange Act Release No. 26100 (September 22, 1988) at note 76], with the US Supreme Court stating that a fact is material if there is "*a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available*" [TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976)]

B. Query: what does materiality mean as investment decisions are increasingly made using big data/machine learning/algorithmic means that rely less and less on standard qualitative and quantitative data traditionally included in securities offering documents?

(1) What is a "prudent investor" where the investor's prudence is a technological solution?

(2) Is the concept of materiality due for a retrospective review?

VI. SEC, CLIMATE/ESG AND CYBERSECURITY DISCLOSURE

A. SEC Initiatives – corporate focus, but analogous to municipal securities

i. February 24, 2021 – Statement on the Review of Climate-Related Disclosure (https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure)

1. Acting Chair Allison Herren Lee directs the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings.

2. The Commission in 2010 provided guidance to public companies regarding existing disclosure requirements as they apply to climate change matters. As part of its enhanced focus in this area, the staff will review the extent to which public companies address the topics identified in the 2010 guidance, assess compliance with disclosure obligations under the federal securities laws, engage with public companies on these issues, and absorb critical lessons on how the market is currently managing climate-related risks.

ii. March 3, 2021 – SEC Division of Examinations Announces 2021 Examination Priorities with Enhanced Focus on Climate-Related Risks (https://www.sec.gov/news/press-release/2021-39)

1. SEC announced greater focus on climate-related risks by examining proxy voting policies and practices to ensure voting aligns with investors' best interest and expectations as well as business continuity plans in light of intensifying climate change risks.

iii. March 4, 2021 – SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (https://www.sec.gov/news/press-release/2021-42)

1. Creates Climate and ESG Task Force in the Division of Enforcement led by Kelly Gibson, Acting Deputy Director of Enforcement.

2. Consistent with increasing investor focus and reliance on climate and ESG-related disclosure and investment, the Climate and ESG Task Force will develop initiatives to proactively identify ESG-related misconduct.

3. The initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

iv. March 15, 2021 – Request for Comment on Climate Disclosure (Acting Chair Allison Herren Lee) (https://www.sec.gov/news/public-statement/lee-climate-change-disclosures)

1. Public input requested from investors, registrants and other market participants on climate change disclosure.

2. Acting Chair Allison Herren Lee has asked the staff to evaluate SEC disclosure rules with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change.

3. SIFMA response – https://www.sifma.org/wp-content/uploads/2021/06/SIFMA-Climate-Disclosure-SEC-RFI-June-10-2021.pdf

   a. SIFMA recommends a high level response urging the SEC to take action on climate disclosure through formal rulemaking, thus allowing for appropriate public notice and comment periods to opine on the proposals.

   b. Recommends nature and placement of climate-related disclosure be determined by materiality, which varies by industry and among companies within industries. SIFMA recommends the SEC adopt a smart mix of climate disclosure requirements, consisting of (A) a principles-based requirement to disclose material climate-related information and (B) a limited set of core metrics that are generally applicable across industries, with safe harbor protections for any forward-looking climate-related information, whether qualitative or quantitative.

   c. Approach to climate disclosures should be coordinated (globally and nationally) and consistent, and any rulemaking should keep compliance burdens in mind and minimize them to the greatest extent possible and be phased in over time.

   d. Data and methodologies must improve and the SEC should be mindful that some disclosures may be dependent on data or information from other companies.

4. NABL Response – https://www.sec.gov/comments/climate-disclosure/cll12-9218139-250189.pdf

   a. Any disclosure guidance from the SEC should be grounded in materiality.

   b. Issuers should be able to decide whether to label or market their bonds to environmentally or socially-driven investors,

but should not be required to otherwise meet climate change labelling requirements, barring materiality concerns.

v. March 21, 2022 – SEC proposed amendments to the Securities Act that would require corporate issuers to provide certain climate-related information in their registration statements and annual reports - https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

vi. May 25, 2022 – SEC issued two rule proposals in connection with investment advisors and investment companies relating in whole or in part to environmental, social and governance matters:

1. Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies – https://www.sec.gov/rules/proposed/2022/33-11068.pdf

2. Investment Company Names – https://www.sec.gov/rules/proposed/2022/33-11067.pdf

Together, these proposals would, among other things, require funds and their advisers to disclose additional information regarding their ESG investment practices, as well as to adhere to additional practices and standards with respect to their invested assets designed to ensure consistency with fund names and terminology indicative of the fund's focus or strategy, including in connection with ESG strategies.

While not directly applicable to municipal issuers, the proposed rule amendments, if adopted, could have potentially significant impacts on municipal issuers whose bonds are held by mutual funds and other investors engaging in ESG strategies, which may need to modify their standards and practices when investing in municipal securities to conform to their new ESG-related obligations.

B. MSRB Request for Information on ESG Practices – December 8, 2021 (https://www.msrb.org/-/media/Files/Regulatory-Notices/RFCs/2021-17.ashx)

i. The MSRB issued a request for information on ESG market practices in the municipal securities market as part of its broader engagement on ESG trends and to enhance issuer and investor protections related to these matters.

ii. Among other topics, the MSRB is specifically seeking to compile comments on: (i) the disclosure of information regarding ESG-related risk factors and ESG-related practices and (ii) the labeling and marketing of municipal securities with ESG designations. Presently, there are no uniform standards for ESG-related disclosures or ESG-labeled bonds.

The MSRB hopes to gather information from municipal issuers, investors in municipal securities, broker-dealers, municipal advisors, and other participants to

gather a record of stakeholder perspectives and inform the Board on market trends.

iii. The MSRB received 52 submissions from issuers, individuals and industry groups and announced that its next steps with respect to ESG practices in the municipal securities market would be to prepare and publish a summary of the comments and to host a series of virtual town halls to explore themes raised by commenters.

C. GFOA Best Practices

i. ESG Best Practice – "E" Environmental (https://www.gfoa.org/materials/esg-disclosure)

1. Without clear ESG information—either through a rating agency report or disclosures—potential buyers of municipal bonds are likely to conduct their own ESG analysis, which may not include all relevant information or context that a government can provide especially regarding steps taken to mitigate these risks.

2. The GFOA best practices paper notes that the first step for issuers in developing environmental disclosure information is to consider the environmental risks applicable to the issuer and its bonds. To identify these risks, the paper suggests that issuers start by identifying internal resources, such as an emergency planner or sustainability officer, and relevant reports or studies. An issuer also can consult external resources, such as bond offering documents of other relevant jurisdictions, particularly because environmental and climate risks often affect other jurisdictions in the region.

3. After identifying environmental risks, issuers should consider the potential operational and financial impacts of these risks (were they to materialize), evaluate whether the risks can be quantified, and consider whether the risks represent material risks that should be disclosed in bond offering documents, together with appropriate cautionary language and the steps the issuer is taking (if any) to address the risk.

4. The GFOA best practices paper includes a checklist of considerations in preparing environmental disclosure.

ii. ESG Best Practice – "S" Social (https://www.gfoa.org/materials/esg-best-practice-s-social)

1. One important distinction between "E" risks and "S" factors is the lack of consensus within the municipal finance space about what factors would fall under the "S" umbrella that may constitute important information related to credit analysis, which could leave

the issuer in the position of having to decide what social factors, if any, may have a meaningful and relevant connection to its credit quality or the willingness or ability to repay its bonds.

2. Issuers can start by considering the "S" factors that challenge their own community, evaluating whether these factors could have operational and financial impacts, and considering the potential materiality of these factors.

3. The paper suggests that issuers start by reviewing what is already included on these topics in their bond offering documents, and consider whether to provide additional context for how these "S" factors are affecting the jurisdiction and how the factors are being addressed. Because there is less consensus on the "S" factors to consider, "S" disclosure may be most informative when it includes an explanation of the significance of the factor and a discussion of its potential impacts on the jurisdiction.

iii. ESG Best Practice – "G" Governance (https://www.gfoa.org/materials/esg-best-practice-g-governance)

1. Governance factors have always been a part of government management, operations, and finances and information on organizational structure, management, decision-making, policies, and budget and financial management and reporting is already available from issuers and communicated in some way. However, the focus on ESG provides an opportunity for issuers to think about "G" factors in light of ESG and verify that important information of this nature is available and clearly communicated.

2. The GFOA paper notes that "G" (and other disclosure) should be reviewed from time to time to take into account new developments.

E. SEC Cybersecurity Releases – two releases in February and March 2022 address cybersecurity risk management for investment advisers, registered investment companies and business development companies.

i. Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies proposed rules would require advisers and funds to adopt and implement written policies and procedures that are reasonably designed to address cybersecurity risks; require advisers to report significant cybersecurity incidents to the Commission on proposed Form ADV-C; enhance adviser and fund disclosures related to cybersecurity risks and incidents; and require advisers and funds to maintain, make, and retain certain cybersecurity-related books and records. https://www.sec.gov/rules/proposed/2022/33-11028.pdf (February 9, 2022)

ii. Cybersecurity Risk Management, Strategy, Governance and Incident Disclosure proposed rules would require current reporting about material cybersecurity incidents on Form 8-K; require periodic disclosure regarding among other things, registrant's policies and procedures to identify and manage cybersecurity risks; management's role in implementing cybersecurity policies and procedures; board of directors' cybersecurity expertise, if any, and its oversight of cybersecurity risk; and updates about previously reported material cybersecurity incidents; and require the cybersecurity disclosures to be presented in Inline eXtensible Business Reporting Language (Inline XBRL). https://www.sec.gov/rules/proposed/2022/33-11038.pdf (March 9, 2022)

F. How will rule changes in the corporate world create a materiality standard for municipal securities? How well will the concept of 'materiality' be used to elicit information in the context of ESG disclosures in municipal securities offerings and secondary market disclosures? How will proposed SEC corporate amendments on ESG disclosure affect municipal disclosure?

G. How do practitioners glean what is material to investors respecting ESG disclosures?

VII. DISCLOSURE OF RISK FACTORS

A. Use of forward looking statements as a safe harbor from anti-fraud liability.

(1) Based on corporate securities doctrine under the Private Securities Litigation Reform Act.

(2) Creates safe harbor from antifraud provisions for forward looking statements that are reasonably based, honestly believed, and accompanied by meaningful cautionary language like risk factors.

B. Should include well-developed assumptions and cautionary statements that disclose material facts that indicate risk.

(1) Tailored to issuer or borrower's particular circumstances

(2) Cautionary statements do not protect against omission of material facts

VIII. RECENT REGULATORY PROPOSALS

A. In FINRA Regulatory Notice 21-11, FINRA proposes to require dealers to post margin for contracts to sell securities on a "when-issued" basis in a primary distribution in connection with a bona fide offering by the issuer to the general public for cash if they settle after the 42nd calendar day after the trade date.

(1) Potential Impact if Rule Adopted

(a) Additional costs to underwriters for forward settled underwritings

(b) Cost to issuers?

B. In MSRB Notice 2021-07, the MSRB proposes to codify interpretive guidance previously issued in 2017 under MSRB Rule G-17 that relates to the obligations of "solicitor municipal advisors" and add additional requirements that would align some of the obligations imposed on solicitor municipal advisors with those applicable to non-solicitor advisors.

(1) "Solicitor municipal advisors" are persons who solicit municipal entities or obligated persons. A solicitation is "a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor or investment advisor that does not control the person undertaking the solicitation, for the purpose of obtaining or retaining and engagement by a municipal entity or obligated person of a broker, dealer municipal securities dealer or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment advisor to provide investment advisory services to or on behalf of a municipal entity."

C. MSRB proposes extending Regulation Best Interest (Reg BI) Obligations to Bank Dealers.

In 2019, the SEC adopted Reg BI, which set a new standard of conduct for broker-dealers when making a recommendation to retail customers of securities transaction or investments involving securities. Retail customers are those that use recommendations primarily for personal, family or household purposes. Reg BI provided that broker-dealers are obligated to act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker dealer ahead of the interest of the retail customer.

As drafted, Reg BI did not apply to municipal recommendations to retail customers made by bank dealers, which led to a potential for disparate treatment of retail customers by bank dealers compared to broker-dealer recommendations.

On April 29, 2022, the MSRB filed a proposed rule change with the SEC to amend MSRB Rule G-19 on suitability of recommendations in order to require bank dealers to comply with Regulation Best Interest to the same extent as broker-dealers when making municipal securities recommendations to retail customers. If approved by the SEC, the proposed rule change would impose the Disclosure Obligation, Care Obligation, Conflict-of-Interest Obligation and Compliance Obligation under Regulation Best Interest on bank dealers. The SEC published a notice to solicit comments on the Reg BI on May 4, 2022 approved the rule changes on June 23, 2022. The approval order can be found here – https://www.sec.gov/rules/sro/msrb/2022/34-95145.pdf.

IX. LATE BREAKING ENFORCEMENT ACTIONS AND OTHER DEVELOPMENTS

A. The panel will discuss additional issues, regulatory developments and enforcement actions arising since the completion of this outline.

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18 – 20, 2023

LET ME CHECK WITH MY DESK

Chair:

Lee Birchall	Bradley Arant Boult Cummings, LLP – Birmingham, Alabama

Panelists:

Sam Denton-Schneider	Goldman Sachs & Co. LLC – New York, New York
Anthony Leyden	IHS Markit – New York, New York

***Let Me Check With My Desk* will educate bond lawyers on the role played by the municipal bond trading desk. Participants in a typical municipal bond transaction (other than bond lawyers!), including investment bankers and representatives of IPREO, will give attendees a behind-the-scenes look at how municipal bonds are structured, marketed, priced, and closed. Attendees will leave with a better understanding of the factors that shape pricing and trends in the municipal bond market, the mechanics of underwriting an actual sale of municipal bonds, as well as special topics such as the inner workings of DTC, proprietary trading risk, and hypothetical situations posed to the panelists.**

I. What is “the Desk”?

A. The “Desk” is the physical location in an investment bank where the buying and selling of securities occurs. Formally, the “Desk” is bifurcated into two separate groups of professionals:

1. The Underwriting Desk (also known as the Syndicate Desk), which conducts transactions in primary offerings (“new issues”), and

2. The Sales & Trading Desk(s) (also known as the Trading Desk), which is primarily involved in secondary market trading.

B. Although these two groups will work in tandem in the marketing and underwriting of a new bond issue, the distinction between them is important. The Underwriting Desk is generally part of the investment banking (“private”) side of the investment bank, while the Sales & Trading Desk are on the investor (“public”) side. Underwriting Desk professionals can be privy to material nonpublic information (“MNPI”); sales & trading professionals generally are not, unless they are “wall crossed,” and restricted from trading on the MNPI received. The Underwriting Desk serves the critical role as a “bridge” between the investment banking team and the Sales and Trading Desk (and, derivatively the larger investor market as a whole).

C. Thus, when bankers refer to “the Desk”, the actual meaning of that term, and the subparts of the functions, will depend upon the context in which they are using it.

D. All underwriting and sales and trading professionals must pass certain FINRA licensing/qualification exams: the Securities Industry Essentials Exam, Series 7 (General Securities Representative) and Series 63 (Uniform Securities Agent State Law) being the basic ones. Municipal-specific licenses include the Series 52 (Municipal Securities Representative) and 53 (Municipal Securities Principal). Other licenses may be required depending upon a professional’s specific function, e.g., Series 57 (Securities Trader Representative).

NOTE: All municipal securities transactions (on either desk) must be “supervised” by a Municipal Securities Principal. (Series 53 license); this is required for municipal securities transactions even if the bonds are taxable. Thus, for example, a tax-exempt municipal bond issue for a private college, combined with a taxable obligation of the college, may be handled by two different professionals of a syndicate and/or Sales and Trading Desk, depending upon what licenses are held by the supervisor, as well as the structural organization of the desk operations.

II. What Does the Underwriting Desk Do?

A. The Underwriting Desk serves as the central point in many aspects of a primary issuance, not all of which will be visible to counsel (or for that matter, the issuer).

1. As noted above, the Underwriting Desk is the bridge between the investment banking team (the "deal team") and the Sales and Trading Desk (and, derivatively the larger investor market as a whole). In that role, the Underwriting Desk serves:

    a) As a resource – before and during the issuance process -- to bankers (as thus to issuers) for market perspectives and intelligence.
    b) As a central clearing point for investor questions and feedback.
    c) As the party responsible for delivering pricing and structuring information to the market, via "wires".
    d) As a representative of the underwriting syndicate, if one is formed

2. More specifically, the Underwriting Desk:

    a) Provides bankers with interest rate "scales" for proposals to municipal issuers, as well as development of plans of finance before a transaction is made public
    b) Provides bankers and issuer clients with a range of non-deal-specific data:
        (1) Market technicals, e.g.:
            (a) Bond redemptions: what is the expected amount of bonds maturing (cash to be re-invested) (by State, sector, and ratings)?
            (b) Supply (YTD and projected): what has / will be issued?
            (c) Bond fund returns
        (2) Trading Data (volumes / inventory): How much of the issuer's bonds has traded throughout the year?
        (3) Investor Data, e.g., Lipper for investor fund flow data
        (4) Market Updates / Meetings
    c) Provides a perspective on market receptivity to (and price for) various structural alternatives for a financing (e.g., coupons, call features, etc.). Helps develop marketing strategy once the transaction is underway
    d) Coordinates input from sales professionals as to investor demand and interests and more general market feedback
    e) Helps finalize bond sales/structure
    f) As the coordinator of the marketing process, establishes price/yield levels
    g) If necessary, provides an underwriting commitment for any unsold balances.

3. Working with the Sales & Trading Desk, the Underwriting Desk will coordinate and submit bids on competitive bid sales.

4. Syndicates. If two or more banks and broker dealers are appointed by an issuer to market its bonds, a "syndicate" will be created to sell a bond issue. The Underwriting Desk typically will serve as the liaison between its particular investment bank and the rest of the syndicate, especially the senior managing underwriter appointed by the issuer

    a) Not all transactions have a syndicate; many smaller issues will have a sole underwriter
    b) May include larger and smaller firms, based upon regional diversity, DBE, retail sales strength
    c) Number of syndicate members can be driven by size of transaction

d) The Master Agreement Among Underwriters ("AAU") governs participation arrangements and risk sharing of liability of the underwriters
e) A Selling Group (which can sell bonds, but does not have underwriting liability) can also be added to the marketing process

III. What Does the Sales & Trading Desk Do?

A. Sales & Trading Desk(s) serve two general roles:

1. Traders will buy and sell bonds on behalf of the broker/dealer or bank, executing "principal" trades for which the bank putting up its own capital to purchase bonds that are part of the inventory of bonds held by the bank or, conversely, selling bonds held in inventory.

2. Sales professionals are the professionals that focus on investors as their clients. Sales professionals are often further subdivided by the type of investors that they cover:
a) "Retail brokers" are sales professionals that cover individual investors.
b) "Institutional sales" professionals will cover mutual funds, ETFs, corporations (e.g., insurance companies, pension funds, large portfolio managers and similar portfolio managers.

3. Depending upon the size, client base, and product focus, banks and broker dealers may segregate or consolidate components of the firm's overall sales and trading platform. Thus, for example, a small firm may combine both the trading function and the institutional sales function; a larger firm may allow for limited trading by a retail sales desk. Others may combine certain fixed income products (municipal bonds, U.S. Treasuries, corporate bonds, etc.) on a single sales or trading platform. Generally, banks and broker/dealers will separate their fixed income and equity trading desks; other financial products such as junk bonds and credit default swaps (CDS) may be further traded and sold from separate desks.

4. In the context of municipal bonds, the Sales & Trading Desk performs two specific functions:
a) For new issuances ("primary offerings"), the Sales Desk has the primary responsibility for marketing the bonds to investors. As part of this process, the sales professionals will typically
(1) Provide feedback to the Underwriting Desk as to investor demand and interest rate or yield levels at which intuitional investors would be willing to participate.
(2) Manage and direct any questions that investors may have about the bond issue.
(3) Enter orders received into the order book for the underwriting.

b) Because a Preliminary Official Statement will have been distributed prior to marketing to investors, there is time for a dialogue between the issuer's

"side" of the transaction (issuer, bond counsel, the investment banking team) and the sales desk, and even with investors directly. The sales desk helps to facilitate those discussions. In all cases, all parties need to be mindful that no MNPI (i.e., material information, such as internal financial projections, not disclosed in the Preliminary Official Statement) is discussed,

c) Second, to the extent that an "unsold balance" (bonds that have been bought by a broker/dealer in either a competitive or negotiated underwriting, but for which no buyers have been lined up) exists on a new issue, the Trading Desk may choose to take a portion of those unsold bonds on as a risk position for its own account.

d) And, obviously, the Sales & Trading Desks conduct all secondary market trades; the Underwriting Desk would as a rule would not be involved in secondary market trades.

IV. The Marketing Process (from the Desk Perspective)

A. MSRB Rules. The marketing process is bound to a significant extent by MSRB rules governing primary issuance practices. In addition to general market practice rules, the rules specific to new issue underwritings include:

1. Rule G-11: Primary Offering Practices; governing priority of orders, syndicate allocations and settlement of accounts, and disclosures to the issuer and syndicate members.

2. Rule G-32, Disclosures in Connection with Primary Offerings; governing certain customer disclosures, underwriter submissions of OS and advance refunding documents, and submission of Form G-32 data to the MSRB.

3. Rule G-34; requiring that CUSIPs be obtained for all eligible bonds, submission of NIIDS data to DTC, and limits on the use of the NRO designation.

B. Before a POS is Posted:

1. Internal Approvals/Processes

2. Internal Committee Approvals/ Limits

a) Know Your Customer review/Credit Approval, etc.

3. Preliminary discussion with the client and the banking team of syndicate formation and policies

4. Printer Labels:

5. Ipreo Set up and Access: (discussed below)

6. Draft Sales Point Memorandum / New Issue Packet (more on that later)

7. Dialogue with issuer and its municipal advisor: critical that Underwriting Desk, the issuer, and the banking team are on same page as to what to expect as the process moves forward

8. Dialogue with the client as to timing and structure

C. The Formal Launch: Posting of the POS

1. When the POS is posted (made available to investors), the public marketing of the transaction can begin

a) Posting of the POS can be via a variety means:

(1) "Online" printing services, e.g., MuniOS.com

(2) EMMA
(3) Hard copies mailed to customers (less and less frequent)
(4) Investor calls
(5) Flyers

2. The POS is often supplemented by two additional communications tools:
    a) An <u>internal</u> Sales Point Memorandum or New Issue Packet (SPM), which summarizes many transactional and marketing aspects of the deal:
        (1) Links to the online version of the POS and Roadshow (if one is done)
        (2) Structure Summary
        (3) Use of Proceeds / Refunded Series
        (4) Issuer Overview
        (5) Relevant Credit Points, with Rating Reports Links
        (6) Top Holders and Holders of Refunded Bonds

    b) For certain large offerings, it is customary, not only in the municipal bond market, but other capital-raising businesses, for the underwriting team and the management of the issuer to make virtual (electronic) or in-person presentations and/or meetings with potential investor groups to discuss the transaction (such meetings are commonly known as"Roadshows."
        (1) Presentation will highlight many of points 1-4 above for investors
        (2) Investors often have the opportunity to participate in a follow-up telephonic group call or 1x1 discussions with the issuer.
        (3) All material information presented to or discussed with investors needs to be derived from information in the POS.
    c) Investor participation in a Roadshow, and the Roadshow's contents, is coordinated by the Underwriting Desk, working with Sales and Trading Desk and the banking team.

D. The Pricing of the Bonds: Can be followed in the stages of the Ipreo "Pricing Wires" (see also below): Multi-step process to find the clearing prices for bonds.

1. Structure Wire
    a) Broadcasts the structure to market
    b) Allows accounts to set aside money for specific maturities
2. Price Views Wire
    a) Allows senior manager to get syndicate's views on price
    b) Co-Managers have ability to opine on levels
3. Retail Order Period ("ROP")/ Pre-Marketing / Price Thoughts Wire
    a) First chance to broadcast levels to market
    b) If have an ROP, retail has ability to place orders before institutions
4. Preliminary Pricing Wire
    a) After we have orders from retail and/or indications from institutional accounts, book opens to institutions
    b) Order period generally runs for an hour or so (Senior Manager / bankers have ability to see order books in Ipreo)

c) After books close, Senior Manager has ability to adjust price based on levels of subscription

5. At this point, final yields are agreed upon with the issuer (verbal award from issuer)

a) Bankers then will update and finalize the amortization structure of the issue, and reconvey that to the Underwriting Desk

E. After the "Handshake": The Finalization of the Transaction (again, follow the wires!)

1. Re-Pricing Wire: Updated levels communicated to market

a) Investors have the ability to drop if yields have changed (lowered).

b) Underwriting Desk provides allotments to specific investors once all investor drops are received

2. CUSIP Wire: information on CUSIPs sent to market

a) Underwriting Desk typically orders CUSIPs for new money issuances

b) For refundings, CUSIPs may be needed for partially refunded and/or partially unrefunded bonds

3. Final Pricing Wire: Final pricing terms and CUSIPs communicated to market

4. DTC NIIDS & MSRB G-32 submissions

5. Execution of the BPA: Starts the process of trade ticketing. Actual sales tickets cannot be written to accounts until:

a) The BPA is signed (which is why it is important to have a written award ASAP); and

b) DTC is notified

(1) DTC closes at 5pm ET and the MSRB has a rule that does not allow bonds to trade until 2 hours after DTC is notified.

(2) Thus, bonds can only be freed to trade the same day if we have BPA executed by 3pm ET

(3) If not, bonds "freed up" at 9am next day

6. Trades are usually set up prior to the execution of the BPA, but are formally "booked" or ticketed within the parameters of the DTC and MSRB rules above at a specific time set by the Underwriting Desk, working the back office operations.

a) Trades are reported within 15 minutes of actual booking.

7. Free to Trade Wire: Restrictions on syndicate members are lifted. And bonds are "freed to trade" in secondary market.

a) Prior to then, all underwriters in the syndicate are required to offer to sell any unsold bonds at only the offering price(s) set by the syndicate.

8. Closing: Settlement Typically through DTC (see below)

F. After Bonds are Freed to Trade:

1. Generally considered secondary market trading, which will typically run through the Sales and Trading Desks

2. Unsold balances may be retained by the Underwriting Desk and sold from that part of the Desk, or may be transferred to the "books" of the Trading Desk.

G. Taxable Bonds follow a similar multistep process, with differing nomenclature

1. Usually marketed based upon the spread to an "on the run" (newly issued) Treasury of comparable maturity.

2. Coupon/yield is "set" AFTER the BPA is signed and bonds are allotted, based upon the actual Treasury rates at a specific, previously announced time.

V. Structuring & Pricing Municipal Bonds: The Factors Affecting Prices and Yields

A. Bond Prices and Yields are inverse to Each Other. A $100 principal bond with a 4% coupon returns $4 and has a 4% yield when sold at an initial offering price of $100. However, if the price to purchase that bond increases to $101, then the $4 return yields less than 4%. If the cost to purchase the bond goes down to $99, then the $4 return yields more than 4%.

B. U.S. Treasury Market. The federal government uses the U.S. Treasury Market to borrow money to finance governmental operations. Treasuries, backed by the U.S. Government, are considered to be risk-free investments. The U.S. Treasury Market is highly liquid. Consequently, Treasuries, and changes in that market, serve an important reference point for pricing assets in markets with credit risk – including municipals.

1. As noted above, taxable municipal bonds are often explicitly priced as a spread to comparable Treasuries.

C. Yield Curves. A yield curve represents the yield on an investment at different fixed duration points. Treasury Market securities have durations from 13 weeks all the way to 30 years. Typically, investors require greater yield as the duration of an investment increases. Short-term Treasuries have lower yields than long-term Treasuries, which gives the curve an upward slope. A normal slope indicates a stable economic cycle, where investors expect long-term rates to continue rising. A flat curve, where yields are consistent across various durations, indicates an uncertain economic period. An inverted curve, where short-term rates are higher than long-term rates, indicates a recessionary cycle where investors expect long-term rates to go down and therefore seek safer long-term investments, driving down the price of long-term Treasuries.

D. Municipal Bond Yield Curves. Various services and entities maintain indices of municipal bond pricing. Among the more popular, The Municipal Market Data (MMD) AAA Curve (currently owned by Refinitiv) is based on "AAA rated" state general obligation bonds and is utilized by sellers to gauge sale prices. Others (publicly available le on EMMA) include:

1. Bloomberg's BVAL AAA Curves
2. BondWave AA QCurve
3. ICE US Municipal AAA Curve
4. IHS Markit Municipal Bond AAA Curve
5. MBIS Municipal Benchmark Curve
6. S&P Municipal Bond Index
7. Variable rate bonds are often quoted or priced based on a spread to a floating rate index:
    a) SIFMA Municipal Swap Index (based on tax-exempt VRDN rates)
    b) LIBOR Index (to be phased out by 6/30/23)
    c) Secured Overnight Financing Rate (SOFR)
    d) Bloomberg Short-Term Bank Yield Index (BSBY)

E. Municipal Bonds to Treasuries Ratio. As a class, municipal bonds are considered to be among the lowest risk category of investments, although the interest on typical municipal bonds is tax-free, while the interest on Treasuries is federally taxable. Therefore, bankers and traders will often compare the prices of bonds and Treasuries against each other to determine, on any given day, or at any given moment, which is relatively more valuable—taking into account the taxes on Treasury interest.

F. Spreads. Investment banks and intuitional investors commonly price riskier assets in terms of the "spread" to an index such as MMD – the more the perceived risk in a bond, the wider the spread. Investors will focus on both the absolute level of the spread as well as the relative spread., compared to other available investments.

VI. The Two "Backbones" of the Operations System: DTC & Ipreo

A. DTC and Ipreo are two of the critical "behind the scenes" systems that help to make the municipal bond market among the most efficient in terms of execution in the securities market.

1. These two platforms operate in tandem with the bank's own internal trade execution, reporting and operating systems to provide for efficient execution of new issue underwriting and trades, with the aim of minimizing the amount of manual input (consequent reduction in time and potential for error).

B. DTCC. ***For an excellent overview of DTC and its operations, please read NABL's white paper, "Demystifying DTC: the Depositary Trust Company and the Municipal Bonds Market (March 2017):*** https://www.nabl.org/DesktopModules/Bring2mind/DMX/API/Entries/Download?portalid=0&EntryId=1093

1. DTCC is a SEC-registered "clearing agency" that serves multiple functions:
   a) Custodian of bonds: bonds are "immobilized" and held in custody, either by DTC directly or via arrangements with bank trustees and other financial institutions via DTC's FAST system.
   b) Book entry transfer of ownership of bonds among DTC participants only
      (1) Participation in DTC is limited to registered broker-dealers, banks, clearing corporations, and similar financial institutions approved by DTC
      (2) Actual ("beneficial") owners of bonds are not participants in the DTC system, unless they are one of the entities above.
      (3) Consequently, not all trades will clear and settle through DTC's operations. For example, the sale of a bond to a retail customer of the senior managing underwriter of a bond issue will not be settled on DTC, but rather on the internal books and records of the broker /dealer. Conversely, the sale of bonds to a retail customer of co-manager will be settled first on DTC as a transfer to the co-manager's DTC account, with a similar internal settlement between the customer and the comanager.
   c) Comparison of Broker-Broker Trades: National Securities Clearing Corp. (NSCC). For all broker-to-broker trades, DTC's processes require that BOTH

brokers report the trade to NSCC; NSCC then "compares the two trade reports to make sure that they match, after which they are settled in the normal process.

d) Settlement of trade amounts, debiting the account of the purchasing DTC participant (or its financial institution) and crediting that of the seller.

e) Payment of principal, interest, redemption amounts, etc. to the Beneficial Owners (the actual holders) on its books and records.

f) Tracking of amounts of bonds outstanding, adjusting for redemptions, refundings, sinking fund installments, etc.

g) Processes and systems for the conduct of tenders, exchanges, etc.,

h) Physical delivery of issuer communications to investors via the Participants, as requested by the issuer.

2. To our knowledge, DTC currently is the only clearing agency approved by the SEC for municipal bonds

C. Ipreo is a multiuse/multipurpose platform, intended to automate & facilitate new issuance underwriting and transaction execution and providing new issue information to the street at large. These functions include:

1. Communications platform for information dissemination ("wires") among syndicate desks of underwriters and selling group members. The "wires" that Ipreo can provide include:
    - a) Syndicate formation wire AAU/Invitation wire
    - b) Preliminary structure/price views wire
    - c) Preliminary pricing wire
    - d) Repricing Wire
    - e) CUSIP wire
    - f) Final pricing wire
    - g) Refunded bonds wire
    - h) Allotments letter
    - i) "Free to trade" wire
    - j) "Hold the price" wire(s)
    - k) Summary of orders by priority / Order Letter
    - l) Order Status Wire Order Termination Wire
    - m) MSRB G-11 / Preliminary and Final Designation
    - n) Syndicate balances wire
    - o) Spread detail wire
    - p) "Free Text" wire with any message to be shared with syndicate
    - q) Syndicate List wire
2. Book- building function (Electronic Order Entry):
    - a) Direct new issue order from investors and other underwriters and broker/dealers
    - b) Entry of orders received by/conveyed to the senior manager
3. "Game Day": graphic and tabular presentation, in real time, of orders, by maturity/investor/dealer, with comparison to maturity limits (premium feature)
4. Interface with trade ticket processing within the broker/dealer
5. Data feed to DTCC's New Issue Information Dissemination Service (NIIDS)

a) NIIDS is the central repository for all information, available to ALL broker/dealers, about each bond necessary for trade processing (coupon, maturity, call date, interest payment dates etc.)

6. Data feed to DTCC's Underwriter Source function

   a) Information necessary to enable DTCC to clear and settle trades on its books and records, including the initial settlement, as well as bond payment information.

7. Reporting per deal (including P&L calculations) and cross-deal data
8. Street-wide forward calendar

VII. Discussion Topics

A. What are the Current Factors Affecting Bond Pricing?

B. How does the Desk determine whether to offer premium or discount bonds, as well as serial versus term bonds?

C. Not all Bonds are the Same – How are General Obligation, Revenue, Project Finance, Private Activity, and "High Yield" bonds priced and marketed differently?

D. The Sale Process

1. Timing leading up to the sale date – when does it all start? What does the Desk do leading up to the sale date?
2. How is the sale actually conducted? Are sales/trades happening over the phone, Bloomberg messaging, electronic trading platforms
3. How are sale dates selected for pricing? What is the impact of economic news, Fed meeting, other issues pricing that same day
4. What happens if all the orders aren't filled? Or if the issue is oversubscribed. Is it the Desk that fills (or over-fills) the order book for an offering or is it the underwriting deal team?
5. Hold-the-Price
6. What are "tickets" and how do you write them?
7. Changing tickets and busted trades

E. Stories from the Desk

Institutional vs retail investors – How are they different and how does the Desk approach them? What happens when the Desk receives feedback/questions from them? What are typical questions that the Desk commonly receives from such investors?

VI. Closing

1. How does the Desk prepare for a closing?

a. Wires
b. Coordination with Trustee and Issuer

c. Contact with the Investors

2. DTC (See NABL White Paper)
   3. How are funds transferred at closing?
   4. What happens if the deal does not close by the DTC cut-off time?

VII. Special Topics

   1. How do you identify bondholders in a consent situation?
   2. How does the Desk trade bonds?
   3. POS/OS stickered—what problems can that cause with investors?
   4. What happens with the Blue Sky memo after it is sent to the banker?

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18 – 20, 2023

MULTIFAMILY HOUSING

Chair:

Jon P. Jurich	Pacifica Law Group LLP – Seattle, WA

Panelists:

Sisera M. Daniel	Kutak Rock LLP – Washington, D.C.
Cory G. Kalanick	Sherman & Howard LLC – Denver, CO
Victoria N. Ozimek	Bracewell LLP – Austin, TX

This panel will discuss the range of housing development strategies in the current market (including senior, affordable, and "missing middle/workforce" housing), current issues in deal structures, the impact of the return of opportunities for positive arbitrage, issues relating to increasingly complex capital stacks and available sources of funds to construct housing developments, and emerging tax and disclosure issues in an environment with rising costs and interest rates.

I. Legislative and Regulatory Updates

a. 50% Test and potential for movement
    i. The Affordable Housing Credit Improvement Act (S. 1557/H.R. 3238)
b. ESG, Fossil Fuels and Other Political Issues in Housing Deals
    i. Each item may present new challenges depending on your role in the deal
    ii. Who can participate on the finance team?
    iii. What markets might be closed off to you based on how you market the bonds and at what cost?
    iv. What might you need to (or not be able to) disclose?
c. Pending (or passed) housing-specific legislation

II. Market Conditions

a. Construction, Lease-Up and Conversion Delays
    i. Disclosure relating to liquidity extensions
    ii. Reissuance Analysis (Treas. Reg. §1.1001-3)
        1. Is it a unilateral option?
        2. Addressing change in timing of payments
        3. All the ways to cause changes in yield
        4. WAM Extensions/Plan of Finance TEFRA
b. Cost Overruns
    i. Supplemental Issuances and Reimbursement Questions
        1. Treas. Reg. §1.150-2
c. Positive Arbitrage
    i. New Structures
    ii. Dealing with Investment Earnings (blending yields, etc.)
    iii. Borrower Education

III. Other Current Issues in 142(d) Deals

a. Acq/Rehabs and Resyndications
    i. Related Parties and Substantial Users
        1. Treas. Reg. §1.142-4(c) and §1.103-11(b)
        2. True sale
    ii. Tax-Exempt Seller Financing to Hit the 50% Test
b. Mezzanine financing and related issues

IV. Structuring Issues and New Models

a. 501(c)(3) Deals
    i. Related Parties and Structuring with Qualified Management Contracts
        1. Rev. Proc. 2017-13
b. Cash flow-based subordinate series bonds
    i. Types of deals
    ii. Debt/equity issues
    iii. CABs and other cash flows
c. Short-term cash-backed Converting to Long-term TEL
    i. Reissuance
    ii. Yield blending
    iii. Program Investment Rule Issues in tax-exempt loans

            1. Seller-servicer issues
            2. Issuer fee timing items
        iv. Contingent Payment Debt Instruments
            1. Treas. Reg. §1.1275-4
    d. Essential / Workforce / Middle Income Housing
        i. Condominium structures
        ii. Donnelly Amendment compliance, owner requirements
        iii. Management contract issues
        iv. Property tax exemptions and fair market value issues
        v. Subordinate Debt

V. Bonus Round

- a. Thinking Through New Structures and What Matters
    - i. GNMA / PLC issues
    - ii. Condo sales in workforce housing

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THE WORKSHOP 2023

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OPPORTUNITY ZONES & ECONOMIC DEVELOPMENT PROJECT FINANCING

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Designed for public finance attorneys, this panel will provide an overview of Qualified Opportunity Zones and Qualified Opportunity Zone Funds and how they are used within various economic development structures. This panel is intended to help public finance attorneys understand the basics of Qualified Opportunity Zones and how to discuss them with municipal and private sector clients who may also be including tax-exempt and taxable bond financing within their economic development projects.

In addition to Qualified Opportunity Zones, this outline provides as resource an overview of New Markets Tax Credits, Historic Tax Credits, Energy Tax Credits, Green and Social Impact Bonds, PACE Financing, and Low-Income Housing Tax Credits; however, the NABL panel will focus specifically on Qualified Opportunity Zones.

I. Qualified Opportunity Zones
II. New Markets Tax Credits
III. Historic Tax Credits
IV. Energy Investment Tax Credits
V. Green & Social Impact Bonds
VI. PACE Financing
VII. Low-Income Housing Tax Credits

I. QUALIFIED OPPORTUNITY ZONES

A. HISTORY AND SCOPE OF THE OZ STATUTE

- The Tax Cuts and Jobs Act of 2017 (the "TCJA") added Sections 1400Z-1 and 1400Z-2 (collectively, the "OZ Statute") to the Internal Revenue Code of 1986 (the "Code"). The broad policy behind the OZ Statute is to spur targeted economic and job growth by driving long-term capital to underserved communities in the United States and its territories.
- Unlike most other aspects of the TCJA, the concept of the OZ Statute originally enjoyed bipartisan support. Notably, Senators Scott (R-South Carolina) and Booker (D-New Jersey), as well as Representatives Tiberi (R-Ohio) and Kind (D-Wisconsin), championed a prior version of the legislation called the "Investing in Opportunity Act".[1] However, because the OZ Statute was ultimately passed as part of the TCJA, as opposed to being considered on a standalone basis (or as part of less controversial legislation), it ultimately lost some of its bipartisan support. Further, certain aspects of the original legislation that appealed to Democrats, most notably a reporting requirement, were not included in the final OZ Statute.
- The OZ Statute is similar in many respects to other tax incentives intended to spur economic development in distressed areas (e.g., the New Markets Tax Credit). For example, the eligibility requirements for census tracts to be designated as Qualified Opportunity Zones ("QOZs") generally is the same as the eligibility requirements for low-income tracts under the New Markets Tax Credit.
- Despite these similarities, the OZ Statute has the potential to attract a far larger pool of investors. Specifically, whereas the New Markets Tax Credit contemplates the allocation of a specified amount of tax credits pursuant to a competitive award process, the OZ Statute is available, without a cap, to any taxpayer who has realized capital gains. Some have estimated the pool of unrealized capital gains to be as high as *$6.1 trillion* – far exceeding the congressional allocation of tax credits under the New Markets Tax Credit program of *$5 billion* (as extended through 2025 by The Consolidated Appropriations Act, 2021 (P.L. 116-260).[2]
- Original estimates suggested that the OZ Statute would cost $1.6 billion in revenue from 2018-2027. As described below, the potential tax benefits afforded by the OZ Statute are predominately in the years following this window of time, e.g., after the 10-year holding period. New Treasury Regulations stipulate that the program's benefits would continue through 2047, meaning the program's revenue impact could increase over time depending on how many investors utilize the program.
- ***Takeaway:*** The breadth of the OZ Statute has the potential to cause an enormous amount of capital to flow into QOZs – which could result in a demonstrable positive impact for these communities. As discussed below, however, some of the initial bipartisan support of

[1] H.R. 828 – 115th Congress (2017-2018). For an interesting article providing a history of the OZ Statute, including the involvement of Sean Parker from Napster and Facebook fame, *see* https://www.forbes.com/sites/forbesdigitalcovers/2018/07/17/an-unlikely-group-of-billionaires-and-politicians-has-created-the-most-unbelievable-tax-break-ever/#5c8430141485.

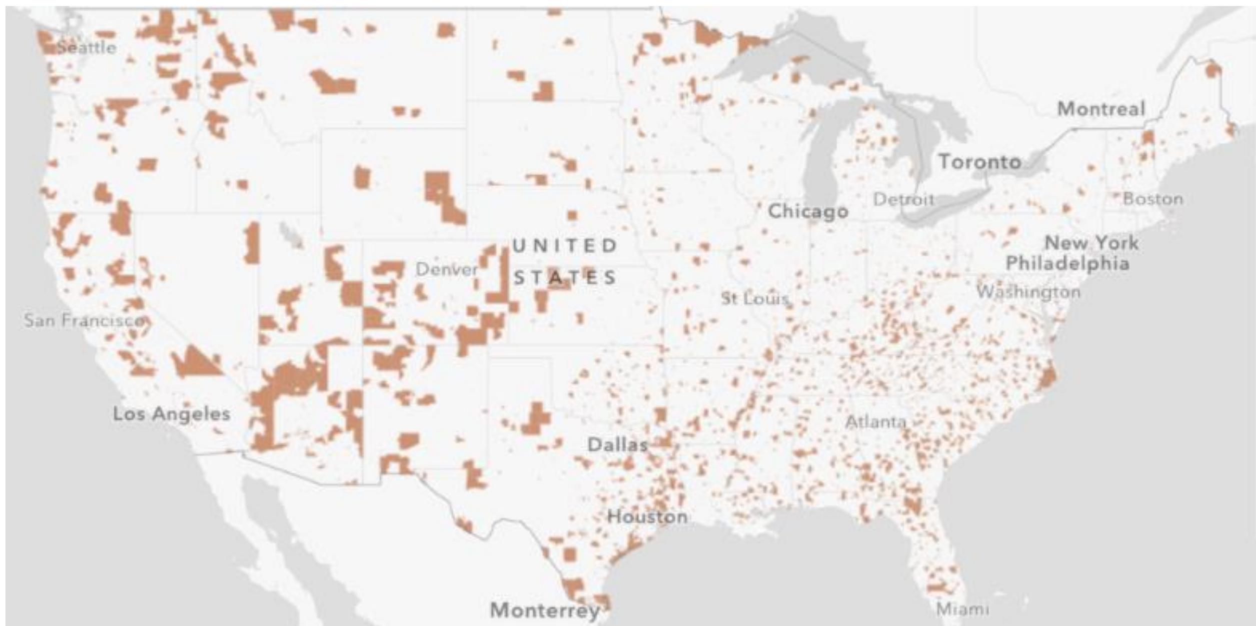
[2] *See* https://eig.org/news/opportunity-zones-tapping-6-trillion-market.

the OZ Statute has eroded as a result of the lack of reporting requirements and other concerns. As such, when discussing the OZ Statute with municipal issuers that have one or more QOZs in their jurisdictions, it is important to understand that not everyone sees this incentive (as currently enacted) as a positive for their communities.

B. WHAT ARE QUALIFIED OPPORTUNITY ZONES AND WHERE ARE THEY LOCATED?

- QOZs were identified by governors of each U.S. state or territory, often in consultation with local governments and, per press reports, sometimes in consultation with local developers, investors and business leaders. A list of all designated QOZs is available in IRS Notices 2018-48 and 2019-42.
- QOZs are comprised of:
  - Low-Income Community Tracts – Census tract poverty rate is at least 20% or median family income for the tract does not exceed 80% of the area median family income (Currently 25% of QOZs in each state are designated as Low-Income Community Tracts (LICs), but the Expanding Opportunity Zones Act of 2021 (HR 4177) introduced by Jim Hagedorn (R-MN) proposes to expand the LICs to 30% of QOZs in each state), and
  - Eligible Contiguous Non-Low-Income Tracts – Contiguous census tracts where the median family income for the tract does not exceed 125% of the area median family income (limited to 5% of total QOZs within a state).
- Over 8,700 QOZs have been designated in the U.S. and territories.[3] California has the most QOZs (879); the U.S. Virgin Islands has the least (14).

[3] *See* https://www.enterprisecommunity.org/opportunity360/opportunity-zone-eligibility-tool for an interactive map of QOZs, a portion of which appears herein (but note the map does not include all designated QOZs, as Alaska, Hawaii, and U.S. territories are not reflected). Note that the larger QOZs identified on the map, particularly in western states, reflect the size of the census tract; there is no correlation to the number of residents that live in such areas.



- Neither the OZ Statute nor the Treasury Regulations promulgated thereunder include an ability to designate additional QOZs nor the ability of a QOZ to lose its status (for example, if the census tract income increases).
- ***Takeaway:*** There are QOZs in every state, including both rural and urban areas. State and local governments took different approaches to designating census tracts (e.g., strict adherence to the policy goals of legislation compared to likelihood of seeing actual investments). When talking with municipal clients, it may be important to understand the approach taken when potential QOZs were identified.

C. THE OZ STATUTE'S THREE TAX BENEFITS – DEFERRAL, REDUCTION, AND EXEMPTION

- ***Deferral of Current Capital Gains Tax***: A U.S. taxpayer that makes an equity investment of recognized capital gain in a Qualified Opportunity Fund ("QOF") during the 180-day period following such recognition is eligible to defer the resulting capital gains tax until the earlier of (i) the date the QOF investment is sold (or an "inclusion event" occurs) and (ii) December 31, 2026.[4] The Expanding Opportunity Zones Act of 2021 (HR 4177) introduced by Jim Hagedorn (R-MN) proposes to extend the deferral date to December 31, 2029, and the Opportunity Zone Extension Act of 2021 introduced by Tim Burchett (R-TN) and Henry Cuellar (R-TX) proposes to extend the deferral date to December 31, 2028.
  - If the QOF investment is sold for cash on or before December 31, 2026, then the taxpayer presumably will have the liquidity to pay the deferred tax liability.

[4] Taxpayers that invest eligible gain in a QOF are required to file IRS Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments (*see* https://www.irs.gov/pub/irs-dft/f8997--dft.pdf).

However, if the taxpayer holds the QOF investment through December 31, 2026, the taxpayer will have to consider the consequences of having "phantom income."

- ***Reduction of Tax on Capital Gains***: If the taxpayer holds the QOF investment for 5 years, 10% of the deferred capital gain is added to the taxpayer's basis in the QOF investment – resulting in a 10% permanent reduction of the taxpayer's deferred capital gain. *NOTE: Under current law, QOZ investments after December 31, 2021 do not receive the basis adjustment; however, there is proposed legislation in Congress that may revive the basis adjustment benefit.*

- ***Appreciation on QOF Investment is Permanently Exempt from Tax***: A QOF investor that holds its QOF investment for at least 10 years can elect to increase its basis in the QOF investment up to an amount equal to the FMV on the eventual date of sale, resulting in 100% exemption from tax on the appreciation.
  - Most see this as the OZ Statute's primary tax benefit. However, the taxpayer must be willing/able to hold the QOF investment for at least 10 years to enjoy this benefit, which may be longer than its usual holding period.

- ***Takeaway:*** The OZ Statute has the ability to confer significant tax benefits upon taxpayers. In addition to deferring and reducing the original capital gain, imagine if an investor in a successful startup (e.g., Facebook) was able to eliminate 100% of the tax on the appreciation of its investment! That said, the tax benefits under the OZ Statute do not make bad investments good (paying tax is typically better than losing money), so the same diligence that would be conducted for a non-QOF investment should be done when considering a QOF investment. Interested taxpayers should consult with qualified CPAs and/or other tax advisors who understand the OZ Statute to assess the viability of an investment in a QOF and its potential tax implications.

D. OVERVIEW OF THE OZ STATUTE

Warning: As described under Part VI below, the OZ Statute omitted many specifics, leaving it to the IRS and Treasury to fill in the gaps via Treasury Regulations.[5] A detailed review of all of the nuances of the OZ Statute, as modified by the Final Regulations, is beyond the scope of this presentation. Rather, the general summary of the OZ Statute set forth below is intended to provide public finance attorneys with a general understanding of the rules so that they can effectively communicate with public finance clients at a high level. Practitioners who specialize in the OZ Statute should be consulted for more detailed discussions with clients and potential clients.

Illustration of the General Concept

[5] For example, the term "substantially all" is used but not defined several times in the Code. Similarly, the Final Regulations "override" the Code in some respects (e.g., a de minimis amount of "sin business" activity is permitted despite the plain language of the Code, and a QOF can lease property in certain instances despite the use of the term "by purchase" in the Code).

- ***QOF***: A QOF is an investment vehicle that:
  - Is organized as a domestic corporation or a partnership for federal tax purposes (can be an LLC as long as it is not disregarded for federal tax purposes);
  - Is organized for the purpose of investing in Qualified Opportunity Zone Property ("QOZP") (other than another QOF); and
  - Holds at least 90% of its assets in QOZP, determined by the average of the percentage of QOZP held in the QOF as measured every 6 months, including after the first 6 months of QOF's taxable year and at the end of each taxable year.[6]
- ***QOZP***: QOZP can be direct ownership of Qualified Opportunity Zone Business Property ("QOZBP") or indirect ownership of QOZBP through the ownership of an intermediary entity that operates as a Qualified Opportunity Zone Business ("QOZB").
- ***QOZBP***: QOZBP is tangible property used in a trade or business if the following requirements are met:
  - The QOF acquires such property by purchase after December 31, 2017, from an unrelated party (20% related party definition);
  - The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property; and
  - During 90% of the QOF's holding period for such property, 70% of the use of such property was in a QOZ.
- ***QOZB***: A QOZB means a trade or business that meets the following requirements:
  - 70% of the tangible property owned or leased by the business is QOZBP (determined by substituting QOZB for QOF in the definition above);
  - At least 50% of the business's total gross income is from the active conduct of its business;
  - 40% of the intangible property of such business is used in the active conduct of a trade or business;

[6] There is not an advance approval process to be certified as a QOF. Rather, an entity self-certifies its QOF status by filing IRS Form 8996, Qualified Opportunity Fund (*see* https://www.irs.gov/forms-pubs/about-form-8996).

    - Less than 5% of the average of the aggregate unadjusted bases of the property of such business is attributable to nonqualified financial property; and
    - The business must not be a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.
- ***Takeaway:*** The OZ Statute contains very few requirements relating to the types of property or businesses that can qualify for purposes of the QOF's 90% ownership test. The general lack of restrictions has the ability to spur substantially more economic development than other types of tax incentives; however, the lack of restrictions also creates the potential for investments that do not further the stated policy of the OZ Statute.

E. THE OZ STATUTE TREASURY REGULATIONS

- When signed into law in December 2017, the OZ Statute was met with great enthusiasm from a wide variety of groups, including investors, funds, real estate developers and operating businesses, as well as state and local governments that have one or more QOZs within their jurisdictions; however, the OZ Statute was limited in the specifics it provided and the IRS and Treasury have come out with multiple interpretive guidance documents related to the OZ Statute.
- ***First Tranche***: The first tranche of proposed Treasury Regulations concerning the OZ Statute (the "First Tranche") was published in the Federal Register on October 29, 2018. Among other areas, the First Tranche addressed the following items:
    - Types of gain that may be deferred;
    - Expiration of the 10-year exemption;
    - Types of taxpayers that can take advantage of the OZ Statute;
    - How a fund qualifies as a QOF; and
    - Additional helpful guidance regarding QOZP, QOZBP, and QOZBs.

  Although the First Tranche answered some of the questions left open in the OZ Statute, in many instances it caused even more issues with respect to the OZ Statute's application. Thus, those who were otherwise enthusiastic about the OZ Statue continued to be hesitant to actually move forward with investments and projects.
- ***Second Tranche***: The second tranche of proposed Treasury Regulations (the "Second Tranche") was published in the Federal Register on May 1, 2019. Among other areas, the Second Tranche addressed the following items:
    - The treatment of land as QOZBP;
    - What constitutes "original use" of tangible property for purposes of the substantial improvement requirements (including provisions relating to vacant property);
    - The treatment of leased property;
    - Valuation of QOZBP for purposes of QOFs and QOZBs (including a helpful safe harbor for newly contributed investments);

- The definitions of "substantially all" in the various places it is used in the OZ Statute;
- Guidance regarding property that straddles a QOZ;
- What constitutes the receipt of gross income from the "active conduct of a trade or business in the QOZ" (including the helpful addition of three safe harbors);
- Sourcing of gross income of a QOZB to a QOZ;
- The ability of a QOF to sell QOZBP after 10 years;
- Whether debt is included in the tax basis for a QOF investor's interest in a QOF partnership;
- Whether carried interest is eligible for QOZ benefits;
- How Section 1231 gain is treated;
- Events that end a QOF investor's gain deferral; and
- Reinvestment by a QOF of proceeds from a sale of QOZBP or an interest in a QOZB.

While questions remained, the Second Tranche provided sufficient clarity for some hesitant taxpayers to move forward with QOF investments. This was particularly the case for investors seeking to obtain the full 15% basis increase for QOF investments held for 7 years, as such investments had to be made by December 31, 2019. *NOTE: Under current law, QOZ investments do not receive the basis adjustment; however, there is proposed legislation in Congress that may revive the basis adjustment benefit.*

- ***Final Regulations***. On December 19, 2019, the IRS and Treasury released final Treasury Regulations (the "Final Regulations") that merge the First Tranche and the Second Tranche into a single set of regulations, as well as make additional changes.[7] The Final Regulations were published in the Federal Register on January 13, 2020. Among other issues, the Final Regulations address the following items:
  - What types of gains may be invested and when;
  - Additional guidance regarding Section 1231 gain;
  - The start of the 180-day investment period for partners in a partnership, shareholders of S corporations, and beneficiaries of estates and complex trusts;
  - RIC and REIT gains;
  - Installment sale gains;
  - Guidance for nonresident aliens with effectively connected income;
  - When gains may be excluded from tax after an investment is held for a 10-year period;
  - When purchased original use assets that improve the functionality of non-original use assets in the same QOZ or a contiguous QOZ can be taken into account;

[7] T.D. 9889.

- When a group of two or more buildings located on the same parcel(s) of land can be treated as a single property;
- Revised guidance regarding vacant property;
- Revised guidance regarding leasing activity;
- Several refinements to the working capital safe harbor set forth in the prior guidance;
- A clearer way for determining satisfaction of the substantial use test applicable to QOZBs, including a safe harbor for certain tangible property used both inside and outside the geographic borders of a QOZ;
- Guidance regarding determinations of location and "use" of intangible property;
- A square footage test and an unadjusted cost test to determine if a project is primarily in a QOZ;
- Guidance that parcels or tracts of land will be considered contiguous if they possess common boundaries, and would be contiguous but for the interposition of a road, street, railroad, stream or similar property;
- Application of the straddle rules to QOFs and QOZBs;
- Guidance regarding Brownfield sites;
- Guidance that self-constructed property can count for purposes of a QOF's asset test and a QOZB's asset test;
- Guidance that allows for a de minimis amount of "sin business" activity; and
- Guidance regarding unimproved land, demolition of existing property, self-constructed property, and inventory in transit.

- ***Regulations related to Covid-19 Pandemic***: Additionally, the Covid-19 pandemic resulted in relief, deadline extension and other modifications of how the OZ Statute was to be implemented during this period. These modifications are extensive; see these IRS Notices for additional information:
  - Notice 2020-39, Relief for Qualified Opportunity Funds and Investors Affected by Ongoing Coronavirus Disease 2019 Pandemic
  - Extension of Relief for Qualified Opportunity Funds and Investors Affected by Ongoing Coronavirus Disease 2019 Pandemic to the Opportunity Zone (Notice 2021-10)

F. INTERSECTION BETWEEN PUBLIC FINANCE AND OPPORTUNITY ZONES

- The OZ Statute does not create a governmental "program" – rather, it is simply a tax incentive under the Code intended to unlock and direct private capital towards QOZs and potentially encourage public-private partnerships ("P3s") and foster economic development. QOFs and the property and businesses in which they invest typically have no actual governmental involvement.
- Tax-exempt bonds can be used to complement investments in QOZs. As a result, many public finance attorneys will be asked about the OZ Statute by a variety of clients, including

(but not limited to) affordable housing developers, private entities interested in IDBs for manufacturing facilities or that might otherwise benefit from exempt facility bonds, as well as state and local governments that have a QOZ within their jurisdiction.

- Affordable housing projects were some of the first that received QOF interest because, for the most part, they neatly fit within the OZ Statute; additional guidance from the IRS and Treasury was needed for most other operating businesses. It would be entirely possible for an affordable housing project's capital stack to include proceeds of exempt facility bonds for qualified residential rental projects under Section 142(d) of the Code, equity investments relating to the Low Income Housing Tax Credit, plus investments from QOFs.
- In addition to affordable housing, various entities that can borrow proceeds of IDBs, sewage facility bonds, and/or solid waste disposal facility bonds have expressed interest in pursuing QOF investments.
- Governmental units that have one or more QOZs located in their jurisdiction should consider what role they can play in attracting investments resulting from the OZ Statute in order to produce clear and unambiguous policies that the private sector may rely upon in determining investment opportunities in a QOZ.
- In addition to promoting the QOZs, a state and local government can use additional means to make the projects more attractive to opportunity zone investors and potentially increase the internal rate of return. For example, tax-exempt obligations could be issued to finance improvements intended to help the QOF succeed, such as those for streets and sidewalks, utilities, schools and community colleges, public safety, greenspace and area beautification, among several others. The government also could offer additional incentives to spur investment, such as issuing economic development bonds and/or other means of tax increment financing, property tax abatements and efficient governmental approvals and permits.

Takeaway: A general understanding of the OZ Statue will help public finance attorneys effectively counsel their clients and provide valuable insight to help them with economic development project financing.

II. NEW MARKETS TAX CREDITS

A. Overview.[8] The New Markets Tax Credit ("NMTC") program permits taxpayers to receive a credit against Federal income taxes for making qualified equity investments ("QEIs") in designated Community Development Entities ("CDEs"). Substantially all of the QEI must in turn be used by the CDE to provide qualified low-income community investments ("QLICIs") in low-income communities. The credit provided to the investor totals 39% of the cost of the investment and is claimed over a seven-year credit allowance period. The credit allowance date means, with respect to any QEI, (i) the date on which such investment is initially made and (ii) each of the six anniversary dates of such date. In each of the first three credit allowance dates, the investor receives a credit equal to 5% of the total amount paid to the CDE for the QEI at its original issue. For each of the final four credit allowance dates, the value of the credit is 6%. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period but are permitted to sell their interest with the credits still available.

Similar to tax-exempt bond financing, the investor receives the actual tax benefit in the form of tax credits, while the project owner/borrower gets the economic benefit of the credits through more favorable loan terms available because the investor's return comes partially through the credits.

B. Law. Section 121(a) of the Community Renewal Tax Relief Act of 2000 (Pub. L. 106-554), enacted on December 21, 2000 (the "NMTC Act"), amended the Code by adding Code Section 45D, New Markets Tax Credit. The program has been extended several times as part of several dozen of the so-called "tax extenders." The program was most recently renewed through the Consolidated Appropriations Act, 2021. This Act included a five-year, $25 billion extension of the program. The New Markets Tax Credit Extension Act of 2023 (S.234/H.R. 2539), introduced in the Senate/House this year, would make the NMTC permanent if adopted. The related regulations are found at Treasury Regulations ("Treas. Reg.") Section 1.45D-1, et seq. A portion of the NMTC program is administered through the Community Development Financial Institutions Fund ("CDFI Fund") of the U.S. Treasury Department. Guidance published by the CDFI Fund on how an entity may apply to become certified as a CDE is found at 66 **Federal Register** 65806 (December 20, 2001).

C. Allocation of New Markets Tax Credits. The NMTC Act did not provide a required process for allocating the NMTCs and there are no statutory suballocations to States. The CDFI Fund was tasked with making allocations of credits to CDEs. The CDFI Fund provides two functions. First, the CDFI Fund certifies organizations as qualifying CDEs. Second, it makes the allocations of NMTCs upon application by the CDEs. The CDFI Fund is responsible for establishing the credit application process, eligibility guidelines, and a scoring model for ranking applicants requesting allocations of NMTCs.

In making the allocations described in the preceding sentence, the CDFI Fund is required to give priority to any entity (i) with a record of having successfully provided capital or technical

[8] Note: See IRS Publication entitled New Markets Tax Credit LMSB-04-0510-016 (May 2010), www.irs.gov/pub/irs-utl/atgnmtc.pdf for an IRS summary of the program.

assistance to disadvantaged businesses or communities or (ii) which intends to make QLICIs in one or more businesses in which persons unrelated to such entity hold the majority equity interest.

The amount of available allocation is limited by statute. The amount has been increased in the past to address need for recovery after natural disasters (GO Zone allocations) and economic distress (American Recovery and Reinvestment Act – ARRA).

Once a CDE has applied for, and received, an allocation, it enters into an agreement with the CDFI Fund relating to that allocation, which includes requirements as to how quickly that allocation must be used and the terms and conditions of the allocation. Typically, the CDE has two years to use at least 60% of such allocation to make a QEI, and, under IRC §45D(b)(1), must use all of its allocation within five years after it signs the allocation agreement with the CDFI Fund.

D. <u>Key Terms in NMTC Transactions</u>.

1. *CDEs:* Under IRC § 45D(c)(1), a CDE is any domestic corporation or partnership:

(a) Whose primary mission is serving or providing investment capital for low-income communities or low-income persons;

(b) That maintains accountability to residents of low-income communities through their representation on any governing board or advisory board of the CDE; and

(c) Has been certified as a CDE by the CDFI Fund.

Under IRC § 45D(c)(2), any specialized small business investment company as defined in IRC § 1044(c)(3) and any CDFI as defined in § 103 of the Community Development Banking and Financial Institutions Act of 1994 is treated as having met these requirements. A CDE certification lasts for the life of the organization unless it is revoked or terminated by the CDFI Fund. To maintain its CDE certification, a CDE must certify annually during this period that the CDE has continued to meet the CDE certification requirements.

Both for-profit and non-profit CDEs may apply to the CDFI Fund to be certified and to receive an allocation of NMTCs, but only a for-profit CDE is permitted to provide the NMTCs to its investors. Thus, if a non-profit CDE receives an allocation of NMTCs, it must “suballocate” its NMTC allocation to one or more for-profit CDEs.

A governmental unit is not eligible to be certified as a CDE because it is not a domestic corporation or partnership under federal tax law, so it must form a separate entity (non-profit or for-profit) if it wishes to be a CDE. Single member LLCs of governmental units do not qualify either. Many State and local governments and 501(c)(3) organizations have formed CDEs and have obtained an allocation of NMTCs over the years.

Most CDEs with an allocation of NMTCs will create a separate single-purpose sub-CDE for each project, “sub-allocating” NMTCs for the project in this manner.

2. *QEIs:* The tax credit is calculated based on the amount of the QEI made in a CDE. Under IRC § 45D(b)(1), a QEI is, in general, any equity investment in a CDE if all of the following requirements are met:

(a) Such investment is acquired by the investor at its original issue (directly or through an underwriter) solely in exchange for cash;

(b) Substantially all (at least 85%) of the cash is used by the CDE to make a QLICI; and

(c) The investment is designated by the CDE as a QEI on its books and records using any reasonable method.

The term "equity investment" means any stock in an entity that is a corporation, and any capital interest in an entity that is a partnership for federal tax purposes.

With respect to (a) above, the IRS ruled in Revenue Ruling 2003-20, 2003-1 C.B.-465, that funds derived from a loan (the so-called "Leverage Loan") made to the investor will meet the requirement of a cash investment, subject to certain conditions. The Leverage Loan will typically be nonrecourse to the investor, secured solely by the investor's interest in the CDE. The primary requirement is that the Leverage Loan cannot be secured by the project being financed or the assets of the borrower. The Leveraged Loan model has become the standard for many NMTC transactions, with the Leverage Loan being sourced from funds that might otherwise have gone directly into the projects. The source of the Leveraged Loan has ranged from taxable loans, capital campaign contributions, federal or state grants, equity of parties related to the QALICB (as defined in Section 3(a) below), low interest loans from mission-driven organizations, USDA guaranteed loans, and, in some instances, tax-exempt bond proceeds. Any requirements that might otherwise have been placed on the use of the funds being leveraged must be monitored indirectly through the CDE which is the actual lender to the QALICB in the NMTC structure. The leverage lender will typically be asked to forbear on exercising remedies against the investor during the NMTC Compliance Period, as defined in Section 4(c) below. Most investors will require that the leverage lender and the QALICB be separate entities in order to conclude that the NMTC structure has been respected and that the Leverage Loan is not a direct loan to the QALICB which would not qualify for NMTCs. Counsel take different views on the extent of overlapping control between a leverage lender and a QALICB.

With respect to (c) above, the CDE is able to designate QEIs only up to the limit of the NMTC allocation it has received.

3. *QLICIs*: As indicated above, under the QEI requirements substantially all of the QEI must be used to make a QLICI. The investor's cash investment received by a CDE is treated as invested in a QLICI only to the extent that the cash is so invested no later than twelve months after the date the cash is paid by the investor (directly or through an underwriter) to the CDE. The cash investment can be one of the four following types of QLICIs under IRC § 45D(d)(1):

(a) Any capital or equity investment in, or loan to, any qualified active low-income community business ("QALICB").

(b) A loan purchased by a CDE from another CDE which is a QLICI.

(c) Financial counseling and other services to any QALICB, or to any residents of a low-income community.

(d) Any equity investment in, or loan to, other CDEs.

See Treas. Reg. § 1.45D-1(d)(1)(iv).

4. *QALICBs*: Under IRC § 45D(d)(2)(A), a QALICB, is, for any tax year, a corporation (including a nonprofit corporation) or partnership if, for the year, all of the following requirements are met:

(a) at least 50% of the total gross income of the entity is derived from the active conduct of a qualified business within low-income communities;

(b) a substantial portion (at least 40%) of the use of the entity's tangible property (whether owned or leased) is within low-income communities;

(c) a substantial portion (at least 40%) of the services performed for the entity by its employees are performed in low-income communities;

(d) less than 5% of the average of the aggregate unadjusted basis of the entity's property is attributable to collectibles, other than those held primarily for sale to customers in the ordinary course of the business; and

(e) less than 5% of the average of the aggregate unadjusted basis of the entity's property is attributable to "nonqualified financial property" (i.e. investment assets such as debt instruments not issued in the ordinary course of business, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts or annuities), except that such term does not include (i) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (ii) certain debt instruments.

A QALICB includes a business carried on by an individual as a proprietor if the business, were it incorporated, would meet the above requirements for corporations and partnerships. A so-called "portion of a business" may also qualify as a QALICB if the portion would meet the requirements of a QALICB if it were separately incorporated and it maintains a complete and separate set of books and records for the portion of the business.

A "qualified business" is any trade or business, subject to certain restrictions described below. The rental to others of real property is treated as a qualified business if and only if (i) the property is not residential rental property and (ii) there are substantial improvements located on such property. A "qualified business" does not include (i) any trade or business consisting predominantly of the development or holding of intangibles for sale or license, (ii) any trade or business consisting of the operation of a facility for any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or (iii) any trade or business the principal activity of which is farming (with certain de minimis exceptions).

These QALICB requirements are very similar to the requirements of an "enterprise zone business" under Section 1394 of the Code for purposes of enterprise zone facility

bonds, but without the requirement that 35% of the employees be residents of the enterprise zone.

In general, the QALICB test is based on reasonable expectations at the time the QLICI is made that the requirements will be met throughout the 7-year compliance term (the "NMTC Compliance Period"). If the CDE obtains control of the QALICB at any time during the NMTC Compliance Period, the determination of QALICB status is made based on actual facts.

A governmental unit cannot qualify as a QALICB because it is not a trade or business for Federal tax purposes. In order to finance typical governmental projects through the NMTC program, the governmental unit may form a separate for-profit or nonprofit entity to serve as the QALICB project owner and borrower. A governmental entity may be the lessee of the QALICB's project under a true lease. A financing lease would likely result in the lessee/governmental unit being treated as the QALICB (which is not a qualified business) or the lease could be treated as a loan to the governmental unit, causing the QALICB to exceed the 5% "nonqualified financial property" test described above.

5. *Low-income community*: IRC § 45D(e)(1) defines a "low-income community" as any population census tract where the poverty rate for such tract is at least 20%, <u>or</u> in the case of a tract not located within a metropolitan area, median family income for such tract does not exceed 80% of statewide median family income, <u>or</u> in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income.

As part of the American Jobs Creation Act of 2004, IRC § 45D(e)(2) was amended to provide that targeted *populations* may be treated as low-income communities. A "targeted population" means individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. "Targeted population" also includes the Hurricane Katrina Gulf Opportunity (GO) Zone, where individuals' principal residences or principal sources of income were located in areas that were flooded, sustained heavy damage, or sustained catastrophic damage as a result of Hurricane Katrina. Final regulations on targeted populations under Treas. Reg. § 1.45D-1 were published at 76 Federal Register 75774 (December 5, 2011).

The CDFI Fund and the IRS have agreed as to the source of information regarding qualification of a census tract. The qualification information is available by entering an address on the CDFI Fund web page (www.cdfifund.gov). In general, the census information in place when the QLICI is made will govern throughout the NMTC Compliance Period, even if the census tract lines or characteristics change during that period. The CDFI Fund also has compliance Questions and Answers which address particular problems related to determining the qualification of a census tract.

E. <u>Recapture</u>. Section 45D of the Code contains extensive recapture provisions. If, at any time during the NMTC Compliance Period beginning on the date of the original issue of a QEI in a CDE, there is a "recapture event" with respect to such investment, then the tax imposed

for the taxable year in which such event occurs shall be increased by the "credit recapture amount." A recapture event occurs for a CDE if:

(1) the entity ceases to be a qualified CDE;

(2) substantially all of the proceeds of the investment cease to be used by the entity to make QLICIs; or

(3) a QEI is redeemed by the entity.

With respect to (2) above, any repayments of principal during the NMTC Compliance Period, including recovery from foreclosure, must be reinvested such that the 85% substantially all test is met. Failure of the borrower to qualify as a QALICB could also trigger recapture. In the case of an investor formed as a partnership, distributions from the CDE in excess of amounts described in Treas. Reg. § 1.45D-1(d)(1)(iv) are treated as a redemption of a QEI.

If there is a credit recapture event for an investment at any time during the NMTC Compliance Period, the tax payable by the holder of the equity interest for the tax year in which the event occurs is increased by an amount known as the "credit recapture amount," and no further credits are allowed. The credit recapture amount is equal to the increase in a taxpayer's general business credit attributable to the NMTCs used by the taxpayer to reduce tax liability for all years prior to the recapture event, plus interest at the underpayment rate for the resulting underpayment in tax for these years.

The investor will require indemnification of recapture amounts from both the CDE and the QALICB for certain specified recapture events.

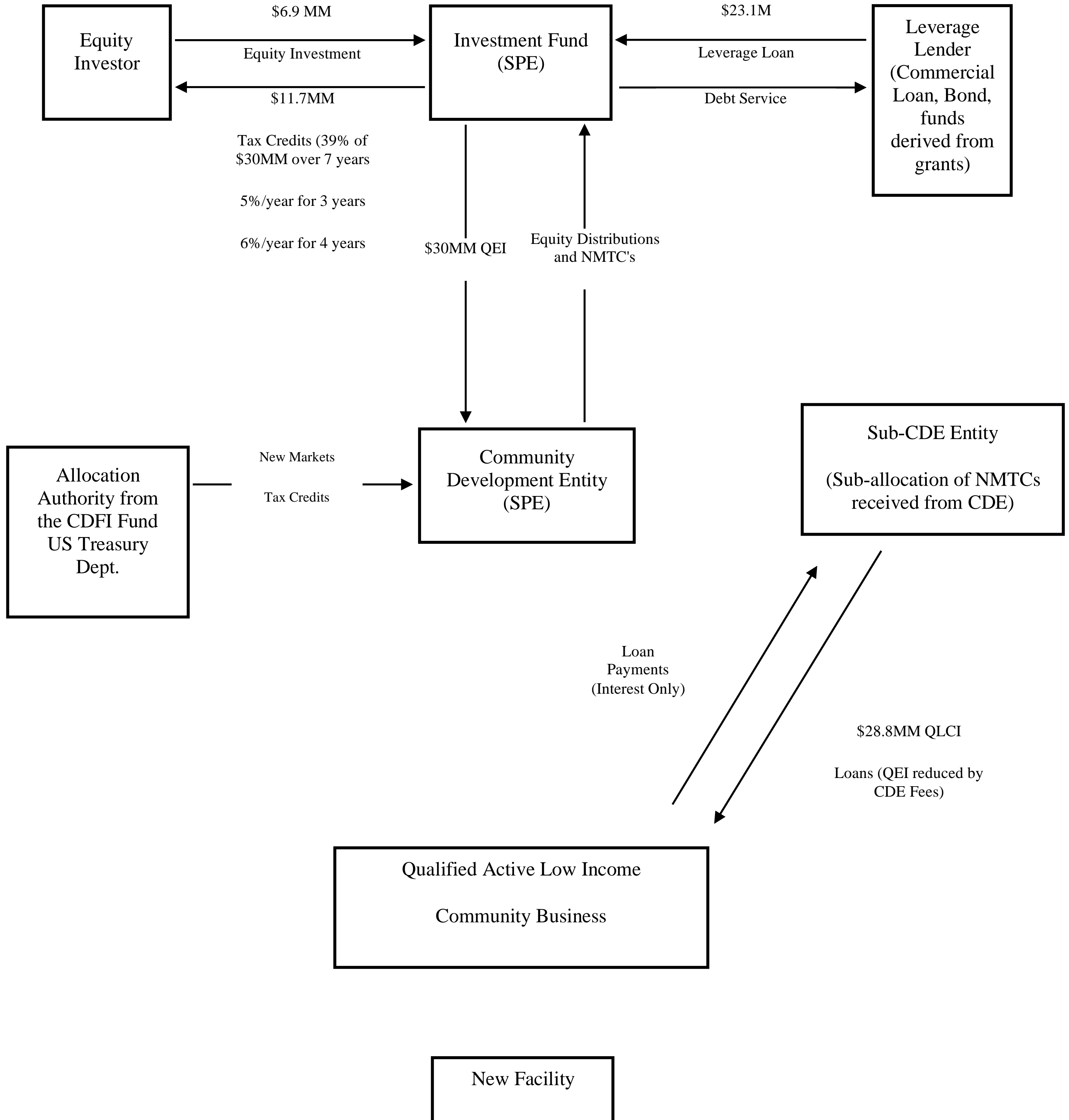
F. **Fundamental Economics.**

NMTCs reduce a taxpayer's tax liability on a dollar-for-dollar basis. The tax credit, unlike historic tax credits or low income housing tax credits, arises from the investment in the CDE which then sub-allocates the allocation to a single-purpose entity created by the CDE to act as the lender in the structure (the Sub-CDE). The Sub-CDE makes the QLICI, rather than from participation in a partnership or LLC that owns the asset itself. The Investment Fund makes a capital contribution (i.e., the QEI) into the CDE, and the CDE allocates the tax credit to the investor over a period of seven years. The CDE must use the QEI to make a QLICI (loan or investment in a qualifying business or project) at below market terms or rates.

In order for the investor to get a return for its investment, it needs to pay less than $1.00 for each dollar in tax credit. To achieve that, in the "Leverage Loan model" a third-party lender or the sponsor lends money into the structure through a loan to a single-purpose LLC created by the NMTC investor (the "Investment Fund") which is combined with the equity of the investor to fund the QEI. The lender ("leverage lender") is paid interest at a market rate during the seven-year tax credit period (or at a lower interest rate if the leverage lender is not a commercial lender); the tax credit investor gets the tax credit. The leverage lender needs to forbear for 7 years, and the leverage loan cannot be collateralized by the assets of the QALICB. The addition of the Leverage Loan proceeds increases the amount of NMTCs for which the transaction is eligible and the availability of the cash from the investor reduces the interest rate passed through by the CDE because the amount of funds coming from distributions from the CDE needs to be sufficient to pay only the Leverage Loan.

The following chart shows the fundamental structure of the NMTC with a Leverage Loan (bank loan or tax-exempt or taxable bonds). Note that the CDE is making a suballocation of NMTCs to the Sub-CDE. The Sub-CDE then makes a loan to the QALICB using both the proceeds of the QEI, which was funded by the investor equity contribution and the proceeds of a Leverage Loan. In most cases, the Leverage Loan is sourced with a taxable loan. However, because of the advantages of issuing tax-exempt bonds as compared to taxable loans, there is increased attention to the possibility that the Leverage Loan to the QALICB from the CDE could be funded from the proceeds of tax-exempt bonds. The QALICB oftentimes will develop and construct the New Facility and then lease the New Facility to the sponsor or Leverage Lender.

$30,000,000 Investment through New Markets Tax Credit Structure



G. Combining other Tax Benefits with NMTCs, including Tax-Exempt Bonds. IRC § 45D(i) authorizes the Secretary of the Treasury to promulgate regulations appropriate to carry out the purposes of the NMTC program, including regulations which limit the credit for investments which are directly or indirectly subsidized by other federal tax benefits (including the credit under Section 42 and the exclusion from gross income under Section 103). Thus, the analysis of what combination of benefits would be available focuses both on the NMTCs and the rules applicable to the other tax benefit. The IRS issued a notice of proposed rulemaking and proposed regulations before finalizing the regulations under Treas. Reg. § 1.45D-1((g)(3). The final regulations take the approach that the benefit of NMTCs is not limited except as specifically provided. The final regulations state that NMTCs cannot be used together with low income housing tax credits under Section 42 of the Code. A capital or equity investment or a loan by a CDE with respect to a qualified low-income building under Section 42 of the Code is not a QLICI to the extent the building's eligible basis under Section 42(d) of the Code is financed by the proceeds of the investment or loan. Federal tax benefits that do not limit the availability of NMTCs include, for example, (i) the rehabilitation credit under Section 47 of the Code, (ii) all deductions under Sections 167 of the Code and 168 of the Code, including the additional first-year depreciation under Section 168(k) of the Code, and the expense deduction for certain depreciable property under Section 179, and (iii) all tax benefits relating to certain designated areas such as empowerment zones and enterprise communities under Sections 1391 through 1397D of the Code, the District of Columbia Enterprise Zone under Sections 1400 through 1400B of the Code, renewal communities under Sections 1400E through 1400J of the Code, and the New York Liberty Zone under Section 1400L of the Code. The latter category encompasses several tax benefits, including tax-exempt bonds, in part because the qualified business requirements of these provisions are similar to the QALICB requirements of Section 45D of the Code. Through the NMTC regulation process, the IRS did not identify any examples of how tax-exempt bonds and NMTCs would produce "double-dipping".

Low income housing tax credits under Section 42 of the Code are the only specific limitation in the Treas. Reg. In any tax-exempt bond issue, it is important to determine how the proceeds of the bonds are used. The uses determine the qualification of the bonds for tax-exempt treatment and the nature of that exemption. For some types of issues, as described below, the characterization of the CDE as a taxable entity (as required for the NMTC transaction) is not problematic for the tax analysis on the tax-exempt bonds. For example, use of private activity manufacturing bonds as a source of the Leverage Loan is consistent with the characterization of the NMTC tax analysis. However, for other types of tax-exempt bonds where private use is not permitted or the private use must be 501(c)(3) use, the bond analysis of the use of tax-exempt bonds or tax credit bonds to make the Leverage Loan which ultimately flows down the NMTC structure to the QALICB to fund the project may complicate the required NMTC tax analysis that the Leverage Loan is true debt to the Investment Fund.

1. The essential issue raised in the use of tax-exempt bonds arises from the NMTC structure itself. If the bond proceeds are being used as the source of the Leverage Loan, bond counsel must be able to conclude that the ultimate use of the proceeds is the determining factor. In the NMTC structure, the bond proceeds are first loaned to the Investment Fund who then uses the proceeds of the Leverage Loan (together with the investor equity) to make a QEI in a CDE. While the investor must be a private business if it is to be able to obtain the tax benefit of the NMTC, the proceeds at that point are being used to purchase an investment (i.e. the QEI), not to build a project. The CDE then uses the proceeds of the QEI to make a QLICI to the QALICB.

The proceeds of the QLICI are then used by the QALICB to finance a project. The CDE is also required by the NMTC rules to be a for-profit business and it is required to use the proceeds of the QEI to make a QLICI (i.e. a loan to, or purchase an equity investment in) to a QALICB. Once the CDE makes the QLICI, the ultimate use of the proceeds can be determined. On the other hand, counsel to the NMTC investor must conclude that the loan of the bond proceeds (i.e. the Leverage Loan) to the Investment Fund is a true debt of the Investment Fund, because the NMTC structure does not permit a direct loan of the bond proceeds to the QALICB. The ultimate use analysis which gives bond counsel comfort is a different analysis than that of the NMTC counsel who must be comfortable that the three levels of the NMTC structure remain separate.

2. Some bond counsel have focused on the private business test and concluded that there are generally no issues presented by funding the Leverage Loan with the proceeds of private activity bonds (other than qualified 501(c)(3) bonds), such as enterprise zone bonds (Code Section 1394), and solid waste disposal bonds (Code Section 142). During recent years, recovery zone facility bonds (Code Section 1400U-3), Midwest disaster area bonds (Code Section 1400N), Qualified Energy Conservation Bonds ("QECBs") under Section 54D and Qualified School Construction Bonds ("QSCBs") under Code Section 54F have also been used because these categories all permit private business use. This conclusion must still rely to some extent on the ultimate use analysis to conclude that proceeds were used to build a project that meets the bond qualifications.

3. Other bond counsel take the position that combining NMTCs with tax-exempt bonds is not limited to certain private activity bonds and can be used in connection with qualified 501(c)(3) bonds and traditional governmental non-private activity bonds. Such bond counsel base this conclusion on the fact that the proceeds of the bonds are ultimately used for a qualified bond project without creating impermissible private use from the bond loan to the investor. Those bond counsel look to the following:

(a) Treas. Reg. §1.141-3(a)(2) states that the ultimate use of the proceeds or the direct and indirect use of proceeds are what govern the qualification of the bond issue under Code Section 141/145;

(b) Treas. Reg. §1.141-3(d)(2) states that use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. The NMTC structure is essentially a financing arrangement;

(c) Prior IRS approval that loans to private lenders may not have impermissible private use derived from the loan of the proceeds to the lender where the lender is required to loan the proceeds to a qualified housing development (the so-called "loans-to-lenders" ruling). The enterprise zone facility bond regulations specifically permit the issuer to ignore the use by a lender in a loans-to-lender program; and

(d) Prior case law holdings that the substance, not the form, of the transaction governs the tax law analysis.

i. California Health Facilities Authority v. Commissioner 90 T.C. 832 (May 2, 1988); and

ii. General Counsel Memorandum 39455 (March 30, 1984).

In either case, it is essential to be able to trace the proceeds of the bonds through the structure to determine the ultimate use of the bond proceeds and conclude that the tax-exempt bond tests, including, in particular, use of proceeds and arbitrage, are satisfied.

4. Issues surround the security for the tax-exempt bonds because of the IRS requirement that the Leverage Loan be secured solely by the investor's equity interest in the CDE. The CDE is the entity that will have any security in the financed project as a result of the QLICI. In order to avoid the collapse of the NMTC structure, the leverage lender will be asked to "stand still" in exercising remedies for the NMTC Compliance Period in order to accommodate the need of the CDE to be able to reinvest QLICI proceeds during the 7-year NMTC Compliance Period in the event of a default and foreclosure. This requirement will significantly reduce the pool of potential lenders for transactions using the NMTC structure. In general, the lender or bond purchaser must be the same entity as the NMTC investor. This may raise issues for the counsel giving the NMTC opinion, because the same entity will then be receiving the benefit of both the credits and the tax-exempt interest. Another alternative may be for the leverage lender to make a separate loan directly to the QALICB that is not generating NMTCs and have rights under an intercreditor agreement with respect to direct remedies at least with respect to that separate loan.

5. NMTCs may be combined with other types of tax credits, including Historic Tax Credits under Section 47 of the Code, energy tax credits under Sections 46 and 48 of the Code and various state and federal grants. Each additional subsidy results in adjustment of the structure to accommodate the different rules.

III. **<u>HISTORIC TAX CREDITS</u>**

A. <u>Overview</u>. The Federal Historic Tax Credit ("HTC") program permits owners to receive a credit against Federal income taxes as an incentive to make expenditures to rehabilitate or preserve historic buildings. The credit is equal to 20% of qualified rehabilitation expenditures made to a "certified historic building" (certified by the National Park Service). Generally, the expenditures must be incurred in a 24-month period selected by the taxpayer (in accordance with the Treasury Regulations – generally exceeding the adjusted basis of the building) ending within the year the building is "placed in service." As a result of changes enacted by the Tax Cuts and Jobs Act of 2017, the HTC is taken over a five-year period generally beginning in the year in which the rehabilitated building is placed in service. Only the property owner who first places the building in service is entitled to the HTC. A party who begins rehabilitation can sell the property before completing the work and pass on the HTC provided that no one has already claimed the HTC and the building acquired has not been placed in service by the seller before the date of acquisition.

The HTC program is administered by the National Park Service ("NPS") and the IRS in partnership with State Historic Preservation Offices ("SHPO") in each state. The HTC is available to an owner of a "certified historic structure" or a lessee of such a structure with a lease term of at least 27½ years for residential rental property and 39 years for nonresidential real property.

In order to qualify for the HTC, a building must be a "certified historic structure" and must be rehabilitated in accordance with the Secretary of the Interior's standards for rehabilitation. There are four (4) factors needed to meet the basic application requirements for the HTC:

1. The historic building must be listed in the National Register of Historic Places or be certified as being of historic significance to a "registered historic district."

2. After rehabilitation, the historic building must be used for an income-producing purpose for at least five years. Owner-occupied residential properties do not qualify for the federal rehabilitation tax credit.

3. The project must meet the "substantial rehabilitation test." In brief, this means that the cost of rehabilitation must exceed the pre-rehabilitation cost of the building. Generally, this test must be met within two years or within five years for a project completed in multiple phases.

4. The rehabilitation work must be done according to the Secretary of the Interior's Standards for Rehabilitation. The rehabilitation standards include ten principles which, when followed, ensure the historic character of the building has been preserved in the rehabilitation.

B. <u>Law</u>. Section 47 of the Code (formerly section 48(g)), which became law on November 5, 1990 (Public Law 101-508; 26 U.S.C. 47). The related regulations are found at Treas. Reg. § 1.48-1 et seq.

C. **Key Definitions and Provisions**.

1. *Certified Historic Structure*. A certified historic structure is defined as a building (and is structural components) that is either listed in the National Register of Historic Places or located within a registered historic district and has been certified by the Department of the Interior as being of historic significance to the district. The National Register of Historic Places is maintained by the Department of the Interior under the National Historic Preservation Act. The cumulative list of properties in the National Register of Historic Places is published annually in the *Federal Register*. Buildings in historic districts must be "certified" or approved by NPS as contributing to the district as part of the "Historic Preservation Certification Application" (a three-part form application promulgated by the Department of the Interior).

A "registered historic district" is a district that is either:

(a) listed in the National Register, or

(b) both:

(i) designated under a state or local statute certified by the Secretary of the Interior as containing criteria that will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and

(ii) certified by the Secretary of the Interior as meeting substantially all of the requirements for the listing of Districts in the National Register. Department of Interior regulations set forth criteria for evaluating structures within "registered historic districts" to determine whether the structure should be certified as being "of historic significance to the district."

Only certified historic structures qualify for the credits. The "structure" must be a building.

The National Park Service must approve, or "certify," all rehabilitation projects seeking the HTC. A certified rehabilitation is a rehabilitation of a certified historic structure that is approved by the NPS as being consistent with the historic character of the property and, where applicable, the district in which it is located.

2. *Qualified Rehabilitated Building*. A "qualified rehabilitated building" is generally defined in Section 47(c)(1)(A) of the Code as any building (including its structural components) that has been "substantially rehabilitated," was placed in service before the beginning of the rehabilitation, and for which depreciation (or amortization) is allowable.

3. *Building*. The Code does not provide a definition of "building" for this purpose; however, Treasury Regulations issued under earlier Code provisions define "building" and distinguish between that term and other "structures" that are not "buildings" and, therefore, cannot qualify as "qualified rehabilitated buildings." Under Treas. Reg. § 1.48-1(e)(1), a "building" is "any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space." The term specifically includes apartment houses, factory and

office buildings, warehouses, barns, garages, railway or bus stations, and stores. Certain "structural components" of a building (i.e., parts of the building such as walls, floors and ceilings, and mechanical components) may be included, but the term "building" expressly does not include other "structures" such as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, coke ovens, and brick kilns.

4. *Substantially Rehabilitated.* A building is "substantially rehabilitated" only if the "qualified rehabilitation expenditures" during the 24-month period selected by the taxpayer exceed the greater of the adjusted basis of the building (and its structural components) or $5,000. The adjusted basis of the building is generally the purchase price, minus the cost of land, plus improvements already made, minus depreciation already taken. The basis is determined as of the beginning of the first day of the 24-month period, or of the holding period of the building, whichever is later. Once the substantial rehabilitation test is met, the credit may be claimed for all qualified expenditures incurred before the measuring period, during the measuring period and after the measuring period through the end of the taxable year that the building is placed in service.

5. *Qualified Rehabilitation Expenditure*. A "qualified rehabilitation expenditure" is any amount properly chargeable to a capital account in connection with the rehabilitation of a "qualified rehabilitated building" for which depreciation under Section 168 of the Code is allowed and which is (1) nonresidential real property, (2) residential rental property, (3) real property with a class life of more than 12.5 years, or (4) an addition or improvement to one of the previous types of property. Code § 47(c)(2)(A). The definition of "qualified rehabilitation expenditure" expressly excludes "the cost of acquiring any building or interest therein." Where the taxpayer acquires a building after another person has incurred "qualified rehabilitation expenditures," however, the regulations allow the taxpayer to be treated as having incurred the expenditures if the building was not used after the rehabilitation expenditures were incurred and no one other than the taxpayer is claiming the credit. Treas. Reg. § 1.48-12(c)(3)(ii). "Qualified rehabilitation expenditures" do not include "any expenditure attributable to the enlargement of an existing building." The Treasury Regulations provide that a building is "enlarged" to the extent that its total volume is increased. Where expenditures only partially qualify because some are used for enlarging the building, the expenditures must be specifically allocated between the original portion of the building and the enlargement to the extent possible. Treas. Reg. §§ 1.48-12(c)(7)(iii) and (c)(10). Section 280B of the Code disallows deductions for any amount expended for demolition of any structure and requires these costs to instead be treated as charged to the capital account for the land on which the demolished structure was located. Costs of demolition that result in complete removal of the building do not qualify for the rehabilitation credit. If the building still exists after some demolition, however, the costs of the demolition may qualify. Qualified rehabilitation expenditures typically do not include parking lots, sidewalks, landscaping or other related facilities.

6. *Certified Rehabilitation*. "Qualified rehabilitation expenditures" generally do not include expenditures for rehabilitating a "certified historic structure" unless the rehabilitation is a "certified rehabilitation." Code § 47(c)(2)(B)(iv). A "certified rehabilitation" is a rehabilitation of a "certified historic structure" that the Secretary of the Interior has certified to the Secretary of the Treasury as being "consistent with the historic character of such property or the district in which such property is located." Code § 47(c)(2)(C). The property owner must submit an Historic Preservation Certification Application to the National Park Service of the Department of the Interior in accordance with its regulations, and the National Park Service will determine whether

the rehabilitation meets the "Secretary of the Interior's Standards for Rehabilitation." The entire project is reviewed, including related demolition and new construction.

7. *Lessees*. Expenditures of a lessee of a building are not "qualified rehabilitation expenditures" if, on the date the rehabilitation is completed, the remaining term of the lease (not including any renewal periods) is less than the recovery period determined under Section 168(c) of the Code. Code § 47(c)(2)(B)(vi). This generally means that for nonresidential real property, the remaining term of the lease must be at least 39 years, and for residential rental property the remaining term must be at least 27½ years.

8. *Tax-Exempt Use Property*. A qualified rehabilitation associated with "tax-exempt use property" under Section 168(h) of the Code is not eligible for the HTC. This issue arises when a property owner leases its building or a portion of the building to a governmental unit, a tax-exempt organization or a foreign person/entity. Section 47(c)(2)(B)(v) of the Code excludes from the definition of "qualified rehabilitation expenditure" any expenditure allocable to any portion of the property that is or may reasonably be expected to be "tax-exempt use property" as defined in section 168(h) of the Code. The term "tax-exempt use property" includes that portion of the property leased to a tax-exempt entity in a "disqualified lease."

(a) *Disqualified Lease to Tax-exempt Entity*. The term disqualified lease means any lease of the property to a tax-exempt entity, but only if:

(i) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under Section 103(a) of the Code and the entity (or a related entity) participated in such financing,

(ii) under the lease there is a fixed or determinable price purchase or sale option which involves the entity (or a related entity) or there is the equivalent of such an option,

(iii) the lease has a lease term in excess of 20 years (including certain renewals), or

(iv) the lease occurs after a sale (or other transfer) of the property by, or lease of the property from, the entity (or a related entity) and the property has been used by the entity (or a related entity) before the sale (or other transfer) or lease.

(b) *50% Threshold Test*. If the portion of the property leased to tax-exempt entities in "disqualified leases" is no more than 50% of the property (based on net rentable floor space in the building), such portion of the property is not considered "tax-exempt use property." Code § 168(h)(1)(B)(iii) as modified by Code § 47(c)(2)(B)(v)(I). Although an expenditure allocable to "tax-exempt use property" is not a "qualified rehabilitation expenditure," and is, therefore, ineligible for the HTC, such expenditure may still be taken into account for purposes of determining whether a building has been "substantially rehabilitated." Treas. Reg. § 1.48-12(c)(7)(vi). If more than 50% of the building is leased to a tax-exempt entity, however, the HTC will not be allowed for that that portion of the building. For example, if a taxpayer spends $30,000 rehabilitating a building, and then leases 2/3 of it to a tax-exempt entity such that 2/3 of the building is tax-exempt use

property, the taxpayer may claim the rehabilitation credit only on $10,000 of the rehabilitation expenses.

(c) *Exception for Short-Term Leases*. Property is not considered "tax-exempt use property" merely by reason of a "short-term lease." A short-term lease means any lease the term of which is:

(i) less than three years, and

(ii) less than the greater of one year or 30% of the property's present class life.

(d) *Exception Where Property Used in an Unrelated Trade or Business*. The term tax-exempt use property does not include any portion of the property predominantly used by the tax-exempt entity (directly or through a partnership of which such entity is a partner) in an unrelated trade or business the income of which is subject to tax under Section 511 of the Code.

(e) *Property Leased to a Partnership*. When property is owned by a partnership that consists of both taxable and tax-exempt partners, Section 168(h)(5) of the Code provides a special rule for property which is leased to a partnership to prevent the use of tiered arrangements or partnerships or other pass-through entities. Under this rule, the determination of whether any portion of such property is tax-exempt use property is made by treating each tax-exempt entity partner's "proportionate share" of such property as being leased to such partner. A tax-exempt entity's proportionate share is determined on the basis of such entity's share of partnership items of income or gain (excluding gain allocated under section 704(c) of the Code), whichever results in the largest proportionate share. If a tax-exempt entity's share of partnership items of income or gain varies during the period such entity is a partner in the partnership, such share is the highest share such entity may receive. For purpose of this special rule, any tax-exempt controlled entity is treated as a tax-exempt entity unless the tax-exempt controlled entity makes a special election. A tax-exempt controlled entity is any corporation (which is not a tax-exempt entity) if 50% or more (in value) of the stock in such corporation is held by one or more tax-exempt entities. If the tax-exempt controlled entity makes the special election, any gain recognized by a tax-exempt entity on any disposition of an interest in the tax-exempt controlled entity (and any dividend or interest received or accrued by a tax-exempt entity from such tax-exempt controlled entity) will be treated as unrelated business taxable income for purposes of Section 511 of the Code.

(f) *Property Owned by a Partnership*. Section 168(h)(6) of the Code also provides a special rule for property owned by a partnership which has both a tax-exempt entity (or tax-exempt controlled entity) and a person who is not a tax-exempt entity as partners. Under this rule, the property can be treated as tax-exempt use property in certain circumstances even if the property is not leased to a tax-exempt entity. Specifically, if any allocation to a tax-exempt entity of partnership items is not a "qualified allocation," the tax-exempt entity's "proportionate share" of the partnership's property (except property predominately used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under Section 511 of the Code) will be deemed to be tax-exempt use property.

(i) *Qualified Allocation*. A qualified allocation means any allocation to a tax-exempt entity which (i) is consistent with such entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership and (ii) has substantial economic effect within the meaning of Section 704(b)(2) of the Code.

(ii) *Proportionate Share*. A tax-exempt entity's proportionate share is determined on the basis of such entity's share of partnership items of income or gain (excluding gain allocated under Section 704(c) of the Code), whichever results in the largest proportionate share. If a tax-exempt entity's share of partnership items of income or gain varies during the period such entity is a partner in the partnership, such share is the highest share such entity may receive.

D. Key Provisions for Financing Structure.

1. *Pass-Through Election by Lessor*. Section 50(d) of the Code permits a lessor and lessee to agree to treat the lessee as having incurred all or a portion of the rehabilitation expenditures incurred by the lessor, provided the owner is not a tax-exempt entity. A tax-exempt entity cannot pass the HTC through because the Treasury Regulations require that the property be "section 38 property" in the hands of the lessor (that is, it must be property with respect to which depreciation is allowable to the lessor).

2. *Progress Expenditures*. If a building is being rehabilitated and the "normal rehabilitation period" for the building is two years or more, and it is "reasonable to expect" that the building will be a "qualified rehabilitated building" in the hands of the taxpayer when it is placed into service, Section 47(d) of the Code allows the taxpayer to irrevocably elect to use a special accounting method for the qualified rehabilitation expenditures. Rather than taking the credit in the taxable year the building is "placed into service," if the building is a "self-rehabilitated building," the taxpayer can take the qualified rehabilitation expenditures into account for the taxable year in which the expenditure is properly chargeable to capital account. If the building is not a "self-rehabilitated building," the expenditure is taken into account for the taxable year in which it was paid.

(a) *Normal Rehabilitation Period*. For the purposes of this provision, the "normal rehabilitation period" means the period reasonably expected to be required to rehabilitate the building from the time physical work begins and ending on the date the building is expected to be available to be placed in service.

(b) *Self-Rehabilitated Building*. A "self-rehabilitating building" is one for which it is reasonable to believe that more than half of the qualified rehabilitation expenditures will be made directly by the taxpayer.

3. *Effect of Credit on Basis*. Section 50(c) of the Code requires that the basis of the property must be reduced by the amount of the HTC. If the building is subject to the credit recapture provisions discussed immediately below, then the basis immediately before the event causing recapture (e.g., sale or other disposition) is increased by the recapture amount.

4. *Recapture of Credit*. If the rehabilitated building is disposed of or "otherwise ceases to be investment credit property with respect to the taxpayer" within five years after the building was placed in service, the HTC previously claimed is recaptured by increasing the taxpayer's tax by the amount of total HTC taken for rehabilitation expenditures, multiplied by a "recapture percentage" determined based on the holding period of the property. The recapture amount decreases by 20% for each year up to five years, so that if the property is disposed (or otherwise ceases to qualify) within one year after being placed in service, 100% of the HTC is recaptured; if during the second year, 80% is recaptured; if during the third year, 60% is recaptured, and so forth. Any carryback or carryover amounts also must be adjusted. Code § 50(a).

E. Combination with other Tax Credits/Tax-Exempt Bonds. HTCs can be combined with other types of tax credits and with tax-exempt bonds so long as the rules of both programs are met. However, the deal must be carefully structured to avoid the rules relating to "tax-exempt use" property. For example, HTCs can be combined with LIHTCs (Section 42 of the Code), NMTCs and with affordable housing tax-exempt bonds/tax credits under Section 42/142 of the Code (e.g. in an adaptive reuse scenario).

F. Historic Boardwalk Case. On August 27, 2012, the Third Circuit Court of Appeals issued an opinion in *Historic Boardwalk Hall, LLC, et al v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012) in which the court held that a federal historic rehabilitation tax credit investor was not a bona fide partner in the limited liability company that owned the rehabilitated project as the investor "lacked a meaningful stake in the success or failure" of the company. The *Historic Boardwalk Hall* decision related to the redevelopment beginning in 1998 of Historic Boardwalk Hall, the historic home to the Miss America beauty pageant. Historic Boardwalk Hall was redeveloped by the New Jersey Sports and Exposition Authority, a state agency ("NJSEA"). In order to reduce the cost to NJSEA of the project, NJSEA solicited bids for federal rehabilitation tax credit investors. Pitney Bowes, Inc. ("PB") was chosen as the investor and, in an elaborately structured transaction, Historic Boardwalk Hall, LLC (the "Company") was formed; its managing member was as affiliate of NJSEA owning a 0.1% interest and its investor member was an affiliate of Pitney Bowes ("PB") having a 99.9% ownership interest.

The facts as described by the court focused on the structure of the transaction to isolate PB from any risks related to the Company's ownership and operation of the real estate. In this regard: (a) PB's capital contributions were scheduled to eliminate exposure to construction risk and NJSEA provided an uncapped completion guaranty to ensure construction completion of the project; (b) NJSEA provided PB with an uncapped environmental guaranty indemnifying PB from liability for losses from hazardous materials relating to the project; (c) NJSEA provided PB with a comprehensive tax benefits guaranty insulating PB from a failure to receive projected tax benefits; (d) the project was so laden with debt that it was unrealistic for PB to expect to receive any economic return other than the 3% preferred return to which it was entitled under the operating agreement of the Company; (e) one of NJSEA's purchase options for PB's interest, the price of which was tied to PB's 3% return, was fully funded pursuant to a guaranteed investment contract obtained by NJSEA; and (f) NJSEA provided PB with an uncapped operating deficit guaranty that in the court's view eliminated operational risk of the project. As the Third Circuit noted, NJSEA had the ability to fund all such guarantees as a result of its taxing authority.

In evaluating the totality of the factors as to whether PB's investor member was a partner in the venture, the Third Circuit found that the PB investor member had no meaningful stake in the success or failure of the enterprise (i.e. it did not have any meaningful downside risk or any

meaningful upside risk in the venture) and, therefore, was not a "bona fide partner" for federal income tax purposes. The Third Circuit found that NJSEA's extensive guarantees for construction completion risks, tax audit risks, environmental risks and operating deficit risks eliminated any downside risks of the venture to the PB investor member. Likewise the court concluded that there was no meaningful upside potential to the PB member in the Company because, while it technically had a 99.9% interest in any residual proceeds from the sale of the property, in reality, PB could never expect to share in any upside because NJSEA held a purchase option to acquire PB's interest after the tax credit recapture period, the purchase price of which was fully funded under the guaranteed investment contract obtained by NJSEA. The case caused quite a stir when decided and had effects beyond the HTC market.

G. <u>Revenue Procedure 2014-12 HTC Safe Harbors</u>. On December 30, 2013, the IRS issued Revenue Procedure 2014-12 (2014-3 IRB 1) (the "Revenue Procedure") establishing a safe harbor (the "Safe Harbor") under which allocations by partnerships to partners of historic tax credit projects will be respected and the status of investors as partners would not be challenged by the IRS in response to the disruption to the HTC market as a result of the Historic Boardwalk Hall case. As with all safe harbor guidance, not complying with all of the requirements of the Safe Harbor does not mean that an investor is not a partner or that an HTC transaction will not be respected under judicial and other applicable law. The Safe Harbor applies to transactions which only involve HTCs. Specific factors discussed in the Revenue Procedure include:

1. *Minimum Ownership Interest*. The general partner must have a minimum 1% interest in each material item of the partnership's income, gain, loss, deduction, and credit; and the investor must have a minimum interest in each material item of income, gain, loss, deduction, and credit during the period it owns an interest equal to 5% of its largest percentage interest for any taxable year (which presumably would be 99%, resulting in a 4.95% minimum interest).

2. *Bona Fide Investment*. The investor's interest must constitute a bona fide equity investment with a reasonable anticipated value commensurate with the investor's overall percentage interest in the partnership, separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the partnership to the investor. The investment cannot be substantially protected from losses and the investor must participate in profits in a manner that is not limited to a preferred return that is in the nature of a payment for capital.

3. *Guarantees*. Certain guarantees listed in the Safe Harbor are impermissible (such as a guaranty of the investor's ability to claim historic credits, the cash equivalents of the credits, or the repayment of the investor's capital contribution due to its inability to claim the credits in the event the IRS challenges the transaction structure). Other guarantees are permissible if unfunded.

4. *Purchase and Sale Rights on Exit*. Neither the general partner, developer, owner, master tenant nor any person related to any of these may have a contractual right to purchase or redeem the investor's interest at a future date. This does not prohibit the parties from negotiating a present sale at some time in the future, as long as it was not pre-arranged. The investor may have a contractual right to require a person involved in the transaction to purchase or liquidate its interest in the owner or the master tenant at a future date for not more than fair market value as determined at the time of exercise. If an investor abandons its interest at any time, the investor will be presumed to have acquired its interest with the intent of later abandoning it unless the facts and circumstances clearly establish otherwise. Although superficially this provision would seem to

prohibit puts at a nominal price, it is only intended to prevent the investor from claiming an ordinary loss (as opposed to a capital loss) on exit, pursuant to Rev. Rul. 93-80, 1993-2 C.B. 239.

IV. <u>ENERGY INVESTMENT TAX CREDITS</u>

A. <u>Overview</u>. Taxpayers are permitted a 30% investment tax credit (the "Energy Credit") in the case of certain "energy property." Energy property that qualifies for the Energy Credit includes equipment placed in service after December 31, 2005 and before January 1, 2017 which uses solar energy (a) to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat (except property used to generate energy for the purposes of heating a swimming pool), or (b) to illuminate the inside of a structure using fiber-optic distributed sunlight. In addition, the energy property must be constructed, reconstructed or erected by the taxpayer or acquired by the taxpayer if the original use of the energy property commences with such taxpayer. Finally, depreciation or amortization must be allowable with respect to the energy property. The term "energy property" does not include (i) for periods before February 13, 2008, any property which is "public utility property" (as defined in Section 46(f)(5) of the Code as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990), (ii) any property which is part of a facility that generated Code Section 45 tax credits for the taxable year or any prior taxable year, or (iii) any portion of the basis of any property which is attributable to qualified rehabilitation expenditures for purposes of the HTCs described above. Energy Credits are also not available for property to the extent that it is "tax-exempt use property."

B. **<u>Law</u>**. IRC §46 is the governing overall section for several credits, including the Energy Credit. The specific provisions for the Energy Credits are found in IRC §48.

C. **<u>Key Terms for the Energy Credit</u>**.

1. *Eligible Basis*. It is expected that the basis for determining the Energy Credit will be its cost, and would include all items properly includible by the taxpayer in the depreciable basis of the property, such as installation and freight costs under the rules of Treas. Reg. § 1.46-3(c)(1). The basis for determining the Energy Credit for costs attributable to periods prior to January 1, 2009, may be reduced proportionately to the extent the energy property is financed by "subsidized energy financing" or the proceeds of tax-exempt private activity bonds. No basis reduction is generally required for costs incurred on or after January 1, 2009.

2. *Timing of Energy Credit*. The Energy Credit can be claimed only in the year in which the energy property is "placed in service." Even where partners are admitted to a partnership after the partnership begins constructing or installing the energy property, Treas. Reg. § 1.46-3(f) provides that partners admitted to the partnership prior to the date on which the energy property is placed in service will be entitled to an allocation of their share of the Energy Credit with respect to that property.

3. *Reduction in Depreciable Basis*. If a taxpayer claims the Energy Credit with respect to energy property, the depreciable basis of the energy property must be reduced by one-half of the amount of the Energy Credit. This adjustment means that only 85% of the cost of the energy property can be deducted through cost recovery deductions and gain on disposition of the property is increased by one-half of the amount of the Energy Credit. Accordingly, the Energy

Credit results in part in a permanent reduction of tax liability, unless subject to recapture, and in part in a deferral of tax liability. Additionally, Eligible Basis for purposes of computing the HTCs must also be reduced by one-half of the amount of any Energy Credit.

D. Limitations on Energy Investment Tax Credits. The Energy Credit is a direct credit against a taxpayer's federal income tax liability and is subject to limitations on use by many investors as a result of at-risk rules and passive activity rules. The Code limits use of the Energy Credit and certain other tax credits to the amount of federal income tax liability that does not exceed $25,000 in such year plus 75% of any federal income tax liability in excess of $25,000. Any excess unused credits disallowed under this rule must be carried back 1 year and forward 20 years.

E. Recapture of the Energy Investment Tax Credit.

1. *Sale of Energy Property*. If energy property qualifying for the Energy Credit is sold or otherwise disposed of, assigned, retired, abandoned or converted to personal or non-business use prior to the expiration of five years from the date it was placed in service, all or a portion of the Energy Credit claimed will be recaptured. In such an event, a taxpayer's tax liability for the year in which such event occurs will be increased by an amount equal to the amount of the Energy Credit originally allowed multiplied by the "recapture percentage," which will vary depending on the date of disposition. The "recapture percentage" is 100% for a disposition within the first year after property is placed in service and decreases by 20% for dispositions within each of the next five years. The Energy Credit fully vests at the end of this 5-year recapture and is no longer subject to recapture.

2. *Reduction in Partnership Interest*. If a partner's interest in a partnership owning such energy property is reduced to less than two-thirds of its interest for the year in which the property was placed in service, whether by a transfer of all or part of its interest, the admission of new partners or a reduction in its share of profits, the partner will be required to recapture some or all of the Energy Credit claimed. Once recapture is required in a taxable year, additional recapture will not be required in subsequent years unless the partner's interest in the partnership is reduced to less than one-third of its interest at the time the property was placed in service. However, if the transfer of the partner's interest occurs because of a technical termination of a partnership under Section 708 of the Code, recapture will not be required if the termination meets the "mere change in form" exception in Treas. Reg. § 1.47-3(f) and Section 50(a)(4) of the Code.

V. GREEN AND SOCIAL IMPACT BONDS

Note: Neither Green Bonds nor Social Impact Bonds qualify for any specific federal tax credits or exemptions.

Green Bonds

(1) Designation that attracts investors from funds and other buyers targeting renewable energy, energy efficiency, carbon sequestration, clean transportation, etc.
(2) Is not limited to tax exempt bonds, but certain kinds of tax-exempt bonds qualify
(3) International Capital Market Association ("ICMA") has developed a set of "Green Bond Principles" (GBP) to be followed to certify that a bond qualifies for designation as a "green bond"
(4) Green Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green bond purposes and which are aligned with the four core components of the GBP. Those translate into various types of governmental and private activity bonds in the tax-exempt market.
(5) Green Purposes:
   (a) renewable energy (including production, transmission, appliances and products);
      (i) PACE programs
      (ii) Landfill gas energy production
   (b) energy efficiency (such as in new and refurbished buildings, energy storage, district heating, smart grids, appliances and products);
      (i) Guaranteed energy savings project financings
   (c) pollution prevention and control (including waste water treatment, reduction of air emissions, greenhouse gas control, soil remediation, waste prevention, waste reduction, waste recycling and energy/emission-efficient waste to energy, value added products from waste and remanufacturing, and associated environmental monitoring);
      (i) Solid waste disposal bonds to finance waste to energy projects
      (ii) Governmental solid waste disposal and sewage treatment systems that meet GBP requirements
   (d) environmentally sustainable management of living natural resources and land use (including environmentally sustainable agriculture and animal husbandry)
      (i) Solid waste disposal bonds to finance hog/chicken/cattle waste to energy projects.
(6) Green Principles:
   (a) Use of Proceeds – project meets the criteria outlined above
   (b) Process for Project Evaluation and Selection
      Issuer clearly communicates to investors the environmental sustainability objectives; the process by which the issuer determines how the projects fit within the eligible Green Projects categories identified above; and the related eligibility criteria, including, if applicable, exclusion criteria or any other

process applied to identify and manage potentially material environmental and social risks associated with the Projects.

(c) Management of Proceeds

Green bond proceeds are tracked by the issuer in an appropriate manner and attested to by the issuer in a formal internal process linked to the issuer's lending and investment operations for Green Projects.

(d) Reporting

Regular reporting on use of proceeds and their impact.

(7) A number of states and issuers have issued bonds that have been designated as "green bonds".

(a) Central Puget Sound Regional Transit Authority sales Tax and Motor Vehicle Excise Tax Improvement Bonds Series 2015S-1, 2A, 2B (Green Bonds) and Series 2016S-1(Green Bonds) - expansion of the region's light rail system

(b) DC Water Authority $350 million Public Utility Senior Lien Revenue Bonds, Series 2014A – DC clean rivers project; first green bond issuance to include an independent second-party opinion

(c) Connecticut, Cleveland, Indiana, San Francisco Public Utilities Commission, and St. Paul, Minn. have also issued green water bonds

(d) FNMA and FHLMC have "green designations" for projects meeting energy saving criteria

(e) Several underwriters (JP Morgan, Goldman, among others) have green bond targets or funds

(8) Some statewide/local conduit issuers are considering the program, working with a third-party administrator, who for a fee, provides some or all of the services described, including vetting projects for inclusion in the program, evaluation and selection, oversight of use of proceeds and ongoing reporting as to the project and its compliance with the Green Bond principles

Social Impact Bonds

(1) Social Impact Bonds are any type of bond or debt instrument that will finance or refinance eligible social projects.

(i) The ICMA notes that certain eligible social projects will also have overlapping environmental co-benefits.

(ii) Social projects directly aim to address or mitigate a specific social issue and/or seek to achieve positive social outcomes especially but not exclusively for a target population.

(2) ICMA also has Social Bond Principles (SBP) to certify a bond as a "social bond"

(3) Eligible Social Projects

(i) affordable basic infrastructure (clean drinking water, sewers, sanitation, transportation)

(ii) access to essential services (e.g. health, education and vocational training, healthcare, financing and financial services)

(iii) affordable housing

(iv) employment generation, and programs designed to prevent and/or alleviate unemployment stemming from socioeconomic crises

(v) food security and sustainable food systems (such as physical, social, and economic access to safe, nutritious, and sufficient food that meets dietary needs and requirements
(vi) resilient agricultural practices; reduction of food loss and waste; and improved productivity of small scale producers)
(vii) socioeconomic advancement and empowerment (e.g. equitable access to and control over assets, services and resources, and opportunities; equitable participation and integration into the market and society, including reduction of income inequality)

(4) Target populations include, but are not limited to: (i) individuals and families living below the poverty line, (ii) excluded and/or marginalized populations and /or communities, (iii) people with disabilities, (iv) migrants and /or displaced persons, (v) undereducated persons, (vi) underserved, owing to a lack of quality access to essential goods and services (vii) unemployed individuals, (viii) women and/or sexual and gender minorities, (ix) aging populations and vulnerable youth, and (x) other vulnerable groups (for instance, as a result of natural disasters).

VI. PACE FINANCING

Property Assessed Clean Energy (PACE), which is currently available in 33 states, is a financing mechanism that enables low-cost, long-term funding for energy efficiency, renewable energy and water conservation projects. PACE financing is repaid as an assessment on the property's tax bill. PACE transactions are typically not tax-exempt obligations.

(1) Benefits of using PACE:
   (a) Long-term fixed rate financing up to 20 years.
   (b) Non-recourse.
   (c) Finance 100% of eligible project costs.
   (d) Can be combined with other debt and local, state, and federal incentive programs.
   (e) Energy savings typically exceeds annual PACE assessment allowing for positive cash flow, improved net operating income, and enhanced property value.

(2) Here's the general process for using PACE financing to install solar panels on your property:
   (a) A county, local, or municipal government passes legislation that establishes a PACE program and makes funds available to investors, usually through the sale of municipal bonds.
   (b) An authorized PACE lender provides those funds to property owners who want to make clean energy improvements, like installing solar panels on their home or business.
   (c) Property owners repay the financial institution through an assessment attached to their annual property tax bill.

VII. Comparison Of Historic, New Markets And Energy Tax Credits

	HTC	NMTC	ENERGY
Who receives the credit?	• Owner of the project • Lease pass- through structure –credits to master tenant	• Investor making the QEI in the CDE	• Owner of project • Lease pass-through structure – credits to master tenant
Is credit amount subject to volume limit?	• No	• Maximum dollar limit (currently $5 billion per year through 2025 • Competitive application to U.S. Treasury CDFI Fund	• No
What type of project/borrower qualifies?	• Building listed on National Register of Historic Places • Qualified Historic building originally placed in service before 1936 • Owner-occupied residential properties do not qualify • Project must be "substantial rehabilitation" (cost of rehab exceeds pre-rehab cost of building) • Not available for tax-exempt use property	• Borrower must be a QALICB • Project must be in qualified census tract or serve targeted population (employment, sales, services) • Certain "sin businesses" excluded • Governmental unit not a business • Can be used with "portion of a business • Rental of residential property not a QALICB	• Solar energy equipment (generate electricity, heat or cool structure, provide solar process heat • "Qualified facilities" including wind, closed-loop biomass, open-loop biomass, geothermal landfill gas, trash, hydropower, or marine, hydrokinetic • Energy credit eligibility subject to construction commencement dates varying with type of qualified facility • Not available for tax-exempt use property

	HTC	NMTC	ENERGY
How is the credit calculated?	• 20% of cost of the QRE for National Register property • 10% of costs of the QRE for qualified historic building • Entire credit taken in first year placed in service	• Aggregate of 39% of the QEI (5% for three years, 6% for 4 years • Calculated off the QEI, with requirement that 85% be used by the Sub-CDE for loan or equity investment in the QALICB	• 30% of capital cost of energy property (FMV) for investment tax credit (ITC) • Cents per kWh for production tax credit (PTC) • Phase down for wind facilities (PTC) and solar energy (ITC) • Portion of property receiving HTC not eligible • Tax-exempt financed costs eligible for credit
What is the compliance period/compliance burden	• 5 years from date project placed in service • Verification of qualified rehabilitation expenditures before eligible for credit by Department of Interior • QRE must be made within 2-year period (extended to 5 years if project completed in phases)	• 7 years • Transaction documents will require annual or semi-annual compliance certifications as to the QALICB status • CDE/Investor reporting to the CDFI Fund • Community Benefits Agreement in transaction documents (not required by Code)	• 5 years from date property is placed in service for ITC • 10 years for PTC

	HTC	NMTC	ENERGY
Does change in use, sale, casualty loss, foreclosure or other disposition of credit cause recapture?	• Recapture upon sale or disposition of property • Recapture on conversion of property to personal or non-income producing property • Recapture amount decreased by 20% each of 5 years (lose 100% of credits if dispose of in first year)	• Credits recaptured if (1) 85% of the QEI not invested in the QALICB, (2) the CDE fails to continue to be qualified the CDE, (3) the CDE repays the QLICI • Recapture of credits taken to date of event causing recapture, the CDE and the QALICB indemnify for the full credits taken plus value of expected credits to investor • Sale of the QEI to another investor does not cause recapture, so long as the original QEI is not redeemed. • Sale of the QALICB or project financed may not be a recapture if disposition proceeds reinvested within 1 year	• For ITC, recapture on sale or disposition, assignment, retirement, abandonment or conversion to personal or non-business use prior to end of 5 years after placed in service date • For ITC, recapture amount decreases by 20% each year • For ITC, only partners admitted prior to date property placed in service, or, for sale leasebacks, within 3 months

VIII. LOW-INCOME HOUSING TAX CREDITS

A. Availability and Use

a. Available to owner of a residential rental project under IRC Section 42
    i. Competitively allocated or used with tax-exempt exempt facility bonds under IRC Section 142(d)
b. Typical owner is a limited partnership or limited liability company
c. Ownership structure is utilized so tax credits can flow through (allocated vs. certificated)
d. Amount of Credit
    i. Qualified Basis x Applicable Fraction x Applicable Percentage (i.e. 4% or 9%)
        1. Qualified Basis is eligible basis
            a. Generally, costs of residential rental property
            b. Common areas are included in basis
            c. Property funded with grants not included
            d. 130% basis boost applies for projects in qualified census tracts and difficult to develop areas
    ii. Applicable Fraction
        1. Competitive (9%) Credits fixed applicable percentage at 9% since 2008
        2. IRC 42(b)(3), enacted in 2020, "fixes" applicable percentage for "non-competitive" LIHTC at 4%
e. LIHTC is "collected" or "used" over 10-year period but compliance period is 15 years
    i. If minimum set-asides are not met or a change in ownership occurs during the 15-year period, recapture of the unearned portion of credit may occur.

B. Requirements

a. Qualifying Project- similar to IRC 142(d)
    i. 40-60, 20-50 unit set asides
        1. Income averaging also permitted
    ii. Must be residential rental property
    iii. Rent Restrictions
        1. Gross rent applicable to a unit cannot exceed 30% of the elected set-aside area median gross income.
            a. Gross rent does not include Section 8 payments or comparable rental assistance program payments.

C. Special Considerations for Existing Buildings

a. Anti-Churning
    i. Tax credit property cannot have been placed in service by the taxpayer or any related party to the taxpayer (*tested at time of placed in service*)
    ii. Related party status tested on capital interests and profits and losses.
b. 10-year hold

i. The building must have been placed in service at least 10 years prior to the date of acquisition by the new owner.
    1. Exceptions exist
        a. Placed in service by governmental entity or not-for-profit
        b. Building is substantially assisted, financed or operated under state or federal program.
            i. i.e., Section 8, HUD/GNMA, USDA

PREPARING TO DELIVER THE BOND OPINION: TAX DILIGENCE AND DOCUMENTATION

Chair:

Brian Teaff	**Bracewell LLP – Houston, TX**

Panelists:

Sarah Breitmeyer:	**Chapman and Cutler LLP – Chicago, IL**
Dan Semmens	**Dorsey & Whitney LLP – Missoula, MT**

Purchasers of tax-exempt obligations typically rely on the "unqualified opinion" of bond counsel as to the excludability of interest on the bonds. The tax due diligence performed by bond counsel is a critical foundation for the delivery of the opinion. This "practice-focused" panel will explore the due diligence, legal research and analysis, and documentation necessary to support the tax opinion.

I. Overview

The performance of the appropriate level of due diligence coupled with receipt and review of essential documentation is a prerequisite to the issuance of the tax opinion. In conducting tax due diligence, practitioners should keep in mind that:

- The required level of diligence is unique to each transaction
- The due diligence review should be consistent with standards of practice
- Due diligence is an important element in relying upon documentation produced

Due diligence documentation is critical for the following reasons:

- To demonstrate compliance with statutory and regulatory requirements for the issuer's, and any conduit borrower's, statements of reasonable expectations and for certain elections
- To indicate appropriate covenants maintaining the tax-advantaged treatment of the bonds
- To ensure appropriate document retention

A careful process of diligence and documentation will also help issuers and conduit borrowers understand ongoing compliance issues.

II. Tax Opinion and Due Diligence Standards for Bond Counsel

The bond counsel opinion addresses legal consequences but is based upon stated facts and assumptions. Practitioners have a duty to make inquiries with respect to material facts, but there generally is no requirement to audit or independently verify such facts. Reliance on facts, however, must be reasonable and red flags should not be ignored. The factual basis for the opinion is established through tax due diligence and documentation.

As described below, the National Association of Bond Lawyers, the American Bar Association, the Treasury Department and, most importantly, the Internal Revenue Code of 1986 (the "Code"), and the related Treasury Regulations (the "Regulations") provide general guidance with respect to the level of due diligence that may be appropriate in any given transaction.

NABL Model Opinion Standard

> Counsel should give an unqualified opinion only if <u>firmly convinced</u> a reasonable, properly briefed court would agree. Due to the lack of judicial precedent in the tax-exempt bond area, the Model Bond Opinion Report (2003) states further that "bond counsel may nonetheless give an unqualified opinion with respect to federal income tax matters if it is firmly convinced that, upon due consideration of the material facts and all of the relevant sources of applicable law on federal income tax matters [described in the report], the Supreme Court would reach the federal income tax conclusions stated in the opinion or the IRS would concur or acquiesce in the federal income tax conclusions stated in the opinion."

ABA Formal Opinion 335

> In connection with giving opinions, a lawyer should (1) make inquiry of a client as to relevant facts and receive answers, and (2) assuming answers are not incomplete, suspect or inherently inconsistent, the lawyer may assume facts as related to the lawyer and checked by the lawyer by reviewing such documents as are available.

Circular 230 – Section 10.37 - (Applies to many state or local bond opinions)

> In rendering "written advice" a practitioner (i) cannot base such advice upon unreasonable factual or legal assumptions, (ii) may not unreasonably rely on representations, findings, etc., (iii) must consider all relevant facts, and (iv) cannot take into account the potential for audit or possible settlement of issues.

Section 6700 of the Code

> Under certain circumstances, a practitioner can be fined for statements with respect to excludability of income from tax if the practitioner knows or <u>has reason to know</u> that the statement is false.

III. Performance of Due Diligence

The tax due diligence process is the key means for obtaining the information needed as bond counsel to be able to render the unqualified bond counsel opinion.

While the general process for conducting due diligence can be somewhat uniform, there are nuances that require the process to be tailored depending on the client and the nature of the transaction.

Key issues to consider ***BEFORE*** starting the diligence process:

- What is the **type of transaction?** (*e.g.*, governmental bond, qualified 501(c)(3) bond, exempt facility bond, small issue industrial development bond)
- What is the **nature of the client and the project?** (*e.g.,* level of sophistication of client, what is already known, if anything, about the assets being financed, any other available background information, is it a new client or existing client?)
- What is the **best approach for eliciting information?** (*e.g.*, letters, questionnaires, phone calls, conferences, publicly available information or combination thereof)
- What is the **goal** of the process? (takeaway for bond counsel; takeaway for the client)

Due diligence materials and responses can be elicited in many ways, often consisting of a combination of the following:

- <u>Tax Questionnaire</u> – The questionnaire often consists of a list of relevant questions concerning the plan of financing, use of proceeds, actual and expected use and ownership of financed or refinanced facilities, sources of repayment, and status of the borrower. The questionnaire may include a request for back-up documentation such as project lists, sources of funding, economic life calculations, management contracts, leases and tax filings.

- Conduit Borrower Application – Tax-related questions and requests for materials may be included in a conduit borrower's application to the issuer.

- Informal Information Gathering – This may include such things as e-mail correspondence, review of an issuer's/conduit borrower's website, review of EMMA filings, review of newspaper references, review of other publicly available information, etc.

- Conferences and/or Interviews – This may occur in-person or by video conference or phone calls with relevant parties.

- Role of Post-Issuance Compliance Procedures – Review of post-issuance compliance procedures of the issuer and the conduit borrower and adherence to procedures; drafting/updating procedures may be necessary or advisable.

- Due Diligence Session – A due diligence session for a disclosure document may yield helpful insights that are relevant to tax analysis, such as potential for private business use of financed property and the identities of the various users of the financed property.

- Closing Certificates – Facts and expectations can be confirmed in separate certificates delivered by the issuer and any conduit borrower at closing.

Issues to consider:

- What is the nature of the client (*e.g.,* municipality, 501(c)(3) organization, for-profit entity; frequency of issuances and level of sophistication)?

- Who is performing diligence (associate, partner, tax specialist)?

- Is there more than one user of the bond-financed property that should be interviewed?

- Does the law firm performing the due diligence have "institutional knowledge" that should be taken into account?

- Due diligence responses are not helpful if the responder does not understand the questions being asked.

- A written questionnaire may be easier to complete if it is tailored to the client's situation and does not include "boilerplate" questions that have already been answered in other contexts (for example, during the due diligence process for the offering document) or are not applicable. Long or duplicative questionnaires may overwhelm or confuse a client.

- While written questionnaires provide a tangible diligence file, they also may lead to inconsistent information and, even when carefully drafted, incorrect answers (due to the responder's misunderstanding of what was asked), which then need to be corrected.

- Conferences may provide a better opportunity to educate the issuer and/or borrower and may result in more accurate responses. (Best practices are typically a combination of written questionnaires and conferences.)

- To what extent should the presence of written post-issuance compliance procedures and adherence to such procedures be taken into account for refundings or otherwise?

- To what extent, if at all, should non-tax diligence be reviewed and taken into account?

- How much "deal knowledge" is appropriate?

Due diligence should begin early in the transaction to ensure ample time to conduct an appropriate review and avoid last minute surprises. The due diligence process does not end once the initial responses have been received. Rather, due diligence needs to be performed as the transaction progresses to ensure that any transaction changes are properly considered. "Bring down" documentation can be used to back up the attorney's understanding of the facts.

Drafting tax documentation (*e.g.,* tax certificates, tax regulatory agreements, no arbitrage certificates, project certificates) often provides an excellent opportunity to think about the various diligence issues that need to be addressed. For that reason, (a) it may be helpful to start drafting tax documentation early during the transaction and (b) the person who is responsible for diligence should also be the person who drafts the tax documentation. This opportunity to conduct diligence is lost when tax documents are not drafted until the hours preceding the closing or when tax documents are drafted by multiple persons or by legal assistants who are not otherwise part of the diligence process.

IV. Documentation

In drafting documentation, the attorney is memorializing the diligence findings, stating the parties' understanding of the facts and reasonable expectations with respect to future events and setting forth the covenants of the parties, making applicable allocations, designations and elections and setting forth the on-going requirements for maintaining the tax status of the bonds, with the goal of providing proof that the bonds were tax-exempt or otherwise tax-advantaged upon issuance and will retain such status so long as the parties comply with the undertakings contained in such documentation. Documentation takes many forms and usually consists of a combination of the following:

- Tax Certificate, No Arbitrage Certificate or Tax Regulatory Agreement: Tax documents are used to document the requirements for the tax status of the bonds by describing in sufficient detail the past, current and expected uses of the financed (or refinanced) facilities, the use of proceeds of the bonds and any refunded bonds, non-arbitrage representations and expectations and required designations and elections. Representations in tax documents may change over time, depending on legislative, administrative or other considerations. In conduit transactions, tax documents may include tax documents to which both the issuer and the conduit borrower are parties, and in addition, separate certificates of the conduit borrower, which may address, for example, project representations and use of facilities.

- Third-Party Certifications: Third-party certifications may be attached to the tax documents to serve as the basis for the issuer's or conduit borrower's conclusions or representations. Such certifications may include:

  - Appraisals

  - Certificates regarding bond yield, loan yield, need for reserve funds, and weighted average maturity calculations

  - Qualified guarantee provider certificates

  - Qualified hedge provider and advisor certificates

- Feasibility studies
- Engineering letters (often in the context of the 5-year temporary period under section 1.148-2(e)(2)(ii))
- Verification reports
- Issue price certificates
- Financial advisor certificates
- Investment documentation including bidding agent certificates

➢ Bond Documents: Bond documents may include the ongoing covenants necessary to maintain the tax status of the bonds. Often such covenants will be included in the bond documents even if they are also included in the tax documents. The bond documents may also include requirements for opinions of bond counsel upon the occurrence of certain events (*e.g.*, interest rate mode changes, release of debt service reserve fund moneys) as well as written procedures of the issuer and conduit borrower, including post-issuance compliance procedures.

➢ Rebate Compliance Agreement or Instructions: Rebate compliance agreements or instructions set forth rules and procedures for calculating and paying arbitrage rebate to the United States. These agreements and instructions may not be needed for bond issues where no proceeds remain unspent at closing. Arbitrage rebate requirements may be covered in the bond documents, general tax certificate or other tax documents. Where a separate agreement or instruction letter is used, the bond trustee may be a party to, or recipient of, periodic rebate computations or reports.

Issues to consider:

➢ Factual statements may become entwined with legal conclusions. For example, a statement that "the Bonds are not federally guaranteed" typically will not be given any weight by IRS examiners during an examination of the tax issues because of the legal conclusion represented by the statement.

➢ Verbatim language of Code/Regulations versus "user-friendly" paraphrasing of requirements.

➢ Avoiding a standardized, "one size fits all" form with all definitions relevant to tax-exempt bond requirements as opposed to a "customized" form with only definitions considered material to the specific transaction.

➢ Look out for potential inconsistencies between various documents (*e.g.,* materially different sources and uses in the offering document and tax certificate or different project descriptions in offering documents, bond documents and tax documents, including documents for any bonds being refunded).

➢ Be alert to substance over form. Have the correct parties represented the necessary facts and agreed to take the appropriate future actions? Do the appropriate parties understand their

continuing obligations? Have the parties with actual knowledge reviewed and/or executed the factual certifications?

- The tax documents should be carefully reviewed with the client and the client's legal counsel to ensure the client understands the representations, certifications and statements as well as the client's responsibilities following the closing of the bond issue.

V. Record Retention

The Code provides a general rule for the proper retention of records for federal tax purposes. Under this rule, every person liable for tax imposed by the Code must, among other things, keep such records as are sufficient to establish the amount of gross income, deductions, credits or other matters required to be shown in any return of such information. In the case of tax-advantaged bonds, the issuer and conduit borrower typically will have covenanted in the bond documents to maintain the tax status of the bonds, and in audits the issuer is treated as the taxpayer. This means the issuer will need to retain sufficient records to support the continuing tax-advantaged status of the bonds, and to prove compliance with the rules for expenditure of proceeds, use of the financed assets and investment of proceeds.

In connection with bond counsel's diligence review, bond counsel will want to ensure that proper recordkeeping procedures are in place such that records supporting the tax status of the bonds are available long enough to be helpful in examinations of the bonds, even many years after the bond issuance date.

Examples of records to be retained include, but are not limited to:

- Basic records and documents relating to the bonds (and any refunded bonds)
- Documentation evidencing the investment and expenditure of proceeds of the bonds (and any refunded bonds) and expenditure of any qualified equity
- Documentation evidencing the use of the project or any component thereof by public and private sources (e.g., copies of management contracts, research agreements, leases)
- Documentation evidencing all sources of payment or security for the bonds (and any refunded bonds)
- Documentation evidencing compliance with the timing and allocation of expenditures of proceeds of the issue (and any refunded bonds)
- Records of all amounts paid to the United States in satisfaction of the rebate requirement for the issue and IRS Forms 8038-T (or successor forms thereto) related to such payments

VI. Documentation of Elections, Designations and Allocations

Where elections, designations (sometimes also referred to as identifications) or allocations are required, IRS examiners will expect to find them documented in the bond transcript. Certain elections and designations must be made by the issuer on or before the issue date in the issuer's books and records. Failure to make these elections or designations on or before the date the bonds are issued may cause the bonds to lose their tax-advantaged status.

VII. Documentation of Post-Closing Requirements and Change in Use Events

Compliance with federal tax requirements for tax-advantaged bonds does not end once the bonds are issued. Instead, issuers and conduit borrowers must be ready to provide ongoing monitoring throughout the term of the bonds to ensure that all continuing requirements are met.

The fundamental post-issuance tax compliance tasks are to:

- document and monitor use of bond proceeds (including use of financed facilities)
- comply with all applicable investment yield restrictions
- satisfy arbitrage rebate responsibilities
- promptly address any changes in use that may adversely affect the tax status of the bonds

Issuers and conduit borrowers should have effective policies and procedures in place to ensure that these tasks are adequately completed.

Issuers and conduit borrowers should be advised concerning the requirements to document a "change in use" and the timing of certain remedial actions, as applicable. Often a change in use will involve issuance of a favorable tax opinion by bond counsel or special tax counsel. A tax certificate that documents the facts and circumstances of the change in use and the remedial action taken will provide the background necessary for such an opinion and provide a valuable record to show compliance with applicable tax rules.

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP
October 18-20, 2023

Private Activity Bond Tests
Basic Session

Chair:

Neil Kaplan	Hawkins Delafield & Wood LLP – New York, NY

Panelists:

Mike Andreana	Pullman & Comley
Martye Kendrick	Greenberg Traurig, LLP
Vanessa Lowry	Greenberg Traurig, LLP
Luisella Perri	Foley & Lardner LLP

This panel will review the basic principles of the private activity bond tests as well as address issues frequently encountered in the identification and allocation of private business use of bond-financed property. The panelists and the audience will have the opportunity to issue spot and discuss potential private activity issues during the discussion of hypotheticals addressing both pre and post issuance events. The panel is meant to provide an overview of private activity bond issues for bond lawyers and tax lawyers with less than 5 years of experience.

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PRIVATE ACTIVITY BOND TESTS*

I. DEFINITIONS AND GENERAL RULES – SECTION 141 AND SECTION 1.141-1

A. Private Business Tests.

1. General. Code Section 141(a)(1)[1] defines a "private activity bond" issue as a bond issue that satisfies both of the following tests, which are set forth in Code Section 141(b) (the "private business tests"):

a. Private Business Use Test. More than 10% (or 5% if the private business use is unrelated or disproportionate to the governmental use) of the bond proceeds are to be used, directly or indirectly, in the trade or business of a person other than a state or local government unit (the "private business use test"); and

b. Private Security or Payment Test. The payment of the principal of, or the interest on, more than 10% (or 5% if the private business use is unrelated or disproportionate to the governmental use) of the proceeds of the bond issue is (under the terms of the issue or any underlying arrangement) directly or indirectly (i) secured by an interest in property used or to be used for a private business use or payments in respect of such property, or (ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use (the "private security or payment test").

2. $15 Million Limitation. Even if the private business tests are not met, the bonds may be private activity bonds if the "nonqualified amount" exceeds $15 million. The nonqualified amount is the lesser of (i) the portion of the bond proceeds to be used for private business use or (ii) the portion of the bonds that are secured by, or payments derived from, property used in private business use. If the nonqualified amount exceeds $15 million, the bonds are private activity bonds unless the issuer allocates its annual volume cap for qualified private activity bonds to the nonqualified amount in excess of $15 million.

3. Separate Private Loan Financing Test. In addition, Code Sections 141(a)(2) and 141(c) independently treat bonds as private activity bonds if more than the lesser of 5% or $5,000,000 of the proceeds of the bond issue are to be used, directly or indirectly, to make or finance loans (excluding certain permitted tax assessment loans) to non-governmental persons (the "private loan financing test"). Private loans may arise even if there is no private business use, such as in the case of loans to individuals acting in a non-business capacity.

B. Private Activity Definitions.

Certain definitions that are specifically applicable to the private activity bond regulations (referred to herein as the "Regulations") are noted below. Unless otherwise noted, these definitions are set forth in Treas. Reg. §1.141-1(b).

*This outline draws significantly from the excellent outlines and updates prepared by prior chairs and panelists.

[1] Unless otherwise noted herein, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

1. Common Areas mean portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

2. Discrete Portion means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls, partitions, or other physical barriers are examples of a discrete portion.

3. Disposition means the sale, exchange or other distribution or transfer of property (other than investments) financed with the proceeds of an issue. *See* Treas. Reg. §1.141-12(c)(1).

4. Disposition Proceeds means any amounts (including property, such as an agreement to provide services) derived from a disposition of property financed with the proceeds of an issue. *See* Treas. Reg. §1.141-12(c)(1).

5. Governmental Person means a state or local governmental unit as defined in Code Section 1.103-1 or any instrumentality thereof. The federal government is not a Governmental Person.

6. Measurement Period. Except as provided in Treas. Reg. §1.141-3(g)(2), the measurement period of property financed by an issue begins on the later of the issue date of the bonds or the date on which the financed property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date. *See* Treas. Reg. §1.141-3(g)(2).

7. Proceeds means the sale proceeds of an issue (other than sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve fund). Proceeds also include any investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period). Disposition proceeds are treated as proceeds to the extent provided in Treas. Reg. §1.141-12 (remedial actions). The Commissioner may treat replaced amounts as proceeds.

8. Project Period means the period beginning on the issue date of the bonds and ending on the date that the project is placed in service. A project is placed in service on the date, which based on all the facts and circumstances, (a) the project has reached a degree of completion which would permit its operation at substantially its design level, and (b) the project is in fact in operation at such level. In the case of a multipurpose issue, the issuer may elect to treat the project period for the entire issue as ending on the expiration of the applicable temporary period or the end of the fifth bond year.

9. Renewal Option means a legally enforceable right to renew a contract. A provision that provides for automatic renewal in the absence of the exercise of a cancellation right by either party is not a renewal option, even if it is expected to be renewed.

10. Replaced Amounts means replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds.

C. Related Parties. Except as otherwise provided, related parties are treated as one person and any reference to "person" includes any related party. *See* Treas. Reg. §1.141-1(d) and Treas. Reg. §1.150-1(b) for the general definition of related party.

1. PLR 200942037. In this ruling, a university, by reason of a special (although redacted citation) tax act definition, is a qualified educational organization equivalent to a state governmental unit for purposes of the tax-exempt bond provisions of the Code for any trade or business not constituting an unrelated trade or business. The university established a hospital corporation to run the clinical operations of the university's medical school. The hospital corporation qualifies as an organization described in Section 501(c)(3), and the operation of the clinics does not constitute an unrelated trade or business of the corporation. The hospital corporation is controlled by the university because the university has the power both to appoint and remove, without cause, a controlling portion of the board of the corporation. Under these facts, the Internal Revenue Service (the "IRS") determined that the university and the hospital corporation are related governmental users of a bond-financed project because both entities meet (1) the related party definition of Treas. Reg. §§1.150-1(b) and (2) the related party attribution rule of Treas. Reg. §1.141-1(d).

II. PRIVATE ACTIVITY BOND TESTS - SECTION 1.141-2

A. Overview. Treas. Reg. §1.141-1 (a) states that the purpose of the private activity bond tests set out in Code Section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons,[2] without regard to whether a financing actually transfers the benefits of tax-exempt financing to a nongovernmental person. Regulations under Code Section 141 serve to identify arrangements *that have a potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits*. The anti-abuse rules of Treas. Reg. §1.141-14 should be considered in light of this purpose. The Regulations under Code Section 141 may not be applied in a manner that is inconsistent with these purposes.

B. Scope. Treas. Reg. §§1.141-0 through 1.141-16 apply generally for the purposes of the private activity bond limitations under Code Section 141.

C. Reasonable Expectations and Deliberate Actions.

1. General. A bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either (1) the private business tests or (2) the private loan financing test. In addition, an issue is an issue of private activity bonds if the issuer takes a deliberate action after the issue date that causes the conditions of either the private business tests or the private loan financing test to be met. *See* Treas. Reg. §1.141-2(d)(1).

[2] The terms nongovernmental person and private business user are used herein interchangeably to refer to users whose use may result in private business use, including use by the federal government and not-for-profit entities, including 501(c)(3) entities.

2. Reasonable Expectations. In general, the issuer's reasonable expectations about events and actions affecting the use of bond proceeds must be taken into account over the entire stated term of the issue.

a. Special Rule for Contingent Mandatory Redemption. Treas. Reg. §1.141-2(d)(2)(ii) provides that an issuer may disregard an action that is reasonably expected on the issue date and that otherwise would violate the private activity bond tests if, on the issue date, (i) the issuer reasonably expects that the financed property will be used for a governmental purpose for a "substantial period" of time; (ii) the issuer is required to redeem all "nonqualified bonds" (even if the cost to redeem is in excess of the disposition proceeds by contributing its own funds) within six months of the action; (iii) the issuer has not entered into an arrangement with a nongovernmental person with respect to the action; and (iv) the mandatory redemption meets the change-in-use rules contained in Treas. Reg. §1.141-12 (taking into account the redemption described in (ii) above). This special rule allows bond redemptions to cure expected, but unpredictable, future private involvement during the term of a bond issue. The requirement that bonds be redeemed irrespective of the amount of disposition proceeds received places a certain amount of risk on the issuer.

b. Substantial Period. The absence of a definition of "substantial period" for purposes of this rule leaves some uncertainty. One possible analogy may be the definition of substantial period for a different purpose under Treas. Reg. §1.141-3(g)(7) on measurement of private business use, in which 10% of the measurement period is treated as a substantial period. Another analogy is the old five-year period used in the original change-in-use safe harbors under Revenue Procedure 93-17, 1993-1 C.B. 507.

3. Deliberate Actions. A deliberate action is an action taken by the issuer that is within its control. See Treas. Reg. §1.141-2(d)(3). An intention to violate the requirements of Code Section 141 is not necessary for any action to be deliberate. Involuntary conversions under Code Section 1033 and actions taken in response to a regulatory directive of the federal government are not deliberate actions. Certain remedial actions described in Treas. Reg. §1.141-12 can prevent a deliberate action from causing the related nonqualifying bonds to cease to be treated as tax-exempt bonds. A deliberate action occurs on the date the issuer enters into a binding contract for nongovernmental use of the financed property that is not subject to any material contingencies. The binding contract notion is important to keep in mind if an issuer signs a contract with a later effective date.

4. Special Rules. Special rules are provided for two governmental bond program situations.

a. Certain Personal Property Dispositions. Dispositions of personal property in the ordinary course of an established governmental program meeting certain requirements (*i.e.*, weighted average bond life not more than 120% of reasonably expected governmental use, the fair market value of property at time of disposition is not reasonably expected to exceed 25% of cost, the property is no longer suitable for governmental purposes on date of disposition) are not treated as deliberate actions if the issuer is required to commingle disposition amounts with substantial tax or other funds and such amounts are reasonably expected

to be expended within 6 months of commingling. Bonds properly allocated to this personal property may be treated as a separate issue under Treas. Reg. §1.150-1(c)(3).

b. Certain General Obligation Bond Programs. In addition, the determination of whether an issue of general obligation bonds of a general purpose governmental issuer that finances a large number of separate purposes (at least 25 separate purposes and not less than 4 predominant purposes) satisfies the private activity bond tests may be based solely on the issuer's reasonable expectations as of the issue date (without regard to subsequent deliberate actions) if the following requirements are satisfied: (i) the issue must be a general obligation of the issuer; (ii) the issuer must be a general purpose governmental unit; (iii) the issue must finance at least 25 separate purposes but cannot "predominantly" finance fewer than four purposes; (iv) the issuer must employ a "fund" accounting method; (v) the accounting method must make specific tracing of bond proceeds to expenditures unreasonably burdensome; (vi) the issuer must reasonably expect to spend all the net bond proceeds on capital expenditures within six months after the issue date; (vii) the issuer must adopt reasonable procedures to verify such expenditures (a program for random spot checks of actual use of 10% of the bond proceeds qualifies); (viii) the issuer must reasonably expect to spend all the net bond proceeds before spending any later similar general obligation bond proceeds; (ix) the issuer must reasonably expect to make no private loans with the bond proceeds; (x) the issuer must reasonably expect that it could make governmental capital expenditures during the ensuing six months of at least 125% of the amount financed; and (xi) the issuer must reasonably expect that the average maturity of the bond issue does not exceed 120% of the weighted average reasonably expected economic life of the financed capital improvements.

III. DEFINITION OF PRIVATE BUSINESS USE - SECTION 1.141-3

A. General Rule. Generally, the private business use test of Code Section 141(b)(1) is met if more than 10% (or, in certain cases, 5%) of the proceeds of an issue is used in a trade or business carried on by a nongovernmental person. For this purpose, the use of financed property is treated as the use of proceeds. Both indirect use and the ultimate and intermediate uses of proceeds are considered in determining whether an issue meets the private business use test.

B. General Definition of Private Business Use.

1. General. Proceeds are used for private business use if they are used in a trade or business carried on by a nongovernmental person. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business. For the purposes of the private business use test, a nongovernmental person uses bond proceeds and will generally be a private business user if it (i) owns financed property, (ii) leases/subleases financed property (unless an exception is met), (iii) manages or is a service provider with respect to the financed property under a nonqualifying management contract, (iv) purchases or agrees to purchase the output of an output facility under a nonqualifying arrangement, (v) sponsors a nonqualifying research arrangement that relates to the financed property, (vi) otherwise enjoys special legal entitlements for the beneficial use of the financed facility, or (vii) solely in the case of financed property that is not available for use by the general public, receives special economic benefit from the financed property.

2. Actual or Beneficial Use.

a. In General. In the catch-all category of other actual or beneficial use, Treas. Reg. §1.141-3(b)(7) provides that private business use may arise under two separate standards, depending on whether the financed property is available for general public use: (i) "special legal entitlements" to general public use property; and (ii) "special economic benefits" from property that is not available for general public use, based on all the facts and circumstances.

b. Special Legal Entitlements to General Public Use Property. For bond-financed property that is available for general public use, Treas. Reg. §1.141-3(b)(7)(i) provides that private business use of such property arises if a private business has special legal entitlements to beneficial use of the property. For example, an arrangement that provides priority rights to the use or capacity of a facility generally causes private business use under this standard. The special legal entitlement standard generally seems workable in that it looks to objective legal rights granted to private businesses to use bond-financed facilities.

c. Special Economic Benefits from Non-general Public Use Property. For bond-financed property that is unavailable for general public use, Treas. Reg. §1.141-3(b)(7)(h) provides that private business use of such property arises if a private business derives special economic benefits from the property, based on all the facts and circumstances, even if it has no special legal entitlements. The Regulations state that the following factors weigh towards private business use under this standard:

(i) a functional relationship or physical proximity of the bond-financed property to other private business use property;

(ii) a small number of private businesses receiving the special economic benefit; and

(iii) the cost of the property being depreciable by a private business (this depreciable interest factor would seem to give rise to private business use anyway, based on ownership).

3. Exception. A special exception under Treas. Reg. §1.141-3(d)(2) excludes nominal ownership by a nongovernmental person that is solely incidental to a financing arrangement. For example, a private business may hold title in a sale-leaseback transaction with a governmental lessee.

4. Management Contract as Lease. Treas. Reg. §1.141-3(b)(3) provides that the determination of whether an arrangement such as a management contract properly constitutes a lease is based on all of the facts and circumstances, including (i) the degree of private business control over the financed property; and (ii) whether the private business user bears risk of loss on the financed property.

5. Selected Examples from the Regulations.

a. Treas. Reg. §1.141-3(f), Example 5 - Parking Lot. Corporation C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory.

Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for the use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest.

b. Treas. Reg. §1.141-3(f), Example 8 - Airport Runway.

(i) City I issues bonds and uses all of the proceeds to finance construction of a runway at a new city-owned airport. The runway will be available for take-off and landing by any operator of any aircraft desiring to use the airport, including general aviation operators who are natural persons not engaged in a trade or business. It is reasonably expected that most of the actual use of the runway will be by private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. These leases for the use of terminal space provide no priority rights or other preferential benefits to the air carriers for use of the runway. Moreover, under the leases, the lease payments are determined without taking into account the revenues generated by runway landing fees (that is, the lease payments are not determined on a "residual" basis). Although the lessee air carriers receive a special economic benefit from the use of the runway, this special economic benefit is not sufficient to cause the air carriers to be private business users, because the runway is available for general public use. The issue does not meet the private business use test.

(ii) The facts are the same as in paragraph (i) above, except that the runway will be available for use only by the private air carriers. The use by these private air carriers is not for general public use, because the runway is not reasonably available for use on the same basis by natural persons not engaged in a trade or business. Depending on all of the facts and circumstances, including whether there are only a small number of lessee private air carriers, the issue may meet the private business use test solely because the private air carriers receive a special economic benefit from the runway.

(iii) The facts are the same as in paragraph (i) above, except that the lease payments under the leases with the private air carriers are determined on a residual basis by taking into account the net revenues generated by runway landing fees. These leases cause the private business use test to be met with respect to the runway because they are arrangements that convey special legal entitlements to the financed facility to nongovernmental persons.

c. Treas. Reg. §1.141-3(f), Example 9 – Governmental Airport Parking. A governmentally owned airport parking facility that is generally available to both private airline employees and the general public using the airport qualifies for general public use, despite the special economic benefit to the private airlines.

d. Treas. Reg. §1.141-3(f), Example 11 - Port Road - Highway Authority. W uses all of the proceeds of its bonds to construct a 25-mile road to connect an industrial port owned by Corporation with the existing roads owned and operated by W. Other

than the port, the nearest residential or commercial development to the new road is 12 miles away. There is no reasonable expectation that development will occur in the area surrounding the new road. W and Y enter into no arrangement (either by contract or ordinances) that conveys special legal entitlements to Y for the use of the road. Use of the road will be available without restriction to all users, including natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because the road is treated as used only by the general public.

6. Private Letter Rulings. Certain private letter rulings issued since release of the 1997 private activity bond regulations are summarized below in addition to the summaries under specific sections of this outline. Earlier private letter rulings are summarized in the National Association of Bond Lawyers' Federal Taxation of Municipal Bonds, Third Edition.

a. PLR 202205016 and PLR 202205017. City acquired property, which is reclaimed land consisting of sand fill on top of native soil. The District will issue bonds to be payable by incremental tax revenues generated by improvements to be financed with bond proceeds. The bond-financed projects include (i) strengthening of an existing revetment, including adding rocks to the revetment and adjacent areas and raising the level of the revetment to reduce the risk of flooding, (ii) soil stabilization improvements (iii) governmental structures, including police, fire and school facilities, and (iv) public access facilities, including roads, rights of way and sidewalks. No person or entity, other than state and local governmental units will have any special rights, privileges or other legal entitlements with respect to the bond funded improvements. A portion of the ground improvements to be funded with bond proceeds will be located on portions of the property on which private use facilities are located, however the design of the ground improvements took into account the needs of the governmental improvements, but not the needs of the private use facilities. Nevertheless the revetment strengthening and ground improvements will protect the entire area without distinction between public or private property or the type of area occupant or user. The IRS noted that when completed, the improvements would provide some benefit to all of the owners, lessees and operators of private business use facilities, and not only a small number of private business users. The IRS did not decide whether there will be a special economic benefit to such owners, lessees and operators, but held that under the facts and circumstances the benefits to such private business users would be insufficient to give rise to private business use.

b. PLR 201412011. Management contract entered into by a governmental electric company had an initial term of 12 years with potential extension to 20 years. The IRS had previously ruled favorably on the original contract and was asked to review the Amended Agreement made primarily to deal with operational difficulties encountered by the Electric Company as a result of a "Storm Event." The compensation involved a fixed fee component, an incentive fee component, and a reimbursement of certain costs, none of which exactly fit within the definitions in Revenue Procedure 97-13 ("Rev. Proc. 97-13"). The fixed component did not fit the definition of periodic fixed fee because the amount could be reduced if certain performance standards related to customer satisfaction and service interruptions were not met. The IRS concluded that the standards for reduction were not based on objective, external factors as permitted under the safe harbor, but did not give rise to private business use because the reduction was not based on net profits, and further, even after a reduction, the fee was a stated amount for a particular annual period. The incentive compensation is also different from the type described in Rev. Proc. 97-13. The Electric Company was to establish an incentive compensation pool. The incentive fee could be earned based on "favorable" performance measured against

certain detailed performance metrics but could also adjust downwards if minimum performance standards were not met. None of the performance criteria described in the ruling relate directly to revenues or profits but do include adherence to capital and operating budgets and meeting the Electric Company's "financial needs." The IRS notes that the some of the performance categories provide incentives to reduce expenses, but that the incentive fee does not create private business use because it is not based on gross revenues or net profits of the Electric Company. The contract included reimbursement for transactions with affiliates. The costs passed on are described as being based on methodologies such as the fully allocated cost methodology approved by statute or regulations, which are described as not including a profit or mark-up component for the affiliate. Pass-through expenditures do not include amounts paid to senior management of the Manager. Because none of the reimbursements are based on net profits of the Electric Company, the IRS concludes that these payments do not cause private business use. The ruling addressed ancillary contracts that could arise with the manager or manager affiliate for major storm and other emergency expenditures beyond the reasonable control of the manager. Because these services were for unforeseen events and not for the day-to-day operations and must be separately approved by the Electric Company, the IRS concludes that these contracts would not be taken into account in analyzing the Amended Agreement.

c. PLR 201346002. Authority issued Bonds in part to finance construction of Facility owned by Authority and leased to State pursuant to multi-year operating Lease. State intends to enter into management contracts for performance of certain substantial services at Facility that will cause the Bonds to satisfy the private business test. Lease payments and State's rental payments on other facilities financed by parity bonds are security for the Bonds. Bondholders do not have a mortgage or other security agreement creating a security interest in Facility under State law. Authority has covenanted that generally it will not sell, lease, mortgage or otherwise dispose of Facility other than the Lease, as long as the parity bonds are outstanding. These restrictions do not apply after the Lease is terminated or if other monies are sufficient to cover the amounts of the Lease payments. Held: The Lease and related covenants will not cause the private security or payment test to be met because the Lease and indenture covenants merely provide assurance to bondholders that Authority will continue to make Facility available to State and State will continue to use Facility and make Lease payments until Lease is ended and neither bondholders nor any other parties (other than State or Authority) will be granted rights in Facility.

d. PLR 201338031. Bonds were issued to finance construction and renovation of a Hotel. Pursuant to a management contract, Manager supervises, controls, manages and operates the Hotel. The compensation to Manager is being amended to include an annual base fee and an annual incentive fee. The proposed annual base fee is the greater of (i) the amount that would be a periodic fixed fee if paid every year or (ii) a percentage of the hotel's actual gross receipts for the fiscal year. The proposed annual incentive fee amount is a percentage of actual gross receipts for the fiscal year which amount the Issuer will pay the Manager only if the Hotel's Achieved Revenue Per Available Room (RevPAR) is at least a set percentage of the Achieved RevPAR of a group of specific hotels comparable to the Hotel. Held: Under the facts and circumstances, notwithstanding the management contract will not meet the requirements of Section 5 of Rev. Proc. 97-13, the management contract will not result in private business use of the Hotel because both the base fee and the incentive fee, both independently and in combination, are not based on a share of net profits.

e. <u>PLR 201338026</u>. Bond proceeds are to be used to finance acquisition or renovation of facilities to be owned or leased by Hospital for purpose of providing clinical medical services. Pursuant to a management contract, Medical Group will provide physician services to Hospital at the financed clinical facilities and is paid base compensation and incentive compensation and reimbursement for certain expenses by Hospital. Every third year, the base compensation and incentive compensation will be renegotiated to ensure that they remain within fair market value. Hospital also pays a portion of the compensation of the President of the Medical Group which includes base compensation and incentive compensation. Held: Under the facts and circumstances, notwithstanding the management contract does not meet the requirements of Section 5 of Rev. Proc. 97-13, the management contract does not result in private business use of the clinical facilities because (i) neither the Hospital's payment or reimbursement of the Medical Group's miscellaneous expenses nor its payment or reimbursement of the Medical Group's compensation expenses are calculated based on net profits, (ii) the facts and circumstances of the President's incentive pay do not support a conclusion of private business use of the clinical facilities, (iii) based in part on the periodic renegotiation of base compensation and incentive compensation, the management contract provides for reasonable compensation for the services provided by the Medical Group, and (iv) the Medical Group does not have any role or relationship with Hospital that substantially limits the Hospital's ability to exercise its rights under the management contract, including its termination right.

f. <u>PLR 201228029</u>. Electric Company, a governmental person that owns and controls an electric transmission and distribution system, will enter into an agreement with Manager for the single-purpose subsidiary of Manager to operate the electric transmission and distribution system. The term of the agreement will not exceed 10 years, and Manager and Electric Company (and Electric Company's sole shareholder, Authority) are not related parties and do not have any overlapping board members. The compensation of Manager will consist of the following components: (1) Fixed Direct Fee, (2) Incentive Compensation Component, and (3) Reimbursement of Pass-Through Expenditures. The Fixed Direct Fee is a stated dollar amount subject to adjustment for reduced credit support and reduction for poor performance. The Incentive Compensation Component is expressed in the first year of the contract as a stated dollar amount that the Manager may earn if it attains certain favorable performance goals, including expense reduction incentives. The Reimbursement of Pass-Through Expenses includes the Manager's actual costs without mark-up or profit, but Manager's costs on transactions with affiliates, if any, may include a mark-up of the affiliates' direct expenses in accordance with Federal Energy Regulatory Commission ("FERC") sanctioned cost allocation methods. Held: Based on all facts and circumstances, the agreement with Manager does not result in private business use of the tax-exempt bond-financed electric transmission and distribution facilities within the meaning of Code Section 141(b). Although the potential adjustments to the Fixed Direct Fee cause it not to meet the definition of a "periodic fixed fee" under Rev. Proc. 97-13, such fee does not result in private business use. The Incentive Compensation Component similarly does not result in private business use because the expense reduction incentives of such fee are not based on gross revenues or net profits of the facilities. The Reimbursement of Pass-Through Expenditures component does not result in private business use because any mark-up of actual costs will occur pursuant to FERC sanctioned cost allocation methods and not a share of net profits from the facilities. Finally, the length of the agreement does not cause the contact to result in private business use because the 10-year term does not exceed the 20-year term allowable under

Rev. Proc. 97-13 for contracts that relate to public utility property and satisfy either the 95% or 80% periodic fixed fee safe harbor.

g. PLR 201216009. IRS concludes that, if an agreement between a public hospital district and a public university creates a partnership, the partnership would nonetheless not create private business use because, applying the aggregate approach to partnership, the persons using the facilities will all be governmental persons.

h. PLR 201213010. Automated people mover (APM) transporting airline employees and passengers between terminals of an airport facility is not a common area of the terminals and may be treated as a separate facility. Further, because passengers and employees may ride the APM at no cost and no preferential treatment, the APM is available to the general public, despite security requirements imposed on those entering the terminals.

i. PLR 201043001. The IRS concluded that bonds issued to pay insurance claims for losses on commercial policies and residential policies resulted in private business use, but the bonds will not be treated as private activity bonds because the bonds will be repaid with taxes of general application. In the private letter ruling, an association was established by the state legislature to provide insurance to applicants who would otherwise be unable to obtain insurance in the marketplace. To the extent that the association's funds are insufficient to pay claims, the association will issue bonds to pay the remaining claims and the bonds will be repaid from either premium surcharges assessed on policyholders or assessments on all property insurers licensed to do business in the state. The IRS concluded that the bonds meet the private business use test because the commercial policyholders who receive bond proceeds in satisfaction of their claims are private business users. The IRS noted that the association is not able to avail itself of the public use exception because there are enough differences between residential and commercial policies that each policy type must be rated separately, and the policy terms exceed 200 days. However, the IRS concluded that the premium surcharges and assessments used to repay the bonds are taxes of general application and, therefore, the bonds fail the private security or payment test.

j. PLR 201049003. The IRS concluded that an agreement with a university to broadcast and televise its college sports games did not result in private business use of the bonds. In the private letter ruling, a corporation received under the agreement (i) broadcast and telecast rights, (ii) advertising sales and corporate sponsorship program rights, and (iii) publishing and vending rights. The agreement did not give the corporation any rights to control the teams, ticket sales, security, personnel management, or general management of the venues. For the rights granted under the agreement, the corporation must (a) pay a stated annual fee to the university in semi-annual installments over the term of the agreement, (b) pay the university a royalty in each contract year equal to a percentage of net revenues in excess of specified threshold amounts, (c) make investments in signage and technological upgrades, and (d) promote the university's athletic scholarship fund by providing a media package with a specified value. The IRS concluded that the agreement conveyed special legal entitlements to the corporation to use portions of bond-financed improvements but did not result in private business use. In reaching this conclusion, the IRS stated that the corporation's right to broadcast and televise the sports game and the sale of the advertisements is too remote to be considered use of the bond-financed improvements and provides no control over any element of the game schedules. In addition, the IRS stated that the tangible use of the bond-financed portions of the venues, including the use of

broadcast equipment and certain personnel at the venues, are incidental uses that do not exceed more than 2.5 percent of the bond-financed improvements.

k. PLR 200829008. With this private letter ruling, the IRS continues its favorable line of rulings dealing with the acquisition of separate property interests. A governmental agency sought to issue bonds to refund a taxable financing used to acquire undivided interests in certain mineral and working interests purchased from a nongovernmental seller who retained undivided interests in the same properties, the result being that the total property (mineral interests and interests in depreciable property associated with the mineral interests) was jointly owned by the private seller and the agency. The purchase price paid for the property by the agency was adjusted in accordance with trade usage to reflect the existence of the seller's and other interests in the property. Largely because the purchase price and operations of the various interests reflected separate rights and obligations associated with the interests, the IRS, relying heavily on Example 1 in Treas. Reg. §1.141-7(i) (recognizing and respecting separate ownership interests in output facilities), ruled that no portion of the purchase price for the interests acquired by the agency would be treated as used in a private business use as a result of seller's retained interests in the property.

l. PLR 200827023. The IRS ruled that the transmission and distribution of electricity that was generated or purchased with the proceeds of tax-exempt obligations issued by a governmental utility through distribution and transmission facilities owned by a for-profit, investor owned utility did not constitute private business use of the electricity where the for-profit utility did not enter into any arrangement to purchase the bond-financed electricity, the arrangement did not convey to the private party any special legal entitlements with respect to the bond-financed electricity, and where the private parties were simply using their private facilities to transmit the bond-financed electricity to customers of the governmental utility.

1. PLR 200718021. County prison facility with 100-day contracts with a federal agency for housing prisoners and with an expectation that there will be up to 90 percent non-federal prisoner use over time will not create private business use, because facility is available for use by the county on the same basis as the federal contracts and is not constructed for the principal purpose of providing the facility for federal use.

n. PLR 200542032. The IRS considered whether the transfer of "firm transmission rights" (FTR) under a regimen established by an electric transmission independent system operator (ISO) and approved by the FERC would be treated as a "deliberate action" causing bonds issued to provide the municipally-owned transmission facilities to which the FTR's related to be private activity bonds. A central question presented was whether the transfer of an FTR, which gave to the holder the right to participate in the receipt of special fees charged by the ISO as a market mechanism to control "congestion" over specific transmission interfaces, constituted a transfer of an ownership interest in the bond-financed facilities. The FTR's, which were to be sold by the ISO through public auction, were to have a term of one year. While the FTR could be held by any person, they would be particularly attractive to a power generation or distribution utility as a hedge against the adverse impact of high congestion charges across points necessary to its business. Looking to guidance under section 1001 of the Code and general tax cases, the IRS set forth several factors in concluding that no ownership interest in the financed transmission facilities was transferred: Incidence of ownership include (1) legal title, (2) contractual duty to

pay for capital investment, (3) responsibility to pay maintenance and operating costs, (4) duty to pay taxes, (5) risk of loss and (6) risk of diminution of value. The benefits and burdens indicative of ownership include (1) right to possession, (2) obligation to pay taxes, (3) responsibility to insure property, (4) duty to maintain property, (5) right to improve property, (6) risk of loss and (7) legal title.

o. PLR 200502012. The IRS considered whether the acquisition of various interests in land and certain related arrangements gave rise to private business use. An authority created to acquire, operate and maintain property for a city would acquire the property interests through arms' length negotiations with the sellers and would pay no more than FMV for the interests. The authority described five types of property interests. The IRS focused its analysis on identifying the bond-financed property, identifying the seller's distinct property, determining whether the seller's use of that distinct property impinged on the authority's use of the bond-financed property, and determining whether and on what basis the seller used the authority's property. The IRS specifically noted that the type of property interest was not controlling.

(i) A Conservation Easement in Perpetuity, Restricting the Seller's Use of the Property Subject to the Easement. The bond-financed property is the easement. The Authority is the owner of the easement in perpetuity and the seller does not have any interest (such as a reversionary interest) in the easement. The seller has a distinct interest in the property and the seller's use of the retained interest does not impinge on the Authority's use of its interest. The seller's only use of the easement is as a member of the general public. Other than that use, the seller's use of the parcel is not the use of bond-financed property. The Authority's acquisition of the conservation easement does not give rise to private business use of the bond proceeds.

(ii) A Future Interest in Fee Simple, with the Seller Retaining a Life Estate. The bond-financed property is the future interest. The Authority and the seller have distinct interests in the parcel, which occur at different times. The use of the parcel by the seller during the life estate does not impinge on the Authority's use of the future interest. The seller's use of the parcel will end with the termination of the life estate and, therefore, the seller will not use the bond-financed property. The Authority's acquisition of the future interest in fee simple does not give rise to private business use.

(iii) Fee Simple, with a Subsequent Lease to the Seller or a Third Party that Grants the Lessee Certain Agricultural Rights. The bond-financed property is the present interest in fee simple. The subsequent lease to a nongovernmental person results in private business use during the term of the lease of 100% of the proceeds used to acquire the fee simple interest.

(iv) Fee Simple, with the Seller Retaining a *Profit A Prende* Interest that Allows the Seller to Enter the Parcel for Limited Purposes, which are Less Extensive than those Permitted under a Lease. The bond-financed property is the fee simple, subject to (or less) the *profit a prende* interest. The Authority has a possessory right to use the parcel while the seller holds a non-possessory interest to use the parcel for limited purposes. The seller has a distinct interest in the parcel and the seller's permitted uses under the *profit a prende* interest will not impinge on the Authority's use of its interest in the parcel. The seller's only use of the

Authority's interest will be as a member of the general public. The Authority's acquisition of a present interest in fee simple subject to *profit a prende* interest will not give rise to private business use of bond proceeds.

(v) Fee Simple, With a Subsequent Conveyance of a *Profit A Prende* Interest to a Third Party. In this case, the fee simple is the bond-financed property. When the Authority sells the *profit a prende* interest, it is conveying a portion of the fee simple to a nongovernmental person. The *profit a prende* interest, like a discrete portion of a facility, is a distinct property interest. Therefore, the private business use may be measured on a reasonable basis that reflects the proportionate benefit to the users, such as fair market value of the interests.

p. PLR 200524015. Use of tax-exempt bond proceeds by a nonprofit corporation consisting of natural gas and electric joint action agencies and natural gas and electric distribution systems that were all political subdivisions will not in and of itself cause private business use. Private business use was determined based on the ultimate use of bond proceeds by the members. In addition, the ruling held that use by a subsidiary of the non-profit formed as a limited liability company similarly did not constitute private business use.

q. PLR 200336001. The distribution of a district's cable television programming by a cable television provider does not constitute a special legal entitlement of the facilities used by the district to produce and distribute such programming.

r. PLR 200323006. The IRS determined, in the context of a governmental stadium financing, that the sale of naming rights to a private business user for a term of years during which the private business would pay the city a certain dollar amount per year in exchange for the identification of the facility by the name selected by the private business in all advertising, communications, etc., would constitute a private business use for purposes of the private business use tests. The IRS concluded that the naming rights agreement resulted in the conveyance of legally enforceable rights with respect to the facility for a term of years; that is, the right to require the facility to be referred to with the name of the private business user. The IRS stated that the naming rights did not result in the private party being a private business user due to ownership, lease, management or other incentive payment contract. However, the "contract provides specific rules regarding the manner in which the facility will be operated, that is, the right to require the facility to be referred to with the name of the private business user's selection and this gives the private business user special legal entitlements to control the use of the facility. The private business use of the facility is described as being simultaneous with the governmental use thereof and was held to be a related use to the governmental use of the facility. The naming rights use is measured by reference to the fair market value of the contract as compared to the fair market value of the facility for each year of the contract. As no information was provided in the recitation of the facts in respect of the fair market value of all of the other uses of the facility, the IRS used the cost of construction of the facility as a reasonable proxy for the minimum value of the facility.

s. PLR 200309003. A new building to be constructed by a 501(c)(3) organization on its campus with bond proceeds would not be built specifically to meet the needs of certain federal agencies with which the Section 501(c)(3) organization had contracts to perform certain services for such agencies and would be available for general public use.

t. PLR 200250004. Notwithstanding the fact that a harbor channel was used mainly by business shippers, the harbor was available for general public use and therefore met the general public use exception to private business use.

u. PLR 200240028. Agency, a joint powers agency, requests on behalf of several of its members (the "Cities") a ruling that their becoming participating transmission owners in an Independent System Operator (ISO) by entering into an Agreement will not be treated as a deliberate action that causes outstanding Bonds, issued to finance the projects, to be private activity bonds under Section 141 of the 1986 Code or industrial development bonds under Section 103(b) of the 1954 Code. The Agency owns an undivided ownership interest in, or is otherwise entitled to the transfer capability of, each of the projects. The Agency represents that, if it is relying on this ruling, it will apply the provisions of Temporary Regulations Section 1.141-7T(f)(5) to the Bonds. The IRS concludes (1) that entering into the Agreement with the ISO is an action described in Temporary Regulations Section 1.141-7T(f)(5)(ii) because (i) the action is being taken to implement the offering of non-discriminatory, open access tariffs for the use of transmission facilities financed by an issue in a manner consistent with the rules promulgated by the FERC, and (ii) there is no sale, exchange, or other disposition of the projects to a nongovernmental person, and (2) that entering into the Agreement with the ISO will not be treated as a deliberate action for purposes of either the 1986 Code or the 1954 Code.

v. PLR 200222006. A ruling is requested as to whether a Hotel Management Contract will result in private business use. The Management Contract has a stated term of 15 years beginning on the placed-in-service date of the Hotel, but the Hotel Owner and the Manager also entered into a Technical Services and Preopening Agreement that will have a term of about 3 years and will terminate when the Hotel is placed in service. Under the Management Contract, Manager will be paid: (1) a management fee that is a fixed amount per year subject to an annual adjustment beginning in year 5 based on the percentage change in total revenues per available room for a comparable group of hotels in the City, excluding the Hotel; (2) a single productivity reward during the term of the Management Contract; and (3) a centralized services fee that is a stated dollar amount per year, subject to a CPI adjustment, for certain group services that the Manager provides to a majority of hotels that it owns or manages. The management fee, beginning in the third year, and the productivity reward are subject to deferral based on available net revenues but in all events must be paid by or at the termination of the Management Contract. A feasibility study projects that no deferrals will occur. The Manager is required under the Management Contract to pay the Owner an "inducement fee." The Owner is deemed to repay the Manager a fixed amount per month over the term of the Management Contract. If the Owner terminates the Management Contract other than for cause, the Owner is obligated to repay the remaining outstanding balance of the inducement fee. The Owner will reimburse the Manager for third-party expenses and for the salaries of the Manager's on-site employees and off-site employees who provide services to the Hotel, but not the salaries of the Hotel executive staff. Ruled: The Management Contract does not result in private business use because: (1) the non-deferrable amount of the management fee and the centralized services fee constitute periodic fixed fees; (2) the deemed repayment of the inducement fee and the expense and salary reimbursement are not compensation to the Manager; (3) although the deferred elements of the Manager's compensation do not satisfy the requirements of Rev. Proc. 97-13, these deferred elements do not indicate private business use under Regulation Treas. Reg. §1.141-3 (b)(4); and (4) the term of the

Preopening Agreement should not be aggregated with the term of the Management Contract in testing the term of the Contract.

w. PLR 200211022. The Agency, a political subdivision whose 32 members are all municipalities, was created to permit its members to secure a supply of electric power. The Agency issued the Bonds to refinance the acquisition of certain Transmission Facilities. While the Agency is not subject to the jurisdiction of the FERC, the regulatory changes made by the FERC have changed the marketplace for electricity transmission and, in response to these changes, the Agency entered into the Agreement with other transmission facilities owners to form an independent system operator (ISO). Under the Agreement, the Agency will transfer operational control of the Transmission Facilities to the ISO, but the Agency will retain ownership of the Transmissions Facilities. The ISO will provide non-discriminatory access to the transmission facilities by its members pursuant to an open access transmission tariff approved by the FERC. The Agency represents that it will apply the provisions of Treas. Reg. §1.141-7T(f)(5) of the temporary regulations to the Bonds. Ruled: The Agency's entering into the Agreement will not be treated as a deliberate action because it is an action described in Treas. Reg. §1.141-7T(f)(5)(ii), i.e., an action taken to implement the offering of non-discriminatory, open access tariffs for the use of transmission facilities financed by an issue in a manner consistent with the rules promulgated by the FERC.

x. PLR 200211003. Bonds were issued for the University, a state university, to finance the Center, a multipurpose fitness and recreation center. In addition to students, faculty, and staff already using the Center, the University would like to permit various other groups to use the Center. These groups would include spouses and dependent children of students, faculty, and staff of the University; certain retired faculty and staff of the University; a limited number of guests of members of the Center; participants in on-campus programs and non-credit classes sponsored by the University; students participating in activities conducted by the County Board of Education and a governmental agency of the State; persons being recruited by the University as students, faculty, and staff; members paying a fee to undergo health and fitness appraisals; members paying a fee for University-employed personal trainers; members paying a fee for use of equipment necessary for outdoor recreational activities; and nonmembers using a juice bar. Ruled: The proposed uses of the Center will not constitute private business use.

y. PLR 200205009. Conduit Borrower, a 501(c)(3) organization, has used the Vessel to conduct expeditions. The Borrower is proposing to use the Vessel for several months to provide ferry service to the public by entering into a non-renewable agreement with the Manager to provide this ferry service for a term of less than one year. The Borrower and Manager will each be responsible for specified costs. The Manager will collect passenger fees on behalf of the Borrower and will retain a specified amount for each passenger trip. In addition, the Manager will retain a percentage of the gross revenues from the galley service. These amounts are described as reasonable. The Borrower will reimburse the Manager for costs incurred by the Manager in the operation of the galley service to the extent those costs are owed to third parties and do not exceed the remaining receipts from the galley service. These costs do not include amounts paid to the Manager's employees as salary or wages. Ruled: The proposed agreement complies with Rev. Proc. 97-13 because the Manager's compensation consists of a per-unit fee and a percentage of gross revenues, compensation is not based on net profits, compensation has been represented to be reasonable, reimbursement of expenses is not considered as compensation, the term of the

agreement is less than one year, and this is the commencement of a new activity for the Vessel and the Borrower.

z. PLR 200132017. University/Medical School (University), a 501(c)(3) organization, owns research facilities with respect to which the University enters into Qualified Research Arrangements, which do not result in private business use, and Non-Qualified Research Arrangements, which do not result in private business use. Over the last "a" years, research revenue from Qualified Research Arrangements has averaged "b%" of total research revenue. Authority proposes to issue Bonds to finance new research facilities for the University. More than 5% of the new research facilities will be used for Non-Qualified Research Arrangements each year throughout the term of the Bonds. University makes a series of representations demonstrating that it is not possible for the University to allocate the usage of the research facilities between Non-Qualified Research Arrangements and Qualified Research Arrangements other than based on the relative amounts of revenue from such arrangements. Ruled: Proceeds of the Bonds may be allocated to the portions of the new research facilities that are used for Qualified Research Arrangements, with such portions based on the ratio of the present value of revenues from Qualified Research Arrangements to the present value of total research revenue, using the yield on the Bonds as the discount rate.

aa. PLR 200123057. B, a 501(c)(3) organization and qualified user of bond proceeds that operates a hospital and medical clinics, is the sole member of C, a taxable nonprofit corporation that provides professional services to B. B appoints 3 of 7 members of C's board of directors. The chief executive officer of B is one of those 3 members of C's board. One additional director of C's, must contemporaneously be a community representative (appointed by B) on B's board of directors. As a result, 4 of the 7 members on C's board of directors are either appointed by or are on B's board of directors. B has entered into a professional services agreement with C, pursuant to which C agrees to provide professional medical services to B. B has the power to approve the following with respect to C: (1) amendments to articles of incorporation and bylaws; (2) capital budgets, incurrence of long term debt, and operating budgets; (3) strategic plans; (4) risk management policies; (5) human resources and benefit policies; (6) health plan, payor or risk contracting agreements; and (7) merger, consolidation, dissolution, or sale or transfer of assets other than in the ordinary course of business. In addition, C is required to obtain B's approval of its proposed budget on an annual basis. Section 5.04 of Rev. Proc. 97-13 requires that a service provider not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under a service contract. A safe harbor is provided, but C and B are related and do not meet the safe harbor. Ruled: C does not have any role or relationship with B that substantially limits B's ability to exercise its rights, including cancellation rights, under the professional service agreement.

bb. PLR 200026020. City owns and operates a sewage enterprise system that includes a treatment plant and a reservoir for storing treated effluent from the plant. The bond-financed project includes a pipeline running from City's existing sewage system to a thermally active geyser field. The pipeline will consist of a Multi-Use Pipeline section and a Geyser Field Pipeline section. Under a contract with Company, City will be obligated to deliver to the geyser field a quantity of wastewater per day equal to about 27% of the capacity of the Multi-Use Pipeline. The remaining capacity of the Multi-Use Pipeline will be available to provide

irrigation water to various persons along its route. The aggregate amounts received under irrigation contracts will not exceed 5% of the debt service on the bonds. In general, Company will neither pay City for the wastewater nor share with City any revenues from the sale of electricity it generates at the geyser field. Ruled (reviewable ruling under Section 4 of Revenue Procedure 96-16): Project is not an output facility; even if the project is an output facility, the contract must be analyzed under Regulation Treas. Reg. §1.141-3 and 1.141-4 because it provides Company with specific performance rights; project is not a water facility; project is used in the trade or business of Company and the private business use test is met; sewer fees paid by ratepayers are private payments and the private payment or security test is met. Related case is City of Santa Rosa, California v. Commissioner, 120 T.C. No. 12 (2003).

cc. PLR 199950036. The Authority owns a hydroelectric generating facility (Project). The Federal Act requires the Authority to allocate b percent of the total power produced by the Project (Preference Power) to a group of customers consisting of public body Governmental Preference Customers and nonprofit cooperatives, which are considered nongovernmental persons. The Federal Act further allocates Preference Power between Preference Customers within and outside the State. In selling to out-of-state Preference Customers, the Authority deals with bargaining agents. All Governmental Preference Customers are publicly-owned utilities that sell energy directly to retail end-users and are governmental entities. Currently, the Governmental Preference Customers' aggregate contractual right to Project capacity is f percent of the capacity of the Project. In-state Governmental Preference Customers resell to various end-users, including customers who are natural persons not engaged in a trade or business. No such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. All Governmental Preference Power that is sold to the out-of-state Governmental Preference Customers is resold to retail customers, including customers who are natural persons not engaged in a trade or business. With respect to certain out-of-state Governmental Preference Customers, no such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. For all other out-of-state Governmental Preference Customers, payments that are substantially certain to be made in any year by each such out-of-state Governmental Preference Customer do not exceed 0.5 percent of the expected average annual debt service on the Proposed Debt. Bargaining agents are permitted to enter into arrangements with out-of-state Governmental Preference Customers that allow those customers to resell Governmental Preference Power at wholesale (non-conforming sale) if the Authority approves the non-conforming sale, but the Authority has not, and does not expect to, approve any non-conforming sales. The Authority proposes to use the proceeds of the Proposed Debt to finance additional costs relating to a portion of the Project, namely the f percent of Project capacity that is allocable to the use of Governmental Preference Customers. Ruled: (1) the portion of the Project (f percent, based on the Governmental Preference Customers' entitlement to Project capacity) allocable to the Governmental Preference Customers represents an identifiable interest in the Project, and (2) in part because all resales of Governmental Preference Power will satisfy either the Treas. Reg. §1.141-7T(f)(1) exception for small purchases of output or will satisfy the Treas. Reg. §1.141-3(c) exception to the private business use test and because the bargaining agents act on behalf of the out-of-state Governmental Preference Customers and are disregarded under Treas. Reg. §1.141.7T(f)(6) in determining whether the private business tests are met with respect to the Project, the use of the portion of the Project allocable to the Governmental Preference Customers will not cause the Proposed Debt to satisfy the private business tests.

dd. PLR 199931042. Districts Q and I are political subdivisions formed to provide health care for residents of County. Q and I have signed an affiliation agreement to provide for the cooperation and coordination of the Q and I hospital systems to create an integrated health care delivery system. M, a new 501(c)(3) organization the sole members of which are Q and I, has been formed to serve as the parent of the system. M will coordinate any financial sharing between Q and I, as well as between the various entities admitted to the system. Q and I have certain reserved powers. In the past Q and I have issued various issues of governmental bonds and 501(c)(3) bonds. Held: (i) certain affiliates are instrumentalities of Q and I; (ii) M is an instrumentality of Q and I; (iii) M is an "affiliate of a governmental unit" as described in Section 4 of Revenue Procedure 95-48 and relieved of filing Form 990; (iv) the execution of the agreement will not result in the creation of an entity separate from M for tax purposes; and (v) the execution and implementation of the agreement will not result in a change in use of any Q bonds that will cause them to be private activity bonds or in a change in use of any I bonds that will cause them to be other than qualified 501(c)(3) bonds.

ee. PLR 199929041. Two 501(c)(3) organizations formed a joint venture, Q, which includes several tax-exempt and two taxable subsidiaries. The IRS had previously ruled that the joint venture would not affect the exempt status of the organizations. Various portions of the facilities of certain exempt hospital subsidiaries were financed with proceeds of a 1987 bond issue. A 1998 bond issue was issued to finance the construction of a replacement hospital. Q, a limited liability company, will be treated as a partnership for tax purposes. Based on the representations of the 501(c)(3) members as to the application of the revenues of Q, the IRS held that the implementation of the joint operating agreement (which will result in Q being substituted as the sole member of the 501(c)(3) organizations that own the bond-financed facilities) will not cause the facilities to be owned or used in the trade or business of a person other than a governmental unit or a 501(c)(3) organization.

ff. PLR 199927042. A ruling was requested that proposed affiliation and economic integration agreements will not result in private use that could impact outstanding bonds. The parent of an exempt hospital system and an unrelated exempt entity, which has numerous subsidiaries, will enter into these agreements to create a single integrated health care delivery network. The parties will retain their respective assets. The proposed agreements will not result in use of the bond-financed facilities by a Section 501(c)(3) organization.

gg. PLR 199914045. Corporation is a 501(c)(3) organization with the primary exempt purpose of performing "scientific research in the public interest." Substantially all of Corporation's research enters the public domain through scientific and technical publications, presentations, use by the Corporation or provisions of services to its clients. Currently, Corporation has numerous scientific research contracts with terms ranging from six months to five years. The typical contract has a one-year term with no renewal requirements. The funding under federal contracts may be reduced at any time by the federal government. Corporation has no affiliation with the federal government, even if much of its research is performed for its agencies. The contracts do not grant clients ownership of any intellectual property developed or discovered in the course of research. Under applicable federal rules, certain special rules apply with respect to licenses, etc. The price to be paid by any federal agency for the use of any discovery will not be less than the price payable by any non-federal agency for the use of any discovery and will not be less than the price payable by any non-federal party for use of same property. Held: The

research contract is for basic research as such term is used in Revenue Procedure 97-14 ("Rev. Proc. 97-14"). Further, the services to the federal agencies will not constitute private business use within the meaning of Code Sections 141(b) or 145(a). Additionally, payments by the federal government under these contracts will not cause the bonds to be federally guaranteed within the meaning of Code Section 149(b).

hh. PLR 9844022 and PLR 9844019. Qualified 501(c)(3) bonds were issued by Q and loaned to 501(c)(3) organization T to finance the construction and acquisition of Clinic. State S issued bonds to refund other bond issues and make improvements to an acute teaching hospital operated by S. Such bonds were issued as governmental bonds. S and T have entered into an operating agreement, forming new entity W. S and T each provided 50% of the initial operating capital of W. W will provide common management of the facilities of S and T. The IRS finds that the arrangement created by the joint operating agreement lacks the essential corporate characteristics of continuity of life and limited liability, making it a partnership. Use by a partnership is generally private business use. However, the purposes of Code Section 145 are realized if partnership is treated as an aggregate instead of a separate entity using the bond-financed facilities. The operating agreement does not create any joint ownership of operating assets now separately owned by S and T. Certain actions, including disposal of property and incurrence of debt, require consent of both S and T. The joint operating agreement does not transfer the benefits of tax-exempt financing to the partnership. Based on the foregoing, none of the bonds will be treated as used for private business use under Code Sections 141(b) or 145(a).

ii. PLR 9842005, PLR 9841008 and PLR 9841009. State R created a special tax district Q to operate a hospital. The members of Q's governing body are appointed by the governor of R; Q has the power of eminent domain. S, a 501(c)(3) organization, was formed to provide facilities, hospital and related healthcare facilities for Q; Q is the sole member of S. Pursuant to a reorganization, Q will lease or transfer substantially all of its assets to S, which thereafter will be responsible for the operation of the hospital. X, a 501(c)(3) organization the sole member of which is Q, was formed to acquire the assets and business of an HMO. P, another 501(c)(3) organization, was also formed by Q to own certain buildings that will be leased by P to Q. Q has issued various issues of governmental bonds, both for new money and refunding purposes. Held: (i) Q qualifies as a political subdivision of R, (ii) each of S, X and P are instrumentalities of Q, and (iii) the execution and implementation of the transfer and lease arrangements between the various subsidiaries will not result in a change in use of bond proceeds.

jj. PLR 9835032. Prison was constructed with taxable bonds; Issuer R wants to issue tax-exempt bonds to refund them. Prison was not designed to meet specific needs of federal prisoners. However, R has entered into intergovernmental agreement with U.S. Marshals Service ("IGA"). Under IGA, (i) R is not required to reserve any particular number of beds for federal prisoners, (ii) United States to pay negotiated per diem rate comparable to fees paid by nonfederal governments, and (iii) United States has no enforceable right to renew IGA. IGA has 90-day term and is comparable in terms to agreements entered into by R with nonfederal governments. Held: use of prison by federal prisoners is general public use.

kk. PLR 9823008. R, Political subdivision, will issue bonds to (i) acquire common stock of OE, investor-owned utility, (ii) pay the cost of redemption or conversion in cash of OE preferred stock and debt, (iii) finance improvements, and (iv) pay

transaction expenses. After acquisition transaction, R will control new utility, NE, appoint its board, and approve its budgets and major contracts. NE will be managed pursuant to contract (outlined in the ruling) which does not meet Rev. Proc. 97-13. Ruled: (i) transaction meets transition rule exception to 141 (d) limitation on output facilities, (ii) purchase of stock with bond proceeds is an indirect purchase of OE electric system for purposes of Code Section 103 and Code Sections 141 through 150, (iii) NE will be governmental person, making its use of bond proceeds a governmental use, (iv) notwithstanding the fact that the management agreement does not meet Rev. Proc. 97-13, it does not give rise to private use, and (v) use of proceeds to pay property tax settlement is extraordinary item under Treas. Reg. §1.148-6(d). *See* companion PLR 9823012.

ll. PLR 9816017. State agency to issue bonds for benefit of 501(c)(3), C, and State University U. Bonds will finance public infrastructure projects for U. U's board of trustees is governmental body established to oversee operation of U and other campuses; members are selected by governor of State N and subject to consent of senate. C was formed on initiative of administrators of U as an auxiliary organization. C engages in activities relating to housing, acquisition and development of real estate, and other activities which are "integral part of the educational mission" of U. C is to undertake similar activities in connection with bond-financed facilities. U's president and board of directors together elect C's board of directors. U's board may remove directors of C except for U's president, who serves as ex officio member. C's funds are gifts and grants which must be used under the control and oversight procedures of U. U's board of trustees has access to all of C's records and audits them annually. On dissolution, C's assets are to be distributed to successor 501(c)(3) organization approved by U. Held: C meets the criteria of Revenue Ruling 57-128 as a state instrumentality and that, as such, C's trade or business is that of a governmental unit and, therefore, not private business use for purposes of Code Section 141(b).

mm. PLR 9813003. T, joint powers agency, has as members two cities, X and Y. T has all powers necessary, including power of eminent domain and power to issue bonds, to develop and implement Corridor Project. Among other things, Corridor Project aims to alleviate traffic to and from the ports of X and Y by consolidating rail traffic, thereby increasing their efficiency and competitiveness. Corridor Project will also include many sub-projects including removal of buildings, relocation of water and sewer lines, road and bridge expenditures, highway overpasses, etc. Corridor Project includes construction of Trench to separate the rail facilities from adjacent and crossing roads; Trench is the largest component of Corridor Project and will be utilized by railroads to access ports. Pursuant to Memorandum of Understanding, railroads will pay user fees for use of Trench. Amounts paid by railroads will be used to repay, among other things, the debt incurred to finance Corridor Project. The IRS considered the allocation of bond proceeds to the various components of Corridor Project (street improvements, non-Trench grade separations, Trench bridges, etc.) under the private activity tests and concluded such components constitute governmental improvements to street and roads which are available for use by the public and owned by governmental units and with respect to which the railroads have no special legal entitlement; accordingly, it is held that the railroads are not treated as private business users of these improvements. With respect to Trench, the IRS noted that the public improvements, including Trench, are not appropriately treated as discrete facilities under Treas. Reg. §1.141-3(g)(4)(iv). IRS also noted that railroads will derive substantial benefit and pay fees for the use of Trench. Because Trench is functionally related to the rail facilities and facilities owned by X and Y, Trench is properly treated as "common area" to multiple facilities. IRS

concluded that 50% of the cost of Trench could be allocated to the street improvements. Finally, where utilities are under no legal obligation to relocate the lines, utilities are not treated as private business users of proceeds used for relocation; however, to the extent such relocation is allocable to construction of Trench, relocation costs should be treated accordingly.

nn. PLR 9807015. Authority was formed as a nonprofit membership organization to coordinate the operation of electric generation resources and the purchase and sale of electric power on behalf of its members. The members are governmental units or instrumentalities thereof. No portion of Authority's earnings inures to the benefit of any individual or any private person; in the event of dissolution, assets of the Authority are distributed ratably to the members. Each member has contributed and agrees to contribute additional capital as needed; expenses and gains on transactions not specifically benefiting one member are allocated to members equitably. Authority is treated as a wholly-owned instrumentality of its members for purposes of Code Section 141.

oo. PLR 9741013. State authority issues Notes secured by general obligation notes of Academies. The proceeds of the Notes are used to purchase notes of the Academies, which are temporary debt incurred to pay school operations. The Academy notes are secured by the State school aid allocated to the respective Academies. The Notes were issued prior to the effective date of Treas. Reg. §1.141-1. Academies are created under State law and, for purposes of receiving school aid, tuition policy, etc., are treated on the same basis as public elementary and secondary schools. The board of each Academy is formed so that there is no private inurement in the organization or operation of the Academy, and the board members are subject to control and supervision of the State Board of Education. State law expressly permits and fosters the creation of Academies, and State is a principal source of operating expenses. Ruled: under State law, each Academy is a governmental unit for purposes of determining use under private activity bond tests and private financing loan test.

pp. PLR 9740016 and PLR 9740015. City 1 and City 2, together with private participants, own undivided interests in a nuclear electric generating facility. The various owners propose that the project be operated by O, a nonstock, nonmember, nonprofit corporation under state law that will not be a 501(c)(3) organization. Pursuant to Operating Agreement, O is authorized to maintain and operate the project on behalf of the owners, executing all contracts relating to maintenance, improvement, etc. Each participant will pay its respective share of the costs of operation. O will have no ownership interest. City 1 and City 2 have elected to apply Treas. Reg. §1.141-3(b)(4) to the bonds. Because the project is public utility property, O's operation of it will not be treated as a management contract if the only compensation to O is the reimbursement of actual and direct expenses and of reasonable administrative overhead. Ruled: (1) The Operating Agreement imposes reasonable limitations on O's reimbursable costs; (2) the arrangement will not pass on any benefits of tax-exempt financing to O or any of the private participants; and (3) the Operating Agreement is not an arrangement that gives rise to private business use.

7. City of Santa Rosa, California v. Commissioner, 120 T.C. No. 12 (2003), held that a private entity did not use a bond-financed pipeline for treated wastewater "in any quantifiable amount" when it took delivery of water from the pipeline and used the water to generate steam by injecting the water into a geyser steam-field. The steam-field boiled the water

into steam for use in generating electricity. The IRS had ruled negatively on the question on various theories alleging private business use in excess of 10% (PLR 200026020). Appeal was not sought by the IRS and U.S. Department of Justice. The IRS has published neither an acquiescence nor a non-acquiescence in the case.

C. Qualified Management Contracts.

1. General. Treas. Reg. §1.141-3-(b)(4) states the general rule that, except as otherwise provided therein, a management contract may result in private business use of bond-financed property based on all the facts and circumstances. A management contract similarly results in private business use if, based on all the facts and circumstances, the service provider is treated as the lessee or owner of the bond-financed property for federal income tax purposes.

2. Definition. Treas. Reg. §1.141-3(b)(4) defines a management contract to be a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all or a portion of, or any function of, the financed facility. A management contract includes not only a contract that provides for the actual management of a facility (such as an operator of a cafeteria or a hospital or a nursing home), but also one that provides services (such as a contract to provide medical services, other than as an employee, to patients of a hospital whether or not compensation is paid directly by the hospital or by patients or third party payers). Arrangements not treated as management contracts include: (i) contracts for services that are incidental to the primary function of the facility (*e.g.*, janitorial services, office equipment repair, hospital billing), (ii) the granting of admitting privileges by a hospital, (iii) a contract to provide for the operation of public utility property (as defined in Code Section 168(i)(10)) if the only compensation is reimbursement of direct expenses and reasonable administrative overhead expenses, and (iv) a contract to provide services, if the only compensation is the reimbursement of the service provider for direct expenses paid by the service provider to unrelated parties. There appears to be continuing debate, for purposes of this provision and the section of Rev. Proc. 2017-13 that excludes the reimbursement of expenses paid to unrelated third parties from the manager's compensation, whether the reimbursement of employee salaries and wages paid by the management fall within that rule. *See* PLR 200222006 (statement in facts that employees for whom reimbursement is sought do not include executive staff) and PLR 200205009 (statement in facts that reimbursed costs do not include amounts paid by manager as salaries and wages). These PLRs are referenced below.

3. Qualifying Management Contract Safe Harbor Arrangements. Revenue Procedure 1997-13, as modified by Revenue Procedure 2001 -39 ("Rev. Proc. 97-13") provided certain bright line tests that if satisfied would allow a management or service contract to be treated as not giving rise to private business use. On August 22, 2016, the IRS released Revenue Procedure 2016-44 ("Rev. Proc. 2016-44"), which modified Rev. Proc. 97–13 and section 3.02 of Notice 2014–67 (discussed below), to provide new safe harbor terms under which management contracts will not result in private business use. Rev. Proc. 2016-44 applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider. The IRS subsequently modified, amplified and superseded Rev. Proc. 2016-44 in Revenue Procedure 2017-13 ("Rev. Proc. 2017-13"). Rev. Proc. 2017-13 provided certain clarifications and amendments to Rev. Proc. 2016-44 to address certain types of compensation, the

timing of payment of compensation, the treatment of land and methods of approval of rates. Rev. Proc. 2017-13 is generally effective for management contracts entered into, materially modified or extended (other than pursuant to a renewal option) on or after January 17, 2017. Issuers may elect to apply Rev. Proc. 97-13 to contracts entered into before August 18, 2017, provided that such contracts are not materially modified or extended (other than pursuant to a renewal option) on or after August 18, 2017.

4. Rev. Proc. 2017-13

Rev. Proc. 2017-13 applies to any management contract involving managed property financed with the proceeds of an issue of governmental bonds or qualified 501(c)(3) bonds. A management contract is defined to mean a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property. Rev. Proc. 2017-13 clarifies that a management contract does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management). The term "managed property" is defined to mean the portion of a project with respect to which a service provider provides services. Treas. Reg. §1.141-6(a)(3) defines project to mean one or more facilities or capital projects, including land, buildings, equipment, or other property, financed in whole or in part with proceeds of the issue. The definition of qualified user is consistent with the definition as set forth in Rev. Proc. 97-13.

If a management contract meets each of the requirements set forth in Rev. Proc. 2017-13, or is "an eligible expense reimbursement arrangement," the management contract does not result in private business use (the "2017-13 Safe Harbor"). Rev. Proc. 2017-13 also provides that a service provider's use of a project that is functionally related and subordinate to performance of its services under a management contract for managed property that meets the 2017-13 Safe Harbor does not result in private business use. For example, the use of storage areas to store equipment used to perform activities required under the management contract that meets the 2017-13 Safe Harbor does not result in private business use.

a. Reasonable Compensation. Payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider. Under Rev. Proc. 97-13, reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation. For this purpose, employees of the service provider are treated as unrelated parties. Under Rev. Proc. 2017-13, payments for reimbursement to the service provider and administrative overhead of the service provider must be analyzed with other forms and methods of compensation to determine if that compensation is reasonable, is not based on a share of net profit, and does not result in the service provider bearing net losses, as described below.

b. No Net Profits Arrangements. The restriction against sharing of net profits under Rev. Proc. 97-13 and its predecessors was brought forward. Under Rev. Proc. 2017-13 the management contract must not provide to the service provider a share of the net profits from the operation of the managed property. Compensation to the service provider will not be treated as

providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) for any fiscal period. The "elements of the compensation" are the eligibility for, the amount of, and the timing of the payment of the compensation. Unrelated parties are defined as persons other than either (i) a related party (as defined in the Regulations) to the service provider or (ii) a service provider's employee. In addition, incentive compensation is not treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation otherwise meet the requirements set forth in this paragraph.

c. No Burden of Net Losses. The management contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement will not be treated as requiring the service provider to bear a share of net losses if: (a) the determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and (b) the timing of the payment of compensation is not contingent upon the managed property's net losses. Compensation can however be reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) without being treated as bearing a share of net losses as a result of this reduction. Without regard to whether the service provider pays expenses with respect to the operation of the managed property without reimbursement by the qualified user, compensation for services will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses if the compensation for services is (i) based solely on a capitation fee, a periodic fixed fee, or a per-unit fee; (ii) incentive compensation (as described above) or (iii) a combination of these types of compensation. *Capitation fee* and *periodic fixed fee* retain the definitions under Rev. Proc. 97-13. The definition of *per-unit fee* in Rev. Proc. 97-13 provides that separate billing arrangements between physicians and hospitals generally are treated as per-unit fees; Rev. Proc. 2017-13 removes the word "generally," and confirms the treatment of separate billing arrangements as per-unit fees.

d. Treatment and Timing of Compensation. The deferral of compensation (that otherwise meets the requirements of Rev. Proc. 2017-13) due to insufficient net cash flows from the operation of the managed property will not cause the deferred compensation to be treated as contingent upon net profits or losses if the contract includes requirements that: (i) the compensation is payable at least annually; (ii) the qualified user is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and (iii) the qualified user will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

e. Contract Term. The term of the contract, including all renewal options, must be no greater than the lesser of (a) 80 percent of the weighted average reasonably

expected economic life of the managed property or (b) 30 years[3]. Economic life is determined in the same manner as under Code Section 147(b) as of the beginning of the term of the contract. Thus, land will be treated as having an economic life of 30 years if 25 percent or more of the net proceeds of the issue that finances the managed property is to be used to finance the costs of such land. A contract that is materially modified with respect to any matters relevant to its treatment as a qualified contract under Rev. Proc. 2017-13 is retested for compliance with Rev. Proc. 2017-13 as a new contract as of the date of the material modification.

f. Control over Use of Managed Property. The qualified user must exercise a significant degree of control over the use of the managed property. This requirement is met if the contract requires the qualified user to approve (a) the annual budget of the managed property, (b) capital expenditures with respect to the managed property, (c) each disposition of property that is part of the managed property, (d) rates charged for the use of the managed property and (e) the general nature and type of use of the managed property. A qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and it may show approval of dispositions of property that is part of the managed property in a similar manner. In addition, a qualified user may show approval of rates charged for use of the managed property by either (i) expressly approving such rates or a general description of the methodology for setting such rates (such as a method that establishes hotel room rates using specified revenue goals based on comparable properties) or (ii) by including in the contract a requirement that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party.

g. Risk of Loss with respect to Managed Property. The qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, due to force majeure). The qualified user will not fail to meet this requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.

h. No Inconsistent Tax Position. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. For example, the service provider must agree not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property.

i. No Circumstances Substantially Limiting Exercise of Rights. The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances. A service provider will not be treated as having a prohibited role or relationship with the qualified user if: (i) no more than 20 percent of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners,

[3] Note that to fit within the 2017-13 Safe Harbor (other than as an eligible expense reimbursement arrangement), the economic life limitation on the contract term must be satisfied regardless of how short or long the term of the contract.

members, and employees of the service provider, in the aggregate; (ii) the governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and (iii) the chief executive officer of the service provider is not the chief executive officer of the qualified user or any related parties of the qualified user.

For purposes of this provision, the term "chief executive officer" includes a person with equivalent management responsibilities. In addition, the term "service provider" includes the service provider's related parties. A "related party" is defined to mean, with respect to a qualified user, any member of the same controlled group (as defined in Treas. Reg. 1.150-1(e)) and, with respect to a person other than a qualified user, a related person (defined by reference to Code Section 144(a)(3)).

5. Eligible Expense Reimbursement Arrangements. For management contracts that are considered to be "eligible expense reimbursement arrangements," such contracts are deemed to meet the safe harbor of Rev. Proc. 2017-13 and will not result in private business use. An eligible expense reimbursement arrangement is defined to mean a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider. An "unrelated party" is defined to mean persons other than a related party to the service provider or a service provider's employee. Rev. Proc. 2017-13 treats employees of the service provider as related for purposes of expense reimbursement, a deviation from prior IRS guidance.

6. Net Profits. Management contracts in which the service provider is compensated with a capitation fee, periodic fixed fee, per unit fee, qualitative incentive payment or any combination of such fees will not be deemed to be based, in whole or in part, on net profits of the managed property irrespective of any expense reimbursement paid to the service provider, including expenses paid to related persons (e.g., employees of the service provider). Other forms of compensation such as those based on a percentage of gross revenues or non-qualitative incentive payments are not provided this same protection.

7. Facts and Circumstances Test. A management contract that fails to satisfy a safe harbor from private business use does not automatically create private business use. Instead, the contract should be analyzed under the general rule that a management contract gives rise to private business use based on all the facts and circumstances.[4] The IRS has issued a number of private letter rulings (for example, PLR 201726007, 201622003 and PLR 201338026) that deal with contracts that fall outside the safe harbors in Rev. Proc. 97-13. The IRS often ruled that the contract did not give rise to private business use under the facts and circumstances test. Because the facts and circumstances test is contained in the Treasury Regulations, which have not changed even after the IRS released Rev. Proc. 2017-13, these rulings should continue to have some value as guidance.

[4] Bond Counsel may be reluctant to rely on the facts and circumstances test to render an unqualified opinion that interest on the bonds is excluded from gross income for federal income tax purposes without a private letter ruling issued specifically to the qualified user.

8. Revenue Procedure 97-13 (Qualifying Management Contract Safe Harbors). Rev. Proc. 97-13 states that the arrangements set forth below are qualifying management contracts:

a. 95% Periodic Fixed Fee Arrangement/15 and 20 Year Contracts. At least 95% of the compensation is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80% of the reasonably expected useful life of the financed property and 15 years (20 years for "public utility property" as defined in Code Section 168(I) (10)). A one-time fixed dollar incentive award based on a gross revenue or expense target (but not both) is permitted.

b. 80% Periodic Fixed Fee Arrangement/10 and 20 Year Contracts. At least 80% of the compensation is based on a periodic fixed fee. The contract term, including all renewal options, must not exceed the lesser of 80% of the reasonably expected useful life of the financed property and 10 years (20 years for public utility property). Again, a one-time fixed dollar incentive award based on a gross revenue or expense target (but not both) is permitted.

c. 50% Fixed Fee Arrangements/5 Year Contracts. Either 50% of the compensation is based on a periodic fixed fee or 100% of the compensation is based upon a capitation fee or a combination of a capitation fee and periodic fixed fee. The contract term, including renewal options, must not exceed 5 years and the contract must be terminable by the qualified user (governmental entity or qualified 501(c)(3) organization, where applicable) without penalty or cause at the end of the third year of the contract term.

d. Per-Unit Fee Arrangements/Certain 3 Year Contracts. All of the compensation is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user without penalty or cause at the end of the second year.

e. Percentage of Revenue or Expense Fee Arrangements/2 Year Contracts. All of the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. The term of the contract, including renewal options, must not exceed 2 years and the contract must be terminable by the qualified user without penalty or cause at the end of the first year of the contract. The contract safe harbor is limited to circumstances involving services to third parties (*e.g.*, radiology services to patients) or certain start-up situations. Periodic fixed fees and, pursuant to the amendments to Rev. Proc. 97-13 set forth in Revenue Procedure 2001-39, capitation fees and per unit fees may be automatically increased according to a specified, objective, external standard that is not linked to the output or efficiency of a facility.

4. Notice 2014-67.

a. Notice 2014-67 "amplifies" the existing safe harbors of Rev. Proc. 97-13. One of the key provisions of Rev. Proc. 97-13 is the prohibition of compensation based on net profits. The Notice states that a productivity reward for services during the term of a contract does not cause the compensation to be based on a share of net profits of the financed facility if:

(1) the eligibility for the productivity award (the Notice renames this as an "award" rather than "reward") is based on the quality of the services provided under the management contract (for example, the achievement of Medicare Shared Savings Program quality performance standards or meeting data reporting requirements), rather than increases in revenues or decreases in expenses of the facility; and (2) the amount of the productivity award is a stated dollar amount, a periodic fixed fee, or a tiered system of stated dollar amounts or periodic fixed fees based solely on the level of performance achieved with respect to the applicable measure.

b. The Notice created a new safe harbor for certain five-year contracts under the Permissible Arrangements section of Rev. Proc. 97-13. This safe harbor permits compensation for services based on a stated amount, periodic fixed fee, a capitation fee, a per unit fee, or a percentage of gross revenues, adjusted gross revenues, or expenses of the facility (but not both revenues and expenses). In addition, the safe harbor does not require that the contract be terminable by the qualified user of the facility prior to the end of the term. Under the Rev. Proc. 97-13 safe harbors, the permissible two-year, three-year and five-year arrangements require that the governmental or 501(c)(3) organization have the ability to terminate without cause at an earlier date. The Notice did not eliminate the existing two, three and five-year contract safe harbors.

c. The expanded five-year safe harbor is effective for contracts entered into, materially modified, or extended (other than pursuant to a renewal option) on or after January 22, 2015, but may also be applied to contracts entered into before January 22, 2015.

9. Private Letter Rulings.

a. PLR 202229002. A management contract for a hotel under which the manager is paid a management fee consisting of three components: (i) a tiered percentage of gross revenues from hotel operations, (ii) reimbursement to the service provider for operating expenses, including employee costs, such as salaries, fringe benefits, incentive compensation and bonuses, and (iii) reimbursement of the hotel's allocable share of centralized services the service provider provides, such as promotion and marketing, centralized reservations, guest incentive programs and technology services. The ruling notes that incentive compensation and bonuses to senior management employees for which the service provider is reimbursed are evaluated based on formulas used to measure performance of the hotel, by factors that include the hotel's financial performance, guest experience and individual goals. Employee bonuses and incentive compensation are payable as a percentage of the employees' respective salaries and the timing and amount of such bonuses and incentive compensation are not contingent upon net profits from the operations of the hotel. The contract was determined to not satisfy all of the safe harbor conditions under Rev. Proc. 2017-13 because the compensation to the service provider included reimbursement of employee costs of the service provider. Such employee costs included bonuses and incentive compensation paid by the service provider to its employees that are based, in part, on the hotel's financial performance. However, the ruling concludes that the incentive compensation and bonuses that are reimbursed to the service provider under the agreement are not compensation based, in whole or in part, on a share of net profits from the hotel operations and, under the facts and circumstances, the contract is a management contract that does not result in private use of the hotel by the service provider.

Language in the ruling that the contract did not comply with Section 502(2) of the ruling because the compensation included reimbursement expenses may be overbroad. Such assertion may mistakenly imply that the reimbursement of employee expenses, in and of itself, would cause a contract to not comply with Revenue Procedure 2017-13. Rather, the IRS could have stated that reimbursement of employee expenses constitutes "compensation" for purposes of Revenue Procedure 2017-13, and the elements of such compensation must be examined to determine whether any such element is based on a sharing of net profits.

b. PLR 201726007. A teaching hospital service agreement between a school and a county hospital was determined to be a management contract; however, such management contract did not satisfy all of the safe harbor conditions under Rev. Proc. 2017-13. Thus, the determination of whether the agreement resulted in private business use depended on the facts and circumstances test. Ultimately, the agreement was held not to result in private business use after examination through the lens of the safe harbors under Rev. Proc. 2017-13. There was no compensation to the hospital, the manager, *i.e.,* the school did not bear any share of the costs or losses from the operation of the hospital, the term did not exceed 30 years or 80 percent of the useful of the hospital, the school bore no risk of loss for the facility, the school was not entitled to take any tax position inconsistent with that of a service provider, had no prohibited relationships with the hospital, and had no control over the operations, nature or general use of the hospital.

c. PLR 201622003. A management contract for a hotel under which the manager would receive base fee equal to a percentage of the hotel's annual gross revenues and incentive pay in any year in which certain tests were met does not result in private use. The contract did not meet all criteria of Rev. Proc. 97-13 as amplified by Notice 2014-67, however, a review of the facts and circumstances supported a ruling that the management contract did not result in private business use of the hotel because the incentive fee, while partly based on a variant of net profits, was not derived from net profits and was treated as a share of gross revenue and the term of the contract was reasonable under the facts and circumstances.

d. PLR 201338026. A management contract under which a hospital would pay a medical group base compensation, incentive compensation and reimbursement of certain expenditures did not result in private business use of the clinical facilities. Using the factors of Rev. Proc. 97-13, the IRS concluded that neither the hospital's payment or reimbursement of the medical group's miscellaneous or compensation expenses supported a conclusion that the management contract resulted in private business use of the clinical facilities because those expenses were not calculated based on net profits. Likewise, the facts and circumstances of the incentive pay of the medical group's president did not support a conclusion that the management contract caused private business use of the clinical facilities because the metric used would not be based on net profits.

e. PLR 201228029. Though the fixed fee component of a manager's compensation did not qualify as a periodic fixed fee because it allowed for adjustments based on reduced credit support or poor performance, it did not result in private business use because it was not based on net profits and, after adjustment, would remain a stated amount for the particular annual period. Additionally, pass-through expenditures that included mark-up would not create private business use because they were based on federally-regulated cost allocation methods and not net profits of the facility.

f. PLR 201145005. A management contract for a municipally-owned, bond-financed exhibition and convention center provided for three types of compensation: (1) a base fee, (2) an incentive fee, and (3) reimbursement of certain expenses. In order to receive the incentive fee, the manager must attain (1) operating revenues equal to or greater than a target benchmark, (2) a stated net operating surplus/deficit level for the fiscal year, established in advance each fiscal year and (3) an average overall customer satisfaction score equal to or greater than a target benchmark. The amount of the incentive fee was adjustable, but in no event would exceed the annual base fee.

The IRS concluded that the incentive fee (particularly the revenue benchmark and the net operating surplus/deficit benchmark) did not constitute compensation based on a share of net profits because "the amount of the incentive fee paid to the Manager will not vary depending on the margin of increase in revenues and/or decrease in expenses or be based on a percentage of revenue increases, a percentage of expenses decreases, or some combination of both." Additionally, the IRS stated that "although the net operating surplus/deficit benchmark takes into account both expenses and revenues, it is not based on increases in revenues and decreases in expenses, but on stated surplus/deficit amounts that may reflect decreasing revenues and increasing expenses."

g. PLR 200926005. A hospital facility financed with the proceeds of qualified 501(c)(3) bonds proposed to enter into professional service agreements with certain contracting physicians. The agreements provided that the hospital would reimburse certain expenses incurred by the physicians, and the physicians would be compensated based on a percentage of net professional patient billings, which under the agreements consisted of gross patient billings provided by each such contracting physician, adjusted for certain items, including certain insurance discounts. The contracting physicians would also receive supplemental compensation paid into a non-qualified deferred compensation plan and could also be compensated for supervising "physician extenders" (nurse practitioners and physician assistants).

The IRS initially found that the agreements were "management contracts" within the meaning of Treas. Reg. §1.141-3(b)(4)(ii), and that the contracts did not satisfy the safe harbors set forth in Rev. Proc. 97-13. The IRS went on to consider whether, under all of the facts and circumstances the agreements resulted in a private business use of the facility. Using the facts and circumstances analysis, the IRS determined that the agreements did not result in a private business use of the facility, largely because (1) the compensation under the agreements consisted of a percentage of fees generated by the physicians, adjusted for items such as bad debts and insurance discounts, which was deemed by the IRS to closely resemble a permissible arrangement under Rev. Proc. 97-13, (2) the agreements provided for reasonable compensation, partly because the agreements allowed the hospital the right to review physician compensation that reaches a certain percentage of an objective industry standard, (3) a physician's base compensation was based not on a share of the net profits from the operation of the facility, but rather on a percentage of adjusted gross revenues allocable to the physician, (4) none of the expenses of the facility or of the contracting physicians were taken into account in determining a physicians' base compensation, (5) the physician's incentive compensation was based on how the physician met specific goals, none of which were based on the number of patients treated by the physician at the facility, the productivity of the facility or the net profits of the hospital, (6) the amount of deferred compensation that a physician was eligible to receive was not based upon the net profits of the

hospital or the productivity of the physician at the hospital, (7) the terms of the agreements were specifically tailored to address the difficulties encountered by the health care industry in the hospital's coverage area in attracting and retaining physicians, and (8) none of the physicians entering into the agreements were related parties with the hospital or the entity owning the hospital for purposes of Code Section 1.150-1(b), and none of the physicians had a role in or relationship with the hospital or the entity owning the hospital that substantially limited the ability of the hospital and the entity to exercise their rights under the respective agreements.

h. PLR 200813016. A 10-year contract with a private manager of a county-owned solid waste disposal facility provided for an arm's-length negotiated 80 percent fixed compensation and 20 percent variable compensation based upon the volume of solid waste handled by the manager. In addition, the manager was to be compensated extra (determined without regard to the 20 percent variable limit) in the event of excessive rainfall in the county and in the event of hurricane or major storm declared emergencies occurred. The contract was held not to meet the requirements of the Rev. Proc. 97-13 safe harbor, but nonetheless did not create private business use under all the facts and circumstances presented by the county, including the likelihood of excessive rainfall.

i. PLR 200651012. A dormitory management contract between a university and its wholly owned taxable subsidiary did not give rise to private business use. The university was the sole shareholder of the manager and appointed all its members of the board of directors and had the power to approve its articles and by-laws, budgets, strategic plans and even its dissolution. The contract was for a period of 15 years, which was less than 80% of the useful life of the facility. Compensation was paid based on a fixed annual fee, adjusted only for changes in the consumer price index, plus reimbursements for direct expenses. The university had the right to terminate the contract on 90 days written notice at the end of each year. Under these facts and circumstances, the IRS concluded that the manager does not have any role or relationship that would limit the university's ability to exercise its rights under the contract (including the cancellation rights) and, thus, the contract did not give rise to private business use.

j. PLR 200330010. Though compensation arrangement did not meet the safe harbor, 20-year public utility contract nonetheless was held not to give rise to private business use.

k. PLR 200222006. Hotel management contract, having a 15-year term, providing several forms of compensation, including some employee expenses, and entered into in connection with a "Preopening Agreement" with a term of about 3 years, is a qualified management contract.

l. PLR 200205009. Management contract with a term of less than one year under which the manager receives a per unit fee plus a percentage of revenues, as well as reimbursement of third-party expenses but not employee costs, complies with Rev. Proc. 97-13.

m. PLR 200123057. Because a Section 501(c)(3) medical organization controls a majority of the board of directors of a taxable professional corporation and has substantial powers over that corporation's budgeting and operations, the Section 501(c)(3) organization is not substantially limited in the exercise of its rights under a service agreement between the Section 501(c)(3) organization and the taxable corporation.

D. Research Agreements.

1. General. Treas. Reg. § 1.141-3(b)(6) states the general rule that, except as otherwise provided therein, an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of bond-financed property based on all the facts and circumstances. Unless otherwise provided in Treas. Reg. § 1.141-3(b)(6), an arrangement that results in the sponsor being treated as the lessee or owner of the bond-financed property for federal income tax purposes will give rise to private business use of the bond-financed property. Research means basic research or the original investigation of scientific knowledge not having a specific commercial objective. Product testing supporting nongovernmental trades or businesses is not basic research.

2. Revenue Procedure 2007-47. Revenue Procedure 2007-47 ("Rev. Proc. 2007-47", which superseded Revenue Procedure 97-14), contains two safe harbors for research agreements. The first is for "corporate-sponsored" research agreements. Under this safe harbor, any licensee of the sponsor is permitted to use the results of research only on the same terms which the owner of a bond-financed facility would permit use by an unrelated party. In other words, the sponsor must pay a competitive price for the right to use the results of the research funded by that sponsor, and the price must be determined at the time the technology is available for use.

The second safe harbor is for industry or federally-sponsored research agreements in which one or more sponsors agree to fund basic research. This safe harbor requires that (1) the research to be performed and the manner in which it is to be performed be determined by the owner of the bond-financed property (*i.e.*, the governmental person), (2) title to any product resulting from the research lies exclusively with the issuer and (3) the sponsors be entitled to no more than a nonexclusive, royalty-free license to use the product of that research. Rev. Proc. 2007-47 provides that the rights of the federal government under the Bayh-Dole Act will not cause an arrangement to fall out of second safe harbor so long as (1) and (2) are met and the license to use any resulting product of the research granted to any third party is no more than a "nonexclusive, royalty-free license."

3. Private Letter Rulings.

a. PLR 200347009. Interprets Rev. Proc. 97-14 to conclude that a license agreement will cause an issue of bonds to meet the private business use tests where a corporation was given an exclusive, perpetual, non-terminable, worldwide license to all of the research created at the bond-financed facility and the exclusive right to sublicense the research to any person of the corporation's choice.

b. PLR 200309003. Organization's research contracts with two agencies of the federal government do not give rise to either private business use or federal guarantee where neither of the agency contracts requires that the organization perform any activities at the facility, and the facility will not be constructed to meet the specific needs of the federal agencies.

c. PLR 199914045. Federal research contracts do not give rise to private business use or federal guarantee where research is basic and is not generally being used a

specific commercial objective and the availability of federal revenues is not dependent upon a default on debt service payments.

E. Output Contracts. Certain output contracts (including take-or-pay and take-and-pay arrangements) can give rise to private business use. Output contracts relate to output facilities, which are electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. On September 19, 2002, the IRS released final output regulations which generally apply to bonds sold on or after November 22, 2002. The output regulations contain special rules to determine whether arrangements for the purchase of output from an output facility (including water facilities) cause an issue of bonds to meet the private business tests. A detailed description of these rules is set forth in Section VII of this outline. Note, however, that the rules of Treas. Reg. § 1.141-3 still apply for non-output types of uses of an output facility (*e.g.*, pursuant to a management contract or lease).

1. In PLR 201037006, under facts similar to PLR 200915002, the IRS concluded that the sale of "renewable energy certificates" under contract did not result in private business use. The private letter ruling explained that a number of states are now imposing mandatory compliance programs that require some or all electric utilities providing service within those states to demonstrate that a specific portion of their electric supplies are derived from renewable generating resources. Many states imposing such standards allow utilities to meet those requirements by purchasing renewable energy certificates ("RECs"). The RECs represent the environmental attributes of renewable energy, with one REC representing the attributes for one MW hour generated by a renewable energy resource.

The issuer was a public instrumentality that had the authority to acquire, construct, and operate electric generating facilities, to sell electricity generated by such facilities, and in connection with such activities it issued tax-exempt governmental bonds to finance an electric generating project that would give rise to RECs. The issuer will sell all output from the bond-financed facility to a company, which is not currently subject to the REC requirements. The issuer proposed to enter into contracts with nongovernmental purchasers that would require the purchaser to buy the lesser of the stated amount of RECs or all of the RECs associated with the project's generation of electricity for the period stated. The IRS emphasized that the sale of RECs did not entitle the purchaser to any electric energy from the project, that although the contract provides for liquidated damages in the event of non-delivery of RECs to purchaser, the issuer had exclusive control over the project and its operations, and that because it was unlikely that the purchaser would be awarded specific performance for issuer's nonperformance under the contract, purchaser could not use legal or equitable remedies to force issuer to operate the facility at any particular level.

2. In PLR 200915002, the IRS concluded that the sale of RECs generated with respect to a bond-financed output facility did not give rise to private business use, because the purchasers of the RECs received no right to use the output property and the RECs did not represent capacity generated by or use of the property.

3. PLR 200739005 concludes that the private business use test was not met where an agreement granted a private utility the rights to all of the capacity and output of a bond-financed generating plant in exchange for agreeing to provide a public water provider with a certain

amount of energy at all times, reasoning that the agreement met the so-called "swapping agreement" safe-harbor of Treas. Reg. § 1.141-7(f)(2).

F. General Public Use.

1. General. Private business use does not include use as a member of the general public. Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available, and in fact is reasonably available, for use by natural persons not engaged in a trade or business.

2. Use on the Same Basis. Use of the financed facility under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Rates that are generally applicable and uniformly applied do not convey priority rights. Rates may be treated as generally applicable and uniformly applied, even if (i) different rates apply to different classes of users, if the differences in rates are customary and reasonable; and (ii) a specially negotiated arrangement is entered into, but only if the user is prohibited by federal law from paying generally applicable rates and the terms of the arrangement are as comparable as reasonably possible to the generally applicable rates.

3. 200 Day Use Arrangements. General public use property may be subject to an arrangement for temporary exclusive use of up to 200 days, including all renewal options. A right of first refusal to renew is not included in the term of the arrangement if the renewal price is at generally applicable fair market value rates and the use of the property under the same or similar arrangements is predominantly by natural persons not engaged in a trade or business. The maximum number of days permitted usage under this exception is absolute, and not a per-year limit; therefore, a contract that contemplates 50 days use every year for 5 years would not satisfy this use exception.

G. Special Rules for Affordable Care Organizations.

1. Notice 2014-67 provides specific relief for 501(c)(3) organizations participating in "accountable care organizations" ("ACOs").

2. The Notice provides interim guidance regarding private business use of tax-exempt bond-financed facilities that are used by "accountable care organizations" under the Patient Protection and Affordable Care Act (the "ACA"). The ACA created the "Shared Savings Program" to achieve efficiencies in providing medical care under Medicare through cost savings, improved coordination of services, and investment in infrastructure. This program contemplates that 501(c)(3) organizations could enter into an ACO with physicians or other health care group practices, a network of individual practices, or a partnership or joint venture. The ACO is required to be a separate legal entity, must share "governance" as provided in the ACO guidance, and must distribute Shared Savings Program payments. The arrangement promoted by one federal program raised obvious concerns for 501(c)(3) health care organizations because it would likely be treated as a "partnership" under the private activity bond regulations or potentially give rise to net profits which would take the arrangements out of the management contract safe harbor guidelines.

3. The Notice states that the participation of an organization in the Shared Savings Program through an ACO will not result in private business use of a tax-exempt

bond-financed facility used by the organization or ACO if the following conditions are met: (a) The Centers for Medicare & Medicaid Services has accepted the ACO into the Shared Savings Program, and the ACO has not been terminated from the program, (b) The terms of the organization's participation in the Shared Savings Program through the ACO are established in a written agreement negotiated at arm's length. (c) The organization's share of economic benefits derived from the ACO (including payments received under the Shared Savings Program) is proportional to the benefits or contributions the organization provides to the ACO. If the organization receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO, and all ACO returns of capital, allocations, and distributions are made in proportion to ownership interests. (d) The organization's share of ACO losses does not exceed the share of ACO economic benefits to which the organization is entitled in (c) above. (e) All contracts and transactions entered into by the organization with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value. (f) The organization does not contribute or otherwise transfer the tax-exempt bond-financed property to the ACO unless the ACO is an entity that is a "governmental person" or, in the case of 501(c)(3) bonds, either a "governmental person" or a "501(c)(3) organization," as such terms are defined for tax purposes.

4. The ACO provisions apply to bonds sold on or after January 22, 2015, but may also be applied to bonds sold before that date. There is no specific election to apply the provision to bonds issued before the effective date

H. Other Exceptions.

1. General. Treas. Reg. §1.141-3(d) provides additional exceptions to private business use for use of bond-financed property by an agent, use incidental to financing arrangements, certain short-term uses not involving ownership by a nongovernmental person (see below), certain temporary use of bond-financed property by developers (see below), "incidental use" and use of proceeds to provide "qualified improvements" (see below).

2. Certain Short-term Arrangements. Certain short-term arrangements for the use of bond-financed property not involving the ownership of the property by a nongovernmental person will not result in private business use.

a. Permitted 100 Day Arrangements. An arrangement for the use of bond-financed property by a nongovernmental person will be permitted for a period of up to 100 days (including renewal options), if the arrangement would be treated as general public use, except that (i) the property is not available for use by natural persons not engaged in a trade or business, and (ii) the property was not financed for the purpose of providing the property to that nongovernmental person.

b. Permitted 50 Day Arrangements. An arrangement for the use of bond-financed property by a nongovernmental person will be permitted for a period of up to 50 days (including renewal options), if (i) the arrangement is a negotiated arm's length arrangement, (ii) the compensation is at fair market value, and (iii) the property was not financed for the purpose of providing the property to that nongovernmental person.

c. These permitted number of day arrangements are applied as described in F.3. above, by reference to the total number of days of use contemplated over the life of the contract, not by reference to the term/duration of the contract.

3. Temporary Use by Developer. Use by developer of a bond-financed improvement that carries out an essential governmental function during an initial development period will not give rise to private business use if the issuer and developer reasonably expect to proceed with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

4. Incidental Use and Qualified Improvements.

a. Incidental Use. Non-possessory uses of a financed facility that in the aggregate do not involve more than 2.5% of the facility may be disregarded for the purposes of determining private business use if the non-possessory use is not functionally related to some other use of the facility by the same person (e.g., pay telephones, vending machines, advertising displays and use for television cameras).

b. Qualified Improvements. Proceeds that provide "qualified improvements" are not used for private business use. Qualified improvements are governmentally-owned improvements to an existing governmentally-owned building, where the building was originally placed in service more than 1 year before the improvements are acquired or constructed, the improvements do not involve an enlargement of the building or an improvement of interior space used exclusively for a private business use, the improved building is not pledged as security for the bonds and not more than 15% of the improved building is used for private business use.

I. Special Rules for Tax Assessment Bonds. A deemed loan in a tax assessment bond situation is ignored for the purposes of the private loan financing test if the tax assessment bond financing satisfies the requirements of Treas. Reg. §1.141-5(d) (relating to tax assessment bond financings that are permitted under the tax assessment bond exception to the private loan financing test). *See* Section V below.

J. Measurement of Private Business Use.

1. General. The amount of private business use of property is determined according to the average percentage of private business use during the measurement period. In general, the measurement period begins on the later of the issue date or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property. The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. (If the private business use arises from ownership by a nongovernmental person or if the bonds are outstanding longer than reasonably necessary, the amount of private business use is the greatest percentage of private business use in any 1-year period.)

Under Treas. Reg. §§1.141-3(g)(3) and (4), the measure of private business use in any year generally is the average percentage of private business use to total actual use (disregarding periods of non-use of bond-financed property) in that year. The measure of such use over the entire measurement period is based on the average of the annual percentages of such use. The focus on average annual use instead of some present value computation is administratively easier. The disregard of non-use, however, while perhaps theoretically sound, can increase administrative tracking burdens for states and local governments because it can produce a frequently-changing denominator in the private business use percentages. It would seem equally sound from a tax policy standpoint and administratively easier to treat unused portions of bond-financed property for which a governmental unit is economically responsible as governmental use.

a. Uses at Different Times. For property used for private business use and governmental use at different times, the average amount of private business use generally is based on the amount of time that the property is used for private business use as a percentage of total time for all actual use. "Dark time" is disregarded.

b. Simultaneous Use. If property is used for governmental use and private business use simultaneously, the entire facility is treated as having private business use; however, if the governmental use and private business use is on the same basis, the average amount of private business use may be determined on a reasonable basis that reflects the proportionate benefit to be derived by the various users of the facility.

c. Common Areas, Neutral Costs. The amount of private business use of common areas is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. Neutral costs must be allocated ratably among the other purposes for which the proceeds are used.

d. Discrete Portion Use. In measuring private business use of a discrete portion of a facility, discrete portions are treated as separate facilities. For example, a discrete portion includes a floor of a building or a portion of a building separated by walls.

2. Commencement of Use. Private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if ownership or other long-term use is involved, and the issuer enters into an "arrangement" for private business use for a substantial period (10% of measurement period) before the right to actual use commences, private business use commences on the date of the arrangement.

3. Fair Market Value. If private business use is reasonably expected as of the issue date to have a significantly greater fair market value than governmental use, the average amount of private business use must be determined according to the "relative reasonably expected fair market values" of use. The determination of relative fair market value may be made as of the date the property is acquired or placed in service if this determination is not reasonably possible on the issue date. "Relative reasonably expected fair market value" must be determined by taking into account the amount of reasonably expected payments for private business use in a manner that properly reflects the proportionate benefit to be derived from the private business use.

4. Private Letter Rulings.

a. PLR 200323006. Governmental entity's sale of naming rights to stadium meets private business tests. *See* description of private letter ruling at III.B.6. above.

b. PLR 200304015. The bond portion of the cost of constructing a stadium eligible to be financed with the proceeds of a tax-exempt bond issue was determined based upon (i) an allocation method reflecting physically discrete areas and corresponding common area costs; and (ii) an allocation method reflecting relative temporal units of use and the corresponding common area costs.

c. PLR 200132017. A university research facility that is used for both private business use and Section 501(c)(3) use may determine the portion of the facility used for Section 501(c)(3) use based on the ratio of revenue from non-private business use to total research revenue.

K. Treatment of Partnerships.

1. General Rule. Final Allocation Regulations § 1.141-1(e) provides that a partnership "is treated as an aggregate of its partners, rather than as an entity." These Regulations provide flexibility to both state and local government and 501(c)(3) organizations to, in certain instances, finance, with tax-exempt obligations, such entity's "partner's share" of property owned by a partnership. Treas. Reg. § 1.141-3(g)(2)(v).

2. Partner's Share Determination. The Final Allocation Regulations (defined below under Section VI.A) provide that the amount of private business use by a nongovernmental person of property resulting from a partnership is that nongovernmental "partner's share" of the amount of use of the property by the partnership. Treas. Reg. §1.141-3(g)(2)(v). A "partner's share" is defined as the "nongovernmental partner's greatest percentage share under section 704(b) of any partnership item of income, gain, loss, deduction, or credit attributable to the period that the partnership uses the property during the measurement period." Treas. Reg. §1.141-3(g)(2)(v) clarifies that if a partnership item varies, then the "partner's share" will be the highest percentage, and Treas. Reg. §1.141-3(g)(2)(B) provides that guidance may be published in the Internal Revenue Bulletin to assist issuers in determining a "partner's share." Clarification is needed that mandatory allocations under Code Section 704(b) of the Code and the Treasury Regulations promulgated thereunder that, similar to the alternative depreciation system rules for tax-exempt use property under Code Section 168(h)(6), issuers can disregard such mandatory allocations that otherwise comply with relevant Code and regulation provisions.

IV. PRIVATE SECURITY OR PAYMENT TEST - SECTION 1.141-4

A. General Rule.

1. Private Security. The private security portion of the private payment or security test takes into account the payment of any debt service on the issue that is directly or indirectly secured by any interest in (i) property used or to be used for private business use; or (ii) payments in respect of property used or to be used for a private business use.

2. Private Payment. The private payment portion of this test takes into account the payment of any debt service on the issue that is directly or indirectly to be derived from

payments (whether to the issuer or to any related party) in respect of property, or borrowed money, used or to be used for private business use.

3. Aggregation of the Two Tests.

Payments taken into account as private payments and payments or property taken into account as private security are aggregated for the purposes of determining whether private security and/or payments exceed 10% (or in certain cases, 5%) of the debt service on the bonds, provided that no payment is taken into account under both prongs of the test.

4. Underlying Arrangement. Payments include payments made pursuant to an underlying arrangement and may result from agreements among the parties or may be based on facts and circumstances surrounding the issuance of the bonds. The Regulations give an example (Treas. Reg. §1.141-4(g), Example 2) of debt service being secured by a full faith and credit pledge and interest in property used in private business use. *See also* Revenue Ruling 80-251 and Revenue Ruling 73-481, in which, because only tax increments secured the bond issue, the pre-1986 "security interest" test was failed. Compare Revenue Rulings 80-251 and 80-339, which made inroads to the liberal conclusion of Revenue Ruling 73-481, demonstrating the concept of "underlying arrangement."

B. Measurement of Private Security and Payments.

1. Private Security. For purposes of determining the present value of debt service secured by property, such property is valued at its fair market value as of the first date on which such property secures the bond issue.

2. Private Payment. The present value of any payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

a. General. Debt service on the issue does not include any amount paid or to be paid from sale proceeds or investment proceeds of the issue (*e.g.*, capitalized interest, earnings on a debt service reserve fund applied to the payment of debt service, etc.). Debt service on the issue is adjusted to take into account payments and receipts that adjust the yield on the issue for the purposes of Code Section 148(f) (*e.g.*, qualified guarantee fees). The yield on the issue is used as a discount rate for the purposes of computing present values. In general, yield is determined on the issue date and is not adjusted to take into account subsequent events. For a variable issue yield, the issuer may assume the future interest rate on the variable yield bonds,.except as described below.

b. Deliberate Actions and Variable Yield Issues. Deliberate actions require a recomputation of the variable issue's yield, determined as of the date of the deliberate action, for purposes of determining the present value of the payments to be made pursuant to the arrangement that constitutes the deliberate action.

(i) The Regulations appear not to require a recomputation of the present value of payments made and to be made pursuant to the original arrangement in place prior to the deliberate action. Although Treas. Reg. §1.141-4(g), Example 3, which demonstrates the principle of recomputing the yield for purposes of calculating the present value of payments to be

made under the new arrangement giving rise to the deliberate action, does not explicitly address this point, its silence suggests that the present value of the payments made under the original arrangement are not changed. Additionally, the language in Treas. Reg. §1.141-4(b)(iii)(C) appears to support that conclusion.

(ii) If the deliberate action consists of the modification of the original arrangement (*e.g.*, the leasing of an additional floor to an existing tenant) rather than the issuer's entering into an arrangement with a separate person (as in Example 3), it is not clear whether the present value of payments already made under the original arrangement must be recalculated.

C. Private Payments.

1. General. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user (*e.g.*, parking fees paid by members of the general public for use of a parking garage that is managed under a nonqualifying management agreement constitute payments taken into account).

2. Payments Not to Exceed Use.

a. General. Payments with respect to proceeds used for a private business use are not taken into account to the extent that the present value of the payments exceeds the present value of the debt service on those proceeds.

b. Allocation Based on Time. Payments are taken into account only to the extent they are made for the period of time proceeds are used for a private business use. For example, payments made by the general public to attend events at a governmentally owned stadium would be taken into account only to the extent allocable to the periods in which there is private business use. Payments for events involving performers who are not considered private business users (e.g., due to the short length of their arrangement) would not be taken into account.

3. Scope of Payments. Payments for a use of proceeds include "payments of debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property ... used or to be used for a private business use". Treas. Reg. §1.141-4(a)(1).

a. History: 1986 Blue Book. This point historically received much debate. The 1986 Tax Act's Blue Book suggested that only payments actually made by private persons are taken into account. *See Blue Book,* p. 1161: "Payments from persons who are not treated as using the bond proceeds under the trade or business use test, described above, are not counted unless the payments are pledged to pay debt service or otherwise satisfy the prior-law security interest test."

b. Post-1986 Practice. This question came up frequently in the context of land-based financings *(e.g.*, special assessment bonds), in which payments were clearly being made by the general public, and also tended to arise with respect to convention centers, stadiums and the like.

c. Regulations Example. Treas. Reg. §1.141-4(g), Example 5, illustrates the position of the IRS. In that example, hospital is managed pursuant to a nonqualified management contract that results in private business use. Hospital revenues are treated as payments in respect of property used for a private business use. *See also* PLR 200026020 wherein sewage ratepayers are similarly situated to the patients paying for hospital services in Treas. Reg. §1.141-4(g), Example 5, with the consequence that their payment results in private payments.

d. Payments Not in Respect of Financed Property: Utility Relocation. Treas. Reg. §1.141-4(g), Example 4 addresses the relocation of utility lines. There, the theory was that, although the utility lines are privately owned and the utility customers whose property was being assessed make payments to the utility company for the use of the utility lines, the assessments were payments in respect of the cost of relocating the utility lines, and not the cost of the lines themselves.

4. "Fair Market Value of Other Property" Carve-Out. The Regulations provide that payments are not considered made in respect of financed property if those payments are directly allocable to other property directly used by the payor and the payments represent fair market value compensation for the other use. For example, if a person has been previously using city-owned property that was not bond-financed and has been paying fair market value rent for the use of such property, if the city then bond finances a different piece of property which it rents to such person, the amount of previously payable rent will continue to remain allocable to the pre-existing property.

5. The "Use Cap". Payments with respect to proceeds used for a private business use are not taken into account to the extent the present value of the payments exceeds the present value of debt service on those proceeds. Since the present value of debt service on proceeds will roughly equate to the amount of the proceeds, the amount of the proceeds used for the private business use will serve as a cap on the amount of payments taken into account. This would appear to be relevant only in the context of multiple uses, where the application of the cap would prevent the "crossing over" of payments to a different use.

6. Operating Expenses. Ordinary and necessary expenses (as defined under Code Section 162) directly attributable to the operation and maintenance of the financed property may be used to offset payments paid for the use of proceeds. General overhead and administrative expenses may not be taken into account for these purposes.

7. Refinanced Debt Service.

a. General. Payments of debt service on an issue to be made from the proceeds of a refunding issue will be treated as involving private payments in the same proportion as the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on a refunding issue. However, deliberate actions taken more than 3 years after the retirement of the refunded issue that are not reasonably expected on the issue date of the refunding issue, will be disregarded for the purposes of the refunded issue.

b. Example. If all debt service on a note is paid with the proceeds of a refunding issue, the note meets the private security or payment test if and to the extent the refunding issue meets the private security or payment test. To determine whether an issue is a refunding issue for this purpose, the exception in Treas. Reg. §1.150-1(d)(2)(i) (relating to the payment of interest) does not apply.

8. Allocation of Payments.

a. General. The allocation of private payments to the source or sources of funding is based on all the facts and circumstances. In general, this allocation is based upon the nexus between the payment, the financed property and the source of funding.

b. PLR 200747009. Payments of net operating revenues and certain reserves were properly allocable first to certain revenue bonds and equipment leases issued by a state port authority and thus did not cause other bonds issued to finance the same construction to meet the private security and or payment test.

c. Discrete Property. Payments for the use of a discrete facility are allocated to the sources of funding for that facility.

d. Multiple Sources of Funding. In general, a payment made for the use of property financed from two or more sources must be allocated to those sources in a manner that reasonably corresponds to the relative amount of those sources. A payment made for the use of property allocated to two or more issues may be allocated to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if this allocation reflects economic substance (*e.g.*, the maturity of bonds reflects' economic life of property, and the debt service is approximately level from year to year).

e. Issuance Arrangements. A private payment for the use of property made under an arrangement entered into in connection with the issuance of bonds that finances the property generally is allocated to the issue.

f. Allocations to Equity. A private payment may be allocated to equity before allocation to an issue, only if (i) the issuer adopts an official intent not later than 60 days after an expenditure indicating that the issuer reasonably expects to be repaid from a specific arrangement; and (ii) the private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

D. Private Security.

1. Security Taken Into Account.

a. General. Property used or to be used for private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. The property involved need not be financed with the proceeds of the bonds. Proceeds qualifying for an initial temporary period under Treas. Reg. §1.148-2(e)(2) or (3) or a deposit to a reasonably required reserve or replacement fund described in Treas. Reg. §1.148-2(f)(2)(i) are not taken into account before the date on which those

amounts are either expended or loaned by the issuer to an unrelated party. Private security (other than financed property and private payments) is taken into account only to the extent it is provided, directly or indirectly, by a user of the proceeds.

b. Treas. Reg. §1.141-4(g), Example 9. Example 9 demonstrates the principle that property used need not be financed to be private security and sheds light on determining whether obligations are "secured by an interest in property" (note the Code's language and see below). In the example, County W issues certificates of participation in a lease of a building it owns (an "asset-transfer" lease) and covenants to appropriate annual payments for the lease. More than 10% of the building is used in a private business use. None of the proceeds of the COPs are used with respect to the building but are granted to Corporation Y for the construction of a factory Y will own. Y makes no payments to W and has no relationship with the users of the building securing the COPs. If W defaults under the lease, the trustee for the COP holders has a limited right of repossession under which the trustee may lease the property to a new tenant at fair market value. The example concludes that the COPs are secured by an interest in property used for a private business use. The private security or payment test is not met, however, because the property, which is not being financed by the COPs, is not provided by a private business user.

2. Payments In Respect of Property. The payments taken into account as private security are payments in respect of property used or to be used for private business use. Payments need not be made by the private business user (*e.g.*, payments by persons using a facility that is the subject of a management contract that results in a private business use). Except as provided in paragraph 3 below, in general, the present value rules described above for private payments apply to determine the amount of payments treated as payments in respect of property used or to be used for private business use. *See* PLR 201519015 where the IRS held that the fare revenues collected by an issuer for bus service along a route subject to a nonqualifying management contract under Rev. Proc. 97-13, were not payments in respect of the managed lanes under Code Section 141(b)(2)(B).

3. Allocation of Security among Issues. Property or payments that are taken into account as a private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholder's rights to the payments or property upon default.

E. Generally Applicable Taxes.

1. General. Generally applicable taxes are not taken into account for the purposes of the private security or payment test.

2. Definition of Generally Applicable Taxes. A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental or public purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction, and a generally applicable manner of determination and collection. Payments for special privileges, services or special benefit assessments are not generally applicable taxes.

3. Manner of Determination and Collection.

a. General. A tax does not have a generally applicable manner of determination and collection (and is therefore not a "generally applicable tax") to the extent that one or more taxpayers make impermissible agreements relating to payment of those taxes. An impermissible agreement relating to the payment of a tax is taken into account whether or not it is reasonably expected to result in payments that would not otherwise have been made. If an issuer makes a grant of proceeds to a taxpayer to improve property, agreements that impose reasonable conditions on the use of the grant do not cause a tax on that property to not be a generally applicable tax. If an agreement by a taxpayer causes the tax imposed on the taxpayer not to be treated as a generally applicable tax, the entire tax paid by that taxpayer is treated as a special charge unless the agreement is limited to a specific portion of the tax.

b. Examples of Impermissible Agreements:

(i) An agreement to be personally liable on a tax that does not impose personal liability, to provide additional credit support such as a third-party guarantee or to pay unanticipated shortfalls;

(ii) An agreement regarding the minimum market value of property subject to property tax; and

(iii) An agreement not to challenge or seek deferral of the tax.

c. Examples of Permissible Agreements:

(i) An agreement to use a grant for specified purposes (whether or not that agreement is secured),

(ii) A representation regarding the expected value of the property following the improvement;

(iii) An agreement to insure the property and, if damaged, to restore the property;

(iv) A right of a grantor to rescind the grant if property taxes are not paid; and

(v) An agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose.

F. Payments In Lieu of Taxes ("PILOTs").

1. General. On October 24, 2008, the Treasury Department released final Regulations governing the private payment treatment of PILOT payments (the "PILOT Regulations"). Recall that under Treas. Reg. §1.141-4(e)(1) for purposes of the private security or payment test, generally applicable taxes are not payments from a nongovernmental person and are not payments in respect of property used in a private business use. See IV.E of this outline. Thus,

the purpose of the generally applicable taxes exception is to allow eligible tax payments made with respect to property or services to be used to pay debt service on an issue without causing private payments.

The PILOT Regulations conclude that PILOTs are treated as generally applicable taxes if and only if both (i) the payments are commensurate with and not greater than the amounts imposed by the statute for a tax of general application and (ii) the payments are designated for a governmental or public purpose and are not special charges. *See* Treas. Reg. §1.141-4(e)(5).

2. Commensurate Standard.

By retaining a restrictive "commensurate" standard, the PILOT Regulations take a conservative approach to ensuring a close relationship between eligible PILOTs and generally applicable taxes. The PILOT Regulations do not prohibit any use of PILOTs to pay debt service, but provide instead that a PILOT is commensurate with a generally applicable tax only if it is equal to a fixed percentage of the generally applicable tax that would otherwise apply in each year or it reflects a fixed adjustment to the generally applicable tax that would otherwise apply in each year.

A PILOT based upon a property tax must take into account the current assessed value of the property for property tax purposes for each year in which the PILOT is paid and that assessed value must be determined in the same manner and with the same frequency as property subject to the property tax.

A PILOT is not commensurate with a generally applicable tax if the PILOT is set at a fixed dollar amount (e.g., equal to the fixed debt service on a bond issue) that cannot vary with changes in the level of the generally applicable tax on which the PILOT is based.

Under the PILOT Regulations, PILOTs are commensurate even though the amount of the PILOTs are adjusted to accommodate the development, construction or initial start-up periods for the financed project.

3. Public Purpose Standard.

The Preamble to the PILOT Regulations and the text of the PILOT Regulations state that the underlying generally applicable tax upon which the PILOT is based be for public or governmental purposes. The PILOT Regulations require that use of an eligible PILOT be for the governmental or public purposes for which the underlying generally applicable tax on which the PILOT is based.

4. No Special Charges Requirement.

a. Examples of Special Charges. Special charges are not generally applicable taxes. The PILOT Regulations provide that a special charge includes (i) a payment for a special privilege granted or regulatory function (e.g., a license fee), (ii) a service rendered (e.g., a sanitation services fee), (iii) a use of property (e.g., rent), or (iv) a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons

based on benefits received from the capital improvements financed with the assessment (e.g., amounts charged for sidewalks, streets, streetlights or utility improvements on property owners in a defined area such as an industrial park).

b. Examples of what is Not a Special Charge. By contrast to the list of special charges above, a PILOT based upon an otherwise-qualified generally applicable tax (e.g., a generally applicable ad valorem tax on all real property within a governmental taxing jurisdiction) is not treated as a special charge merely because the PILOTs received are used for governmental or public purposes in a manner that benefits particular property owners.

c. Existence of Tax-Exempt Bonds Not Relevant for Special Charges Determinations. The PILOT Regulations remove the example in the last sentence of Treas. Reg. §1.141-4(e)(5)(ii) of the prior regulations that stated "[f]or example, a payment in lieu of taxes made in consideration for the use of property financed with tax-exempt bonds is treated as a special charge". This sentence was removed as a technical clarification rather than a substantive change. The Preamble to the PILOT Regulations states that the substantive determination of whether a payment is or is not a special charge (e.g., is a payment for the use of property such as rent) or is a generally applicable tax does not depend upon the presence or absence of tax-exempt bond financing.

5. Effective Dates.

a. General. The PILOT Regulations generally apply to bonds sold on or after October 24, 2008.

b. New Money Project Transition Exception. The prior Regulations apply to new money projects substantially in progress if (i) a governmental person took official action evidencing its preliminary approval of the project to be financed before October 19, 2006, and the plan of finance for the project contemplated PILOTs as security for the bonds, (ii) before October 19, 2006, significant expenditures were paid or incurred with respect to the project or a contract was entered into to pay or incur significant expenditures with respect to the project, and (iii) the bonds for the project (excluding refunding bonds) are issued on or before December 31, 2009.

c. Refunding Exception. The prior Regulations apply to refunding bonds if either (i) the refunded bonds (or the original bonds in a series of refundings) were sold before October 24, 2008, or (ii) the refunded bonds (or the original bonds in a series of refundings) satisfied the project transition exception and (iii) the weighted average maturity of the refunding bonds does not exceed the remaining weighted average maturity of the refunded bonds.

6. Private Letter Rulings. PLR 200640001 (Yankees) and PLR 200641002 (Mets) provide that payments in lieu of taxes made by a private party in connection with the use of baseball stadiums in New York City do not constitute private payments or private security with respect to bonds issued by an agency of the State of New York to finance construction of those baseball stadiums. Because the PILOTs in question are designated for the public purposes of promoting tourism and economic development and are calculated with respect to generally applicable ad valorem taxes, they are "commensurate with" the amounts otherwise imposed by

statute and do not constitute a special charge as defined in Treas. Reg. §1.141-4(e)(5). It is not at all clear that these private letter rulings would have been issued if subject to the PILOT Regulations.

PLR 201246007 (assessment bonds) and its companion PLR 201246032 (lease revenue bonds), provide that assessment bonds and lease revenue bonds issued by an authority to finance the construction of a new convention center wing to be solely owned by a municipality did not satisfy the private loan test where the assessment bonds would be payable from assessments levied on the property of a private company despite such private company's contractual agreements with the municipality, to among other things, construct the new wing, lease the event center, certain related parking and the stadium, and enter into a signage agreement. The IRS held that no direct loan of the proceeds existed and the transaction did not convey to the private company benefits that were the economic equivalent of a loan of the proceeds of the bonds.

PLR 202144007 provides that a portion of the rates and charges to be paid by customers that are private business users of an Agency's water supply system will be treated as private payments where the agency applies bond proceeds to fund costs of replacing lead services lines with copper service lines owned by such customers. The IRS noted that the only way to eliminate health risks from lead leaching into the water pipes owned by residential and commercial customers is to remove the lead service lines and replace them with copper service lines. The Agency will replace such lines for both residential and commercial customers, including residential customers that treat their homes as rental property or residential customers operating a business from their homes. The Agency's customers will own the replacement lines. The Agency will issue the bonds to pay costs of such lead service line replacements and other capital costs of its water supply system. The Agency will not impose special charges on customers who receive lead service line replacements and instead will use the rates and charges that it imposes on all of its customers to pay such costs, including debt service on the bonds that fund such replacement costs and other projects. No property financed by the bonds, other than the replacement service lines serving customers that are private business users, will be used for a private business use. The IRS held that payments of rates and charges by customers that receive lead service pipe replacements and are private business users are, in part, private payments for the bonds to the extents such payments are attributable to the costs of replacing the lead service lines, but because the payments that are both received from customers that are private business users of the lead pipe replacements and attributable to costs of such lead pipe replacements do not exceed 10 percent of the debt service on the bonds, the bonds do not meet the private security or payment test.

G. Waste Remediation Bonds.

1. Persons that are Not Private Business Users. Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste from that site are not taken into account as private security. Payments must be made pursuant to either (i) a generally applicable state or local tax statute or (ii) a state or local statute that regulates or restrains activities on an industry-wide basis for persons who are engaged in generating or handling hazardous waste,

or in refining, producing or transferring petroleum, provided that those payments do not represent in substance payments for the use of proceeds.

2. Persons that Are Private Business Users. If the payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on a site do not secure the payment of the principal of or the interest on a bond (directly or indirectly) under the terms of the bond, the payments are not taken into account as private payments, provided that at the time the bonds are issued, the payments from those nongovernmental persons are not material to the security for the bonds.

V. PRIVATE LOAN FINANCING TEST - SECTION 1.141-5

A. General Rules.

1. Elements of Test. The private loan financing test is met if more than the lesser of 5% or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. Treas. Reg. §1.141-2(d) (relating to reasonable expectations and deliberate actions) applies to the private loan financing test.

2. Amount of Loan. The amount actually loaned is not discounted to reflect present value of the loan repayments.

B. Definition of Private Loan.

1. General Federal Tax Principles. Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for the purposes of the private loan financing test. A loan may arise from the direct lending of bond proceeds as well as transactions in which the indirect benefits are the economic equivalent of a loan. For instance, a lease or other contractual arrangement may in substance constitute a loan if the arrangement transfers tax ownership of the facility to a nongovernmental person.

2. Non-purpose Investments; Prepayments. A loan that is a non-purpose investment does not cause the private loan financing test to be met. Except as otherwise provided in the Regulations, a prepayment for property or services is treated as a loan for the purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan if (i) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of a tax-exempt financing, (ii) the prepayments is made within 90 days of the reasonably expected date of delivery of the property or services for which the prepayment is made, or (iii) the prepayment satisfies special rules Treas. Reg. §1.141-1(e)(2)(iii) with respect to prepayments for the acquisition of a supply of natural gas or electricity.

4. Grants, Tax Increment Financing. A grant of proceeds is not a loan. A grant using proceeds of an issue that is secured by generally applicable taxes is not treated as a loan, unless the grantee makes an impermissible agreement that results in taxes not being treated as generally applicable as defined in Treas. Reg. §1.141-4(e). In such case, the entire grant is treated as a loan unless the impermissible agreement is limited to a specific portion of the tax.

5. Hazardous Waste Remediation Bonds. If payments from nongovernmental users of the site or potentially responsible persons do not secure payment of bonds and are not taken into account as private payments under Treas. Reg. §1.141-4(f)(3), no loan will be indicated.

5.

C. Tax Assessment Bond Exception.

1. General Rule. A tax assessment loan meeting the requirements of Treas. Reg. §1.141-5(d)(3)-(5) described below is not treated as a private loan.

2. Mandatory Tax or Assessment. The tax or assessment must be an enforced contribution that is imposed for the purpose of raising revenue to be used for a specific purpose, and the tax or assessment must be imposed pursuant to a state law of general application that "can be applied equally" to natural persons not acting in a trade or business and persons or entities engaged in a trade or business. Fees for services are not taxes or assessments.

3. Essential Governmental Function.

a. General. The tax or assessment must be imposed for an essential governmental function. Essential governmental functions include utilities or systems that are owned by a governmental person and that are available for use by the general public.

b. Other Facilities. The Regulations provide that for other types of facilities (non-governmentally-owned or non-publicly available facilities), the extent to which the service provided by the facility is customarily performed (and financed by governmental bonds) by governments with general taxing powers is a primary factor in determining whether the facility serves an essential governmental function (parks owned by a governmental person and available for use by the general public serve an essential governmental function). Except as otherwise provided, commercial or industrial facilities and improvements to property owned by a nongovernmental person do not serve an essential governmental function.

4. Equal Basis. Owners of business and nonbusiness property must be "eligible or required" to make deferred payments on an equal basis. A tax or assessment does not satisfy the equal basis requirement if the terms for payment are not the same for all taxed or assessed persons. The "equal basis" requirement will not be met if a person or entity subject to a tax or assessment guarantees debt service on bonds or on taxes or assessments provided that it is reasonable to expect on the date of the guarantee that payments will made under the guarantee.

5. PLR 201246007. In this ruling, the IRS concluded that assessment bonds issued in connection with the financing and construction of convention and exhibition facilities, which are located in the immediate area of existing convention center, parking facilities, a stadium and entertainment complex will not satisfy the private loan financing test. The assessment bonds are secured by and payable from assessments imposed by and payable from assessments imposed on certain interests in property related to the development that is held by a private company, which will end on the last year of the term of the bonds. The private company has agreed to pay such assessments in return for the extension of a stadium lease and for rights to locate advertising signage in certain parts of the development and the amount of the special taxes will correspond to

and be in lieu of fair market value payments that the private business user would otherwise make in exchange for the lease extension and signage rights. Based on these facts (and while it does not appear that the IRS directly addressed the tax assessment bond exception), the IRS concluded that the arrangement was not a private loan because "the special taxes...will be made in exchange for rights and benefits of equal or greater value." Presumably, the IRS viewed the payments not as a governmental tax imposed to finance a governmental function, but as compensation to the City for the benefits of the lease extension and signage rights.

VI. ALLOCATION AND ACCOUNTING RULES - SECTION 1.141-6

A. Final Allocation Regulations.

1. Background and Scope. The 1997 private activity bond regulations reserved substantial portions of the rules pertaining to the allocation of and accounting for bond proceeds under Code Section 141. Proposed regulations were subsequently issued addressing, among other things, the allocation of bond proceeds under Code Section 141. On October 27, 2015, the Treasury Department published final regulations under Code Section 141 that, among other things, modified general rules under Treas. Reg. §1.141-6 relating to the allocation of bond proceeds to expenditures, and in particular, the allocation of bond proceeds and other moneys applied to pay costs of the same project among qualified use and private use of that project (the "Final Allocation Regulations").[5] The Final Allocation Regulations generally apply to all bonds sold on or after January 25, 2016, however, under certain circumstances an issuer may elect to apply the final regulations adopted on October 27, 2015, in whole, but not in part, to any bonds that are subject to the 1997 private activity bond regulations.

2. General Rule. In general, Treas. Reg. §1.141-6(a)(2) provides that if two or more sources of funding are allocated to capital expenditures for a "project," those sources are allocated to the governmental use and private use proportionally. In addition, Treas. Reg. §1.141-6(a)(1) provides that the allocations of proceeds and other sources of funds to expenditures under Treas. Reg. §1.148-6(d) apply for purposes of Treas. Reg. §§1.141-1 through 1.141-15. Thus, an issuer may use any reasonable accounting method to allocate proceeds to expenditures, provided that the current outlay of cash rule is met and that the accounting for expenditures takes place within the appropriate time period.

(a) Definition of "Project". Treas. Reg. §1.141-6(a)(3)(i) states that "project" means one or more facilities or capital projects, including land, buildings, equipment, or other property financed in whole or in part with proceeds of the issue.

(b) Timing Considerations. Treas. Reg. 1.141-6(a)(1) provides that the allocation of proceeds and other funds to expenditures under Treas. Reg. §1.148-6(d) applies for purposes of the allocation of proceeds and other sources of funds to expenditures under Treas. Reg. §1.141-6. Thus, an issuer must account for the allocation of proceeds to expenditures not later than eighteen (18) months after the later of the date the expenditure is paid or the project that is financed by the issue is placed in service, but in no event later than sixty (60) days after the fifth

[5] These regulations also addressed (i) the treatment of certain partnerships, and (ii) remedial actions, including "anticipatory remedial actions".

(5th) anniversary of the date the bonds are issued. This timing limitation may lead to anomalous results, particularly when project costs are paid following the expiration of such period.

The preamble to the Final Allocation Regulations specifically states that the definition of "Project" "permits an issuer in its bond documents to identify as a single project all of the properties to be financed by a single bond issue" and that "issuers may identify specific properties or portions of properties regardless of the properties' locations or placed-in-service dates." Issuers are given broad, but not unrestricted, latitude to identify the components of their "project." See Example 3 in Treas. Reg. §1.141-6(f), which provides that the financing of a hospital financed in 1998 and placed in service in 2001 is a separate "project" from an addition to the hospital financed with proceeds of bonds issued in 2017 and with other sources of funds.

An issuer may, under the Final Allocation Regulations, define any contemporaneous assets as being part of the same project so long as bond proceeds are being spent on capital costs of at least one of those assets. A broad definition of a "project" encompassing numerous unrelated facilities may dramatically complicate (1) the tracking of expenditures of proceeds and other sources of funds and (2) the tracking of governmental and private use. Issuers might adopt a practice of preliminarily declaring the scope of the project in a tax certificate or similar document and later adopt a final definition of the project no later than the final allocation of bond proceeds. Where a project is financed with more than one bond issue, it may be appropriate to make the final definition of the "project" no later than when the final allocation of bond proceeds is made with respect to the last bond issue financing the project.

It is unclear what happens if an issuer fails to specifically identity the "project" that is being financed. There may or may not be an implicit default rule that in the absence of the issuer defining the "project," the project will consist of all capital facilities financed in whole or in part with the proceeds of the bonds, based either upon a written allocation of the issuer or based on tracing the proceeds of the bonds to the capital facilities. In this default situation, qualified equity that is spent on the bond-financed capital facilities would also be treated as financing a portion of the "project."

3. Eligible Mixed-Use Projects.

(a) General. The Final Allocation Regulations contain provisions which provide that, in the case of an eligible mixed-use project, private business use of the project in each year is first allocated to qualified equity that financed the project, and only private business use of the project in excess of the percentage of qualified equity is allocated to the proceeds of the bonds.[6] Treas. Reg. §1.141-6(b)(1). For this purpose, an eligible mixed-use project is a project

[6] The allocation rules are meant to be consistent with the rules pertaining to the measurement of private use under Treas. Reg. § 1.141-3(g) in which private use is generally measured over the measurement period of a project based on the average percentage of private use in each annual period. This year-by-year rule does not permit a global allocation of qualified equity throughout the entire measurement period. For example, if 10% of the costs of a project is allocated to qualified equity, no more than 10% of a project may be allocated to qualified equity in any annual period. Thus, if 100% of a project is used in a private use in the first year, and 0% of the project is used in a private use in later years, all of the qualified equity would be allocated to private use in the first year, and all of the equity would be allocated to qualified uses in all subsequent years.

that is financed with bonds that when issued purported to be governmental bonds and with "qualified equity" and is wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner. Treas. Reg. §1.141-6(b)(2). In the case of an issue of qualified 501(c)(3) bonds, a 501(c)(3) organization, acting in furtherance of its exempt purposes, is treated as a governmental person. Questions arise whether a project that is initially financed with equity, together with taxable debt, such as a line of credit, taxable commercial paper or a long-term taxable bond, which is refinanced with tax-exempt proceeds, can be treated as a qualified mixed use project. The issuer may be able to establish that tax-exempt refinancing debt and the equity were spent pursuant to a common plan of financing if tax-exempt refinancing bonds are issued within 18 months after the project was placed in service. It would be helpful for the Service to clarify that in cases where tax-exempt debt is refinancing either interim or even permanent taxable financing the determination of whether a project is an eligible mixed use project should be tested as if the tax-exempt refinancing bonds were issued at the same time or times as the refinanced taxable debt was issued.

(b) Ownership test. The ownership test presents some concerns. It is unlikely that any "floating" qualified equity would be used with respect to a project where it is expected that some components are to be owned by a governmental entity and others by a nongovernmental entity. In such a case, where the private use would exceed 10%, an issuer would generally specifically allocate equity to the privately-owned facilities and would treat only the portion owned by the governmental unit as the "project". However, once an eligible mixed-use project has been financed, the issuer may later decide to sell some elements of that project. In such a case, the "mixed-use project", as defined in the Final Allocation Regulations, may not permit an issuer to permanently assign equity to that portion (reducing the percentage of qualified equity remaining for the portion of the project retained by the issuer). In addition, the issuer should have the opportunity to exercise a remedial action (including either redemption of bonds or alternate use of the disposition proceeds) or (if the numbers work) assign the equity to the portion of the project that is sold. It would be helpful in this instance for the Treasury Department to clarify that the "wholly owned" requirement only applies at the time the bonds are issued.

4. Qualified Equity.

(a) General Considerations. In order to be an eligible mixed-use project, a project must be financed with proceeds of bonds and with qualified equity. Qualified equity is comprised of proceeds of bonds that are not proceeds of tax-advantaged bonds and funds that are not proceeds of a borrowing that are spent on the same eligible mixed use project as proceeds of the bonds. Furthermore, the qualified equity must be spent on the project "pursuant to the same plan of financing (within the meaning of Treas. Reg. §1.150-1(c)(1)(ii))." Treas. Reg. §1.141-6(b)(4) adds restrictions on whether expenditures of qualified equity finance a project under the same plan of financing as a bond issue. These restrictions relate to the timing of the expenditure and are discussed in more detail below.

(b) Same Plan of Financing Requirement. The reference to Treas. Reg. §1.150-1(c)(1)(ii) is confusing. The provision does not provide guidance on when capital project

This inability to move equity across annual periods would pose difficulties where private business use is front loaded (due, for example, to holdover tenants).

expenditures are or are not pursuant to the same plan of financing. Single issues of tax-exempt bonds are often used for project components that are not proximate or functionally related, and a single plan of finance would not be limited to facilities that are proximate or functionally related, as is the case under certain of the examples in Treas. Reg. §1.150-1(c)(1). However, other than the timing restrictions found in Treas. Reg. §1.141-6(b)(4), there are no additional restrictions imposed by Treas. Reg. §1.150-1(c)(1)(ii). The timing restrictions are sufficient to cause the expenditures of qualified equity to be pursuant to a single plan of financing, but the IRS may need to clarify that the rules of Treas. Reg. §1.141-6(b)(4) are the only rules needed to assure that expenditures of qualified equity for a capital project are part of the same plan of finance as those financed by a bond issue.

(c) Expenditure Period Requirement. The Final Allocation Regulations also provide that qualified equity finances the same plan of financing only if the qualified equity pays for capital expenditures of the project within a specified time period. Treas. Reg. §1.141-6(b)(4) states that the time period begins on the date on which the capital expenditures would be eligible for reimbursement by proceeds of the bonds under Treas. Reg. §1.150-2(d)(2). Treas. Reg. §1.150-2(d)(2) describes the reimbursement period for reimbursement bonds. The reimbursement period generally begins between eighteen (18) months and up to three (3) years before the bonds are issued, depending on when the original expenditure is paid and when the related project is placed in service or abandoned. Treas. Reg. §1.141-6(b)(4) states that the determination of when the qualified equity period begins does not depend on whether the applicable bonds are actually issued as reimbursement bonds.

(d) Ambiguities in Expenditure Period Definition. Ambiguity arises when the text of Treas. Reg. §1.141-6(b)(4) is compared to the discussion in the preamble for the regulation. The preamble suggests that an expenditure that is to be counted as qualified equity must be an expenditure that can be reimbursed from the applicable bonds if the bonds were reimbursement bonds. An expenditure that can be reimbursed from a reimbursement bond must not only meet the timing requirement described in Treas. Reg. §1.150-2(d)(2) but must also be an expenditure for which an official intent was adopted, or which satisfies the *de minimis* exception or preliminary expenditures exception. The preamble does not limit its discussion to the specific timing rule that is referenced in Treas. Reg. §1.141-6(b)(4). Clarification that Treas. Reg. §1.141-6(b)(4) does not require the adoption of an official intent or satisfaction of the *de minimis* or preliminary expenditures exceptions and that the extended reimbursement period for *de minimis* and preliminary expenditures is applicable to the determination of qualified equity would be helpful.

A single project can be partially financed by multiple tax-exempt bond issues. If bond issues partially financing the project have different issue dates, the expenditure and placed in service dates may have different permitted timing intervals for the different bond issues. Neither the Final Allocation Regulations nor the preamble explains how to make a determination of qualified equity where proceeds of more than one issue finance an eligible mixed-use project. Assume, for example, that a project placed in service in 2016 is financed with equity contributed in 2012 and with proceeds of bond issue "A" issued in 2015 and bond issue "B" issued in 2016. Presumably, all equity should count towards qualified equity with respect to the project because the equity is contributed within the reimbursement period of the bonds issued in 2015. However, the Final Allocation Regulations are not entirely clear that, in a case such as this, the equity need

not simultaneously qualify within the reimbursement periods of both bond issues to be treated as qualified equity with respect to the project.

Under the Final Allocation Regulations, equity contributed to a project is not counted as "qualified equity" of a mixed-use project for purposes of the special allocation rule if it is contributed after the date on which the measurement period begins. Under Treas. Reg. § 1.141-3(g), the measurement period of property financed by an issue begins not later than the later of the date the bonds are issued or the date the property is placed in service. Thus, the financing of punch list items could need to be treated as a separate project from the remainder of the same capital improvement. The concept of placed in service is particularly difficult to apply in the context of equity contributions because equity contributions cannot necessarily be allocated to specific components of a "project" under the special allocation rule. Instead, equity may be contributed to the project generally. When a determination is made regarding the start of the measurement period for purposes of the special allocation rule, bond counsel may need to decide whether to rely on the placed in service date of the project as a whole or the placed in service dates of functionally separate components of a mixed-use project.

Equity that constitutes a "reasonable retainage" is, under an exception in Treas. Reg. §1.141-6(b)(4), eligible to be included as qualified equity even if contributed after the measurement period begins. Reasonable retainage is defined with reference to Treas. Reg. §1.148-7(h) as an amount that does not exceed five percent of the available construction proceeds of an issue that is retained for reasonable business purposes. A further exception for expenditures that are paid after the placed in service date and that are not included in the definition of reasonable retainage would be useful. For example, it should be possible for an issuer to pay costs of construction of a project component from qualified equity even after the project component is placed in service if the cost is a normal cost of the project.

1. PLR 201507002. In the ruling, the IRS ruled on the allocation of proceeds between governmental and private activity bonds for water distribution facilities. The ruling illustrates the willingness of the IRS to consider multiple allocation approaches within a system of improvements, including the allocation between two supply sources of water such that private business use of one supply source did not taint the measurement of private business use of the other supply source.

2. PLR 201435013. In the ruling, the Issuer could make allocations under Treas. Reg. §1.141-6(a) and Treas. Reg. §1.148-6 that related to both tax-exempt bonds and build America bonds.

3. PLR 200924013. In the ruling, the City used a specific tracing method to account for investments and expenditures of gross proceeds of its bonds (the "Stadium Bonds"), which Stadium Bonds were issued to finance the acquisition, construction, improvement and equipping of a sports stadium (the "Stadium Project"). The Stadium Bonds were not expected to meet the private business use tests of Code Section 141 upon issuance, but certain private business use opportunities arose that the City sought to take advantage of (including naming rights). The City subsequently (approximately two years after the issuance of the Stadium Bonds) issued

taxable bonds (the "Park Bonds") to finance an expansion of the City's park network (the "Park Project"). The City sought to allocate proceeds of the Stadium Bonds to expenditures related to the Park Project, and proceeds of the Park Bonds to expenditures incurred for the Stadium Project as a result of the private business use of the Stadium Project. Because the allocations would occur no later than 18 months after the expenditures for the Park Project were paid, the Stadium Project was placed in service during the 18-month period prior to the date the City allocated the proceeds of the Park Bonds to the Stadium Project expenditures, and because the City had on hand at all times since the date of issuance of the Stadium Bonds an amount of proceeds of the Stadium Bonds equal to the amount of such proceeds to be allocated to the Park Project expenditures, plus investment earnings thereon, the IRS ruled that the City's allocation method was a permissible allocation method under Treas. Reg. §§1.141-6(a) and 1.148-6.

4. Additional PLRs. Additional private letter ruling addressing allocations include PLR 200248002, PLR 200036033 and PLR 9706008.

VII. SPECIAL RULES FOR OUTPUT FACILITIES - SECTION 1.141-7

On September 19, 2002, the IRS released the long-awaited private activity bond regulations for public power and other output facilities (the "Output Regulations"). The Output Regulations provide rules specifically applicable to "output" facilities, which are electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. An output contract will meet the private business use tests if it transfers the benefits and burdens of a bond-financed facility to a non-governmental person.

A. Definitions.

1. Available Output. The available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for a bond issue.

a. In General.

(i) With respect to generating facilities, the number of units produced or to be produced in one year is determined by reference to nameplate capacity or the equivalent (where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserved, maintenance or other unutilized capacity,

(ii) With respect to transmission, distribution, cogeneration and other output facilities, available output must be measured in a reasonable manner to reflect capacity, and

(iii) With respect to electric transmission facilities, measurement of available output of all or a portion of such facilities may be determined in a manner consistent with the reporting rules and the requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC). An example is provided in the Output Regulations where the use of aggregate load and load share ratios in a manner consistent with the requirements of FERC was determined to be reasonable. Measurement of the available output of

transmission facilities using thermal capacity or transfer capacity may be reasonable, depending on the facts and circumstances of the specific case.

b. Special Rule for Facilities with Significant Underutilized Capacity. If an issuer reasonably expects on the issue date of a bond issue that persons that are treated as private business users will purchase more than 30 percent of the actual output of the facility financed with the proceeds of the issue, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate or other capacity, such as the average expected annual output of the facility. The reasonably expected annual output of the generating facility must be consistent with the capacity reported for prudent reliability purposes.

c. Special Rule for Facilities with a Limited Source of Supply. If a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by taking into account those constraints. For this purpose, a limited source of supply shall include a physical limitation on the flow of water, but not an economic limitation such as the cost of coal or gas. The available output with regard to a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

d. PLR 200915002. In this private ruling, the IRS considered whether the sale of renewable energy certificates ("RECs") to non-governmental persons generated by a facility that was owned by the District (a political subdivision of the State) constituted a private business use of bond-financed property for purposes of Code Section 141(b)(6) of the Code. The bond proceeds were to be spent on the District's electrical distribution system and to "replace or rehabilitate turbines, generators, governors and unit controls for each of the facility's electric generating units." On completion of the project, the facility at issue was expected to generate the RECs. The District, in turn, expected to sell the RECs to nongovernmental persons for use in a trade or business under contracts with terms exceeding three years. The IRS addressed two questions in the ruling: first, whether the generation of the RECs constituted "output" for purposes of Treas. Reg. §1.141-7, and second, whether the generation and sale of the RECs by the District from the facility constituted a private business use under Treas. Reg. §1.141-3. The IRS relied on the following analytical factors to conclude that the RECs themselves did not constitute "output" for purposes of Treas. Reg. §1.141-7: (i) the generation of the RECs did not impact the nameplate capacity of the facility or the flow of water through a hydroelectric unit; (ii) the sale of the RECs did not affect the units of electricity that may be sold; and (iii) the sale of the RECs does not entitle the purchaser to any generator capacity. As to the second question, the IRS, in concluding that the use of the facilities, in part, to generate the RECs did not give rise to any private business use, emphasized that (i) the purchasers of the RECs received no right to use the property, and (ii) the RECs did not represent capacity generated by or use of the property.

2. Measurement Period has the same meaning with respect to output facilities as it does in general for purposes of the private business tests. *See* Treas. Reg. §1.141-3(g)(2).

3. Sale at Wholesale means a sale of output to any person for resale.

4. Take Contract means an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output.

5. Take or Pay Contract means an output contract under which the purchaser agrees to pay for the output under the contract, *whether or not* the output facility is capable of providing the output.

6. Requirements Contract means an output contract other than a take contract or a take or pay contract, under which a nongovernmental person agrees to purchase all or part of its output requirements.

7. Nonqualified Amount means, with respect to a bond issue, the lesser of (a) the proceeds of such issue which are to be used for any private business use; or (b) the proceeds of such issue with respect to which there are private payments (or property or borrowed money). *See* Code Section 141(b)(8).

B. Output Contracts.

1. In General. The purchase pursuant to a contract by a nongovernmental person of available output of an output facility financed with the proceeds of a bond issue is taken into account under the private business tests, if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on the bonds used (directly or indirectly) to finance the facility (the "benefits and burdens test").

a. Measurement of Private Business Use. If an output contract results in private business use, the amount of private business use generally is the amount of output purchased under the contract.

b. Measurement of Private Payments. The amount of payments made or to be made by nongovernmental persons under output contracts that satisfy the private business test is measured as a percentage of the debt service of an issue the proceeds of which financed the facility from which the output is purchased. The rules set forth in Treas. Reg. §1.141-4 govern this computation.

2. Take or Pay Contracts. Take or Pay Contracts generally will be determined to have satisfied the benefits and burdens test.

3. Requirements Contracts.

a. In General. A requirements contract may satisfy the benefits and burdens test if (i) it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser or that obligate the purchaser to have output requirements, or (ii) it is a sale at wholesale that may satisfy the benefits and burdens test depending on all the facts and circumstances.

b. Wholesale Requirements Contract.

(i) In General. A requirements contract that is a sale at wholesale may satisfy the benefits and burdens test depending on all the facts and circumstances.

(ii) Significant Factors. Significant factors establishing whether wholesale requirements contracts meet the benefits and burdens test include: (A) the term of the contract is substantial relative to the term of the issue or issues that finance the facility and (B) the amount of output to be purchased under the contract represents a substantial portion of the available output of the facility.

(iii) Safe Harbors Against a Wholesale Requirements Contract Meeting the Benefits and Burdens Test. Two safe harbors against a wholesale requirements contract meeting the benefits and burdens test include: (A) the term of the contract, including renewal options, does not exceed the lesser of 5 years or 30 percent of the term of the issue; and (B) the amount of output to be purchased under the contract (and any other requirements contract with the same purchaser or a related party with respect to the facility) does not exceed 5 percent of the available output of the facility.

c. Requirements Contract other than a Wholesale Requirements Contract. A requirements contract that is not a wholesale requirements contract generally will not meet the benefits and burdens test. However, see paragraph 3(a) above.

d. Factors Not Causing a Requirements Contract to Satisfy the Benefits and Burdens Test. A requirements contract will not meet the benefits and burdens test by reason of a provision in the contract that requires the purchaser to pay reasonable and customary damages (including liquidated damages) in the event of a default, or a provision that permits the purchaser to pay a specified amount to terminate the contract while the purchaser has requirements, in each case if the amount of the payment is reasonably related to the purchaser's obligation to buy requirements that is discharged by the payment.

4. Output Contract Characterized as a Lease. An output contract that is properly characterized as a lease for federal income tax purpose will be analyzed under the general rules to determine whether such contract need be taken into account under the private business tests.

C. Certain Contracts Exempted from the Private Business Tests.

1. Small Purchase Contracts. An output contract for the use of a facility is not taken into account for purposes of the private business test if the average annual payments to be made under the contract do not exceed 1 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

2. Swapping and Pooling Arrangements. An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the governmentally owned output facility if:

(i) the swapped output is reasonably expected to be approximately equal in value (determined over periods of 3 years or less); and

(ii) the purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.

3. Short-term Output Contracts. An output contract with a nongovernmental person is not taken into account under the private business tests if:

(i) the term of the contract, including all renewal options, is not longer than 3 years;

(ii) the contract is either a negotiated, arm's length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and

(iii) the output facility is not financed for a principal purpose of providing the facility for use by the nongovernmental person.

4. Conduit Parties Disregarded in Certain Circumstances. A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person.

D. Special Rules for Electrical Output Facilities Used to Provide Open Access.

1. Operation of Transmission Facilities by Nongovernmental Persons.

a. In General. The operation of an electric transmission facility by a nongovernmental person may result in private business use of the facility based on all the facts and circumstances. A nongovernmental operator who is compensated for transmission services, in whole or in part, based on a share of net profits from the operation of the facility will be considered a private business user of such facility.

b. Independent Transmission Operators. A contract for the operation of an electric transmission facility by an independent entity, such as a regional transmission organization ("RTO") or an independent system operator ("ISO") (each, an "independent transmission operator") does not constitute private business use if:

(i) the facility is governmentally owned;

(ii) the operation of the facility by the RTO or the ISO is approved by the FERC under one or more provisions of the Federal Power Act or by a state authority under comparable provisions of state law;

(iii) no portion of the compensation of the RTO or the ISO is based on a share of net profits from the operation of the facility; and

(iv) the independent transmission operator does not bear risk of loss of the facility.

c. Use by Nongovernmental Persons under Certain Output Contracts.

(i) Transmission Facilities. The use of an electric transmission facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if:

(A) the facility is governmentally owned;

(B) the facility is operated by an independent transmission operator in a manner approved by FERC or a state authority; and

(C) the facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(ii) Distribution Facilities. The use of an electric distribution facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if:

(A) the facility is owned by a governmental person;

(B) the facility is available for use on a nondiscriminatory, open access basis by buyers and sellers of electricity in accordance with rates that are generally applicable and uniformly applied, which includes situations in which different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable or specifically negotiated rate arrangement is entered into, but only if the user is prohibited by federal law from paying the generally applicable rates and the rates established are as comparable as reasonably possible to the generally applicable rates; and

(C) the facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person (other than a retail end-user).

(iii) Ancillary Services. The use of an electric output facility to provide ancillary services required to be offered as part of an open access Transmission tariff under rules promulgated by FERC does not result in private business use.

E. Exceptions to "Deliberate Action" Rules with Respect to Change In Use Situations.

1. Mandated Wheeling. Entering into a contract for the use of electric transmission or distribution facilities is not treated as a "deliberate action" if (a) the contract is entered into in response to (or in anticipation of) an order of the United States or a relevant state regulatory authority; and (b) the terms of the contract are bona fide and arm's length, and the consideration paid is consistent with the applicable provisions of the Federal Power Act.

2. Actions Taken to Implement Non-Discriminatory, Open Access. An action similarly is not treated as a "deliberate action" if it is taken to implement the offering of

nondiscriminatory, open access tariffs for the use of electric transmission or distribution facilities, in a manner consistent with rules promulgated by FERC. This paragraph does not apply to the sale, exchange or other disposition of transmission or distribution facilities to a nongovernmental person.

3. Certain Current Refunding Bonds. An action to be taken with respect to electric transmission or distribution facilities refinanced by an issue is not taken into account for purpose of establishing "reasonable expectations and deliberate actions" with respect to private business use if (i) the action is described in the two immediately preceding paragraphs, (ii) the bonds are current refunding bonds that refund bonds originally issued before February 23, 1998, and (iii) the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

4. The Commissioner May Permit Additional Transactions. Additional circumstances in which the use of electric output facilities in a restructured electric industry does not constitute private business use may be identified by the Commissioner in published guidance.

5. PLR 200850003. The IRS ruled that the sale of financial instruments available through an allocation and auction process that resulted in allocating priority rights to bond-financed electrical transmission facilities during times of high congestion does not constitute deliberate action causing the bonds to become private activity bonds where implementation of the system is done at the direction and guidance of the FERC and undertaken to enhance the goal of providing open and non-discriminatory access to transmission facilities consistent with Treas. Reg. §1.141-7(g)(4)(ii) of the Regulations. The IRS also ruled that implementation of the new system of allocating priority among users during high congestion times does not constitute a sale, exchange, or other disposition of the bond-financed facilities under Code Section 1001(a) for purposes of Treas. Reg. §1.141-7(g)(4)(ii) where the owners of the bond-financed property retained the legal entitlements and burdens associated with the ownership of the facilities.

F. Allocations of Output Facilities and Systems - Treas. Reg. §1.141-7(h).

1. Facts and Circumstances Analysis. Whether output sold under an output contract is allocated to a particular facility (*e.g.*, a generating unit), to the entire system of the seller of that output (out of any uses of that system output allocated to a particular facility) or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered include:

(i) the extent to which it is physically possible to deliver output to or from a particular facility or system;

(ii) the terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources);

(iii) whether a contract is entered into as part of a common plan of financing for a facility; and

(iv) the method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

2. Transmission and Distribution Contracts. Whether use under an output contract for transmission or distribution is allocated to a particular facility or to a transmission or distribution network is based on all the facts and circumstances, as described above.

3. Allocation of Payments. Payments for output provided by an output facility financed with two or more sources of funding are allocated pursuant to the general rules regarding payment allocations.

4. PLR 201128010. PLR 201128010 concludes that the allocation of output based on reserved net rated capacity of the facility is equivalent to an allocation based upon output of the facility.

G. $15 Million Limitation for Output Facilities.

1. In General. An issue is considered to be a private activity bond if the nonqualified amount with respect to output facilities (other than a facility for the furnishing of water) financed by the proceeds of the issue exceeds $15 million. This limitation applies to issues 5% or more of the proceeds of which are to be used to finance output facilities and is in addition to the general $15 million limitation on private business use.

2. Application of $15 Million Output Facility Limitation.

a. In General. The private business use tests will be met if more than $15 million of the proceeds of the issue to be used with respect to an output facility are to be used for a private business use. Investment proceeds are disregarded for this purpose if they are not allocated disproportionately to the private business use portion of the issue. The private business tests will similarly be met if the payment of the principal of, or the interest on more than $15 million of the sale proceeds of the portion of the issue is used with respect to an output facility is (under the terms of the issue or any underlying arrangement) directly or indirectly secured by any interest in an output facility used or to be used for a private business use (or payments in respect of such an output facility); or to be derived from payments (whether or not to the issuer) in respect of an output facility used or to be used for a private business use.

b. Reduction in the $15 Million Limit for Outstanding Issues. In determining whether an issue 5% or more of the proceeds of which are to be used with respect to an output facility consists of private activity bonds under the $15 million output limitation, the $15 million limitation is applied by taking into account the aggregate nonqualified amounts of any outstanding bonds of other issues 5% or more of the proceeds of which are or will be used with respect to that output facility or any other output facility that is part of the same "project" (as defined below). A tax-exempt bond of another issue is taken into account if:

(i) that bond is outstanding on the issue date of the later issue;

(ii) that bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of that bond by the later issue; and

(iii) 5% or more of the proceeds of the earlier issue financed an output facility that is a part of the same project as the output facility that is financed by 5% or more of the sale proceeds of the later issue.

c. Modification of Private Business Use Tests. The $15 million limitation with respect to output facilities as it relates to the "benefits and burdens test" described above, is applied by replacing "10%" or "5%" with $15 million each place it appears. The amount of bonds of an earlier issue that are required to be taken into account in connection with the foregoing analysis equals the nonqualified amount of the earlier issue multiplied by a fraction, the numerator of which is the adjusted issue price of the earlier issue as of the issue date of the later issue, and the denominator of which is the issue price of the earlier issue (pre-issuance accrued interest is disregarded for purposes of this calculation).

3. Definitions.

a. Project. Facilities that are functionally related and subordinate are treated as part of the same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. *e.g.*, (i) generation, transmission and distribution facilities; (ii) separate facilities to serve wholesale customers and retail customers; and (iii) a peaking unit and a baseload unit (regardless of the location thereof).

b. Separate Ownership. Facilities that are not owned by the same person are not part of the same project. If a project is financed as a collaborative effort among different governmental persons, their interests are aggregated with respect to that project to determine whether the $15 million output limitation has been met (for example as participants in a joint powers authority). Where there are undivided ownership interests in a single output facility, property that is not owned by different persons is treated as separate projects if the separate interests are financed (i) with bonds of different issuers, and (ii) without a principal purpose of avoiding the Output Regulations. In the case of generating property and related facilities, project means property located at the same site. However, separate generating units are not treated as part of the same project if on the issue date of each of the issues that finances the units, the unit is reasonably expected on the issue date to be placed in service more than 3 years before the other. Common facilities or property must be allocated on a reasonable basis.

c. Transmission and Distribution. In the case of transmission or distribution facilities, project means functionally related contiguous property. Separate transmission or distribution facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the facilities, to be placed in service more than 2 years before the other.

d. Subsequent Improvements.

(i) In General. An improvement to generation, transmission or distribution facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or

acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service.

(ii) Transmission and Distribution Facilities. An improvement to transmission or distribution facilities that is not part of the original design of that properly is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

(iii) Replacement Property. For purposes of these provisions, property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless:

(A) the need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property; and

(B) the bonds that finance (and refinance) the output facility have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the facility.

H. Effective Dates - Treas. Reg. §1.141-15(f).

1. In General. The Output Regulations apply to bonds sold on or after November 22, 2002.

2. Permitted Elections into Output Regulations. For bonds subject to the Treasury Regulations that implement the private business tests, the Output Regulations apply to output contracts entered into on or after September 19, 2002. An output contract is treated as entered into on or after that date if it is amended on or after that date, but only if the amendment results in a change to the contract or increases the amount of the requirements covered by the contract by reason of an extension of the contract term or a change in the method of determining such requirements.

3. PLR 201114003. In PLR 20114003, the IRS concluded that an agreement between a state authority and rural electrical power cooperative to defer the effective date of any termination of a wholesale electricity requirements contract is not an amendment to the contract for purposes of Treas. Reg. §1.141-15(f)(2) and will not cause the contract to be treated as an output contract entered after September 19, 2002.

4. Refunding Bonds. Except as provided in the two immediately preceding paragraphs, the Output Regulations do not apply to any bonds sold on or after November 22, 2002, to refund a bond to which the Output Regulations do not apply unless the bonds are subject to the applicable provisions of the Tax Reform Act of 1986 and the weighted average maturity of the refunding bonds is longer than: (a) the weighted average maturity of the refunded bonds; or (b) in

the case of a short-term obligation that the issuer expects to refund with a long-term financing, 120 percent of the weighted average reasonably expected economic life of the facilities financed or a principal purpose for the issuance of the bonds is to make one or more new conduit loans.

5. Elective Application of Output Regulations. The Output Regulations may be, at the election of the issuer, applied in whole, but not in part, to outstanding bonds sold before November 22, 2002 or refunding bonds sold on or after November 22, 2002. The exception to the benefits and burdens test for short term output contracts and for electric output facilities used to provide open access may be applied by an issuer to any bonds.

I. Acquisition of Non-Governmental Output Facilities.

A. General Rule. Under Code Section 141(d), which was added by the Budget Reconciliation Act of 1987, an issue will be treated as a "private activity bond" if more than the lesser of five percent or $5,000,000 of the proceeds of such issue are used (directly or indirectly) to acquire nongovernmental output property. The term "nongovernmental output property" means any property (or interest therein) which before such acquisition was used (or held for use) by a nongovernmental person in connection with an output facility.

B. Exceptions. For this purpose, (i) a facility for the furnishing of water, and (ii) property used in connection with an output facility 95 percent or more of the output of which is consumed in an area treated as a "qualified service area" or a "qualified annexed area" of the governmental unit acquiring such property is not treated as nongovernmental output property for purposes of Code Section 141(d). In addition, property (other than property which is part of the output function of a nuclear power facility) is not nongovernmental output property if such property is converted to a use not in connection with an output facility.

VIII. UNRELATED OR DISPROPORTIONATE USE TEST - SECTION 1.141-9

A. General Rule. Under Code Section 141(b)(3), an issue meets the private business tests if the amount of private business use and private payments or security attributable to unrelated or disproportionate private business use exceeds 5% of the proceeds of the issue.

B. Application of Test.

1. Order. The test is applied by first determining whether a private business use is related to a governmental use. Next, private business use that is "related" is examined to see if it is disproportionate.

2. Aggregation. All unrelated and disproportionate use is aggregated.

C. Unrelated Use. Whether use is related is determined on a case-by-case basis, emphasizing operational relationship. Generally, related use must be located within or adjacent to the governmentally-used facility. Parallel related and unrelated uses (*i.e.*, use of a facility by a nongovernmental person for the same purpose as use by a governmental person, and use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use) are not treated as unrelated use if the government use or the related use,

as applicable, is not insignificant (*e.g.*, parking garage; pharmacy in governmentally-owned hospital used by hospital and nonhospital patrons).

D. Disproportionate Use.

1. Definition of Disproportionate Use. Private business use is defined to be a disproportionate use in Treas. Reg. §1.141-9(c) only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use.

2. Aggregation of Related Uses. If two or more private business uses relate to a single government use, those related uses are aggregated in applying the disproportionate use test.

3. Allocation Rule. If a private business use relates to two or more government uses or a government use and a private business use, the amount of any disproportionate use may be determined by allocating the private business use among the related uses, aggregating government uses that are directly related to each other or allocating the private business use to the government use to which it is primarily related.

E. Maximum Use Taken into Account. The determination of the amount of unrelated use or disproportionate use is based on the maximum amount of reasonably expected government use of a facility during the term of the issue.

IX. REMEDIAL ACTIONS – SECTION 1.141-12

A. General Rule. An action that causes the private activity bond tests or private loan financing test to be met is not treated as a deliberate action if the issuer takes a specified remedial action and all of the following requirements are met.

1. Reasonable Expectations. The issuer reasonably expected on the issue date of the issue would not meet either the private activity bond tests or the private loan financing test for the entire term of the bonds. If the issuer reasonably expects to take deliberate action during the term of the bonds and the special redemption requirements described in II.C.2 above are met, the term of the bonds for this purpose may be determined taking into account such redemption provisions.

2. Maturity Not Unreasonably Long. The term of the issue must not be longer than reasonably necessary for the governmental purposes of the issue.

3. Fair Market Value Consideration. Except with respect to the alternative use of facility remedial action described in B.3. below, the terms of any agreements that result in satisfaction of either the private activity bond tests or the private loan financing test are bona fide, and arm's length and the new user pays fair market value for the use of the financed property.

4. Disposition Proceeds. The issuer must treat any disposition proceeds as gross proceeds for the purposes of Code Section 148.

5. Proceeds Expended. Except with respect to the redemption or defeasance remedial action, the proceeds of the issue affected by the deliberate action must have been expended before the deliberate action.

B. Alternatives for Remedial Action.

1. Redemption or Defeasance of Nonqualified Bonds.

a. If there is a transfer exclusively for cash, the requirements are satisfied if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds within 90 days of the deliberate action or establish a defeasance escrow within such period. If the deliberate action does not involve a transfer exclusively for cash, funds other than proceeds of a tax-exempt bond must be used to redeem all the nonqualified bonds within 90 days of the deliberate action or a defeasance escrow must be established within such period.

b. Rev. Proc. 2018-26 provides that the investments in the defeasance escrow must either be yield restricted or rebate payments must be made on any excess yield, with the first computation period beginning on the date on which the escrow is established.

c. If a defeasance escrow is established, the issuer must notify the IRS of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

d. Notwithstanding the foregoing, the establishment of a defeasance escrow will not be considered a remedial action if the period between the issue date and the first call date is more than 10.5 years.

2. Alternative Use of Disposition Proceeds-General Rule. Use of disposition proceeds for an alternative use is a remedial action, if:

a. The deliberate action involves a transfer exclusively for cash.

b. The issuer reasonably expects to spend the disposition proceeds within 2 years of the deliberate action.

c. The disposition proceeds are used in a manner that does not cause the issue to meet either the private activity bond tests or the private loan financing test. In the case of use by a Section 501(c)(3) organization, the bonds must be treated as reissued for the purposes of Code Sections 141, 145, 147, 149 and 150.

d. Any disposition proceeds not so used are used for another remedial action.

3. Alternative Use of Disposition Proceeds—Private Business Use Arising from Certain Leases.

(i) Rev. Proc. 2018-26 allows excess private business use resulting from eligible leases to be remediated through expenditure of moneys on eligible projects, even

though private business use does not result from the sale of a bond-financed asset exclusively for cash.

(ii) Eligible leases only include leases whose entire consideration consist of cash payments (regardless of when paid) not financed with an issue of tax-advantaged bonds.

(iii) The term of an eligible lease must either (X) be at least equal to the lesser of 20 years or 75 percent of the weighted average reasonably expected economic life of the leased property or (Y) run through the end of the applicable measurement period.

(iv) Remedial expenditures must be in an amount equal to the present value of all lease payments, using the yield on the bonds, as of the start of the lease, as the discount rate; such amount is treated as disposition proceeds from purposes of Treas. Reg. §1.141-12(e) and must be spent in the manner prescribed by such Regulations Section.

(v) The effect of the alternate use of disposition proceeds is that the assets on which such disposition proceeds are spent, but only for the term of the lease. Once the lease has terminated, the proceeds of the Bonds once again are allocated to the leased property.

4. Alternative Use of Facility. Alternative use of a facility is treated as a remedial action if all of the following are met:

(i) The facility is used in an alternative manner (*i.e.*, use by a nongovernmental person for a qualifying purpose or use by a Section 501(e)(3) organization).

(ii) The nonqualified bonds are treated as reissued as of the date of deliberate action for purposes of Code Sections 55-59, 141-147, 149 and 150. Under this treatment, the nonqualified bonds are treated as qualified bonds throughout the remaining term.

(iii) The deliberate action does not involve a transfer to a purchaser that finances the acquisition with proceeds of tax-exempt bonds.

(iv) Any disposition proceeds other than those arising from an agreement to provide services are used to pay debt service on the bonds on the next debt service payment date or are deposited in a yield restricted escrow within 90 days of receipt to pay debt service on bonds on the next available debt service payment date. (Note that Code Section 147(d), the existing property limitation, does not apply.)

5. Other Remedial Actions.

a. General. The Commissioner may provide additional remedial actions.

b. Notice 2008-31[7]. This Notice extends to Code Sections 54, 1397E and 1400N the remedies under Rev. Proc. 97-15. Rev. Proc. 97-15 established an IRS closing agreement procedure applicable to failures to meet the requirements for excludability of interest from gross income in Code Sections 141 through 150 that can be remediated under Treas. Reg. §§ 1.141-12, 1.142-2, 1.144-2, 1.145-2 or 1.147-2. Rev. Proc. 97-15 had no effect on the application of Code Sections 150(b) and (c).

6. Definition of Nonqualified Bonds. The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the deliberate action date, the remaining bonds would not meet the private business use test. Should the "issuance" of the remaining bonds be treated as a refunding or a new money issue? Unless it is treated as a refunding, application of the definition can, depending on the facts, produce results that either amplify the required remediation or eliminate it entirely.

Consider two examples, both involving a 20-year bullet bond that finances the acquisition of a building on the issue date. In the first, on the issue date, the issuer leases 20% of the building for a 10-year period. Total private business use for the issue is 10%, so no remediation is required. Then, on the first day of the 11th year, the issuer leases 10% of the building for the remaining 10 years of the measurement period. Private business use for the issue is now 15%, and remediation is required. If the bonds are treated as reissued on the deliberate action date, and the reissuance is treated as a new money issue with prior private business use disregarded, then no remediation is required, because the reissued bonds have private business use of 10%, which is within permissible limits, and there are no nonqualified bonds.

In the second example, there is no private business use during the first 10 years. Then, on the first day of the 11th year, the issuer leases 30% of the building for the remaining 10 years of the measurement period. Again, private business use for the issue is now 15%, as with the first example. However, private business use for the new issue is now 30%, rather than 10%, and approximately 20% of the bonds (with adjustments for the gross-down) must be remediated.

7. As part of its outreach and educational services program, the IRS posted to its website an article that summarized the remedial action rules found in Treas. Reg. §1.141-12 of the Regulations. It also presented three examples meant to illustrate the application of the remedial action rules. While the IRS expressed its intent that the article not be considered an authoritative source, the content of the examples gave rise to questions. NABL raised some of these interpretive questions in a letter to the IRS dated July 24, 2012 (the "NABL Letter"). Specifically, the NABL Letter focuses on Example 3 of the article, which describes a $10M facility financed with multiple sources of funds - $4M provided from funds on hand and $6M from the proceeds of tax-exempt bonds. Upon sale of the facility for $12M, the example states that, if the borrower decides to remediate using the "alternative use of disposition proceeds" option, the borrower must use the entire $12M for an alternative use within two years. Of this $12M of disposition proceeds, $6M are to be treated as gross proceeds of the bonds, suggesting that the IRS is reading this provision to mean that, so long as any portion of a piece of property has been financed with proceeds of an issue, then all of the sale proceeds will be "disposition proceeds." The NABL Letter also raises an

[7] TD 9777 obsoleted Revenue Procedure 1997-15 on 7/18/2016 because the scope of violations that can be remedied under Notice 2008-31 is broader than what Rev. Proc. 97-15 provided.

interpretive question regarding Example 2 of the article. Example 2 describes an issuer's use of a $10M bond issue to finance a school ($8M) and land ($2M). After sale of the land for $3M, the IRS notes that, if the issuer chooses to remediate by redeeming nonqualified bonds, it must redeem $2M of the outstanding bonds (all $10M of the bonds are assumed to remain outstanding), leaving $1M to be treated as gross proceeds for purposes of Code Section 148, raising a question regarding whether, when multiple facilities are financed with a single bond issue, an amount greater than the amount of the nonqualified bonds be considered gross proceeds. The IRS has not provided further clarification of its position, however these examples are no longer posted on the IRS website.

C. Anticipatory Remedial Actions.

1. General Rule. Treas. Reg. §1.141-12 of the Final Allocation Regulations expands the remedial action rules to encourage the retirement of tax-exempt bonds before the occurrence of nonqualified use by permitting an issuer to redeem or defease bonds at any time in advance of a deliberate action that would cause the private business tests to be met.

2. Declaration of Intent. To address the concern of issuers potentially treating ordinary bond amortization payments as "anticipatory remedial actions," the Final Allocation Regulations require an issuer to declare its intent to redeem or defease bonds in advance of a deliberate action in a manner similar to the declaration of intent for reimbursement contained in Treas. Reg. §1.150-2(e). The Final Allocation Regulations require the issuer to "describe the deliberate action that potentially may result in the private business tests being met." This description requirement may significantly impair the usefulness of the anticipatory remedial action unless it is clarified.

With regard to official intent for reimbursement, Treas. Reg. §1.150-2(e) provides that a general description is sufficient to describe the project for which the issuer is seeking reimbursement (e.g. highway capital improvement program, hospital equipment acquisition, etc.). Clarification from the IRS that it is permissible to describe a future deliberate action with similar generalization would be helpful.

The following example illustrates the problem: City A sells to a private developer a parcel of unused bond-financed land, the acquisition of which was part of a larger bond-financed project. Prior to the sale of the land, City A calculated a total of 3% cumulative private business use in the Project from the lease of a portion of its City Hall to a small cafe on the ground floor. City A calculates that the sale of the land will generate an additional 6% private business use on the Bonds. City A adopts an Official Intent Resolution outlining the private business use from the cafe lease and land sale and a general description of private business use that may arise in the future with respect to the Project. City A then redeems the nonqualified bonds associated with the land sale with proceeds from the sale.

In the example above, City A only reached a total of 9% private business use from the sale of the land. A requirement that the declaration of intent describe with detail the deliberate action that may result in the private business tests to be met would result in the City being unable to take an anticipatory remedial action with respect to the sale. At the time of the land sale, the City does not know the nature of future use that may provide the additional 1% use to cause the Bonds to meet the private business use test. However, it is at that time that the City is best positioned to

remediate the private use with proceeds of the sale. If the City were instead to invest the land sale proceeds until an additional amount of private business use causes the private business tests to be met, the result is detrimental to both the City (from the negative arbitrage cost of retaining the land sale proceeds) and the federal government (since the nonqualified Bonds remain outstanding until the 10% threshold is reached). Allowing a general description in the intent resolution better serves the stated policy of the Final Allocation Regulations of encouraging redemption of tax-exempt bonds earlier rather than later.

3. Permitted Anticipatory Remedial Action. The Final Allocation Regulations only permit an issuer to take an anticipatory remedial action in the form of a redemption or defeasance of nonqualified bonds.

The Final Allocation Regulations give the example of a sale of bond-financed property that the buyer may then lease to a nongovernmental person. City B, for example, may sell property to State University C, who may (but has not yet taken action to) lease the property to a nongovernmental person. Thus, City B in this example has not yet generated any private business use from the sale of the land. The Final Allocation Regulations would allow the City to declare its official intent to redeem or defease a portion of the bonds from the future nonqualified use.

4. Nonqualified Bonds. The Final Allocation Regulations provide that the amount of nonqualified bonds is equal to the portion of the outstanding bonds that, if the remaining bonds were issued on the date of the deliberate action, the remaining bonds would not meet the private business tests. This language has the effect of only requiring an issuer to redeem or defease enough bonds to reduce the amount of private business use to 10% (or 5%, if applicable).

D. Remedial Actions for Direct Pay Bonds.

1. General. Rev. Proc. 2018-26 authorizes the use of certain remedial actions for Direct Pay Bonds and other tax-advantaged taxable bonds. Significant uncertainties exist regarding the requirements for effective remedial actions under Rev. Proc. 2018-26. While these remedial provisions allow a variety of potential violations to be remediated, a general discussion of the requirements applicable to tax-advantaged taxable bonds is beyond the scope of this outline, and the summary below solely addresses non-qualified use arising from excess private business use under Code Section 141 of the Code.

2. Reduction of Federal Tax Credit for Direct Pay Bonds. Issuers may remediate excess private business use by voluntarily eliminating the federal tax credit on "nonqualified bonds." The amount and identity of non-qualified bonds are determined using the general principles of Treas. Reg. §§1.141-12(j) and 1.142-2(e) (i.e. it is the portion of bonds that, if the remaining bonds were issued on the date of the deliberate acquisition, the proceeds of the remaining bonds would be used for a qualified use). Issuers must notify the IRS of the voluntary reduction in credits, identity the date of the deliberate action and submit a revised debt service schedule.

Section 6 of Rev. Proc. 2018-26 also includes a puzzling statement that if the deliberate action results in the creation of "disposition proceeds," the issuer must treat the disposition proceeds as gross proceeds for purposes of Code Section 148 and as proceeds for

purposes of the Code section applicable to the relevant category of tax advantaged bonds. It is unclear if the Revenue Procedure really intends to require an issuer to both surrender the tax credit with respect to the nonqualified bonds and to be subject to expenditure requirements with respect to disposition proceeds allocable to the nonqualified bonds; if it does, no issuer of Direct Pay Bonds taking a deliberate action involving a disposition exclusively for cash would ever use this remedial action, since it also would have to use the alternate use of disposition proceeds described in Section IX.C.4 below.

3. Redemption or Defeasance of Direct Pay Bonds and Tax Credit Bonds. Section 7 of the Rev. Proc. 2018-26 also permits issuers of certain tax credit bonds and direct pay bonds to remediate excess private business use by redeeming or defeasing nonqualified bonds within 90 days of the deliberate action. Issuers may either yield restrict or pay rebate on the investments in a remedial defeasance escrow. These provisions do not contain an analogue to Treas. Reg. §1.141-12(d)(2), which reduces the redemption/defeasance requirement in certain cases of dispositions exclusively for cash in which the cash received is insufficient to redeem or defease all the nonqualified bonds. This remedial action, like that applicable to termination of the credit in the prior paragraph of this outline, also requires the issuer to treat any disposition proceeds as gross proceeds for purposes of Code Section 148 and as proceeds for purposes of the Code section applicable to the relevant category of tax advantaged bonds. It is unclear if the Revenue Procedure really intends to require an issuer to both defease or redeem the nonqualified bonds and to be subject to expenditure requirements with respect to disposition proceeds allocable to the nonqualified bonds; if it does, no issuer taking a deliberate action involving a disposition exclusively for cash would ever use this remedial action, since it would also have to also use the alternate use of disposition proceeds described in Section IX.C.4 below. A special rule provides that defeasance of nonqualified bonds will not trigger a reissuance of the defeased bonds.

4. Alternate Use of Disposition Proceeds of Direct Pay Bonds and Tax Credit Bonds. Finally, if the deliberate action involves a disposition of financed property exclusively for cash, Section 7.05 of Rev. Proc. 2018-26 permits issuers to make use of an alternate use of disposition proceeds remedial action like that found in Treas. Reg. §1.141-12.

X. OTHER REMEDIAL ACTION RULES

A. Exempt Facility Bonds - Treas. Reg. §1.142-2.

1. General. If, with respect to an exempt facility bond issued under Code Section 142, there is a failure to meet the requirement that 95% of the net proceeds actually be used to provide an exempt facility, such bond will be treated as meeting the requirements of Code Section 142(a) if (i) the issuer reasonably expected on the date of issue that 95% of the net proceeds of the issue would be used to provide an exempt facility and (ii) all nonqualified bonds are redeemed on the earliest call date after the date on which the failure to properly use the proceeds occurs. If bonds are not redeemed within 90 days of the failure to properly use proceeds, a defeasance escrow must be established for those bonds within this period. In the case of the establishment of a defeasance escrow, the issuer must give notice to the IRS within 90 days and, in addition, the bonds must have an initial call date that is not more than 10.5 years from the issue date.

2. Application. The remedial action rules in Treas. Reg. §1.142-2 apply to Code Sections 147(c)(3), (d)(2) and (3), (e) and (f).

B. Small Issue and Qualified Redevelopment Bonds - Treas. Reg. §1.144-2. Treas. Reg. §1.144-2 provides that the remedial action rules of Treas. Reg. §1.142-2 apply to qualified small issue bonds issued under Code Section 144(a) and qualified redevelopment bonds issued under Code Section 144(c).

XI. REGULATIONS FOR APPLYING PRIVATE ACTIVITY BOND RESTRICTIONS TO REFUNDING ISSUES - SECTION 1.141-13

The Treasury Department published final Regulations, addressing the application of the private activity bond restrictions to refunding bonds in the Federal Register in February 2006 (the "Refunding Regulations").

A. Private Business Use.

1. Rules with respect to Private Activity Bonds.

a. General. The Refunding Regulations as they apply to private activity bonds apply the private activity bond rules to the refunded issue and the refunding issue separately. Treas. Reg. §1.141-13(a). The proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the refunded issue. Treas. Reg. §1.141-13(b)(1). The amount of private business use associated with a bond issue is based upon the respective measurement period of the refunded issue and the refunding issue, calculated separately. Treas. Reg. §1.141-13(b)(2).

b. Example. Airport issues taxable bonds to construct a facility because it knows that the management contract creates private business use. The management contract terminated, and a "good" management contract is executed. Airport issues refunding bonds to refund the taxable bonds. This means that the refunding bonds do not carry over the "bad use" caused by the original management contact.

2. Rules with respect to Governmental Bonds and Qualified Section 501(c)(3) Bonds.

a. In General. The private business use test is applied to a combined measurement period with respect to a refunding of a governmental obligation, so that the measurement period begins on the issue date of the refunded bond or the date the facility financed with the proceeds of such bond is placed in service, whichever is later, and ends on the date the refunding bonds are retired. Treas. Reg. §1.141-13(b)(2)(ii)(A). In a series of refundings, the measurement period begins by reference to the earliest bond issue. Treas. Reg. §1.141-13(b)(2)(iii).

b. Optional Election To Apply Measurement Period Separately. If the refunded issue did not, based upon actual use, satisfy the private business use test by reference to the measurement period beginning on the date the refunded bonds were issued or the date the facility financed with the refunded bonds is placed in service, whichever is later, and ending on

the issue date of the refunding bonds, for purposes of applying the private business use tests, the issuer has the option to treat the measurement periods for refunded bonds and refunding bonds as separate. Treas. Reg. §1.141-13(b)(2)(ii)(B).

c. Qualified 501(c)(3) Bonds. Use of property refinanced with the proceeds of a refunding issue by a Section 501(c)(3) organization in activities that are not unrelated trade or business activities under Code Section 513(a) is treated as governmental use. Treas. Reg. §1.141-13(b)(v). Solely, for purposes of the Refunding Regulations, the use of proceeds of a Qualified Section 501(c)(3) Bond for the purpose of paying costs of issuance (ordinarily a private business use) is treated as a governmental use of proceeds.

3. Private Payments and Security Tests.

a. Separate Issue Treatment. The private payment or security interest test is measured separately for the refunded and the refunding issue, if the private business use is measured separately. Treas. Reg. §1.141-13(c)(1).

b. Combined Issue Treatment.

(i) In General. The private payment or security interest test is measured on a combined basis if the private business use test is measured on a combined basis.

(ii) Computing the Present Value. The present value of the private security and private payments is compared to the present value of the debt service on the combined issue (other than debt service paid with the proceeds of the refunding bond). The present value is computed using the earliest issue date in a series of refundings. Except as set forth in 4. below, the present values are determined by using the yield on the combined issue as the discount rate, using payments on the refunding issue and all earlier issues (other than payments made with the proceeds of refunding bonds) and using as the target price, the issue price of the earliest bond issue in the measurement period. In the case of partial refundings, only the payments with respect to the refunded debt is taken into account. Treas. Reg. §1.141-13(c)(2).

4. Arrangements Not Entered into in Contemplation of a Refunding. The issuer may use the yield on the refunded issue in applying the private payment or security interest test, in determining the present value of private payment and private security interest under arrangements that were not entered into in contemplation of the refunding issue. An arrangement entered into more than 1 year prior to the issue date of the refunding issue is treated as not having been entered into in contemplation of a refunding issue. Treas. Reg. §1.141-13(c)(3).

B. Multipurpose Allocation Rules. The multipurpose allocation rules of Treas. Reg. §1.148-9(h) apply for purposes of applying the Refunding Regulations, unless such allocation is unreasonable in that it achieves more a favorable result under the private activity bond tests than could be achieved with actual separate issues. Treas. Reg. §1.141-13(d). Allocations made under Treas. Reg. §1.141-13(d) must be consistent with allocations made under Treas. Reg. §1.148-9(h). Treas. Reg. §1.141-13 (d) by its terms, does not apply to private loan financing test determinations under Code Section 141(c)(1) or determinations regarding the acquisition of nongovernmental output property to be treated as private activity bonds pursuant to Code Section 141(d)(1).

C. Application of Reasonable Expectations Test in Certain Refunding Bond Situations. An action that would otherwise cause a refunding bond to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of Treas. Reg. §1.141-2(d) (including the mandatory redemption provisions hereof) if (i) the action is not a deliberate action within the meaning of Treas. Reg. §1.141-2(d)(3), *i.e.*, an action taken by the issuer that is within its control, and (ii) the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the refunded bonds.

D. Miscellaneous. The Refunding Regulations provide that the term "private activity bond" in the context of these rules does not include taxable bonds.

E. Effective Dates. The Refunding Regulations apply to bonds sold on or after the date of publication of final regulations in the Federal Register; the Refunding Regulations will not apply to refunding bonds issued to refund bonds issued prior to the effective date of the private activity bond regulations of May 16, 1997, unless the weighted average maturity of the refunding bonds exceeds the remaining weighted average maturity of the refunded bonds.

XII. ANTI-ABUSE RULES - SECTION 1.141-14

If an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons significant benefits of tax-exempt financing inconsistent with the restrictions of Code Section 141, the Commissioner may take any action to reflect the substance of the transaction, including: (i) treating separate issues as a single issue for purposes of the private activity bond tests; (ii) reallocating proceeds to expenditures, property, use or bonds; (iii) reallocating payments to use or proceeds; (iv) measuring private business use on a basis that reasonably reflects the economic benefit; or (v) measuring private payments or security on a basis that reasonably reflects the economic substance. *See* PLR 201148005 for analysis by the IRS of the anti-abuse rules in responding to a request for a ruling on whether the refinancing of taxable debt with the proceeds of a 501(c)(3) bond issue would cause the issue to fail to qualify as a 501(c)(3) issue.

XIII. EFFECTIVE DATES - SECTION 1.141-15; SECTION 1.141-15T

A. General Effective Date. Treas. Reg. §§1.141-1 through 1.141-6(a), Treas. Reg. §§1.141-9 through 1.141-14, Treas. Reg. §§1.145-1 through 1.145-2, Treas. Reg. §1.150-1(a)(3) and the definition of bond documents contained in Treas. Reg. §1.150-1(b) (collectively, the "May 1997 Regulations") apply to bonds issued on or after May 16, 1997, that are subject to the Tax Reform Act of 1986.

B. Refunding Bonds. The May 1997 Regulations do not apply to refunding bonds issued on or after May 16, 1997, unless (i) the weighted average maturity of the refunding bonds is greater than (A) the remaining weighted average maturity of the refunded bonds, or (B), in the case of certain short-term obligations, 120% of the weighted average reasonably expected economic life of the facilities financed, or (ii) a principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

C. Permissive Application of Regulations. The May 1997 Regulations may be applied in whole but not in part to actions taken before February 23, 1998, with respect to (1) bonds

outstanding on May 16, 1997, and subject to Code Section 141, or (2) refunding bonds issued on or after May 16, 1997.

D. Permissive Retroactive Application of Sections. The following may be applied to any bonds issued before May 16, 1997: Treas. Reg. §1.141-3(b)(4) (management contracts), Treas. Reg. §1.141-3(b)(6) (research agreements) and Treas. Reg. §1.141-12 (remedial actions).

E. Output Regulations. Treas. Reg. §1.141-15(f) provides special effective dates applicable to regulations pertaining to the treatment of output facilities under the private activity bond tests.

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP
October 18-20, 2023

Private Activity Bond Tests
Real World Challenges

Chair:
Neil Kaplan Hawkins Delafield & Wood LLP – New York, NY

Panelists:
Mike Andreana Pullman & Comley
Martye Kendrick Greenberg Traurig, LLP
Vanessa Lowry Greenberg Traurig, LLP
Luisella Perri Foley & Lardner LLP

This panel will address more advanced issues encountered in the identification, allocation and remediation of private business use of bond-financed property. The hypotheticals are intended to identify and nuances in the private activity bond regulations that may affect whether private use arises, the availability and allocation of qualified equity and the application of the remedial action regulations. The panel is intended for bond and tax lawyers with more than five years of experience.

The following fact pattern and questions will be discussed during the session:

MetroCity owns 50 acres of undeveloped land on the edge of its downtown district. The land is dedicated parkland, which can be used only for recreational and cultural purposes. The adjacent area includes the campus of a university that is a 501(c)(3) organization, a bustling shopping and entertainment district and several new office towers. MetroCity formed a membership corporation under the State's not for profit corporation law to develop the land ("CiviCorp"). CiviCorp has 7 members, consisting of the Mayor of MetroCity, 2 members appointed by the MetroCity Council, 1 member appointed by the president of the University and 3 members who are nominated by the president of the University and appointed by the Mayor of MetroCity.

On January 1, 2013, MetroCity issued a 4-year taxable note in the amount of $50 million, which was used to finance the core and shell of a new 30,000 square foot performing arts center and the fit-out of a 15,000 square foot hall, which was placed in service in January 2014. In February 2014 CiviCorp contributed $50 million of capital campaign cash to fit out a second opera theater in the performing arts center. Construction of the second theater began March 2014 and the second theater was placed in service in January 2016. On January 1, 2017, issued $100 million of its tax-exempt bonds to refinance the outstanding taxable note in the amount of $50 million and applied the remaining $50 million of proceeds to (i) install acoustical panels in the music hall, landscape the surrounding parkland ($10 million) and construct a new 300 space parking garage ($35

million). The final maturity date of the MetroCity Bonds is January 1, 2028. CiviCorp contributed $5 million of its cash to pay costs of constructing the parking garage. The parking garage project included a $10 million pedestrian bridge connecting the parking garage to the performing arts center and the shopping and entertainment district. Construction of the parking garage and pedestrian bridge commenced on January 1, 2017 and was placed in service on January 1, 2018.

All of the bond financed property was owned and operated by MetroCity through December 31, 2023. MetroCity proposes to enter into an arrangement with CiviCorp on January 1, 2024 whereby for a period of 5 years CiviCorp will manage the music hall in the performing arts center. CiviCorp will not receive a fee for its services. MetroCity and CiviCorp will agree on an annual budget for the operation of the performing arts center. All revenues from the music hall will be paid to MetroCity and MetroCity will reimburse CiviCorp for its costs of managing the performing arts center. MetroCity agreed to use any net profits from the operations of the performing arts center for capital improvements to the park complex in consultation with CiviCorp.

On January 1, 2026, MetroCity modified its arrangement with CiviCorp by leasing the performing arts center to CiviCorp for a term of 40 years. Pursuant to the lease, CiviCorp is required to pay annual rentals to MetroCity of $5 million per year.

What amounts contributed by CiviCorp, if any, may be treated as qualified equity?

On what date or dates did a deliberate action occur?

What type of remedial actions are available to MetroCity?
If instead of leasing the facility, CiviCorp determines to purchase a 99 year leasehold of the performing arts center for $150 million, how much of the purchase price must be treated as disposition proceeds? How would the answer change if the 2017 issue was in the amount of $500 million with $400 million used to finance street improvements?

How may the disposition proceeds in excess of the cost of defeasing the non qualified bonds, if any, be treated as spent?

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PRIVATE ACTIVITY BOND TESTS*

I. DEFINITIONS AND GENERAL RULES – SECTION 141 AND SECTION 1.141-1

A. Private Business Tests.

1. General. Code Section 141(a)(1)[1] defines a "private activity bond" issue as a bond issue that satisfies both of the following tests, which are set forth in Code Section 141(b) (the "private business tests"):

a. Private Business Use Test. More than 10% (or 5% if the private business use is unrelated or disproportionate to the governmental use) of the bond proceeds are to be used, directly or indirectly, in the trade or business of a person other than a state or local government unit (the "private business use test"); and

b. Private Security or Payment Test. The payment of the principal of, or the interest on, more than 10% (or 5% if the private business use is unrelated or disproportionate to the governmental use) of the proceeds of the bond issue is (under the terms of the issue or any underlying arrangement) directly or indirectly (i) secured by an interest in property used or to be used for a private business use or payments in respect of such property, or (ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use (the "private security or payment test").

2. $15 Million Limitation. Even if the private business tests are not met, the bonds may be private activity bonds if the "nonqualified amount" exceeds $15 million. The nonqualified amount is the lesser of (i) the portion of the bond proceeds to be used for private business use or (ii) the portion of the bonds that are secured by, or payments derived from, property used in private business use. If the nonqualified amount exceeds $15 million, the bonds are private activity bonds unless the issuer allocates its annual volume cap for qualified private activity bonds to the nonqualified amount in excess of $15 million.

3. Separate Private Loan Financing Test. In addition, Code Sections 141(a)(2) and 141(c) independently treat bonds as private activity bonds if more than the lesser of 5% or $5,000,000 of the proceeds of the bond issue are to be used, directly or indirectly, to make or finance loans (excluding certain permitted tax assessment loans) to non-governmental persons (the "private loan financing test"). Private loans may arise even if there is no private business use, such as in the case of loans to individuals acting in a non-business capacity.

B. Private Activity Definitions.

Certain definitions that are specifically applicable to the private activity bond regulations (referred to herein as the "Regulations") are noted below. Unless otherwise noted, these definitions are set forth in Treas. Reg. §1.141-1(b).

*This outline draws significantly from the excellent outlines and updates prepared by prior chairs and panelists.

[1] Unless otherwise noted herein, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

1. Common Areas mean portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

2. Discrete Portion means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls, partitions, or other physical barriers are examples of a discrete portion.

3. Disposition means the sale, exchange or other distribution or transfer of property (other than investments) financed with the proceeds of an issue. *See* Treas. Reg. §1.141-12(c)(1).

4. Disposition Proceeds means any amounts (including property, such as an agreement to provide services) derived from a disposition of property financed with the proceeds of an issue. *See* Treas. Reg. §1.141-12(c)(1).

5. Governmental Person means a state or local governmental unit as defined in Code Section 1.103-1 or any instrumentality thereof. The federal government is not a Governmental Person.

6. Measurement Period. Except as provided in Treas. Reg. §1.141-3(g)(2), the measurement period of property financed by an issue begins on the later of the issue date of the bonds or the date on which the financed property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date. *See* Treas. Reg. §1.141-3(g)(2).

7. Proceeds means the sale proceeds of an issue (other than sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve fund). Proceeds also include any investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period). Disposition proceeds are treated as proceeds to the extent provided in Treas. Reg. §1.141-12 (remedial actions). The Commissioner may treat replaced amounts as proceeds.

8. Project Period means the period beginning on the issue date of the bonds and ending on the date that the project is placed in service. A project is placed in service on the date, which based on all the facts and circumstances, (a) the project has reached a degree of completion which would permit its operation at substantially its design level, and (b) the project is in fact in operation at such level. In the case of a multipurpose issue, the issuer may elect to treat the project period for the entire issue as ending on the expiration of the applicable temporary period or the end of the fifth bond year.

9. Renewal Option means a legally enforceable right to renew a contract. A provision that provides for automatic renewal in the absence of the exercise of a cancellation right by either party is not a renewal option, even if it is expected to be renewed.

10. Replaced Amounts means replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds.

C. Related Parties. Except as otherwise provided, related parties are treated as one person and any reference to "person" includes any related party. *See* Treas. Reg. §1.141-1(d) and Treas. Reg. §1.150-1(b) for the general definition of related party.

1. PLR 200942037. In this ruling, a university, by reason of a special (although redacted citation) tax act definition, is a qualified educational organization equivalent to a state governmental unit for purposes of the tax-exempt bond provisions of the Code for any trade or business not constituting an unrelated trade or business. The university established a hospital corporation to run the clinical operations of the university's medical school. The hospital corporation qualifies as an organization described in Section 501(c)(3), and the operation of the clinics does not constitute an unrelated trade or business of the corporation. The hospital corporation is controlled by the university because the university has the power both to appoint and remove, without cause, a controlling portion of the board of the corporation. Under these facts, the Internal Revenue Service (the "IRS") determined that the university and the hospital corporation are related governmental users of a bond-financed project because both entities meet (1) the related party definition of Treas. Reg. §§1.150-1(b) and (2) the related party attribution rule of Treas. Reg. §1.141-1(d).

II. PRIVATE ACTIVITY BOND TESTS - SECTION 1.141-2

A. Overview. Treas. Reg. §1.141-1 (a) states that the purpose of the private activity bond tests set out in Code Section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons,[2] without regard to whether a financing actually transfers the benefits of tax-exempt financing to a nongovernmental person. Regulations under Code Section 141 serve to identify arrangements *that have a potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits*. The anti-abuse rules of Treas. Reg. §1.141-14 should be considered in light of this purpose. The Regulations under Code Section 141 may not be applied in a manner that is inconsistent with these purposes.

B. Scope. Treas. Reg. §§1.141-0 through 1.141-16 apply generally for the purposes of the private activity bond limitations under Code Section 141.

C. Reasonable Expectations and Deliberate Actions.

1. General. A bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either (1) the private business tests or (2) the private loan financing test. In addition, an issue is an issue of private activity bonds if the issuer takes a deliberate action after the issue date that causes the conditions of either the private business tests or the private loan financing test to be met. *See* Treas. Reg. §1.141-2(d)(1).

[2] The terms nongovernmental person and private business user are used herein interchangeably to refer to users whose use may result in private business use, including use by the federal government and not-for-profit entities, including 501(c)(3) entities.

2. Reasonable Expectations. In general, the issuer's reasonable expectations about events and actions affecting the use of bond proceeds must be taken into account over the entire stated term of the issue.

a. Special Rule for Contingent Mandatory Redemption. Treas. Reg. §1.141-2(d)(2)(ii) provides that an issuer may disregard an action that is reasonably expected on the issue date and that otherwise would violate the private activity bond tests if, on the issue date, (i) the issuer reasonably expects that the financed property will be used for a governmental purpose for a "substantial period" of time; (ii) the issuer is required to redeem all "nonqualified bonds" (even if the cost to redeem is in excess of the disposition proceeds by contributing its own funds) within six months of the action; (iii) the issuer has not entered into an arrangement with a nongovernmental person with respect to the action; and (iv) the mandatory redemption meets the change-in-use rules contained in Treas. Reg. §1.141-12 (taking into account the redemption described in (ii) above). This special rule allows bond redemptions to cure expected, but unpredictable, future private involvement during the term of a bond issue. The requirement that bonds be redeemed irrespective of the amount of disposition proceeds received places a certain amount of risk on the issuer.

b. Substantial Period. The absence of a definition of "substantial period" for purposes of this rule leaves some uncertainty. One possible analogy may be the definition of substantial period for a different purpose under Treas. Reg. §1.141-3(g)(7) on measurement of private business use, in which 10% of the measurement period is treated as a substantial period. Another analogy is the old five-year period used in the original change-in-use safe harbors under Revenue Procedure 93-17, 1993-1 C.B. 507.

3. Deliberate Actions. A deliberate action is an action taken by the issuer that is within its control. See Treas. Reg. §1.141-2(d)(3). An intention to violate the requirements of Code Section 141 is not necessary for any action to be deliberate. Involuntary conversions under Code Section 1033 and actions taken in response to a regulatory directive of the federal government are not deliberate actions. Certain remedial actions described in Treas. Reg. §1.141-12 can prevent a deliberate action from causing the related nonqualifying bonds to cease to be treated as tax-exempt bonds. A deliberate action occurs on the date the issuer enters into a binding contract for nongovernmental use of the financed property that is not subject to any material contingencies. The binding contract notion is important to keep in mind if an issuer signs a contract with a later effective date.

4. Special Rules. Special rules are provided for two governmental bond program situations.

a. Certain Personal Property Dispositions. Dispositions of personal property in the ordinary course of an established governmental program meeting certain requirements (*i.e.*, weighted average bond life not more than 120% of reasonably expected governmental use, the fair market value of property at time of disposition is not reasonably expected to exceed 25% of cost, the property is no longer suitable for governmental purposes on date of disposition) are not treated as deliberate actions if the issuer is required to commingle disposition amounts with substantial tax or other funds and such amounts are reasonably expected

to be expended within 6 months of commingling. Bonds properly allocated to this personal property may be treated as a separate issue under Treas. Reg. §1.150-1(c)(3).

b. Certain General Obligation Bond Programs. In addition, the determination of whether an issue of general obligation bonds of a general purpose governmental issuer that finances a large number of separate purposes (at least 25 separate purposes and not less than 4 predominant purposes) satisfies the private activity bond tests may be based solely on the issuer's reasonable expectations as of the issue date (without regard to subsequent deliberate actions) if the following requirements are satisfied: (i) the issue must be a general obligation of the issuer; (ii) the issuer must be a general purpose governmental unit; (iii) the issue must finance at least 25 separate purposes but cannot "predominantly" finance fewer than four purposes; (iv) the issuer must employ a "fund" accounting method; (v) the accounting method must make specific tracing of bond proceeds to expenditures unreasonably burdensome; (vi) the issuer must reasonably expect to spend all the net bond proceeds on capital expenditures within six months after the issue date; (vii) the issuer must adopt reasonable procedures to verify such expenditures (a program for random spot checks of actual use of 10% of the bond proceeds qualifies); (viii) the issuer must reasonably expect to spend all the net bond proceeds before spending any later similar general obligation bond proceeds; (ix) the issuer must reasonably expect to make no private loans with the bond proceeds; (x) the issuer must reasonably expect that it could make governmental capital expenditures during the ensuing six months of at least 125% of the amount financed; and (xi) the issuer must reasonably expect that the average maturity of the bond issue does not exceed 120% of the weighted average reasonably expected economic life of the financed capital improvements.

III. DEFINITION OF PRIVATE BUSINESS USE - SECTION 1.141-3

A. General Rule. Generally, the private business use test of Code Section 141(b)(1) is met if more than 10% (or, in certain cases, 5%) of the proceeds of an issue is used in a trade or business carried on by a nongovernmental person. For this purpose, the use of financed property is treated as the use of proceeds. Both indirect use and the ultimate and intermediate uses of proceeds are considered in determining whether an issue meets the private business use test.

B. General Definition of Private Business Use.

1. General. Proceeds are used for private business use if they are used in a trade or business carried on by a nongovernmental person. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business. For the purposes of the private business use test, a nongovernmental person uses bond proceeds and will generally be a private business user if it (i) owns financed property, (ii) leases/subleases financed property (unless an exception is met), (iii) manages or is a service provider with respect to the financed property under a nonqualifying management contract, (iv) purchases or agrees to purchase the output of an output facility under a nonqualifying arrangement, (v) sponsors a nonqualifying research arrangement that relates to the financed property, (vi) otherwise enjoys special legal entitlements for the beneficial use of the financed facility, or (vii) solely in the case of financed property that is not available for use by the general public, receives special economic benefit from the financed property.

2. Actual or Beneficial Use.

a. In General. In the catch-all category of other actual or beneficial use, Treas. Reg. §1.141-3(b)(7) provides that private business use may arise under two separate standards, depending on whether the financed property is available for general public use: (i) "special legal entitlements" to general public use property; and (ii) "special economic benefits" from property that is not available for general public use, based on all the facts and circumstances.

b. Special Legal Entitlements to General Public Use Property. For bond-financed property that is available for general public use, Treas. Reg. §1.141-3(b)(7)(i) provides that private business use of such property arises if a private business has special legal entitlements to beneficial use of the property. For example, an arrangement that provides priority rights to the use or capacity of a facility generally causes private business use under this standard. The special legal entitlement standard generally seems workable in that it looks to objective legal rights granted to private businesses to use bond-financed facilities.

c. Special Economic Benefits from Non-general Public Use Property. For bond-financed property that is unavailable for general public use, Treas. Reg. §1.141-3(b)(7)(h) provides that private business use of such property arises if a private business derives special economic benefits from the property, based on all the facts and circumstances, even if it has no special legal entitlements. The Regulations state that the following factors weigh towards private business use under this standard:

(i) a functional relationship or physical proximity of the bond-financed property to other private business use property;

(ii) a small number of private businesses receiving the special economic benefit; and

(iii) the cost of the property being depreciable by a private business (this depreciable interest factor would seem to give rise to private business use anyway, based on ownership).

3. Exception. A special exception under Treas. Reg. §1.141-3(d)(2) excludes nominal ownership by a nongovernmental person that is solely incidental to a financing arrangement. For example, a private business may hold title in a sale-leaseback transaction with a governmental lessee.

4. Management Contract as Lease. Treas. Reg. §1.141-3(b)(3) provides that the determination of whether an arrangement such as a management contract properly constitutes a lease is based on all of the facts and circumstances, including (i) the degree of private business control over the financed property; and (ii) whether the private business user bears risk of loss on the financed property.

5. Selected Examples from the Regulations.

a. Treas. Reg. §1.141-3(f), Example 5 - Parking Lot. Corporation C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory.

Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for the use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest.

b. Treas. Reg. §1.141-3(f), Example 8 - Airport Runway.

(i) City I issues bonds and uses all of the proceeds to finance construction of a runway at a new city-owned airport. The runway will be available for take-off and landing by any operator of any aircraft desiring to use the airport, including general aviation operators who are natural persons not engaged in a trade or business. It is reasonably expected that most of the actual use of the runway will be by private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. These leases for the use of terminal space provide no priority rights or other preferential benefits to the air carriers for use of the runway. Moreover, under the leases, the lease payments are determined without taking into account the revenues generated by runway landing fees (that is, the lease payments are not determined on a "residual" basis). Although the lessee air carriers receive a special economic benefit from the use of the runway, this special economic benefit is not sufficient to cause the air carriers to be private business users, because the runway is available for general public use. The issue does not meet the private business use test.

(ii) The facts are the same as in paragraph (i) above, except that the runway will be available for use only by the private air carriers. The use by these private air carriers is not for general public use, because the runway is not reasonably available for use on the same basis by natural persons not engaged in a trade or business. Depending on all of the facts and circumstances, including whether there are only a small number of lessee private air carriers, the issue may meet the private business use test solely because the private air carriers receive a special economic benefit from the runway.

(iii) The facts are the same as in paragraph (i) above, except that the lease payments under the leases with the private air carriers are determined on a residual basis by taking into account the net revenues generated by runway landing fees. These leases cause the private business use test to be met with respect to the runway because they are arrangements that convey special legal entitlements to the financed facility to nongovernmental persons.

c. Treas. Reg. §1.141-3(f), Example 9 – Governmental Airport Parking. A governmentally owned airport parking facility that is generally available to both private airline employees and the general public using the airport qualifies for general public use, despite the special economic benefit to the private airlines.

d. Treas. Reg. §1.141-3(f), Example 11 - Port Road - Highway Authority. W uses all of the proceeds of its bonds to construct a 25-mile road to connect an industrial port owned by Corporation with the existing roads owned and operated by W. Other

than the port, the nearest residential or commercial development to the new road is 12 miles away. There is no reasonable expectation that development will occur in the area surrounding the new road. W and Y enter into no arrangement (either by contract or ordinances) that conveys special legal entitlements to Y for the use of the road. Use of the road will be available without restriction to all users, including natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because the road is treated as used only by the general public.

6. Private Letter Rulings. Certain private letter rulings issued since release of the 1997 private activity bond regulations are summarized below in addition to the summaries under specific sections of this outline. Earlier private letter rulings are summarized in the National Association of Bond Lawyers' Federal Taxation of Municipal Bonds, Third Edition.

a. PLR 202205016 and PLR 202205017. City acquired property, which is reclaimed land consisting of sand fill on top of native soil. The District will issue bonds to be payable by incremental tax revenues generated by improvements to be financed with bond proceeds. The bond-financed projects include (i) strengthening of an existing revetment, including adding rocks to the revetment and adjacent areas and raising the level of the revetment to reduce the risk of flooding, (ii) soil stabilization improvements (iii) governmental structures, including police, fire and school facilities, and (iv) public access facilities, including roads, rights of way and sidewalks. No person or entity, other than state and local governmental units will have any special rights, privileges or other legal entitlements with respect to the bond funded improvements. A portion of the ground improvements to be funded with bond proceeds will be located on portions of the property on which private use facilities are located, however the design of the ground improvements took into account the needs of the governmental improvements, but not the needs of the private use facilities. Nevertheless the revetment strengthening and ground improvements will protect the entire area without distinction between public or private property or the type of area occupant or user. The IRS noted that when completed, the improvements would provide some benefit to all of the owners, lessees and operators of private business use facilities, and not only a small number of private business users. The IRS did not decide whether there will be a special economic benefit to such owners, lessees and operators, but held that under the facts and circumstances the benefits to such private business users would be insufficient to give rise to private business use.

b. PLR 201412011. Management contract entered into by a governmental electric company had an initial term of 12 years with potential extension to 20 years. The IRS had previously ruled favorably on the original contract and was asked to review the Amended Agreement made primarily to deal with operational difficulties encountered by the Electric Company as a result of a "Storm Event." The compensation involved a fixed fee component, an incentive fee component, and a reimbursement of certain costs, none of which exactly fit within the definitions in Revenue Procedure 97-13 ("Rev. Proc. 97-13"). The fixed component did not fit the definition of periodic fixed fee because the amount could be reduced if certain performance standards related to customer satisfaction and service interruptions were not met. The IRS concluded that the standards for reduction were not based on objective, external factors as permitted under the safe harbor, but did not give rise to private business use because the reduction was not based on net profits, and further, even after a reduction, the fee was a stated amount for a particular annual period. The incentive compensation is also different from the type described in Rev. Proc. 97-13. The Electric Company was to establish an incentive compensation pool. The incentive fee could be earned based on "favorable" performance measured against

certain detailed performance metrics but could also adjust downwards if minimum performance standards were not met. None of the performance criteria described in the ruling relate directly to revenues or profits but do include adherence to capital and operating budgets and meeting the Electric Company's "financial needs." The IRS notes that the some of the performance categories provide incentives to reduce expenses, but that the incentive fee does not create private business use because it is not based on gross revenues or net profits of the Electric Company. The contract included reimbursement for transactions with affiliates. The costs passed on are described as being based on methodologies such as the fully allocated cost methodology approved by statute or regulations, which are described as not including a profit or mark-up component for the affiliate. Pass-through expenditures do not include amounts paid to senior management of the Manager. Because none of the reimbursements are based on net profits of the Electric Company, the IRS concludes that these payments do not cause private business use. The ruling addressed ancillary contracts that could arise with the manager or manager affiliate for major storm and other emergency expenditures beyond the reasonable control of the manager. Because these services were for unforeseen events and not for the day-to-day operations and must be separately approved by the Electric Company, the IRS concludes that these contracts would not be taken into account in analyzing the Amended Agreement.

c. PLR 201346002. Authority issued Bonds in part to finance construction of Facility owned by Authority and leased to State pursuant to multi-year operating Lease. State intends to enter into management contracts for performance of certain substantial services at Facility that will cause the Bonds to satisfy the private business test. Lease payments and State's rental payments on other facilities financed by parity bonds are security for the Bonds. Bondholders do not have a mortgage or other security agreement creating a security interest in Facility under State law. Authority has covenanted that generally it will not sell, lease, mortgage or otherwise dispose of Facility other than the Lease, as long as the parity bonds are outstanding. These restrictions do not apply after the Lease is terminated or if other monies are sufficient to cover the amounts of the Lease payments. Held: The Lease and related covenants will not cause the private security or payment test to be met because the Lease and indenture covenants merely provide assurance to bondholders that Authority will continue to make Facility available to State and State will continue to use Facility and make Lease payments until Lease is ended and neither bondholders nor any other parties (other than State or Authority) will be granted rights in Facility.

d. PLR 201338031. Bonds were issued to finance construction and renovation of a Hotel. Pursuant to a management contract, Manager supervises, controls, manages and operates the Hotel. The compensation to Manager is being amended to include an annual base fee and an annual incentive fee. The proposed annual base fee is the greater of (i) the amount that would be a periodic fixed fee if paid every year or (ii) a percentage of the hotel's actual gross receipts for the fiscal year. The proposed annual incentive fee amount is a percentage of actual gross receipts for the fiscal year which amount the Issuer will pay the Manager only if the Hotel's Achieved Revenue Per Available Room (RevPAR) is at least a set percentage of the Achieved RevPAR of a group of specific hotels comparable to the Hotel. Held: Under the facts and circumstances, notwithstanding the management contract will not meet the requirements of Section 5 of Rev. Proc. 97-13, the management contract will not result in private business use of the Hotel because both the base fee and the incentive fee, both independently and in combination, are not based on a share of net profits.

e. PLR 201338026. Bond proceeds are to be used to finance acquisition or renovation of facilities to be owned or leased by Hospital for purpose of providing clinical medical services. Pursuant to a management contract, Medical Group will provide physician services to Hospital at the financed clinical facilities and is paid base compensation and incentive compensation and reimbursement for certain expenses by Hospital. Every third year, the base compensation and incentive compensation will be renegotiated to ensure that they remain within fair market value. Hospital also pays a portion of the compensation of the President of the Medical Group which includes base compensation and incentive compensation. Held: Under the facts and circumstances, notwithstanding the management contract does not meet the requirements of Section 5 of Rev. Proc. 97-13, the management contract does not result in private business use of the clinical facilities because (i) neither the Hospital's payment or reimbursement of the Medical Group's miscellaneous expenses nor its payment or reimbursement of the Medical Group's compensation expenses are calculated based on net profits, (ii) the facts and circumstances of the President's incentive pay do not support a conclusion of private business use of the clinical facilities, (iii) based in part on the periodic renegotiation of base compensation and incentive compensation, the management contract provides for reasonable compensation for the services provided by the Medical Group, and (iv) the Medical Group does not have any role or relationship with Hospital that substantially limits the Hospital's ability to exercise its rights under the management contract, including its termination right.

f. PLR 201228029. Electric Company, a governmental person that owns and controls an electric transmission and distribution system, will enter into an agreement with Manager for the single-purpose subsidiary of Manager to operate the electric transmission and distribution system. The term of the agreement will not exceed 10 years, and Manager and Electric Company (and Electric Company's sole shareholder, Authority) are not related parties and do not have any overlapping board members. The compensation of Manager will consist of the following components: (1) Fixed Direct Fee, (2) Incentive Compensation Component, and (3) Reimbursement of Pass-Through Expenditures. The Fixed Direct Fee is a stated dollar amount subject to adjustment for reduced credit support and reduction for poor performance. The Incentive Compensation Component is expressed in the first year of the contract as a stated dollar amount that the Manager may earn if it attains certain favorable performance goals, including expense reduction incentives. The Reimbursement of Pass-Through Expenses includes the Manager's actual costs without mark-up or profit, but Manager's costs on transactions with affiliates, if any, may include a mark-up of the affiliates' direct expenses in accordance with Federal Energy Regulatory Commission ("FERC") sanctioned cost allocation methods. Held: Based on all facts and circumstances, the agreement with Manager does not result in private business use of the tax-exempt bond-financed electric transmission and distribution facilities within the meaning of Code Section 141(b). Although the potential adjustments to the Fixed Direct Fee cause it not to meet the definition of a "periodic fixed fee" under Rev. Proc. 97-13, such fee does not result in private business use. The Incentive Compensation Component similarly does not result in private business use because the expense reduction incentives of such fee are not based on gross revenues or net profits of the facilities. The Reimbursement of Pass-Through Expenditures component does not result in private business use because any mark-up of actual costs will occur pursuant to FERC sanctioned cost allocation methods and not a share of net profits from the facilities. Finally, the length of the agreement does not cause the contact to result in private business use because the 10-year term does not exceed the 20-year term allowable under

Rev. Proc. 97-13 for contracts that relate to public utility property and satisfy either the 95% or 80% periodic fixed fee safe harbor.

g. PLR 201216009. IRS concludes that, if an agreement between a public hospital district and a public university creates a partnership, the partnership would nonetheless not create private business use because, applying the aggregate approach to partnership, the persons using the facilities will all be governmental persons.

h. PLR 201213010. Automated people mover (APM) transporting airline employees and passengers between terminals of an airport facility is not a common area of the terminals and may be treated as a separate facility. Further, because passengers and employees may ride the APM at no cost and no preferential treatment, the APM is available to the general public, despite security requirements imposed on those entering the terminals.

i. PLR 201043001. The IRS concluded that bonds issued to pay insurance claims for losses on commercial policies and residential policies resulted in private business use, but the bonds will not be treated as private activity bonds because the bonds will be repaid with taxes of general application. In the private letter ruling, an association was established by the state legislature to provide insurance to applicants who would otherwise be unable to obtain insurance in the marketplace. To the extent that the association's funds are insufficient to pay claims, the association will issue bonds to pay the remaining claims and the bonds will be repaid from either premium surcharges assessed on policyholders or assessments on all property insurers licensed to do business in the state. The IRS concluded that the bonds meet the private business use test because the commercial policyholders who receive bond proceeds in satisfaction of their claims are private business users. The IRS noted that the association is not able to avail itself of the public use exception because there are enough differences between residential and commercial policies that each policy type must be rated separately, and the policy terms exceed 200 days. However, the IRS concluded that the premium surcharges and assessments used to repay the bonds are taxes of general application and, therefore, the bonds fail the private security or payment test.

j. PLR 201049003. The IRS concluded that an agreement with a university to broadcast and televise its college sports games did not result in private business use of the bonds. In the private letter ruling, a corporation received under the agreement (i) broadcast and telecast rights, (ii) advertising sales and corporate sponsorship program rights, and (iii) publishing and vending rights. The agreement did not give the corporation any rights to control the teams, ticket sales, security, personnel management, or general management of the venues. For the rights granted under the agreement, the corporation must (a) pay a stated annual fee to the university in semi-annual installments over the term of the agreement, (b) pay the university a royalty in each contract year equal to a percentage of net revenues in excess of specified threshold amounts, (c) make investments in signage and technological upgrades, and (d) promote the university's athletic scholarship fund by providing a media package with a specified value. The IRS concluded that the agreement conveyed special legal entitlements to the corporation to use portions of bond-financed improvements but did not result in private business use. In reaching this conclusion, the IRS stated that the corporation's right to broadcast and televise the sports game and the sale of the advertisements is too remote to be considered use of the bond-financed improvements and provides no control over any element of the game schedules. In addition, the IRS stated that the tangible use of the bond-financed portions of the venues, including the use of

broadcast equipment and certain personnel at the venues, are incidental uses that do not exceed more than 2.5 percent of the bond-financed improvements.

k. PLR 200829008. With this private letter ruling, the IRS continues its favorable line of rulings dealing with the acquisition of separate property interests. A governmental agency sought to issue bonds to refund a taxable financing used to acquire undivided interests in certain mineral and working interests purchased from a nongovernmental seller who retained undivided interests in the same properties, the result being that the total property (mineral interests and interests in depreciable property associated with the mineral interests) was jointly owned by the private seller and the agency. The purchase price paid for the property by the agency was adjusted in accordance with trade usage to reflect the existence of the seller's and other interests in the property. Largely because the purchase price and operations of the various interests reflected separate rights and obligations associated with the interests, the IRS, relying heavily on Example 1 in Treas. Reg. §1.141-7(i) (recognizing and respecting separate ownership interests in output facilities), ruled that no portion of the purchase price for the interests acquired by the agency would be treated as used in a private business use as a result of seller's retained interests in the property.

l. PLR 200827023. The IRS ruled that the transmission and distribution of electricity that was generated or purchased with the proceeds of tax-exempt obligations issued by a governmental utility through distribution and transmission facilities owned by a for-profit, investor owned utility did not constitute private business use of the electricity where the for-profit utility did not enter into any arrangement to purchase the bond-financed electricity, the arrangement did not convey to the private party any special legal entitlements with respect to the bond-financed electricity, and where the private parties were simply using their private facilities to transmit the bond-financed electricity to customers of the governmental utility.

1. PLR 200718021. County prison facility with 100-day contracts with a federal agency for housing prisoners and with an expectation that there will be up to 90 percent non-federal prisoner use over time will not create private business use, because facility is available for use by the county on the same basis as the federal contracts and is not constructed for the principal purpose of providing the facility for federal use.

n. PLR 200542032. The IRS considered whether the transfer of "firm transmission rights" (FTR) under a regimen established by an electric transmission independent system operator (ISO) and approved by the FERC would be treated as a "deliberate action" causing bonds issued to provide the municipally-owned transmission facilities to which the FTR's related to be private activity bonds. A central question presented was whether the transfer of an FTR, which gave to the holder the right to participate in the receipt of special fees charged by the ISO as a market mechanism to control "congestion" over specific transmission interfaces, constituted a transfer of an ownership interest in the bond-financed facilities. The FTR's, which were to be sold by the ISO through public auction, were to have a term of one year. While the FTR could be held by any person, they would be particularly attractive to a power generation or distribution utility as a hedge against the adverse impact of high congestion charges across points necessary to its business. Looking to guidance under section 1001 of the Code and general tax cases, the IRS set forth several factors in concluding that no ownership interest in the financed transmission facilities was transferred: Incidence of ownership include (1) legal title, (2) contractual duty to

pay for capital investment, (3) responsibility to pay maintenance and operating costs, (4) duty to pay taxes, (5) risk of loss and (6) risk of diminution of value. The benefits and burdens indicative of ownership include (1) right to possession, (2) obligation to pay taxes, (3) responsibility to insure property, (4) duty to maintain property, (5) right to improve property, (6) risk of loss and (7) legal title.

o. PLR 200502012. The IRS considered whether the acquisition of various interests in land and certain related arrangements gave rise to private business use. An authority created to acquire, operate and maintain property for a city would acquire the property interests through arms' length negotiations with the sellers and would pay no more than FMV for the interests. The authority described five types of property interests. The IRS focused its analysis on identifying the bond-financed property, identifying the seller's distinct property, determining whether the seller's use of that distinct property impinged on the authority's use of the bond-financed property, and determining whether and on what basis the seller used the authority's property. The IRS specifically noted that the type of property interest was not controlling.

(i) A Conservation Easement in Perpetuity, Restricting the Seller's Use of the Property Subject to the Easement. The bond-financed property is the easement. The Authority is the owner of the easement in perpetuity and the seller does not have any interest (such as a reversionary interest) in the easement. The seller has a distinct interest in the property and the seller's use of the retained interest does not impinge on the Authority's use of its interest. The seller's only use of the easement is as a member of the general public. Other than that use, the seller's use of the parcel is not the use of bond-financed property. The Authority's acquisition of the conservation easement does not give rise to private business use of the bond proceeds.

(ii) A Future Interest in Fee Simple, with the Seller Retaining a Life Estate. The bond-financed property is the future interest. The Authority and the seller have distinct interests in the parcel, which occur at different times. The use of the parcel by the seller during the life estate does not impinge on the Authority's use of the future interest. The seller's use of the parcel will end with the termination of the life estate and, therefore, the seller will not use the bond-financed property. The Authority's acquisition of the future interest in fee simple does not give rise to private business use.

(iii) Fee Simple, with a Subsequent Lease to the Seller or a Third Party that Grants the Lessee Certain Agricultural Rights. The bond-financed property is the present interest in fee simple. The subsequent lease to a nongovernmental person results in private business use during the term of the lease of 100% of the proceeds used to acquire the fee simple interest.

(iv) Fee Simple, with the Seller Retaining a *Profit A Prende* Interest that Allows the Seller to Enter the Parcel for Limited Purposes, which are Less Extensive than those Permitted under a Lease. The bond-financed property is the fee simple, subject to (or less) the *profit a prende* interest. The Authority has a possessory right to use the parcel while the seller holds a non-possessory interest to use the parcel for limited purposes. The seller has a distinct interest in the parcel and the seller's permitted uses under the *profit a prende* interest will not impinge on the Authority's use of its interest in the parcel. The seller's only use of the

Authority's interest will be as a member of the general public. The Authority's acquisition of a present interest in fee simple subject to *profit a prende* interest will not give rise to private business use of bond proceeds.

(v) Fee Simple, With a Subsequent Conveyance of a *Profit A Prende* Interest to a Third Party. In this case, the fee simple is the bond-financed property. When the Authority sells the *profit a prende* interest, it is conveying a portion of the fee simple to a nongovernmental person. The *profit a prende* interest, like a discrete portion of a facility, is a distinct property interest. Therefore, the private business use may be measured on a reasonable basis that reflects the proportionate benefit to the users, such as fair market value of the interests.

p. PLR 200524015. Use of tax-exempt bond proceeds by a nonprofit corporation consisting of natural gas and electric joint action agencies and natural gas and electric distribution systems that were all political subdivisions will not in and of itself cause private business use. Private business use was determined based on the ultimate use of bond proceeds by the members. In addition, the ruling held that use by a subsidiary of the non-profit formed as a limited liability company similarly did not constitute private business use.

q. PLR 200336001. The distribution of a district's cable television programming by a cable television provider does not constitute a special legal entitlement of the facilities used by the district to produce and distribute such programming.

r. PLR 200323006. The IRS determined, in the context of a governmental stadium financing, that the sale of naming rights to a private business user for a term of years during which the private business would pay the city a certain dollar amount per year in exchange for the identification of the facility by the name selected by the private business in all advertising, communications, etc., would constitute a private business use for purposes of the private business use tests. The IRS concluded that the naming rights agreement resulted in the conveyance of legally enforceable rights with respect to the facility for a term of years; that is, the right to require the facility to be referred to with the name of the private business user. The IRS stated that the naming rights did not result in the private party being a private business user due to ownership, lease, management or other incentive payment contract. However, the "contract provides specific rules regarding the manner in which the facility will be operated, that is, the right to require the facility to be referred to with the name of the private business user's selection and this gives the private business user special legal entitlements to control the use of the facility. The private business use of the facility is described as being simultaneous with the governmental use thereof and was held to be a related use to the governmental use of the facility. The naming rights use is measured by reference to the fair market value of the contract as compared to the fair market value of the facility for each year of the contract. As no information was provided in the recitation of the facts in respect of the fair market value of all of the other uses of the facility, the IRS used the cost of construction of the facility as a reasonable proxy for the minimum value of the facility.

s. PLR 200309003. A new building to be constructed by a 501(c)(3) organization on its campus with bond proceeds would not be built specifically to meet the needs of certain federal agencies with which the Section 501(c)(3) organization had contracts to perform certain services for such agencies and would be available for general public use.

t. PLR 200250004. Notwithstanding the fact that a harbor channel was used mainly by business shippers, the harbor was available for general public use and therefore met the general public use exception to private business use.

u. PLR 200240028. Agency, a joint powers agency, requests on behalf of several of its members (the "Cities") a ruling that their becoming participating transmission owners in an Independent System Operator (ISO) by entering into an Agreement will not be treated as a deliberate action that causes outstanding Bonds, issued to finance the projects, to be private activity bonds under Section 141 of the 1986 Code or industrial development bonds under Section 103(b) of the 1954 Code. The Agency owns an undivided ownership interest in, or is otherwise entitled to the transfer capability of, each of the projects. The Agency represents that, if it is relying on this ruling, it will apply the provisions of Temporary Regulations Section 1.141-7T(f)(5) to the Bonds. The IRS concludes (1) that entering into the Agreement with the ISO is an action described in Temporary Regulations Section 1.141-7T(f)(5)(ii) because (i) the action is being taken to implement the offering of non-discriminatory, open access tariffs for the use of transmission facilities financed by an issue in a manner consistent with the rules promulgated by the FERC, and (ii) there is no sale, exchange, or other disposition of the projects to a nongovernmental person, and (2) that entering into the Agreement with the ISO will not be treated as a deliberate action for purposes of either the 1986 Code or the 1954 Code.

v. PLR 200222006. A ruling is requested as to whether a Hotel Management Contract will result in private business use. The Management Contract has a stated term of 15 years beginning on the placed-in-service date of the Hotel, but the Hotel Owner and the Manager also entered into a Technical Services and Preopening Agreement that will have a term of about 3 years and will terminate when the Hotel is placed in service. Under the Management Contract, Manager will be paid: (1) a management fee that is a fixed amount per year subject to an annual adjustment beginning in year 5 based on the percentage change in total revenues per available room for a comparable group of hotels in the City, excluding the Hotel; (2) a single productivity reward during the term of the Management Contract; and (3) a centralized services fee that is a stated dollar amount per year, subject to a CPI adjustment, for certain group services that the Manager provides to a majority of hotels that it owns or manages. The management fee, beginning in the third year, and the productivity reward are subject to deferral based on available net revenues but in all events must be paid by or at the termination of the Management Contract. A feasibility study projects that no deferrals will occur. The Manager is required under the Management Contract to pay the Owner an "inducement fee." The Owner is deemed to repay the Manager a fixed amount per month over the term of the Management Contract. If the Owner terminates the Management Contract other than for cause, the Owner is obligated to repay the remaining outstanding balance of the inducement fee. The Owner will reimburse the Manager for third-party expenses and for the salaries of the Manager's on-site employees and off-site employees who provide services to the Hotel, but not the salaries of the Hotel executive staff. Ruled: The Management Contract does not result in private business use because: (1) the non-deferrable amount of the management fee and the centralized services fee constitute periodic fixed fees; (2) the deemed repayment of the inducement fee and the expense and salary reimbursement are not compensation to the Manager; (3) although the deferred elements of the Manager's compensation do not satisfy the requirements of Rev. Proc. 97-13, these deferred elements do not indicate private business use under Regulation Treas. Reg. §1.141-3 (b)(4); and (4) the term of the

Preopening Agreement should not be aggregated with the term of the Management Contract in testing the term of the Contract.

w. PLR 200211022. The Agency, a political subdivision whose 32 members are all municipalities, was created to permit its members to secure a supply of electric power. The Agency issued the Bonds to refinance the acquisition of certain Transmission Facilities. While the Agency is not subject to the jurisdiction of the FERC, the regulatory changes made by the FERC have changed the marketplace for electricity transmission and, in response to these changes, the Agency entered into the Agreement with other transmission facilities owners to form an independent system operator (ISO). Under the Agreement, the Agency will transfer operational control of the Transmission Facilities to the ISO, but the Agency will retain ownership of the Transmissions Facilities. The ISO will provide non-discriminatory access to the transmission facilities by its members pursuant to an open access transmission tariff approved by the FERC. The Agency represents that it will apply the provisions of Treas. Reg. §1.141-7T(f)(5) of the temporary regulations to the Bonds. Ruled: The Agency's entering into the Agreement will not be treated as a deliberate action because it is an action described in Treas. Reg. §1.141-7T(f)(5)(ii), i.e., an action taken to implement the offering of non-discriminatory, open access tariffs for the use of transmission facilities financed by an issue in a manner consistent with the rules promulgated by the FERC.

x. PLR 200211003. Bonds were issued for the University, a state university, to finance the Center, a multipurpose fitness and recreation center. In addition to students, faculty, and staff already using the Center, the University would like to permit various other groups to use the Center. These groups would include spouses and dependent children of students, faculty, and staff of the University; certain retired faculty and staff of the University; a limited number of guests of members of the Center; participants in on-campus programs and non-credit classes sponsored by the University; students participating in activities conducted by the County Board of Education and a governmental agency of the State; persons being recruited by the University as students, faculty, and staff; members paying a fee to undergo health and fitness appraisals; members paying a fee for University-employed personal trainers; members paying a fee for use of equipment necessary for outdoor recreational activities; and nonmembers using a juice bar. Ruled: The proposed uses of the Center will not constitute private business use.

y. PLR 200205009. Conduit Borrower, a 501(c)(3) organization, has used the Vessel to conduct expeditions. The Borrower is proposing to use the Vessel for several months to provide ferry service to the public by entering into a non-renewable agreement with the Manager to provide this ferry service for a term of less than one year. The Borrower and Manager will each be responsible for specified costs. The Manager will collect passenger fees on behalf of the Borrower and will retain a specified amount for each passenger trip. In addition, the Manager will retain a percentage of the gross revenues from the galley service. These amounts are described as reasonable. The Borrower will reimburse the Manager for costs incurred by the Manager in the operation of the galley service to the extent those costs are owed to third parties and do not exceed the remaining receipts from the galley service. These costs do not include amounts paid to the Manager's employees as salary or wages. Ruled: The proposed agreement complies with Rev. Proc. 97-13 because the Manager's compensation consists of a per-unit fee and a percentage of gross revenues, compensation is not based on net profits, compensation has been represented to be reasonable, reimbursement of expenses is not considered as compensation, the term of the

agreement is less than one year, and this is the commencement of a new activity for the Vessel and the Borrower.

z. PLR 200132017. University/Medical School (University), a 501(c)(3) organization, owns research facilities with respect to which the University enters into Qualified Research Arrangements, which do not result in private business use, and Non-Qualified Research Arrangements, which do not result in private business use. Over the last "a" years, research revenue from Qualified Research Arrangements has averaged "b%" of total research revenue. Authority proposes to issue Bonds to finance new research facilities for the University. More than 5% of the new research facilities will be used for Non-Qualified Research Arrangements each year throughout the term of the Bonds. University makes a series of representations demonstrating that it is not possible for the University to allocate the usage of the research facilities between Non-Qualified Research Arrangements and Qualified Research Arrangements other than based on the relative amounts of revenue from such arrangements. Ruled: Proceeds of the Bonds may be allocated to the portions of the new research facilities that are used for Qualified Research Arrangements, with such portions based on the ratio of the present value of revenues from Qualified Research Arrangements to the present value of total research revenue, using the yield on the Bonds as the discount rate.

aa. PLR 200123057. B, a 501(c)(3) organization and qualified user of bond proceeds that operates a hospital and medical clinics, is the sole member of C, a taxable nonprofit corporation that provides professional services to B. B appoints 3 of 7 members of C's board of directors. The chief executive officer of B is one of those 3 members of C's board. One additional director of C's, must contemporaneously be a community representative (appointed by B) on B's board of directors. As a result, 4 of the 7 members on C's board of directors are either appointed by or are on B's board of directors. B has entered into a professional services agreement with C, pursuant to which C agrees to provide professional medical services to B. B has the power to approve the following with respect to C: (1) amendments to articles of incorporation and bylaws; (2) capital budgets, incurrence of long term debt, and operating budgets; (3) strategic plans; (4) risk management policies; (5) human resources and benefit policies; (6) health plan, payor or risk contracting agreements; and (7) merger, consolidation, dissolution, or sale or transfer of assets other than in the ordinary course of business. In addition, C is required to obtain B's approval of its proposed budget on an annual basis. Section 5.04 of Rev. Proc. 97-13 requires that a service provider not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under a service contract. A safe harbor is provided, but C and B are related and do not meet the safe harbor. Ruled: C does not have any role or relationship with B that substantially limits B's ability to exercise its rights, including cancellation rights, under the professional service agreement.

bb. PLR 200026020. City owns and operates a sewage enterprise system that includes a treatment plant and a reservoir for storing treated effluent from the plant. The bond-financed project includes a pipeline running from City's existing sewage system to a thermally active geyser field. The pipeline will consist of a Multi-Use Pipeline section and a Geyser Field Pipeline section. Under a contract with Company, City will be obligated to deliver to the geyser field a quantity of wastewater per day equal to about 27% of the capacity of the Multi-Use Pipeline. The remaining capacity of the Multi-Use Pipeline will be available to provide

irrigation water to various persons along its route. The aggregate amounts received under irrigation contracts will not exceed 5% of the debt service on the bonds. In general, Company will neither pay City for the wastewater nor share with City any revenues from the sale of electricity it generates at the geyser field. Ruled (reviewable ruling under Section 4 of Revenue Procedure 96-16): Project is not an output facility; even if the project is an output facility, the contract must be analyzed under Regulation Treas. Reg. §1.141-3 and 1.141-4 because it provides Company with specific performance rights; project is not a water facility; project is used in the trade or business of Company and the private business use test is met; sewer fees paid by ratepayers are private payments and the private payment or security test is met. Related case is City of Santa Rosa, California v. Commissioner, 120 T.C. No. 12 (2003).

cc. PLR 199950036. The Authority owns a hydroelectric generating facility (Project). The Federal Act requires the Authority to allocate b percent of the total power produced by the Project (Preference Power) to a group of customers consisting of public body Governmental Preference Customers and nonprofit cooperatives, which are considered nongovernmental persons. The Federal Act further allocates Preference Power between Preference Customers within and outside the State. In selling to out-of-state Preference Customers, the Authority deals with bargaining agents. All Governmental Preference Customers are publicly-owned utilities that sell energy directly to retail end-users and are governmental entities. Currently, the Governmental Preference Customers' aggregate contractual right to Project capacity is f percent of the capacity of the Project. In-state Governmental Preference Customers resell to various end-users, including customers who are natural persons not engaged in a trade or business. No such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. All Governmental Preference Power that is sold to the out-of-state Governmental Preference Customers is resold to retail customers, including customers who are natural persons not engaged in a trade or business. With respect to certain out-of-state Governmental Preference Customers, no such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. For all other out-of-state Governmental Preference Customers, payments that are substantially certain to be made in any year by each such out-of-state Governmental Preference Customer do not exceed 0.5 percent of the expected average annual debt service on the Proposed Debt. Bargaining agents are permitted to enter into arrangements with out-of-state Governmental Preference Customers that allow those customers to resell Governmental Preference Power at wholesale (non-conforming sale) if the Authority approves the non-conforming sale, but the Authority has not, and does not expect to, approve any non-conforming sales. The Authority proposes to use the proceeds of the Proposed Debt to finance additional costs relating to a portion of the Project, namely the f percent of Project capacity that is allocable to the use of Governmental Preference Customers. Ruled: (1) the portion of the Project (f percent, based on the Governmental Preference Customers' entitlement to Project capacity) allocable to the Governmental Preference Customers represents an identifiable interest in the Project, and (2) in part because all resales of Governmental Preference Power will satisfy either the Treas. Reg. §1.141-7T(f)(1) exception for small purchases of output or will satisfy the Treas. Reg. §1.141-3(c) exception to the private business use test and because the bargaining agents act on behalf of the out-of-state Governmental Preference Customers and are disregarded under Treas. Reg. §1.141.7T(f)(6) in determining whether the private business tests are met with respect to the Project, the use of the portion of the Project allocable to the Governmental Preference Customers will not cause the Proposed Debt to satisfy the private business tests.

dd. PLR 199931042. Districts Q and I are political subdivisions formed to provide health care for residents of County. Q and I have signed an affiliation agreement to provide for the cooperation and coordination of the Q and I hospital systems to create an integrated health care delivery system. M, a new 501(c)(3) organization the sole members of which are Q and I, has been formed to serve as the parent of the system. M will coordinate any financial sharing between Q and I, as well as between the various entities admitted to the system. Q and I have certain reserved powers. In the past Q and I have issued various issues of governmental bonds and 501(c)(3) bonds. Held: (i) certain affiliates are instrumentalities of Q and I; (ii) M is an instrumentality of Q and I; (iii) M is an "affiliate of a governmental unit" as described in Section 4 of Revenue Procedure 95-48 and relieved of filing Form 990; (iv) the execution of the agreement will not result in the creation of an entity separate from M for tax purposes; and (v) the execution and implementation of the agreement will not result in a change in use of any Q bonds that will cause them to be private activity bonds or in a change in use of any I bonds that will cause them to be other than qualified 501(c)(3) bonds.

ee. PLR 199929041. Two 501(c)(3) organizations formed a joint venture, Q, which includes several tax-exempt and two taxable subsidiaries. The IRS had previously ruled that the joint venture would not affect the exempt status of the organizations. Various portions of the facilities of certain exempt hospital subsidiaries were financed with proceeds of a 1987 bond issue. A 1998 bond issue was issued to finance the construction of a replacement hospital. Q, a limited liability company, will be treated as a partnership for tax purposes. Based on the representations of the 501(c)(3) members as to the application of the revenues of Q, the IRS held that the implementation of the joint operating agreement (which will result in Q being substituted as the sole member of the 501(c)(3) organizations that own the bond-financed facilities) will not cause the facilities to be owned or used in the trade or business of a person other than a governmental unit or a 501(c)(3) organization.

ff. PLR 199927042. A ruling was requested that proposed affiliation and economic integration agreements will not result in private use that could impact outstanding bonds. The parent of an exempt hospital system and an unrelated exempt entity, which has numerous subsidiaries, will enter into these agreements to create a single integrated health care delivery network. The parties will retain their respective assets. The proposed agreements will not result in use of the bond-financed facilities by a Section 501(c)(3) organization.

gg. PLR 199914045. Corporation is a 501(c)(3) organization with the primary exempt purpose of performing "scientific research in the public interest." Substantially all of Corporation's research enters the public domain through scientific and technical publications, presentations, use by the Corporation or provisions of services to its clients. Currently, Corporation has numerous scientific research contracts with terms ranging from six months to five years. The typical contract has a one-year term with no renewal requirements. The funding under federal contracts may be reduced at any time by the federal government. Corporation has no affiliation with the federal government, even if much of its research is performed for its agencies. The contracts do not grant clients ownership of any intellectual property developed or discovered in the course of research. Under applicable federal rules, certain special rules apply with respect to licenses, etc. The price to be paid by any federal agency for the use of any discovery will not be less than the price payable by any non-federal agency for the use of any discovery and will not be less than the price payable by any non-federal party for use of same property. Held: The

research contract is for basic research as such term is used in Revenue Procedure 97-14 ("Rev. Proc. 97-14"). Further, the services to the federal agencies will not constitute private business use within the meaning of Code Sections 141(b) or 145(a). Additionally, payments by the federal government under these contracts will not cause the bonds to be federally guaranteed within the meaning of Code Section 149(b).

hh. PLR 9844022 and PLR 9844019. Qualified 501(c)(3) bonds were issued by Q and loaned to 501(c)(3) organization T to finance the construction and acquisition of Clinic. State S issued bonds to refund other bond issues and make improvements to an acute teaching hospital operated by S. Such bonds were issued as governmental bonds. S and T have entered into an operating agreement, forming new entity W. S and T each provided 50% of the initial operating capital of W. W will provide common management of the facilities of S and T. The IRS finds that the arrangement created by the joint operating agreement lacks the essential corporate characteristics of continuity of life and limited liability, making it a partnership. Use by a partnership is generally private business use. However, the purposes of Code Section 145 are realized if partnership is treated as an aggregate instead of a separate entity using the bond-financed facilities. The operating agreement does not create any joint ownership of operating assets now separately owned by S and T. Certain actions, including disposal of property and incurrence of debt, require consent of both S and T. The joint operating agreement does not transfer the benefits of tax-exempt financing to the partnership. Based on the foregoing, none of the bonds will be treated as used for private business use under Code Sections 141(b) or 145(a).

ii. PLR 9842005, PLR 9841008 and PLR 9841009. State R created a special tax district Q to operate a hospital. The members of Q's governing body are appointed by the governor of R; Q has the power of eminent domain. S, a 501(c)(3) organization, was formed to provide facilities, hospital and related healthcare facilities for Q; Q is the sole member of S. Pursuant to a reorganization, Q will lease or transfer substantially all of its assets to S, which thereafter will be responsible for the operation of the hospital. X, a 501(c)(3) organization the sole member of which is Q, was formed to acquire the assets and business of an HMO. P, another 501(c)(3) organization, was also formed by Q to own certain buildings that will be leased by P to Q. Q has issued various issues of governmental bonds, both for new money and refunding purposes. Held: (i) Q qualifies as a political subdivision of R, (ii) each of S, X and P are instrumentalities of Q, and (iii) the execution and implementation of the transfer and lease arrangements between the various subsidiaries will not result in a change in use of bond proceeds.

jj. PLR 9835032. Prison was constructed with taxable bonds; Issuer R wants to issue tax-exempt bonds to refund them. Prison was not designed to meet specific needs of federal prisoners. However, R has entered into intergovernmental agreement with U.S. Marshals Service ("IGA"). Under IGA, (i) R is not required to reserve any particular number of beds for federal prisoners, (ii) United States to pay negotiated per diem rate comparable to fees paid by nonfederal governments, and (iii) United States has no enforceable right to renew IGA. IGA has 90-day term and is comparable in terms to agreements entered into by R with nonfederal governments. Held: use of prison by federal prisoners is general public use.

kk. PLR 9823008. R, Political subdivision, will issue bonds to (i) acquire common stock of OE, investor-owned utility, (ii) pay the cost of redemption or conversion in cash of OE preferred stock and debt, (iii) finance improvements, and (iv) pay

transaction expenses. After acquisition transaction, R will control new utility, NE, appoint its board, and approve its budgets and major contracts. NE will be managed pursuant to contract (outlined in the ruling) which does not meet Rev. Proc. 97-13. Ruled: (i) transaction meets transition rule exception to 141 (d) limitation on output facilities, (ii) purchase of stock with bond proceeds is an indirect purchase of OE electric system for purposes of Code Section 103 and Code Sections 141 through 150, (iii) NE will be governmental person, making its use of bond proceeds a governmental use, (iv) notwithstanding the fact that the management agreement does not meet Rev. Proc. 97-13, it does not give rise to private use, and (v) use of proceeds to pay property tax settlement is extraordinary item under Treas. Reg. §1.148-6(d). *See* companion PLR 9823012.

ll. PLR 9816017. State agency to issue bonds for benefit of 501(c)(3), C, and State University U. Bonds will finance public infrastructure projects for U. U's board of trustees is governmental body established to oversee operation of U and other campuses; members are selected by governor of State N and subject to consent of senate. C was formed on initiative of administrators of U as an auxiliary organization. C engages in activities relating to housing, acquisition and development of real estate, and other activities which are "integral part of the educational mission" of U. C is to undertake similar activities in connection with bond-financed facilities. U's president and board of directors together elect C's board of directors. U's board may remove directors of C except for U's president, who serves as ex officio member. C's funds are gifts and grants which must be used under the control and oversight procedures of U. U's board of trustees has access to all of C's records and audits them annually. On dissolution, C's assets are to be distributed to successor 501(c)(3) organization approved by U. Held: C meets the criteria of Revenue Ruling 57-128 as a state instrumentality and that, as such, C's trade or business is that of a governmental unit and, therefore, not private business use for purposes of Code Section 141(b).

mm. PLR 9813003. T, joint powers agency, has as members two cities, X and Y. T has all powers necessary, including power of eminent domain and power to issue bonds, to develop and implement Corridor Project. Among other things, Corridor Project aims to alleviate traffic to and from the ports of X and Y by consolidating rail traffic, thereby increasing their efficiency and competitiveness. Corridor Project will also include many sub-projects including removal of buildings, relocation of water and sewer lines, road and bridge expenditures, highway overpasses, etc. Corridor Project includes construction of Trench to separate the rail facilities from adjacent and crossing roads; Trench is the largest component of Corridor Project and will be utilized by railroads to access ports. Pursuant to Memorandum of Understanding, railroads will pay user fees for use of Trench. Amounts paid by railroads will be used to repay, among other things, the debt incurred to finance Corridor Project. The IRS considered the allocation of bond proceeds to the various components of Corridor Project (street improvements, non-Trench grade separations, Trench bridges, etc.) under the private activity tests and concluded such components constitute governmental improvements to street and roads which are available for use by the public and owned by governmental units and with respect to which the railroads have no special legal entitlement; accordingly, it is held that the railroads are not treated as private business users of these improvements. With respect to Trench, the IRS noted that the public improvements, including Trench, are not appropriately treated as discrete facilities under Treas. Reg. §1.141-3(g)(4)(iv). IRS also noted that railroads will derive substantial benefit and pay fees for the use of Trench. Because Trench is functionally related to the rail facilities and facilities owned by X and Y, Trench is properly treated as "common area" to multiple facilities. IRS

concluded that 50% of the cost of Trench could be allocated to the street improvements. Finally, where utilities are under no legal obligation to relocate the lines, utilities are not treated as private business users of proceeds used for relocation; however, to the extent such relocation is allocable to construction of Trench, relocation costs should be treated accordingly.

nn. PLR 9807015. Authority was formed as a nonprofit membership organization to coordinate the operation of electric generation resources and the purchase and sale of electric power on behalf of its members. The members are governmental units or instrumentalities thereof. No portion of Authority's earnings inures to the benefit of any individual or any private person; in the event of dissolution, assets of the Authority are distributed ratably to the members. Each member has contributed and agrees to contribute additional capital as needed; expenses and gains on transactions not specifically benefiting one member are allocated to members equitably. Authority is treated as a wholly-owned instrumentality of its members for purposes of Code Section 141.

oo. PLR 9741013. State authority issues Notes secured by general obligation notes of Academies. The proceeds of the Notes are used to purchase notes of the Academies, which are temporary debt incurred to pay school operations. The Academy notes are secured by the State school aid allocated to the respective Academies. The Notes were issued prior to the effective date of Treas. Reg. §1.141-1. Academies are created under State law and, for purposes of receiving school aid, tuition policy, etc., are treated on the same basis as public elementary and secondary schools. The board of each Academy is formed so that there is no private inurement in the organization or operation of the Academy, and the board members are subject to control and supervision of the State Board of Education. State law expressly permits and fosters the creation of Academies, and State is a principal source of operating expenses. Ruled: under State law, each Academy is a governmental unit for purposes of determining use under private activity bond tests and private financing loan test.

pp. PLR 9740016 and PLR 9740015. City 1 and City 2, together with private participants, own undivided interests in a nuclear electric generating facility. The various owners propose that the project be operated by O, a nonstock, nonmember, nonprofit corporation under state law that will not be a 501(c)(3) organization. Pursuant to Operating Agreement, O is authorized to maintain and operate the project on behalf of the owners, executing all contracts relating to maintenance, improvement, etc. Each participant will pay its respective share of the costs of operation. O will have no ownership interest. City 1 and City 2 have elected to apply Treas. Reg. §1.141-3(b)(4) to the bonds. Because the project is public utility property, O's operation of it will not be treated as a management contract if the only compensation to O is the reimbursement of actual and direct expenses and of reasonable administrative overhead. Ruled: (1) The Operating Agreement imposes reasonable limitations on O's reimbursable costs; (2) the arrangement will not pass on any benefits of tax-exempt financing to O or any of the private participants; and (3) the Operating Agreement is not an arrangement that gives rise to private business use.

7. City of Santa Rosa, California v. Commissioner, 120 T.C. No. 12 (2003), held that a private entity did not use a bond-financed pipeline for treated wastewater "in any quantifiable amount" when it took delivery of water from the pipeline and used the water to generate steam by injecting the water into a geyser steam-field. The steam-field boiled the water

into steam for use in generating electricity. The IRS had ruled negatively on the question on various theories alleging private business use in excess of 10% (PLR 200026020). Appeal was not sought by the IRS and U.S. Department of Justice. The IRS has published neither an acquiescence nor a non-acquiescence in the case.

C. Qualified Management Contracts.

1. General. Treas. Reg. §1.141-3-(b)(4) states the general rule that, except as otherwise provided therein, a management contract may result in private business use of bond-financed property based on all the facts and circumstances. A management contract similarly results in private business use if, based on all the facts and circumstances, the service provider is treated as the lessee or owner of the bond-financed property for federal income tax purposes.

2. Definition. Treas. Reg. §1.141-3(b)(4) defines a management contract to be a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all or a portion of, or any function of, the financed facility. A management contract includes not only a contract that provides for the actual management of a facility (such as an operator of a cafeteria or a hospital or a nursing home), but also one that provides services (such as a contract to provide medical services, other than as an employee, to patients of a hospital whether or not compensation is paid directly by the hospital or by patients or third party payers). Arrangements not treated as management contracts include: (i) contracts for services that are incidental to the primary function of the facility (*e.g.*, janitorial services, office equipment repair, hospital billing), (ii) the granting of admitting privileges by a hospital, (iii) a contract to provide for the operation of public utility property (as defined in Code Section 168(i)(10)) if the only compensation is reimbursement of direct expenses and reasonable administrative overhead expenses, and (iv) a contract to provide services, if the only compensation is the reimbursement of the service provider for direct expenses paid by the service provider to unrelated parties. There appears to be continuing debate, for purposes of this provision and the section of Rev. Proc. 2017-13 that excludes the reimbursement of expenses paid to unrelated third parties from the manager's compensation, whether the reimbursement of employee salaries and wages paid by the management fall within that rule. *See* PLR 200222006 (statement in facts that employees for whom reimbursement is sought do not include executive staff) and PLR 200205009 (statement in facts that reimbursed costs do not include amounts paid by manager as salaries and wages). These PLRs are referenced below.

3. Qualifying Management Contract Safe Harbor Arrangements. Revenue Procedure 1997-13, as modified by Revenue Procedure 2001 -39 ("Rev. Proc. 97-13") provided certain bright line tests that if satisfied would allow a management or service contract to be treated as not giving rise to private business use. On August 22, 2016, the IRS released Revenue Procedure 2016-44 ("Rev. Proc. 2016-44"), which modified Rev. Proc. 97–13 and section 3.02 of Notice 2014–67 (discussed below), to provide new safe harbor terms under which management contracts will not result in private business use. Rev. Proc. 2016-44 applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider. The IRS subsequently modified, amplified and superseded Rev. Proc. 2016-44 in Revenue Procedure 2017-13 ("Rev. Proc. 2017-13"). Rev. Proc. 2017-13 provided certain clarifications and amendments to Rev. Proc. 2016-44 to address certain types of compensation, the

timing of payment of compensation, the treatment of land and methods of approval of rates. Rev. Proc. 2017-13 is generally effective for management contracts entered into, materially modified or extended (other than pursuant to a renewal option) on or after January 17, 2017. Issuers may elect to apply Rev. Proc. 97-13 to contracts entered into before August 18, 2017, provided that such contracts are not materially modified or extended (other than pursuant to a renewal option) on or after August 18, 2017.

4. Rev. Proc. 2017-13

Rev. Proc. 2017-13 applies to any management contract involving managed property financed with the proceeds of an issue of governmental bonds or qualified 501(c)(3) bonds. A management contract is defined to mean a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property. Rev. Proc. 2017-13 clarifies that a management contract does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management). The term "managed property" is defined to mean the portion of a project with respect to which a service provider provides services. Treas. Reg. §1.141-6(a)(3) defines project to mean one or more facilities or capital projects, including land, buildings, equipment, or other property, financed in whole or in part with proceeds of the issue. The definition of qualified user is consistent with the definition as set forth in Rev. Proc. 97-13.

If a management contract meets each of the requirements set forth in Rev. Proc. 2017-13, or is "an eligible expense reimbursement arrangement," the management contract does not result in private business use (the "2017-13 Safe Harbor"). Rev. Proc. 2017-13 also provides that a service provider's use of a project that is functionally related and subordinate to performance of its services under a management contract for managed property that meets the 2017-13 Safe Harbor does not result in private business use. For example, the use of storage areas to store equipment used to perform activities required under the management contract that meets the 2017-13 Safe Harbor does not result in private business use.

a. Reasonable Compensation. Payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider. Under Rev. Proc. 97-13, reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation. For this purpose, employees of the service provider are treated as unrelated parties. Under Rev. Proc. 2017-13, payments for reimbursement to the service provider and administrative overhead of the service provider must be analyzed with other forms and methods of compensation to determine if that compensation is reasonable, is not based on a share of net profit, and does not result in the service provider bearing net losses, as described below.

b. No Net Profits Arrangements. The restriction against sharing of net profits under Rev. Proc. 97-13 and its predecessors was brought forward. Under Rev. Proc. 2017-13 the management contract must not provide to the service provider a share of the net profits from the operation of the managed property. Compensation to the service provider will not be treated as

providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) for any fiscal period. The "elements of the compensation" are the eligibility for, the amount of, and the timing of the payment of the compensation. Unrelated parties are defined as persons other than either (i) a related party (as defined in the Regulations) to the service provider or (ii) a service provider's employee. In addition, incentive compensation is not treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation otherwise meet the requirements set forth in this paragraph.

c. No Burden of Net Losses. The management contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement will not be treated as requiring the service provider to bear a share of net losses if: (a) the determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and (b) the timing of the payment of compensation is not contingent upon the managed property's net losses. Compensation can however be reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) without being treated as bearing a share of net losses as a result of this reduction. Without regard to whether the service provider pays expenses with respect to the operation of the managed property without reimbursement by the qualified user, compensation for services will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses if the compensation for services is (i) based solely on a capitation fee, a periodic fixed fee, or a per-unit fee; (ii) incentive compensation (as described above) or (iii) a combination of these types of compensation. *Capitation fee* and *periodic fixed fee* retain the definitions under Rev. Proc. 97-13. The definition of *per-unit fee* in Rev. Proc. 97-13 provides that separate billing arrangements between physicians and hospitals generally are treated as per-unit fees; Rev. Proc. 2017-13 removes the word "generally," and confirms the treatment of separate billing arrangements as per-unit fees.

d. Treatment and Timing of Compensation. The deferral of compensation (that otherwise meets the requirements of Rev. Proc. 2017-13) due to insufficient net cash flows from the operation of the managed property will not cause the deferred compensation to be treated as contingent upon net profits or losses if the contract includes requirements that: (i) the compensation is payable at least annually; (ii) the qualified user is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and (iii) the qualified user will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

e. Contract Term. The term of the contract, including all renewal options, must be no greater than the lesser of (a) 80 percent of the weighted average reasonably

expected economic life of the managed property or (b) 30 years[3]. Economic life is determined in the same manner as under Code Section 147(b) as of the beginning of the term of the contract. Thus, land will be treated as having an economic life of 30 years if 25 percent or more of the net proceeds of the issue that finances the managed property is to be used to finance the costs of such land. A contract that is materially modified with respect to any matters relevant to its treatment as a qualified contract under Rev. Proc. 2017-13 is retested for compliance with Rev. Proc. 2017-13 as a new contract as of the date of the material modification.

f. Control over Use of Managed Property. The qualified user must exercise a significant degree of control over the use of the managed property. This requirement is met if the contract requires the qualified user to approve (a) the annual budget of the managed property, (b) capital expenditures with respect to the managed property, (c) each disposition of property that is part of the managed property, (d) rates charged for the use of the managed property and (e) the general nature and type of use of the managed property. A qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and it may show approval of dispositions of property that is part of the managed property in a similar manner. In addition, a qualified user may show approval of rates charged for use of the managed property by either (i) expressly approving such rates or a general description of the methodology for setting such rates (such as a method that establishes hotel room rates using specified revenue goals based on comparable properties) or (ii) by including in the contract a requirement that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party.

g. Risk of Loss with respect to Managed Property. The qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, due to force majeure). The qualified user will not fail to meet this requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.

h. No Inconsistent Tax Position. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. For example, the service provider must agree not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property.

i. No Circumstances Substantially Limiting Exercise of Rights. The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances. A service provider will not be treated as having a prohibited role or relationship with the qualified user if: (i) no more than 20 percent of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners,

[3] Note that to fit within the 2017-13 Safe Harbor (other than as an eligible expense reimbursement arrangement), the economic life limitation on the contract term must be satisfied regardless of how short or long the term of the contract.

members, and employees of the service provider, in the aggregate; (ii) the governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and (iii) the chief executive officer of the service provider is not the chief executive officer of the qualified user or any related parties of the qualified user.

For purposes of this provision, the term "chief executive officer" includes a person with equivalent management responsibilities. In addition, the term "service provider" includes the service provider's related parties. A "related party" is defined to mean, with respect to a qualified user, any member of the same controlled group (as defined in Treas. Reg. 1.150-1(e)) and, with respect to a person other than a qualified user, a related person (defined by reference to Code Section 144(a)(3)).

5. Eligible Expense Reimbursement Arrangements. For management contracts that are considered to be "eligible expense reimbursement arrangements," such contracts are deemed to meet the safe harbor of Rev. Proc. 2017-13 and will not result in private business use. An eligible expense reimbursement arrangement is defined to mean a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider. An "unrelated party" is defined to mean persons other than a related party to the service provider or a service provider's employee. Rev. Proc. 2017-13 treats employees of the service provider as related for purposes of expense reimbursement, a deviation from prior IRS guidance.

6. Net Profits. Management contracts in which the service provider is compensated with a capitation fee, periodic fixed fee, per unit fee, qualitative incentive payment or any combination of such fees will not be deemed to be based, in whole or in part, on net profits of the managed property irrespective of any expense reimbursement paid to the service provider, including expenses paid to related persons (e.g., employees of the service provider). Other forms of compensation such as those based on a percentage of gross revenues or non-qualitative incentive payments are not provided this same protection.

7. Facts and Circumstances Test. A management contract that fails to satisfy a safe harbor from private business use does not automatically create private business use. Instead, the contract should be analyzed under the general rule that a management contract gives rise to private business use based on all the facts and circumstances.[4] The IRS has issued a number of private letter rulings (for example, PLR 201726007, 201622003 and PLR 201338026) that deal with contracts that fall outside the safe harbors in Rev. Proc. 97-13. The IRS often ruled that the contract did not give rise to private business use under the facts and circumstances test. Because the facts and circumstances test is contained in the Treasury Regulations, which have not changed even after the IRS released Rev. Proc. 2017-13, these rulings should continue to have some value as guidance.

[4] Bond Counsel may be reluctant to rely on the facts and circumstances test to render an unqualified opinion that interest on the bonds is excluded from gross income for federal income tax purposes without a private letter ruling issued specifically to the qualified user.

8. Revenue Procedure 97-13 (Qualifying Management Contract Safe Harbors). Rev. Proc. 97-13 states that the arrangements set forth below are qualifying management contracts:

a. 95% Periodic Fixed Fee Arrangement/15 and 20 Year Contracts. At least 95% of the compensation is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80% of the reasonably expected useful life of the financed property and 15 years (20 years for "public utility property" as defined in Code Section 168(I) (10)). A one-time fixed dollar incentive award based on a gross revenue or expense target (but not both) is permitted.

b. 80% Periodic Fixed Fee Arrangement/10 and 20 Year Contracts. At least 80% of the compensation is based on a periodic fixed fee. The contract term, including all renewal options, must not exceed the lesser of 80% of the reasonably expected useful life of the financed property and 10 years (20 years for public utility property). Again, a one-time fixed dollar incentive award based on a gross revenue or expense target (but not both) is permitted.

c. 50% Fixed Fee Arrangements/5 Year Contracts. Either 50% of the compensation is based on a periodic fixed fee or 100% of the compensation is based upon a capitation fee or a combination of a capitation fee and periodic fixed fee. The contract term, including renewal options, must not exceed 5 years and the contract must be terminable by the qualified user (governmental entity or qualified 501(c)(3) organization, where applicable) without penalty or cause at the end of the third year of the contract term.

d. Per-Unit Fee Arrangements/Certain 3 Year Contracts. All of the compensation is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user without penalty or cause at the end of the second year.

e. Percentage of Revenue or Expense Fee Arrangements/2 Year Contracts. All of the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. The term of the contract, including renewal options, must not exceed 2 years and the contract must be terminable by the qualified user without penalty or cause at the end of the first year of the contract. The contract safe harbor is limited to circumstances involving services to third parties (*e.g.*, radiology services to patients) or certain start-up situations. Periodic fixed fees and, pursuant to the amendments to Rev. Proc. 97-13 set forth in Revenue Procedure 2001-39, capitation fees and per unit fees may be automatically increased according to a specified, objective, external standard that is not linked to the output or efficiency of a facility.

4. Notice 2014-67.

a. Notice 2014-67 "amplifies" the existing safe harbors of Rev. Proc. 97-13. One of the key provisions of Rev. Proc. 97-13 is the prohibition of compensation based on net profits. The Notice states that a productivity reward for services during the term of a contract does not cause the compensation to be based on a share of net profits of the financed facility if:

(1) the eligibility for the productivity award (the Notice renames this as an "award" rather than "reward") is based on the quality of the services provided under the management contract (for example, the achievement of Medicare Shared Savings Program quality performance standards or meeting data reporting requirements), rather than increases in revenues or decreases in expenses of the facility; and (2) the amount of the productivity award is a stated dollar amount, a periodic fixed fee, or a tiered system of stated dollar amounts or periodic fixed fees based solely on the level of performance achieved with respect to the applicable measure.

b. The Notice created a new safe harbor for certain five-year contracts under the Permissible Arrangements section of Rev. Proc. 97-13. This safe harbor permits compensation for services based on a stated amount, periodic fixed fee, a capitation fee, a per unit fee, or a percentage of gross revenues, adjusted gross revenues, or expenses of the facility (but not both revenues and expenses). In addition, the safe harbor does not require that the contract be terminable by the qualified user of the facility prior to the end of the term. Under the Rev. Proc. 97-13 safe harbors, the permissible two-year, three-year and five-year arrangements require that the governmental or 501(c)(3) organization have the ability to terminate without cause at an earlier date. The Notice did not eliminate the existing two, three and five-year contract safe harbors.

c. The expanded five-year safe harbor is effective for contracts entered into, materially modified, or extended (other than pursuant to a renewal option) on or after January 22, 2015, but may also be applied to contracts entered into before January 22, 2015.

9. Private Letter Rulings.

a. PLR 202229002. A management contract for a hotel under which the manager is paid a management fee consisting of three components: (i) a tiered percentage of gross revenues from hotel operations, (ii) reimbursement to the service provider for operating expenses, including employee costs, such as salaries, fringe benefits, incentive compensation and bonuses, and (iii) reimbursement of the hotel's allocable share of centralized services the service provider provides, such as promotion and marketing, centralized reservations, guest incentive programs and technology services. The ruling notes that incentive compensation and bonuses to senior management employees for which the service provider is reimbursed are evaluated based on formulas used to measure performance of the hotel, by factors that include the hotel's financial performance, guest experience and individual goals. Employee bonuses and incentive compensation are payable as a percentage of the employees' respective salaries and the timing and amount of such bonuses and incentive compensation are not contingent upon net profits from the operations of the hotel. The contract was determined to not satisfy all of the safe harbor conditions under Rev. Proc. 2017-13 because the compensation to the service provider included reimbursement of employee costs of the service provider. Such employee costs included bonuses and incentive compensation paid by the service provider to its employees that are based, in part, on the hotel's financial performance. However, the ruling concludes that the incentive compensation and bonuses that are reimbursed to the service provider under the agreement are not compensation based, in whole or in part, on a share of net profits from the hotel operations and, under the facts and circumstances, the contract is a management contract that does not result in private use of the hotel by the service provider.

Language in the ruling that the contract did not comply with Section 502(2) of the ruling because the compensation included reimbursement expenses may be overbroad. Such assertion may mistakenly imply that the reimbursement of employee expenses, in and of itself, would cause a contract to not comply with Revenue Procedure 2017-13. Rather, the IRS could have stated that reimbursement of employee expenses constitutes "compensation" for purposes of Revenue Procedure 2017-13, and the elements of such compensation must be examined to determine whether any such element is based on a sharing of net profits.

b. PLR 201726007. A teaching hospital service agreement between a school and a county hospital was determined to be a management contract; however, such management contract did not satisfy all of the safe harbor conditions under Rev. Proc. 2017-13. Thus, the determination of whether the agreement resulted in private business use depended on the facts and circumstances test. Ultimately, the agreement was held not to result in private business use after examination through the lens of the safe harbors under Rev. Proc. 2017-13. There was no compensation to the hospital, the manager, *i.e.,* the school did not bear any share of the costs or losses from the operation of the hospital, the term did not exceed 30 years or 80 percent of the useful of the hospital, the school bore no risk of loss for the facility, the school was not entitled to take any tax position inconsistent with that of a service provider, had no prohibited relationships with the hospital, and had no control over the operations, nature or general use of the hospital.

c. PLR 201622003. A management contract for a hotel under which the manager would receive base fee equal to a percentage of the hotel's annual gross revenues and incentive pay in any year in which certain tests were met does not result in private use. The contract did not meet all criteria of Rev. Proc. 97-13 as amplified by Notice 2014-67, however, a review of the facts and circumstances supported a ruling that the management contract did not result in private business use of the hotel because the incentive fee, while partly based on a variant of net profits, was not derived from net profits and was treated as a share of gross revenue and the term of the contract was reasonable under the facts and circumstances.

d. PLR 201338026. A management contract under which a hospital would pay a medical group base compensation, incentive compensation and reimbursement of certain expenditures did not result in private business use of the clinical facilities. Using the factors of Rev. Proc. 97-13, the IRS concluded that neither the hospital's payment or reimbursement of the medical group's miscellaneous or compensation expenses supported a conclusion that the management contract resulted in private business use of the clinical facilities because those expenses were not calculated based on net profits. Likewise, the facts and circumstances of the incentive pay of the medical group's president did not support a conclusion that the management contract caused private business use of the clinical facilities because the metric used would not be based on net profits.

e. PLR 201228029. Though the fixed fee component of a manager's compensation did not qualify as a periodic fixed fee because it allowed for adjustments based on reduced credit support or poor performance, it did not result in private business use because it was not based on net profits and, after adjustment, would remain a stated amount for the particular annual period. Additionally, pass-through expenditures that included mark-up would not create private business use because they were based on federally-regulated cost allocation methods and not net profits of the facility.

f. PLR 201145005. A management contract for a municipally-owned, bond-financed exhibition and convention center provided for three types of compensation: (1) a base fee, (2) an incentive fee, and (3) reimbursement of certain expenses. In order to receive the incentive fee, the manager must attain (1) operating revenues equal to or greater than a target benchmark, (2) a stated net operating surplus/deficit level for the fiscal year, established in advance each fiscal year and (3) an average overall customer satisfaction score equal to or greater than a target benchmark. The amount of the incentive fee was adjustable, but in no event would exceed the annual base fee.

The IRS concluded that the incentive fee (particularly the revenue benchmark and the net operating surplus/deficit benchmark) did not constitute compensation based on a share of net profits because "the amount of the incentive fee paid to the Manager will not vary depending on the margin of increase in revenues and/or decrease in expenses or be based on a percentage of revenue increases, a percentage of expenses decreases, or some combination of both." Additionally, the IRS stated that "although the net operating surplus/deficit benchmark takes into account both expenses and revenues, it is not based on increases in revenues and decreases in expenses, but on stated surplus/deficit amounts that may reflect decreasing revenues and increasing expenses."

g. PLR 200926005. A hospital facility financed with the proceeds of qualified 501(c)(3) bonds proposed to enter into professional service agreements with certain contracting physicians. The agreements provided that the hospital would reimburse certain expenses incurred by the physicians, and the physicians would be compensated based on a percentage of net professional patient billings, which under the agreements consisted of gross patient billings provided by each such contracting physician, adjusted for certain items, including certain insurance discounts. The contracting physicians would also receive supplemental compensation paid into a non-qualified deferred compensation plan and could also be compensated for supervising "physician extenders" (nurse practitioners and physician assistants).

The IRS initially found that the agreements were "management contracts" within the meaning of Treas. Reg. §1.141-3(b)(4)(ii), and that the contracts did not satisfy the safe harbors set forth in Rev. Proc. 97-13. The IRS went on to consider whether, under all of the facts and circumstances the agreements resulted in a private business use of the facility. Using the facts and circumstances analysis, the IRS determined that the agreements did not result in a private business use of the facility, largely because (1) the compensation under the agreements consisted of a percentage of fees generated by the physicians, adjusted for items such as bad debts and insurance discounts, which was deemed by the IRS to closely resemble a permissible arrangement under Rev. Proc. 97-13, (2) the agreements provided for reasonable compensation, partly because the agreements allowed the hospital the right to review physician compensation that reaches a certain percentage of an objective industry standard, (3) a physician's base compensation was based not on a share of the net profits from the operation of the facility, but rather on a percentage of adjusted gross revenues allocable to the physician, (4) none of the expenses of the facility or of the contracting physicians were taken into account in determining a physicians' base compensation, (5) the physician's incentive compensation was based on how the physician met specific goals, none of which were based on the number of patients treated by the physician at the facility, the productivity of the facility or the net profits of the hospital, (6) the amount of deferred compensation that a physician was eligible to receive was not based upon the net profits of the

hospital or the productivity of the physician at the hospital, (7) the terms of the agreements were specifically tailored to address the difficulties encountered by the health care industry in the hospital's coverage area in attracting and retaining physicians, and (8) none of the physicians entering into the agreements were related parties with the hospital or the entity owning the hospital for purposes of Code Section 1.150-1(b), and none of the physicians had a role in or relationship with the hospital or the entity owning the hospital that substantially limited the ability of the hospital and the entity to exercise their rights under the respective agreements.

h. PLR 200813016. A 10-year contract with a private manager of a county-owned solid waste disposal facility provided for an arm's-length negotiated 80 percent fixed compensation and 20 percent variable compensation based upon the volume of solid waste handled by the manager. In addition, the manager was to be compensated extra (determined without regard to the 20 percent variable limit) in the event of excessive rainfall in the county and in the event of hurricane or major storm declared emergencies occurred. The contract was held not to meet the requirements of the Rev. Proc. 97-13 safe harbor, but nonetheless did not create private business use under all the facts and circumstances presented by the county, including the likelihood of excessive rainfall.

i. PLR 200651012. A dormitory management contract between a university and its wholly owned taxable subsidiary did not give rise to private business use. The university was the sole shareholder of the manager and appointed all its members of the board of directors and had the power to approve its articles and by-laws, budgets, strategic plans and even its dissolution. The contract was for a period of 15 years, which was less than 80% of the useful life of the facility. Compensation was paid based on a fixed annual fee, adjusted only for changes in the consumer price index, plus reimbursements for direct expenses. The university had the right to terminate the contract on 90 days written notice at the end of each year. Under these facts and circumstances, the IRS concluded that the manager does not have any role or relationship that would limit the university's ability to exercise its rights under the contract (including the cancellation rights) and, thus, the contract did not give rise to private business use.

j. PLR 200330010. Though compensation arrangement did not meet the safe harbor, 20-year public utility contract nonetheless was held not to give rise to private business use.

k. PLR 200222006. Hotel management contract, having a 15-year term, providing several forms of compensation, including some employee expenses, and entered into in connection with a "Preopening Agreement" with a term of about 3 years, is a qualified management contract.

l. PLR 200205009. Management contract with a term of less than one year under which the manager receives a per unit fee plus a percentage of revenues, as well as reimbursement of third-party expenses but not employee costs, complies with Rev. Proc. 97-13.

m. PLR 200123057. Because a Section 501(c)(3) medical organization controls a majority of the board of directors of a taxable professional corporation and has substantial powers over that corporation's budgeting and operations, the Section 501(c)(3) organization is not substantially limited in the exercise of its rights under a service agreement between the Section 501(c)(3) organization and the taxable corporation.

D. Research Agreements.

1. General. Treas. Reg. § 1.141-3(b)(6) states the general rule that, except as otherwise provided therein, an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of bond-financed property based on all the facts and circumstances. Unless otherwise provided in Treas. Reg. § 1.141-3(b)(6), an arrangement that results in the sponsor being treated as the lessee or owner of the bond-financed property for federal income tax purposes will give rise to private business use of the bond-financed property. Research means basic research or the original investigation of scientific knowledge not having a specific commercial objective. Product testing supporting nongovernmental trades or businesses is not basic research.

2. Revenue Procedure 2007-47. Revenue Procedure 2007-47 ("Rev. Proc. 2007-47", which superseded Revenue Procedure 97-14), contains two safe harbors for research agreements. The first is for "corporate-sponsored" research agreements. Under this safe harbor, any licensee of the sponsor is permitted to use the results of research only on the same terms which the owner of a bond-financed facility would permit use by an unrelated party. In other words, the sponsor must pay a competitive price for the right to use the results of the research funded by that sponsor, and the price must be determined at the time the technology is available for use.

The second safe harbor is for industry or federally-sponsored research agreements in which one or more sponsors agree to fund basic research. This safe harbor requires that (1) the research to be performed and the manner in which it is to be performed be determined by the owner of the bond-financed property (*i.e.*, the governmental person), (2) title to any product resulting from the research lies exclusively with the issuer and (3) the sponsors be entitled to no more than a nonexclusive, royalty-free license to use the product of that research. Rev. Proc. 2007-47 provides that the rights of the federal government under the Bayh-Dole Act will not cause an arrangement to fall out of second safe harbor so long as (1) and (2) are met and the license to use any resulting product of the research granted to any third party is no more than a "nonexclusive, royalty-free license."

3. Private Letter Rulings.

a. PLR 200347009. Interprets Rev. Proc. 97-14 to conclude that a license agreement will cause an issue of bonds to meet the private business use tests where a corporation was given an exclusive, perpetual, non-terminable, worldwide license to all of the research created at the bond-financed facility and the exclusive right to sublicense the research to any person of the corporation's choice.

b. PLR 200309003. Organization's research contracts with two agencies of the federal government do not give rise to either private business use or federal guarantee where neither of the agency contracts requires that the organization perform any activities at the facility, and the facility will not be constructed to meet the specific needs of the federal agencies.

c. PLR 199914045. Federal research contracts do not give rise to private business use or federal guarantee where research is basic and is not generally being used a

specific commercial objective and the availability of federal revenues is not dependent upon a default on debt service payments.

E. Output Contracts. Certain output contracts (including take-or-pay and take-and-pay arrangements) can give rise to private business use. Output contracts relate to output facilities, which are electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. On September 19, 2002, the IRS released final output regulations which generally apply to bonds sold on or after November 22, 2002. The output regulations contain special rules to determine whether arrangements for the purchase of output from an output facility (including water facilities) cause an issue of bonds to meet the private business tests. A detailed description of these rules is set forth in Section VII of this outline. Note, however, that the rules of Treas. Reg. § 1.141-3 still apply for non-output types of uses of an output facility (*e.g.*, pursuant to a management contract or lease).

1. In PLR 201037006, under facts similar to PLR 200915002, the IRS concluded that the sale of "renewable energy certificates" under contract did not result in private business use. The private letter ruling explained that a number of states are now imposing mandatory compliance programs that require some or all electric utilities providing service within those states to demonstrate that a specific portion of their electric supplies are derived from renewable generating resources. Many states imposing such standards allow utilities to meet those requirements by purchasing renewable energy certificates ("RECs"). The RECs represent the environmental attributes of renewable energy, with one REC representing the attributes for one MW hour generated by a renewable energy resource.

The issuer was a public instrumentality that had the authority to acquire, construct, and operate electric generating facilities, to sell electricity generated by such facilities, and in connection with such activities it issued tax-exempt governmental bonds to finance an electric generating project that would give rise to RECs. The issuer will sell all output from the bond-financed facility to a company, which is not currently subject to the REC requirements. The issuer proposed to enter into contracts with nongovernmental purchasers that would require the purchaser to buy the lesser of the stated amount of RECs or all of the RECs associated with the project's generation of electricity for the period stated. The IRS emphasized that the sale of RECs did not entitle the purchaser to any electric energy from the project, that although the contract provides for liquidated damages in the event of non-delivery of RECs to purchaser, the issuer had exclusive control over the project and its operations, and that because it was unlikely that the purchaser would be awarded specific performance for issuer's nonperformance under the contract, purchaser could not use legal or equitable remedies to force issuer to operate the facility at any particular level.

2. In PLR 200915002, the IRS concluded that the sale of RECs generated with respect to a bond-financed output facility did not give rise to private business use, because the purchasers of the RECs received no right to use the output property and the RECs did not represent capacity generated by or use of the property.

3. PLR 200739005 concludes that the private business use test was not met where an agreement granted a private utility the rights to all of the capacity and output of a bond-financed generating plant in exchange for agreeing to provide a public water provider with a certain

amount of energy at all times, reasoning that the agreement met the so-called "swapping agreement" safe-harbor of Treas. Reg. § 1.141-7(f)(2).

F. General Public Use.

1. General. Private business use does not include use as a member of the general public. Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available, and in fact is reasonably available, for use by natural persons not engaged in a trade or business.

2. Use on the Same Basis. Use of the financed facility under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Rates that are generally applicable and uniformly applied do not convey priority rights. Rates may be treated as generally applicable and uniformly applied, even if (i) different rates apply to different classes of users, if the differences in rates are customary and reasonable; and (ii) a specially negotiated arrangement is entered into, but only if the user is prohibited by federal law from paying generally applicable rates and the terms of the arrangement are as comparable as reasonably possible to the generally applicable rates.

3. 200 Day Use Arrangements. General public use property may be subject to an arrangement for temporary exclusive use of up to 200 days, including all renewal options. A right of first refusal to renew is not included in the term of the arrangement if the renewal price is at generally applicable fair market value rates and the use of the property under the same or similar arrangements is predominantly by natural persons not engaged in a trade or business. The maximum number of days permitted usage under this exception is absolute, and not a per-year limit; therefore, a contract that contemplates 50 days use every year for 5 years would not satisfy this use exception.

G. Special Rules for Affordable Care Organizations.

1. Notice 2014-67 provides specific relief for 501(c)(3) organizations participating in "accountable care organizations" ("ACOs").

2. The Notice provides interim guidance regarding private business use of tax-exempt bond-financed facilities that are used by "accountable care organizations" under the Patient Protection and Affordable Care Act (the "ACA"). The ACA created the "Shared Savings Program" to achieve efficiencies in providing medical care under Medicare through cost savings, improved coordination of services, and investment in infrastructure. This program contemplates that 501(c)(3) organizations could enter into an ACO with physicians or other health care group practices, a network of individual practices, or a partnership or joint venture. The ACO is required to be a separate legal entity, must share "governance" as provided in the ACO guidance, and must distribute Shared Savings Program payments. The arrangement promoted by one federal program raised obvious concerns for 501(c)(3) health care organizations because it would likely be treated as a "partnership" under the private activity bond regulations or potentially give rise to net profits which would take the arrangements out of the management contract safe harbor guidelines.

3. The Notice states that the participation of an organization in the Shared Savings Program through an ACO will not result in private business use of a tax-exempt

bond-financed facility used by the organization or ACO if the following conditions are met: (a) The Centers for Medicare & Medicaid Services has accepted the ACO into the Shared Savings Program, and the ACO has not been terminated from the program, (b) The terms of the organization's participation in the Shared Savings Program through the ACO are established in a written agreement negotiated at arm's length. (c) The organization's share of economic benefits derived from the ACO (including payments received under the Shared Savings Program) is proportional to the benefits or contributions the organization provides to the ACO. If the organization receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO, and all ACO returns of capital, allocations, and distributions are made in proportion to ownership interests. (d) The organization's share of ACO losses does not exceed the share of ACO economic benefits to which the organization is entitled in (c) above. (e) All contracts and transactions entered into by the organization with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value. (f) The organization does not contribute or otherwise transfer the tax-exempt bond-financed property to the ACO unless the ACO is an entity that is a "governmental person" or, in the case of 501(c)(3) bonds, either a "governmental person" or a "501(c)(3) organization," as such terms are defined for tax purposes.

4. The ACO provisions apply to bonds sold on or after January 22, 2015, but may also be applied to bonds sold before that date. There is no specific election to apply the provision to bonds issued before the effective date

H. Other Exceptions.

1. General. Treas. Reg. §1.141-3(d) provides additional exceptions to private business use for use of bond-financed property by an agent, use incidental to financing arrangements, certain short-term uses not involving ownership by a nongovernmental person (see below), certain temporary use of bond-financed property by developers (see below), "incidental use" and use of proceeds to provide "qualified improvements" (see below).

2. Certain Short-term Arrangements. Certain short-term arrangements for the use of bond-financed property not involving the ownership of the property by a nongovernmental person will not result in private business use.

a. Permitted 100 Day Arrangements. An arrangement for the use of bond-financed property by a nongovernmental person will be permitted for a period of up to 100 days (including renewal options), if the arrangement would be treated as general public use, except that (i) the property is not available for use by natural persons not engaged in a trade or business, and (ii) the property was not financed for the purpose of providing the property to that nongovernmental person.

b. Permitted 50 Day Arrangements. An arrangement for the use of bond-financed property by a nongovernmental person will be permitted for a period of up to 50 days (including renewal options), if (i) the arrangement is a negotiated arm's length arrangement, (ii) the compensation is at fair market value, and (iii) the property was not financed for the purpose of providing the property to that nongovernmental person.

c. These permitted number of day arrangements are applied as described in F.3. above, by reference to the total number of days of use contemplated over the life of the contract, not by reference to the term/duration of the contract.

3. Temporary Use by Developer. Use by developer of a bond-financed improvement that carries out an essential governmental function during an initial development period will not give rise to private business use if the issuer and developer reasonably expect to proceed with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

4. Incidental Use and Qualified Improvements.

a. Incidental Use. Non-possessory uses of a financed facility that in the aggregate do not involve more than 2.5% of the facility may be disregarded for the purposes of determining private business use if the non-possessory use is not functionally related to some other use of the facility by the same person (e.g., pay telephones, vending machines, advertising displays and use for television cameras).

b. Qualified Improvements. Proceeds that provide "qualified improvements" are not used for private business use. Qualified improvements are governmentally-owned improvements to an existing governmentally-owned building, where the building was originally placed in service more than 1 year before the improvements are acquired or constructed, the improvements do not involve an enlargement of the building or an improvement of interior space used exclusively for a private business use, the improved building is not pledged as security for the bonds and not more than 15% of the improved building is used for private business use.

I. Special Rules for Tax Assessment Bonds. A deemed loan in a tax assessment bond situation is ignored for the purposes of the private loan financing test if the tax assessment bond financing satisfies the requirements of Treas. Reg. §1.141-5(d) (relating to tax assessment bond financings that are permitted under the tax assessment bond exception to the private loan financing test). *See* Section V below.

J. Measurement of Private Business Use.

1. General. The amount of private business use of property is determined according to the average percentage of private business use during the measurement period. In general, the measurement period begins on the later of the issue date or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property. The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. (If the private business use arises from ownership by a nongovernmental person or if the bonds are outstanding longer than reasonably necessary, the amount of private business use is the greatest percentage of private business use in any 1-year period.)

Under Treas. Reg. §§1.141-3(g)(3) and (4), the measure of private business use in any year generally is the average percentage of private business use to total actual use (disregarding periods of non-use of bond-financed property) in that year. The measure of such use over the entire measurement period is based on the average of the annual percentages of such use. The focus on average annual use instead of some present value computation is administratively easier. The disregard of non-use, however, while perhaps theoretically sound, can increase administrative tracking burdens for states and local governments because it can produce a frequently-changing denominator in the private business use percentages. It would seem equally sound from a tax policy standpoint and administratively easier to treat unused portions of bond-financed property for which a governmental unit is economically responsible as governmental use.

a. Uses at Different Times. For property used for private business use and governmental use at different times, the average amount of private business use generally is based on the amount of time that the property is used for private business use as a percentage of total time for all actual use. "Dark time" is disregarded.

b. Simultaneous Use. If property is used for governmental use and private business use simultaneously, the entire facility is treated as having private business use; however, if the governmental use and private business use is on the same basis, the average amount of private business use may be determined on a reasonable basis that reflects the proportionate benefit to be derived by the various users of the facility.

c. Common Areas, Neutral Costs. The amount of private business use of common areas is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. Neutral costs must be allocated ratably among the other purposes for which the proceeds are used.

d. Discrete Portion Use. In measuring private business use of a discrete portion of a facility, discrete portions are treated as separate facilities. For example, a discrete portion includes a floor of a building or a portion of a building separated by walls.

2. Commencement of Use. Private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if ownership or other long-term use is involved, and the issuer enters into an "arrangement" for private business use for a substantial period (10% of measurement period) before the right to actual use commences, private business use commences on the date of the arrangement.

3. Fair Market Value. If private business use is reasonably expected as of the issue date to have a significantly greater fair market value than governmental use, the average amount of private business use must be determined according to the "relative reasonably expected fair market values" of use. The determination of relative fair market value may be made as of the date the property is acquired or placed in service if this determination is not reasonably possible on the issue date. "Relative reasonably expected fair market value" must be determined by taking into account the amount of reasonably expected payments for private business use in a manner that properly reflects the proportionate benefit to be derived from the private business use.

4. Private Letter Rulings.

a. PLR 200323006. Governmental entity's sale of naming rights to stadium meets private business tests. *See* description of private letter ruling at III.B.6. above.

b. PLR 200304015. The bond portion of the cost of constructing a stadium eligible to be financed with the proceeds of a tax-exempt bond issue was determined based upon (i) an allocation method reflecting physically discrete areas and corresponding common area costs; and (ii) an allocation method reflecting relative temporal units of use and the corresponding common area costs.

c. PLR 200132017. A university research facility that is used for both private business use and Section 501(c)(3) use may determine the portion of the facility used for Section 501(c)(3) use based on the ratio of revenue from non-private business use to total research revenue.

K. Treatment of Partnerships.

1. General Rule. Final Allocation Regulations § 1.141-1(e) provides that a partnership "is treated as an aggregate of its partners, rather than as an entity." These Regulations provide flexibility to both state and local government and 501(c)(3) organizations to, in certain instances, finance, with tax-exempt obligations, such entity's "partner's share" of property owned by a partnership. Treas. Reg. § 1.141-3(g)(2)(v).

2. Partner's Share Determination. The Final Allocation Regulations (defined below under Section VI.A) provide that the amount of private business use by a nongovernmental person of property resulting from a partnership is that nongovernmental "partner's share" of the amount of use of the property by the partnership. Treas. Reg. §1.141-3(g)(2)(v). A "partner's share" is defined as the "nongovernmental partner's greatest percentage share under section 704(b) of any partnership item of income, gain, loss, deduction, or credit attributable to the period that the partnership uses the property during the measurement period." Treas. Reg. §1.141-3(g)(2)(v) clarifies that if a partnership item varies, then the "partner's share" will be the highest percentage, and Treas. Reg. §1.141-3(g)(2)(B) provides that guidance may be published in the Internal Revenue Bulletin to assist issuers in determining a "partner's share." Clarification is needed that mandatory allocations under Code Section 704(b) of the Code and the Treasury Regulations promulgated thereunder that, similar to the alternative depreciation system rules for tax-exempt use property under Code Section 168(h)(6), issuers can disregard such mandatory allocations that otherwise comply with relevant Code and regulation provisions.

IV. PRIVATE SECURITY OR PAYMENT TEST - SECTION 1.141-4

A. General Rule.

1. Private Security. The private security portion of the private payment or security test takes into account the payment of any debt service on the issue that is directly or indirectly secured by any interest in (i) property used or to be used for private business use; or (ii) payments in respect of property used or to be used for a private business use.

2. Private Payment. The private payment portion of this test takes into account the payment of any debt service on the issue that is directly or indirectly to be derived from

payments (whether to the issuer or to any related party) in respect of property, or borrowed money, used or to be used for private business use.

3. Aggregation of the Two Tests.

Payments taken into account as private payments and payments or property taken into account as private security are aggregated for the purposes of determining whether private security and/or payments exceed 10% (or in certain cases, 5%) of the debt service on the bonds, provided that no payment is taken into account under both prongs of the test.

4. Underlying Arrangement. Payments include payments made pursuant to an underlying arrangement and may result from agreements among the parties or may be based on facts and circumstances surrounding the issuance of the bonds. The Regulations give an example (Treas. Reg. §1.141-4(g), Example 2) of debt service being secured by a full faith and credit pledge and interest in property used in private business use. *See also* Revenue Ruling 80-251 and Revenue Ruling 73-481, in which, because only tax increments secured the bond issue, the pre-1986 "security interest" test was failed. Compare Revenue Rulings 80-251 and 80-339, which made inroads to the liberal conclusion of Revenue Ruling 73-481, demonstrating the concept of "underlying arrangement."

B. Measurement of Private Security and Payments.

1. Private Security. For purposes of determining the present value of debt service secured by property, such property is valued at its fair market value as of the first date on which such property secures the bond issue.

2. Private Payment. The present value of any payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

a. General. Debt service on the issue does not include any amount paid or to be paid from sale proceeds or investment proceeds of the issue (*e.g.*, capitalized interest, earnings on a debt service reserve fund applied to the payment of debt service, etc.). Debt service on the issue is adjusted to take into account payments and receipts that adjust the yield on the issue for the purposes of Code Section 148(f) (*e.g.*, qualified guarantee fees). The yield on the issue is used as a discount rate for the purposes of computing present values. In general, yield is determined on the issue date and is not adjusted to take into account subsequent events. For a variable issue yield, the issuer may assume the future interest rate on the variable yield bonds,.except as described below.

b. Deliberate Actions and Variable Yield Issues. Deliberate actions require a recomputation of the variable issue's yield, determined as of the date of the deliberate action, for purposes of determining the present value of the payments to be made pursuant to the arrangement that constitutes the deliberate action.

(i) The Regulations appear not to require a recomputation of the present value of payments made and to be made pursuant to the original arrangement in place prior to the deliberate action. Although Treas. Reg. §1.141-4(g), Example 3, which demonstrates the principle of recomputing the yield for purposes of calculating the present value of payments to be

made under the new arrangement giving rise to the deliberate action, does not explicitly address this point, its silence suggests that the present value of the payments made under the original arrangement are not changed. Additionally, the language in Treas. Reg. §1.141-4(b)(iii)(C) appears to support that conclusion.

(ii) If the deliberate action consists of the modification of the original arrangement (*e.g.*, the leasing of an additional floor to an existing tenant) rather than the issuer's entering into an arrangement with a separate person (as in Example 3), it is not clear whether the present value of payments already made under the original arrangement must be recalculated.

C. Private Payments.

1. General. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user (*e.g.*, parking fees paid by members of the general public for use of a parking garage that is managed under a nonqualifying management agreement constitute payments taken into account).

2. Payments Not to Exceed Use.

a. General. Payments with respect to proceeds used for a private business use are not taken into account to the extent that the present value of the payments exceeds the present value of the debt service on those proceeds.

b. Allocation Based on Time. Payments are taken into account only to the extent they are made for the period of time proceeds are used for a private business use. For example, payments made by the general public to attend events at a governmentally owned stadium would be taken into account only to the extent allocable to the periods in which there is private business use. Payments for events involving performers who are not considered private business users (e.g., due to the short length of their arrangement) would not be taken into account.

3. Scope of Payments. Payments for a use of proceeds include "payments of debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property ... used or to be used for a private business use". Treas. Reg. §1.141-4(a)(1).

a. History: 1986 Blue Book. This point historically received much debate. The 1986 Tax Act's Blue Book suggested that only payments actually made by private persons are taken into account. *See Blue Book,* p. 1161: "Payments from persons who are not treated as using the bond proceeds under the trade or business use test, described above, are not counted unless the payments are pledged to pay debt service or otherwise satisfy the prior-law security interest test."

b. Post-1986 Practice. This question came up frequently in the context of land-based financings *(e.g.*, special assessment bonds), in which payments were clearly being made by the general public, and also tended to arise with respect to convention centers, stadiums and the like.

c. Regulations Example. Treas. Reg. §1.141-4(g), Example 5, illustrates the position of the IRS. In that example, hospital is managed pursuant to a nonqualified management contract that results in private business use. Hospital revenues are treated as payments in respect of property used for a private business use. *See also* PLR 200026020 wherein sewage ratepayers are similarly situated to the patients paying for hospital services in Treas. Reg. §1.141-4(g), Example 5, with the consequence that their payment results in private payments.

d. Payments Not in Respect of Financed Property: Utility Relocation. Treas. Reg. §1.141-4(g), Example 4 addresses the relocation of utility lines. There, the theory was that, although the utility lines are privately owned and the utility customers whose property was being assessed make payments to the utility company for the use of the utility lines, the assessments were payments in respect of the cost of relocating the utility lines, and not the cost of the lines themselves.

4. "Fair Market Value of Other Property" Carve-Out. The Regulations provide that payments are not considered made in respect of financed property if those payments are directly allocable to other property directly used by the payor and the payments represent fair market value compensation for the other use. For example, if a person has been previously using city-owned property that was not bond-financed and has been paying fair market value rent for the use of such property, if the city then bond finances a different piece of property which it rents to such person, the amount of previously payable rent will continue to remain allocable to the pre-existing property.

5. The "Use Cap". Payments with respect to proceeds used for a private business use are not taken into account to the extent the present value of the payments exceeds the present value of debt service on those proceeds. Since the present value of debt service on proceeds will roughly equate to the amount of the proceeds, the amount of the proceeds used for the private business use will serve as a cap on the amount of payments taken into account. This would appear to be relevant only in the context of multiple uses, where the application of the cap would prevent the "crossing over" of payments to a different use.

6. Operating Expenses. Ordinary and necessary expenses (as defined under Code Section 162) directly attributable to the operation and maintenance of the financed property may be used to offset payments paid for the use of proceeds. General overhead and administrative expenses may not be taken into account for these purposes.

7. Refinanced Debt Service.

a. General. Payments of debt service on an issue to be made from the proceeds of a refunding issue will be treated as involving private payments in the same proportion as the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on a refunding issue. However, deliberate actions taken more than 3 years after the retirement of the refunded issue that are not reasonably expected on the issue date of the refunding issue, will be disregarded for the purposes of the refunded issue.

b. Example. If all debt service on a note is paid with the proceeds of a refunding issue, the note meets the private security or payment test if and to the extent the refunding issue meets the private security or payment test. To determine whether an issue is a refunding issue for this purpose, the exception in Treas. Reg. §1.150-1(d)(2)(i) (relating to the payment of interest) does not apply.

8. Allocation of Payments.

a. General. The allocation of private payments to the source or sources of funding is based on all the facts and circumstances. In general, this allocation is based upon the nexus between the payment, the financed property and the source of funding.

b. PLR 200747009. Payments of net operating revenues and certain reserves were properly allocable first to certain revenue bonds and equipment leases issued by a state port authority and thus did not cause other bonds issued to finance the same construction to meet the private security and or payment test.

c. Discrete Property. Payments for the use of a discrete facility are allocated to the sources of funding for that facility.

d. Multiple Sources of Funding. In general, a payment made for the use of property financed from two or more sources must be allocated to those sources in a manner that reasonably corresponds to the relative amount of those sources. A payment made for the use of property allocated to two or more issues may be allocated to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if this allocation reflects economic substance (*e.g.*, the maturity of bonds reflects' economic life of property, and the debt service is approximately level from year to year).

e. Issuance Arrangements. A private payment for the use of property made under an arrangement entered into in connection with the issuance of bonds that finances the property generally is allocated to the issue.

f. Allocations to Equity. A private payment may be allocated to equity before allocation to an issue, only if (i) the issuer adopts an official intent not later than 60 days after an expenditure indicating that the issuer reasonably expects to be repaid from a specific arrangement; and (ii) the private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

D. Private Security.

1. Security Taken Into Account.

a. General. Property used or to be used for private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. The property involved need not be financed with the proceeds of the bonds. Proceeds qualifying for an initial temporary period under Treas. Reg. §1.148-2(e)(2) or (3) or a deposit to a reasonably required reserve or replacement fund described in Treas. Reg. §1.148-2(f)(2)(i) are not taken into account before the date on which those

amounts are either expended or loaned by the issuer to an unrelated party. Private security (other than financed property and private payments) is taken into account only to the extent it is provided, directly or indirectly, by a user of the proceeds.

b. Treas. Reg. §1.141-4(g), Example 9. Example 9 demonstrates the principle that property used need not be financed to be private security and sheds light on determining whether obligations are "secured by an interest in property" (note the Code's language and see below). In the example, County W issues certificates of participation in a lease of a building it owns (an "asset-transfer" lease) and covenants to appropriate annual payments for the lease. More than 10% of the building is used in a private business use. None of the proceeds of the COPs are used with respect to the building but are granted to Corporation Y for the construction of a factory Y will own. Y makes no payments to W and has no relationship with the users of the building securing the COPs. If W defaults under the lease, the trustee for the COP holders has a limited right of repossession under which the trustee may lease the property to a new tenant at fair market value. The example concludes that the COPs are secured by an interest in property used for a private business use. The private security or payment test is not met, however, because the property, which is not being financed by the COPs, is not provided by a private business user.

2. Payments In Respect of Property. The payments taken into account as private security are payments in respect of property used or to be used for private business use. Payments need not be made by the private business user (*e.g.*, payments by persons using a facility that is the subject of a management contract that results in a private business use). Except as provided in paragraph 3 below, in general, the present value rules described above for private payments apply to determine the amount of payments treated as payments in respect of property used or to be used for private business use. *See* PLR 201519015 where the IRS held that the fare revenues collected by an issuer for bus service along a route subject to a nonqualifying management contract under Rev. Proc. 97-13, were not payments in respect of the managed lanes under Code Section 141(b)(2)(B).

3. Allocation of Security among Issues. Property or payments that are taken into account as a private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholder's rights to the payments or property upon default.

E. Generally Applicable Taxes.

1. General. Generally applicable taxes are not taken into account for the purposes of the private security or payment test.

2. Definition of Generally Applicable Taxes. A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental or public purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction, and a generally applicable manner of determination and collection. Payments for special privileges, services or special benefit assessments are not generally applicable taxes.

3. Manner of Determination and Collection.

a. General. A tax does not have a generally applicable manner of determination and collection (and is therefore not a "generally applicable tax") to the extent that one or more taxpayers make impermissible agreements relating to payment of those taxes. An impermissible agreement relating to the payment of a tax is taken into account whether or not it is reasonably expected to result in payments that would not otherwise have been made. If an issuer makes a grant of proceeds to a taxpayer to improve property, agreements that impose reasonable conditions on the use of the grant do not cause a tax on that property to not be a generally applicable tax. If an agreement by a taxpayer causes the tax imposed on the taxpayer not to be treated as a generally applicable tax, the entire tax paid by that taxpayer is treated as a special charge unless the agreement is limited to a specific portion of the tax.

b. Examples of Impermissible Agreements:

(i) An agreement to be personally liable on a tax that does not impose personal liability, to provide additional credit support such as a third-party guarantee or to pay unanticipated shortfalls;

(ii) An agreement regarding the minimum market value of property subject to property tax; and

(iii) An agreement not to challenge or seek deferral of the tax.

c. Examples of Permissible Agreements:

(i) An agreement to use a grant for specified purposes (whether or not that agreement is secured),

(ii) A representation regarding the expected value of the property following the improvement;

(iii) An agreement to insure the property and, if damaged, to restore the property;

(iv) A right of a grantor to rescind the grant if property taxes are not paid; and

(v) An agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose.

F. Payments In Lieu of Taxes ("PILOTs").

1. General. On October 24, 2008, the Treasury Department released final Regulations governing the private payment treatment of PILOT payments (the "PILOT Regulations"). Recall that under Treas. Reg. §1.141-4(e)(1) for purposes of the private security or payment test, generally applicable taxes are not payments from a nongovernmental person and are not payments in respect of property used in a private business use. See IV.E of this outline. Thus,

the purpose of the generally applicable taxes exception is to allow eligible tax payments made with respect to property or services to be used to pay debt service on an issue without causing private payments.

The PILOT Regulations conclude that PILOTs are treated as generally applicable taxes if and only if both (i) the payments are commensurate with and not greater than the amounts imposed by the statute for a tax of general application and (ii) the payments are designated for a governmental or public purpose and are not special charges. *See* Treas. Reg. §1.141-4(e)(5).

2. Commensurate Standard.

By retaining a restrictive "commensurate" standard, the PILOT Regulations take a conservative approach to ensuring a close relationship between eligible PILOTs and generally applicable taxes. The PILOT Regulations do not prohibit any use of PILOTs to pay debt service, but provide instead that a PILOT is commensurate with a generally applicable tax only if it is equal to a fixed percentage of the generally applicable tax that would otherwise apply in each year or it reflects a fixed adjustment to the generally applicable tax that would otherwise apply in each year.

A PILOT based upon a property tax must take into account the current assessed value of the property for property tax purposes for each year in which the PILOT is paid and that assessed value must be determined in the same manner and with the same frequency as property subject to the property tax.

A PILOT is not commensurate with a generally applicable tax if the PILOT is set at a fixed dollar amount (e.g., equal to the fixed debt service on a bond issue) that cannot vary with changes in the level of the generally applicable tax on which the PILOT is based.

Under the PILOT Regulations, PILOTs are commensurate even though the amount of the PILOTs are adjusted to accommodate the development, construction or initial start-up periods for the financed project.

3. Public Purpose Standard.

The Preamble to the PILOT Regulations and the text of the PILOT Regulations state that the underlying generally applicable tax upon which the PILOT is based be for public or governmental purposes. The PILOT Regulations require that use of an eligible PILOT be for the governmental or public purposes for which the underlying generally applicable tax on which the PILOT is based.

4. No Special Charges Requirement.

a. Examples of Special Charges. Special charges are not generally applicable taxes. The PILOT Regulations provide that a special charge includes (i) a payment for a special privilege granted or regulatory function (e.g., a license fee), (ii) a service rendered (e.g., a sanitation services fee), (iii) a use of property (e.g., rent), or (iv) a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons

based on benefits received from the capital improvements financed with the assessment (e.g., amounts charged for sidewalks, streets, streetlights or utility improvements on property owners in a defined area such as an industrial park).

b. Examples of what is Not a Special Charge. By contrast to the list of special charges above, a PILOT based upon an otherwise-qualified generally applicable tax (e.g., a generally applicable ad valorem tax on all real property within a governmental taxing jurisdiction) is not treated as a special charge merely because the PILOTs received are used for governmental or public purposes in a manner that benefits particular property owners.

c. Existence of Tax-Exempt Bonds Not Relevant for Special Charges Determinations. The PILOT Regulations remove the example in the last sentence of Treas. Reg. §1.141-4(e)(5)(ii) of the prior regulations that stated "[f]or example, a payment in lieu of taxes made in consideration for the use of property financed with tax-exempt bonds is treated as a special charge". This sentence was removed as a technical clarification rather than a substantive change. The Preamble to the PILOT Regulations states that the substantive determination of whether a payment is or is not a special charge (e.g., is a payment for the use of property such as rent) or is a generally applicable tax does not depend upon the presence or absence of tax-exempt bond financing.

5. Effective Dates.

a. General. The PILOT Regulations generally apply to bonds sold on or after October 24, 2008.

b. New Money Project Transition Exception. The prior Regulations apply to new money projects substantially in progress if (i) a governmental person took official action evidencing its preliminary approval of the project to be financed before October 19, 2006, and the plan of finance for the project contemplated PILOTs as security for the bonds, (ii) before October 19, 2006, significant expenditures were paid or incurred with respect to the project or a contract was entered into to pay or incur significant expenditures with respect to the project, and (iii) the bonds for the project (excluding refunding bonds) are issued on or before December 31, 2009.

c. Refunding Exception. The prior Regulations apply to refunding bonds if either (i) the refunded bonds (or the original bonds in a series of refundings) were sold before October 24, 2008, or (ii) the refunded bonds (or the original bonds in a series of refundings) satisfied the project transition exception and (iii) the weighted average maturity of the refunding bonds does not exceed the remaining weighted average maturity of the refunded bonds.

6. Private Letter Rulings. PLR 200640001 (Yankees) and PLR 200641002 (Mets) provide that payments in lieu of taxes made by a private party in connection with the use of baseball stadiums in New York City do not constitute private payments or private security with respect to bonds issued by an agency of the State of New York to finance construction of those baseball stadiums. Because the PILOTs in question are designated for the public purposes of promoting tourism and economic development and are calculated with respect to generally applicable ad valorem taxes, they are "commensurate with" the amounts otherwise imposed by

statute and do not constitute a special charge as defined in Treas. Reg. §1.141-4(e)(5). It is not at all clear that these private letter rulings would have been issued if subject to the PILOT Regulations.

PLR 201246007 (assessment bonds) and its companion PLR 201246032 (lease revenue bonds), provide that assessment bonds and lease revenue bonds issued by an authority to finance the construction of a new convention center wing to be solely owned by a municipality did not satisfy the private loan test where the assessment bonds would be payable from assessments levied on the property of a private company despite such private company's contractual agreements with the municipality, to among other things, construct the new wing, lease the event center, certain related parking and the stadium, and enter into a signage agreement. The IRS held that no direct loan of the proceeds existed and the transaction did not convey to the private company benefits that were the economic equivalent of a loan of the proceeds of the bonds.

PLR 202144007 provides that a portion of the rates and charges to be paid by customers that are private business users of an Agency's water supply system will be treated as private payments where the agency applies bond proceeds to fund costs of replacing lead services lines with copper service lines owned by such customers. The IRS noted that the only way to eliminate health risks from lead leaching into the water pipes owned by residential and commercial customers is to remove the lead service lines and replace them with copper service lines. The Agency will replace such lines for both residential and commercial customers, including residential customers that treat their homes as rental property or residential customers operating a business from their homes. The Agency's customers will own the replacement lines. The Agency will issue the bonds to pay costs of such lead service line replacements and other capital costs of its water supply system. The Agency will not impose special charges on customers who receive lead service line replacements and instead will use the rates and charges that it imposes on all of its customers to pay such costs, including debt service on the bonds that fund such replacement costs and other projects. No property financed by the bonds, other than the replacement service lines serving customers that are private business users, will be used for a private business use. The IRS held that payments of rates and charges by customers that receive lead service pipe replacements and are private business users are, in part, private payments for the bonds to the extents such payments are attributable to the costs of replacing the lead service lines, but because the payments that are both received from customers that are private business users of the lead pipe replacements and attributable to costs of such lead pipe replacements do not exceed 10 percent of the debt service on the bonds, the bonds do not meet the private security or payment test.

G. Waste Remediation Bonds.

1. Persons that are Not Private Business Users. Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste from that site are not taken into account as private security. Payments must be made pursuant to either (i) a generally applicable state or local tax statute or (ii) a state or local statute that regulates or restrains activities on an industry-wide basis for persons who are engaged in generating or handling hazardous waste,

or in refining, producing or transferring petroleum, provided that those payments do not represent in substance payments for the use of proceeds.

2. Persons that Are Private Business Users. If the payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on a site do not secure the payment of the principal of or the interest on a bond (directly or indirectly) under the terms of the bond, the payments are not taken into account as private payments, provided that at the time the bonds are issued, the payments from those nongovernmental persons are not material to the security for the bonds.

V. PRIVATE LOAN FINANCING TEST - SECTION 1.141-5

A. General Rules.

1. Elements of Test. The private loan financing test is met if more than the lesser of 5% or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. Treas. Reg. §1.141-2(d) (relating to reasonable expectations and deliberate actions) applies to the private loan financing test.

2. Amount of Loan. The amount actually loaned is not discounted to reflect present value of the loan repayments.

B. Definition of Private Loan.

1. General Federal Tax Principles. Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for the purposes of the private loan financing test. A loan may arise from the direct lending of bond proceeds as well as transactions in which the indirect benefits are the economic equivalent of a loan. For instance, a lease or other contractual arrangement may in substance constitute a loan if the arrangement transfers tax ownership of the facility to a nongovernmental person.

2. Non-purpose Investments; Prepayments. A loan that is a non-purpose investment does not cause the private loan financing test to be met. Except as otherwise provided in the Regulations, a prepayment for property or services is treated as a loan for the purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan if (i) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of a tax-exempt financing, (ii) the prepayments is made within 90 days of the reasonably expected date of delivery of the property or services for which the prepayment is made, or (iii) the prepayment satisfies special rules Treas. Reg. §1.141-1(e)(2)(iii) with respect to prepayments for the acquisition of a supply of natural gas or electricity.

4. Grants, Tax Increment Financing. A grant of proceeds is not a loan. A grant using proceeds of an issue that is secured by generally applicable taxes is not treated as a loan, unless the grantee makes an impermissible agreement that results in taxes not being treated as generally applicable as defined in Treas. Reg. §1.141-4(e). In such case, the entire grant is treated as a loan unless the impermissible agreement is limited to a specific portion of the tax.

5. Hazardous Waste Remediation Bonds. If payments from nongovernmental users of the site or potentially responsible persons do not secure payment of bonds and are not taken into account as private payments under Treas. Reg. §1.141-4(f)(3), no loan will be indicated.

5.

C. Tax Assessment Bond Exception.

1. General Rule. A tax assessment loan meeting the requirements of Treas. Reg. §1.141-5(d)(3)-(5) described below is not treated as a private loan.

2. Mandatory Tax or Assessment. The tax or assessment must be an enforced contribution that is imposed for the purpose of raising revenue to be used for a specific purpose, and the tax or assessment must be imposed pursuant to a state law of general application that "can be applied equally" to natural persons not acting in a trade or business and persons or entities engaged in a trade or business. Fees for services are not taxes or assessments.

3. Essential Governmental Function.

a. General. The tax or assessment must be imposed for an essential governmental function. Essential governmental functions include utilities or systems that are owned by a governmental person and that are available for use by the general public.

b. Other Facilities. The Regulations provide that for other types of facilities (non-governmentally-owned or non-publicly available facilities), the extent to which the service provided by the facility is customarily performed (and financed by governmental bonds) by governments with general taxing powers is a primary factor in determining whether the facility serves an essential governmental function (parks owned by a governmental person and available for use by the general public serve an essential governmental function). Except as otherwise provided, commercial or industrial facilities and improvements to property owned by a nongovernmental person do not serve an essential governmental function.

4. Equal Basis. Owners of business and nonbusiness property must be "eligible or required" to make deferred payments on an equal basis. A tax or assessment does not satisfy the equal basis requirement if the terms for payment are not the same for all taxed or assessed persons. The "equal basis" requirement will not be met if a person or entity subject to a tax or assessment guarantees debt service on bonds or on taxes or assessments provided that it is reasonable to expect on the date of the guarantee that payments will made under the guarantee.

5. PLR 201246007. In this ruling, the IRS concluded that assessment bonds issued in connection with the financing and construction of convention and exhibition facilities, which are located in the immediate area of existing convention center, parking facilities, a stadium and entertainment complex will not satisfy the private loan financing test. The assessment bonds are secured by and payable from assessments imposed by and payable from assessments imposed on certain interests in property related to the development that is held by a private company, which will end on the last year of the term of the bonds. The private company has agreed to pay such assessments in return for the extension of a stadium lease and for rights to locate advertising signage in certain parts of the development and the amount of the special taxes will correspond to

and be in lieu of fair market value payments that the private business user would otherwise make in exchange for the lease extension and signage rights. Based on these facts (and while it does not appear that the IRS directly addressed the tax assessment bond exception), the IRS concluded that the arrangement was not a private loan because "the special taxes...will be made in exchange for rights and benefits of equal or greater value." Presumably, the IRS viewed the payments not as a governmental tax imposed to finance a governmental function, but as compensation to the City for the benefits of the lease extension and signage rights.

VI. ALLOCATION AND ACCOUNTING RULES - SECTION 1.141-6

A. Final Allocation Regulations.

1. Background and Scope. The 1997 private activity bond regulations reserved substantial portions of the rules pertaining to the allocation of and accounting for bond proceeds under Code Section 141. Proposed regulations were subsequently issued addressing, among other things, the allocation of bond proceeds under Code Section 141. On October 27, 2015, the Treasury Department published final regulations under Code Section 141 that, among other things, modified general rules under Treas. Reg. §1.141-6 relating to the allocation of bond proceeds to expenditures, and in particular, the allocation of bond proceeds and other moneys applied to pay costs of the same project among qualified use and private use of that project (the "Final Allocation Regulations").[5] The Final Allocation Regulations generally apply to all bonds sold on or after January 25, 2016, however, under certain circumstances an issuer may elect to apply the final regulations adopted on October 27, 2015, in whole, but not in part, to any bonds that are subject to the 1997 private activity bond regulations.

2. General Rule. In general, Treas. Reg. §1.141-6(a)(2) provides that if two or more sources of funding are allocated to capital expenditures for a "project," those sources are allocated to the governmental use and private use proportionally. In addition, Treas. Reg. §1.141-6(a)(1) provides that the allocations of proceeds and other sources of funds to expenditures under Treas. Reg. §1.148-6(d) apply for purposes of Treas. Reg. §§1.141-1 through 1.141-15. Thus, an issuer may use any reasonable accounting method to allocate proceeds to expenditures, provided that the current outlay of cash rule is met and that the accounting for expenditures takes place within the appropriate time period.

(a) Definition of "Project". Treas. Reg. §1.141-6(a)(3)(i) states that "project" means one or more facilities or capital projects, including land, buildings, equipment, or other property financed in whole or in part with proceeds of the issue.

(b) Timing Considerations. Treas. Reg. 1.141-6(a)(1) provides that the allocation of proceeds and other funds to expenditures under Treas. Reg. §1.148-6(d) applies for purposes of the allocation of proceeds and other sources of funds to expenditures under Treas. Reg. §1.141-6. Thus, an issuer must account for the allocation of proceeds to expenditures not later than eighteen (18) months after the later of the date the expenditure is paid or the project that is financed by the issue is placed in service, but in no event later than sixty (60) days after the fifth

[5] These regulations also addressed (i) the treatment of certain partnerships, and (ii) remedial actions, including "anticipatory remedial actions".

(5th) anniversary of the date the bonds are issued. This timing limitation may lead to anomalous results, particularly when project costs are paid following the expiration of such period.

The preamble to the Final Allocation Regulations specifically states that the definition of "Project" "permits an issuer in its bond documents to identify as a single project all of the properties to be financed by a single bond issue" and that "issuers may identify specific properties or portions of properties regardless of the properties' locations or placed-in-service dates." Issuers are given broad, but not unrestricted, latitude to identify the components of their "project." See Example 3 in Treas. Reg. §1.141-6(f), which provides that the financing of a hospital financed in 1998 and placed in service in 2001 is a separate "project" from an addition to the hospital financed with proceeds of bonds issued in 2017 and with other sources of funds.

An issuer may, under the Final Allocation Regulations, define any contemporaneous assets as being part of the same project so long as bond proceeds are being spent on capital costs of at least one of those assets. A broad definition of a "project" encompassing numerous unrelated facilities may dramatically complicate (1) the tracking of expenditures of proceeds and other sources of funds and (2) the tracking of governmental and private use. Issuers might adopt a practice of preliminarily declaring the scope of the project in a tax certificate or similar document and later adopt a final definition of the project no later than the final allocation of bond proceeds. Where a project is financed with more than one bond issue, it may be appropriate to make the final definition of the "project" no later than when the final allocation of bond proceeds is made with respect to the last bond issue financing the project.

It is unclear what happens if an issuer fails to specifically identity the "project" that is being financed. There may or may not be an implicit default rule that in the absence of the issuer defining the "project," the project will consist of all capital facilities financed in whole or in part with the proceeds of the bonds, based either upon a written allocation of the issuer or based on tracing the proceeds of the bonds to the capital facilities. In this default situation, qualified equity that is spent on the bond-financed capital facilities would also be treated as financing a portion of the "project."

3. Eligible Mixed-Use Projects.

(a) General. The Final Allocation Regulations contain provisions which provide that, in the case of an eligible mixed-use project, private business use of the project in each year is first allocated to qualified equity that financed the project, and only private business use of the project in excess of the percentage of qualified equity is allocated to the proceeds of the bonds.[6] Treas. Reg. §1.141-6(b)(1). For this purpose, an eligible mixed-use project is a project

[6] The allocation rules are meant to be consistent with the rules pertaining to the measurement of private use under Treas. Reg. § 1.141-3(g) in which private use is generally measured over the measurement period of a project based on the average percentage of private use in each annual period. This year-by-year rule does not permit a global allocation of qualified equity throughout the entire measurement period. For example, if 10% of the costs of a project is allocated to qualified equity, no more than 10% of a project may be allocated to qualified equity in any annual period. Thus, if 100% of a project is used in a private use in the first year, and 0% of the project is used in a private use in later years, all of the qualified equity would be allocated to private use in the first year, and all of the equity would be allocated to qualified uses in all subsequent years.

that is financed with bonds that when issued purported to be governmental bonds and with "qualified equity" and is wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner. Treas. Reg. §1.141-6(b)(2). In the case of an issue of qualified 501(c)(3) bonds, a 501(c)(3) organization, acting in furtherance of its exempt purposes, is treated as a governmental person. Questions arise whether a project that is initially financed with equity, together with taxable debt, such as a line of credit, taxable commercial paper or a long-term taxable bond, which is refinanced with tax-exempt proceeds, can be treated as a qualified mixed use project. The issuer may be able to establish that tax-exempt refinancing debt and the equity were spent pursuant to a common plan of financing if tax-exempt refinancing bonds are issued within 18 months after the project was placed in service. It would be helpful for the Service to clarify that in cases where tax-exempt debt is refinancing either interim or even permanent taxable financing the determination of whether a project is an eligible mixed use project should be tested as if the tax-exempt refinancing bonds were issued at the same time or times as the refinanced taxable debt was issued.

(b) Ownership test. The ownership test presents some concerns. It is unlikely that any "floating" qualified equity would be used with respect to a project where it is expected that some components are to be owned by a governmental entity and others by a nongovernmental entity. In such a case, where the private use would exceed 10%, an issuer would generally specifically allocate equity to the privately-owned facilities and would treat only the portion owned by the governmental unit as the "project". However, once an eligible mixed-use project has been financed, the issuer may later decide to sell some elements of that project. In such a case, the "mixed-use project", as defined in the Final Allocation Regulations, may not permit an issuer to permanently assign equity to that portion (reducing the percentage of qualified equity remaining for the portion of the project retained by the issuer). In addition, the issuer should have the opportunity to exercise a remedial action (including either redemption of bonds or alternate use of the disposition proceeds) or (if the numbers work) assign the equity to the portion of the project that is sold. It would be helpful in this instance for the Treasury Department to clarify that the "wholly owned" requirement only applies at the time the bonds are issued.

4. Qualified Equity.

(a) General Considerations. In order to be an eligible mixed-use project, a project must be financed with proceeds of bonds and with qualified equity. Qualified equity is comprised of proceeds of bonds that are not proceeds of tax-advantaged bonds and funds that are not proceeds of a borrowing that are spent on the same eligible mixed use project as proceeds of the bonds. Furthermore, the qualified equity must be spent on the project "pursuant to the same plan of financing (within the meaning of Treas. Reg. §1.150-1(c)(1)(ii))." Treas. Reg. §1.141-6(b)(4) adds restrictions on whether expenditures of qualified equity finance a project under the same plan of financing as a bond issue. These restrictions relate to the timing of the expenditure and are discussed in more detail below.

(b) Same Plan of Financing Requirement. The reference to Treas. Reg. §1.150-1(c)(1)(ii) is confusing. The provision does not provide guidance on when capital project

This inability to move equity across annual periods would pose difficulties where private business use is front loaded (due, for example, to holdover tenants).

expenditures are or are not pursuant to the same plan of financing. Single issues of tax-exempt bonds are often used for project components that are not proximate or functionally related, and a single plan of finance would not be limited to facilities that are proximate or functionally related, as is the case under certain of the examples in Treas. Reg. §1.150-1(c)(1). However, other than the timing restrictions found in Treas. Reg. §1.141-6(b)(4), there are no additional restrictions imposed by Treas. Reg. §1.150-1(c)(1)(ii). The timing restrictions are sufficient to cause the expenditures of qualified equity to be pursuant to a single plan of financing, but the IRS may need to clarify that the rules of Treas. Reg. §1.141-6(b)(4) are the only rules needed to assure that expenditures of qualified equity for a capital project are part of the same plan of finance as those financed by a bond issue.

(c) Expenditure Period Requirement. The Final Allocation Regulations also provide that qualified equity finances the same plan of financing only if the qualified equity pays for capital expenditures of the project within a specified time period. Treas. Reg. §1.141-6(b)(4) states that the time period begins on the date on which the capital expenditures would be eligible for reimbursement by proceeds of the bonds under Treas. Reg. §1.150-2(d)(2). Treas. Reg. §1.150-2(d)(2) describes the reimbursement period for reimbursement bonds. The reimbursement period generally begins between eighteen (18) months and up to three (3) years before the bonds are issued, depending on when the original expenditure is paid and when the related project is placed in service or abandoned. Treas. Reg. §1.141-6(b)(4) states that the determination of when the qualified equity period begins does not depend on whether the applicable bonds are actually issued as reimbursement bonds.

(d) Ambiguities in Expenditure Period Definition. Ambiguity arises when the text of Treas. Reg. §1.141-6(b)(4) is compared to the discussion in the preamble for the regulation. The preamble suggests that an expenditure that is to be counted as qualified equity must be an expenditure that can be reimbursed from the applicable bonds if the bonds were reimbursement bonds. An expenditure that can be reimbursed from a reimbursement bond must not only meet the timing requirement described in Treas. Reg. §1.150-2(d)(2) but must also be an expenditure for which an official intent was adopted, or which satisfies the *de minimis* exception or preliminary expenditures exception. The preamble does not limit its discussion to the specific timing rule that is referenced in Treas. Reg. §1.141-6(b)(4). Clarification that Treas. Reg. §1.141-6(b)(4) does not require the adoption of an official intent or satisfaction of the *de minimis* or preliminary expenditures exceptions and that the extended reimbursement period for *de minimis* and preliminary expenditures is applicable to the determination of qualified equity would be helpful.

A single project can be partially financed by multiple tax-exempt bond issues. If bond issues partially financing the project have different issue dates, the expenditure and placed in service dates may have different permitted timing intervals for the different bond issues. Neither the Final Allocation Regulations nor the preamble explains how to make a determination of qualified equity where proceeds of more than one issue finance an eligible mixed-use project. Assume, for example, that a project placed in service in 2016 is financed with equity contributed in 2012 and with proceeds of bond issue "A" issued in 2015 and bond issue "B" issued in 2016. Presumably, all equity should count towards qualified equity with respect to the project because the equity is contributed within the reimbursement period of the bonds issued in 2015. However, the Final Allocation Regulations are not entirely clear that, in a case such as this, the equity need

not simultaneously qualify within the reimbursement periods of both bond issues to be treated as qualified equity with respect to the project.

Under the Final Allocation Regulations, equity contributed to a project is not counted as "qualified equity" of a mixed-use project for purposes of the special allocation rule if it is contributed after the date on which the measurement period begins. Under Treas. Reg. § 1.141-3(g), the measurement period of property financed by an issue begins not later than the later of the date the bonds are issued or the date the property is placed in service. Thus, the financing of punch list items could need to be treated as a separate project from the remainder of the same capital improvement. The concept of placed in service is particularly difficult to apply in the context of equity contributions because equity contributions cannot necessarily be allocated to specific components of a "project" under the special allocation rule. Instead, equity may be contributed to the project generally. When a determination is made regarding the start of the measurement period for purposes of the special allocation rule, bond counsel may need to decide whether to rely on the placed in service date of the project as a whole or the placed in service dates of functionally separate components of a mixed-use project.

Equity that constitutes a "reasonable retainage" is, under an exception in Treas. Reg. §1.141-6(b)(4), eligible to be included as qualified equity even if contributed after the measurement period begins. Reasonable retainage is defined with reference to Treas. Reg. §1.148-7(h) as an amount that does not exceed five percent of the available construction proceeds of an issue that is retained for reasonable business purposes. A further exception for expenditures that are paid after the placed in service date and that are not included in the definition of reasonable retainage would be useful. For example, it should be possible for an issuer to pay costs of construction of a project component from qualified equity even after the project component is placed in service if the cost is a normal cost of the project.

1. PLR 201507002. In the ruling, the IRS ruled on the allocation of proceeds between governmental and private activity bonds for water distribution facilities. The ruling illustrates the willingness of the IRS to consider multiple allocation approaches within a system of improvements, including the allocation between two supply sources of water such that private business use of one supply source did not taint the measurement of private business use of the other supply source.

2. PLR 201435013. In the ruling, the Issuer could make allocations under Treas. Reg. §1.141-6(a) and Treas. Reg. §1.148-6 that related to both tax-exempt bonds and build America bonds.

3. PLR 200924013. In the ruling, the City used a specific tracing method to account for investments and expenditures of gross proceeds of its bonds (the "Stadium Bonds"), which Stadium Bonds were issued to finance the acquisition, construction, improvement and equipping of a sports stadium (the "Stadium Project"). The Stadium Bonds were not expected to meet the private business use tests of Code Section 141 upon issuance, but certain private business use opportunities arose that the City sought to take advantage of (including naming rights). The City subsequently (approximately two years after the issuance of the Stadium Bonds) issued

taxable bonds (the "Park Bonds") to finance an expansion of the City's park network (the "Park Project"). The City sought to allocate proceeds of the Stadium Bonds to expenditures related to the Park Project, and proceeds of the Park Bonds to expenditures incurred for the Stadium Project as a result of the private business use of the Stadium Project. Because the allocations would occur no later than 18 months after the expenditures for the Park Project were paid, the Stadium Project was placed in service during the 18-month period prior to the date the City allocated the proceeds of the Park Bonds to the Stadium Project expenditures, and because the City had on hand at all times since the date of issuance of the Stadium Bonds an amount of proceeds of the Stadium Bonds equal to the amount of such proceeds to be allocated to the Park Project expenditures, plus investment earnings thereon, the IRS ruled that the City's allocation method was a permissible allocation method under Treas. Reg. §§1.141-6(a) and 1.148-6.

4. Additional PLRs. Additional private letter ruling addressing allocations include PLR 200248002, PLR 200036033 and PLR 9706008.

VII. SPECIAL RULES FOR OUTPUT FACILITIES - SECTION 1.141-7

On September 19, 2002, the IRS released the long-awaited private activity bond regulations for public power and other output facilities (the "Output Regulations"). The Output Regulations provide rules specifically applicable to "output" facilities, which are electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. An output contract will meet the private business use tests if it transfers the benefits and burdens of a bond-financed facility to a non-governmental person.

A. Definitions.

1. Available Output. The available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for a bond issue.

a. In General.

(i) With respect to generating facilities, the number of units produced or to be produced in one year is determined by reference to nameplate capacity or the equivalent (where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserved, maintenance or other unutilized capacity,

(ii) With respect to transmission, distribution, cogeneration and other output facilities, available output must be measured in a reasonable manner to reflect capacity, and

(iii) With respect to electric transmission facilities, measurement of available output of all or a portion of such facilities may be determined in a manner consistent with the reporting rules and the requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC). An example is provided in the Output Regulations where the use of aggregate load and load share ratios in a manner consistent with the requirements of FERC was determined to be reasonable. Measurement of the available output of

transmission facilities using thermal capacity or transfer capacity may be reasonable, depending on the facts and circumstances of the specific case.

b. Special Rule for Facilities with Significant Underutilized Capacity. If an issuer reasonably expects on the issue date of a bond issue that persons that are treated as private business users will purchase more than 30 percent of the actual output of the facility financed with the proceeds of the issue, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate or other capacity, such as the average expected annual output of the facility. The reasonably expected annual output of the generating facility must be consistent with the capacity reported for prudent reliability purposes.

c. Special Rule for Facilities with a Limited Source of Supply. If a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by taking into account those constraints. For this purpose, a limited source of supply shall include a physical limitation on the flow of water, but not an economic limitation such as the cost of coal or gas. The available output with regard to a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

d. PLR 200915002. In this private ruling, the IRS considered whether the sale of renewable energy certificates ("RECs") to non-governmental persons generated by a facility that was owned by the District (a political subdivision of the State) constituted a private business use of bond-financed property for purposes of Code Section 141(b)(6) of the Code. The bond proceeds were to be spent on the District's electrical distribution system and to "replace or rehabilitate turbines, generators, governors and unit controls for each of the facility's electric generating units." On completion of the project, the facility at issue was expected to generate the RECs. The District, in turn, expected to sell the RECs to nongovernmental persons for use in a trade or business under contracts with terms exceeding three years. The IRS addressed two questions in the ruling: first, whether the generation of the RECs constituted "output" for purposes of Treas. Reg. §1.141-7, and second, whether the generation and sale of the RECs by the District from the facility constituted a private business use under Treas. Reg. §1.141-3. The IRS relied on the following analytical factors to conclude that the RECs themselves did not constitute "output" for purposes of Treas. Reg. §1.141-7: (i) the generation of the RECs did not impact the nameplate capacity of the facility or the flow of water through a hydroelectric unit; (ii) the sale of the RECs did not affect the units of electricity that may be sold; and (iii) the sale of the RECs does not entitle the purchaser to any generator capacity. As to the second question, the IRS, in concluding that the use of the facilities, in part, to generate the RECs did not give rise to any private business use, emphasized that (i) the purchasers of the RECs received no right to use the property, and (ii) the RECs did not represent capacity generated by or use of the property.

2. Measurement Period has the same meaning with respect to output facilities as it does in general for purposes of the private business tests. *See* Treas. Reg. §1.141-3(g)(2).

3. Sale at Wholesale means a sale of output to any person for resale.

4. Take Contract means an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output.

5. Take or Pay Contract means an output contract under which the purchaser agrees to pay for the output under the contract, *whether or not* the output facility is capable of providing the output.

6. Requirements Contract means an output contract other than a take contract or a take or pay contract, under which a nongovernmental person agrees to purchase all or part of its output requirements.

7. Nonqualified Amount means, with respect to a bond issue, the lesser of (a) the proceeds of such issue which are to be used for any private business use; or (b) the proceeds of such issue with respect to which there are private payments (or property or borrowed money). *See* Code Section 141(b)(8).

B. Output Contracts.

1. In General. The purchase pursuant to a contract by a nongovernmental person of available output of an output facility financed with the proceeds of a bond issue is taken into account under the private business tests, if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on the bonds used (directly or indirectly) to finance the facility (the "benefits and burdens test").

a. Measurement of Private Business Use. If an output contract results in private business use, the amount of private business use generally is the amount of output purchased under the contract.

b. Measurement of Private Payments. The amount of payments made or to be made by nongovernmental persons under output contracts that satisfy the private business test is measured as a percentage of the debt service of an issue the proceeds of which financed the facility from which the output is purchased. The rules set forth in Treas. Reg. §1.141-4 govern this computation.

2. Take or Pay Contracts. Take or Pay Contracts generally will be determined to have satisfied the benefits and burdens test.

3. Requirements Contracts.

a. In General. A requirements contract may satisfy the benefits and burdens test if (i) it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser or that obligate the purchaser to have output requirements, or (ii) it is a sale at wholesale that may satisfy the benefits and burdens test depending on all the facts and circumstances.

b. Wholesale Requirements Contract.

(i) In General. A requirements contract that is a sale at wholesale may satisfy the benefits and burdens test depending on all the facts and circumstances.

(ii) Significant Factors. Significant factors establishing whether wholesale requirements contracts meet the benefits and burdens test include: (A) the term of the contract is substantial relative to the term of the issue or issues that finance the facility and (B) the amount of output to be purchased under the contract represents a substantial portion of the available output of the facility.

(iii) Safe Harbors Against a Wholesale Requirements Contract Meeting the Benefits and Burdens Test. Two safe harbors against a wholesale requirements contract meeting the benefits and burdens test include: (A) the term of the contract, including renewal options, does not exceed the lesser of 5 years or 30 percent of the term of the issue; and (B) the amount of output to be purchased under the contract (and any other requirements contract with the same purchaser or a related party with respect to the facility) does not exceed 5 percent of the available output of the facility.

c. Requirements Contract other than a Wholesale Requirements Contract. A requirements contract that is not a wholesale requirements contract generally will not meet the benefits and burdens test. However, see paragraph 3(a) above.

d. Factors Not Causing a Requirements Contract to Satisfy the Benefits and Burdens Test. A requirements contract will not meet the benefits and burdens test by reason of a provision in the contract that requires the purchaser to pay reasonable and customary damages (including liquidated damages) in the event of a default, or a provision that permits the purchaser to pay a specified amount to terminate the contract while the purchaser has requirements, in each case if the amount of the payment is reasonably related to the purchaser's obligation to buy requirements that is discharged by the payment.

4. Output Contract Characterized as a Lease. An output contract that is properly characterized as a lease for federal income tax purpose will be analyzed under the general rules to determine whether such contract need be taken into account under the private business tests.

C. Certain Contracts Exempted from the Private Business Tests.

1. Small Purchase Contracts. An output contract for the use of a facility is not taken into account for purposes of the private business test if the average annual payments to be made under the contract do not exceed 1 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

2. Swapping and Pooling Arrangements. An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the governmentally owned output facility if:

(i) the swapped output is reasonably expected to be approximately equal in value (determined over periods of 3 years or less); and

(ii) the purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.

3. Short-term Output Contracts. An output contract with a nongovernmental person is not taken into account under the private business tests if:

(i) the term of the contract, including all renewal options, is not longer than 3 years;

(ii) the contract is either a negotiated, arm's length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and

(iii) the output facility is not financed for a principal purpose of providing the facility for use by the nongovernmental person.

4. Conduit Parties Disregarded in Certain Circumstances. A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person.

D. Special Rules for Electrical Output Facilities Used to Provide Open Access.

1. Operation of Transmission Facilities by Nongovernmental Persons.

a. In General. The operation of an electric transmission facility by a nongovernmental person may result in private business use of the facility based on all the facts and circumstances. A nongovernmental operator who is compensated for transmission services, in whole or in part, based on a share of net profits from the operation of the facility will be considered a private business user of such facility.

b. Independent Transmission Operators. A contract for the operation of an electric transmission facility by an independent entity, such as a regional transmission organization ("RTO") or an independent system operator ("ISO") (each, an "independent transmission operator") does not constitute private business use if:

(i) the facility is governmentally owned;

(ii) the operation of the facility by the RTO or the ISO is approved by the FERC under one or more provisions of the Federal Power Act or by a state authority under comparable provisions of state law;

(iii) no portion of the compensation of the RTO or the ISO is based on a share of net profits from the operation of the facility; and

(iv) the independent transmission operator does not bear risk of loss of the facility.

c. Use by Nongovernmental Persons under Certain Output Contracts.

(i) Transmission Facilities. The use of an electric transmission facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if:

(A) the facility is governmentally owned;

(B) the facility is operated by an independent transmission operator in a manner approved by FERC or a state authority; and

(C) the facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(ii) Distribution Facilities. The use of an electric distribution facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if:

(A) the facility is owned by a governmental person;

(B) the facility is available for use on a nondiscriminatory, open access basis by buyers and sellers of electricity in accordance with rates that are generally applicable and uniformly applied, which includes situations in which different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable or specifically negotiated rate arrangement is entered into, but only if the user is prohibited by federal law from paying the generally applicable rates and the rates established are as comparable as reasonably possible to the generally applicable rates; and

(C) the facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person (other than a retail end-user).

(iii) Ancillary Services. The use of an electric output facility to provide ancillary services required to be offered as part of an open access Transmission tariff under rules promulgated by FERC does not result in private business use.

E. Exceptions to "Deliberate Action" Rules with Respect to Change In Use Situations.

1. Mandated Wheeling. Entering into a contract for the use of electric transmission or distribution facilities is not treated as a "deliberate action" if (a) the contract is entered into in response to (or in anticipation of) an order of the United States or a relevant state regulatory authority; and (b) the terms of the contract are bona fide and arm's length, and the consideration paid is consistent with the applicable provisions of the Federal Power Act.

2. Actions Taken to Implement Non-Discriminatory, Open Access. An action similarly is not treated as a "deliberate action" if it is taken to implement the offering of

nondiscriminatory, open access tariffs for the use of electric transmission or distribution facilities, in a manner consistent with rules promulgated by FERC. This paragraph does not apply to the sale, exchange or other disposition of transmission or distribution facilities to a nongovernmental person.

3. Certain Current Refunding Bonds. An action to be taken with respect to electric transmission or distribution facilities refinanced by an issue is not taken into account for purpose of establishing "reasonable expectations and deliberate actions" with respect to private business use if (i) the action is described in the two immediately preceding paragraphs, (ii) the bonds are current refunding bonds that refund bonds originally issued before February 23, 1998, and (iii) the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

4. The Commissioner May Permit Additional Transactions. Additional circumstances in which the use of electric output facilities in a restructured electric industry does not constitute private business use may be identified by the Commissioner in published guidance.

5. PLR 200850003. The IRS ruled that the sale of financial instruments available through an allocation and auction process that resulted in allocating priority rights to bond-financed electrical transmission facilities during times of high congestion does not constitute deliberate action causing the bonds to become private activity bonds where implementation of the system is done at the direction and guidance of the FERC and undertaken to enhance the goal of providing open and non-discriminatory access to transmission facilities consistent with Treas. Reg. §1.141-7(g)(4)(ii) of the Regulations. The IRS also ruled that implementation of the new system of allocating priority among users during high congestion times does not constitute a sale, exchange, or other disposition of the bond-financed facilities under Code Section 1001(a) for purposes of Treas. Reg. §1.141-7(g)(4)(ii) where the owners of the bond-financed property retained the legal entitlements and burdens associated with the ownership of the facilities.

F. Allocations of Output Facilities and Systems - Treas. Reg. §1.141-7(h).

1. Facts and Circumstances Analysis. Whether output sold under an output contract is allocated to a particular facility (*e.g.*, a generating unit), to the entire system of the seller of that output (out of any uses of that system output allocated to a particular facility) or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered include:

(i) the extent to which it is physically possible to deliver output to or from a particular facility or system;

(ii) the terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources);

(iii) whether a contract is entered into as part of a common plan of financing for a facility; and

(iv) the method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

2. Transmission and Distribution Contracts. Whether use under an output contract for transmission or distribution is allocated to a particular facility or to a transmission or distribution network is based on all the facts and circumstances, as described above.

3. Allocation of Payments. Payments for output provided by an output facility financed with two or more sources of funding are allocated pursuant to the general rules regarding payment allocations.

4. PLR 201128010. PLR 201128010 concludes that the allocation of output based on reserved net rated capacity of the facility is equivalent to an allocation based upon output of the facility.

G. $15 Million Limitation for Output Facilities.

1. In General. An issue is considered to be a private activity bond if the nonqualified amount with respect to output facilities (other than a facility for the furnishing of water) financed by the proceeds of the issue exceeds $15 million. This limitation applies to issues 5% or more of the proceeds of which are to be used to finance output facilities and is in addition to the general $15 million limitation on private business use.

2. Application of $15 Million Output Facility Limitation.

a. In General. The private business use tests will be met if more than $15 million of the proceeds of the issue to be used with respect to an output facility are to be used for a private business use. Investment proceeds are disregarded for this purpose if they are not allocated disproportionately to the private business use portion of the issue. The private business tests will similarly be met if the payment of the principal of, or the interest on more than $15 million of the sale proceeds of the portion of the issue is used with respect to an output facility is (under the terms of the issue or any underlying arrangement) directly or indirectly secured by any interest in an output facility used or to be used for a private business use (or payments in respect of such an output facility); or to be derived from payments (whether or not to the issuer) in respect of an output facility used or to be used for a private business use.

b. Reduction in the $15 Million Limit for Outstanding Issues. In determining whether an issue 5% or more of the proceeds of which are to be used with respect to an output facility consists of private activity bonds under the $15 million output limitation, the $15 million limitation is applied by taking into account the aggregate nonqualified amounts of any outstanding bonds of other issues 5% or more of the proceeds of which are or will be used with respect to that output facility or any other output facility that is part of the same "project" (as defined below). A tax-exempt bond of another issue is taken into account if:

(i) that bond is outstanding on the issue date of the later issue;

(ii) that bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of that bond by the later issue; and

(iii) 5% or more of the proceeds of the earlier issue financed an output facility that is a part of the same project as the output facility that is financed by 5% or more of the sale proceeds of the later issue.

c. Modification of Private Business Use Tests. The $15 million limitation with respect to output facilities as it relates to the "benefits and burdens test" described above, is applied by replacing "10%" or "5%" with $15 million each place it appears. The amount of bonds of an earlier issue that are required to be taken into account in connection with the foregoing analysis equals the nonqualified amount of the earlier issue multiplied by a fraction, the numerator of which is the adjusted issue price of the earlier issue as of the issue date of the later issue, and the denominator of which is the issue price of the earlier issue (pre-issuance accrued interest is disregarded for purposes of this calculation).

3. Definitions.

a. Project. Facilities that are functionally related and subordinate are treated as part of the same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. *e.g.*, (i) generation, transmission and distribution facilities; (ii) separate facilities to serve wholesale customers and retail customers; and (iii) a peaking unit and a baseload unit (regardless of the location thereof).

b. Separate Ownership. Facilities that are not owned by the same person are not part of the same project. If a project is financed as a collaborative effort among different governmental persons, their interests are aggregated with respect to that project to determine whether the $15 million output limitation has been met (for example as participants in a joint powers authority). Where there are undivided ownership interests in a single output facility, property that is not owned by different persons is treated as separate projects if the separate interests are financed (i) with bonds of different issuers, and (ii) without a principal purpose of avoiding the Output Regulations. In the case of generating property and related facilities, project means property located at the same site. However, separate generating units are not treated as part of the same project if on the issue date of each of the issues that finances the units, the unit is reasonably expected on the issue date to be placed in service more than 3 years before the other. Common facilities or property must be allocated on a reasonable basis.

c. Transmission and Distribution. In the case of transmission or distribution facilities, project means functionally related contiguous property. Separate transmission or distribution facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the facilities, to be placed in service more than 2 years before the other.

d. Subsequent Improvements.

(i) In General. An improvement to generation, transmission or distribution facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or

acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service.

(ii) Transmission and Distribution Facilities. An improvement to transmission or distribution facilities that is not part of the original design of that properly is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

(iii) Replacement Property. For purposes of these provisions, property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless:

(A) the need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property; and

(B) the bonds that finance (and refinance) the output facility have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the facility.

H. Effective Dates - Treas. Reg. §1.141-15(f).

1. In General. The Output Regulations apply to bonds sold on or after November 22, 2002.

2. Permitted Elections into Output Regulations. For bonds subject to the Treasury Regulations that implement the private business tests, the Output Regulations apply to output contracts entered into on or after September 19, 2002. An output contract is treated as entered into on or after that date if it is amended on or after that date, but only if the amendment results in a change to the contract or increases the amount of the requirements covered by the contract by reason of an extension of the contract term or a change in the method of determining such requirements.

3. PLR 201114003. In PLR 20114003, the IRS concluded that an agreement between a state authority and rural electrical power cooperative to defer the effective date of any termination of a wholesale electricity requirements contract is not an amendment to the contract for purposes of Treas. Reg. §1.141-15(f)(2) and will not cause the contract to be treated as an output contract entered after September 19, 2002.

4. Refunding Bonds. Except as provided in the two immediately preceding paragraphs, the Output Regulations do not apply to any bonds sold on or after November 22, 2002, to refund a bond to which the Output Regulations do not apply unless the bonds are subject to the applicable provisions of the Tax Reform Act of 1986 and the weighted average maturity of the refunding bonds is longer than: (a) the weighted average maturity of the refunded bonds; or (b) in

the case of a short-term obligation that the issuer expects to refund with a long-term financing, 120 percent of the weighted average reasonably expected economic life of the facilities financed or a principal purpose for the issuance of the bonds is to make one or more new conduit loans.

5. Elective Application of Output Regulations. The Output Regulations may be, at the election of the issuer, applied in whole, but not in part, to outstanding bonds sold before November 22, 2002 or refunding bonds sold on or after November 22, 2002. The exception to the benefits and burdens test for short term output contracts and for electric output facilities used to provide open access may be applied by an issuer to any bonds.

I. Acquisition of Non-Governmental Output Facilities.

A. General Rule. Under Code Section 141(d), which was added by the Budget Reconciliation Act of 1987, an issue will be treated as a "private activity bond" if more than the lesser of five percent or $5,000,000 of the proceeds of such issue are used (directly or indirectly) to acquire nongovernmental output property. The term "nongovernmental output property" means any property (or interest therein) which before such acquisition was used (or held for use) by a nongovernmental person in connection with an output facility.

B. Exceptions. For this purpose, (i) a facility for the furnishing of water, and (ii) property used in connection with an output facility 95 percent or more of the output of which is consumed in an area treated as a "qualified service area" or a "qualified annexed area" of the governmental unit acquiring such property is not treated as nongovernmental output property for purposes of Code Section 141(d). In addition, property (other than property which is part of the output function of a nuclear power facility) is not nongovernmental output property if such property is converted to a use not in connection with an output facility.

VIII. UNRELATED OR DISPROPORTIONATE USE TEST - SECTION 1.141-9

A. General Rule. Under Code Section 141(b)(3), an issue meets the private business tests if the amount of private business use and private payments or security attributable to unrelated or disproportionate private business use exceeds 5% of the proceeds of the issue.

B. Application of Test.

1. Order. The test is applied by first determining whether a private business use is related to a governmental use. Next, private business use that is "related" is examined to see if it is disproportionate.

2. Aggregation. All unrelated and disproportionate use is aggregated.

C. Unrelated Use. Whether use is related is determined on a case-by-case basis, emphasizing operational relationship. Generally, related use must be located within or adjacent to the governmentally-used facility. Parallel related and unrelated uses (*i.e.*, use of a facility by a nongovernmental person for the same purpose as use by a governmental person, and use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use) are not treated as unrelated use if the government use or the related use,

as applicable, is not insignificant (*e.g.*, parking garage; pharmacy in governmentally-owned hospital used by hospital and nonhospital patrons).

D. Disproportionate Use.

1. Definition of Disproportionate Use. Private business use is defined to be a disproportionate use in Treas. Reg. §1.141-9(c) only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use.

2. Aggregation of Related Uses. If two or more private business uses relate to a single government use, those related uses are aggregated in applying the disproportionate use test.

3. Allocation Rule. If a private business use relates to two or more government uses or a government use and a private business use, the amount of any disproportionate use may be determined by allocating the private business use among the related uses, aggregating government uses that are directly related to each other or allocating the private business use to the government use to which it is primarily related.

E. Maximum Use Taken into Account. The determination of the amount of unrelated use or disproportionate use is based on the maximum amount of reasonably expected government use of a facility during the term of the issue.

IX. REMEDIAL ACTIONS – SECTION 1.141-12

A. General Rule. An action that causes the private activity bond tests or private loan financing test to be met is not treated as a deliberate action if the issuer takes a specified remedial action and all of the following requirements are met.

1. Reasonable Expectations. The issuer reasonably expected on the issue date of the issue would not meet either the private activity bond tests or the private loan financing test for the entire term of the bonds. If the issuer reasonably expects to take deliberate action during the term of the bonds and the special redemption requirements described in II.C.2 above are met, the term of the bonds for this purpose may be determined taking into account such redemption provisions.

2. Maturity Not Unreasonably Long. The term of the issue must not be longer than reasonably necessary for the governmental purposes of the issue.

3. Fair Market Value Consideration. Except with respect to the alternative use of facility remedial action described in B.3. below, the terms of any agreements that result in satisfaction of either the private activity bond tests or the private loan financing test are bona fide, and arm's length and the new user pays fair market value for the use of the financed property.

4. Disposition Proceeds. The issuer must treat any disposition proceeds as gross proceeds for the purposes of Code Section 148.

5. Proceeds Expended. Except with respect to the redemption or defeasance remedial action, the proceeds of the issue affected by the deliberate action must have been expended before the deliberate action.

B. Alternatives for Remedial Action.

1. Redemption or Defeasance of Nonqualified Bonds.

a. If there is a transfer exclusively for cash, the requirements are satisfied if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds within 90 days of the deliberate action or establish a defeasance escrow within such period. If the deliberate action does not involve a transfer exclusively for cash, funds other than proceeds of a tax-exempt bond must be used to redeem all the nonqualified bonds within 90 days of the deliberate action or a defeasance escrow must be established within such period.

b. Rev. Proc. 2018-26 provides that the investments in the defeasance escrow must either be yield restricted or rebate payments must be made on any excess yield, with the first computation period beginning on the date on which the escrow is established.

c. If a defeasance escrow is established, the issuer must notify the IRS of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

d. Notwithstanding the foregoing, the establishment of a defeasance escrow will not be considered a remedial action if the period between the issue date and the first call date is more than 10.5 years.

2. Alternative Use of Disposition Proceeds-General Rule. Use of disposition proceeds for an alternative use is a remedial action, if:

a. The deliberate action involves a transfer exclusively for cash.

b. The issuer reasonably expects to spend the disposition proceeds within 2 years of the deliberate action.

c. The disposition proceeds are used in a manner that does not cause the issue to meet either the private activity bond tests or the private loan financing test. In the case of use by a Section 501(c)(3) organization, the bonds must be treated as reissued for the purposes of Code Sections 141, 145, 147, 149 and 150.

d. Any disposition proceeds not so used are used for another remedial action.

3. Alternative Use of Disposition Proceeds—Private Business Use Arising from Certain Leases.

(i) Rev. Proc. 2018-26 allows excess private business use resulting from eligible leases to be remediated through expenditure of moneys on eligible projects, even

though private business use does not result from the sale of a bond-financed asset exclusively for cash.

(ii) Eligible leases only include leases whose entire consideration consist of cash payments (regardless of when paid) not financed with an issue of tax-advantaged bonds.

(iii) The term of an eligible lease must either (X) be at least equal to the lesser of 20 years or 75 percent of the weighted average reasonably expected economic life of the leased property or (Y) run through the end of the applicable measurement period.

(iv) Remedial expenditures must be in an amount equal to the present value of all lease payments, using the yield on the bonds, as of the start of the lease, as the discount rate; such amount is treated as disposition proceeds from purposes of Treas. Reg. §1.141-12(e) and must be spent in the manner prescribed by such Regulations Section.

(v) The effect of the alternate use of disposition proceeds is that the assets on which such disposition proceeds are spent, but only for the term of the lease. Once the lease has terminated, the proceeds of the Bonds once again are allocated to the leased property.

4. Alternative Use of Facility. Alternative use of a facility is treated as a remedial action if all of the following are met:

(i) The facility is used in an alternative manner (*i.e.*, use by a nongovernmental person for a qualifying purpose or use by a Section 501(e)(3) organization).

(ii) The nonqualified bonds are treated as reissued as of the date of deliberate action for purposes of Code Sections 55-59, 141-147, 149 and 150. Under this treatment, the nonqualified bonds are treated as qualified bonds throughout the remaining term.

(iii) The deliberate action does not involve a transfer to a purchaser that finances the acquisition with proceeds of tax-exempt bonds.

(iv) Any disposition proceeds other than those arising from an agreement to provide services are used to pay debt service on the bonds on the next debt service payment date or are deposited in a yield restricted escrow within 90 days of receipt to pay debt service on bonds on the next available debt service payment date. (Note that Code Section 147(d), the existing property limitation, does not apply.)

5. Other Remedial Actions.

a. General. The Commissioner may provide additional remedial actions.

b. Notice 2008-31[7]. This Notice extends to Code Sections 54, 1397E and 1400N the remedies under Rev. Proc. 97-15. Rev. Proc. 97-15 established an IRS closing agreement procedure applicable to failures to meet the requirements for excludability of interest from gross income in Code Sections 141 through 150 that can be remediated under Treas. Reg. §§ 1.141-12, 1.142-2, 1.144-2, 1.145-2 or 1.147-2. Rev. Proc. 97-15 had no effect on the application of Code Sections 150(b) and (c).

6. Definition of Nonqualified Bonds. The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the deliberate action date, the remaining bonds would not meet the private business use test. Should the "issuance" of the remaining bonds be treated as a refunding or a new money issue? Unless it is treated as a refunding, application of the definition can, depending on the facts, produce results that either amplify the required remediation or eliminate it entirely.

Consider two examples, both involving a 20-year bullet bond that finances the acquisition of a building on the issue date. In the first, on the issue date, the issuer leases 20% of the building for a 10-year period. Total private business use for the issue is 10%, so no remediation is required. Then, on the first day of the 11th year, the issuer leases 10% of the building for the remaining 10 years of the measurement period. Private business use for the issue is now 15%, and remediation is required. If the bonds are treated as reissued on the deliberate action date, and the reissuance is treated as a new money issue with prior private business use disregarded, then no remediation is required, because the reissued bonds have private business use of 10%, which is within permissible limits, and there are no nonqualified bonds.

In the second example, there is no private business use during the first 10 years. Then, on the first day of the 11th year, the issuer leases 30% of the building for the remaining 10 years of the measurement period. Again, private business use for the issue is now 15%, as with the first example. However, private business use for the new issue is now 30%, rather than 10%, and approximately 20% of the bonds (with adjustments for the gross-down) must be remediated.

7. As part of its outreach and educational services program, the IRS posted to its website an article that summarized the remedial action rules found in Treas. Reg. §1.141-12 of the Regulations. It also presented three examples meant to illustrate the application of the remedial action rules. While the IRS expressed its intent that the article not be considered an authoritative source, the content of the examples gave rise to questions. NABL raised some of these interpretive questions in a letter to the IRS dated July 24, 2012 (the "NABL Letter"). Specifically, the NABL Letter focuses on Example 3 of the article, which describes a $10M facility financed with multiple sources of funds - $4M provided from funds on hand and $6M from the proceeds of tax-exempt bonds. Upon sale of the facility for $12M, the example states that, if the borrower decides to remediate using the "alternative use of disposition proceeds" option, the borrower must use the entire $12M for an alternative use within two years. Of this $12M of disposition proceeds, $6M are to be treated as gross proceeds of the bonds, suggesting that the IRS is reading this provision to mean that, so long as any portion of a piece of property has been financed with proceeds of an issue, then all of the sale proceeds will be "disposition proceeds." The NABL Letter also raises an

[7] TD 9777 obsoleted Revenue Procedure 1997-15 on 7/18/2016 because the scope of violations that can be remedied under Notice 2008-31 is broader than what Rev. Proc. 97-15 provided.

interpretive question regarding Example 2 of the article. Example 2 describes an issuer's use of a $10M bond issue to finance a school ($8M) and land ($2M). After sale of the land for $3M, the IRS notes that, if the issuer chooses to remediate by redeeming nonqualified bonds, it must redeem $2M of the outstanding bonds (all $10M of the bonds are assumed to remain outstanding), leaving $1M to be treated as gross proceeds for purposes of Code Section 148, raising a question regarding whether, when multiple facilities are financed with a single bond issue, an amount greater than the amount of the nonqualified bonds be considered gross proceeds. The IRS has not provided further clarification of its position, however these examples are no longer posted on the IRS website.

C. Anticipatory Remedial Actions.

1. General Rule. Treas. Reg. §1.141-12 of the Final Allocation Regulations expands the remedial action rules to encourage the retirement of tax-exempt bonds before the occurrence of nonqualified use by permitting an issuer to redeem or defease bonds at any time in advance of a deliberate action that would cause the private business tests to be met.

2. Declaration of Intent. To address the concern of issuers potentially treating ordinary bond amortization payments as "anticipatory remedial actions," the Final Allocation Regulations require an issuer to declare its intent to redeem or defease bonds in advance of a deliberate action in a manner similar to the declaration of intent for reimbursement contained in Treas. Reg. §1.150-2(e). The Final Allocation Regulations require the issuer to "describe the deliberate action that potentially may result in the private business tests being met." This description requirement may significantly impair the usefulness of the anticipatory remedial action unless it is clarified.

With regard to official intent for reimbursement, Treas. Reg. §1.150-2(e) provides that a general description is sufficient to describe the project for which the issuer is seeking reimbursement (e.g. highway capital improvement program, hospital equipment acquisition, etc.). Clarification from the IRS that it is permissible to describe a future deliberate action with similar generalization would be helpful.

The following example illustrates the problem: City A sells to a private developer a parcel of unused bond-financed land, the acquisition of which was part of a larger bond-financed project. Prior to the sale of the land, City A calculated a total of 3% cumulative private business use in the Project from the lease of a portion of its City Hall to a small cafe on the ground floor. City A calculates that the sale of the land will generate an additional 6% private business use on the Bonds. City A adopts an Official Intent Resolution outlining the private business use from the cafe lease and land sale and a general description of private business use that may arise in the future with respect to the Project. City A then redeems the nonqualified bonds associated with the land sale with proceeds from the sale.

In the example above, City A only reached a total of 9% private business use from the sale of the land. A requirement that the declaration of intent describe with detail the deliberate action that may result in the private business tests to be met would result in the City being unable to take an anticipatory remedial action with respect to the sale. At the time of the land sale, the City does not know the nature of future use that may provide the additional 1% use to cause the Bonds to meet the private business use test. However, it is at that time that the City is best positioned to

remediate the private use with proceeds of the sale. If the City were instead to invest the land sale proceeds until an additional amount of private business use causes the private business tests to be met, the result is detrimental to both the City (from the negative arbitrage cost of retaining the land sale proceeds) and the federal government (since the nonqualified Bonds remain outstanding until the 10% threshold is reached). Allowing a general description in the intent resolution better serves the stated policy of the Final Allocation Regulations of encouraging redemption of tax-exempt bonds earlier rather than later.

3. Permitted Anticipatory Remedial Action. The Final Allocation Regulations only permit an issuer to take an anticipatory remedial action in the form of a redemption or defeasance of nonqualified bonds.

The Final Allocation Regulations give the example of a sale of bond-financed property that the buyer may then lease to a nongovernmental person. City B, for example, may sell property to State University C, who may (but has not yet taken action to) lease the property to a nongovernmental person. Thus, City B in this example has not yet generated any private business use from the sale of the land. The Final Allocation Regulations would allow the City to declare its official intent to redeem or defease a portion of the bonds from the future nonqualified use.

4. Nonqualified Bonds. The Final Allocation Regulations provide that the amount of nonqualified bonds is equal to the portion of the outstanding bonds that, if the remaining bonds were issued on the date of the deliberate action, the remaining bonds would not meet the private business tests. This language has the effect of only requiring an issuer to redeem or defease enough bonds to reduce the amount of private business use to 10% (or 5%, if applicable).

D. Remedial Actions for Direct Pay Bonds.

1. General. Rev. Proc. 2018-26 authorizes the use of certain remedial actions for Direct Pay Bonds and other tax-advantaged taxable bonds. Significant uncertainties exist regarding the requirements for effective remedial actions under Rev. Proc. 2018-26. While these remedial provisions allow a variety of potential violations to be remediated, a general discussion of the requirements applicable to tax-advantaged taxable bonds is beyond the scope of this outline, and the summary below solely addresses non-qualified use arising from excess private business use under Code Section 141 of the Code.

2. Reduction of Federal Tax Credit for Direct Pay Bonds. Issuers may remediate excess private business use by voluntarily eliminating the federal tax credit on "nonqualified bonds." The amount and identity of non-qualified bonds are determined using the general principles of Treas. Reg. §§1.141-12(j) and 1.142-2(e) (i.e. it is the portion of bonds that, if the remaining bonds were issued on the date of the deliberate acquisition, the proceeds of the remaining bonds would be used for a qualified use). Issuers must notify the IRS of the voluntary reduction in credits, identity the date of the deliberate action and submit a revised debt service schedule.

Section 6 of Rev. Proc. 2018-26 also includes a puzzling statement that if the deliberate action results in the creation of "disposition proceeds," the issuer must treat the disposition proceeds as gross proceeds for purposes of Code Section 148 and as proceeds for

purposes of the Code section applicable to the relevant category of tax advantaged bonds. It is unclear if the Revenue Procedure really intends to require an issuer to both surrender the tax credit with respect to the nonqualified bonds and to be subject to expenditure requirements with respect to disposition proceeds allocable to the nonqualified bonds; if it does, no issuer of Direct Pay Bonds taking a deliberate action involving a disposition exclusively for cash would ever use this remedial action, since it also would have to use the alternate use of disposition proceeds described in Section IX.C.4 below.

3. Redemption or Defeasance of Direct Pay Bonds and Tax Credit Bonds. Section 7 of the Rev. Proc. 2018-26 also permits issuers of certain tax credit bonds and direct pay bonds to remediate excess private business use by redeeming or defeasing nonqualified bonds within 90 days of the deliberate action. Issuers may either yield restrict or pay rebate on the investments in a remedial defeasance escrow. These provisions do not contain an analogue to Treas. Reg. §1.141-12(d)(2), which reduces the redemption/defeasance requirement in certain cases of dispositions exclusively for cash in which the cash received is insufficient to redeem or defease all the nonqualified bonds. This remedial action, like that applicable to termination of the credit in the prior paragraph of this outline, also requires the issuer to treat any disposition proceeds as gross proceeds for purposes of Code Section 148 and as proceeds for purposes of the Code section applicable to the relevant category of tax advantaged bonds. It is unclear if the Revenue Procedure really intends to require an issuer to both defease or redeem the nonqualified bonds and to be subject to expenditure requirements with respect to disposition proceeds allocable to the nonqualified bonds; if it does, no issuer taking a deliberate action involving a disposition exclusively for cash would ever use this remedial action, since it would also have to also use the alternate use of disposition proceeds described in Section IX.C.4 below. A special rule provides that defeasance of nonqualified bonds will not trigger a reissuance of the defeased bonds.

4. Alternate Use of Disposition Proceeds of Direct Pay Bonds and Tax Credit Bonds. Finally, if the deliberate action involves a disposition of financed property exclusively for cash, Section 7.05 of Rev. Proc. 2018-26 permits issuers to make use of an alternate use of disposition proceeds remedial action like that found in Treas. Reg. §1.141-12.

X. OTHER REMEDIAL ACTION RULES

A. Exempt Facility Bonds - Treas. Reg. §1.142-2.

1. General. If, with respect to an exempt facility bond issued under Code Section 142, there is a failure to meet the requirement that 95% of the net proceeds actually be used to provide an exempt facility, such bond will be treated as meeting the requirements of Code Section 142(a) if (i) the issuer reasonably expected on the date of issue that 95% of the net proceeds of the issue would be used to provide an exempt facility and (ii) all nonqualified bonds are redeemed on the earliest call date after the date on which the failure to properly use the proceeds occurs. If bonds are not redeemed within 90 days of the failure to properly use proceeds, a defeasance escrow must be established for those bonds within this period. In the case of the establishment of a defeasance escrow, the issuer must give notice to the IRS within 90 days and, in addition, the bonds must have an initial call date that is not more than 10.5 years from the issue date.

2. Application. The remedial action rules in Treas. Reg. §1.142-2 apply to Code Sections 147(c)(3), (d)(2) and (3), (e) and (f).

B. Small Issue and Qualified Redevelopment Bonds - Treas. Reg. §1.144-2. Treas. Reg. §1.144-2 provides that the remedial action rules of Treas. Reg. §1.142-2 apply to qualified small issue bonds issued under Code Section 144(a) and qualified redevelopment bonds issued under Code Section 144(c).

XI. REGULATIONS FOR APPLYING PRIVATE ACTIVITY BOND RESTRICTIONS TO REFUNDING ISSUES - SECTION 1.141-13

The Treasury Department published final Regulations, addressing the application of the private activity bond restrictions to refunding bonds in the Federal Register in February 2006 (the "Refunding Regulations").

A. Private Business Use.

1. Rules with respect to Private Activity Bonds.

a. General. The Refunding Regulations as they apply to private activity bonds apply the private activity bond rules to the refunded issue and the refunding issue separately. Treas. Reg. §1.141-13(a). The proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the refunded issue. Treas. Reg. §1.141-13(b)(1). The amount of private business use associated with a bond issue is based upon the respective measurement period of the refunded issue and the refunding issue, calculated separately. Treas. Reg. §1.141-13(b)(2).

b. Example. Airport issues taxable bonds to construct a facility because it knows that the management contract creates private business use. The management contract terminated, and a "good" management contract is executed. Airport issues refunding bonds to refund the taxable bonds. This means that the refunding bonds do not carry over the "bad use" caused by the original management contact.

2. Rules with respect to Governmental Bonds and Qualified Section 501(c)(3) Bonds.

a. In General. The private business use test is applied to a combined measurement period with respect to a refunding of a governmental obligation, so that the measurement period begins on the issue date of the refunded bond or the date the facility financed with the proceeds of such bond is placed in service, whichever is later, and ends on the date the refunding bonds are retired. Treas. Reg. §1.141-13(b)(2)(ii)(A). In a series of refundings, the measurement period begins by reference to the earliest bond issue. Treas. Reg. §1.141-13(b)(2)(iii).

b. Optional Election To Apply Measurement Period Separately. If the refunded issue did not, based upon actual use, satisfy the private business use test by reference to the measurement period beginning on the date the refunded bonds were issued or the date the facility financed with the refunded bonds is placed in service, whichever is later, and ending on

the issue date of the refunding bonds, for purposes of applying the private business use tests, the issuer has the option to treat the measurement periods for refunded bonds and refunding bonds as separate. Treas. Reg. §1.141-13(b)(2)(ii)(B).

c. Qualified 501(c)(3) Bonds. Use of property refinanced with the proceeds of a refunding issue by a Section 501(c)(3) organization in activities that are not unrelated trade or business activities under Code Section 513(a) is treated as governmental use. Treas. Reg. §1.141-13(b)(v). Solely, for purposes of the Refunding Regulations, the use of proceeds of a Qualified Section 501(c)(3) Bond for the purpose of paying costs of issuance (ordinarily a private business use) is treated as a governmental use of proceeds.

3. Private Payments and Security Tests.

a. Separate Issue Treatment. The private payment or security interest test is measured separately for the refunded and the refunding issue, if the private business use is measured separately. Treas. Reg. §1.141-13(c)(1).

b. Combined Issue Treatment.

(i) In General. The private payment or security interest test is measured on a combined basis if the private business use test is measured on a combined basis.

(ii) Computing the Present Value. The present value of the private security and private payments is compared to the present value of the debt service on the combined issue (other than debt service paid with the proceeds of the refunding bond). The present value is computed using the earliest issue date in a series of refundings. Except as set forth in 4. below, the present values are determined by using the yield on the combined issue as the discount rate, using payments on the refunding issue and all earlier issues (other than payments made with the proceeds of refunding bonds) and using as the target price, the issue price of the earliest bond issue in the measurement period. In the case of partial refundings, only the payments with respect to the refunded debt is taken into account. Treas. Reg. §1.141-13(c)(2).

4. Arrangements Not Entered into in Contemplation of a Refunding. The issuer may use the yield on the refunded issue in applying the private payment or security interest test, in determining the present value of private payment and private security interest under arrangements that were not entered into in contemplation of the refunding issue. An arrangement entered into more than 1 year prior to the issue date of the refunding issue is treated as not having been entered into in contemplation of a refunding issue. Treas. Reg. §1.141-13(c)(3).

B. Multipurpose Allocation Rules. The multipurpose allocation rules of Treas. Reg. §1.148-9(h) apply for purposes of applying the Refunding Regulations, unless such allocation is unreasonable in that it achieves more a favorable result under the private activity bond tests than could be achieved with actual separate issues. Treas. Reg. §1.141-13(d). Allocations made under Treas. Reg. §1.141-13(d) must be consistent with allocations made under Treas. Reg. §1.148-9(h). Treas. Reg. §1.141-13 (d) by its terms, does not apply to private loan financing test determinations under Code Section 141(c)(1) or determinations regarding the acquisition of nongovernmental output property to be treated as private activity bonds pursuant to Code Section 141(d)(1).

C. Application of Reasonable Expectations Test in Certain Refunding Bond Situations. An action that would otherwise cause a refunding bond to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of Treas. Reg. §1.141-2(d) (including the mandatory redemption provisions hereof) if (i) the action is not a deliberate action within the meaning of Treas. Reg. §1.141-2(d)(3), *i.e.*, an action taken by the issuer that is within its control, and (ii) the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the refunded bonds.

D. Miscellaneous. The Refunding Regulations provide that the term "private activity bond" in the context of these rules does not include taxable bonds.

E. Effective Dates. The Refunding Regulations apply to bonds sold on or after the date of publication of final regulations in the Federal Register; the Refunding Regulations will not apply to refunding bonds issued to refund bonds issued prior to the effective date of the private activity bond regulations of May 16, 1997, unless the weighted average maturity of the refunding bonds exceeds the remaining weighted average maturity of the refunded bonds.

XII. ANTI-ABUSE RULES - SECTION 1.141-14

If an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons significant benefits of tax-exempt financing inconsistent with the restrictions of Code Section 141, the Commissioner may take any action to reflect the substance of the transaction, including: (i) treating separate issues as a single issue for purposes of the private activity bond tests; (ii) reallocating proceeds to expenditures, property, use or bonds; (iii) reallocating payments to use or proceeds; (iv) measuring private business use on a basis that reasonably reflects the economic benefit; or (v) measuring private payments or security on a basis that reasonably reflects the economic substance. *See* PLR 201148005 for analysis by the IRS of the anti-abuse rules in responding to a request for a ruling on whether the refinancing of taxable debt with the proceeds of a 501(c)(3) bond issue would cause the issue to fail to qualify as a 501(c)(3) issue.

XIII. EFFECTIVE DATES - SECTION 1.141-15; SECTION 1.141-15T

A. General Effective Date. Treas. Reg. §§1.141-1 through 1.141-6(a), Treas. Reg. §§1.141-9 through 1.141-14, Treas. Reg. §§1.145-1 through 1.145-2, Treas. Reg. §1.150-1(a)(3) and the definition of bond documents contained in Treas. Reg. §1.150-1(b) (collectively, the "May 1997 Regulations") apply to bonds issued on or after May 16, 1997, that are subject to the Tax Reform Act of 1986.

B. Refunding Bonds. The May 1997 Regulations do not apply to refunding bonds issued on or after May 16, 1997, unless (i) the weighted average maturity of the refunding bonds is greater than (A) the remaining weighted average maturity of the refunded bonds, or (B), in the case of certain short-term obligations, 120% of the weighted average reasonably expected economic life of the facilities financed, or (ii) a principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

C. Permissive Application of Regulations. The May 1997 Regulations may be applied in whole but not in part to actions taken before February 23, 1998, with respect to (1) bonds

outstanding on May 16, 1997, and subject to Code Section 141, or (2) refunding bonds issued on or after May 16, 1997.

D. Permissive Retroactive Application of Sections. The following may be applied to any bonds issued before May 16, 1997: Treas. Reg. §1.141-3(b)(4) (management contracts), Treas. Reg. §1.141-3(b)(6) (research agreements) and Treas. Reg. §1.141-12 (remedial actions).

E. Output Regulations. Treas. Reg. §1.141-15(f) provides special effective dates applicable to regulations pertaining to the treatment of output facilities under the private activity bond tests.

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023
October 18-20, 2023

PUBLIC PRIVATE PARTNERSHIPS –
LEGAL, COMMERCIAL AND FINANCING ISSUES IN P3s

Chair:

Steve T. Park	Ballard Spahr LLP – Philadelphia, PA

Panelists:

Helen Pinkston-Pope	Georgia Department of Transportation, Atlanta, GA
Lauren Wilson	KPMG, Chicago, IL
Joseph R. Saverino	Chapman and Cutler LLP, Chicago, IL

The use of public-private partnerships ("P3") as a tool for governments to build public infrastructure projects continues to be a growing trend in the United States. This outline is a primer on P3s and discusses legal, commercial and financial issues relating to P3 projects. Please see below for a description of the panel to be presented at The Workshop.

A Glossary of Terms setting forth frequently used terms in P3 transactions is included as Appendix I to this outline.

Panel Description: This panel will provide a high level overview of the P3 process. It will also discuss legal, commercial and financial issues that are often negotiated during a P3 transaction including structuring and tax issues. Hot topics will also be discussed including new types of P3 projects.

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APPENDIX I Glossary of Terms

I. INTRODUCTION

A. Overview of Public Private Partnerships ("*P3s*").

The National Council for Public-Private Partnerships defines a Public Private Partnership as:

> "A contractual agreement between a public agency (federal state or local) and a private sector entity. Through this agreement, the skills, and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. In addition to the sharing of resources, each party shares in the risks and rewards potential in the delivery of the service and/or facility".[1]

The United States has a long history of establishing P3s in one form or another to finance certain infrastructure and other projects. The use of P3s in the United States predates the American Revolutionary War. In 1652, the Boston Water Works Company was the first private entity to supply drinking water to the United States citizens.[2] Another early example was the Lancaster Turnpike, a toll road built in 1793 by the private sector with public sector oversight and rights of way. The Lancaster Turnpike connected Pennsylvania Farmers with the Philadelphia market and reduced travel times drastically. The Erie Canal (1825) and the First Transcontinental Railroad (1868) are two other early examples of P3s.[3] The Transcontinental Railroad was funded by stock issued by private companies that were chartered by Congress. As tracks were completed, federal lands adjacent to the tracks were granted to the railroads for private development that provided a return to investors.[4]

Today, P3s between governmental entities and private companies continue to be entered into for the development and monetization of infrastructure, facilities used for water, wastewater, transportation, urban development, and delivery of social services, to name only a few areas.[5]

Generally, under a P3, a governmental entity (the "*Public Sector Partner*" or "*Public Sector*") enters into a contractual arrangement ("*Agreement*" or "*P3 Agreement*") with a non-governmental entity such as a for-profit corporation or a 501(c)(3) not-for-profit corporation (the "*Private Sector Partner*" or the "*Private Sector*") to design, renovate, construct, operate, maintain, finance and/or manage in whole or in part, or to monetize either an existing or a new asset of the

[1] *Testing Tradition: Assessing the Added Value of Public-Private Sector Partnerships*, THE NATIONAL COUNCIL FOR PUBLIC PRIVATE PARTNERSHIPS, 2 (Arlington, Virginia 2012), https://www.researchgate.net/profile/Kimberly_Meyer3/publication/269694120_Testing_Tradition_Assessing_the_Added_Value_of_Public-Private_Partnerships/links/54924c780cf2ac83c53dc0fb/Testing-Tradition-Assessing-the-Added-Value-of-Public-Private-Partnerships.pdf?origin=publication_detail.

[2] Ewoh, A.I.E., & Dillard, T.T. *Public-Private Sector Partnerships in Houston and Seattle Urban Municipalities*, Journal of Public Management & Social Policy, 9, 31-41 (2003).

[3] *Ten Principles for Successful Public/Private Partnerships*, URBAN LAND INSTITUTE, iv (2005), http://uli.org/wp-content/uploads/2005/01/TP_Partnerships.pdf.

[4] *For the Good of the People: Using Public-Private Partnerships to Meet America's Essential Needs*, THE NATIONAL COUNCIL FOR PUBLIC PRIVATE PARTNERSHIPS (Washington, D.C.).

[5] *Top Ten Facts About PPPS*, NATIONAL COUNCIL FOR PUBLIC PRIVATE PARTNERSHIPS (Washington, D.C.).

Public Sector. The Public Sector may also contract with the Private Sector to provide certain public services. All or a combination of the above will be referred to as the "*Project*".

P3 Agreements are structured in a myriad of different ways and many are a hybrid of different arrangements, but each basic arrangement can be categorized as discussed below. Under the Agreements, the Public Sector Partner typically retains ownership of the asset, and the Private Sector Partner invests its own equity and capital to the Project. Typically, each partner shares in revenue resulting from the partnership. Such a venture differs from typical service contracting in that the Private Sector Partner usually makes a substantial cash, at-risk, equity investment in the Project, and the Public Sector gains access to new upfront revenue or service delivery capacity.

B. "Public Private Partnership" or "P3" versus "Privatization".

The terms "Public Private Partnership" or "P3" and "Privatization" are often used interchangeably but are not necessarily synonymous. In a P3, the Public Sector Partner retains ownership and control over the asset, "… [even where] some responsibilities are transferred to the private sector."[6] The Public Sector retains control over the establishment of user rates, operating standards, and other legal requirements to which the Private Sector must adhere. The degree to which responsibilities are retained or shared is defined in the Agreement. In a Privatization, the Public Sector sells some or all of the asset to the Private Sector.[7]

Notwithstanding the term used to describe the transaction, it is crucial to understand the nature of the Project and the goals of the Public Sector and Private Sector partners. The practitioner must also be familiar with the Project's financial structure, the rights, obligations and risks incurred by each party, and the control and ownership of the subject Project.

II. PROJECTS FINANCED WITH P3s

A. Types of Projects Commonly Developed As P3s.

1. *Transportation/Highway Infrastructure Projects*. The authority to develop transportation/highway P3 Agreements typically rests with the Federal Highway Administration ("*FHWA*") and the U.S. Department of Transportation ("*USDOT*"), a state's Department of Transportation or with another agency within the state. The FHWA and USDOT also have certain authority with respect to state projects. Depending on the location and ownership of the infrastructure, authority is sometimes extended to municipalities or regional authorities.

2. *Other Infrastructure Projects (e.g., airports, bridges, tunnels)*. The authority to develop P3 Agreements for other infrastructure projects generally depends on the location and ownership of the subject infrastructure. Authority may rest with municipalities or other regional authorities with the power to contract and issue debt. For example, with respect to airports, authority may rest with the local governmental unit's department of aviation or a regional

[6] *Public Sector Decision Making for Public-Private Sector Partnerships: A Synthesis of Highway Practice* TRANSPORTATION RESEARCH BOARD NATIONAL COOPERATIVE HIGHWAY RESEARCH PROGRAM [hereinafter TRB], National Research Council, Washington, D.C.: National Academies Press, 2009.
[7] *Id.*

airport authority. Federal agencies such as the federal aviation administration ("*FAA*") or the FHWA may also have certain authority with respect to local projects.

3. *Utility Projects (e.g., water, electricity, solid waste)*. The authority to develop utility project P3 Agreements depends on the location and ownership of the subject asset as well as the governmental agency regulating the utility. The authority may rest with municipalities or other regional water or electric power authorities with the power to contract and issue debt, such as water reclamation districts. Of note is the areas of municipal water utilities and sewer service delivery where it is common for smaller municipal water or sewage systems to band together with other water and sewage systems and form "Public-Public" partnerships through pooled purchasing, joint infrastructure projects and utility employee collaboration.[8]

4. *Social Infrastructure projects (e.g., education, healthcare, courthouses, civic centers)*. The authority to develop social infrastructure project P3 Agreements depends on the location and ownership of the subject assets or the location and type of service provided. The authority rests with municipalities or other local agencies that provide the social service such as boards of education and departments of public health.

5. *Real Estate Development (e.g., economic development and affordable housing)*. The authority to enter into real estate development P3 Agreements depends on the location and ownership of the subject real estate asset. The authority rests with state agencies, municipalities or other local governments and agencies with the power to contract and issue debt.

This outline covers the certain fundamental concepts that all of the above Projects have in common. Nevertheless, each Project is subject to the applicable local, state and Federal laws and regulations and each Project must be reviewed in this context.

B. Greenfield and Brownfield Projects. Projects developed as P3s are further sub-divided into two general categories:

1. *Greenfield Projects* – Projects involving new construction of infrastructure or an asset; and

2. *Brownfield Projects* – Projects involving infrastructure or assets already in existence (also referred to as asset recycling projects). The use of the term "Brownfield" in the P3 context is different from the term used by the Environmental Protection Agency to refer to reused, potentially contaminated property.

The applicable legal treatment and analysis of Greenfield and Brownfield Projects are discussed below in more detail.

[8] *Public-Public Partnerships — An Alternative Model to Leverage the Capacity of Municipal Water Utilities*, Cornell University ILR School Global Labor Institute (January 2012), https://www.foodandwaterwatch.org/sites/default/files/Public%20Public%20Partnerships%20Report%20Feb%202012.pdf.

III. EVALUATING WHETHER TO UNDERTAKE A PROJECT AS A P3

A. Public Sector Motivations and Disadvantages.

One of the primary motivations for the Public Sector to undertake a Project as a P3 is expanded financial capacity. Private Sector equity, capital contributions, commercial loans, and other debt taken out by a Private Sector Partner can substitute for public debt when the governmental entity is unable or unwilling to borrow for the Project. Other incentives created by P3s include improved asset management, on-time and on-budget delivery of the Project and Private Sector expertise in the area. In addition, risk-sharing enabled by a P3 arrangement is an attractive alternative to the Public Sector because it provides protection from the cost and consequences of certain negative events relating to the Project including, but not limited to, cost overruns, design flaws, catastrophic failures and unanticipated lower revenue streams. The following are considered Public Sector advantages to a P3 Project arrangement:

1. leveraging limited Public Sector resources and expertise with Private Sector resources and expertise;
2. access to increased up-front financing for the Project using private equity/capital;
3. reducing or sharing Project development, operating and maintenance risks;
4. better likelihood of providing more cost effective and timely delivery of the Project;
5. guaranteed continued operation and maintenance ("*O&M*") for the Project; and
6. maintaining significant Public Sector control and oversight over the Project.

There are certain possible disadvantages to a P3 Project arrangement. These disadvantages must be considered when structuring the P3 and drafting related documentation. These issues also should be addressed when communicating with the public, government officials and other stakeholders in the Project:

1. Public Sector's loss of control and flexibility of the Project;
2. excessive Private Sector profits at the Public Sector's expense;
3. loss of future public revenues;
4. risk of the Private Sector Partner's bankruptcy or default;
5. lack of accountability and transparency;
6. environmental issues;
7. labor concerns;
8. foreign companies;
9. toll road controversies, if applicable;
10. lack of, or unacceptable, terms of the Agreement;
11. unreliability of Private Sector Partners, no technical strength or adherence to performance and method specifications; and
12. inappropriate risk allocations via contractual arrangements[9].

[9] *Testing Tradition*, *supra* note 1, at 8-10.

B. Private Sector Motivations and Disadvantages.

The Private Sector's fundamental motivation for entering into a P3 is the desire to earn a good return on their investment. P3 Agreements provide a particular type of long-term investment that offers the possibility of long-term returns for equity investors. If a Project is financially successful, it is likely to provide more stable returns for a number of years than can other investment alternatives, such as stocks or bonds. Not-for-profit, 501(c)(3) corporations which often provide expert services in certain areas (such as education) see P3s as a good vehicle through which they can raise money and further their not-for-profit purpose by performing certain services on behalf of the Public Sector. The following are considered Private Sector advantages to a P3 Project arrangement:

1. profit;
2. enhanced reputation in a certain market niche;
3. potential for economic growth in a market niche;
4. community betterment, enhanced quality of life; and
5. additional resources to sustain a not-for-profit organization.

Possible disadvantages for the Private Sector Partner which must be considered when structuring the P3 and drafting the related documentation include:

1. unprofitability, loss of invested equity;
2. too time consuming;
3. failure to create long-term value;
4. accusation of being enriched at expense of Public Sector, public opposition;
5. market shortfall, failure;
6. change in key public, political, or staff leadership that negatively impacts partnership; and
7. liability exposure.[10]

C. P3 Goals of the Public Sector versus the Private Sector

[10] Urban Land Institute, *supra* note 3, at 13.

The following table summarizes the general goals of the Public Sector versus the Private Sector when entering into a P3:[11]

Public Sector Goals	**Private Sector Goals**
Project – Seeks to address infrastructure, utility or public service needs by developing the Project.	*Deals* – Sees the process in terms of negotiated transactions.
Stakeholders – Seeks to address the concerns of various parties, including local residents, governmental employees, asset users, and political representatives.	*Stockholders* – Seeks to generate dividends for its stockholders.
Process – Applies and complies with prescriptive, standard operating procedures designed to provide uniformity, minimize risk and build consensus among stakeholders. Ensures compliance with Federal, state and local laws and regulations.	*Outcome* – Demands greater flexibility and expediency to arrive at final objective.
Policy/Operation Goals – Develops Projects to achieve various policy/governmental operations goals.	*Profits* – Interested in a competitive return on investment.
Transparency – Seeks to share information with the public to ensure public participation and accountability.	*Confidentiality* – Protects intellectual property and the competitive advantages derived from innovations.
Public Service – seeks to continue providing better options for the public with respect to services traditionally provided by government as health care and education.	*Not-for-Profit Corporation* – Seeks to raise funds and further the purpose of the organization.

IV. VALUE OF P3 FINANCING - ASSESSMENTS

A. Undertake Project Now Versus Later. A threshold question when evaluating whether it is financially feasible to undertake a Project in the first place is making a comparison between what (i) the current cost of the Project and the costs of its continued O&M would be, versus (ii) the estimated cost of the Project at a future date, including any costs of the Project's deferral.[12]

B. Value For Money Assessment[13]. Once it is determined that the Project will most likely be undertaken, the Value for Money assessment ("*VfM*") is a process through which the Public Sector analyzes the best financing for Projects that are candidates for possible P3 financing. There are no uniform VfM guidelines across the various states in the United States. States that

[11] Adopted from the U.S. Department of Transportation Federal Highway Administration's *Establishing a Public-Private Partnership Program: A Primer* (November 2012), https://www.fhwa.dot.gov/ipd/pdfs/p3/p3_establishing_a_p3_program_112312.pdf.
[12] *Testing Tradition*, *supra* note 1 at 5.
[13] *Id*. at 8-10.

reportedly conduct VfM or an equivalent analysis which include: Virginia, California, Florida, Texas, Georgia and few other states[14].

A VfM assessment enables the Public Sector to identify the type of financing that provides the maximum benefit for the Project. VfM is a common tool for comparing traditional public finance options such as design-bid-build, tax-exempt bond financing, TIFIA loans, etc., with P3 alternatives. After comparing the long-term assessments of the total costs incurred under traditional versus P3 financing options, the approach with the lowest cost, after considering lifecycle cost, risks, and other items has the best value for money. All VfM assessments at the least include the following factors:

1. Public Sector Comparator ("*PSC*") used to assess the public's costs of a P3 financing versus other more traditional financing alternatives; and
2. Full Life-Cycle ("*FLC*") cost and revenue assessment for each financing option.

Public Sector Comparator Analysis

VfM is based on a comparison of the public costs of traditional project financing options versus the costs of using various P3 financing options. The costs of delivery of the Project under traditional financing options are known as the, "Public Sector Comparator." The PSC is compared to the P3 financing options to determine what financing alternative can provide positive added value to the Project. The PSC provides "an estimate of risk-adjusted costs" to the Public Sector when the Public Sector delivers the Project under traditional financing methods. Within the PSC, all project costs, revenues, and risks must be projected over the full life of the Project and include, but are not limited to:

1. capital/construction costs (during construction and for ongoing O&M, determined by precedent);
2. operating costs (core functions, non-core supporting services, maintenance, insurance, personnel, replacement and replenishment of supplies and equipment over time);
3. taxes;
4. project income (based on the Public Sector's ability to generate revenue, *e.g.*, from user fees); and
5. risk-related costs.

All of the above costs are necessary in order for the PSC to show an accurate comparison. For instance, if risks of cost overruns or time delays are not incorporated into the PSC based on the Public Sector's previous experience, the PSC will be inaccurate. Once the total public cost has been determined for a Project delivered through traditional financing methods, it can be compared to the cost of delivery through P3 financing methods. The amount saved by using the cheaper option is termed, "Value for Money" and claimed by whichever option has the lowest total cost.

[14] *Value for Money State of the Practice*, U.S. Department of Transportation Federal Highway Administration at 46, (December 2011), https://www.fhwa.dot.gov/ipd/pdfs/p3/vfm_state_of_the_practice.pdf.

Full Life-Cycle Analysis

The "Full Life-Cycle" analysis allows for a determination of whether a Project is affordable based upon costs incurred over the full life of the Project. Costs incurred will include not only construction costs but also financing and continued O&M costs. Components of a FLC cost analysis include initial construction, operations, maintenance, and other anticipated costs such as those associated with future expansion of the Project. Layering the FLC analysis, over the analysis of traditional and P3 financing methods will provide a greater insight into the best VfM option. One issue with many valuation efforts is that they do not take into account these costs.

Net Present Value

Net Present Value ("*NPV*") determines both the long-term and short term affordability of a Project. NPV brings all future costs into present terms and bases them on a current dollar value. The short term perspective provided by NPV is the true total costs before beginning the Project to determine how much funding is needed from the P3 partners or other sources. The long-term perspective provided by NPV is the costs over the full life of the Project which can be compared with expected revenues. The long-term approach can save money on O&M because those expenses can be accounted for in the P3 Agreement. By considering O&M expenses from the outset, the Project timeline and life cycle can be set up to improve the chances that Project revenues will balance the initial capital costs and provide a return for both the Public Sector and Private Sector Partners later.

Risk Allocation Analysis

Risk allocation is one of the primary motivations for the Public Sector to enter into a P3. The best way to allocate risk involves allocating risk to the party best able to manage it. An important consideration in evaluating a P3 delivery model for a Project is how Project risks are allocated between the Public Sector Partner and the Private Sector Partner. For example, the Public Sector Partner might have to use general government revenues to make up the difference if there are shortfalls in anticipated Project revenue, or if there is an increase in the cost of a Project because of a design flaw or an increase in construction costs. The Public Sector Partner may mitigate this risk by allocating some or all of it to the Private Sector Partner. While the Public Sector Partner will be protected against the risk of shortfall, it will forgo some or all of the potential for additional revenue if the Project succeeds financially.[15]

Any risk allocation must be based on economics since not all risks can be reallocated to the Private Sector Partner under a P3 Agreement. In a P3, the Public Sector Partner and Private Sector Partner can negotiate who will be responsible for managing each type of risk and paying the costs when unanticipated events increase costs. The Private Sector Partner will generally take on risk in exchange for some kind of compensation and may build the acceptance of that risk into the rate of return expected for the Project. This is known as the "risk premium". Risk premium is the additional return expected by the Private Sector Partner in exchange for accepting additional Project risk. If the Public Sector Partner believes it can manage a risk at a lower cost than the risk premium, it can choose to retain the risk.

[15] *Testing Tradition*, *supra* note 1, at 10.

Private Sector Partners, equity investors and lenders will analyze all of the risks retained by the Private Sector and prepare an accounting of how each risk will be mitigated. Risk can be mitigated through insurance, by passing it down to a sub-contractor, or the risk must be priced and a reserve or other form of mitigation may be used. When prioritizing each risk, certain fundamental questions should be taken into account:

1. Will the risk allocation go against the investment criteria for any equity investor?

2. Will the risk allocation have a negative impact on the perceived investment potential for the Project?

3. Will the risk allocation require reserves or contingencies that will negatively impact whether the Project can be financed?

4. Will the risk allocation affect pricing of sub-contractors or other underlying providers for the Project?

Typical Risk Allocations in Public Sector Financed Versus P3 Financed Projects[16]

Risk	Risk Allocation In a Public Sector Financed Project	Risk Allocation In a P3 Financed Project
Development- Performance	Public	Private
Development – Interface	Public	Private
Design – Scope	Public	Shared
Design - Error/Omission	Public	Private
Design -Interference/Coordination	Public	Private
Design- Life-Cycle	Public	Private
Construction – Performance	Private	Private
Construction - Schedule	Public	Private
Construction - Cost Overruns	Public	Private
Construction - Changes in Scope	Public	Public
Construction - Force Majeure	Shared	Shared
Financing - Schedule delays/additions	Public	Private
Financing - Interest rate risk	Public	Private
Financing - Vehicle Supply /Performance risk	Private	Private
Vehicle - financing risk	Public	Private
Vehicle - supply defects	Private	Private
Maintenance - Level	Public	Private
Deferred maintenance/repair/replacement	Public	Shared
Defective components	Private	Private

[16] Adopted from Peter Raymond, Presentation at the Implementation of Public-Private Sector Partnerships for Transit Workshop, "PPPs and Use of Availability Payments," PRICEWATERHOUSECOOPERS LLC., (May 20, 2009) https://www.transit.dot.gov/sites/fta.dot.gov/files/docs/raymond_finance_chi090519.pdf.

Residual value	Public	Shared
Operations – revenue	Public	Shared
Operations – service and quality	Public	Shared

Risks Ordinarily Assumed By Private Sector Partner By Type of P3 Transaction[17]

Project Type	Design	Build	Finance	Operate	Maintain	Traffic
Traditional Design- Bid-Build		X				
Design-Build	X	X				
Design-Build-Finance	X	X	X			
Design-Build-Finance-Operate (Availability Payment Concession)	X	X	X	X	X	
Design-Build-Finance-Operate (Toll Concession)	X	X	X	X	X	X

V. BASIC STRUCTURES OF P3s

A. Generally. A P3 has three primary elements:

1. the Project with defined goals, such as the operation and maintenance of the asset, and monetization (the Public Sector Partner receives compensation from the Private Sector for allowing a lease of a financially successful existing facility) of the asset, if any;

2. a compensation structure; and

3. a term or length of time.

Each element is established by the Public Sector in negotiation with the Private Sector Partner. P3s include a wide range of Agreements which generally can be described in terms of three broad parameters:

1. whether the P3 is for a new or existing asset;

2. what functions are the responsibility of the Private Sector Partner; and

3. how the Private Sector Partner is paid.

B. Private Sector Partner Obligations. The obligations for which the Private Sector Partner is typically responsible in a P3 Agreement depend on the type of asset and service

[17] *Public-Private Sector Partnership Concessions for Highway Projects: A Primer* U.S. Department of Transportation Federal Highway Administration (October 2010), https://www.fhwa.dot.gov/ipd/pdfs/p3/p3_concession_primer.pdf.

involved. The obligations that may be transferred to the Private Sector Partner, depending on the Project, include the following:

1. *Design* - developing the Project from its initial concept and output requirements to its construction design specifications.

2. *Build or Renovate* - when P3s are used for new infrastructure assets, they typically require the Private Sector Partner to construct the asset and install all equipment. When P3s involve existing assets, the Private Sector Partner may be responsible for renovating or expanding the asset.

3. *Finance* - when a P3 includes building or rehabilitating the asset, the Private Sector Partner is typically also required to finance all or part of the necessary capital expenditures; and when a P3 includes recycling of an existing asset, the Private Sector Partner may be required to finance an upfront lump sum payment.

4. *Maintain* - the Public Sector Partner assigns responsibility to the Private Sector Partner for maintaining an infrastructure asset to a specified standard over the life of the Agreement.

5. *Operate* - the operating responsibilities of the Private Sector Partner to a P3 can vary widely, depending on the nature of the underlying asset and associated service. For example, the Private Sector Partner could be responsible for:

i) Technical operation of an asset, and providing a bulk service to a government off-taker, for example, a bulk water treatment plant; or

ii) Technical operation of an asset, and providing services directly to users for example, a P3 for a water distribution system.

C. Basic Types of P3s[18]. P3s can be structured in a variety of ways and can be characterized as follows:

1. *O&M: Operations and Maintenance* – The Public Sector contracts with the Private Sector to provide and/or maintain a specific service. Under the private operation and maintenance option, the Public Sector retains ownership and overall management of the asset.

2. *OMM: Operations, Maintenance & Management* – The Public Sector contracts with the Private Sector to operate, maintain, and manage a facility or system providing a service. Under this option, the Public Sector retains ownership of the asset, but the Private Sector may invest its own capital in the asset. Any private investment is carefully calculated in relation to its contributions to operational efficiencies and savings over the term of the Agreement. Generally, the longer the term, the greater the opportunity for increased private investment

[18] These definitions were extracted from *Public-Private Partnerships: Terms Related to Building and Facility Partnerships*, US General Accounting Office (April 1999).

because there is more time available in which to recoup any investment and earn a reasonable return.

3. *DB: Design-Build* – In a DB, the Private Sector provides both design and construction of a project for the Public Sector. This type of partnership can reduce time, save money, provide stronger guarantees and allocate additional project risk to the Private Sector. It also reduces conflict by having a single entity responsible to the Public Sector for the design and construction of the Project. The Public Sector owns the assets and has the responsibility for its operation and maintenance.

4. *DBM: Design-Build-Maintain* – A DBM is similar to a DB, except that the asset is also maintained by the Private Sector for some period of time. The benefits are similar to the DB, plus maintenance risk is allocated to the Private Sector and the guarantee expanded to include maintenance. The Public Sector owns and operates the asset.

5. *DBO: Design-Build-Operate* – A single contract is awarded for the design, construction, and operation of the Project. Title to the asset remains with the Public Sector. A DBO approach maintains the continuity of Private Sector involvement and can facilitate Private Sector financing of Projects supported by user fees generated during the operations phase.

6. *DBOM: Design-Build-Operate-Maintain* – DBOM is an integrated partnership that combines the design and construction responsibilities of design-build procurements with operations and maintenance. These Project components are procured from the Private Sector pursuant to a single contract. Financing for the Project is secured by the Public Sector. The Public Sector also maintains ownership and retains a significant level of oversight of the operations through terms defined in the Agreement.

7. *DBFOM: Design-Build-Finance-Operate-Maintain* – In a DBFOM, the responsibilities for designing, building, financing, operating and maintaining the Project are bundled together and transferred to the Private Sector under a single Agreement. One commonality that cuts across all DBFOM Projects is that they are either partly or wholly financed by debt leveraging revenue streams dedicated to the Project. Direct user fees (*e.g.*, tolls) are the most common revenue source. However, other fees ranging from lease payments, shadow tolls and vehicle registration fees may be used, or payment from the Public Sector Partner in the form of Availability Payments may be used. Future revenues are leveraged to issue bonds or other debt that provide funds for capital and project development costs. They are also often supplemented by Public Sector grants in the form of money or contributions in kind, such as right-of-way. The Private Sector Partners may be required to make equity investments as well.

8. *DBFOMT: Design-Build-Finance-Operate-Maintain-Transfer* – DBFOMT is the same as a DBFOM except that the Private Sector owns the asset

until the end of the Agreement when the ownership is transferred to the Public Sector. While common abroad, DBFOMT is not often used in the United States.

9. *BOT: Build-Operate-Transfer* – The Private Sector Partner builds a facility to the specifications agreed to by the Public Sector Partner, operates the facility for a specified time period under a contract or franchise agreement with the Public Sector, and then transfers the facility to the Public Sector Partner at the end of the specified period of time. In most cases, the Private Sector Partner will also provide some, or all, of the financing for the facility, so the length of the contract or franchise must be sufficient to enable the Private Sector Partner to realize a reasonable return on its investment through user charges. At the end of the franchise period, the Public Sector Partner can assume operating responsibility for the facility, contract the operations to the original franchise holder, or award a new contract or franchise to a new Private Sector Partner. The Build-Transfer-Operate (BTO) model is similar to the BOT model except that the transfer to the Public Sector takes place at the time that construction is completed, rather than at the end of the franchise period.

10. *BOO: Build-Own-Operate* – Under a BOO model, the Private Sector Partner constructs and operates a facility without transferring ownership to the Public Sector Partner. Legal title to the facility remains in the Private Sector Partner, and there is no obligation for the Public Sector Partner to purchase the facility or take title.

11. *BBO: Buy-Build-Operate* – A BBO is a form of asset sale that includes a rehabilitation or expansion of an existing facility. The Public Sector sells the asset to the Private Sector, which then makes the improvements necessary to operate the facility in a profitable manner.

12. *Developer Finance* – The Private Sector finances the construction or expansion of a Public Sector facility in exchange for the right to build residential housing, commercial stores, and/or industrial facilities at the site. The Private Sector contributes capital and may operate the facility under the oversight of the government. The Private Sector gains the right to use the facility and may receive future income from user fees.

While Private Sector developers may in rare cases build a facility, more typically they are charged a fee or required to purchase capacity in an existing facility. This payment is used to expand or upgrade the facility. Private Sector developer financing arrangements are often called capacity credits, impact fees, or extractions. Private Sector developer financing may be voluntary or involuntary depending on the specific local circumstances.

13. *EUL: Enhanced Use Leasing or Underutilized Asset* - An EUL is an asset management program in the Department of Veterans Affairs the "*VA*" that can include a variety of different leasing arrangements (e.g. lease/develop/operate, build/develop/operate). EULs enable the VA to long-term lease VA-controlled

property to the private sector or other public entities for non-VA uses in return for receiving fair consideration (monetary or in-kind) that enhances the VA's mission or programs.

14. *LDO or BDO: Lease-Develop-Operate or Build-Develop-Operate* – Under these partnership arrangements, the Private Sector leases or buys an existing facility from the Public Sector; invests its own capital to renovate, modernize, and/or expand the facility; and then operates it under a contract with the Public Sector. A number of different types of municipal transit facilities have been leased and developed under LDO and BDO arrangements.

15. *Lease/Purchase* – A lease/purchase is an installment-purchase contract. Under this model, the Private Sector finances and builds a new facility, which it then leases to a Public Sector. The Public Sector makes scheduled lease payments to the Private Sector. The public agency accrues equity in the facility with each payment. At the end of the lease term, the Public Sector owns the facility or purchases it at the cost of any remaining unpaid balance in the lease. Under this arrangement, the facility may be operated by either the Public Sector or the Private Sector during the term of the lease. Lease/purchase arrangements have been used by the General Services Administration for building federal office buildings and by a number of states to build prisons and other correctional facilities.

16. *Sale/Leaseback* – This is a financial arrangement in which the owner of a facility sells it to another entity, and subsequently leases it back from the new owner. Both Public Sector and the Private Sector entities may enter into sale/leaseback arrangements for a variety of reasons. An innovative application of the sale/leaseback technique is the sale of a Public Sector's facility to a public or private holding company for the purposes of limiting governmental liability under certain statutes. Under this arrangement, the Public Sector Partner that sold the facility leases it back and continues to operate it.

17. *Tax-Exempt Lease* – The Public Sector Partner finances capital assets or facilities by borrowing funds from a private investor or financial institution. The Private Sector Partner generally acquires title to the asset, but then transfers it to the Public Sector Partner either at the beginning or end of the lease term. The portion of the lease payment used to pay interest on the capital investment is tax exempt under state and federal laws. Tax-exempt leases have been used to finance a wide variety of capital assets, ranging from computers to telecommunication systems and municipal vehicle fleets.

18. *Turnkey* – The Public Sector contracts with a Private Sector investor/vendor to design and build a complete facility in accordance with specified performance standards and criteria agreed to between the Public Sector Partner and the Private Sector Partner. The Private Sector commits to build the facility for a fixed price and absorbs the construction risk of meeting that price commitment. Generally, in a turnkey transaction, the Private Sector Partners use fast-track construction techniques (such as design-build) and are not bound by traditional Public Sector

procurement regulations. This combination often enables the Private Sector Partner to complete the facility in significantly less time and for less cost than could be accomplished under traditional construction techniques. In a turnkey transaction, financing and ownership of the facility can rest with either the Public Sector Partner or the Private Sector Partner. For example, the Public Sector Partner might provide the financing, with the attendant costs and risks. Alternatively, the Private Sector Partner might provide the financing capital, generally in exchange for a long-term contract to operate the facility.

VI. GREENFIELD AND BROWNFIELD PROJECTS

A. Greenfield Projects – Greenfield Projects often are structured as DBFOM Projects. The Private Sector Partner is compensated either from user fees (*e.g.*, tolls, user charges) or annual payments from the Public Sector Partner (*e.g.*, Availability Payments). Greenfield Projects generally are structured as long-term (25 to 40 years) Agreements. The Private Sector Partner generally does not have a real property interest in the asset. To date, the primary focus of Greenfield Projects has been on surface transportation assets (*e.g.*, road, bridge, tunnel, mass transit) with increasing interest in social infrastructure (*e.g.*, courthouses, civic centers, schools).

B. Brownfield Projects – Brownfield Projects involve the sale or long-term lease of existing infrastructure assets (also known as asset recycling). To reiterate, the use of the term "Brownfield" in the P3 context is different from the term used by the Environmental Protection Agency to refer to reused, potentially contaminated property. Leases are more common in Brownfield Projects and sales generally have been limited to traditional utility assets. Brownfield Projects tend to involve long-term leases ranging from 40 to 99 years, sometimes with renewal options. The Private Sector Partner who is the lessee usually receives full right to collect user fees and rights to specified collateral revenues. Brownfield Project Agreements require compliance with detailed operating standards and obligations to specified capital expenditures, both short and long-term. To date, the focus of Brownfield Projects has been on surface transportation assets (*e.g.*, road, bridge, tunnel), parking (*e.g.*, off-street garages and on-street parking meters) and airports.

VII. P3 PROJECT FINANCING

A. Basic P3 Project Financing. Financing plans for P3s often include a combination of the following eight elements:[19]

1. Multiple sources of public and private financing from primary and secondary Private Sector Partners and Public Sector Partners or other related

[19] DR. QINGBIN CUI & DR. JAY K. LINDLY, EVALUATION OF PUBLIC-PRIVATE PARTNERSHIP PROPOSALS (University Transportation Center for Alabama Report No. 08402, June 2010).

entities, such as county, state, and applicable federal agencies; local business improvement districts; and other public entities. Potential secondary Private Sector Partners include construction companies and facility operators;

2. Public/private financing instruments, such as revenue bonds, general obligation bonds and soft second mortgages;

3. Long-term lease obligations by the Public Sector Partner;

4. Government-owned land/infrastructure or other assets;

5. Credit enhancement, bond insurance, or both;

6. Development, investment, and operational incentives from different levels of government;

7. Methods to reduce development costs; and

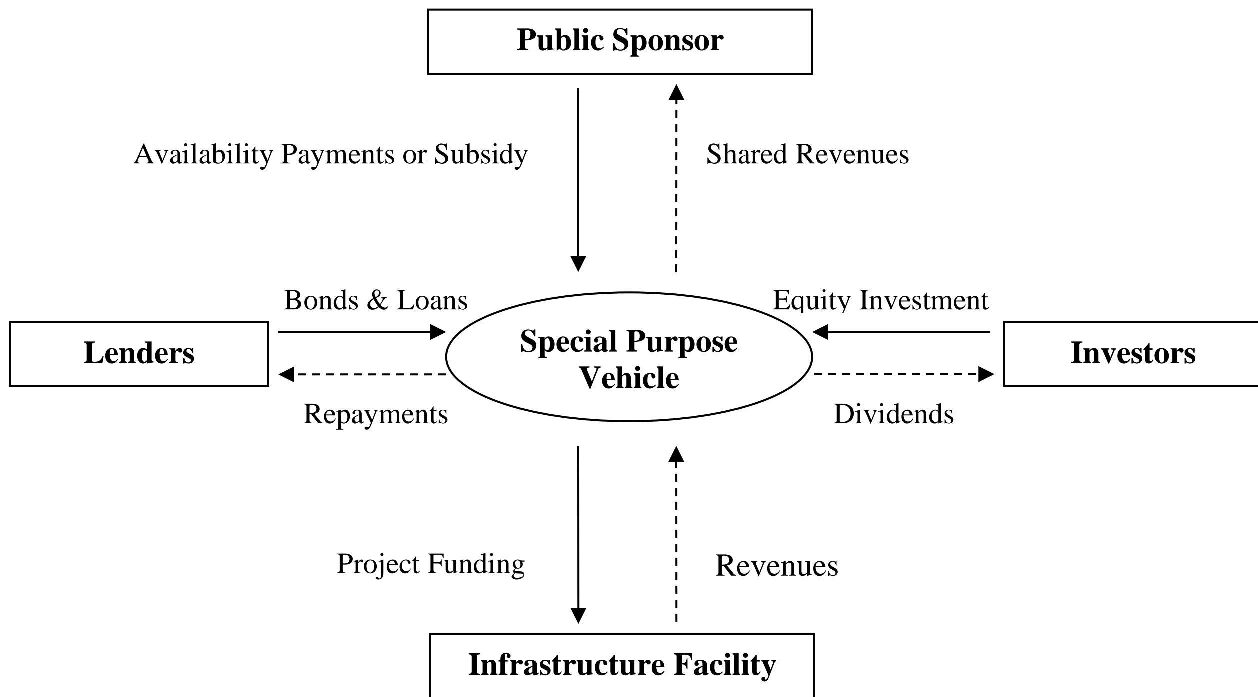
8. Methods to enhance cash flow, such as tax abatements, surcharges, and lease naming rights.[20]

In its most basic form, a P3 Project financing structure has the Private Sector Partner form a specific project company especially for that purpose, a Special Purpose Vehicle ("*SPV*"). The SPV raises funds through a combination of equity provided by the SPV's shareholders, debt provided by banks or through bonds, funds from governmental programs or other financial instruments. The finance structure is the combination of equity, debt and grants. Contractual relationships exist among the Public Sector Partner, the SPV, equity holders, lenders such as banks or bondholders, and the applicable local, state or federal governmental entities.

[20] Urban Land Institute, *supra* note 3, at 19.

Below is an illustration of a very basic financing and contract structure for a P3 Project.

Basic P3 Private Financing Structure



Source: FEDERAL HIGHWAY ADMINISTRATION, FINANCIAL STRUCTURING AND ASSESSMENT FOR PUBLIC-PRIVATE PARTNERSHIPS: A PRIMER 10 (Dep't of Transp., October 1, 2012).

Usually, the Public Sector contracts directly with the SPV. The initial equity investors who develop the P3 proposal are usually called "Project Sponsors." Equity investors are usually developers, engineering or construction companies, infrastructure management companies, and private equity funds. As a general rule, equity investment is "first in, last out," that is, any Project losses are borne first by the equity investors, and lenders suffer only if the equity investment is lost. As a result, equity investors accept a higher risk than debt providers, and require a higher return on their investment. The aim of the Project Sponsor and its advisors is typically to minimize the cost of finance for the Project. Because equity is regarded as more expensive than debt, Project Sponsors often try to use a high proportion of debt to finance the Project.

The Public Sector's goal is to structure a P3 Agreement in a way that achieves public benefits and attracts private financial resources. Potential Project Sponsors determine whether and how much to invest or lend to a Project based on an evaluation of projected Project cash flows and associated risks. Both equity investors and lenders assess the extent and likelihood of Project risks and price those risks. To the extent that they perceive risks to projected net revenues, investors will demand a higher rate of return and lenders will demand a higher interest rate or reduce the amount they are willing to lend.

Investors will decide to make a bid depending on whether they believe there is a good chance they can meet a defined internal rate of return ("*IRR*"), also known as the "hurdle rate." The IRR calculation measures how well an investment pays off over time. It enables potential

investors to compare different types of investments to decide where to invest their capital. Different investors have different hurdle rates.

Lenders are primarily concerned with the projected debt service coverage ratio or the amount of annual cash flow available to meet debt service payments in a given year and pay special attention to the quality of the analysis that led to the Project. Lenders generally expect a debt service coverage ratio of 1.2 or higher, depending on the source of revenue and other factors. Equity investors often anticipate refinancing a Project on more favorable terms when the Project has been fully operational for several years and the uncertainties associated with the Project are significantly less.

Under non-recourse Project finance, lenders can be paid only from the SPV's revenues, without recourse to the equity investors. The debt is secured on the cash flows of the Project. Project finance structures typically involve a large proportion of debt, from 70 to 95 percent. From the equity investors' perspective, this helps manage risk, by limiting exposure to a Project, and makes it possible to undertake much larger projects than would otherwise be the case. For lenders, it means undertaking rigorous due diligence focusing on Project cash flow and contractual structure.[21]

B. Forms of P3 Funding Other than Private Sector Loans, Equity or Capital Contributions[22]

There are many funding sources that can be accessed, depending on the nature of the Project. For example, for real estate developments, community development block grants, tax increment financing, and local revolving loan funds are available. Federal grants and tax credits are available for energy and water projects, and there are funding programs available for transportation infrastructure.[23] Private Activity Bonds ("*PABs*") are a tax-exempt bond financing method that can be used for certain Projects, as well. Below are brief descriptions of main programs available for transportation infrastructure Projects. The P3 practitioner should familiarize him or herself with the traditional financing sources available for P3s. The following are some examples of funding sources for certain Projects.

1. *Grant Anticipation Bonds ("GARVEE").* A Grant Anticipation Revenue Vehicle is a debt financing instrument where debt service and related financing costs can be reimbursed by Federal-aid highway funds. GARVEEs can be issued by a State, a political subdivision of a State, or a public authority. States can receive Federal-aid reimbursements for a wide array of debt-related costs incurred in connection with an eligible debt financing instrument, such as a bond, note, certificate, mortgage, or lease. Reimbursable debt-related costs include interest payments, retirement of principal, and any other cost incidental to the sale of an eligible debt instrument. The GARVEE program enables States and other public authorities to issue debt-financing instruments, such as bonds, to pay for current expenditures on transportation construction projects and repay the debt using future Federal apportionments.

[21] PUBLIC-PARTNERSHIP IN INFRASTRUCTURE RESOURCE CENTER, WORLD BANK GROUP, Public-Private Partnerships Reference Guide, Version 2.0 (2016).
[22] CUI& LINDLY, *supra* note 20, at 36.
[23] Urban Land Institute, *supra* note 3, at 5.

2. *Direct User Charges*. Direct user charges applied for such things as the use of roads which can include fuel taxes, license fees, parking taxes, tolls, and congestion charges, including those which may vary by time of day, by the specific road, or by the specific vehicle type being used. User charges have two distinct objectives: revenue generation, usually for road infrastructure financing, and congestion pricing for demand management purposes. Toll roads are the typical example of revenue generation.

3. *Federal Credit Assistance.* Federal credit assistance can take one of two forms: loans, where a project sponsor borrows Federal highway funds directly from a state Department of Transportation or the Federal government; and credit enhancement, where a state DOT or the Federal government makes Federal funds available on a contingent (or standby) basis.

4. *Section 129 Loans.* Section 129 loans allow states to use regular Federal-aid highway apportionments to fund loans for Projects with dedicated revenue streams.

5. *TIFIA Credit.* The Transportation Infrastructure Financing and Innovation Act ("*TIFIA*") program, enacted in 1998 as part of TEA-21, allows the U.S. Department of Transportation to provide direct credit assistance to sponsors of major transportation projects. The TIFIA program provides assistance to projects with their own repayment streams such as tolls or other dedicated funding sources (including Availability Payments). Under TIFIA, the U.S. Department of Transportation provides direct credit assistance, typically up to 33% of eligible project costs despite statutory authority to provide up to 49%, to sponsors of major transportation projects (which assistance may be provided to either the Public Sector Partner or the Private Sector Partner). The TIFIA credit program offers three distinct types of financial assistance, direct loans, loan guarantees, and standby lines of credits. These instruments are designed to address the varying requirements of Projects throughout their life cycles.

In accordance with revisions adopted pursuant to MAP-21 and the FAST Act, Projects must meet certain threshold criteria to apply for TIFIA assistance. The Project's estimated eligible costs must be at least $50 million or 33-1/3% of the State's annual Federal-aid highway apportionments, whichever is less, or at least $15 million for intelligent transportation systems Projects and at least $10 million for transit-oriented development Projects and local infrastructure Projects, and for rural infrastructure projects, at least $10 million, but not in excess of $100 million. The Project must be supported in whole or part from user charges or other non-Federal dedicated funding sources, and be included in the State's Transportation Improvement Plan. The Project is subject to all Federal requirements.[24]

6. *Private Activity Bonds ("PABs").* Before 1987, industrial development bonds were widely available as a tax-exempt tool for economic development. The Tax Reform Act of 1986 eliminated industrial development bonds but replaced them with tax-exempt private activity bonds. Generally, for a PAB to be tax-exempt, 95% or more of the net bond proceeds must be used for one of the several qualified purposes described in sections 142 through 145 of the Internal Revenue Code of 1986. PABs are generally paid solely from revenues generated by the Project and other security provided by the private user. In 2005, Section 11143 of Title XI of SAFETEA-LU amended Section 142 of the Internal Revenue Code to add highway and freight

[24] *See* https://www.transportation.gov/buildamerica/financing/tifia/eligibility.

transfer facilities to the types of privately developed and operated projects for which PABs may be issued. This change allows private activity on these types of projects, while maintaining the tax-exempt status of the bonds. No substantive changes have been made to the PABs program by MAP-21 or any other legislation.[25] Qualified projects, which must already be receiving Federal assistance, include surface transportation projects eligible under Title 23, international bridge or tunnel projects for which an international entity authorized under Federal or State law is responsible, and facilities for the transfer of freight from truck to rail or rail to truck (including any temporary storage facilities related to the transfers).

7. *Railroad Rehabilitation and Improvement Financing Program ("RRIF")*.[26] The RRIF program was initially established by the Transportation Equity Act for the 21st Century ("*TEA 21*"). The RRIF program provides direct loans and loan guarantees to finance the development of railroad infrastructure. Under this program, the US Department of Transportation is authorized to provide direct loans and loan guarantees up to $35.0 billion to finance development of railroad infrastructure. Eligible applicants include state and local governments, interstate compacts, government sponsored authorities and corporations, railroads, limited option rail freight shippers that own or operate a plant or other facility, and joint ventures that include at least one of the entities previously listed.

8. *WIFIA*.[27] Congress enacted the Water Infrastructure Finance and Innovation Act of 2014 ("*WIFIA*") program as part of the Water Resources Reform and Development Act of 2014 ("*WRRDA*").[28] WIFIA was subsequently amended by The Fixing America's Surface Transportation Act of 2015 ("*FAST* Act")[29], the Water Infrastructure Improvements for the Nation Act of 2016[30] and the America's Water Infrastructure Act (AWIA) of 2018.[31] The WIFIA program is a federal credit program administered by the U.S. Environmental Protection Agency ("*EPA*") modeled after the TIFIA program for water and wastewater infrastructure throughout the US. WIFIA authorizes EPA to provide secured (direct) loans and loan guarantees to eligible water infrastructure projects. Eligible borrowers may receive loans for up to 49 percent of eligible Project costs. The WIFIA program lends at a low, fixed interest rate equal to the Treasury rate for a comparable maturity.

9. *Fixing America's Transportation Act (the "Fast Act")*.[32] The Fast Act was signed into law on December 4, 2015, and re-authorized Federal-aid highway and highway safety construction programs through 2020. The Fast Act improved access to the TIFIA program and established the National Surface Transportation and Innovative Finance Bureau (now referred to as the Build America Bureau) within the U.S. Department of Transportation to serve as a one-stop shop for state and local governments to receive federal funding, financing or technical assistance.

[25] 26 U.S.C. § 142(m).
[26] https://www.transportation.gov/buildamerica/financing/rrif/railroad-rehabilitation-improvement-financing-rrif.
[27] WIFIA Program Handbook, US Environmental Protection Agency, pp 7-8 (March 2019), https://www.epa.gov/sites/production/files/2019-09/documents/program_handbook_fy2019_mar_2019.pdf.
[28] P.L. 113-121, §§ 5022-5035.
[29] P.L. 114-94.
[30] P.L. 114-322.
[31] P.L. 115-270.
[32] 23 U.S.C. 133(h).

10. *State Infrastructure Bank.*[33] Section 350 of the National Highway System Designation Act of 1995 (NHS Act) (Public Law 104-59) authorized U.S. Department of Transportation to establish the State Infrastructure Bank ("*SIB*") Pilot Program. A SIB is a revolving fund mechanism for financing a wide variety of highway and transit projects through loans and credit enhancement. SIBs are designed to complement traditional Federal-aid highway and transit grants by providing States increased flexibility for financing infrastructure investments. A SIB functions much like a bank by offering loans and other credit products to public and private sponsors of Title 23, United States Code, highway construction projects or Title 49, United States Code, transit capital projects.

SIB assistance may include loans (at or below market rates), loan guarantees, standby lines of credit, letters of credit, certificates of participation, debt service reserve funds, bond insurance, and other forms of non-grant assistance. As loans are repaid, a SIB's capital is replenished and can be used to support a new cycle of projects. SIBs can also be structured to leverage additional resources. A "leveraged" SIB would issue bonds against its future revenues, increasing the amount of funds available for loans.

VIII. CONSTITUTIONAL LIMITATIONS ON USE OF PUBLIC FUNDS AND PUBLIC CREDIT

A. Lending of Public Credit; Use of Public Funds. As a general rule, state constitutions have provisions that prohibit the Public Sector from using public credit or public funds for the benefit of the Private Sector. These provisions are commonly known as a "Gift Clause". The threshold test to determine whether the Public Sector has the authority to enter into a valid P3, is whether the P3 structure has violated the state's constitutional limits on the use of public credit and public funds.

B. Common Law. Absent any state statutes that will directly address the issue, the practitioner must look at the applicable state's case law to determine how the courts interpret that state's Gift Clauses when considering challenges to the validity of P3s. It is useful for the practitioner to be familiar with the general principals gleaned from how the state courts in the Public Sector's jurisdiction have interpreted that state's Gift Clauses so as to ensure that all the necessary questions are answered and due diligence done when structuring a P3 so that it will most likely overcome a constitutional challenge.

C. Violation of the Gift Clause. Whether or not a P3 has violated a constitutional Gift Clause is an issue that has been considered by courts in many states. There are certain common precepts that can be gleaned based on their decisions as can be illustrated by one representative case, *Turken v. Phil Gordon*[34].

1. *The Turken Case.* The Turken case involved a real estate P3 in Arizona which was a large mixed use development. The City agreed to pay the developer for the use of certain parking spaces in the development in an annual amount equal to 50% of the annual sales tax collected by the City from the retail portion of the project for a certain period, or until the City

[33] Information adopted from the Build America Transportation Investment Center's May 2016 webinar, "Federal Financing to Capitalize State Infrastructure Banks," and related presentation materials, (updated May 2017).
[34] 223 Ariz. 342, 224 P.3d 158 (2010).

had paid $97.4 million. A group of taxpayers challenged the project claiming among other things, that it violated the Arizona Constitution's Gift Clauses. The Arizona Supreme Court reversed the appellate court's decision and affirmed the trial court's dismissal of the Gift Clause claim.

2. *Gift Clause Two-Pronged Test.* In *Turken*, the Court clarified its two-prong test for whether a Gift Clause has been violated. The test consists in whether (i) the expenditure served a public purpose; and (ii) whether the payment to the private party was "grossly disproportionate" to the consideration received by the public. With respect to determining whether the expenditure serves a public purpose, the Court will generally defer to the government's determination of whether there is a public purpose, unless it has "unquestionably abused" its discretion.

3. *P3 Transaction Considerations.* The practitioner should structure and deliberately document a P3 transaction to take into account the applicable state courts' analysis of whether or not a Gift Clause has been violated. The *Turken* test is a representative example of what many state courts may consider. Documentation that may be useful to include in the P3 transaction's record includes official documents from the Public Sector where the governmental entity affirmatively states that it has determined the P3 fulfills a public purpose (i.e. ordinance, resolution); and feasibility studies, financial studies and other empirical documentation from independent expert third parties establishing how the Public Sector will financially benefit from the P3. The Public Sector should be able to empirically prove that the payment to the Private Sector was not "grossly disproportionate" to the consideration received by the Public Sector.

IX. ENABLING LEGISLATION FOR P3s.

A. Legislative Authority for P3s.[35] The practitioner must determine whether the jurisdiction of the proposed P3 project has legislative authority to enter into a P3 transaction. Many states in the U.S. have certain P3 enabling statutes (see attached – "Sampling of P3 Enabling Statutes by State"). These statutes cover issues such as the solicitation and procurement process, surety (payment and performance bonding) requirements, public funding use, rate setting and timing, use of revenues, project or facility type, transportation mode, local and regional authority, lease period, non-compete clauses, O&M and asset management duties.

Certain states have P3 enabling legislation for highways, roads and bridges and others have P3 legislation for transit Projects. State legislation enabling P3s varies greatly across several factors. For example, certain legislation allows eligible public authorities to engage with the Private Sector on infrastructure Projects beyond highways and roads, such as ferries, pipelines, and rail or other public facilities. Certain states have narrowly defined P3 eligibility and confine P3s only to roads.

State laws also differ as to whether they will allow acceptance of unsolicited proposals from bidders for a specific Project. Solicited bids outline the Public Sector's priorities and evaluation criteria. Unsolicited bids, conversely, do not have criteria to meet from a request for

[35] WILLIAM G. COLMAN, STATE AND LOCAL GOVERNMENT AND PUBLIC-PRIVATE PARTNERSHIPS – A POLICY ISSUES HANDBOOK, (New York 1989).

proposals, and are not part of a process where there are other competitive bids. The majority of states with P3 legislation allow for unsolicited P3 proposals.[36]

In certain states, P3s need prior approval by the state legislature before they can be developed. Legislative approval for a Project can be seen as a public mandate in favor of the P3 Project and render the politicians that voted in favor of the P3 deal accountable for guaranteeing success of the Project. P3 legislation may also allow lower levels of government to reject a proposed Project.

Some state P3 legislation expressly allows or prohibits a non-compete clause article added in the P3 Agreement for a privately built or operated toll road. A non-compete clause stipulates that the Public Sector will not build another facility that would directly compete with the P3 toll road. The existence of some type of non-compete clause is attractive to the Private Sector because it lowers the risk of competition from substitute assets. However, a strict non-compete clause paralyzes the Public Sector from building new assets in the public's interest. Over time, the non-compete clause structure has changed, allowing narrow competition, such as the construction of small access roads parallel to the toll road.

Absent specific P3 enabling legislation, certain states and municipalities may be limited in their authority to enter into a P3 transaction. Their authority to enter into a P3 Agreement is subject to common law, local ordinances and state statutes regarding among other things, procurement, surety (payment and performance bonding) laws, government sovereignty and police powers, authority to sell assets or delegate certain basic powers, mixing public and private funds, eminent domain, and contractual limitations. Ultimately, it may be necessary to draft and adopt new P3 enabling legislation.

B. Governmental P3 Dedicated Units. Certain states and local governments have established P3 offices or units. These P3 units differ in terms of functions performed. They either serve as full service agencies, or as a combination of a review body, advisor and center for business.[37]

C. Issues for Consideration During Review of Legislation. There are certain issues that should be considered either as part of the legislative analysis when reviewing existing P3 enabling legislation or when drafting new P3 enabling legislation. These issues are divided into four main areas: procurement, financing, project characteristics, and legal authority of the owner.[38]

1. *Procurement*

With respect to the area of procurement, key questions include the following:

[36] Emilia Istrate & Robert Puentes, *Moving Forward on Public Private Partnerships: U.S. and International Experience with PPP Units*, PROJECT ON STATE & METRO. INNOVATION, BROOKINGS-ROCKEFELLER 12-17 (Dec. 2011).
[37] *Id*. at 14-15.
[38] *National Conference of State Legislatures, Public-Private Partnerships for Transportation: a Toolkit for Legislators*, Appendix D: FHWA Key Elements of State PPP Enabling Statutes for Highway Projects (October 2010), http://www.ncsl.org/Portals/1/Documents/transportation/PPPTOOLKIT.pdf. .

- Does the P3 enabling legislation allow solicited and unsolicited proposals for Projects?

- Does the P3 enabling legislation permit all kinds of procurements for Project delivery? These might include, for example, calls for Projects, competitive RFQ and RFPs, qualifications review followed by an evaluation of proposer concepts, use of design build, procurements based on financial terms such as return on equity rather than on price, long-term asset leases for some period of up to 60 years or longer from the time operations commence.

- Are there explicit exemptions/supplemental procurement authority from the application of the state's general procurement laws?

- Does the P3 enabling legislation permit the Public Sector to make payments to unsuccessful bidders for work product contained in their proposals?

- Can the Public Sector charge application fees to offset its proposal review costs?

- Does the P3 enabling legislation allow adequate time for the preparation, submission, and evaluation of competitive proposals?

- Does the P3 enabling legislation specify evaluation criteria for P3 proposals received under a given procurement approach?

- Does the P3 enabling legislation specify the structure and participants for the review process involving P3 proposals?

- Does the P3 enabling legislation protect the confidentiality of P3 proposals and any related negotiations in the period prior to execution of the P3 Agreement?

2. *Financing*

With respect to the area of financing projects, threshold questions are the following:

- Does the P3 enabling legislation permit local/state/federal funds to be combined with the Private Sector funds on a Project?

- Who has rate-setting authority to impose user fees, and under what circumstances may they be changed or otherwise reviewed?

- Does the P3 enabling legislation permit TIFIA loans to be used on the relevant transportation Projects?

- With respect to transportation Projects, is there a legal requirement to remove tolls after the repayment of project debt?

- Is there a restriction that prevents the revenues from Projects from being diverted to the state's general fund or for other unrelated uses?

- Does the Public Sector have the authority to issue toll, water, or other relevant revenue bonds or notes?

- Does the Public Sector have the authority to form nonprofits and let them issue debt on behalf of the Public Sector?

3. *Project Characteristics*

With respect to a Project's characteristics, threshold questions are the following:

- What is the nature of the Projects authorized?

- Is the number of Projects limited to only a few pilot or demonstration Projects?

- Are there restrictions concerning the geographic location of Projects?

- Are there restrictions concerning the particular mode of transportation eligible to be developed as a Project (e.g., truck, passenger auto, freight rail, passenger rail)?

4. *Other Supporting Legal Authority*

With respect to the area of legal authority of the owner, threshold questions are the following:

- Does the P3 enabling legislation permit the renovation or conversion of existing or partially constructed assets (e.g., such as highways into toll roads)?

- Is prior legislative approval required when an individual P3 proposal is received?

- Are there any similar requirements that subject the P3 proposal or the negotiated P3 Agreement to a local veto?

- Does the P3 enabling legislation authorize the Public Sector to grant long-term leases/franchises for the construction, operation, and maintenance of the relevant assets (e.g., toll facilities)?

- Does the Public Sector have the authority to hire its own technical and legal consultants?

- Is the Public Sector required to maintain comparable non-toll routes when it establishes new toll roads?

- Are there any non-compete clause prohibitions?

- Is the authority to enter into P3 Agreements restricted to the certain state authorities only, or can regional or local governmental entities also do so?

- Does the P3 enabling legislation provide for the ability of the Public Sector to outsource long-term operations and maintenance and other asset management duties to the Private Sector?

The degree of flexibility and certainty varies by issue and by jurisdiction. In some legislation, there is no specific guidance regarding solicited versus unsolicited bids. In other legislation, there are specific guidelines.

D. Other Federal Statutes and Regulations Impacting Use of P3s. Several federal statutes which set important public policies and also impose certain requirements that must be borne by Projects receiving federal funding include the following:

1. *Buy America Requirements.* FHWA's Buy America policies require a domestic manufacturing process for all steel or iron products that are permanently incorporated in a Federal-aid highway construction project, subject to certain exceptions. Also, the Buy America provisions in the Surface Transportation Assistance Act of 1982, as amended by SAFETEA-LU, require that when Federal Transportation Authority ("*FTA*") grant monies are used, U.S.-produced materials must be purchased with certain limited exceptions.

2. *Davis-Bacon Act.* The Davis-Bacon Act requires that prevailing wages be paid for work on construction projects that are financed by a loan or grant from the federal government. Whenever the Davis-Bacon Act applies, it is accompanied by significant record keeping and auditing requirements.

3. *Labor Protection.* Public transportation agencies must commit to existing labor protection agreements in their expenditure of federal funding due to 49 U.S.C. 5333(b), also known as "Section 13(c)." The requirement mandates that expenditures that would result in new service or expansion of existing service must be made in a way that does not reduce existing labor protections, including:

(i) Preservation of rights, privileges, and benefits (including continuation of pension rights and benefits) under existing collective bargaining agreements or otherwise;

(ii) Continuation of collective bargaining rights;

(iii) Protection of individual employees against a worsening of their positions related to employment;

(iv) Assurances of employment to employees of acquired mass transportation systems;

(v) Assurances of priority of reemployment of employees whose employment is ended or who are laid off; and

(vi) Paid training or retraining programs.

X. PRACTICAL ISSUES IN P3 TRANSACTIONS.

A. Parties to the P3 Transaction[39]

1. *State Legislatures/local governments/regional agencies and authorities.* Establish the overarching rules or statutes for P3 within their jurisdiction. In some cases, the legislation may require that each concession be specifically approved by a legislative majority.

2. *Governors.* P3 concessions may originate from a gubernatorial initiative.

3. *Public Sector Project Sponsor.* P3s can be sponsored by a state or local government (the "*Public Sector Project Sponsor*"). Within the constraints defined by the enabling legislation, the Public Sector Project Sponsor creates guidelines, defines goals, owns the Project, procures, negotiates, and is responsible for oversight of the Project.

4. *Counsel to Public Sector.* Represents the Public Sector and ensures overall compliance with all applicable Federal, state and local laws and regulations.

5. *Conduit Issuer*. If PABs are used in the financing, the Public Sector must have a "conduit issuer" that will issue bonds whose proceeds are loaned to the Private Sector Partner. The conduit issuer may be an existing State or local agency that issues PABs for other governmental purposes, or the issuer may be created specifically for the purpose of issuing PABs.

6. *Public Sector Contracted Advisors.* The Public Sector may hire private sector consultants as advisors that may assist in analyzing projects considered for P3s, in the initial plan for a P3 on a Project, in negotiating the concession, and in some cases, on certain monitoring and oversight tasks.

7. *U.S. Department of Transportation.* Although State and local governments have the primary role in P3s, when the Project involves transportation/highway infrastructure, the U.S. Department of Transportation may get involved in various capacities, including providing credit assistance, allocating PAB authority, managing toll authority under Congressionally-authorized programs, and conducting stewardship on Projects that receive federal funds or federal credit assistance. The U.S. Department of Transportation will also play a primary role in transactions involving TIFIA loans.

8. *Other Public Sector Sponsors.* Public entities other than the primary Public Sector Project Sponsor may provide Public Sector funds for a portion of the Project. The Project may receive federal-aid or state-allocated funds through the state Department of Transportation or state legislature. The Project may also receive funding from local public agencies or governments; an independent authority, such as a turnpike; or a transit agency. These sponsors may require input into the P3 process as part of their conditions for providing funds to the Project.

9. *Private Sector Partner.* The Private Sector Partner has the right to implement the P3, assemble the financing, and negotiate agreements with the Public Sector

[39] See generally Public-Private Partnership (P3) Procurement: A Guide for Public Owners (March 2019), https://www.fhwa.dot.gov/ipd/p3/toolkit/publications/other_guides/p3_procurement_guide_0319/.

Partner. Most Private Sector Partner companies are established as SPVs or Special Purpose Entities ("*SPE*"), which are a combination of firms that create a joint venture for the purpose of bidding on a Project.

10. *Expert Service Providers.* Expert service providers may be contracted by the Private Sector to design, build, operate, maintain, and perform other functions if the Private Sector does not provide these services itself. These expert service providers may include a construction firm that serves as a design builder; tolling experts who operate tolling technology; firms with expertise in administrative and back-office operations; operations and maintenance; consultant advisers, such as attorneys and financial advisers; and experts in other key aspects of the P3.

11. *Equity Investors.* Various kinds of equity investors provide funds to the SPV. Strategic equity is capital from the SPV partners and expert service providers (*e.g.*, construction firms). The equity is considered "strategic" from a private perspective because the firm has a vested interest in providing capital to ensure that it will be able to do the work that is part of its Project role. The equity is also considered strategic because the equity investment gives the strategic equity partner substantial incentive to complete the Project and meet performance targets, or it will otherwise risk the loss of its equity. The incentive is motivated by the fact that the company's own money is at risk. Another kind of equity can be contributed from infrastructure sector investment funds. These funds may be assembled by investment banks or other entities that offer institutional and private investors the opportunity to invest in long-term infrastructure projects. Public and private pension funds may also contribute equity toward a Project. Pensions invest in Projects as a way to earn long-term, stable returns. In a few U.S. transactions, pension funds have invested directly in local infrastructure Projects.

12. *Counsel to Equity Investor/Private Sector Partner.* Represent Equity Investors and/or Private Sector Partner.

13. *Commercial Lenders.* Banks can provide debt capital to the Project via commercial loans. These loans typically have higher interest rates than do tax-exempt bonds.

14. *Bondholders.* SPVs can also borrow funds from individual investors and institutions that purchase bonds in the capital markets, both taxable and tax-exempt. To borrow funds at the least expensive, tax-exempt rate, the SPV may have to apply for and receive a PAB allocation from the U.S. Department of Transportation, or other PABs as permitted by the Internal Revenue Code. In addition, a public agency must serve as a conduit issuer that actually issues the bonds.

15. *Lender's Counsel*. Represent banks, investors, underwriters and other lenders to a Project.

B. Typical P3 Transaction Process[40]

1. *P3 Working Group Established.* Public Sector staff analyzes and considers the Project. Staff may contact other States that have already established P3 programs to discover best practices and lessons learned.

2. *Legal Authority Adopted and/or P3 Program Established.* Legislation may direct a Public Sector Project Sponsor to develop a program, or a Public Sector Project Sponsor interested in developing a program may seek enabling legislation. Depending on which comes first, the P3 team will generally work to either implement the enabling legislation or obtain enabling legislation.

3. *Potential P3 Projects Identified.* The enabling legislation may (a) specify a process for identifying potential Projects, (b) name certain Projects, or (c) allow the agency to develop its own process. When Project proposals are solicited, the Private Sector is invited to compete on Projects that are already part of the agency's plans. If an agency permits unsolicited proposals, the Private Sector can propose a P3 on a Project for which the Public Sector may not have considered.

4. *Project Goals Established.* Once a Project is selected for evaluation as a potential Project, the Public Sector will identify key goals, which includes what construction or reconstruction needs to occur, what risks should be considered for allocation, and what operational and performance measures may be important.

5. *Industry Meetings Held.* Once a Project has been identified, the Public Sector may choose to hold industry meetings to allow for private industry input into the P3 potential of the Project.

6. *Revenue Options Examined.* The Public Sector examines the possible revenue options associated with a Project. This usually starts by identifying users and beneficiaries of the Project. The Public Sector may conduct additional analysis on the revenue options, including initial feasibility studies, revenue feasibility studies, and review of other applicable federal and state grant programs and other potential sources.

7. *Financial and Other Risks Evaluated.* Once revenue sources have been identified, the Public Sector can make an initial estimate of how much financing might be supported by the revenue sources. The Public Sector will also analyze the status of environmental and other permitting processes and archeological, geotechnical, and other conditions. The Public Sector is gathering information for a risk-based analysis to determine whether Private Sector involvement could lead to added value.

8. *Public Sector Capacity for Project Development Evaluated or Public Sector Comparator Created.* After examining the revenues and potential Project risks, the Public Sector will evaluate its capacity to complete the Project by using traditional methods.

[40] EMANUEL S. SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS (New York 2000).

9. *Possible Benefits of P3 Models Considered or Value for Money Assessment Done.* The Public Sector reviews the possible benefits of a P3 and considers which model to pursue based on analysis of the Project. The Public Sector Comparator developed would be compared with the anticipated risk-adjusted cost of implementing the Project as a P3.

10. *Whether and How to Implement a P3 Determined.* The Public Sector will often use the VfM analysis to determine whether to undertake a Project as a P3, which compensation model to use, and the general framework for the P3.

11. *First-Stage Procurement Document: Request for Information or Request for Qualifications Developed.* If the results of the VfM analysis show that the Public Sector might gain additional value from executing a Project as a P3, Public Sector Partners may first issue a Request for Information ("*RFI*") for the purpose of soliciting preliminary input from the market prior to initiating a formal procurement, although this is not always done. To formally initiate the procurement process, the Public Sector Partner will typically develop an initial or Request for Qualifications ("*RFQ*") that provides information about the Project and the Public Sector's goals and requests qualifications from interested Private Sector Partners. This is usually the first step of a two-step procurement process. The RFQ stage allows the Public Sector to weed out those who do not have the qualifications to implement the P3 successfully.

12. *Second-Stage Procurement Document, Request for Proposal Developed.* After responses have been received for the first stage of procurement, the Public Sector may choose a short list of potential bidders who will be invited to bid on the second stage pursuant to a Request for Detailed Proposals ("*RFP*"). The RFP will incorporate what the Public Sector has learned from the initial RFI and/or RFQ. For example, if the Public Sector proposed a P3 on a bridge, conversations with the industry might have clarified how much of the land that surrounds the bridge approaches needs to be included in the Project and what kinds of toll limitations will protect the public interest while making the Project feasible.

13. *Tax Issues Identified and Resolved*. P3 counsel identifies and assists in resolving federal, state and local tax issues.

14. *Draft Agreements Developed.* The Public Sector may develop a draft Agreement as part of the more detailed stage of procurement. This will provide the basic outline for the Agreement. For example, the draft Agreement might specify performance standards for the facility, the term of the Agreement, and how revenue sharing will be handled. Some details may be left to the bidder to propose (*e.g.*, the level of revenue sharing), and some may be open to negotiation after a successful bidder is identified.

15. *Bidding Process Conducted by the Public Sector*. Interested companies submit confidential bids. In many cases, bidding is limited to the short list of bidders who were deemed qualified from the initial RFQ or RFI. Bidders may also have to demonstrate their financial and technical capabilities to complete the Project and may be required to submit deposits or guarantees or otherwise prove their creditworthiness.

16. *Private Sector Partner/Lender Requirements for Financial Close.* Lenders and the Private Sector Partner will identify prior to final submissions for award the types of

representations, warranties and covenants that will be required of the Public Sector Project Sponsor in order to finance the Project, including availability of consents and approvals for Project construction and disclosure and continuing disclosure obligations of the Public Sector and Private Sector.

17. *Private Sector Partner selected.* Public Sector Project Sponsor will develop criteria to match public goals and use the criteria to assess the Private Sector proposals. Unlike traditional project development, cost will be only one of a number of considerations in choosing the successful bidder. Experience and technical capabilities also will be weighed. For example, if a Project involves construction of a tunnel, a key evaluation criterion might be the proposed bidder's experience with tunnel construction and managing the risks on a large project.

18. *Negotiations with Chosen Private Sector Partner Conducted.* Once the Private Sector Partner has been selected, the Public Sector Partner can negotiate a final P3 Agreement based on the draft developed during the RFP process. The Private Sector Partner may wish to negotiate details, such as how payments will be sent (e.g., revenue share payments from private to public or availability payments from public to private). Counsel attends document mark-up (one-on-one) sessions among the Public Sector, Private Sector, lender and/or equity investor clients.

19. *Drafting of Approval Agreements*. Counsel to the Private Sector Partner drafts corporate approval agreements.

20. *Gathering Debt and Equity Capital (Private Sector Partner).* The Private Sector Partner has to invest enough equity and borrow enough money to construct or reconstruct the facility involved in the Project. In most cases, the different lenders and bond issuers involved in the Project prefer that the funds be assembled at the same time so that they will be assured that the Private Sector Partner will be able to construct the Project and begin the flow of monetary compensation (*i.e.*, revenues) that will be used to repay the debt.

21. *Lender Term Sheets.* Counsel to lender(s) prepares relevant lender term sheet(s).

22. *Review Term Sheet.* If the Public Sector Project Sponsor is submitting a TIFIA loan request, reviewing the term sheet to make the TIFIA term sheet is consistent with the financing.

23. *Finalize Terms*. All terms of P3 Agreement, financing and loans are finalized.

24. *Draft Documents*. Draft and/or revise P3 Agreement, financing, security and disclosure documents.

25. *Review of Project Agreement.* To ensure the Project and the obligations under the P3 Agreement are consistent with the structure of the expected financing.

26. *Finalize Documents.* Finalize and execute documents.

27. *Commercial and Financial Closing*. The process of satisfying all lender requirements and obtaining legally binding commitments to provide sufficient equity and debt to construct the Project.

C. Basic P3 Documentation

1. The following is a general list of documentation in a P3 transaction some of which may or may not apply depending on the nature of the Project:

(i) Enabling Legislation (existing and any adopted especially for the Project)

(ii) Ordinance/Corporate Resolutions

(iii) Feasibility Studies

(iv) Value for Money Analysis

(v) RFI and RFQ

(vi) RFP

(vii) Bid Proposal

(viii) Term Sheet

(ix) Loan Documents

(x) SPV Shareholder Agreement

(xi) Other SPV Corporate Documents

(xii) If applicable, Not-for- profit Corporate documents including Certificate of Good Standing/Existence and IRS Determination Letter.

(xiii) Private Activity Bond Issuance Documentation/Transcript

(xiv) Federal Program Documentation

(xv) Concession/P3 Agreement

(xvi) Engineering, Procurement and Construction Contract (also known as the Design-Build Contract)

(xvii) Operation and Maintenance Agreement

(xviii) Management Contract

(xix) Service Contract

(xx) Lease

(xxi) Sale of Infrastructure Asset Documentation

(xxii) Off-take Agreement

(xxiii) Inter-creditor Agreement

(xxiv) Equity Contribution Agreement

(xxv) Side Agreement between SPV and Lenders

D. Key Terms for Negotiation.[41] When negotiating a P3, ideally all parties will be reasonably satisfied that they will receive the outcomes that were important enough to include in the transaction documents. The Private Sector Partner will accrue proportionate future financial returns in exchange for its financial risk. The Public Sector Partner, in return for providing the infrastructure, entitlements, or other public resources should receive sufficient public benefits, such as improved or additional public infrastructure; an increased property, employment, or sales tax base; provision of needed governmental services; clearing of blight; and nontax income and tax revenue generated by the Project.[42]

Most issues should ideally be negotiated during the bid process. However, negotiations present the last opportunity to work through contractual issues and both sides may have saved issues to be dealt with at this last stage. The Public Sector side is often the less experienced of the parties at the negotiation table and it is vital that it be supported by appropriate advisory expertise and a clear negotiating strategy. Negotiations have to be scheduled with sufficient time for preparation, and conducting negotiations in several rounds may be necessary. Negotiations should not reopen items previously dealt with or should not undermine the integrity of the bidding process by deviating from the original proposal. The goal of clear negotiations is to reduce uncertainty and define rights and obligations.

1. Below is a list of basic provisions to take into account when negotiating P3 Agreements.[43] [44]

- The parties to the Agreement;
- Interpretation: Sets forth the definitions of important terms and providing guidance on the interpretation of the Agreement's provisions;
- The scope, territorial jurisdiction, and duration of the Agreement;

[41] *See Establishing a Public-Private Partnership Program: A Primer*, *supra* note 12.
[42] URBAN LAND INSTITUTE, *supra* note 3, at 26.
[43] PUBLIC-PRIVATE PARTNERSHIPS REFERENCE GUIDE, 3D ED., European Bank for Reconstruction and Development and World Bank Group, https://pppknowledgelab.org/guide/sections/1-introduction.
[44] *Establishing a Public-Private Partnership Program: A Primer*, *supra* note 12.

- The objective of the Agreement;
- Circumstances of commencement, completion, modification, and termination of Agreement;
- The rights and obligations of the Private Sector Partner;
- The rights and obligations of the Public Sector Partner;
- The requirement for performance bonds to provide security for the Public Sector Partner if the construction and/or the service delivery falls below standards;
- Insurance requirements to provide security for the insurable matters;
- Public Sector Partner warranties;
- Private Sector Partner warranties;
- Appropriate uses of any upfront payments;
- Clear performance standards and provision for future O&M costs;
- Identification of revenue stream;
- Consequences to a change in law;
- Service quality, and performance and maintenance targets and schedules;
- The identification of regulatory authorities, if any, and the extent of their roles and authority;
- The responsibilities of the Private Sector Partner and the Public Sector Partner with regard to capital expenditures;
- The form of remuneration of the Private Sector Partner and how it will be covered, whether from fixed fee, fixed fee plus incentives, or another arrangement;
- How key risks will be allocated and managed;
- The Private Sector Partner's rights and responsibilities with regard to passing through or entering public or private property;
- Reporting requirements;
- Procedures for measuring, monitoring, and enforcing performance;
- Procedures for coordinating investment planning;

- Responsibility for environmental liabilities;
- Procedures for resolving disputes;
- Delay provisions describing what is and is not an excuse for a delay in construction or operations;
- Force majeure conditions and reactions;
- Procedures to be followed when either party to the P3 Agreement wishes to change any material portion (variation) of the Agreement;
- Indemnification circumstances;
- The rights of each party to any intellectual property brought to the Project or created during the Project, including the steps to be taken to protect the intellectual property of third parties, such as information technology software manufacturers;
- Conflict of interests and dispute resolution;
- Description of the conditions under which either party may terminate the Agreement, the processes to be undertaken in that regard, and the consequences to each party of a termination, including termination compensation that may be owed by the Public Sector Partner;
- The circumstances that may permit either the Public Sector Partner or any financial institution to "step in" to the Agreement to protect its rights under the P3 contract;
- Consequences of a change in the ownership or key personnel of the Private Sector Partner;
- Mechanisms whereby the parties to the P3 Agreement will interact with each other going forward;
- Requirement that each party comply with all laws pertaining to the Project, including obtaining environmental, zoning, planning, and other permits;
- Conditions by which Public Sector employees are employed by the Private Sector, including any restrictions on terminations or redundancies for operational reasons; and
- Conditions precedent to be fulfilled by either party before the contract takes effect.

2. *Payment Structures*[45] - Compensation structure (payout schedule, revenue sharing provisions, and subsidies) include when, how, and under what circumstances the Private Sector Partner will receive payments; what portion of revenues will be shared at what revenue levels; and the degree to which the Public Sector Partner will contribute to the Project with grants, in-kind donations, tax breaks, or public financing. The Private Sector Partner can be paid by

[45] *See id.*

collecting user fees, by the Public Sector Partner, or by a combination of the two. The options for a payment mechanism can depend on the functions of the Private Sector Partner.

(i) User pays. The Private Sector Partner provides a service to users, and generates revenue by charging users for that service. These fees (or tariffs, or tolls) can be supplemented by subsidies paid by the Public Sector, which may be performance-based (for example, conditional on the availability of the service at a particular quality), or output-based (for example, payments per user). By accepting this form of compensation, the Private Sector also accepts the risk that revenues might be inadequate to repay debt or provide a return on equity, and thus the Project will not be constructed or continue to perform. This revenue risk can also be shared between the Public Sector Partner and the Private Sector Partner.

(ii) Public Sector pays P3s. The Public Sector is the sole source of revenue for the Private Sector Partner. Public Sector payments can depend on the asset or service being available at a contractually-defined quality ("availability" payments). They can also be output-based payments for services delivered to users—for example, a "shadow toll" road that is free for users, but for which the Public Sector pays a fee per driver.

(iii) Availability Payments and Performance Payments (from Public Sector Partner to Private Sector Partner). The Public Sector Partner will compensate the Private Sector Partner for its activities with annual availability payments that depend on performance and availability of the facility. Frequently, the Public Sector Partner first offers milestone payments when construction is complete and then offers annual payments for each period that the facility is available at the specified performance level. If the performance requirements are not met, then the availability payment can be reduced or even eliminated, thereby helping to ensure a high level of performance.

(iv) Shadow Tolls (from Public Sector Partner to Private Sector Partner). The Public Sector Partner pays a fee to the Private Sector Partner for each vehicle that uses a facility.

(v) Up-Front Payment (Private Sector Partner to Public Sector Partner - For a Toll-Based Concession on an Existing Facility). When a facility is generating or is expected to generate more revenue than what is required to repay debt, the Private Sector may pay the Public Sector in advance for the ability to collect future revenue.

(vi) Penalties for Noncompliance. The Public Sector Partner is responsible for tracking the Private Sector Partner's performance and penalizing the Private Sector Partner when contractual obligations are not met. Before penalties are assessed, P3 Agreements typically prescribe a series of actions that must be taken to notify the Private Sector Partner of the issue and a period of time to correct the noncompliance issue after it is detected. Penalties typically consist of payment reductions or retentions and non-compliance or default points. Once noncompliance or default points reach a specified level, they can result in increased oversight, work by the Public Sector Partner at the Private Sector Partner's expense, suspension of work, or termination of the Agreement.

3. *User Fee Adjustments* - It is not likely that the amount of user fees or even a user fee structure to remain viable and appropriate over the typical life of a Project. It is therefore essential to establish practical rules for user fee adjustments.

(i) Define triggers or drivers for a user fee adjustment, such as inflation, etc.;

(ii) Define the mechanisms by which the user fee adjustment will be made, including cost plus and price cap regulation; and

(iii) Establish the frequency of user fee adjustments such as when cost pass-throughs are allowed, and the necessity for any extraordinary user fee adjustments. Take into account any regulatory requirements and limitations.

4. *Term of Agreement.* The Public Sector Partner determines how long the Agreement will be. In most cases, the Public Sector Partner tries to establish a time period that is long enough to provide incentives for good asset management and that allows sufficient time for the Private Sector Partner to repay debt and make a return on the investment to construct or reconstruct the facility. The Private Sector Partner may be able to take advantage of depreciation and other tax benefits if the Agreement term exceeds the expected useful life of the asset. The Public Sector Partner should seek to provide sufficient time to allow the Private Sector Partner to recoup its investment while not forgoing revenues for more years than what is necessary to provide users with service.

(i) Fixed Term. The Public Sector Partner may establish a specific period of time for an Agreement, such as 35, 45, or 50 years. The term may be specified in enabling legislation, determined by policy, or negotiated with the Private Sector Partner. The term is usually, but not always, set to be greater than the life of the asset to facilitate use of depreciation and other tax benefits in a long-term lease.

(ii) Extendable Term. The Public Sector Partner may also offer a term that is fixed but with the possibility of extension under certain limited circumstances, such as an option to compensate the Private Sector Partner for costs or delays that are considered the responsibility of the Public Sector Partner.

(iii) Termination/Buyback provisions. The rights to terminate the Agreement and the conditions under which those rights may be invoked are typically negotiated in the final Agreement. In the event of early termination, mechanisms are usually described in the Agreement to ensure that the harmed party is compensated for any losses or for the residual value of the asset.

5. *Hand-back Provisions.* P3 Agreements generally specify the required condition of the facility at the end of the Agreement term. The condition of a facility at hand-back depends on the maintenance and operation procedures employed throughout the lifecycle of the

facility, so the Private Sector Partner is typically required to develop a capital replacement or asset management plan for equipment, systems and assets. In addition, the Private Sector Partner may be required to develop a plan that specifies the processes for turning over operation of the facility to another party at the conclusion of the Agreement.

Hand-back conditions may involve the use of a third party to assess remaining design life or the residual value of assets through inspections, materials testing, and a review of the history of maintenance and capital investments. If the facility is not in acceptable condition, the Private Sector Partner may be required to make additional capital investments.

To manage the financial risks associated with hand-back, some P3 Agreements require the Private Sector Partner to establish a hand-back reserve account that begins to accrue toward the end of an Agreement and may be used for unplanned repairs required prior to, or shortly after, hand-back of a facility to the Public Sector Partner. This hand-back reserve (or replacement letter of credit) typically serves to alleviate uncertainties and unforeseen costs at the end of the Agreement.

6. *Clear Dispute Resolution Provisions.* P3 Agreements typically specify dispute resolution processes to reduce the risk of legal conflict over technical issues or differences in contract interpretation. Alternative dispute resolution processes may include mediation and third party arbitration following a period of time allowed for both parties to make good faith efforts to resolve the dispute themselves. Arbitration may be conducted by an agreed-upon expert or by a designated board with members selected by both the Public Sector Partner and the Private Sector Partner.

P3 Agreements typically specify alternative dispute resolution processes for various reasons, including the time sensitivity of many Projects and the speed advantage of these extrajudicial processes. Professional arbitrators or mediators can be selected for their industry knowledge and will seek resolution through a collaborative non-adversarial process. Another consideration favoring alternative dispute resolution procedures on P3 Agreements is that that the Public Sector Partner may not be sued even when in breach of the Agreement. This "sovereign immunity" can become an obstacle for the Private Sector to financing a Project unless the agency waives this immunity in favor of contractually-defined alternative dispute resolution mechanisms.

Prior to mediation or arbitration, dispute resolution processes often define tiered systems of problem identification and resolution through negotiation to encourage problems to be resolved at the lowest levels. For example, the Agreement may specify a process whereby the parties to a dispute are given a set time period to seek ways to resolve their dispute before it is elevated to their respective managers. In elevating the dispute, the parties must write a memo to their supervisors, summarizing the nature of the dispute and the steps they attempted to take to resolve the issue. This system can serve as an incentive for parties to seek a speedy resolution to disputes.

In the worst case scenario, underperformance can lead to Agreement failure. Agreement failure occurs when one party is unable or refuses to comply with the Agreement or the parties to an Agreement are unable to resolve disputes concerning the meaning of contract specifications. Agreement failure can result in the need to amend or renegotiate an Agreement, resolve disputes

in courts, replace parties to the Agreement or terminate the Agreement. These events may ultimately lead to higher costs for the Public Sector.

7. *Refinancing/Renegotiation Provisions*. The Private Sector Partner may refinance or renegotiate a Project once the Project is well established and uncertainty diminishes or operational efficiencies are established. Changing macroeconomic conditions such as declining interest rates can make refinancing attractive. Refinancing can result in greater returns to equity from interest rate reductions, extensions of debt maturity or increases in the amount of debt. Agreement provisions related to refinancing may include a negotiated share between the Public Sector Partner and the Private Sector Partner in the gains made from refinancing or renegotiation.

8. *Conditions Precedent* (*i.e.*, the conditions to be met by both sides to declare the Agreement operational). The timetable and process for transition should also be discussed. Other topics to be discussed include registration actions such as the legal incorporation or registration of any joint ventures or Project specific companies; payment of bonds and guarantees, and any worker transition issues.

9. *Key P3 Implementation Issues to Negotiate.*

(i) Stakeholder management during implementation. As the Project moves into implementation, the selected Private Sector Partner should have a well-detailed plan for ongoing communication with the community, including an appointed liaison.

(ii) Assurance that the right people on both sides of the relationship are in place. Key staff on both sides, each with the right technical and managerial skills, and an established protocol for working together must be established. Both parties should be well familiar with the details of the Agreement.

(iii) Recourse to manage changes to the P3 Agreement. The management of the P3 requires some flexibility on both sides and a means to adapt the terms of the Agreement as well as the other agreements relating to the P3 Agreement to reflect inevitable changes in the operating environment that could not have been anticipated or dealt with originally. All Agreements and agreements relating to the P3 Agreement should have amendment provisions, and the parties' relationship should be strong and flexible enough to facilitate any necessary changes and respond to the business needs of the future.

General Responsibilities of Parties

Party	Responsibility
Private Sector Partner	• Develop management plans and procedures • Collect monitoring data • Develop status reports • Self-report violations
Public Sector Partner	• Set performance standards • Review plans, procedures, and status reports • Perform audits and inspections • Assess penalties and awards
Third Party	• Perform independent audits and inspections • Data collection • Resolve disputes
Shared	• Daily communication and problem solving • Conduct regular face-to-face meetings • Complete annual performance reviews

The above discussion is illustrative and does not capture every clause required in the Agreements. The final content of the P3 Agreement will depend on the Project scope, local legal requirements and precedent, and advice of counsel.

XI. DISCLOSURE ISSUES IN P3 TRANSACTIONS

There are three general areas where disclosure issues arise with respect to P3s, (i) under SEC Rule 15c2-12, if applicable; (ii) compliance with covenants under Project loan documents; and (iii) Public Sector and Private Sector audits and other financial reports. In all instances, the Public and Private Sectors must be fully committed to provide full and fair disclosure. The following are topics that should be taken into account when determining disclosure for P3s:

- Availability of disclosure relating to Project participants, from the Private Sector Partner, to the design-build contractor and others, some companies which are privately held.

- Review and integration of advisor reports, including independent technical advisor reports, specifically highlighting particular issues relating to the Project.

- Description of financing structure and flow of funds, including description of inter-creditor rights and remedies and preconditions to payment of equity distributions.

- If TIFIA is offering a loan, description of preconditions to honoring requisitions and conditions to "springing lien."

- A well-developed, accurate "Risk Factors" section that highlights particular issues relating to the Project.

With respect to federal Projects, the Federal Accounting Standards Advisory Board ("*FASAB*") issued its Statement of Federal Accounting Standards 49 entitled, "Public-Private Partnership: Disclosure Requirements", on April 26, 2016 ("*SFFAS 49*") which should be reviewed in its entirety to get a grasp on the analysis involved in determining disclosure. The FASAB's goal is to ensure that the full costs of P3s entered into are disclosed in the reporting entity's general purpose federal financial reports. The SFFAS 49 establishes the definition of a P3 and identifies risk-based characteristics that need to exist before considering the P3 arrangement for disclosure.

FASAB defines federal public-private partnerships as, "…risk-sharing arrangements or transactions with expected lives greater than five years between public and private sector entities. Such arrangements or transactions provide a service or an asset for government and/or general public use where in addition to the sharing of resources, each party shares in the risks and rewards of said arrangements or transactions."

The following arrangements and transactions are excluded from the FASAB definition of federal P3s and are not subject to the provisions of SFFAS 49:

A. Non-lease acquisitions of property, plant, and equipment ("PP&E") that are subject to the Federal Acquisition Regulations ("FAR") and the private entity is not directly financing, operating, or maintaining the PP&E as part of an overall risk-sharing arrangement or transaction;

B. Leases that are not bundled and are entered into using General Services Administration ("*GSA*") - delegated authority;

C. Acquisition of supplies and services, including construction, research and development, and commercial items, made pursuant to the FAR *Simplified Acquisition Procedures* (FAR Part 13);

D. Formal and informal arrangements or transactions that do not share risks or rewards and are solely designed to foster goodwill, encourage economic development, promote research and innovation, or coordinate and integrate strategic initiatives;

E. Grants to state, local, and Indian tribal governments and other public institutions and arrangements or transactions with foreign governments;

F. Arrangements or transactions in which private entities voluntarily contribute nominal resources or provide incidental resources without expectation of compensation or government indemnification for any possible risk of loss.

With respect to Arrangements and transactions *not* excluded from the FASAB definition, SFFAS 49 requires that at a minimum the following information be disclosed[46]:

A. The purpose, objective, and rationale for the P3 arrangement or transaction and the relative benefits/revenues being received in exchange for the government's consideration, monetary and non-monetary; and the entity's statutory authority for entering into the P3.

B. A description of federal and non-federal funding of the P3 over its expected life, including the mix and, where available, the amounts of such funding. For any amounts that are not available, the disclosures should indicate such.

C. The operational and financial structure of the P3 including the reporting entity's rights and responsibilities, including:

1. A description of the contractual terms governing payments to and from the government over the expected life of the P3 arrangement or transaction to include:

a. an explanation of how the expected life was determined;

b. the time periods payments are expected to occur;

c. whether payments are made directly to each partner or indirectly through a third-party, such as, military housing allowances; and

d. in-kind contributions/services and donations.

2. The amounts received and paid by the government during the reporting period(s) and the amounts estimated to be received and paid in aggregate over the expected life of the P3.

D. Identification of the contractual risks of loss the P3 partners are undertaking.

1. Identification of such contractual risks of loss should include a description of (1) the contractual risk and (2) the potential effect on cash flows if the risks were realized (for example, early termination requirements including related exit amounts

[46] *Public-Private Partnerships: Disclosure Requirements*, Federal Accounting Standards Advisory Board 49 (April 27, 2016), http://files.fasab.gov/pdffiles/original_sffas_49.pdf.

and other responsibilities such as asset condition (hand-back) requirements, minimum payment guarantees, escalation clauses, contingent payments, or renewal options).

2. Disclosure of remote risks of loss should be limited to those included in the terms of the contractual P3 arrangements or transactions. If remote risks of loss are disclosed, an explanation should be included that avoids the misleading inference that there is more than a remote chance of a loss.

E. As applicable:

1. Associated amounts recognized in the financial statements such as gains or losses and capitalized items

2. Significant instances of non-compliances with legal and contractual provisions governing the P3 arrangement or transaction; and

3. Whether the private partner(s), including any SPVs, have borrowed or invested capital contingent upon the reporting entity's promise to pay whether implied or explicit description of events of termination or default.

XII. TAX ISSUES IN P3 TRANSACTIONS

The tax analysis of a Project begins with whether the Project involves a Brownfield asset, a Greenfield asset, or a combination of both. The following is a general outline of issues to be considered with respect to each asset category.

A. Brownfield Projects – Involving existing assets.

1. *Brownfield Projects that were financed with tax-exempt bonds that are still outstanding*.

(i) Bond Documents. Determine whether a P3 transaction is permitted under the currently outstanding bond documents. For example, will the P3 structure trigger a requirement to redeem or defease the outstanding bonds under the bond documents?

(ii) If the P3 involves the sale or lease of the Brownfield Project. Consider the Private Business Test regulations (26 C.F.R. §1.141-1 et. seq. (2016)) and Internal Revenue Code 26 U.S.C. §141 that apply to tax-exempt governmental bonds. Most likely, the Private Business Test is met if the Project is sold or leased to a private entity or managed by a private entity under a long-term arrangement not meeting the permissible structures under IRS Rev. Proc. 2017-13.

(iii) Remedial Action. Review the remedial action provisions under 26 C.F.R. §1.141-12 and Revenue Procedure 2018-26 to determine what actions are required to prevent tax-exempt bonds that previously financed the Brownfield Project from becoming taxable private activity bonds. The action to be taken depends on

whether the P3 disposition transaction is exclusively for cash. If it is for cash, it may be possible to either (i) redeem the bonds if callable or establish a bond defeasance escrow; or (ii) make an alternative use of disposition proceeds.

(iv) Defeasance Requirements. If bonds must be defeased, this action can be expensive with low reinvestment rates. Funds for defeasance will likely come from the Private Sector Partner as a concession payment and will affect the economics of the P3 transaction.

(v) Alternative use of disposition proceeds. The issuer of the bonds must expect to expend the disposition proceeds within two years. The expenditure must not cause private activity bond limits to be exceeded. One question is whether the issuer of the bonds can use disposition proceeds for working capital, especially since P3 transactions are often undertaken to plug budget deficits. The Regulations do not require capital expenditures. How should the maturity limit under the replacement proceeds regulations be addressed?

(vi) Alternative use of facility. Limited application to facilities that otherwise qualify as exempt facilities, e.g., sewer, water. Bonds are treated as reissued and need to meet PAB requirements, such as volume cap and TEFRA. Also need to address the non-AMT status – Rev. Proc. 97-15. Note that the used property limitation does not apply.

(vii) Timing Issues. To be a valid remedial action, redemption or defeasance must be addressed within 90 days of the deliberate action.

(viii) Voluntary Compliance Agreement Program ("*VCAP*"). If the Public Sector Partner is unable to take remedial action in a timely fashion then the issuer may need to obtain a closing agreement under VCAP.

2. *Existing Brownfield Projects without outstanding bonds*

(i) Financing with Exempt Facility Bonds (PABs). There is a limited scope of Projects allowed to be financed. Most bond issues will need state volume cap and there may be political reluctance to allocate volume cap to an existing Project. Used property rules may require rehabilitation (15% for buildings, 100% for other structures) or prohibit financing altogether if facility is not a building or structure.

(ii) Financing with Governmental Bonds. The Public Sector Partner will need to address private business use through compliance with qualified management contract requirements under Rev. Proc. 2017-13 or structure the transaction to avoid meeting private payments/security test, *e.g.*, tax increment financing, PILOTs.

B. Greenfield Projects - Involving construction of new assets.

1. *Finance with PABs*

(i) PABs can be issued to finance traditional projects such as sewer and water facilities, airports, mass commuting facilities, etc.

(ii) PABs can be issued to finance facilities specifically contemplating Projects such as qualified public educational facilities, 26 U.S.C. § 142(k); qualified highway or transfer facilities, (26 U.S.C. § 142(m)).

(iii) PAB issuance requires either state volume cap or federal allocation.

2. *Finance with tax-exempt governmental bonds*

(i) Private Business Use Test. It is difficult to avoid meeting the Private Business Use Test with a lease or long-term management contract P3 structure. Qualified management agreements under Rev. Proc. 2017-13 allow for contract terms of up to 30 years and some additional flexibility in structuring management contracts, but most Projects are not likely to meet these requirements.

(ii) Private Business Use, Payments/Security Test. Generally applicable tax, including incremental tax, revenues and PILOTS are not private payments or security. The Public Sector needs to avoid receipt of other payments unless able to offset by allocable operation and maintenance expenses or allocate to another financing source.

(iii) It is possible to combine tax-exempt governmental bonds and PABs/taxable bonds. This allows the separation of governmental and privately used portions of the facilities (*e.g.*, airport facilities).

C. SAFETEA-LU Surface Transportation PABs Authorization. These PABs are not subject to the general annual volume cap for private activity bonds for state agencies and other issuers, but are subject to a separate national cap of $15 billion P.L. 117-58: Law Sec. 80403. raised this to 30,000,000.

1. *Substantive requirements:*

(i) National allocation by the U.S. Department of Transportation, not state volume cap.

(ii) Use for both mass transit as well as road/bridge/highway.

(iii) 95% of proceeds must be spent on qualified facilities within 5 years.

(iv) Redemption requirement if 95% test not met.

(v) May need to allocate tax-exempt proceeds away from certain expenditures such as payments to related parties for development costs by using the allocation rules. May have inconsistent treatment for non-tax purposes.

2. *TEFRA*. For multi- state Projects, host approval as well as issuer approval is required. May have disinterested parties.

3. *TIFIA shared reserve fund structure*. May raise reasonably required reserve and use of proceeds issues.

XIII. ELEMENTS IN SUCCESSFUL P3 TRANSACTIONS

Successful P3 transactions generally contain the following elements:[47]

A. P3 Project Advocate. Recognized public figures should serve as the spokespersons and advocates for the Project and the use of a P3. Well-informed advocates play a critical role in minimizing misperceptions about the value to the public of an effectively developed P3.

B. Public Sector Dedicated P3 Team. The Public Sector should have a dedicated team for Projects or P3 programs. This unit should be involved from conceptualization to negotiation, through final monitoring of the execution of the partnership. This unit should develop RFPs that include performance goals, not design specifications. Consideration of proposals should be based on best value, not lowest prices. Thorough, inclusive VfM calculations provide a powerful tool for evaluating overall economic value.

C. Detailed Agreement. The Agreement should include a detailed description of the responsibilities, risks and benefits of both the Public and Private Sector Partners. Such an Agreement will increase the probability of success of the partnership. Realizing that all contingencies cannot be foreseen, a good Agreement will include a clearly defined method of dispute resolution.

D. Clearly Defined Revenue Stream. While the Private Sector Partner may provide a portion or all of the funding for capital improvements, there must be an identifiable revenue stream sufficient to retire this investment and provide an acceptable rate of return over the term of the partnership. The income stream can be generated by a variety and combination of sources (fees, tolls, availability payments, shadow tolls, tax increment financing, commercial use of underutilized assets or a wide range of additional options), but must be reasonably assured for the length of the partnership's investment period.

E. Public Support. Affected employees, the portions of the public receiving the service, the press, appropriate labor unions and relevant interest groups will all have opinions, and may have misconceptions about a partnership and its value to all the public. It is important to communicate openly and candidly with these stakeholders to minimize potential resistance to establishing a partnership.[48]

[47] Richard Norment, *The Framework of Public-Private Partnerships*, NATIONAL COUNCIL FOR PUBLIC-PRIVATE PARTNERSHIPS (2012).
[48] *Testing Tradition*, *supra* note 1, at 23.

APPENDIX I

GLOSSARY OF TERMS[49]

This Glossary of Terms does not represent all the terms as defined in this document, but rather sets forth frequently used terms in P3 transactions, and with which practitioners should generally be familiar.

Availability Payment - the Public Sector agrees to make regular payments to the Private Sector based on the facility's availability and level of service achieved for operations and maintenance. Unlike shadow tolls, availability payments do not depend on traffic volume (see shadow toll). In the United States, availability payments are more common for transit projects.

Appropriation Risks – The risk that the public agency is incapable of meeting its financial obligations to the project because funds for the project fail to be obligated into its budget. Appropriation risks can affect projects in which the public agency is expected to make payments as a lump sum during the construction period, as availability payments during the life of the project, or as a result of other events occurring in the life of the project.

Bid Stipend - a payment made by a Public Sector to a bidder on a particular contract to encourage competition or to offset transaction costs. Stipends can also be used to compensate losing bidders for specific concepts proposed in their bid that may be incorporated into the final design of the Project.

Brownfield Projects – From a technical/engineering perspective, investments in projects on sites that have previously been used for industrial purposes or have been the site of significant buildings. From an investor perspective, project investments in infrastructure assets that were existing before the time of procurement, or that were previously greenfields but are in operation at the time the investment is made.

Concession - a P3 project delivery structure involving a lease of an existing or to-be-constructed public asset to a private concessionaire for a specified period of time. In general, the concessionaire will receive the right to collect availability payments or direct revenue generated by the asset over the life of the contract (typically 25–99 years) in exchange for agreeing to construct or operate and maintain or improve the facility during the term of the lease.

Concessionaire - the private sector party to a concession agreement. See Special Purpose Vehicle or Special Purpose Entity.

Coverage Ratio, Debt Service Coverage Ratio or DSCR - the ratio of projected future net revenues that will be available to cover future debt service payments. These ratios are calculated by lenders and rating agencies on the basis of projected future revenues. A DSCR of 1.0 suggests that there would be exactly enough revenue to cover debt payments, whereas a DSCR ratio above 1.0 (e.g., 1.75) reflects the fact that anticipated revenues exceed debt payments. A DSCR ratio below 1.0

[49] Adapted from the Federal Highway Administration P3 Toolkits, Public-Private Partnership Library; APMG Public-Private Partnerships Certification Program, *Glossary* (2018).

(e.g., 0.95) reflects the fact that anticipated revenues would not be sufficient to cover debt payments.

Direct Agreement – An agreement normally made between the special purpose vehicle (SPV), the government party, and the lenders. Alternatively, it can be made between the SPV, the lender, and the primary sub-contractors. The agreement gives the lenders step-in rights to take over the operation of the key PPP contracts.

Equity - money contributed from private sources for project finance by project investors, with the expectation of future returns if the project is financially successful.

Greenfield Projects – From an engineering point of view, these are projects to be developed on sites that have not had previous industrial use or significant buildings. From an investor perspective, they are project investments that relate to a PPP that has recently been awarded or is under construction, and where there are significant new structures or very significant upgrades of existing infrastructures. In the latter case, depending on how relevant the value of the existing infrastructure is, greenfield projects may be also defined as yellowfield or secondary stage projects.

Hand-back Provision - the terms, conditions, requirements, and procedures governing the condition in which a Private Sector Partner is to deliver an asset to the Public Sector upon expiration or earlier termination of the agreement, as set forth in the contract.

Hybrid Project - a P3 concession that involves substantial rehabilitation or expansion of an existing facility. Innovative finance - Alternative methods of financing construction, maintenance, or operation of transportation facilities. The term covers a broad variety of non-traditional financing, including the use of private funds or the use of public funds in a new way, such as in a P3 agreement.

Inter-creditor Agreement – an agreement between the main creditors of the Private Sector Partner and the main creditors in connection with the Project financing. The main creditors often enter into the Inter-creditor Agreement to govern the common terms and relationships among the lenders in respect of the Private Sector borrower's obligations.

Interface Agreement – The primary purpose of an interface agreement is to regulate the relationships between the key sub-contractors with regard to their respective responsibilities in relation to the project, certain liabilities and payments, and the recovery of certain sums from one another.

Junior Debt - debt obligations that have a lower priority claim on the source of payment for debt service than does a senior lender. Junior debt is riskier because it is paid after the senior debt payment, and thus it typically carries a higher interest rate.

Key Performance Indicators (KPI) – The financial or non-financial indicators used to measure the progress or success of the private party during the operating term on critical factors relevant to the project, and which will normally vary depending on the contracted services and other attributes of the project. KPIs are often included in the contractual arrangement because they may serve as the basis for certain payments to the private party.

Lease - see Concession.

Life-cycle Cost - the total cost from a project's inception to the end of its useful life. One potential advantage of P3s is optimizing life-cycle costs, either by building to a higher standard at the beginning of a project, minimizing operations and maintenance expenditures over time, or enhancing operations and maintenance such that rehabilitation is not required as often.

Loan Agreement – an agreement between the Public Sector Partner and lender banks. The Loan Agreement governs the relationship between the lenders and the Public Sector borrower. It determines the basis on which the loan can be drawn and repaid.

Long Stop Date – A date set by the procuring authority by which services must commence regardless of what events or claims occur during the construction phase. Non-commencement of services by this date would lead to termination of contract.

Management Contract – A contract wherein the long-term maintenance of the infrastructure is the only core objective which is transferred to the private sector.

Monetization - A Brownfield concession in which the Public Sector receives an up-front payment from the private sector for the right to future revenues from an existing facility. In essence, the Public Sector is "monetizing" (i.e., turning into cash) the asset it owns.

Off-take Agreement – used in utility project P3s, is an agreement such as a "take or pay contract" between the project company and the "off-taker" (the party who is buying the product, service the Project produces or delivers). This agreement provides the Private Sector Partner revenue to pay its Project debt obligation, cover the operating costs and provide certain required return to investors.

Operation and Maintenance Agreement – can either be an agreement between the Private Sector Partner and a third party operator or between the Public Sector and the Private Partner for the operation, maintenance and often performance management of the Project.

Operations or Operating Phase – The period from the end of commissioning to the end of the term of the PPP contract, during which the private partner is responsible for the maintenance, and in many cases the operation, of the infrastructure. It is also named the maintenance phase where there are no operations involved. It is also sometimes known as the Operational Phase.

Performance Measure - outcome-based metrics used to specify standards in a P3 agreement. These measures are used throughout all phases of a project and enable the Public Sector to determine specifications that the private sector must meet in order to be in compliance with the terms of the contract. Failure to perform to these standards may result in a compensation event, whereby the private sector party is penalized a sum of money or receives "cancellation points" that may ultimately lead to loss of the concession.

PPP Contract – A long-term contract between a public party and a private party for the development and/or management of a public asset or service, in which the private agent bears significant risk and management responsibility throughout the life of the contract. Remuneration is significantly linked to performance, and/or the demand or use of the asset or service.

Project Bond – A tradable debt investment in which an investor loans money to the private partner for a defined period of time at a variable or fixed interest rate for the development of a project. Project bond financing is a common option for countries with developed and deep capital markets, but it is usually applied as a re-financing solution and not as a financing mechanism for construction. It provides access to wider resources for long-term finance, usually enjoying longer debt terms, but is a less flexible financial solution (as funds may not be usually drawn down progressively). Further, varying the terms during the life of the PPP is more difficult.

Revenue - money generated from the operation of a facility, usually in the form of tolls.

Revenue Maker Project – A revenue maker is a project that generates its own revenues and provides sufficient revenue to make the project financially feasible without public funding. Another equivalent term is "self-financeable project."

Revenue Risk - the risk that a particular source of revenue will not provide the anticipated funds required to repay debt or project costs or deliver expected returns.

Risk - an uncertain event or condition that, if it occurs, has a positive or negative effect on a P3 Project's objectives.

Risk Allocation - the process of allocating risk between the public and private parties within a P3 contract. The principle is generally to allocate the majority of the risk to the party best able to manage that particular risk. For example, a concessionaire should usually bear the risk of operations and maintenance cost increases, because the company is most likely to be able to control these increases.

Risk Premium-an additional required rate of return that must be paid to investors who invest in risky investments to compensate for the risk.

Senior Debt-debt obligations that have a priority claim on the source of payment for debt service.

Shadow Toll - under this P3 financing arrangement, the sponsoring Public Sector agrees to make payments to the private operator based on use of a facility, which gives the private sector an incentive to maximize volume; thus, shadow tolls are not paid by facility users. Shadow tolls are similar to availability payments, except that shadow tolls depend on traffic volume (see availability payments).

Shareholders Agreement - is an agreement between the project sponsors to form a special purpose vehicle in relation to the Project.

Special Purpose Vehicle – An entity created to undertake a single task or project in order to protect the shareholders with limited liability, often used for limited or non-recourse financing. In establishing a project consortium, the sponsor or sponsors typically establish a private partner in the form of a special purpose vehicle (SPV) which contracts with the government. The SPV is an entity created to act as the legal manifestation of a project consortium with no historical financial or operating record with the government can assess. An SPV/special purpose entity (SPE) is a legal entity with no activity other than those connected with the project. It also includes "private partner" or "project company."

Social Infrastructure – Infrastructure that accommodates social services: hospitals, schools and universities, prisons, housing, courts, and so on.

Step-in – The government's or the lender's option to assume the contractual responsibilities of a project party through managing their contract in cases when that party is not meeting its obligations under such a contract.

Subordinate Debt - See "Junior Debt".

Technical Requirements – The technical details about the project which allow a precise definition of the design of the infrastructure and the characteristics of the service to be implemented, and which address how performance and service delivery will be effected. Clearly defined technical requirements are essential for the assessment and allocation of costs for the commercial feasibility analysis of the project.

Term Sheet - agreement between the Private Sector borrower and the lender bank for the cost, provision and repayment of debt. The term sheet outlines the key terms and conditions of the financing. The term sheet provides the basis for the lead arrangers to complete the credit approval to underwrite the debt.

Transportation Infrastructure Finance and Innovation Act ("*TIFIA*") - This program provides Federal credit assistance in the form of direct loans, loan guarantees, or standby lines of credit to public or private sponsors of major surface transportation projects, including P3s. The program's goal is to leverage Federal funds by attracting substantial private and other non-Federal co-investment in transportation infrastructure.

Unsolicited Proposal - a proposal by the private sector that does not come as a result of a Public Sector solicitation. Unsolicited proposals may often result from the identification by the private sector of an infrastructure need and opportunity that may be met by a privately financed project. Such projects may also involve innovative proposals for infrastructure management and offer the potential for transfer of new technologies.

Upfront payments or concession fee – A payment sharing mechanism wherein the public authority is to be paid upfront by the private partner in case the project shows revenue potential in excess of that required for commercial feasibility.

Value for Money - the estimated project cost savings associated with using a P3 delivery approach, accounting for all project factors throughout the full life cycle of the asset and length of the contract.

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023
October 18-20, 2023

REFUNDING & REISSUANCE

Chair:

Will Milford — Bryant Miller Olive P.A. – Jacksonville, FL

Panelists:

Johnny Hutchinson: Nixon Peabody LLP – New York
Katrina Desmond: Miller Canfield, PLC – Detroit
John Stanley: Orrick, Herrington & Sutcliffe LLP – San Francisco

I. Tenders and Exchanges

(1) Overview/Mechanics/Definitions

a. **Tender (with proceeds of new bonds)**[1]

i. Issuer issues new bonds to new holders in exchange for bond proceeds received from new holders. Issuer pays those bond proceeds to the holders of the issuer's old bonds. These old holders agree to hand in their old bonds even though in most tender transactions the issuer cannot require them to hand in their bonds (in other words, the bonds aren't yet callable).[2]

ii. Lots of interesting non-tax mechanical questions:

1. How do you sync up the tender with the sale of the bonds?
2. Will the issuer make an offer to purchase the bonds, or will it make invitations to the existing holders to make offers to sell to the issuer (which may allow offers only at prices selected beforehand by the issuer and described in the tender invitation)?
3. How will the price be determined?
    a. Single price for all bonds?

[1] The issuer also can use its own cash (rather than proceeds of newly issued bonds) to buy in the old bonds from the holders of the old bonds. This is the Refunding and Reissuance panel, so we're not going to talk about that scenario. It will suffice to say that it is much more boring than real tenders and exchanges (maybe some yield restriction fun if there's a brief escrow period (because the cash used for the tender will become replacement proceeds of the prior issue) but usually the issuer uses the cash to purchase and cancel the prior bonds on the tender date).

[2] *Not* the same as "tender bonds" as discussed in, e.g., Notice 2008-41. In fact, the two things will never overlap.

b. Different prices for different maturities?

c. Price as a spread to an index (per bond or per maturity)?

d. Invitation to holders to make an offer regarding price, or an auction process, etc. (and whether holders can make an offer about the spread (including offering no spread), or whether the issuer will automatically reject any offer that doesn't conform to the price that the issuer invites the holder to offer)?

b. **Exchange –** Similar to a tender, except that the issuer issues the new bonds (which we can call the "Exchange Bonds") directly to old holders in exchange for old bonds.

c. The tender/exchange process is usually run by a **Dealer-Manager**. This same party often will be the underwriter for the new bonds. There may also be an **Information Agent** or a **Settlement Agent** who will assist the Dealer-Manager in all the logistics involved with the tender/exchange (negotiating with existing holders, communicating details about the tender, herding cats, etc.)

d. **Conduit bonds**

i. In general, it will be easier in conduit bond situations for the conduit borrower to deal with the exchange feature. Note that, for the bonds to be cancelled/redeemed, the conduit borrower will need to transfer them to the bond trustee or the issuer for cancellation; the mere purchase in the open market by the conduit borrower doesn't result in cancellation.

ii. For the rest of this outline, when we say "issuer" we mean "conduit borrower" in cases where there's a conduit borrower.

(2) Tender vs. Exchange vs. current refunding:

Question	**Tender**	**Exchange**	**Traditional Current Refunding**
Issue Price of New Bonds	1.148-1(f)	1271-1275	1.148-1(f)
Type of consideration paid to old bondholders	Money from new bond sale (see footnote 1)	New bonds	Money from new bond sale
Amount of consideration paid to old bondholders	Negotiated price in the secondary market (usually at a premium above the market value of the bonds, to entice)	Specified par value of bonds based on an "exchange factor" derived from market conditions, etc.	Enough money to pay principal, accrued interest, and (in rare

			cases), redemption premium.[3]
Escrow period?	No.	No.	Up to 90 days.
Can it count as a remedial action?	Yes.	Yes.	Yes.
How many old bonds are involved?	Uncertain - Don't know until the Tender Period ends.	Uncertain - Don't know until the Exchange Period ends.	Certain - Issuer decides.
Disclosure Documents	Tender Offer and other docs for old bonds; POS/OS for new bonds	Exchange Offer and other docs for old bonds; POS/OS for new bonds	POS/OS for new bonds

(3) Why do a tender or an exchange? (Or, "if it's just a current refunding, why are you doing a panel on it?")

a. **You get the economics of calling bonds that can't be called[4] and can't be advance refunded.**

b. **You can use them to force changes to bond documents that otherwise require bondholder consent.** This can also be done to incentivize existing bondholders to tender their bonds; it is permissible under the securities laws to force changes to the bond documents on bondholders who don't tender. Or, the new bondholders might be willing to offer more favorable terms to the bonds or allow new derivatives, etc.

c. **Historical reasons:**

   i. The tender approach might be cheaper than an actual advance refunding (because of negative arbitrage, for example); less applicable now that most bonds can't be advance refunded with tax-exempt bonds.

   ii. Before the IRS amended the remedial action rules in 1997 to allow issuers to remediate nonqualified bonds by defeasing them to their first call date, many issuers used tenders to remediate noncallable bonds.

d. Whatever the reason, issuers are doing more of these.

   i. "The municipal tender offer trend took hold in 2020 and volume rose above $4 billion in both 2021 and 2022… About $14.1 billion has been tendered

[3] The provisions in the bond documents allowing the issuer to call in the bonds and redeem them will set forth the price the issuer has to pay to do that.

[4] Though there's technically nothing stopping an issuer from doing a tender for callable bonds.

or invited to tender so far this year… Of that, $9.3 billion was taxable and $4.8 billion was tax-exempt."[5]

ii. City of Harvey, Illinois was one recent high-profile case of using an exchange to take out existing holders of its defaulted bonds.[6] The extension of the maturity date of the defaulted bonds and enhanced security features relative to the defaulted bonds resulted in almost 95% participation in the exchange.[7]

(4) Issue Price – in General[8]

a. Tender – easy. Issue price of the new bonds is governed by 1.148-1(f).

b. Exchange – not easy – see below.

(5) **Exchanges**

a. **In general.** When Exchange Bonds are issued in exchange for old bonds (as opposed to cash) and constitute "new debt," and neither the old bonds nor the Exchange Bonds are "publicly traded," then:

i. If the Exchange Bonds bear "adequate stated interest," issue price = stated principal amount.

ii. If the Exchange Bonds do not bear "adequate stated interest," issue price = imputed principal amount.

b. **Mind-bending initial aside: Are the Exchange Bonds . . . actually new bonds?**

i. **First Principles:**

1. Exchanging old debt for new debt requires an analysis similar to a reissuance analysis.

2. We usually read 1.1001-3 and about the Supreme Court's decision in *Cottage Savings* as saying that you have "new debt" for tax purposes if you materially modify existing debt (even if you don't give the holder a new piece of paper that says "new debt" at the top).

3. Remember the "other side" of 1.1001-3 and *Cottage Savings*, though: ***Giving an existing holder of debt a new piece of paper that says "new debt" is neither necessary nor sufficient to create "new debt" for tax purposes***

[5] Jessica Lerner, "With Tax-Exempt Advance Refundings Gone, Tenders Step Up," *The Bond Buyer* (July 28, 2023).

[6] Yvette Shields, "Harvey, Illinois, aiming to launch exchange on defaulted bonds next month," *The Bond Buyer* (May 17, 2023). ("The proposed exchange – which extends the final maturity date by two decades but offers features like a tax levy with a direct intercept and trust estate – is the cornerstone of the consent agreement the city struck with a group of 2007 bondholders.")

[7] Caitlin Devitt, "Harvey, Illinois finally seals deal ending litigation over bond default," The Bond Buyer (Aug. 29, 2023).

[8] Resources – BNA Portfolio T.M. 535; Federal Income Taxation of Debt Instruments by David Garlock (available on CCH and Lexis), in particular, § 203.

4. Thus, the Exchange Bonds need to be treated as materially different from the old bonds for them to be treated as new debt for tax purposes.
    a. A change in yield by more than 25 basis points would be the easiest way.
    b. In addition, under the general "facts and circumstances" rule under 1.1001-3(e)(1), even if the yield of the new bonds happens to be within 25 basis points of the Exchange Bonds, we still conclude that the volume of activity related to the exchange (the offering documents, a new indenture or bond documents, etc.) in many cases likely leads to the result that the new debt differs materially from the old debt.[9]

c. **Issue Price of Exchange Bonds – A Magical Journey Through Sections 1273 and 1274 of the Internal Revenue Code**

i. **Background**

1. The definition of "issue" – key point:

<u>When you see the word "issue" in 1273 and 1274, think "maturity" or "CUSIP"</u>

a. The word "issue" in 1273 and 1274 refers to bonds that have "the same credit and payment terms."
    i. The credit and payment terms of a bond are the coupon, the maturity date, the call date, and possibly other features.
    ii. In our world, we can think of publicly offered bonds as having the "same credit and payment terms" if they share a CUSIP (and this is how the bankers will talk about things when you do a tender/exchange).
    iii. In some cases in a combined tender/exchange, it may make sense to structure the bonds so that they have different features to avoid having them become part of a single "issue" under 1273 and 1274, but you have to weigh this against the difficulties in marketing that can arise when trying to do this.

b. **In this outline, we will use the term "Maturity" to refer to "bonds with the same credit and payment terms" (i.e., a "CUSIP").**

2. The issue price of the Exchange Bonds may depend in some cases on some of the attributes of the old bonds.

[9] If you were trying to avoid a reissuance, you would not want to argue that all that stuff is going on, but it's nevertheless not a reissuance.

3. Remember that the general rule in 1.148-1(f)(1) is that issue price (for arbitrage purposes) *for all bonds* is determined under 1273 and 1274. The other provisions of 1.148-1(f) are a special set of rules that overrides 1273 and 1274, *only in the case of bonds issued for money*.
4. In addition, 1.148-1(f)(4) provides three special rules:
    a. The issue price for each group of bonds with the same credit and payment terms (i.e., a Maturity) is determined separately. (Confirms the approach reflected in the definition of "issue" in 1273 and 1274.)
    b. 'Substantial amount" in 1273 and 1274 means 10%.
    c. Where the applicable federal rate ("AFR") is relevant in determining the issue price for arbitrage purposes (see below), use the adjusted AFR instead of the AFR. AFR is relevant (see below), use the AAFR instead of the AFR.[10]
5. Remember, as always, this goes Maturity by Maturity – same way we do it in a typical bonds-for-cash deal.
6. **Publicly Traded Property.**
    a. A big turning point in the analysis is whether the old bonds and/or the Exchange Bonds are "publicly traded." [11]
    b. **In general, your life will be much easier if both the old bonds and the Exchange Bonds <u>are not</u> considered publicly traded property.** [12]
    c. Thankfully, this will almost always be true because of the Small[13] Maturity[14] Exception:
        i. If a Maturity has a principal amount of $100,000,000 or less and the amount of old bonds being exchanged has a principal amount that is $100,000,000 or less, then the Small Maturity Exception applies and the old bonds and the Exchange Bonds are not treated as publicly traded.[15]

[10] 1.148-1(f)(4)(iii)

[11] See Garlock treatise, ¶ 203.04 ("The issue price can be dramatically different depending on whether there is public trading (in which case section 1273(b)(3) applies) or not (in which case section 1274 or section 1273(b)(4) generally applies)."). The 1273 and 1274 rules use the phrase "traded on an established securities market" to refer to property that is publicly traded.

[12] As further discussed below, this is because most tax-exempt bonds will bear "adequate stated interest," which means that their issue price will equal their stated redemption price at maturity.

[13] [sic]

[14] You will see it described in the authorities as the "small issue" exception, but, as we know, "issue" means "Maturity."

[15] 1.1273-2(f)(6).

ii. **Analysis**[16]

1. **Step 1:** Will there be any Exchange Bonds that are part of a single Maturity with bonds issued for money?
   a. If not, continue.
   b. If yes, will those bonds have a price that crosses the 10% threshold?[17]
      i. If yes, then the issue price of all bonds of that Maturity, *even the Exchange Bonds*, is that first price to cross the 10% threshold.
      ii. If not, continue.
2. **Step 2:** For any Maturity of the Exchange Bonds where the principal amount of **both the old bonds and the Exchange Bonds will be $100 million or less**:
   a. That Maturity meets the Small Maturity Exception. Thus, by definition, it is not publicly traded.[18]
   b. The issue price of that Maturity then depends on whether it bears "adequate stated interest."[19]
      i. If that Maturity does bear adequate stated interest, then its issue price is its stated redemption price at maturity (i.e., its par amount).
      ii. If that Maturity does not bear adequate stated interest, then its issue price is its "imputed principal amount."[20]
   c. What is adequate stated interest?

[16] See the PowerPoint slides for the transaction for a flowchart.

[17] In other words, is there a single price at which 10% of the Maturity is sold? If so, the first price that meets this criterion is the issue price of that Maturity.

[18] 1.1273-2(d)(6).

[19] Tracing through the statute and the regs on whether a Maturity bears adequate stated interest can leave one fairly hopelessly confused. Code Section 1274 is drafted in a circular, confusing fashion. This portion of the outline is intended to provide a path through the mental jungle. At the risk of damning this panel with faint praise, it may be easier to read this outline than the statute and the regs themselves. See Garlock, ¶303 ("A curious and somewhat confusing aspect of the way the statute is drafted is that a debt instrument given in exchange for nonpublicly traded property that has adequate stated interest and all of whose interest payments are qualified stated interest is not technically a debt instrument to which section 1274 applies. Under section 1274(c)(1) and Reg. §1.1274-1(b)(1), section 1274 would not apply to such an instrument because its stated redemption price at maturity would equal its stated principal amount. The issue price of the instrument would be determined under section 1273(b)(4) and would be equal to its stated principal amount. Nevertheless, it is common parlance to say that a debt instrument is "subject to" section 1274 if it is not publicly traded and is issued for nonpublicly traded property, even if it has adequate qualified stated interest. A more accurate formulation would be that the instrument is of the type that must be tested for adequate stated interest under section 1274."). This section of the Garlock treatise has Excel files that assist with the computations.

[20] Defined in 1274.

i. Single fixed rate of interest that is paid or compounded at least annually, and

ii. Equal to or greater than the "**test rate**,[21] which is the "**3-month rate**."[22]

d. The **3-month rate** equals **the lower of**:

i. The lowest adjusted[23] AFR (based on the appropriate period and the same compounding interval as interest on the bonds) in effect during the 3-month period ending with the first month in which the BPA is signed;[24] or

ii. The lowest adjusted[25] applicable Federal rate (based on the appropriate period and the same compounding interval as interest on the bonds) in effect during the 3-month period ending with the month in which the Exchange Bonds are issued.[26]

e. The appropriate period for the AAFR depends on the term of the Maturity:

i. **For a Maturity with a term of not more than three years –** use the federal short-term rate.

ii. **For a Maturity with a term more than three years but not more than nine years)** – use the federal mid-term rate.

iii. **For a Maturity with a term of more than nine years** – use the federal long-term rate.

f. The "adjustments" to the AFR are done by the Secretary of the Treasury,[27] and then published in the Internal Revenue Bulletin (see link below) - Table 2 (generally) of the

[21] 1.1274-2(c)(1).

[22] The "test rate" is governed by 1.1274-4(a)(1)(i). Certain exceptions to the rule noted above apply, but they should not typically apply to tax-exempt bonds.

[23] See 1.148-1(f)(4)(iii) ("Bonds issued for property. If a bond is issued for property, the adjusted applicable Federal rate, as determined under section 1288 and § 1.1288–1, is used in lieu of the applicable Federal rate to determine the bond's issue price under section 1274.").

[24] The regulations say "ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated," which will be the BPA date in most cases. 1.1274-4(a)(1)(ii)(A).

[25] *Id.*

[26] 1.1274-4(a)(1)(i).

[27] 1.1288-1(a).

applicable publication [at this link](https://apps.irs.gov/app/picklist/list/federalRates.html), which is https://apps.irs.gov/app/picklist/list/federalRates.html.[28]

g. As noted above, if, after applying the above tests, a Maturity does not bear adequate stated interest, then its issue price is its imputed principal amount. What is an issue's imputed principal amount?

    i. A Maturity's imputed principal amount is the sum of present values of all payments due under that Maturity, determined by using the **test rate** (defined above) of interest as the discount rate, discounting the payments back to the issue date of the Exchange Bonds.

    ii. If the issuer has a call right with respect to the Exchange Bonds (and it will in most cases), then these rules presume the issuer to exercise its right to call the bonds in a way that *minimizes* the instrument's imputed principal amount.[29] If this rule applies to bonds that are callable less than nine years from issuance, then note that the rule could result in the mid-term AAFR being applicable as opposed to the long-term AAFR.

3. **Step 3:** For any Maturity of the Exchange Bonds where the principal amount of either the Exchange Bonds or the old bonds will be >$100 million, the Exchange Bonds *could be publicly traded:*

    a. Are the bonds actually publicly traded?

        i. In other words, in the 31-day period ending 15 days after the issue date (the "Measurement Period"), is there a "Sales Prices," a "Firm Quote," or an "Indicative Quote"?

        ii. If the bonds are actually publicly traded, then the issue price of that Maturity of the Exchange Bonds is FMV.

        iii. FMV is demonstrated by the presence of Sales Prices, Firm Quotes, or Indicative Quotes during a "Measurement Period," which is the 31-day period ending 15 days after the issuance date. All three are equally legitimate under the regulations, though most

[28] These are the adjusted rates; in other words, you don't have to apply the adjustments described in Reg. 1.1288-1(b); the IRS does the work for you. You just look up the rates.

[29] 1.1274-2(d).

counsel prefer them in the order listed above (i.e. a Sales Price is the best evidence, etc.).

b. Note - this is a very mechanical test that is weighted very heavily in favor of a finding of public trading. The fact that there has not been significant trading "recently" is not enough to conclude that the debt isn't publicly traded.

c. Sales Prices: Look at the sale activity of the old bonds.

    i. Where to find it? Probably EMMA?

        1. MSRB rules require that registered broker-dealers report all trades of municipal securities to EMMA.

        2. Could also be Bloomberg or ICE?

    ii. Could be done via "weighted average sale price" – look for "customer trades" as labeled on EMMA.

    iii. Banker/settlement agent will probably want a carve-out similar to the following:

        1. "For purposes of calculating Sales Price, the Settlement Agents have not considered, inquired or investigated the identity of the counterparties to the transaction, and any Sales Price for the principal amount of a Maturity that exceeds $5,000,000 will be reported as equal to $5,000,000 until the full traded par amount has been "unmasked" after 5 business days."

d. Firm Quotes:

    i. Note that the term "Firm Quote" in the investment banking context generally means that the party providing the quote has to have cash to support the position (for a quote to buy a bond) or own the bond in question (for a quote to sell a bond).

    ii. The legal definition of firm quote for issue price purposes does not appear to require this.

e. Indicative Quotes – a price quote that is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the price quote is not a firm quote.

f. Sample language for Firm/Indicative Quotes:

    i. "Attached as Exhibit B is a report setting forth Firm Quotes or Indicative Quotes, which are provided as

of the end of the day noted on Exhibit B and represent the price observed by [the Settlement Agent] to be a fair reflection of the price of the Maturity in question at that time for each Maturity of the Bonds (each a "Price Quote Bond Value") and in each case the date (or dates) for which the Firm Quotes and Indicative Quotes were obtained. Specifically, at approximately 4:00 pm eastern time each day during the Measurement Period, [Settlement Agent] will provide an Indicative Quote reflecting the fair value of the price of each Maturity. To the extent a Firm Quote exists at the time, [Settlement Agent] will also provide such Firm Quote. To the best of the knowledge and belief of the undersigned, based on information available to the undersigned and taking into account legal restrictions on the availability of such information, there are no other Firm Quotes or Indicative Quotes for the Maturity of the Bonds listed on Exhibit B."

ii. Sample language above is intended to address a situation in which the Settlement Agent may not have access to the firm quote for data control or regulatory reasons. (For example, Bank A may be providing a quote for a position, but the Settlement Agent potentially isn't even legally allowed to *look* for it, much less see it.)

(6) **Disclosure**

a. Tax disclosure may be provided in the Tender or Exchange Offer with respect to the old bonds and in the POS/OS with respect to the new bonds.

b. For the substance of the required tax disclosure, see previous section on issue price. Most of the disclosure is about issue price.

c. It may be important (perhaps more important than in a garden-variety refunding) to disclose that no one is opining on the ongoing tax-exempt status of the refunded bonds.

d. Much of the disclosure will depend on the status of the tender/exchange under the securities laws and the specific facts of the transaction (for example, whether the tender offer is a true "offer" to holders or whether it's an invitation for bondholders to make offers, whether the tender offer is revocable, the sources of funds for the tender, etc.). Talk to your favorite[30] securities lawyer.

(7) **Other Miscellaneous Points**

[30] Or, perhaps your *least favorite* one, given the subject matter.

a. **Combining a Tender/Exchange with Traditional Bonds**

   i. **Uncertainty about the Size of the Issue until Pricing.**

      1. As noted above, the tender/exchange carries some uncertainty about the size of the tender/exchange portion, which will affect the size of the issue as a whole. You won't know how big the tender/exchange portion is until the tender period closes.

      2. You may need to build in some cushion and try to get some guideposts about the likely minimum or maximum size of the tender/exchange portion. This can be important for several purposes:

         a. Amount of proceeds

            i. Not really an overissuance concern (because, by definition, you'll have a use for all of the proceeds required to do the tender or deemed to have arisen as a result of the exchange)

            ii. But, COI limit, amount of volume cap required, and other limits that depend on the amount of proceeds will be affected.

         b. Useful life - if you're calculating useful life on a combined basis, how much of an anchor will the refunding/tender/exchange portion be on the useful life of your new money portion?

         c. Multipurpose issue allocation – will the mix and debt service profile of the tendered bonds affect your savings analysis? Might you be forced into a pro rata allocation when you don't want to do that or can't do that?

   ii. **Uncertainty About Which Bond Issues will be part of Your Issue**

      1. Many times the Dealer-Manager will identify several different prior issues as targets for the tender/exchange, with the final mix dependent on the market.

      2. Best practice is to conduct tax diligence on all candidates, but work closely with Dealer-Manager to determine which candidates are realistic to avoid unnecessary fees/work.

b. **What about additional amounts paid to entice bondholders to tender their bonds?** These amounts should be treated as part of the "redemption price" and thus proceeds of a tax-exempt bond issue used for this purpose would be treated as a refunding. [31]

[31] 1.150-1(d)(1) ("Refunding issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue.").

c. **Are fees for the Dealer-Manager/Information Agent COI?**

   i. Could they be treated as "costs of the refunding" rather than costs of issuance?

If you reach this conclusion, and the Dealer-Manager and/or Information Agent are also underwriting the bonds, you'll need to allocate the fee between COI and these non-COI fees.

II. Forgotten Refunding Considerations in a Positive Arbitrage Environment

I. Current Refunding Escrows

A. Yield Restriction: 90-Day Temporary Period: Treas. Reg. § 1.148-9(d)(2)(ii)

The Treasury Regulations provide a temporary period for current refunding issues. Generally, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days. However, if a current refunding issue has a maturity of 270 days or less, this temporary period is reduced to 30 days. Therefore, in the normal case, tax-exempt bond proceeds may be invested in a current refunding escrow without regard to yield restriction. The earnings in the escrow fund, however, are considered investment proceeds of the Bonds and should be accounted for in the sizing of the escrow fund or otherwise allocated to eligible tax-exempt expenditures.

B. Rebate: Six Month Spending Exception: Treas. Reg. § 1.148-7(b)

In general, the only spending exception applicable to refunding issues is the 6-month exception; although, application of the 6-month spending exception is not mandatory. Additionally, proceeds of the prior issue that become transferred proceeds of the refunding issue (as described in detail below) generally are not treated as proceeds of the refunding issue and need not be spent for the refunding issue to satisfy that spending exception. Therefore, the proceeds of the refunding issue may qualify for the spending exception, even if the unspent proceeds of the prior issue do not. There are certain exceptions to this rule, particularly as it relates to bona fide debt service fund and reasonably required reserve fund monies, as set forth in Treas. Reg. §1.148-7(b)(ii)(B) and Treas. Reg. §1.148-7(c)(3).

C. Temporary Periods for Contributions to the Escrow Fund from Prior Bona Fide Debt Service Funds and Prior Reserve Funds

When determining the sizing of a refunding bond issue, it is often necessary to contribute to the escrow fund (i) any monies set aside to pay debt service on the refunded bonds, and (ii) any monies held in a reasonably required reserve that are no longer needed to secure the refunding bond issue, to ensure that the refunding bond issue is correctly sized. The question becomes whether the foregoing amounts maintain their respective temporary periods, or whether they should be treated as replacement proceeds of the prior bonds and yield restricted to the prior bond yield. With respect to bona fide debt service monies, as long as the prior bond fund was properly sized to meet the 13-month rule for a bona fide debt service fund, the money should retain its temporary period set forth in Treas. Reg. §1.148-2(e).

With respect to prior reserve fund amounts deposited to the escrow fund for a current refunding issue, the Treasury Regulations do not explicitly address whether such amounts retain their temporary period as amounts held in "reasonably required reserve fund". Additionally, when considering the question, it might also be relevant whether the reserve fund is funded with equity or sale and investment proceeds of a prior issue. While it is not clear from the Treasury Regulations, arguably, amounts held in a prior reserve fund, which are contributed to an escrow fund to refund the prior issue, are still being used for their intended purpose – to secure repayment of the prior bond issue – and should not lose their temporary period. Regardless, if the escrow period is less than 30 days, then the amounts will still have a 30-day temporary period for replacement proceeds as described in Treas. Reg. §1.148-2(e)(5).

D. Temporary Period for Transferred Proceeds in Current Refundings: Treas. Reg. § 1.148-9(d)(2)(iii)

In the context of a current refunding, the Treasury Regulations provide that each available temporary period for transferred proceeds of a refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue. Therefore, the regulations allow for the original temporary period to continue to apply. For example, if new money bonds were issued in 2021, the Bond proceeds would qualify for an initial 3-year temporary period through 2024. If the new money bonds are then refunded in 2023, any unspent proceeds of the new money bonds would become transferred proceeds of the refunding issue and maintain the original temporary period through 2024.

In determining the date that amounts become transferred proceeds of a refunding issue, Treas. Reg. §1.148-9(b)(1) provides that proceeds of a prior issue become transferred proceeds of the refunding issue as of the date the refunding issue discharges any of the outstanding principal amount of the refunding issue. In practice, for current refundings, the "transfer date" is typically the same date for all of the proceeds of the prior issue. At this time, if there is no applicable temporary period for the proceeds of the prior issue, such amounts become restricted to the yield of the refunding bond issue. In a typical high-to-low refunding, this often means that any transferred proceeds are restricted to a lower investment yield.

II. Defeasance of Tax-Exempt Bond Issues

A. Defeasance with Taxable Obligations

In recent years, as advance refundings are no longer available, taxable advance refundings of tax-exempt obligations have become more common. Unlike a cash defeasance, the amounts held in the defeasance escrow are proceeds of the taxable obligation, unless the investments de-allocate under universal cap, as set forth in Treas. Reg. §1.148-6(b)(2). If the investments in the defeasance escrow de-allocate from the taxable obligation and become replacement proceeds of the tax-exempt bonds, the yield on such investments will then be restricted to the yield on the tax-

exempt bonds. Pursuant to Treas. Reg. §1.148-5(d)(3)(i), such investments are valued at fair market value at the time of transfer.

B. Cash Defeasance

Often times, an issuer will seek to defease tax-exempt obligations with funds on hand. This may be done for a variety of reasons, including release of bond covenants or as necessary to remediate bonds for private activity as required in Treas. Reg. §1.141-12. If an issuer sets aside funds in a defeasance escrow or otherwise restricts funds for the purpose of paying debt service on an outstanding bond issue, those amounts become replacement proceeds subject to yield restriction at the yield of the defeased issue.

C. Cash Optimization (Cash Defeasance + New Money Bonds)

Cash defeasance transactions are sometimes proposed in connection with an issue of New Money Bonds. Occasionally these are even presented to the Issuer with schedules showing the "refunding savings" achieved by the issuance of the New Money Bonds. Bond Counsel should take care to avoid a nexus between the two transactions that might result in the creation of yield-restricted replacement proceeds. Factors which may be considered in avoiding such a nexus include the timing of the transactions (the cash defeasance should occur prior to the issuance of the new money bonds), separate pricing, and the ability of the New Money Bonds to have been issued independently of the defeasance.

Bond Counsel should take particular care to avoid a "reimbursement refunding" in which New Money Bonds are issued to reimburse the issuer for prior expenditures, which are then deposited into an Escrow Fund to defease a prior issue. Section 1.150-2(h) of the Regulations provides an "anti-abuse" rule, under which a reimbursement allocation is invalid and not an expenditure of proceeds if, within one year after the allocation, funds corresponding to that amount are used in a manner that creates replacement proceeds of the issue or another issuer.

III. Rebate Computations on Refunded Bonds

A. Final Rebate Computation: Code §148(f)(2)

If a bond issue is fully redeemed, then a final rebate computation should be completed, and if the issuer owes, it must make a payment within 60 days of the redemption date. If an issuer is considering contributing unspent proceeds of a prior bond issue, such as prior debt service fund or reserve fund monies, to a refunding escrow, it may want to hold back a portion of such proceeds to make a final rebate payment (see discussion below).

B. Other Rebate Exceptions for Current Refundings

Other than the six-month spending exception, an issuer may also consider the small issuer exception to rebate for current refundings (Code §148(f)(D)), particularly if proceeds borrowed for costs of issuance are not spent within the six-month period to qualify for the spending

exception. Additionally, the step-in-the-shoes rule in Code §148(f)(D)(iii) provides that certain current refunding issues are not taken into account in determining whether an issuer meets the small issuer exception in a particular calendar year. This rule would be helpful if, for example, the issuer issues $5,000,000 of new money bonds and current refunding bonds in the same calendar year. This rule essentially allows the issuer to "ignore" the current refunding bonds in counting up to $5,000,000, as long as the amount of the refunding bonds does not exceed the amount of the refunded bonds.

C. Other Considerations

1. Best Practices? Use of a Rebate Fund in the Indenture waterfall? Provisional rebate computations (which are often required for financial accounting purposes)?

2. Funds used to make a rebate payment. Is it possible to use sale proceeds of a refunding issue to make a rebate payment on the prior bonds? Treas. Reg. §1.148-6 allows rebate to be paid from proceeds of the prior issue. Would this allow transferred proceeds to be used to pay rebate on the refunding issue, as well? Could this be extended to sale proceeds of the refunding issue? It is possible that using sale proceeds of a refunding issue to pay rebate on a prior issue is similar to paying accrued interest or call premium on the prior issue, or is more like a capital expenditure that can generally be tax-exempt financed. The considerations on which funds to use for a rebate payment might be different for exempt facility bonds, for example, which have a strict requirement that at least 95% of the bond proceeds be spent on the qualified purpose.

III. Common Reissuance Patterns

Overview of Reissuance Analysis—are changes to a debt instrument significant enough that original debt instrument should be treated as exchanged for new debt instrument?

- General rules applicable to all debt instruments
    - Treas. Reg. Section 1.1001-3
- Certain special rules for tax-exempt bond purposes (Sections 103 and 141-150)
    - Notice 2008-41
    - Notice 88-130 (may still apply to debt obligations at option of issuer)
    - Proposed Treasury Regulations 1.150-3

Before we get technical—what are the practical consequences to reissuance?

- Treated as "refunding" for purposes of Sections 103 and 141-150
    - Tax analysis/documentation for refunding
        - New Tax Certificate with issuer/conduit borrower covenants and representations
        - Diligence use of projects for private use and other compliance
        - New tax opinion

- New Form 8038 / 8038-G
- If WAM extended, new TEFRA
- Consequences for integrated swaps (deemed termination for tax purposes)
- If "refunded" bonds qualified for transition rules, sensitivity to losing those benefits
  - Eg., Non-AMT refunding opportunities in 2009/2010
- Final rebate payment for "refunded" bonds and new rebate analysis going forward

- Why reissuance may be <u>undesirable</u>
  - Time and expense of tax work
  - Need for new opinion and, if applicable, 501(c)(3) opinion
  - Transition rules, as mentioned above
  - Potential rebate payment, and loss of blending

General rules applicable to all debt instruments under Treas. Reg. 1.1001-3—

Two part test—(1) is the debt instrument *modified*, and (2) is such modification *significant*.

If "yes" to both questions, then reissuance *unless* the special tax-exempt bond rules discussed below apply.

- <u>Is there a modification</u>?
  - "Modification" is defined broadly as any change, including any addition or deletion, in a legal right or obligation of the issuer or holder. Treas. Reg. § 1.1001-3(c)(1)(i)
    - Such change may be evidenced by writing, conduct or otherwise.
  - Main <u>exception</u>: certain changes or alterations that occur *by operation of the terms of the debt instrument*. Treas. Reg. § 1.1001-3(c)(1)(ii)
    - Occurs automatically pursuant to the terms of debt instrument—such as a reset of the interest rate based on an index rate.
    - Exercise of *unilateral* option by holder or issuer—
      - For an option to be unilateral for this purpose:
        - No counter-rights to other party to terminate, alter or put
        - No consent required from the other party, a related party to the other party, or a court or arbitrator
        - No consideration required other than de minimis or incidental costs or consideration based on objective formula
  - Certain changes always constitute a "modification," even if they occur by operation of the terms of the debt instrument—

    - Changes in obligor, including addition or deletion of a co-obligor
    - Changes in recourse/non-recourse nature of debt instrument
    - Changes that create non-debt
    - Non-unilateral options
    - Holder options, even if unilateral, that defer or reduce scheduled debt service payments.
- If there is a modification, it occurs at the time the parties agree to the change, even if the change does not go into effect until some later date.

- If there is a modification, is it significant? Treas. Reg. § 1.1001-3(e).
    - Combination of bright-line and catch-all "general economic significance" tests—
        - Bright-line tests
            - Change in yield by more than the greater of—25 basis points or 5% of the yield on the original debt
                - Often the applicable test for tax exempt bonds due to modifications not covered by other bright line tests
                - Difficulty with calculation in many circumstances—what are you comparing and who provides comfort?
            - Changes in timing of payments—if a material deferral of the scheduled payments
                - Safe harbor—a deferral of payments is not material if it does not exceed the lesser of (1) 5 years from the original due date of the first scheduled payment that is deferred, or (2) 50% of the original term of the debt, with payments unconditionally due/payable at end of safe harbor period
            - Change in obligor/security
                - *For purposes of the rules below, the "obligor" on tax-exempt bonds is generally the actual issuer rather than the conduit borrower*
                - Substitution of new obligor on recourse debt instrument is significant modification
                    - But for tax-exempt bonds, not a significant modification if new obligor is a related entity to the original obligor/issuer and collateral continues to include original collateral
                - Not a significant modification to substitute the obligor on a nonrecourse obligation.
                    - For tax-exempt bonds that finance conduit loans, this may apply if both the bonds and conduit loan are treated as nonrecourse
                    - Notice 2008-41 (discussed below) has special rule that a change in credit enhancement for nonrecourse debt instrument is not a significant modification unless causes change in payment expectations
                        - Extremely helpful for routine credit enhancement changes

            - Modification is significant if causes substantial enhancement, or substantial impairment, of the obligor's capacity to meet <u>payment expectations</u>
                - Change in priority of debt
                - Addition/deletion of co-obligor
                - Release, substitution, addition or other alteration of collateral/guarantee for <u>recourse</u> debt
        - Change in the nature of debt
        - Multiple modifications over time are tested cumulatively under bright line tests (e.g., an initial extension of maturity might meet the safe harbor and not be significant, but a subsequent extension would need to be tested in the aggregate with the initial extension).
    - General economic significance
        - Multiple modifications are each tested separately under each bright-line test. If the bright-line tests are not applicable, then the modifications are tested collectively under general economic significance standards
            - E.g., change in yield of less than 25 basis points and a temporary deferral of payments that satisfies safe harbor are not a problem under bright line tests
        - Contingent or deferred modifications tested under general economic significance standard

Special Rules for Tax-Exempt Variable Rate Bonds

- History of Notices and Application to Floating Rate Debt—
    - Treas. Reg. 1.1001-3(a)(2) states that the rules set forth above do not apply for purposes of determining whether tax-exempt bonds that are *qualified tender bonds* are reissued for purposes of Sections 103 and 141-150
        - The authorities below addressing qualified tender bonds are intended to avoid reissuances due to changes in interest rate modes of VRDOs and auction rate bonds
        - Treas. Reg. 1.1001-3(a)(2) was specifically intended to address the fact that VRDOs and auction rate bonds are subject to a bilateral option
        - Notices referenced below appear to be optional—can use one or the other, but must be consistent
- **Notice 88-130**
    - Notice 88-130 states that rules under § 1001 apply to qualified tender bonds for changes to terms other than existence or exercise of *tender rights*—so this can

require coordination among different sets of rules if modifications are being made that are separate from the qualified tender bond guidance

- Qualified Tender Bonds (QTB) defined in Notice 88-130:
  - Final stated maturity 35 years or less (compare to Notice 2008-41, which allows 40 years)
  - Holder may/must tender at par on one or more dates before final maturity
  - Rate is generally set at lowest rate that allows par remarketing (note, no premium remarketing—compare to Notice 2008-41)
- Provides that changes to interest rates that are caused by changes in interest rate modes/tender periods authorized by the terms of the bond ("qualified tender changes") do not cause a reissuance or otherwise require analysis under 1.1001-3
- But, Notice 88-130 contains a "hair trigger" rule—a reissuance occurs when there is a "change" in connection with a change in the period between tender dates that increases from a period of less than 1 year to a period exceeding 1 year, and vice versa
  - In other words, may be a reissuance for QTBs under 88-130 even if not a reissuance under 1.1001-3
- "Change" for purposes of Notice 88-130 is any discretionary alteration in the legal rights or remedies of the holder
  - "Discretionary" unless all elements are entirely outside the control of the issuer, obligor, or holder
  - Accordingly, the following are "changes" for purposes of 88-130
    - Alteration in the period between tender dates (e.g., daily to weekly) that occurs at the option of the issuer
    - Alterations occurring per the terms of the bond ("completion of construction," "upon obtaining a guarantee," etc.)
- Provides that bond treated as retired if acquired by the issuer
  - Compare "issuer" to conduit borrower—other guidance generally provides that a conduit borrower may acquire its conduit bonds without retiring the debt

- **Notice 2008-41**
  - Issued in response to auction rate crisis in 2008
  - Offers more flexibility than Notice 88-130
  - Intended to track the general rules of 1.1001-3, but disregards changes in interest rates if caused by a "qualified interest rate mode change"
    - Qualified interest rate mode change is mode that is *authorized under the terms of the bond on its original issuance*

                • Allows changes between interest rate modes and terms without risk of "hair-trigger" rule in Notice 88-130
                • However, if a rate or mode is not authorized under the original documents, adding it takes you outside this safe harbor and back into 1.1001-3 (in other words, 25 basis point test)
            ▪ Terms of the bond must require par remarketing, except that if bonds are being remarketed in a fixed rate mode out to maturity, they may be remarketed at a premium (compare to Notice 88-130)
                • But, if bond documents do not permit the ability to fix out with premium, then adding the ability to do so would be outside a qualified interest rate mode change, and put you back in 1.1001-3 (in other words, 25 basis points test)

- **Proposed Treasury Regulations 1.150-3 (Dec. 31, 2018)**
    - Proposed regulations to address reissuance rules for tax-exempt bonds, and if finalized, would make Notice 88-130 and Notice 2008-41 obsolete.
    - Section 1.150-3(b)—a tax-exempt bonds is treated as retired when:
        - A significant modification occurs under § 1.1001-3
        - The issuer or its agent (or a related party) acquires the bond in a manner that liquidates or extinguishes the bondholder's investment. A subsequent sale would be a new issuance.
            - Does not apply to a conduit borrower's purchase of bonds
        - The bond is redeemed (such as redeemed at maturity)
    - Section 1.150-3(c)—exceptions:
        - Qualified tender rights are disregarded for purposes of the 1.1001-3 analysis. A qualified tender right is the right or obligation of the holder to tender the bond, and for each such tender, the purchase price must be equal to par. The issuer or its remarketing agent must redeem the bonds or use reasonable best efforts to resell the bonds within a 90 day period, and must resell at par (note difference from allowing premium remarketing in Notice 2008-41)
        - Acquisitions pursuant to a qualified tender right do not result in a retirement provided the bonds are not held for more than 90 days

Acquisitions by a guarantor or liquidity provider pursuant to the terms of the guarantee or liquidity facility do not result in retirement (provided the guarantor is not a related party to the issuer).

IV. Q&A / Discussion

Potential topics:

- LIBOR: Are we finally finished talking about LIBOR?
- Audience questions

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023
October 18-20, 2023

The Role of Issuer's Counsel Before, During and After Bond Issuance

Chair:

Everett B. Martinez Denver International Airport – Denver, Colorado

This panel will explore the role of issuer's counsel with a particular focus on the perspective of the in-house issuer's counsel. How can issuer's counsel help clients set themselves up for success in their transactions? How should issuer's counsel interact with the other legal and financial professionals involved in the bond issue? How does the issuer's counsel make sure that its client is protected as much as possible while achieving the issuer's goals for the financing? What is the role of issuer's counsel after bonds are issued, and how can the issuer's counsel help the issuer achieve post-issuance compliance? How does the role change if issuer's counsel is outside or internal counsel?

I. INTRODUCTIONS

II. WHAT DOES IT MEAN TO BE ISSUER'S COUNSEL?/WHO IS THE ISSUER'S COUNSEL'S CLIENT?

Issue:

What do we mean when we use the term "issuer's counsel'? How is issuer's counsel's role different from bond counsel and other lawyers involved in a bond issue? What are issuer's counsel's distinct responsibilities and how to these change depending on the particular transaction? Who is the issuer's counsel's client? Is the public the client of issuer's counsel?

Comment:

- Issuer's counsel can be in-house or outside counsel.
- An issuer's counsel works with a variety of individual officers and officials of the issuer, including staff and appointed or elected officials.
- Issuer's counsel typically has a more general role that is broader than issuing bonds and does not render the approving opinion on the bonds
- The client of the issuer's counsel is the governmental entity that issues the bonds – *i.e.*, the issuer itself.
- To the extent issuer's counsel identifies an actual or potential conflict between the interests of the individual whom counsel is advising and the interests of the issuer, issuer's counsel should identify the issuer entity as the client.

ABA Model Rule 1.13. Organization as Client.

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher

authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

III. ISSUER’S COUNSEL’S RELATIONSHIP WITH BOND COUNSEL

Issue:

Issuer’s counsel owes certain duties towards its client, including duties of confidentiality, communication, privilege and consent. One arrangement that can impact that duty is the issuer’s counsel’s relationship with bond counsel. What is the appropriate relationship that issuer’s counsel should have with bond counsel? Additionally, who has responsibility for the various tasks in a

bond transaction? How does this change in different types of transaction (e.g. GO vs. conduit issuer)?

Comment:

- *Conflict issue* – Both issuer's counsel and bond counsel should consider whether the issuer (or bond counsel's client, if not the issuer) or another current or former client of counsel needs to waive a conflict of interest before they can undertake the engagement, or there might be a non-waivable conflict. This is especially important where the same entity serves as both bond counsel and issuer's counsel, whether on the same transaction or two different transactions.

ABA Model Rule 1.6. Confidentiality of Information.

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(6) to comply with other law or a court order; or

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

ABA Model Rule 1.7. Conflict of Interest: Current Clients.

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

ABA Model Rule 1.9 Duties to Former Clients

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; unless the former client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

- Role of Bond Counsel –An excellent treatise on the role of bond counsel is NABL's *The Function and Professional Responsibilities of Bond Counsel (Third Edition, 2011)* (https://www.nabl.org/portals/0/documents/nabl_function_and_professional_responsibilities_of_bond_counsel.pdf).
  - It is important for both issuer's counsel and bond counsel to be clear on the scope of their respective roles (if in-house counsel) or engagements (if outside counsel). Clearly defining roles and responsibilities at the outset of a transaction will pave the way for a smooth pricing and closing where there are no (or minimal) surprises as to opinion delivery and coverage.

- Duty of communication – A special note for in-house issuer's counsel: Bond counsel should treat issuer's counsel as a key member of the issuer's team. To the extent there is a duty of communication owed to the client, it is owed to all key members of the issuer's team. It is reasonable to request that bond counsel include you on its communications to finance or other issuer staff and that bond counsel inform you of its material conversations with and advice to issuer personnel.

IV. ISSUER GOVERNING BODY ACTIONS RELATING TO ISSUANCE OF BONDS

Issue:

Most, if not all, actions of a public body need to occur in a public forum. What is an issuer's counsel's responsibility to ensure that a meeting where bond-related matters are being considered for approval is properly held?

Comment:

- Sunshine Laws provide for open and public meetings. Generally, notice and access are key features of such laws.
  - There are consequences under local law for failure to comply with open public meetings laws, including the voiding of any action taken in violation thereof.
  - Counsel should consider ways to remedy violations.
- Local and state environmental laws should also be considered in connection with approval of a bond-related action. In many states, the obligation to consider

environmental consequences of a project attaches when the issuer makes a decision that commits the issuer to a particular project or course of action.

- o Consequences under local law for failure to comply with environmental laws can include voiding of actions without compliance.
- o This can also subject the issuer to protracted litigation that would delay proceeding with a project.

V. ISSUER'S COUNSEL OPINION

Issue:

Issuer's counsel is asked to deliver an opinion at the closing of the bonds. What are appropriate items to pass upon? What should counsel be entitled to assume and what should counsel be entitled to rely upon? Who should draft the opinion?

Comment:

The issuer's counsel opinion (or, in a conduit issue, a combination of issuer's and obligor's counsel's opinions) often covers some or all of the following points (the exact formulations will vary from deal to deal and state to state and whether issuer's counsel is in-house or outside counsel):

- The issuer is a validly existing entity in good standing under the laws of the state.

- The issuer has the power and authority to undertake the project being financed, to enter into and perform under the issuer documents, and to pledge the security for the bonds.

- No governmental or regulatory approvals are required for the issuance of the bonds and the execution and delivery of the issuer documents which have not already been obtained.

- The members of the issuer's governing body and the issuer's officers have been duly elected or appointed and are legally qualified to serve in such capacities.

- The issuer's governing body has duly adopted the resolution approving the project and the issuance of the bonds, and the resolution remains in full force and effect.

- The issuer documents have been validly authorized, executed and delivered by the issuer and are enforceable against the issuer in accordance with their terms (with the usual exceptions for bankruptcy, etc.).

- The execution and delivery of the issuer documents, the performance by the issuer under the issuer documents, and the pledge of security under the issuer documents do

not violate the relevant laws and organic documents of the issuer or the issuer's agreements or any laws or court orders or regulations.

- The disclosure documents have been approved for distribution by the issuer.

- Certain specified portions of the disclosure document are accurate and/or fairly present the information set forth therein.

- Nothing has come to such counsel's attention that would lead it to believe that certain specified sections of the disclosure document contain an untrue statement of a material fact or omit to state a material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

- There is no litigation pending or, to counsel's knowledge, threatened against the issuer to restrain or enjoin the issuance of the bonds or the collection or pledging of the security for the bonds, or questioning the validity of the bonds or the issuer's right to issue the bonds, or which, if adversely determined, would have a material adverse impact on the transactions contemplated by the issuer documents or the security for the bonds.

While customary past practice is important, it need not dictate future practice. If issuer's counsel wishes to adjust the boundaries of its opinion or bond counsel's opinion, it is important to raise that topic early on in the transaction so that all open points are settled prior to posting the preliminary offering document or execution of any final agreements.

The American Bar Association has published a number of opinion accords and guidance documents for legal opinions, available at https://www.americanbar.org/groups/business_law/publications/the_business_lawyer/find_by_subject/buslaw_tbl_mci_legalopinions/. While these are developed with a focus on the corporate context, the principles found in these accords can be useful for issuer's counsel thinking about appropriate diligence and/or exceptions and assumptions (e.g., effect of bankruptcy, equitable remedies, etc.) to consider in giving customary legal opinions to support bond transactions.

VI. POST CLOSING ISSUES

Issue:

After the closing of the bond transaction, there are still ongoing obligations of the issuer relating to the transaction. What should the issuer's counsel's role be in secondary market disclosure compliance? Is this an appropriate role for a lawyer? Or is it a business function? What is the best approach for an issuer in dealing with post-closing securities and tax law responsibilities?

Comment:

- Issuer's counsel absolutely has a role in confirming that the issuer client has policies and procedures for post-issuance disclosure and tax and arbitrage rebate compliance, and that the issuer receives legal advice as appropriate to support compliance with the policies.

- GFOA Best Practices – The GFOA issued an updated best practice in March 2020 entitled "Understanding Your Continuing Disclosure Responsibilities": https://www.gfoa.org/materials/understanding-your-continuing-disclosure-responsibilities. The GFOA's advice includes the following recommendations:

Issuers should have a clear understanding of their specific reporting responsibilities as detailed in their Continuing Disclosure Agreements (CDAs), both with respect to financial information/operating data and the listed events. If the issuer has determined that certain financial information and operating data is material and must be included in its official statement, its CDA should require that such information be updated annually. Issuers should work with their bond counsel, disclosure counsel, internal counsel, municipal advisor, if applicable, and underwriter (collectively, the "Financing Team") to determine the appropriate financial and operating information to be included in a CDA. Prior to execution, CDAs should be discussed with the Financing Team to ensure a full understanding of the issuer's obligations, including the applicable filing deadlines contained within the CDA.

1. Issuers should develop and adopt continuing disclosure procedures that:

    - identify the person who is designated as responsible for compliance with CDAs and the adopted continuing disclosure policy
    - require development and maintenance of accurate lists of outstanding bond issues subject to CDAs
    - outline the process by which the issuer works with its Financing Team to review, discuss and understand CDA provisions, prior to the related bond closing
    - specifically identify the financial and operating information to be submitted on EMMA, by bond issue and CDA, including the required deadlines for such filings
    - list the sixteen listed events and provide an ongoing framework to ensure prompt issuer monitoring and recognition of any listed events, and timely event filing on EMMA within 10 business days of the occurrence of a listed event
    - detail a process to document and track the required EMMA filings prior to each filing deadline, including use of an external dissemination agent, if applicable
    - describe the process by which any voluntary filings are made
    - identify records relating to continuing disclosure that should be retained and the record retention period
    - describe the process for identifying any noncompliance (such as annual "look-back" reviews), and the process for addressing noncompliance, including remedial filings and notices of noncompliance
    - require ongoing disclosure training for staff and officials responsible for producing, reviewing and approving disclosure

2. Issuer representatives responsible for filing continuing disclosure should carefully review and understand the specific requirements in the CDA for each individual bond issue. For some governments, filing the complete comprehensive annual financial report on EMMA may fulfill annual financial information obligations. Issuers should carefully compare information in their comprehensive annual financial report to information required by a CDA to ensure full compliance. If a government has agreed in the CDA to furnish operating data or other information that is not included in its comprehensive annual financial report, that information may be included as a supplement to the report when filing with EMMA. Some issuers – especially those with multiple types of bond issues – may choose to prepare a supplemental annual disclosure document that provides the specific information identified in its CDAs (in addition to filing the comprehensive annual financial report).

3. A government should complete its audited annual financial information within six months of the end of its fiscal year or sooner if available. Upon its completion, the comprehensive annual financial report should immediately be submitted to EMMA.

4. For bonds issued on or after February 27, 2019 there are two additional event notices under Rule 15c2-12 (Events 15 and 16), dealing with "financial obligations":

(15) Incurrence of a financial obligation, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation, any of which affect security holders, if material

(16) Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation, any of which reflect financial difficulties

"Financial obligation" means a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of (i) or (ii). Some examples of financial obligations include but are not limited to: Direct placements, loans, lines of credit or other credit arrangements with private lenders or commercial banks; letters of credit issued in connection with variable rate debt issuance; and interest rate swaps entered into in connection with debt issuance.

Procedures to ensure prompt issuer recognition of Events 15 and 16 may be different than procedures for the other listed events since they are more general in nature and not specific to a bond or obligation.

5. Event filings with respect to the incurrence of financial obligations should include a description of the material terms of such obligation, which can be done by filing the underlying documents (any sensitive information such as bank accounts and wire information should be redacted from documents prior to posting however, interest rate and spread are considered a material term and should not be redacted).

6. Under Rule 15c2-12, underwriters cannot participate in an offering unless the issuer includes language in their Official Statements for new bond issues describing any material non-compliance with continuing disclosure requirements within the past five years. Issuers should consult with their counsel regarding appropriate language to include in this primary disclosure, as

the official statement disclosure is subject to federal securities laws (and inaccurate statements by issuers regarding their prior compliance with CDAs was the basis for the MCDC Initiative).

7. Issuers, in consultation with internal and external counsel, may wish to submit other information beyond the requirements in the CDA (such as annual budgets, financial plans, financial materials sent to governing bodies for council or board meetings, monthly financial summaries, investment information, and economic and revenue forecasts) to EMMA and post it on their websites. Legal and regulatory implications of voluntary postings remain uncertain. Issuers should consult with Financing Team to determine the best strategy to analyze the market benefits of additional communication and any associated legal risks.

Upon implementation of a formal set of continuing disclosure policies and procedures, issuers should also take steps to ensure standards are being diligently followed. Continuing disclosure policies and practices should be periodically reviewed (annual basis is suggested) to ensure consistency with market and regulatory expectations.

The GFOA also issued an updated best practice in March 2020 entitled "Post-Issuance Policies and Procedures": https://www.gfoa.org/materials/post-issuance-policies-and-procedures. The GFOA recommends issuers of bonds or other debt obligations develop and adopt formal, written post-issuance compliance policies and procedures to assist in meeting compliance requirements and in preventing, identifying and correcting possible violations that might occur during the term that bonds are outstanding. Such procedures will help an issuer mitigate the risk of violation and preempt enforcement action from federal parties. The GFOA recommends issuers revisit these policies and procedures at least every three years or as directed by the Financing Team when there are significant legal or regulatory changes.

The GFOA recommends that the adopted policies and procedures at least consist of the following elements: a list of all of the compliance actions at the time that bonds are sold for each series of bonds; documentation of the source and frequency of such compliance requirements; and identification and assignment of compliance responsibilities to officers by title.

NABL and the GFOA developed a post-issuance compliance checklist (https://gfoa.org/sites/default/files/u2/PostIssuanceCompliance.pdf) to assist issuers in identifying matters that need to be analyzed by the issuer and perhaps by counsel. Issuers are encouraged to retain and distribute the checklist to all responsible parties and others who may find it useful during the lifetime of the financing and to keep the document with the financing transcript. Issuer's counsel should be familiar with such checklists and discuss questions and issues with bond counsel, as necessary or appropriate.

VII. DISCLOSURE

Issue:

What are threshold standards that issuer's need to comply with in disclosure? What are some current "hot topics" in disclosure that issuer's counsel should be aware of?

Comment:

Threshold Disclosure Standards:

- The issuer is ultimately responsible for the offering document, even if someone else drafts it and even if the issuer retains disclosure counsel
- Applicability of antifraud provisions to municipal issuers.

Hot Topics:

- Environmental risks
- Cybersecurity
- Special considerations related to bonds branded as ESG

VIII. PROTECTING THE ISSUER

Issue:

Bond issues can be complex for many issuers. What responsibilities does an issuer's counsel have relating to explaining a structure and the appropriateness of a particular bond issue? Does issuer's counsel risk being charged by the SEC with being an unregistered municipal advisor for advice with respect to a proposed financial structure?

Comment:

- ABA Model Rule 1.3, entitled "Diligence", states that "A lawyer shall act with reasonable diligence and promptness in representing a client." Comment [1] to Rule 1.3 states in part: "A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. A lawyer is not bound, however, to press for every advantage that might be realized for a client."

- ABA Model Rule 2.1, entitled "Advisor", states: "In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."

Comment [1] to Rule 2.1 states: "A client is entitled to straightforward advice expressing the lawyer's honest assessment. Legal advice often involves unpleasant facts and alternatives that a client may be disinclined to confront. In presenting advice, a lawyer endeavors to sustain the client's morale and may put advice in as acceptable a form as honesty permits. However, a lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client."

Comment [4] to Rule 2.1 states: "Matters that go beyond strictly legal questions may also be in the domain of another profession. Family matters can involve problems within the professional competence of psychiatry, clinical psychology or social work; business matters can involve problems within the competence of the accounting profession or of financial specialists. Where consultation with a professional in another field is itself something a competent lawyer would recommend, the lawyer should make such a recommendation. At the same time, a lawyer's advice at its best often consists of recommending a course of action in the face of conflicting recommendations of experts."

- Section 15B(e)(4)(C) of the Securities Exchange Act of 1934 (Section 975(e)(4)(C) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")) excludes from the municipal advisor definition "attorneys offering legal advice or providing services of a traditional legal nature." Since this phrase uses "or", it may be read to imply that "services of a traditional legal nature" includes something different from or in addition to "legal advice".

In SEC Release 34-70462 (September 23, 2013) (the "2013 Release"), the SEC discusses the exclusion of lawyers on pages 213 to 222. The SEC states: "if … an attorney represents himself or herself as a 'financial advisor' or 'financial expert,' the attorney will be required to register as a municipal advisor if the attorney engages in municipal advisory activities." (Page 220.) Clearly, lawyers do not want to call themselves financial advisors or financial experts. Nevertheless, the SEC states: "The Commission recognizes that legal advice and services of a traditional legal nature in the area of municipal finance inherently involves a financial advice component."

In the Release, the SEC describes advice that is primarily financial in nature and would cause the attorney to be outside the exclusion, including: "(1) the financial feasibility of a project or financing; (2) advice estimating or comparing the relative cost to maturity of an issuance of municipal securities depending on various interest rate assumptions; (3) advice recommending a particular structure as being financially advantageous under prevailing market conditions; (4) advice regarding the financial aspects of pursuing a competitive sale versus a negotiated sale; and (5) other types of financial advice that are not related to the attorney's provision of legal advice and services of a traditional legal nature." (Pages 220-221.)

Of particular note for in-house issuer's counsel is the broad exclusion from the definition of "municipal advisor" for public officials and employees of municipal entities and obligated persons to the extent that such persons act within the scope of their official capacity or employment. Registration of Municipal Advisors, Release No. 34-70462 (September 20, 2013), 78 FR 67467, 67506 (November 12, 2013), available at http://www.sec.gov/rules/final/2013/34-70462.pdf.

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THE ROLE OF ISSUER'S COUNSEL IN A BOND ISSUE

By David Unkovic and Donna Kreiser
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Municipalities have their general counsels who handle their normal legal work, including litigation, contracts and labor matters. These lawyers go by different names in different states, such as city attorney, corporation counsel or solicitor. In this article, in the context of their client acting as an issuer of debt, we will refer to them as issuer's counsel.

Sometimes these lawyers are full time municipal employees and sometimes they are attorneys in private practice and the municipality is just one of their clients. Usually they do not have any significant expertise in the law of debt issuance. Nevertheless, they serve an important function when their municipal clients issue debt.

Here is some advice to issuer's counsel regarding their role in bond issues:

1. **Make sure your client understands the roles of the entities involved in the bond issue.** Your role is clear: you represent your municipal client, the issuer. The bond counsel usually considers your municipality to be his or her client too. Review the bond counsel's engagement letter to confirm that the bond counsel has identified the issuer as his or her client. Make sure bond counsel understands that you expect to be kept in the loop if there are any problems that could negatively affect the municipality. The level of anticipated communication required of the bond counsel by the issuer may be confirmed in the bond counsel's engagement letter. The financial advisor to the municipal issuer has a fiduciary duty to your client, but underwriters, bank lenders, investment providers and swap providers may have limited or no duties to your client. Make sure you and your client understand the duties and roles of these other parties.

2. **Kick tires; ask questions.** You are probably not an expert in public finance, but you are an experienced attorney. As the transaction moves forward, ask questions if you do not understand something – there are no "stupid" questions whether one dollar or millions of dollars of public funds are involved. The odds are, if you don't understand something, your client probably doesn't understand it either. Don't accept "that's just the way it's done" as an answer. You and your client deserve clear answers to your questions. Here are a few examples of good general questions: to bond counsel – are there any thorny tax issues you are analyzing? To the financial advisor: do you think the issuer's disclosure is appropriate? If at any point you feel uncertain or uncomfortable regarding the transaction, stop the train until you get comfortable.

3. **The Official Statement is your client's document, no matter who prepares it – make sure it's accurate.** The prospectus in a bond issue is called an official statement (or "OS"). In many transactions, the financial advisor or the underwriter's counsel will draft the OS, but no matter who drafts the OS, it is considered your client's - the issuer's - disclosure. Because you represent and interact with the municipality on a daily basis, you know more about the municipality than any of the other professionals involved in the financing. Be sure to carefully read the draft OS, and make sure your client carefully reviews it too. The OS usually contains a description of the local area and economy – make sure all of that information is accurate. Pension liabilities, OPEB (other post-employment benefits) liabilities, litigation and swap liabilities are areas of specific concern to regulators and investors.

4. **Follow the Sunshine Law.** Make sure the official action to approve the debt taken by the governing body of your municipal client is in conformity with your required procedures, including your Sunshine Law.

5. **Understand your legal opinion.** In many cases, the bond counsel will prepare a draft of your legal opinion to be delivered at closing. Ask bond counsel to give you a draft of the opinion very early on in the course of the transaction. Review it carefully and make sure you are comfortable with the opinions you are required to render. Pay particular attention to opinions regarding outstanding or potential litigation. If there are any complicated litigation matters, be sure to review them with the other parties before the Preliminary OS is distributed.

6. **Get paid an appropriate fee.** If you are in private practice, charge an appropriate fee to cover the time it will take you to diligently represent your client. The duties outlined in this article take time and involve your general expertise as the municipality's lawyer – you should be appropriately compensated.

7. **Post-issuance compliance is more important than ever – make sure your client is prepared to undertake its post-issuance responsibilities.** After a bond issue closes, there are requirements under the tax code and under the securities laws that continue to apply to the bonds. On the tax side, there are regulations governing the investment and spending of bond proceeds and the use of the bond financed facilities. On the securities law side, there are requirements to make annual financial disclosures and special event disclosures with the Municipal Securities Rulemaking Board. Both the Internal Revenue Service and the Securities and Exchange Commission strongly encourage issuers to adopt and follow written post-issuance compliance policies. Before the bond issue closes, you should work closely with bond counsel and the financial advisor to help the issuer develop these policies. After

closing, you should work with your municipal client to make sure it takes these policies seriously and follows them.

8. **Final thoughts.** When you are working on a financing, it may often have the feel of a non-adversarial proceeding, but the stakes for your client are very high. The success of the financing is often integral to your client's economic well being. Approach the financing with part of your brain in an accommodating "let's get the deal done" frame of mind, but you should also approach it in part as you would a piece of litigation for your municipality – be a little skeptical, ask questions, and above all pay attention to your gut. If something bothers you, don't worry about your lack of expertise in public finance; do what you always do – diligently look out for your client.

Good luck on your bond issues!

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NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18–20, 2023

SEC and FINRA Enforcement

Chair:

Ed Fierro	Bracewell LLP – Houston, Texas

Panelists:

Brian Fagel	U.S. Securities and Exchange Commission – Chicago, IL
Meghan Ferguson	Financial Industry Regulatory Authority – Washington, DC
Andrew Kintzinger	Hunton Andrews Kurth – Washington, DC

I. Background

a. The SEC Division of Enforcement and the Enforcement of Municipal Securities

i. Congress charged the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") with civil enforcement of the federal securities laws. The purpose of the SEC is to "protect investors—including investors in municipal securities—maintain fair, orderly and efficient markets, and facilitate capital formation." *U.S. Securities and Exchange Commission, Report on the Municipal Securities Market*, at i (July 31, 2012), *available at* www.sec.gov/news/studies/2012/munireport073112.pdf (the "2012 Report").

ii. Historically, the municipal securities market has been largely exempt from regulation by the Commission. "The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") were both enacted with broad exemptions for municipal securities from all of their provisions except for the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder." *See* 2012 Report, at 27. Pursuant to amendments adopted in 1975 (the "1975 Amendments"), Congress enacted a limited regulatory scheme for the municipal securities market by requiring firms transacting business in municipal securities and banks to register with the SEC as broker-dealers and municipal securities dealers, respectively. The 1975 Amendments also created the Municipal Securities Rulemaking Board (the "MSRB"), a self-regulatory organization subject to SEC oversight that is authorized, as expanded by the Dodd-Frank Act, to adopt rules regulating the sale of municipal securities. While the SEC's Office of Municipal Securities had functioned independently previously, it later was incorporated into

the Division of Trading and Markets. The Dodd-Frank Act required that the Office of Municipal Securities be restored to independent status. The Office of Municipal Securities coordinates the SEC's activities relating to the municipal securities, including three primary areas: municipal advisor regulation, municipal securities market structure initiatives and municipal securities disclosure initiatives.

iii. The Tower Amendment: The 1975 Amendments did not give the SEC the authority to directly regulate municipal securities issuers and certain provisions of the 1975 Amendments (the "Tower Amendment") prohibit the SEC and the MSRB from directly or indirectly requiring municipal issuers to file documents with them or register prior to the sale of their securities. As a result, the SEC has largely relied on its express authority to regulate broker-dealers and municipal securities dealers, its oversight of the MSRB, and its enforcement authority under the antifraud provisions of the Securities Act and the Exchange Act as its regulatory tools.

iv. The Public Finance Abuse Unit: In 2010, the Commission created a specialized Enforcement unit to address abuses in public finance. The Public Finance Abuse Unit is staffed "with experienced attorneys and … non-attorney specialists with real world experience in the public finance industry" who partner with the Commission's Office of Municipal Securities. Andrew Ceresney, Director of Enforcement, *The Impact of SEC Enforcement on Public Finance* (Oct. 13, 2016), *available at* https://www.sec.gov/news/speech/speech-ceresney-10132016.html.

The recent change in administrations has not altered the SEC's primary enforcement priorities. "The core organizing principle is that we want to pursue, and we prioritize, cases where there is a clear risk of investor harm," said LeeAnn Gaunt, Chief of the SEC's Public Finance Abuse Unit. "We also consider it a key part of our mission to protect issuers, particularly small, infrequent issuers, from abusive practices by municipal advisors and broker-dealers." See *Outlook 2021: SEC To Focus On Price Transparency, Muni Advisors And Disclosure Enforcement*, The Bond Buyer, January 4, 2021.

v. In February 2020, the staff of the Office of Municipal Securities issued Legal Bulletin No. 21 ("Bulletin 21") regarding the application of the antifraud provisions of Section 10(b) and Rule 10b-5 to public statements made by issuers of municipal securities. Bulletin 21 provides that the "antifraud provisions apply to the purchase and sale of municipal securities in the secondary market, including to statements made by municipal issuers that are reasonably expected to reach investors and trading markets." Rule 10b-5, in part, "prohibits, in connection with the purchase or sale of any security, the making of any untrue statement of fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."

Bulletin 21 acknowledges that municipal issuers do not have the option of remaining silent and notes that municipal issuers disclose information about themselves in a variety of ways, including "public announcements, press

releases, interviews with media representatives, and discussions with groups whose members have a particular interest in their affairs." Noting that the "access to 'current and reliable information is uneven and inefficient' in the municipal securities market," the SEC staff believes these types of statements are "'a principal source of significant, current information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading markets.'" Considering this information a compliment to the formal disclosures under the Exchange Act, the SEC staff goes on to note in Bulletin 21 that "[t]he fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate the antifraud provisions."https://www.sec.gov/municipal/application-antifraud-provisions-staff-legal-bulletin-21

b. SEC Recent Enforcement Activity

i. Since the 2012 Report, there have been a number of significant municipal enforcement actions. Some examples include:

1. Financial Penalties for Municipal Issuers and Individuals: In 2019, the SEC brought an enforcement action against Montebello Unified School District ("MUSD"), its former Chief Business Officer (Ruben Rojas) and its Superintendent of Schools (Anthony Martinez) for defrauding investors by failing to disclose fraud and internal controls concerns raised by MUSD's independent auditor. According to the SEC's complaint and order, MUSD's independent auditor repeatedly raised concerns about allegations of fraud and internal controls issues to MUSD's Board of Education and management. In response, MUSD allegedly refused to authorize the fees needed for the audit firm to complete its audit and instead decided to terminate the audit firm. The offering documents for MUSD's $100 million of general obligation bonds in December 2016 failed to disclose this information to investors and instead included a copy of the District's audit report from the prior fiscal year, which included an unmodified or "clean" audit opinion from the firm.

   The SEC's complaint charged Rojas with violating the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Section 17(a) of the Securities Act, and seeks permanent and conduct-based injunctions as well as a financial penalty. MUSD was ordered to cease and desist from future violations of the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Section 17(a) of the Securities Act. It also agreed to engage an independent consultant to evaluate its policies and procedures related to its municipal securities disclosures. Martinez was ordered to cease and desist from future violations of Section 17(a)(3) of the Securities Act and also ordered to pay a $10,000 penalty. See *SEC Charges Los Angeles County School District and Two Officials with Defrauding Investors in $100 Million Bond Offering*, SEC Litigation Release No. 24602 (September 19, 2019).

See also: In the Matter of The Greater Wenatchee Regional Events Center Public Facilities District, Allison Williams, Global Entertainment Corporation, and Richard Kozuback, Sec. Act. Release No. 9471 (Nov. 5, 2013) (imposing a $20,000 penalty on the district, $10,000 on the developer and $10,000 on the president of the developer); In the Matter of Westlands Water District, Thomas W. Birmingham, and Louie David Ciapponi, Sec. Act. Release No. 10053 (Mar. 9, 2016) (imposing $125,000 penalty on water district, $50,000 on general manager, and $20,000 on assistant general manager); *SEC Obtains Final Judgments Against Gary Burtka and Eric Waidelich*, Litig. Rel. No. 23229 (Apr. 6, 2015) (imposing $10,000 penalty on former city mayor); In the Matter of the Port Authority of New York and New Jersey, Sec. Act. Release No. 10278 (January 10, 2017) (imposing $400,000 penalty on the Port Authority of New York and New Jersey); In the Matter of O'Connor & Company Securities, Inc. and Anthony Wetherbee, Sec. Act Release No. 81462 (August 23, 2017) and *Former Executive Director of Muni Bond Issuer Charged with Disclosure Failures*, Litig. Release No. 23920 (August 24, 2017) (imposing $15,000 penalty on the underwriter and $37,500 on city manager).

In 2022, the SEC charged the City of Rochester, New York, its former finance director Rosiland Brooks-Harris, and former Rochester City School District CFO Everton Sewell with misleading investors in a $119 million bond offering. The SEC alleges that in 2019 the defendants misled investors with bond offering documents that included outdated financial statements for the Rochester City School District and did not indicate that the district was experiencing financial distress due to overspending on teacher salaries. Sewell was allegedly aware that the district was facing at least a $25 million budget shortfall, but he misled a credit rating agency regarding the magnitude of the expected shortfall. The SEC's complaint against Brooks-Harris filed in the U.S. District Court for the Western District of New York, charges him with violating the antifraud provisions of the securities laws. The complaint also charges others with violating the municipal advisor fiduciary duty, deceptive practices, and fair dealing provisions of the federal securities laws. The Commission sought injunctive relief and financial remedies against all parties. Sewell agreed to settle the SEC's charges by consenting, without admitting or denying any findings, to a court order prohibiting him from future violations of the antifraud provisions and from participating in future municipal securities offerings, and to pay a $25,000 penalty. See SEC Press Release 2022-108 (June 14, 2022).

In 2022, the SEC charged Crosby Independent School District (Crosby ISD) and its former Chief Financial Officer, Carla Merka, with misleading investors in the sale of $20 million of municipal bonds in order to pay its outstanding construction liabilities and fund new capital projects. The SEC also charged Crosby ISD's auditor, Shelby Lackey, with improper professional conduct in connection with the audit of the school district's 2017 fiscal year financial statements. Crosby ISD agreed to settle the SEC's

charges by consenting, without admitting or denying any findings, to the entry of an order finding that it violated the antifraud provisions. The SEC's complaint against Merka, filed in U.S. District Court for the Southern District of Texas, charged her with violating the antifraud provisions of the securities laws. Without admitting or denying the allegations in the complaint, Merka agreed to pay a $30,000 penalty and not participate in any future municipal securities offerings.

2. <u>Focus on Charter Schools</u>. *SEC Charges Two California Charter School Officials with Misleading Investors in Bond Offering,* Litig. Release No. 24806 (April 27, 2020). In April 2020, the SEC charged William Alfred Batchelor and John Michael Zukoski with misleading investors in a $25.4 million bond offering for Tri-Valley Learning Corporation. Batchelor, then CEO, and Zukoski, then Director of Finance, were charged with signing offering documents and related certifications despite knowing that the Tri-Valley Learning Corporation was in "serious financial distress," and that the offering contained misleading financial projections. Batchelor and Zukoski agreed to be enjoined from future violations of Section 17(a)(3) of the Securities Act and from participating in future municipal debt offerings. Batchelor agreed to pay a $20,000 penalty and Zukoski agreed to pay a $15,000 penalty.

   Similarly, in September 2020 the SEC charged Park View School, Inc. based in Arizona and its former President, Debra Kay Slagle, with misleading investors in an April 2016 $7.6 million municipal bond offering. According to the SEC's complaint, in the years and months leading up to the bond offering, Park View experienced significant operating losses and repeatedly made unauthorized withdrawals from two reserve accounts to cover routine operating expenses, to pay other debts, and to transfer money to affiliated entities. Park View allegedly provided investors an offering document that included misleading statements about profit and expense projections and showed that Park View would be profitable in the upcoming fiscal year and able to repay the bondholders. Park View defaulted one year later by reducing the interest payments that it made on the bonds. Without admitting or denying the allegations in the complaint, Slagle and Park View agreed to settle with the SEC and to be enjoined from future violations of Section l0(b) of the Exchange Act, Rule 10b-5 thereunder, Sections 17(a)(l) and (3) of the Securities Act (and, in the case of Park View only, Section 17(a)(2) of the Securities Act). Slagle further agreed to pay a $30,000 penalty and to be enjoined from participating in future municipal securities offerings. See SEC Press Release 2020-208 (September 14, 2020).

3. <u>Court Order to Halt Bond Offering</u>: *City of Harvey Agrees to Settle Charges Stemming from Fraudulent Bond Offering Scheme*, Litig. Release No. 23149 (December 5, 2014). On June 25, 2014, the SEC obtained an emergency court order in the U.S. District Court for the Northern District of Illinois against the City of Harvey and its comptroller, Joseph T. Letke, to stop a fraudulent bond

offering that the city had been marketing to potential investors. The SEC had been investigating the City of Harvey and its comptroller for improperly using proceeds from prior bond offerings. While investigating, the SEC learned that the city intended to issue new limited obligation bonds; the SEC alleged that the offering documents made materially misleading statements about the purpose and risks of those bonds, while omitting that past bond proceeds had been misused.

The city agreed to a final judgment that enjoined it from committing future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In addition, the city was prohibited from engaging in the offer or sale of any municipal securities for three years unless it retained independent disclosure counsel. The court issued a permanent injunction prohibiting Letke from participating in any municipal securities offerings. Letke was further ordered to disgorge a total of $217,115.23, including interest and penalty.

4. Bars: In 2016, the SEC settled with Juan Rangel, the former President of UNO Charter School Network Inc. and former CEO of United Neighborhood Organization of Chicago ("UNO"), for materially misleading investors by failing to disclose terms of certain outstanding obligations in its offering documents, including certain conflicts of interest. Rangel agreed to pay a $10,000 fine, to be permanently enjoined from future violations of Section 17(a)(2) of the Securities Act and to be barred from participating in any future municipal bond offering (other than for his personal account). See SEC Press Release 2016-125 (June 21, 2016), *available at* www.sec.gov/news/pressrelease/2016-125.html.

5. Criminal Charges: In 2016 the SEC brought fraud charges against the Town of Ramapo, New York, the town's local development corporation, and town officials for failing to adequately disclose the town's failing financial condition. The U.S. Department of Justice (the "DOJ") also brought criminal charges against Christopher St. Lawrence, the town supervisor, and Aaron Troodler, the assistant town attorney and executive director of the local development corporation, consisting of 22 counts of securities fraud, wire fraud, and conspiracy—the first criminal securities fraud case brought against city officials for accounting fraud in connection with the sale of municipal bonds. Troodler pled guilty in March 2017 and was ordered to pay a $20,000 fine and a special assessment of $200, and was sentenced to three years of probation. Troodler was also disbarred as a result of his felony conviction. St. Lawrence was found guilty by jurors in May 2017 of securities fraud, wire fraud, and conspiracy. In November 2017 the U.S. District Court for the Southern District of New York permanently enjoined the Town and the local development corporation from violating the antifraud provisions and ordered them to retain independent consultants to review and recommend improvements to financial reporting procedures and controls and disclosure

practices and to adopt such recommendations, to retain independent auditing firms, and for a period of three years, to retain separate disclosure counsel (unaffiliated with bond counsel) prior to proceeding with the offering or sale of municipal securities. In December 2017, St. Lawrence was sentenced to 2 ½ years in prison. In addition to the prison term, St. Lawrence was sentenced to three years of supervised release and a $2,000 special assessment.

See DOJ Press Release No. 17-394 (December 13, 2017), *available at* https://www.justice.gov/usao-sdny/pr/former-ramapo-town-supervisor-christopher-st-lawrence-sentenced-30-months-prison.

In 2022, the SEC charged former City of Johnson City, Texas chief administrative officer and city secretary, Anthony Michael Holland, with securities fraud for creating and causing to be distributed falsified financial statements and a falsified audit report for the city's 2016 fiscal year. According to the SEC's complaint, Holland created the falsified documents to prevent discovery on his ongoing embezzlement of funds. The complaint alleges that, between 2015 and 2020, Holland stole approximately $1 million from the city, including $107,137 during the 2016 fiscal year. The complaint further alleges that, to hide his theft, Holland initially delayed the annual independent audit of the city's 2016 financial statements, and then, in approximately August 2018, falsified the 2016 documents by changing dates on the 2015 financial statements and audit report. According to the complaint, Holland then provided the falsified documents to the city's mayor and municipal advisor, knowing that the material would be posted to the city's public website and the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) system and made available to investors. During the time the falsified documents were available to investors on EMMA, investors engaged in secondary trading in the city's outstanding municipal bonds. Holland was also criminally charged by the United States Attorney's Office for the Western District of Texas and pled guilty to one count of Theft from a State or Local Government and admitted to stealing over $1 million from the city for his personal benefit. See *SEC Charges Former Texas City Official for Falsifying City's Financial Documents*, Litig. Release No. 25426 (June 16, 2022).

6. Unregistered Municipal Advisors: In September 2020, the SEC charged Funding the Gap, LLC, and its principal, Irene P. Carroll, with failing to register as Municipal Advisors. The SEC's order found that from at least July 2014 through September 2019, FTG and Carroll provided municipal advice to twelve charter schools located throughout the country in connection with the issuance of municipal bonds, including advising the schools regarding financing structures, interest rates, and underwriter selection. In total, the charter schools, advised by FTG and Carroll, borrowed, through conduit issuers, $222 million through municipal bond offerings. The order found that while FTG and Carroll provided and FTG was paid for municipal advisory services, neither was registered as a municipal advisor. The SEC's order

found that FTG violated the registration provisions of Section 15B(a)(1)(B) of the Exchange Act and that Carroll caused the violation. Without admitting or denying the findings in the order, FTG and Carroll agreed to cease-and-desist orders and to pay, jointly and severally, a civil penalty of $30,000. See *SEC Charges Charter School Municipal Advisor with Failing to Register with the Commission,* Admin. Proceeding File No. 3-20072 (September 25, 2020).

In 2022, the SEC charged an unregistered municipal advisor, Twin Spires Financial LLC, and its owner, Aaron B. Fletcher, with misleading investors in the sale of $5.8 million in municipal bonds across two offerings in 2017 and 2018. The SEC further alleges that Twin Spires and Fletcher provided municipal advisory services to the town of Sterlington, Louisiana without Twin Spires being registered as a municipal advisor with the Commission. The U.S. District Court for the Western District of Louisiana entered final judgment against Fletcher and Twin Spires and ordered them to pay, on a joint and several basis: (a) disgorgement of $26,303 and prejudgment interest of $6,642.88; and (2) a $200,000 civil penalty. See *SEC Obtains Final Judgment Against Municipal Advisor and Its Owner in Municipal Bond Offering Schemes*, Litig. Release No. 25511 (September 19, 2022).

In 2022, the SEC settled charges against Legacy Funding Services, LLC ("Legacy Funding"), and Raymond Howard Sowell, its sole owner, managing member and president, both of Raleigh, North Carolina, in connection with unregistered municipal advisory activity and unregistered broker services by Legacy Funding. settled charges against Legacy Funding Services, LLC ("Legacy Funding"), and its sole owner, managing member and president, Raymond Howard Sowell, both of Raleigh, North Carolina, in connection with unregistered municipal advisory activity and unregistered broker services by Legacy Funding.

The SEC's order finds that from 2017 through 2019, Legacy Funding, through Sowell, provided municipal advisory and broker services in connection with four municipal bond issuances for the benefit of three public charter schools. These services included providing advice to the charter schools on the structure, timing and terms of the issuances and identifying, soliciting and negotiating with investors to purchase the bonds, and receiving transaction-based compensation. Neither Legacy Funding nor Sowell were registered with the Commission in any capacity when they provided these services. The SEC's order finds that Legacy Funding willfully violated the registration provisions of Sections 15B(a)(1)(B) and 15(a)(1) of the Securities Exchange Act of 1934 and that Sowell caused Legacy Funding's violations. Without admitting or denying the findings in the order, Legacy Funding agreed to be censured and Legacy Funding and Sowell agreed to cease-and-desist orders and to pay, jointly and severally, a civil penalty of $60,000. See *SEC Charges Municipal Advisor and Broker to Charter Schools With Failing to Register With The Commission,* Administrative Proceeding File No. 3-21059.

In 2022, the SEC charged Chicago-based Loop Capital Markets, LLC for providing advice to a municipal entity without registering as a municipal advisor. The action marks the first time the SEC has charged a broker-dealer for violating the municipal advisor registration rule. According to the SEC's order, between September 2017 and February 2019, Loop Capital advised a Midwestern city to purchase particular fixed income securities, which the city purchased using the proceeds of its own municipal bond issuances. In addition, the SEC's order found that Loop Capital did not maintain a system reasonably designed to supervise its municipal securities activities and had inadequate procedures, including insufficient methods to identify potential violations of the municipal advisor registration rules. Loop Capital agreed to settle with the SEC and consented, without admitting or denying any findings, to the entry of an SEC order finding that it violated the rules regarding municipal advisor registration and supervision requirements, censuring it, and ordering it to pay disgorgement and prejudgment interest of $5,456.73 and a civil penalty of $100,000. See SEC Press Release No. 2022-163 (September 14, 2022).

7. Actions Against Municipal Advisors: See In the Matter of Clear Scope Advisors, Inc., Exchange Act Release No. 85618 (April 11, 2019) (advisor did not meet professional qualification standards and was censured and required to pay disgorgement of $20,000 and a penalty of $5,000). See also SEC Charges Municipal Advisor with Breaching Fiduciary Duty, SEC Litigation Release No. 24520 (June 27, 2019). The SEC complaint charged the municipal advisor and its principal with breaching its fiduciary duty and failure to protect the interests of their client in connection with a $6 million municipal bond offering by the Harvey Public Library District in Harvey, Illinois. According to the SEC's complaint, the mispricing of the bonds will cause the Library District to pay more than $500,000 in additional interest over the life of the bonds. The complaint charged the defendants with breaching their fiduciary duties in violation of Section 15B(c)(1) of the Exchange Act. The SEC sought permanent injunctions, disgorgement plus prejudgment interest, and civil penalties.

In 2022, the SEC also charged the City of Rochester's municipal advisor Capital Markets Advisors, LLC (CMA) and its principal Richard Ganci with misleading investors and breaching their fiduciary duty to the city and the Rochester City School District. CMA, Ganci and CMA co-principal Richard Tortora were also charged with failing to disclose conflicts to municipal clients. The SEC alleges that Ganci was also aware of the Rochester City School District's increased financial distress, including overspending on teacher salaries, yet he made no effort to inquire further about the district's financial condition prior to the bond offering, nor did he inform investors of the risks that the overspending posed to the district's finances. In September 2019, 42 days after the offering, the district's auditors revealed that the district had overspent its budget by nearly $30 million, resulting in a downgrade of the city's debt rating and requiring the intervention of the State of New York.

The SEC's complaint also alleges that CMA and Ganci failed to disclose to nearly 200 municipal clients that CMA had material conflicts of interest arising from its compensation arrangements. In many cases, CMA, Ganci and Tortora falsely stated that CMA had no undisclosed material conflicts of interest. See SEC Press Release 2022-108 (June 14, 2022).

In 2021, the SEC charged a Texas- and Colorado-based municipal advisor, Choice Advisors LLC, and its two principals, Matthias O'Meara and Paula Permenter, with violating their duties, engaging in unregistered municipal advisory activities, and related misconduct with respect to Choice's charter school clients. The actions were the first-ever SEC cases enforcing Municipal Securities Rulemaking Board Rule G-42 on the duties of non-solicitor municipal advisors. Permenter, who agreed to settle with the SEC, consented, without admitting or denying any findings, to the entry of an SEC order finding that she violated rules regarding municipal advisor registration and the duties of non-solicitor municipal advisors, censuring her, ordering her to pay a $26,000 penalty, and requiring that she participate in training on the duties of non-solicitor municipal advisors as well as have her engagement letters reviewed by a third party for a period of one year. See SEC Press Release 2021-188 (September 21, 2021).

8. Municipal Continuing Disclosure Cooperation Initiative ("MCDC Initiative"): Under the MCDC Initiative, announced in 2014, municipal issuers, obligated parties and underwriters had the opportunity to self-report inaccurate statements in final official statements about their prior compliance with the continuing disclosure obligations specified in Rule 15c2-12. In exchange for self-reporting, the Public Finance Abuse Unit agreed to recommend standardized, favorable settlement terms. The settlements were achieved through administrative proceedings in which each respondent (1) neither admitted nor denied the SEC's findings, (2) was censured, (3) was ordered to cease-and-desist from future violations, and (4) was ordered to enhance its continuing disclosure compliance.

In three waves of settlements from June 2015 to February 2016, the SEC entered into settlements with 72 underwriting firms under the MCDC Initiative. In 2016 the SEC announced that it had entered into settlements with 71 issuers and obligated parties.

Following the announcement of the MCDC settlements, the SEC began to investigate issuers and underwriters that did not participate in the initiative. For example, in August 2017 the SEC charged the Beaumont California Financing Authority for failing to accurately disclose in its bond disclosure documents its failure to materially comply with its prior continuing disclosure obligations. The financing authority, its former executive director, the underwriting firm (O'Connor & Company Securities Inc.), and the lead individual underwriter each agreed to settle the charges. Among other settlement terms, the financing authority's former executive director agreed

to pay $37,500 and to be barred from participating in future bond offerings, the underwriting firm agreed to pay $150,000, and the lead individual underwriter agreed to pay $15,000 and be subject to a six-month suspension. The SEC noted that the parties "would have been eligible for more lenient remedies had they self-reported during the MCDC Initiative." See SEC Press Release 2017-148 (August 23, 2017), *available at* www.sec.gov/news/press-release/2017-148.

9. Limited Offering Exemption in Rule 15c2-12 and Violations Against Underwriters: In 2022, the SEC filed a litigated action against Oppenheimer & Co. Inc. and separately announced settlements with BNY Mellon Capital Markets LLC, TD Securities (USA) LLC, and Jefferies LLC, charging each of the four firms with failing to comply with municipal bond offering disclosure requirements. These are the first SEC actions addressing underwriters who fail to meet the legal requirements that would exempt them from obtaining disclosures for investors in certain offerings of municipal bonds. According to the SEC's complaint and the settled orders, during different periods since 2017, the four firms sold new issue municipal bonds without obtaining required disclosures for investors. Each of the firms purported to rely on an exemption to the typical disclosure requirements called the limited offering exemption, but they did not take the steps necessary to satisfy the exemption's criteria. The SEC's orders find that BNY, TD, and Jefferies each violated Rule 15c2-12 under the Securities Exchange Act of 1934, which establishes disclosures that must be provided to investors, as well as Municipal Securities Rulemaking Board (MSRB) Rule G-27 relating to supervision and Section 15B(c)(1) of the Exchange Act. Without admitting or denying the SEC's findings, these three firms agreed to settle the charges, cease and desist from future violations of those provisions, be censured, and pay the following monetary relief: (i) BNY: $656,833.56 in disgorgement plus prejudgment interest and a $300,000 penalty; (ii) TD: $52,955.92 in disgorgement plus prejudgment interest and a $100,000 penalty; and (iii) Jefferies: $43,215.22 in disgorgement plus prejudgment interest and a $100,000 penalty. The SEC's complaint against Oppenheimer, filed in federal district court in Manhattan, charges the same violations as above in connection with at least 354 offerings. The complaint also alleges that Oppenheimer made deceptive statements to issuers in violation of MSRB Rule G-17, which prohibits deceptive, dishonest, or unfair practices. The complaint seeks permanent injunctions, disgorgement plus prejudgment interest, and a civil money penalty.

   In addition, in late 2022, the SEC announced that PNC Capital Markets LLC has agreed to settle charges that it failed to comply with municipal bond offering disclosure requirements under Rule 15c2-12 of the Securities Exchange Act of 1934. According to the order, between March 2018 and November 2021, PNC sold new issue municipal bonds without obtaining required disclosures for investors in 36 municipal bond offerings. PNC purported to rely on an exemption to the typical disclosure requirements

called the limited offering exemption, but it did not take the steps necessary to satisfy the exemption's criteria. The order also found that PNC failed to enforce its own policies and procedures for disclosures in limited offerings. The order finds that PNC willfully violated Section 15B(c)(1) of the Exchange Act, Rule 15c2-12 under the Exchange Act, as well as Rule G-27 of the Municipal Securities Rulemaking Board. Without admitting or denying the SEC's findings, PNC agreed to settle the charges, cease-and-desist from future violations of those provisions, be censured, and pay $81,362 in disgorgement plus prejudgment interest of $16,961, and a $100,000 civil money penalty. In March 2023, the SEC also agreed to settle similar charges with Keybanc Capital Markets Inc. As a result of its findings in these investigations, the SEC staff has begun investigations of other firms' reliance on the limited offering exemption.

c. FINRA Division of Enforcement and the Enforcement of Municipal Securities

i. FINRA is a self-regulatory organization that oversees more than 4,400 securities firms and nearly 630,000 registered securities representatives in the United States. FINRA's responsibilities include, among others: regulating broker-dealers and their registered persons; providing market information; adopting and enforcing rules to protect investors and the financial markets; examining broker-dealers for compliance with FINRA rules as well as federal securities laws, including the rules and regulations thereunder, and MSRB rules; informing and educating the investing public; providing industry utilities; and administering the largest dispute resolution forum for investors and registered firms.

ii. While its responsibilities extend well beyond the municipal securities market, FINRA plays an instrumental role in overseeing the registration and examination process for municipal dealer professionals and encouraging, examining, and enforcing compliance with MSRB rules by nonbank municipal dealers. However, FINRA's rules explicitly do not apply to transactions in and business activities relating to municipal securities because transactions in municipal securities effected by municipal bond dealers, and municipal advisory activities engaged in by municipal advisors, are subject to the rules of the MSRB.

iii. MSRB-registered broker-dealers are members of and examined by FINRA, with the remaining dealers registered with the SEC as municipal securities dealers and examined primarily by the various federal bank regulators. The SEC approved a change to MSRB Rule G-16 (Periodic Compliance Examination) to provide for risk-based examinations for FINRA member brokers and dealers. In addition to examinations, FINRA surveils the marketplace with respect to the pricing of bond transactions and markups.

iv. FINRA has conducted sweeps and targeted exams in the area of municipal sales practices; issued guidance reminding firms of their sales practice and due diligence obligations when selling municipal securities in the secondary market;

and conducted an informal look at new-issue retail order periods to address concerns about the potential for "flipping" municipal bonds.

II. Control Person Liability

a. Control Person Liability

i. Section 20(a) of the Exchange Act provides that "every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

b. SEC Enforcement Actions Involving Control Person Liability

i. In 2014, the SEC brought an enforcement action against the City of Allen Park, Michigan and two former city officials (Gary Burtka and Eric Waidelich) in connection with municipal securities offered to finance a movie studio project in the city. The action against the former mayor (Burtka) was brought under Section 20(a) of the Exchange Act as a "control person" for the city. According to the complaint, the offering documents contained false and misleading statements about the scope and viability of the project, as well as the city's overall financial condition, and the mayor was an "active champion of the project and in a position to control the actions of the city" with respect to the fraudulent bond issuances. Accordingly, the SEC held the former mayor jointly and severally liable with the city and the city administrator and enjoined all parties from future violations of the charged securities laws. In addition, both Waidelich and Burtka were barred from participating in future bond offerings and Burtka paid a $10,000 penalty. See SEC Press Release 2014-249 (November 6, 2014).

ii. In 2018, the SEC charged Leonard Genova ("Genova"), the former town attorney and deputy supervisor of Oyster Bay, New York, with defrauding investors in the town's municipal securities offering by allegedly hiding the existence and potential financial impact of side deals with a businessman who owned and operated restaurants and concessions stands at several of the town's facilities. The SEC alleged that Oyster Bay agreed to indirectly guarantee four separate private loans to the vendor totaling more than $20 million. The SEC further alleged that Genova concealed the indirect loan guarantees when they should have been disclosed in connection with dozens of securities offerings. The SEC charged Genova with violations of Sections 17(a)(1) and (a)(3) of the Securities Act and Sections 10(b) of the Exchange Act. In addition, Genova was charged with aiding and abetting violations and as a control person under Section 20(a) of the Exchange Act. See *Former Oyster Bay Town Attorney Agrees to Settle SEC Charges*, SEC Litigation Release No. 24059 (March 1, 2018).

c. **Risk of Disclosure Violations and Control Personal Liability Outside of Offering Materials**

i. As noted above, Legal Bulletin 21 provides that the "antifraud provisions apply to the purchase and sale of municipal securities in the secondary market, including to statements made by municipal issuers that are reasonably expected to reach investors and trading markets." Bulletin 21 clarifies that public officials may have liability for misstatements and fraudulent omission in public speeches and comments. In addition and as discussed above, officials may also have "control person" liability for fraudulent statements or omissions.

ii. State of the City and Public Speeches

1. In May 2013, the SEC determined that misleading statements were made in the City of Harrisburg's budget report, annual and mid-year financial statements, and a State of the City address. This was the first time that the SEC charged a municipality for misleading statements made outside of its securities disclosure documents. See SEC Press Release 2013-82 (May 6, 2013).

iii. City websites are expressly discussed in Legal Bulletin 21. Website content should be reviewed for purposes of consistency and accuracy of disclosures related to municipal securities.

iv. Public meetings can also be a source of disclosure violations if officials make misstatements.

d. **Good Faith Defense**

i. Section 20(a) of the Exchange Act provides for a defense where the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

III. ESG, Cybersecurity and Real Time Disclosure Decisions

a. The SEC launched the Climate and ESG Task Force within the Division of Enforcement to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment.

b. Types of ESG-related enforcement actions filed to-date, include actions against investment advisers, public companies, and a clean water project founder, among others.

c. On July 26, 2023, the SEC adopted a final rule requiring the disclosure of material cybersecurity incidents by public companies pursuant to new item 1.05 of Form 8-K and cybersecurity risk management, strategy, and governance by public companies pursuant to new item 106 of Regulation S-K disclosures.

d. Apart from the mandates of Rule 15c2-12, there may be other issues or events that could be considered material to investors that an issuer may wish to proactively disclose. In this circumstance, an issuer may consider whether to voluntarily file notice of such issue or event. For example, principal and interest payment delinquencies and non-payment defaults, if material, are required to be disclosed; however, if such events are foreseeable but have not come to fruition, disclosure is not technically required but may be considered. On May 4, 2020, Chairman Jay Clayton and the Director of the Office of Municipal Securities, Rebecca Olsen, issued a public statement entitled *The Importance of Disclosure for our Municipal Markets* encouraging issuers to provide voluntary disclosure, particularly related to COVID-19. Examples include information regarding the impact of COVID-19 on operations and financial condition, information regarding sources of liquidity, information regarding availability of federal, state and local aide and reports prepared for other governmental purposes that might include significant sources of current information of interest to investors. Similarly, voluntary disclosures could extend to ESG and cybersecurity matters.

e. Other examples of events where voluntary disclosures may be considered include:

i. The Discovery of Accounting or Audit Issues – New auditors or new financial staff at a public entity may disagree with prior accounting treatment and/or discover new material issues.

ii. Litigation Surprises – Significant new litigation may be threatened or filed and pending litigation may move in an unanticipated direction.

iii. Legal Advice - After the SEC's enforcement action in *In the Matter of the Port Authority of New York and New Jersey,* disagreements between former and current counsel on issues where legal opinions differ could create disclosable events.

iv. Storms that cause significant damage to a municipality and its infrastructure.

v. Cyberattacks that prevent an issuer from collecting certain revenue supporting the payment of outstanding securities.

vi. Public Events – Issuers may consider whether to file notice of major events or news that may become important local or regional news in effort to get ahead of the commentary, such as changes in senior staff, major news regarding operations, economic or environmental factors, or other events that may gain attention.

IV. An Overview of an SEC Investigation

a. General Process. SEC investigations generally involve the following steps and process: legal hold of documents; document requests; witness testimony; Wells Notice and Wells Submission; and settlement negotiations. Defense counsel may also make presentations to the SEC staff.

b. **SEC Investigations Are Not Public**. All SEC investigations are "non-public," meaning that neither the SEC nor its staff should acknowledge or comment on the investigation unless and until charges are brought. However, parties under investigation may, and are sometimes obligated to, disclose the pendency of an investigation. The need to disclose an investigation depends on the facts and circumstances.

c. **Legal Hold and Document Requests**. Most SEC investigations begin with a subpoena to provide documents and to not destroy any documents related to the matter under investigation. In an investigation of any consequence, the SEC may make several sets of document requests.

d. **Witness Testimony**. If the SEC, after reviewing the document productions, continues to have an investigatory interest, it will usually request sworn witness testimony. Sometimes the SEC will have non-sworn conversations or interviews with the parties.

e. **Opportunities for Advocacy**. Throughout an investigation, there are many opportunities for defense counsel to educate the SEC staff and to advocate. Effective advocacy requires defense counsel to have credibility with the SEC staff. In most cases, the staff will agree to in person meetings with counsel to discuss the salient events and circumstances of interest in the investigation. Extraordinary cooperation can also lead to leniency.

f. **Wells Notice and Wells Submission**. After witness testimony has been completed, the SEC's investigative staff will review the evidentiary record to determine whether to recommend the Commission institute charges. If the staff tentatively decides to make an enforcement recommendation to the Commission in non-emergency cases, it issues a Wells Notice to the proposed defendant (typically by telephone and follow-up letter). The recipient is given an opportunity to respond with a Wells Submission—a detailed legal memorandum explaining his or her position. The staff is generally open to meeting with counsel during this process.

g. **Settlement Negotiations**. If defense counsel does not succeed in convincing the staff that no enforcement action is warranted, counsel will routinely engage the staff in settlement discussions to determine whether the matter can be resolved on mutually agreeable terms. If a settlement is not negotiated, the SEC will commence an administrative or judicial proceeding.

h. **Remedies Available to the SEC**. The SEC is authorized to seek several forms of relief, including: an order against future violations in the form of an injunction (a cease-and-desist order); a censure; financial penalties; and/or a temporary or permanent bar from the securities industry. The availability of some of these remedies may depend on whether the matter is brought administratively or in federal court. Additionally, conditions sought by the SEC in many settlements include other forms of relief such as an undertaking to improve relevant policies and procedures, and the appointment and adoption of an independent consultant's recommendations.

i. Self-Reporting and Cooperation Credit

i. In October 2001, the Commission issued a Report of Investigation and Statement, commonly known as *The Seaboard Report*. For an entity, measures of cooperation include:

1. Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;

2. Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely and effectively disclosing the misconduct to the public, to regulatory agencies, and to self-regulatory organizations;

3. Remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and

4. Cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts. See *Spotlight on Enforcement Cooperation Program, available at* https://www.sec.gov/spotlight/enforcement-cooperation-initiative.shtml.

   a. In March 2019, the SEC charged the former controller of the College of New Rochelle for defrauding municipal securities investors by concealing the college's deteriorating finances. The controller purportedly created false financial records, did not file payroll tax submissions and did not assess the collectability of pledged donations. In 2015, the college's financial statements overstated the net assets by $34 million.

      However, the SEC did not charge the College of New Rochelle due to the institution's extensive cooperation and remediation efforts. The college publicly disclosed the financial issues, engaged outside expertise to conduct a full internal investigation and issued restated financial results. The college "promptly and extensively" cooperated with the SEC in its investigation and "proactively undertook wide-reaching remedial measures to enhance its internal controls and governance." See SEC Press Release 2019-46 (March 28, 2019).

      In a related matter, the SEC charged two KPMG auditors (Christopher Stanley and Jennifer Stewart) for the issuance of an unmodified audit opinion regarding the College of New

Rochelle's 2015 financial statements. Specifically, the SEC said the auditors "violated Generally Accepted Auditing Standards by, among other things, failing to obtain sufficient appropriate audit evidence, properly prepare audit documentation, properly examine journal entries, adequately assess audit risk, and exercise due professional care and professional skepticism." Without admitting or denying the findings, Stanley and Stewart each agreed to be suspended from appearing or practicing before the SEC as an accountant with the right to apply for reinstatement after three years and one year, respectively. Each also agreed to not serve as the engagement manager, engagement partner, or engagement quality control reviewer in connection with any audit expected to be posted in the MSRB's Electronic Municipal Market Access system until they are reinstated by the SEC. See SEC Press Release 2021-32 (February 23, 2021).

V. An Overview of FINRA Investigation

a. **General Process**. FINRA investigates potential securities violations and, when appropriate, brings formal disciplinary actions against firms and their associated persons. FINRA investigations may be opened from various sources, including automated surveillance reports, examination findings, filings made with FINRA, customer complaints, tips, referrals from other regulators or other FINRA departments and press reports. As a policy, FINRA's investigations are confidential. If it appears that rules have been violated, FINRA Enforcement ("Enforcement") will determine whether the conduct merits formal disciplinary action. FINRA can take disciplinary action through two separate procedures: a settlement or a litigated proceeding. With a settlement, the respondent can opt to resolve alleged rule violations early by submitting a Letter of Acceptance, Waiver and Consent (AWC). Otherwise, FINRA may issue a formal complaint to FINRA's Office of Hearing Officers (OHO). If the respondent does not settle the complaint, the matter proceeds to a contested hearing before OHO, which hears the case and issues a decision.

b. **Bringing SEC Cases.** Enforcement also brings disciplinary cases on behalf of the securities exchanges with which it has entered into Regulatory Services Agreements (RSAs). These matters may be brought on behalf of a single exchange or, more commonly, may be brought as global settlements on behalf of multiple self-regulatory organizations, sometimes including FINRA.

c. **Sanctions.** Sanctions for wrongdoing include fines, suspensions, and, in cases of serious misconduct, bars from the brokerage industry. FINRA publishes its Sanction Guidelines so that members, associated persons and their counsel understand the types of disciplinary sanctions that may be applicable to various violations. Whenever possible, Enforcement orders firms and individuals to make restitution to harmed customers.

d. **Other Outcomes.** Not all investigations result in formal disciplinary action. For example, if the violation is of a minor nature and there is an absence of customer harm or detrimental market impact, the matter may be resolved with an informal disciplinary action, such as the issuance of a Cautionary Action. While Cautionary Actions are considered by the staff in any future disciplinary matter, these actions do not constitute formal discipline and are not reportable on FINRA's Central Registration Depository (CRD) system or Form BD. In addition, Enforcement may determine not to recommend formal disciplinary action following an investigation and may close the matter without further action.

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NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023

October 18-20, 2023

TAX CONCEPTS IN BANK DIRECT PURCHASES AND BANK QUALIFICATION

Chair:
Brent L. Feller Chapman and Cutler LLP

Panelists:
Stefano Taverna McCall, Parkhurst & Horton LLP
Lauren Mack Reyes Kurson

In this session, tax law practitioners will discuss the tax law issues that arise in bank direct placements and bank loans, with a portion of the session devoted to tax considerations regarding bank-qualified bonds. Issues that will be discussed include determining issue price in a direct placement, reissuance in the direct purchase context, replacement proceeds issues that arise in connection with bank covenants, contingent interest analysis and margin rate factor provisions. The bank qualification discussion will focus on issues relating to refundings and deemed designations, timing of designations, impact of premium, aggregation rules and opinion practice. The LIBOR Act will be briefly discussed in connection with the reissuance discussion, although LIBOR transition will be discussed in more detail in other panels.

I. Issue Price

The issue price regulations issued in 2016 (the "Issue Price Regulations") speak directly to the issue price of a direct placement. The Issue Price Regulations provide that, for a bond issued for money in a private placement to a single buyer that is not an underwriter or a related party (as defined in Treas. Reg. §1.150–1(b)) to an underwriter, the issue price of the bond is the price paid by that buyer. Treas. Reg. §1.148-1(f)(2). The Issue Price Regulations continue to state that issue price is not reduced by any issuance costs (as defined in Treas. Reg. §1.150-1(b)).

The Issue Price Regulations have the effect of modifying the issue price rule in Internal Revenue Code ("IRC") §1273(b)(2) for private placements. Section 1273(b)(2) provides that in the case of any issue of debt instruments not issued for property and not publicly offered, the issue price of each such instrument is the price paid by the first buyer of such debt instrument. For private placements, the Issue Price Regulations replace the concept of "the first buyer of such debt instrument" with "a single buyer that is not an underwriter or a related party (as defined in Treas. Reg. § 1.150–1(b)) to an underwriter." This modification was a helpful clarification that the amount paid for a tax-exempt bond by a bank will be treated as the issue price for federal tax purposes.

Practitioners should continue to be aware that issue price analysis for a bank direct purchase of a tax-exempt bond does not end with the identification of the nominal amount paid for the tax-exempt bond by the bank. The amount that will be considered paid by the bank for purposes of determining issue price will continue to take into account payments from the issuer (or true obligor) to the bank for origination fees, commitment fees and other fees, which otherwise may not be reflected in the nominal purchase price. See Treas. Reg. §1.1273-2(g)(2). Bond counsel will frequently require a closing certificate from the bank and/or the issuer as to the purchase price and related fees in order to determine the issue price.

In larger direct lending transactions, particularly for conduit borrowers, banks will sometimes mitigate credit exposure by selling participations in the credit to other banks or by serving as an administrative agent for a lending group. Bond counsel should consider whether, under those circumstances, the "single buyer" rule applies and, if not, what analysis must be used to establish issue price.

II. Characterization of Payments as Interest

There is a substantial body of case law and administrative guidance interpreting the meaning of "interest" for purposes of federal income tax treatment. For federal income tax purposes, interest is an amount that is paid in compensation for the use or forbearance of money. Deputy v. DuPont, 308 U.S. 488 (1940), 1940-1 C.B. 118; Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932), 1932-1 C.B. 274. Neither the label used for the fee nor a taxpayer's treatment of the fee for financial or regulatory reporting purposes is determinative of the proper federal income tax characterization of that fee. See Rev. Rul. 72-315, 1972-1 C.B. 49 (as to the label); Thor Power Tool Co. v. Commissioner,

439 U.S. 522, 542-43 (1979), 1979-1 C.B. 167, 174-75 (as to financial or regulatory reporting).

The IRS has provided additional guidance as to what payments are considered interest in a series of rulings outside of the tax-exempt bond area. Rev. Rul. 72-315, 1972-1 C.B. 49, states that one factor distinguishing service charges on loans from interest is that a service charge is a fixed charge having no relationship to the amount borrowed or the time given to pay whereas interest is based on the amount deferred and the time of deferral.

Rev. Rul. 2004-52, 2004-22 I.R.B. 973, considers whether credit card annual fees are interest for federal income tax purposes. The revenue ruling states that annual fees are not compensation for the use or forbearance of money, because cardholders pay annual fees to credit card issuers in return for all of the benefits and services available under the applicable credit card agreement. Accordingly, an issuer's annual fee income generally should not be considered interest income for federal tax purposes.

Rev. Rul. 74-187, 1974-1 C.B. 48, holds that late fees on utility bills are interest absent evidence that the late payment charge assessed by the public utility is for a specific service performed in connection with the customer's account. Even if a charge is a one-time charge or is imposed as a flat sum in addition to a stated periodic interest rate, that charge may still be interest for federal income tax purposes. See Rev. Rul.77-417, 1977-2 C.B. 60 and Rev. Rul. 72-2, 1972-1 C.B. 19.

In PLR 200533023 the IRS considers whether several types of credit card fees received by a bank should be considered interest. The PLR states that late fees, over-the-limit fees, cash advance fees, and non-sufficient funds fees are interest, and that annual fees are not interest. When analyzing each of these fees, the IRS first determines whether the fee is a payment for services or property, rather than interest. The IRS also takes into account whether the fee charged bore any relationship to the amount borrowed. The IRS does not seem to give any weight to the fact that a fee is not labelled as a finance charge, may be imposed as a flat sum, or is imposed in addition to the stated periodic rate finance charge.

With respect to the direct purchase of tax-exempt bonds by banks, issues frequently arise as to whether certain amounts that may be payable by issuers constitute interest. For example, banks often request that the documentation for a direct purchase contain one or more of the following:

- Late fees,
- Prepayment penalties or similar breakage fees,
- Adjustments to interest rates due to changes in the maximum federal corporate income tax rate; and/or

- Payments from the borrower to preserve profitability in the event of certain regulatory changes, such as changes due to Dodd-Frank or BASEL III, or other regulatory changes that result in an increase in the cost of capital.

To the extent that these payments are not payments for services or property, bond counsel should determine if they should be characterized as interest payments and what impact such a characterization would cause, including whether characterizing one or more payments as interest would result in the loan being characterized as a contingent payment debt instrument (discussed below). Some bond counsel will not allow some of or all of these types of payments to be characterized as interest under the documents but instead will require characterization of these payments as lender fees (or will just not opine on the tax-exempt status of these payments).

III. Contingent Payment Debt Instruments

Tax-exempt debt may be subject to the regulations regarding contingent payment debt instruments ("CPDI") if the obligations are issued with "contingent payments." The regulations do not define "contingent payments." However, the CPDI regulations should be considered for any payment that is not fixed as to amount and timing. A payment is not contingent merely because insolvency, default, or similar circumstances may impair one or more payments. Treas. Reg. §1.1275-4(a)(3). In addition, a payment is not treated as contingent if the contingency is remote or incidental as of the issue date. Treas. Reg. §1.1275-4(a)(5).

The CPDI regulations generally require that tax-exempt bonds issued with contingent payments for money use the "noncontingent bond method" to compute the amount of interest. Under the noncontingent bond method, the amount of interest taken into account in each accrual period is based upon a projected payment schedule that is constructed using the terms of the bonds and the greater of (i) its yield determined without regard to contingent payments, or (ii) the tax-exempt applicable federal rate that applies to the obligation. For the purposes of determining the amount of tax-exempt interest, the daily portions of interest calculated under the noncontingent bond method are treated as interest. Treas. Reg. §1.1275-4(d)(3)(ii)(B).

When an actual payment differs from the projected fixed amount for a tax-exempt obligation to which the noncontingent bond method applies, the holders and issuers make adjustments to their tax positions. A net positive adjustment is treated as gain to the holder from the sale or exchange of the tax-exempt obligation in the taxable year of the adjustment. Conversely, a net negative adjustment is treated as a loss to the holder from the sale or exchange of the tax-exempt obligation in the taxable year of the adjustment. Treas. Reg. §1.1275-4(d)(3)(ii)(A). These general rules are modified for tax-exempt bonds that provide for "interest-based payments" and "revenue-based payments." See Treas. Reg. §1.1275-4(d)(2).

Because of the complexities of identifying interest payments for tax-exempt bonds that constitute CPDIs, it is important to avoid that characterization if at all possible. Issuers typically avoid the application of the CPDI regulations by structuring their obligations to

fit into one of several exceptions that, when applicable, prevent an obligation from being considered a CPDI. Treas. Reg. §1.1275-4(a)(2). Perhaps the most commonly used exception is for obligations that are "variable rate debt instruments" as defined in Treas. Reg. §1.1275-5. Among the requirements for variable rate debt instruments that are tax-exempt is the requirement that the debt instrument must not provide for any stated interest other than interest that is compounded or paid at least annually at

- One or more qualified floating rates;
- A single fixed rate and one or more qualified floating rates;
- A single qualified inverse floating rate or a qualified inflation rate; or
- A single fixed rate and a qualified inverse floating rate.

Treas. Reg. §1.1275-5(a)(3)(i); Treas. Reg. §1.1275-5(c)(5).

In general, a "qualified floating rate" is a variable rate that is reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated. The rate may measure contemporaneous variations in borrowing costs for the issuer of the debt instrument or for issuers in general. Treas. Reg. §1.1275-5(b)(1). A multiple of a qualified floating rate is not a qualified floating rate unless it is equal to either:

(a) The product of a qualified floating rate and a fixed multiple that is greater than .65 but not more than 1.35; or

(b) The product of a qualified floating rate and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.

Treas. Reg. §1.1275-5(b)(2). In addition, qualified floating rates may be subject to a cap, floor, or governor that is fixed throughout the term of the debt instrument. Treas. Reg. §1.1275-5(b)(3).

"Qualified inverse floating rates" generally are defined as a fixed rate minus a qualified floating rate. Treas. Reg. §1.1275-5(c)(3).

"Qualified inflation rates" are defined as a rate that measures contemporaneous changes in inflation based on a general inflation index. Treas. Reg. §1.1275-5(c)(5).

Bond counsel have taken different positions with respect to the application of the CPDI regulations to tax-exempt bonds that provide for interest rate changes, including changes to a margin factor in calculating a tax-exempt interest rate, due to changes in the credit rating of the issuer (or the true obligor) or due to changes in the federal maximum corporate tax rate (a yield adjustment provision). While most bond counsel conclude that such provisions are acceptable because they are based upon fixed external factors, some bond counsel have expressed a concern that the application of such factors could result in a CPDI.

IV. Rights of Setoff

Banks often require that an Issuer establish a depository account with the bank as a condition of the direct purchase. Banks typically have a state law or contractual right of setoff with respect to the account. A right of setoff is the bank's legal right to seize the issuer's account balance in the depository account to apply it toward the borrower's obligation under any loan in arrears, or in anticipation of a default. In some jurisdictions, the right of setoff may be exercised without prior notice.

Rights of setoff typically do not provide reasonable assurance that an amount will be available to pay principal or interest on obligations, because rights of setoff, by themselves, do not impose restrictions on the use of funds on deposit. However, to the extent that a right of setoff applies to a depository account with a minimum balance requirement or to the extent a borrower is required to maintain all of its bank accounts at the lender, bond counsel should consider whether the combination of the right of setoff and such a requirement create an indirect pledge of the minimum balance amount and therefore a replacement proceeds issue. See Treas. Reg. §1.148-1(c) and discussion below.

V. Replacement Proceeds

Replacement proceeds include pledged funds. An amount is treated as pledged to pay principal of or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged, however, if (A) the issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or (B) the amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date. Treas. Reg. §1.148-1(c)(3)(ii)(B). Based upon this language, many credit agreements with borrowers, particularly 501(c)(3) borrowers, include a covenant that the borrower maintain a minimum liquidity as of semi-annual testing dates.

Unfortunately, the regulations do not provide guidance for determining the reasonableness of a liquidity requirement. The regulations simply provide that the liquidity required cannot exceed the borrower's reasonable needs. The reasonableness of such needs is subjective, and a number of factors could be considered in connection with determining the reasonableness of a liquidity requirement, including historical working capital needs, comparisons to other similar credits, potential growth plans that will reduce cash on hand and cyclicality of the borrower's cash flows. Documenting the reasonableness of a liquidity requirement can be challenging and could require certifications from both the lender and borrower.

Note that restrictions on the sale of assets of the borrower used in its trade or business that are pledged as security for the bonds are not prohibited by the replacement proceeds rules. Such property is not considered investment-type property or property held

principally as a passive vehicle for the production of income under Treas. Reg. §1.148-1(e) and is not subject to the arbitrage rules.

VI. Reissuance

Reissuances of tax-exempt bonds may be treated as a current refunding, retirement (extinguishment) of the debt, or as a new money obligation. However, most reissuances are treated as current refundings. Reissuances of tax-exempt bonds that result in current refundings may trigger a variety of consequences, including:

- Changes in arbitrage yield,
- New temporary periods,
- A final rebate payment for the "refunded" bonds,
- New rebate requirements for the "reissued" bonds,
- Deemed terminations of integrated swaps,
- An IRS filing requirement (Form 8038 or 8038-G),
- Possible gain/loss to the bondholder,
- Possible private use recalculations or determinations,
- Determination if new TEFRA public approval requirements apply,
- Determination if volume cap is required for the reissued bonds,
- An updated tax analysis,
- A confirming or updated tax opinion,
- Possible transferred proceeds issues, and
- Possible change to bank qualified status.

Accordingly, issuers often seek to avoid having their bonds be treated as reissued to avoid negative consequences that may be associated with the reissuance.

In general, IRC §1001 and the regulations thereunder apply to determine whether tax-exempt obligations are considered reissued for all tax purposes. In general, IRC §1001 provides that tax-exempt obligations are considered reissued if there is a "significant modification" of the obligations. However, the general rules under IRC §1001 were hard to apply to tax-exempt variable rate obligations that provided for "puts" by the holder and/or the borrower. Accordingly, the IRS issued a series of Notices to provide additional guidance with respect to these bonds.

The result is that both Notice 2008-41[1] and Notice 88-130 provide rules regarding reissuances of qualified tender bonds. The rules in each of the notices are somewhat different. However, in both notices, it is possible for certain multi-modal bank direct

[1] Note that Notice 2008-41 amends, supplements, and supersedes Notice 2008-27, which was retroactively effective from November 1, 2007 through March 25, 2008. Notice 2008-41 was subsequently amended and supplemented by Notice 2008-88, and was modified by Notice 2010-7 (both of which are now outdated). Also, Announcement 2011-19 established a voluntary closing agreement program for issuers that still could not remarket its bonds after the expiration of Notice 2010-7.

placements to meet the definition of a qualified tender bond. In addition, on December 31, 2018, the IRS issued new proposed regulations (the "2018 Proposed Regulations") that address when tax-exempt bonds are treated as retired and reissued for purposes of IRC §§ 103 and 141 through 150, including the treatment of qualified tender bonds. The 2018 Proposed Regulations provide that they will apply to events and actions taken with respect to bonds that occur on or after the date that is 90 days after the date of publication of the Treasury decision adopting the rules as final regulations, but the preamble further provides that issuers may apply the 2018 Proposed Regulations to events and actions that occur before that date and that the final regulations will make Notice 88-130 and Notice 2008-41 obsolete.

Notice 88-130

Notice 88-130 provides that qualified tender bonds will not be treated as reissued as a result of certain tender rights and certain changes in interest rate modes and other terms of bonds. A qualified tender bond is any tender bond which has a final stated maturity date no later than the earlier of:

(a) The date which is 35 years after the date of issue; or

(b) The latest date reasonably expected (as of the date of issue) to carry out the governmental purpose of the issue of which the bond is a part.

A bond will be deemed to meet (b) above if the average maturity of the issue of which the bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of such issue (as determined under IRC §147(b)).

In general, under Notice 88-130, a qualified tender bond will be considered to be retired and reissued for purposes of IRC §103 and §§141-150 only if, in a transaction or series of transactions:

(a) There is any change to the terms of the bond (other than a qualified corrective change) in connection with a qualified tender change which changes the time between tender dates in one of the following ways:

(i) The period between tender dates changes from a period not exceeding 1 year to a period exceeding 1 year, or

(ii) The period between tender dates changes from a period exceeding 1 year to a period not exceeding 1 year;

(b) There is a change in the period between tender dates that is not a qualified tender change;

(c) There is a change to the bond terms (other than a qualified corrective change) that would cause a disposition of the bond under § 1001 without regard to the existence or exercise of the tender right;

(d) The bond is purchased or acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof; or

(e) The bond is otherwise retired or redeemed.

A qualified tender bond will not be treated as retired merely because of (1) the existence of a tender right, (2) a qualified tender purchase, (3) a qualified tender change, (4) a qualified corrective change, or (5) any combination of the foregoing.

A "qualified corrective change" is defined as any one of the following:

- A change that does not materially alter the rights or remedies of the holder.

- A change that corrects a term of the bond to eliminate a result that could not reasonably have been intended on the date of issue.

- A change which is necessary solely by reason of circumstances occurring after the date of issue which could not have been reasonably anticipated, are not related to the bond market conditions or the credit worthiness of the issue and are not within the control of the issuer, any true obligor, any holders of the bonds, any related person or any combination of the foregoing.

See Notice 88-130 for more details, but generally under Notice 88-130 changes that occur in accordance with the operation of the documents will not result in a reissuance, except that a change that results in the period between tender dates changing from a period not exceeding 1 year to a period exceeding 1 year, or vice-versa, automatically result in a reissuance.

Notice 88-130 was the only substantial guidance from the IRS regarding reissuances of qualified tender bonds until 2008. In 2008, the rating agencies downgraded all the major bond insurers, and auction-rate bonds began to experience failed auctions as a result. Many of these auction rate bonds were issued with letters of credit or standby bond purchase agreements, such that when the auctions failed, the bank that issued the letter of credit or standby bond purchase agreement was forced to buy the tendered bonds. In other instances, issuers desired to bid on and buy their own auction rate bonds so that they could hold them temporarily until they could be remarketed or refunded. However, subject to limited exceptions, a debt instrument generally is treated as retired or extinguished when an issuer acquires its own debt because a merger of the interests of the issuer and the holder occurs.

In this context, questions arose regarding whether or to what extent auction rate bonds (that have no tender options that support the interest rate-setting process) could be treated as qualified tender bonds for purposes of Notice 88-130, and regarding the tax consequences of issuer acquisitions in various circumstances and whether such acquisitions would result in a retirement or extinguishment of such bonds. The IRS addressed these questions, and attempted to provide relief to distressed issuers, in Notice 2008-41.

Notice 2008-41

Notice 2008-41 generally provides that, in the case of a qualified tender bond, any "qualified interest rate mode change" and any "qualified tender right" will not be treated as a modification under Treas. Reg. § 1.1001-3, and therefore will not result in a reissuance.

Notice 2008-41 expands the definition of qualified tender bonds to include auction rate bonds as follows:

> The term "qualified tender bond" means a tax-exempt bond that has all of the following features:
>
> (a) for each interest rate mode that is preauthorized under the terms of the bond considered separately, the bond bears interest during the allowable term of that interest rate mode at either a fixed interest rate, a variable interest rate that constitutes a qualified floating rate on a variable rate debt instrument for a tax-exempt bond under §1.1275-5(b) (e.g., various interest rate indexes and rate-setting mechanisms that reasonably can be expected to measure contemporaneous variations in the cost of newly-borrowed funds, including, without limitation, interest rates determined by reference to eligible interest rate indexes (e.g., the SIFMA index), tender option-based interest rate measures, or a Dutch auction process), or a variable interest rate that constitutes an eligible objective rate for a variable rate debt instrument that is a tax-exempt bond under §1.1275-5(c)(5) (i.e., a qualified inflation rate or a qualified inverse floating rate);
>
> (b) interest on the bond is unconditionally payable at periodic intervals at least annually;
>
> (c) the final maturity date of the bond is no longer than the lesser of 40 years after the issue date of the bond or the latest date that is reasonably expected as of the issue date of the issue of which the bond is a part to be necessary to carry out the governmental purpose of the issue of which the bond is a part (with the 120 percent weighted average economic life of financed facilities test under Section 147(b) with respect to the issue of which the bond is a part being treated as a safe harbor for this purpose); and
>
> (d) the bond is subject to an optional tender right or a mandatory tender requirement which allows or requires a bondholder to tender the bond for purchase in one or more prescribed circumstances under the terms of the bond.

Notice 2008-41 defines a "qualified tender right" as a tender right for the purchase of a bond (regardless of whether the purchase is by or on behalf of a governmental issuer) that is authorized under the terms of a bond upon its original issuance and that involves

either an optional tender right or a mandatory tender requirement which allows or requires the bondholder to tender the bond for purchase on at least one tender date before the final stated maturity date. The tender right also must entitle a tendering bondholder to receive a purchase price equal to par (which may include any accrued interest), and the terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to **remarket** a bond upon a purchase pursuant to the tender right. (emphasis added)

Although issuers of qualified tender bonds sold to the public typically use a remarketing agent and thus are "remarketed," bank direct placements do not. Instead, issuers of bank direct placements are negotiating with a single lender after a tender, such that a remarketing agent, and therefore a "remarketing," are unnecessary.

Bond counsel have expressed concerns to the IRS that by drafting the definition of a qualified tender right using the terms of a remarketing, bank direct placements are not able to take advantage of the favorable rules for qualified tender bonds contained in the Revenue Procedure. See the NABL Letter to IRS on Reissuance Concerns Related to Certain Private Purchases of Multimodal Tax-Exempt Obligations dated July 25, 2012.

Some bond counsel have created documents with "springing" remarketing agents to set the rate for a subsequent rate period, thus seeking to take advantage of Rev. Proc. 2008-41. One problem with this strategy is that, unlike the remarketing of a variable rate demand bond, where the only variable is the interest rate, in a bank purchase the remarketing agent would have to evaluate rate, length of commitment period, collateral and restrictiveness of covenants, all of which make it hard to do an "apples to apples" comparison of offers received as a result of the remarketing. Another problem with the strategy is that the borrower typically wants to continue with the same bank during a subsequent commitment period and does not necessarily want to put its whole banking relationship out to bid to the lowest bidder for its bonds. Other bond counsel have determined that as long as the actual issuer "remarkets" its bonds, the remarketing requirement is satisfied.

2018 Proposed Regulations

The 2018 Proposed Regulations are largely consistent with Notice 2008-41, providing that, in applying Treas. Reg. § 1.1001-3 to a qualified tender bond, both the existence and exercise of a qualified tender right are disregarded. One potentially significant change from Notice 2008-41 in the 2018 Proposed Regulations is in the definition of the term "qualified tender right." As described above, the definition in Notice 2008-41 provides that the terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to remarket a bond upon a purchase pursuant to the tender right. The 2018 Proposed Regulations, in contrast, provide that following a tender pursuant to a qualified tender right, the issuer or its remarketing agent must either redeem the bond or use reasonable efforts to resell the bonds within 90 days after the date of the tender. Thus, the 2018 Proposed Regulations use the term "resell" rather than "remarket" in describing the action that the issuer or its remarketing agent must take following a tender pursuant to a qualified tender right. This change may make it easier for bond counsel to conclude that it is not necessary for the issuer or its remarketing agent to make efforts to

remarket the bonds to other potential holders at the end of the bank's initial commitment period in order to have a qualified tender right.

While the 2018 Proposed Regulations are helpful, bond counsel still must carefully consider reissuance issues in the context of determining what happens at the end of the period that a bank commits to hold a tax-exempt bond. When the bond documentation allows the bank and issuer to agree upon a new rate without parameters, a reissuance is likely to occur. Even with meaningful parameters, bond counsel firms have varying opinions on the extent to which the details of the new rate must be set forth in the original bond documents before one can be confident that there is not a reissuance.

LIBOR Act

The Adjustable Interest Rate Act (the "LIBOR Act") is intended to establish a clear and uniform process to replace the London interbank offered rate ("LIBOR") in certain existing contracts without affecting the ability of parties to use any appropriate benchmark rate in new contracts. See 12 USC Ch. 55 (adopted by Pub. L. 117-103, div. U (March 15, 2022)).

The LIBOR Act generally provides that, unless the parties have opted out, after June 30, 2023 the Secured Overnight Financing Rate ("SOFR"), as adjusted by the provisions of the LIBOR Act, shall be the replacement rate for any LIBOR contract that (i) contains no fallback provisions, or (ii) contains fallback provisions that identify neither (a) a specific benchmark replacement or (b) a determining person. In general, if the fallback provision is based in any way on LIBOR or requires inquiry concerning lending or deposit rates, such provision is disregarded as if not included in the fallback provisions. Final regulations to implement the LIBOR Act have been adopted. See 12 CFR Part 253 (January 26, 2023).

Treasury regulations generally provide that a significant modification of a debt instrument is treated as an exchange of the modified debt instrument for the unmodified debt instrument and treated as reissued for federal income tax purposes. See Treas. Reg. §1.1001-3.

Additionally, Treasury regulations generally provide that certain modifications for a transition from an interbank offered rate to a qualified rate is not a significant modification that would trigger a reissuance for federal income tax purposes. See Treas. Reg. §1.1001-6.

The U.S. House Committee on Financial Services (the "Committee") has stated that the LIBOR Act provisions would not result in a sale, exchange or disposition under existing law. See H. Dept. 117-206, Adjustable Interest Rate (LIBOR) Act of 2021, 117th Cong. 1st Sess., p. 8 (Dec. 7, 2021). The Committee indicated that the language of earlier versions of the LIBOR Act explicitly provided that the LIBOR Act provisions would not result in a sale or exchange, but that such language was removed for merely restating existing law. Id.

Waivers of Defaults and Payment Deferrals

Generally, under Treas. Reg. §1.1001-3, the failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification. In addition, in some circumstances a bank may agree to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) without causing a modification unless and until the forbearance remains in effect for a period that exceeds (A) two years following the issuer's initial failure to perform; and (B) any additional period during which the parties conduct good faith negotiations or during which the issuer is in a bankruptcy or similar insolvency proceeding (as defined in IRC §368(a)(3)(A)). Treas. Reg. §1.1001-3(c)(4). Accordingly, waivers of default that meet the time limitations in Treas. Reg. §1.1001-3(c)(4)(ii), by themselves, generally do not result in modifications of debt instruments.

In conduit bond financings, waivers, particularly as to deferrals of principal and interest, need to be considered in light of the general rule that a conduit borrower and a lender cannot amend the terms of a debt instrument without the consent of the actual bond issuer (otherwise the obligation could become just an obligation between the conduit borrower and the lender). Therefore, many deferrals of principal and/or interest are documented with an actual amendment to the bond documents to avoid this risk. In such cases, the requirements of Treas. Reg. §1.1001-3(e)(3), particularly the safe harbor contained therein, should be considered.

VII. Draw-Down Obligations

Issuers often take draws on draw-down loans from banks over a period of multiple years. Bond counsel have taken different positions as to whether (i) each draw gets a full 3-year temporary period, or (ii) the 3-year temporary period is available only once beginning on the first date the cumulative draws exceed $50,000 and ending three years later. In that same vein, the time periods relating to the spending exceptions to rebate must be measured in many cases, so the start date for those spending exceptions is important. The conservative view is to treat all time periods as commencing on the date of issuance.

The issue date of an issue of bonds may be different from the issue date of the bonds that make up that issue. Treas. Reg. §1.150-1(b) includes a general definition for the issue date of a bond that provides the issue date is the date on which the issuer receives the purchase price in exchange for that bond, provided that in no event is the issue date of a bond earlier than the first day on which interest begins to accrue on such bond for Federal income tax purposes.

Treas. Reg. §1.150-1(c)(4)(i) provides that bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of $50,000 or 5 percent of the issue price.

IRS Notice 2010-81 (the "2010 Notice") stated that the issue date of each bond was relevant when determining compliance with deadlines for issuing Build America Bonds and Recovery Zone Bonds, as well as other deadlines for issuing bonds.

IRS Notice 2011-63 (the "2011 Notice") amended the 2010 Notice for volume cap limitations on private activity bonds under §146 and other bond volume caps and limitations under Federal law. The 2011 Notice permits issuers to elect to treat an entire issue of bonds as issued as of the date of the first draw, subject to requirements for expending proceeds within the maximum carry forward period for volume cap of the year of the first draw. This election applies solely for purposes of the volume cap limitation for private activity bonds and other bond volume caps on State and local bonds under Federal law. Special consideration should be given to qualified small-issue industrial development bonds in applying the 2011 Notice as such bonds are not eligible for volume cap carry over generally, so the 2011 Notice is not as helpful for such bonds.

IX. Bank Eligibility – Section 265 of the IRC

Pro-Rata Disallowance Rule and Exception for Bank Qualified Bonds

In general, interest incurred by the owner of a tax-exempt bond in order for the owner to purchase or carry the tax-exempt bond is not deductible. In the case of a bank or other financial institution, the interest expense of the financial institution is generally allocated pro-rata among its tax-exempt bonds and other assets, resulting in a disallowance of a proportionate share of the bank's interest expense. Because banks are largely funded through bank deposits, the pro-rata disallowance generally applies to a portion of the bank's interest expense with respect to its deposits. An exception to this pro-rata rule applies to bonds known as "Bank Qualified Bonds" ("BQ Bonds") or as Qualified Tax-Exempt Obligations" ("QTEOs"). Even with this exception, a portion of such interest is subject to the pro-rata disallowance rules. In general, BQ Bonds trade with lower yields than other bonds with similar credit quality, and consequently, when possible, bond issuers will desire their tax-exempt bonds to be BQ Bonds. The BQ Bond exception is intended to provide small issuers that might not otherwise have access to capital markets because of their size with better access to banks as purchasers of their bonds.

General Requirements

There are two ways that a tax-exempt bond can qualify as a BQ Bond: it can be designated, or it can be deemed designated. The requirements for each of these two ways are different.

In order for a tax-exempt bond to be designated as a BQ Bond, it must meet each of the following requirements:

- The bond must be issued by a qualified small issuer. A "qualified small issuer" is any issuer of tax-exempt bonds that does not reasonably anticipate to issue more than $10,000,000 of tax-exempt bonds during the calendar year, or otherwise

having more than $10,000,000 of tax-exempt bonds allocated to it. For purposes of small issuer qualification, certain tax-exempt bonds do not count towards the $10,000,000 limit. These include private activity bonds other than qualified 501(c)(3) bonds. Such private activity bonds cannot be bank qualified and are not issued primarily to benefit a small issuer, and hence they have been excluded from the tally. Also, current refunding bonds are not counted for this purpose to the extent of the amount refunded.

- The bond must be designated by the issuer. An issuer may designate no more than $10,000,000 of bonds each calendar year. Designation is generally accomplished by a written statement executed at or before the bond issuance.

- If the bond is part of an issue that includes any refunding bonds, then the size of the bond issue cannot exceed $10,000,000. In other words, an issuer cannot combine a refunding that is deemed designated as a BQ Bond with a new-money BQ Bond if the combined issue would exceed $10,000,000.

- An issuer may not be formed or availed of to avoid the purposes of §265 of the IRC. This generally means that a bond issuer cannot be used to issue the bonds in order to avoid exceeding small issuer status.

In order for a bond to be deemed designated the bond must meet each of the following requirements:

- The bond must be part of a current refunding issue (which could be a portion of a larger multipurpose issue that also has other purposes).

- The refunded bond must itself have been a BQ Bond (or fall within a transition rule for pre-1986 bonds).

- The refunding bonds will only be deemed designated to the extent of the amount refunded.

- The weighted average maturity of the refunding bonds must not be greater than the weighted average maturity of the refunded bonds unless the refunded bonds were part of an issue of bonds with a weighted average maturity of three years or less and in the case of a chain of refunding bonds the earliest bank qualified bond in the chain was also part of an issue with a weighted average maturity of three years or less.

- The final maturity date of the refunding bond to be deemed designated must not be later than 30 years after the issue date of the original bond at the beginning of any chain of refundings.

- The size of the bond issue including any deemed designated bonds is limited to $10,000,000. This is the only size limitation that applies to deemed designated bonds.

- The bond to be deemed designated must be a tax-exempt governmental bond or a qualified 501(c)(3) bond. It may, however, be issued by an issuer that is not a qualified small issuer in the year of issuance. There is no limit on the amount of bonds that can be deemed designated and issued by a particular issuer in a particular year.

In computing each of the $10,000,000 limits described above:

- An issuer and all entities which issue obligations on behalf of such an issuer are treated as a single issuer.

- All obligations issued by a subordinate entity are treated as issued by the entity to which it is subordinate. A subordinate entity is a broader concept than an "on behalf" entity, and, as a result, a subordinate entity may be entitled to its own bank-qualified limit, with its obligations still counting against a "parent" entity.

- An entity formed or availed of to avoid the principal amount limitations and all entities benefiting thereby are treated as one issuer.

- The amount of a bond for purposes of the various limits may be its issue price or it may be a combination valuation using the stated principal amount whenever there is less than 2% discount and less than 2% (plus reasonable underwriter compensation) of premium. Because the correct measure is not explicitly spelled out, many firms use a conservative approach, applying the larger of these two measures for all purposes except determining the amount of refunded bonds, when the lesser of the two methods is used. In measuring the amount of bonds refunded when the refunded bonds were issued with a deep discount, the results may depend on many facts and circumstances.

For purposes of small issuer status, a bond issue that benefits multiple local governmental units may be allocated by agreement among the benefitted local governments. The agreed allocation method must reflect the relative benefit to the respective local governments.

In the case of an obligation issued as part of a direct or indirect composite issue (which is not defined in the statute or any regulations) such obligation shall not be treated as bank qualified unless:

- The requirements described above are met with respect to each composite issue, determined by treating such composite issue as a single issue, and

- The requirements set forth above are met with respect to each separate lot of obligations which are a part of the issue, determined by treating each separate lot as a separate issue.

Rev. Rul. 89-70 concluded that for purposes of Section 265(b) of the IRC, the issue date of a draw-down obligation is the date on which more than a de minimis amount of funds is first advanced under the obligation, and the amount of the draw-down obligation is the stated principal amount thereof. This ruling is very helpful when designating a draw-down obligation as a BQ Bond.

ARRA Rules for 2009 and 2010

The American Recovery and Reinvestment Act of 2009 ("ARRA") adopted special amendments to Section 265(b) effective for obligations issued during 2009 and 2010. Among the special rules applicable for bonds issued in 2009 or 2010 are: (1) $30,000,000 limits substituted for each of the $10,000,000 limits, (2) testing qualified 501(c)(3) bonds by the annual amount issued to benefit the 501(c)(3) organization rather than by the governmental issuer and (3) a special de-minimis rule that allowed all new money bonds issued in 2009 or 2010 to obtain many of the benefits of bank qualified bonds even if they are not bank qualified. Those special amendments were not extended, so that bonds issued after December 31, 2010, do not qualify for those more liberal provisions. Current refundings of bank qualified bonds may be deemed designated even if the refunded bond would not have qualified under current law but the deemed designated refunding bond must not be part of an issue that exceeds $10,000,000, which in some cases means that a current refunding must be separated into separate tranches that are sold at least 15 days apart. As a result, under ARRA, banks were also able to treat a certain portion of their assets as effectively BQ Bonds from an economic perspective, and in refunding ARRA-era debt, it often can be helpful to study that provision as well to determine whether a refunding can get the benefit of effective treatment as a BQ Bond under this separate exception.

Opinion Practice relating to BQ Bonds

The practice of rendering opinions as the status of tax-exempt debt as BQ Bonds varies greatly. Some bond counsel will not render a "clean" opinion as to the status of tax-exempt bonds as BQ Bonds. Other bond counsel will render opinions similar to the opinion on the tax-exemption of interest unequivocally stating that the tax-exempt debt qualifies as BQ Bonds.

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18 – 20, 2023

TAX-EXEMPT LEASING

Chair:

Nate Canova	Dorsey & Whitney LLP – Salt Lake City, UT

Panelists:

Harsha Sekar	Michael Best & Friedrich LLP – Denver, CO
Alan Woolever	Gilmore & Bell, P.C. – Kansas City, MO

Tax-Exempt Leasing Panel

This panel will cover intermediate and advanced topics in tax-exempt leasing, including topics in state law and federal securities and tax law. Commercial financial disclosure laws regulate some lessors and are now in effect in a handful of states, with new legislation introduced in several more states. Panelists will highlight the new laws, their impact on lease transactions and national efforts to create uniform disclosure laws. Panelists will also take a deep dive into the federal securities laws of lease financing and discuss the framework for analyzing leases, including a general discussion of the *Howey* and *Reves* tests, and a series of SEC no-action letters directly applicable to lease financing structures. Finally, the panel will cover fundamental, but advanced, tax topics routinely at issue in tax-exempt leasing transactions, such as distinguishing true leases from capital leases, properly completing the IRS Form 8038-G (Line 20), and dealing with escrow extensions and qualified stated interest / original issue discount.

I. INTRODUCTION

"Tax-exempt leasing" is a financing technique by which state and local governments acquire real and personal property. It may involve documents labeled variously as a "lease," a "municipal lease," a "lease-purchase agreement," an "installment purchase contract," an "installment payment contract," an "installment sale contract," a "purchase order," or simply a "contract," among others. The common elements of such agreements are (1) installment payments, characterized as rent or otherwise, that include a specified interest component, and are being made by a state or political subdivision (*i.e.*, a tax-exempt issuer for federal income tax purposes) lessee for the purpose of acquiring the use of and title to real or personal property and (2) in most jurisdictions, carefully drafted in order that the agreement does not constitute "debt" for state law purposes. In this outline, the term "lease," except when in quotes, is used as the generic term to include all the various types of agreements that make up this financing technique. Banks, leasing companies, insurance companies, other financial institutions and other private investors enter into tax-exempt leases as lessor (or purchase the lessor's interest from vendors or lease brokers) and often hold the leases for their own account during the entire term of the lease. Private parties and even other tax-exempt issuers may also act as lessors. Particularly for public market deals, leases are frequently used to provide a stream of revenues for lease revenue bond structures and leases are frequently certificated by the creation of lease certifications of participation ("COPs").

Part II of this outline examines the various forms of leasing products, from "true leases," which involve no acquisition of title by the lessee, to different types of financing leases, which pass ownership to the lessee, by describing the evolution of the lease as a financing technique and certain state law considerations relating to debt limitations.

Part III of this outline presents a general checklist of the various matters to be considered in rendering an opinion that a particular lease is duly authorized and a valid and binding obligation of a governmental lessee, and that the interest component of the payments due under the lease to be made by the governmental lessee is excluded from gross income for federal and/or state income tax purposes.

Part IV of this outline examines some special state law and tax law issues relating to COPs, which represent a fractionalized interest in a lease and the rights thereunder.

Part V of this outline raises certain other federal tax issues that may be encountered from time to time in lease financings.

Part VI of this outline provides a summary of new commercial financial disclosure laws which may be applicable to some tax-exempt leases.

This outline is not an exhaustive list of the issues that a lawyer must address in reviewing a lease or a COP transaction, but it is intended to be of assistance in identifying areas of analysis. Statements made in this outline do not necessarily reflect the views of any of the authors, nor especially of their respective law firms.

II. FORMS OF LEASES AND APPLICATION OF DEBT LIMITATIONS

A. Distinguishing a "True Lease" or Annual *Quid Pro Quo* from Lease-Purchase Agreements

True leases, sometimes called operating leases, are used by a majority of commercial and private sector entities to provide for the use of property by governmental and private lessees over a certain term without transferring the benefits and burdens of ownership. In true leases, there is no option to purchase the leased property, or the option to purchase is at fair market value at the exercise date. Although the legal analysis upholding the validity of leases varies from jurisdiction to jurisdiction (due primarily to variations in constitutional, statutory and charter provisions relating to the authority for such obligations and the applicable debt and budget limitations), true leases have often withstood challenges that they create unlawful indebtedness because the governmental lessee is only liable to pay rents during each fiscal period in an amount equal to the value of the use and possession of the leased property during that period. In this respect, the obligation of the governmental lessee is comparable to that incurred in, for example, hiring a police officer: for one day's work, one day's pay is owed. Because the true lease obligation does not create an immediate liability for all rents or other amounts scheduled to be paid during the term of the lease, but only a liability to the extent of the contemporaneous value received, it does not create unconstitutional or illegal "indebtedness" for state law purposes Unlike a financing lease, a true lease can be defended in most jurisdictions even in situations where the obligation to pay rent is not expressly conditioned on annual appropriations by the governmental unit, because under common law the lessee has no obligation to pay rent until it comes due under the terms of the lease and there is no right of acceleration of future rents upon default by the lessee. It is generally understood that a "true lease" cannot be structured as a tax-exempt obligation given the federal tax law requirement that the lessee build up equity in the leased property. *See* Rev. Rul. 55-540 and PLRs 8235056 and 8347058.

1. **Current Liability**. *City of Los Angeles v. Offner*, 19 Cal.2d 483 (Cal. 1948), involved a lease/lease-back arrangement under which the city leased a site to a contractor, the contractor built a facility on the site and leased both the site and the facility back to the city. In holding that the lease-back to the city and the installment payments therein did not violate the debt limit provision of the California Constitution, the Court stated: "if the lease or other agreement is entered into in good faith and creates no immediate indebtedness for the aggregate installments therein provided for but, on the contrary, confines liability to each installment as it falls due, and each year's payment is for the consideration actually furnished that year, no violence is done to the constitutional provision." *Id.* at 486. Additionally, contracts for the furnishing of property in the future may be upheld, but only where no liability or indebtedness came into existence until the consideration was actually furnished." *Id.*

2. **Fair Rental Value**. Although not always expressly stated in court decisions, the notion that the rents payable pursuant to a lease during each fiscal period represent fair consideration for the use and occupancy of the property during that period (*i.e.*, the concept of "fair rental value") is

implicit in the supporting state law legal analysis. *See, e.g., id.* at 487; *Dean v. Kuchel*, 218 P.2d 521, 523 (Cal. 1950); *accord City of San Diego v. Rider*, 47 Cal.App.4th 1473 (Cal. Ct. App. 1996). Thus, for example, "front-end loading" rental payments or fully-amortizing the cost of 30-year property over a 5-year lease term could raise questions concerning whether the governmental lessee is purchasing property on an installment basis, and thus has incurred debt, since such arrangements would arguably result in the payment of rent in each fiscal period greatly in excess of the value of the use and occupancy of the property during that period, with a resulting equity build-up.

Because the concept of fair rental value, where expressly recognized, is "judge-made" law, there are no precise standards for determining fair rental value.

The appraised value of leased property is not necessarily legally required to correlate to, or be higher than, the principal amount of the lease. The appraised value is one of many factors to support the lessee's determination that the rental payments payable by the lessee under the Lease do not exceed the fair rental value for the leased property that is subject to the lease. Other factors include the costs of acquisition, design, construction and financing of the leased property, replacement costs of the leased property, obligations of the lessee under the lease other than its rental payment obligation (such as use, operation and maintenance of the leased property for the public benefit), the essential or critical nature of the leased property for the lessee and its governmental operations, the uses and purposes that are served by the leased property and the benefits that will accrue to the lessee and the general public from the leased property.

B. Annual Appropriation Leases

Financing leases transfer ownership of the leased property to the lessee. An annual appropriation lease <u>can</u> be structured as a tax-exempt obligation. In many jurisdictions, financing leases have been upheld because the governmental unit has the option to terminate the lease at the end of each fiscal period, for example, by not appropriating the funds needed to pay the rent coming due in the next fiscal period. Therefore, like a true lease, the financing lease does not obligate public moneys in a future year and will usually be treated as a current liability, and therefore, will not constitute "indebtedness." The underlying state law concept is that a "debt" is something that binds the governmental unit to make payments in future budget years. Without a binding obligation that extends beyond the current fiscal period, there is no "debt" in the requisite sense. This concept has been the subject of a great deal of scrutiny as opponents of financing leases have attempted to have the leases declared to be "debt" and, therefore, invalid, in part, because applicable constitutional, statutory or charter procedures for the creation of "debt" were not followed.

1. **Legal Liability.** One such case, *State ex rel. Kane v. Goldschmidt*, 783 P.2d 988 (Or. 1989), involved a financing agreement whereby the state's interest in the financed property would automatically terminate at the end of each fiscal period unless the legislature appropriated the funds necessary

to pay the amounts scheduled to come due in the next fiscal period. Subject to payment of all scheduled amounts under the agreement, the state would receive title to the property at the end of the term. In sustaining the validity of this arrangement against a challenge that it constituted unconstitutional indebtedness, the Court analyzed the law as follows:

> The debates on the floor of the [constitutional] convention left little doubt as to the purpose of the debt limitation. The central concern was that future generations should not be saddled with the excessive undertakings of an imprudent legislature. The debt limitation was therefore adopted to protect against burdensome and excessive taxation. ... "Long-term obligations create a fixed charge against future revenues and can impair the flexibility of planning and the ability of future legislatures to avoid a tax increase." . . .
>
> This court has looked at not less than two basic characteristics in deciding whether [the] action violates Article XI, section 7: (1) the fund from which payments on the obligation are made; and (2) the degree to which the public body is liable for repayment of the loan.
>
> The state's promise of repayment is conditioned on the willingness of future legislative assemblies to appropriate the funds. The state does not promise that future legislatures will appropriate any funds. The lenders take the risk of non-payment. This aspect of the legislation does not create a fixed charge against future revenues, nor does it impair the flexibility of planning and the ability of future legislatures to avoid a tax increase. 308 Or. 573, 580-81, 586. (Citations omitted.)[1]

A similar case, *Business Computer Rentals v. State Treasurer*, 953 P.2d 13 (Nev. 1998), after analyzing the holding in *Goldschmidt* and other similar cases, determined that a lease for computer equipment containing a nonappropriation clause did not create "public debt" in contravention of the Nevada Constitution, and granted the petitioner's writ of mandamus directing the Nevada State Treasurer to make payments under the lease. Specifically, the Court determined the following:

> [T]he lease's nonappropriation provisions bring it outside the scope of Nevada Constitution article 9, section 3. The agreement's subject

[1] *Id.* at 991-992. *See also Dykes v. North Virginia Transportation District Commission*, 411 S.E.2d 1 (Va. 1991); *Dieck v. Unified School District of Antigo*, 477 N.W.2d 613 (Wis. 1991); *State Department of Ecology v. State Finance Committee,* 804 P.2d 1241 (Wash. 1991); *In re Anzai*, 936 P.2d 637 (Haw. 1996); *State ex rel. Charleston Building Commission v. Dial*, 479 S.E.2d 965 (W. Va. 1996); *Employer Insurance Co. of Nevada v. State Board of Examiners*, 21 P.3d 628 (Nev. 2001) (supporting the proposition that nonappropriation leases do not constitute "debt"). *But see Brown v. City of Stuttgart*, 847 S.W.2d 710 (Ark. 1993) (finding that a lease constituted "interest bearing indebtedness" which was prohibited by the state constitution); *Montano v. Gabaldon*, 766 P.2d 1328 (N.M. 1989) (holding that a lease constituted unlawful indebtedness since it had not been approved by the voters as required by the state constitution).

> matter is fungible equipment, susceptible to repossession. Further, the contract clearly provides that payments are contingent on funds being appropriated by the legislature. The agreement automatically terminates if the legislature fails to appropriate sufficient funds for the payments, and in such a situation, [lessor] is entitled to repossess the equipment. Under the current revenue doctrine, no constitutionally proscribed public debt is created. Unlike the situation in *Hancock,* realism does not demand that "indebtedness ... is immediately created for the aggregate amount required by the period of the pledge." *Hancock,* 468 P.2d 333, 337. Here, the legislature is not compelled to appropriate money in the future.

2. **Compulsion to Appropriate**. Because the failure to appropriate funds necessary to pay rents coming due in the next fiscal period can have severe adverse consequences for the governmental unit, it is often argued that while the governmental unit may not be legally bound to appropriate funds for future fiscal periods, it is economically compelled to do so as a practical matter and thus, the arrangement is the functional equivalent of "debt" for state law purposes. This argument has been rejected by numerous courts; however, it has been a key argument in challenges to the validity of annually renewable/appropriated leases.

The plaintiff in *Kane* argued that the threat of loss of a credit rating in the event of nonappropriation rendered the lease in question a "debt." In rejecting this argument, the Court stated:

> Nor does the fact that the legislature may feel compelled to make payments in a future [fiscal period] out of the fiscal concern to protect its credit rating convert the state's obligation into a legal one subject to [the constitutional restrictions on the incurrence of indebtedness]. The economic and fiscal consequences of either continuing the agreements or allowing them to terminate by failing to appropriate money merely becomes [sic] a factor in the public policy calculus of a political system that automatically subjects the economic wisdom of such projects to [biennial] review by future taxpayers and their elected representatives. [Citation omitted.] These consequences are of no constitutional significance.[2]

Similarly, the court in *Colorado Criminal Justice Reform Coalition v. Ortiz*, 121 P.3d 288 (Colo. App. 2005) rejected the plaintiffs' argument that the contested lease purchase agreements would, in reality, be multiple-fiscal year obligations because the failure to appropriate would have a negative effect on the state's credit rating. Specifically, the court cited state precedent holding that "the . . . argument that nonrenewal of the lease will ruin the credit of the state . . . is a matter that may affect the legislature's exercise of its discretion, but does not commit revenues

[2] *Kane*, 783 P.2d at 995-996. *See also id*. at n. 12 (citing similar cases from other jurisdictions).

available to future legislatures to the payment of rentals under the lease." [Citation omitted.][3]

The plaintiff in *Kane* also argued that the lease created unconstitutional debt because if the state failed to renew the lease for a succeeding year, it stood to lose its entire equity in the financed property. The Court in *Kane* acknowledged that while this argument could have merit under other circumstances, the lease in question was not problematic:

> A common lease-purchase agreement generally allows the lessee to terminate the transaction without further liability if the lessee no longer needs, wants, or can afford the leased property. This does not create a debt or liability [footnote omitted]. The situation is more questionable if, upon terminating the agreement, the state stands to lose more than what remains to be paid on the acquired property, for instance, if most of the agreed price of an outright purchase, including interest, has been paid but termination will cause the state's entire valuable property (worth more than the unpaid balance) to pass into the hands of the seller or lender. In that situation, the agreement confronts future legislators with the choice between the financial cost of continued cash payments or the financial cost of losing valuable nonmonetary property. This contingency may appear to create a liability, prohibited by [the state constitution]. . . . We therefore hold no more than that the participation agreements are not on their face forbidden as a future debt or liability contrary [to the state constitution], so long as the state stands to lose property or the use of property worth no more than the unpaid balance under the agreement.[4]

On the other hand, the fact that upon default, or nonappropriation, property of the governmental unit having a greater value than the unpaid balance of the installment purchase payments could be forfeited may not to be problematic. In the case of *Wayne County Citizens Association for Better Tax Control v. Wayne County Board of Commissioners*, 328 N.C. 24 (N.C. 1991), the Court sustained the validity of an installment purchase contract where the obligation to make installment payments was subject to annual appropriation and the county's obligations under the contract were secured by a security interest in the property covered by the contract. The Court concluded that "debt," within the meaning of the state constitution, included only those obligations for which the taxing power of the governmental unit was pledged:

> What is being pledged is the constitutionally significant factor. Unlike general obligation bonds, wherein the taxing power of the

[3] *Glennon Heights, Inc. v. Central Bank & Trust*, 658 P.2d 872, 879 (Co. 1983). *See also, Bd. Of County Comm'rs v. Dougherty, Dawkins, Strand & Bigelow Inc.*, 890 P.2d 199 (Colo. App. 1994)
[4] *Kane*, 783 P.2d at 997-998.

> governmental unit is pledged, in installment purchase contracts, only the property improved is pledged. The possibility that appropriations that might include income from tax revenues will be used to repay the indebtedness under the contract is not a constitutionally significant factor. *Id.* at 31.

In reaching this conclusion, the Court expressly noted that both the enabling statute and the contract itself barred any deficiency judgments against the county, presumably a significant fact because of the possibility that deficiency judgments could be subject to satisfaction out of tax revenues.

In jurisdictions where the constitutional concept of "debt" is not expressly linked to a pledge of the taxing power (as it was in *Wayne County, supra*) but is more broadly defined to include any obligation extending beyond the current fiscal period for which any assets of the governmental unit are at risk (as in *Goldschmidt, supra*), the logic employed by the Court in *Kane* would seem equally applicable to annual appropriation leases. Thus, in jurisdictions similar to Oregon, it may be prudent to limit the lessor/trustee's remedies in a nonappropriation situation to sale of the leased property and recovery of the balance of the scheduled rents, with any excess, *i.e.* the "equity," being remitted to the governmental unit.

C. Abatement Leases (California and Indiana)

In moving from the "true lease" considered in *Offner, supra* (where the city only had the option to purchase at fair market value), to financing leases which transfer ownership of the leased property to the lessee, the California courts have fashioned the concept of "abatement leases," which are now used as an alternative to annual appropriation financing leases to avoid violating the limitations on indebtedness included in the California Constitution. Local governments in Indiana also use abatement leases from time to time. Like annual appropriation leases, abatement leases can be structured as tax-exempt obligations. An abatement lease has the following characteristics for state law purposes:

1. **Vesting of Title at End of Term**. At the end of the lease term, upon the payment of all rents, or prior to the end of the term upon prepayment of the unpaid principal components of the lease payments and accrued and unpaid interest thereon, title to the property covered by the lease vests in the governmental unit. In sustaining this automatic vesting of title, the Court in *Dean* reasoned:

   > We find no logical distinction between the Offner case and the one at the bar. It is true that [in *Offner*] there was an option to purchase [at fair market value]. . . rather than a vesting of title at the end of the term [as] in the instant case, but as far as liability is concerned, the state under the instrument here is in a better position, for it gets title without the payment of anything other than the rental. The essence of the Offner rule is that the payments are for a month to month use of the building. Here it is clearly stated that the rentals

are for that purpose. There is no substantial or logical difference between the option to purchase in the Offner case and the vesting of title at the end of the term in this case. True, the city was not bound to execute the option and thus pay the purchase price, but it was required to pay the rentals. Here the rentals also must be paid but the state need not pay any more.[5]

2. **Rental Payments Subject to Abatement**. If the property is not available for use by the governmental unit, or if there is substantial interference with the governmental unit's use or occupancy of the property, then the rents otherwise payable under the lease must be proportionately abated. As such most lessors require at least 24 months of rental interruption insurance for abatement leases, the proceeds of which would cover rent due under the lease while the financed property is being rebuilt or replaced.

a. *Abatement Generally; Use and Occupancy of the Project*. In *Starr v. City and County of San Francisco*, 72 Cal.App.3d 164, 172 (Cal. Ct. App. 1977), the Court pointed out the characteristics of the lease in question (which comply with the requirements of *Offner*, *supra*, and *Dean*, *supra*) and noted that "[t]he base rental is for specified amounts to be paid by the City to the Agency 'as rental for use and occupancy of the Project,' with rent abatement provisions if the project is not substantially completed and ready for occupancy by July 15, 1980, or if there is a subsequent substantial interference with use and occupancy of the premises."

b. *Covenant to Appropriate/General Fund Obligation*. Because this approach to holding that the lease does not constitute "debt" is based on the fact that liability for rents is confined to "each installment as it falls due and each year's payment is for the consideration actually furnished that year" (see *Offner*, *supra*), the governmental unit is obligated to make the rent payments as they come due (subject only to abatement) and can be compelled to appropriate money for that purpose. This generally results in inclusion of a covenant to appropriate money from the general fund sufficient to pay the rents due in each fiscal period. The net effect is what might be called a "general fund limited tax obligation subject to abatement," a binding and enforceable obligation payable out of any lawfully available money of the governmental unit (including general fund tax revenues) but for which the governmental unit cannot be compelled to levy taxes beyond those authorized for general purposes and that is subject to abatement to the extent of any substantial interference with use or occupancy of the property. Nevertheless, there is no right to accelerate the rents upon default. Rather, the lessor is limited to suing to collect each rental payment as it comes due.

c. *No Obligation During Construction/Acquisition Period*. In keeping with the abatement theory (*i.e.*, the municipal lessee has no liability for rent

[5] *Dean*, 218 P.2d at 523 (Cal. 1950).

except to the extent the property is available for use and occupancy), until the property subject to the lease has been acquired or constructed, the governmental unit's obligation to pay rents must be limited to sources other than its own funds or assets (*e.g.*, the capitalized interest fund and interest earnings on the acquisition/construction fund created under the financing documents and funded with the proceeds derived from the sale of the lease obligation). This aspect of the abatement lease thus incorporates an element of the special fund doctrine in terms of providing a constitutionally permissible source other than ad valorem taxes from which to pay interest during the acquisition or construction period. If permitted by state law, a governmental unit may want to enter into an "asset transfer" lease financing transaction of the type described below in order to lease property already available for use and occupancy.

D. Limited Tax Full Faith and Credit Leases

In certain jurisdictions, it is possible to structure a financing lease as a limited tax, full faith and credit obligation of the governmental unit that is not subject to annual appropriation or abatement. The availability of this financing technique is highly dependent on the interpretation of constitutional and statutory debt limitations in the jurisdiction in question, and there are often constitutional or statutory provisions that limit the amount of binding obligations that can be incurred. Generally speaking, these leases have the following characteristics:

1. **Obligation to Pay Rents**. The governmental unit is obligated to make the rent payments and can be compelled to appropriate money for that purpose. This aspect of the governmental unit's binding obligation is generally recognized by the inclusion of a provision making the obligation to pay rents a full faith and credit obligation payable out of any lawfully available source of funds, including property taxes that the unit is otherwise authorized to levy.

2. **Obligation Unconditional; No Abatement**. The obligation to pay rents is unconditional and not subject to abatement. Rather, the lease is structured as a true financing arrangement where the risk of loss, or interference with use and occupancy, is borne by the governmental unit.

3. **Right to Accelerate Rents on Default**. In some jurisdictions, the lessor can be given the right to accelerate all unpaid lease payments upon default.

E. Special Fund Leases and Related Variants

In several jurisdictions, financing leases are evolving to incorporate features such as pledges of specific revenues normally associated with the special fund doctrine. For example, the Kentucky Governmental Leasing Act § 65.942(2) allows lease payments to be secured by a pledge of revenues or taxes. Specifically, this section provides that "[A] governmental agency may pledge any revenues or taxes as security for payment under leases, and the leases may provide that the governmental agency may terminate its obligations under the lease at the expiration of each year

during the term of the lease. A governmental agency may pledge any revenue or taxes as security for payment under a lease regardless of any right to terminate." Under that section, the pledge of taxes for an annual appropriation lease would appear to give the holder of the obligation the right upon default or nonappropriation to seize the pledged taxes only to the extent needed to cover the appropriated (*i.e.*, the current fiscal year's) rents.

F. "Asset Transfer" Lease Financing Transactions

If permitted by state law, a governmental unit may wish to enter into an "asset transfer" lease financing transaction, in which the governmental unit leases or sells an existing asset that it already owns to a lessor and simultaneously leases it back. The proceeds generated from the sale or leasing of the existing asset are used for other governmental capital projects.

1. **State Law Issues**. State and local law may only allow a governmental entity to sell or otherwise dispose of property that it owns if the governing body determines that the property is obsolete, unfit or surplus property, which is no longer needed by the governmental entity, or may require that such a sale or disposition be authorized by its voters or by public auction. Other state law considerations under applicable state laws and judicial interpretations would be whether or not this form of lease purchase financing represents a type of "cross-collateralization" that constitutes invalidly incurred debt in the jurisdiction or a "mortgage" of public property that is not permitted. When an asset transfer financing is contemplated, state and local law issues should be very carefully scrutinized.

2. **Potential Advantages.** If state law issues can be resolved, the practical advantages of an asset transfer lease financing include the elimination of construction risk (because the asset securing the lease is already in existence) and the potential need for capitalized interest, having an asset to secure the lease that is potentially more essential to the governmental unit than the asset or assets that need to be financed, or being able to finance improvements to existing buildings that otherwise might be unsuitable for lease financing on a separate basis or cause a "compulsion to renew" because of "over-collateralization."

III. BASIC LEASE ISSUES

A. Is the Lease Valid?

Invalidity of a lease can mean not only the loss of future installments, but also possible recoupment of prior installments. Interest on an invalid lease is not excludable from gross income for federal income tax purposes. Yet, statutory guidance for lease financing is often not clear, and it is often possible that other statutes will unexpectedly come into play. Some of the primary issues in this regard are discussed below.

1. **Is there statutory authority for the governmental unit to enter into the lease?** Many state statutes provide only generalized language as to authority to "lease" or "purchase" or simply to "acquire" real or personal

property or to issue "obligations." Practice varies from state to state and from lawyer to lawyer as to what statutory authority is sufficient to authorize a lease financing transaction.

2. **Does the lease include provisions that are not authorized by law?** Leases and accompanying escrow agreements often include provisions for indemnification of the lessor (its assigns) and/or an escrow agent for contingencies that range from personal injury to loss of tax exemption of interest. Yet, it is the law in many jurisdictions that public bodies cannot indemnify third parties. Another provision found in some leases is the existence of a covenant precluding the lessee from acquiring similar property for some period of time after a nonappropriation, thereby potentially preventing the lessee from performing an important public function required by state law. Such nonsubstitution clauses are generally considered unenforceable and in some states may invalidate the lease. *See, e.g., Frankenmuth Mut. Ins. Co. v. Magaha,* 769 So.2d 1012 (Fla. 2000) (holding that a nonsubstitution clause invalidated a lease as debt incurred in violation of a constitutional requirement for voter approval). *Cf. Miccosukee Tribe of Indians of Florida v. South Florida Water Management. District,* 48 So.3d 811 (Fla. 2010) (affirming that the absence of a nonsubstitution clause helped render the nonappropriation clause as real and not illusory, thereby preserving the integrity of the nonappropriation clause and helping to prevent COPs from being characterized as debt). Leases that include questionable clauses are sometimes funded with the thought that invalidity is not clear or that the questionable provision can be isolated by the phrase "to the extent permitted by law" or that, in any event, a severability clause will excise the offensive provision. In this regard, consideration must be given to the basic rule that municipal entities have only those powers expressly authorized by statute (commonly known as Dillon's Rule). There have been instances where a court has invalidated a lease rather than sever the offending provision. *But see Frankenmuth Mut. Ins. Co. v. Escambia County, Fla.,* 289 F.3d 723 (11th Cir. 2002) in which the court held that the nonsubstitution clause was severable and the lease was valid.

3. **Have procurement laws been observed?** Failure to observe public bidding or other procurement laws may not affect validity of a bond issue, but could invalidate a lease. *See, e.g.*, *McBirney & Associates v. State*, 753 P.2d 1132 (Alaska 1988). Procurement codes are often a morass of requirements, observance of which will involve a fact-laden inquiry. Practice varies, but counsel will often rely on representations of the lessee, local investigation as to such compliance, or an opinion of local counsel. Public bidding laws may apply to the acquisition of the leased property and to the lease financing itself, depending on state law.

4. **Does the lease create unconstitutional or illegal "debt"?** See Part II of this outline for more detail. Despite broad use of nonappropriation clauses

and abatement lease structures, where available, there may be lingering concerns in some jurisdictions that leases might nevertheless be struck down as unvoted or otherwise unconstitutional debt. Rev. Rul. 87-116 adds to the concern with its determination that interest on an obligation found to be unconstitutional is not tax-exempt from its inception. Clauses in the lease should be analyzed as to their potential effect on the issue of debt, such as whether the lease should be subject to annual renewal or annual termination; the consequences of damage, destruction or condemnation; when the rental payment obligation may commence as to the lessee; as well as any clauses (*e.g.*, nonsubstitution clauses) that seek to penalize the lessee for exercising its option to terminate the lease annually.

5. **Does the lease violate positive requirements of state law?** It is often not clear whether usury laws or interest rate ceilings that may apply to bonds also apply to leases. At times, leases may be covered by deceptive trade practices laws. Some states have statutes that require certain specific language to be included in a lease and failure to include that language may invalidate the lease. Many states have specific requirements with respect to leases associated with renewable energy and energy conservation programs. Jurisdictions may have other statutes that unexpectedly affect validity.

6. **Has the lease been properly authorized and entered into?** *Power Equipment Co. v. U.S.*, 748 F.2d 1130 (6th Cir. 1984), holds that even interest on an enforceable lease is not exempt if a statutory step (*e.g.*, approval by city council) has been omitted. The decision in *United States Leasing Co. v. City of Chicopee*, 521 N.E.2d 741 (Mass. 1988) holding that the mayor's signature was called for by the city charter is a reminder that administrative requirements are a precondition to validity, and that the estoppel effect of the lessee counsel's favorable opinion may not be much help.

7. **Is any tax levy necessary to pay lease payments within the lessee's applicable levy limit for operating expenses or, if appropriate under state law, for capital expenditures?** Lease payments typically constitute current expenses of each fiscal year during the lease term and must be raised through a tax levy for operating expenses or capital expenditures within a levy limit imposed by state law for the particular political subdivision entering into the lease. Depending upon how the lease is drafted, the particular state law and the type of political subdivision entering into the lease, as lessee, the lessee may not be obligated to exceed any applicable levy limits in generating money to pay its lease payments without creating the risk that the lease is or may be held to be invalid debt. In addition, a comparison of the level of the required tax levy to any applicable levy limit (considered with and without the proposed additional rental payments) may suggest how likely the risk of nonappropriation may be.

B. Are the Lessor's/Owners'/Investors' Interests Adequately Protected?

1. **Is the leased property "essential"?** Lessors, assignees, and in COP and lease revenue bond transactions, underwriters and investors, generally evaluate the "essentiality" of the property to be financed with the lease. In real property transactions, the following questions may be appropriate: Is lease-financed real property essential to the delivery of critical or mandated governmental services, such as courthouses, jails and governmental offices? Or is the real property being acquired for more discretionary purposes, such as entertainment or sports facilities? Is the real property sufficiently distinct and transferable to be susceptible to lease financing? The following questions may be appropriate in equipment transactions: If the lease finances the acquisition of equipment, is the equipment subject to adequate identification and control? Is the equipment standard equipment of proven usefulness, such as school buses and fire trucks, which are unlikely to be the subject of nonappropriation and also would have value if the lease were nonappropriated? Or is the equipment "customized," "high-tech" or intangible property or systems that are subject to significant risk of not being acquired or completed on time and within budget, or that are subject to unusually fast depreciation in value or technological failure or obsolescence, with a resultant increase in the risk of nonappropriation? Is the equipment or the information stored within the equipment subject to state or federal laws (such as federal privacy laws) or prior liens, making collateral recovery difficult? Governmental lessees are typically asked to certify as to the essentiality of the property to be financed, but such certifications should not take the place of independent analysis. This is primarily a credit issue as opposed to a legal issue.

2. **Other.** The following is a non-exhaustive list of lease provisions, issues or considerations that relate to the needs and/or concerns of lessors, assignees and/or investors:

a. It may be important for credit purposes to include a lease payment schedule that reflects the expected completion date of the construction of the leased property and the expected remaining useful life of the leased property. These details have legal significance as well.

b. Leased property consisting of multiple assets or assets that are more valuable than the total principal portion of the rental payments could reduce the practical risk of nonappropriation, but may not be legally possible or feasible.

c. Protections against completion/acquisition risk include:

(1) Entering into the lease after final design and cost estimates are complete and only slightly before commencement of construction or acquisition.

(2) Requirements for the construction contract which include builder's "all risk" insurance during construction, performance and payment bonds and liquidated damages for delay.

(3) Capitalized interest through completion of construction/acquisition and acceptance by lessee.

d. Protection against loss after completion/acquisition including insurance provisions and required prepayment upon damage/destruction or condemnation.

e. Title to the property/equipment in accordance with state law (either in lessor or lessee, as required) and the grant/retention of a security interest in the property/equipment (as permitted by state law).

f. Release and indemnification of lessor (where permitted by state law).

g. Title insurance in respect of the leased property reflecting ownership or leasehold interest of lessor and mortgage loan or leasehold loan interest of lessor's assignee (which may be a trustee for the owners of COPs).

h. Analysis of appraised or insured value (replacement cost) of leased property.

i. Provisions relating to waiver of condemnation powers of lessee in respect of the leased property. Credit problems coupled with a difficult negotiation situation (*i.e.*, the inability to compromise with the lessor or the lessor's assignee) may cause a lessee to attempt to condemn the leased property at a value that is less than the principal balance of a lease.

j. Provision stating that equipment is and will remain personal property and will not become a fixture (for equipment leases).

k. Irrevocable assignment by a lessor to a bank trustee representing owners of COPs.

l. Remoteness of risk of bankruptcy of lessor to the owners of COPs.

m. Casualty and rental interruption insurance requirements, particularly for abatement leases.

n. Reserve fund relating to failure to pay or appropriate rental payments.

o. A provision confirming the lessee's/debtor's legal name and structure.

p. Provisions affording lessor ability to assign or participate the lease without prior consent of lessee (unless required by state law) or restrictions on future assignments and/or servicing.

q. Lessee covenants to properly maintain the property/equipment at its own cost and expense and to pay all applicable taxes, charges or liens.

r. For installment contracts or leases dependent upon savings (such as energy savings), whether there will be sufficient time for the lessee to realize such savings in relation to the first lease payment, and whether capitalized interest should be considered.

s. Whether a lease is subject to continuous renewal (absent nonappropriation) or whether a lease is subject to annual termination and affirmative renewal.

C. Does the lease properly match the timing and amount of rental payments to the lessee's budgetary cycle?

The budgetary cycle of a governmental lessee varies from jurisdiction to jurisdiction and within each jurisdiction as between the state, cities, counties, school districts, etc. Failure to take these considerations into account when drafting a lease may result in a lack of funds available to the lessee to make timely lease payments. The lease must be drafted with sensitivity to the particular lessee's budgetary process to ensure that the proper steps are taken so that money will be available to make lease payments in the current fiscal year and in future fiscal years if such payments are lawfully appropriated for or otherwise allowed by law. The strength of covenants relating to lessee duties with respect to budgeting and appropriations vary from jurisdiction to jurisdiction depending on how strong the obligation to budget and appropriate may be without causing the lease to become debt for state law purposes.

D. Does the lease trigger unexpected state or local taxes?

1. **Ad valorem taxes.** Even though the lessor is simply providing a financial service, express placement of the title in the lessor (a requirement in some jurisdictions) may trigger a real and/or personal property tax. *See, e.g.*, *University of Utah v. Salt Lake County*, 547 P.2d 207 (Utah 1976); *Pollard v. City of Bozeman*, 741 P.2d 776 (Mont. 1987). Often an equipment lessor will attempt in the lease to pass title up front to the lessee, retaining a "security interest" so the equipment may be repossessed upon early termination. In certain jurisdictions, this structure may raise "indebtedness" or other legal issues. Often, even though this procedure further undermines the lessor-lessee concept, the lessor will never have title to the equipment, asking the vendor to invoice the equipment directly to the lessee instead. On the other hand, in *First Union National Bank of Florida v. Ford*, 636 So.2d 523 (Fla. App. 1993), placement of title in a bank trustee was held not to deprive the municipal lessee of "equitable ownership" and thus preserved the property tax exemption conferred by Florida law. This same result was reached in *Leon County. Educational. Facilities Authority v.*

Hartsfield, 698 So.2d 526 (Fla. 1997), where the court held that "the project is not subject to ad valorem taxation because the Authority holds virtually all the benefits and burdens of ownership."

2. **Sales and use taxes.** Generally, sales and use taxes apply to the initial purchase from the vendor but do not apply to the lease if the lessor takes title simply to lease the equipment to a public body, provided that proper resale certificates are provided. In some states, however, municipalities are not exempt from payment of sales and use taxes.

3. **Franchise taxes.** The business of leasing may itself generate a liability. Failure to qualify to conduct business in a state might lead to invalidity of a lease. *See White Dragon Productions, Inc. v. Performance Guarantees, Inc.*, 241 Cal. Rptr. 745 (Cal. Ct. App. 1987).

4. **Covenant to Pay All Taxes.** Often the tax question is considered to be solved by a clause requiring the lessee to pay any and all taxes applicable to the leased property and the transaction. Although this clause is indispensable, its enforceability may be subject to doubt and, if not properly disclosed to the lessee, may increase the risk of nonappropriation.

E. Has the lessee formally accepted the equipment financed by a lease?

Unless provision has been made to hold lease proceeds in a fund for future release, a lessor and its counsel will want the comfort of knowing the lessee has received and accepted the leased equipment. Although this may be false comfort, as Uniform Commercial Code ("UCC") § 2-608 allows revocation of acceptance (*see Advanced Computer Sales, Inc. v. Sizemore*, 366 S.E.2d 303 (Ga. Ct. App. 1988)), it is customary to have the lessee sign an unequivocal acceptance certificate identifying the equipment and the lease. In some cases, the lease or other financing agreement may be used to fund intangibles or maybe only a portion of the financed property is subject to physical acceptance, for example, when financing software, service contracts, prepaid maintenance or other intangible property, when permitted by state and federal law.

F. Is the lessor properly secured?

1. **Is title good?** Under the UCC, an unpaid vendor retains title; accordingly, one must be satisfied that the vendor is paid. Used equipment may be subject to competing liens or security interests and, at least for expensive computer units, it may be prudent to trace title back to the manufacturer, checking to see that the serial numbers match those on the invoice. Vehicles should be accompanied by certificates of title, and title to aircraft may be searched and perfected.

2. **Does the lessor "own" the lease?** The basic protection here is, of course, to know the lessor whose paper is being examined, as a UCC search of the lessor's principal place of business will often be unavailing, and it may be that more than one original counterpart of the lease exists. Purchase of leases from a lessor-vendor in good faith and for value will generally defeat

a competing claim, but it is important that the governmental lessee acknowledge the assignment. Some lessors will continue to receive the rental payments to "service" the account for the investor; but the risks of confusion (should the lessor become insolvent or reassign the paper) call for extreme confidence in the lessor's financial stability and integrity.

3. **Is the security interest in the leased property perfected as against the lessee?** In some, but not all, states, Article 9 of the UCC applies to the creation of security interests by state and local governments. Unless a state has adopted a non-uniform amendment, Article 9 governs security interests created by a state or governmental unit of a state except to the extent another statute of the state expressly governs the creation, perfection, priority or enforcement of such security interest. Whether or not Article 9 applies, the practice is to file UCC financing statements to have the benefit of the public notice that such filing provides. For motor vehicles, applications for certificates of title are typically made with the lessee listed as the "registered owner" and the lessor, as the lienholder.

4. **Is the investor's security interest perfected vis-a-vis its assignor?** Generally, the assignment is considered an outright sale of all of the assignor's right, title and interest in the lease (and the underlying leased property), rather than an assignment for security, and the investor in any event takes physical possession of the original counterpart of the lease (chattel paper). Article 9, however, specifically applies to the sales of accounts and chattel paper. UCC financing statements covering such sales, therefore, must be filed.

5. **Does the assignment insulate the assignee from the risks associated with the bankruptcy of the assignor, at least for the applicable bankruptcy period?** The answer to this depends upon whether the assignment is absolute or is intended as collateral security for performance of obligations by the assignor. The assignment document for the lease should be drafted carefully to resolve this question in favor of protecting the investor.

6. **Is the lease unsecured or effectively unsecured?** In some cases, the lease or other financing agreement may be used to fund intangibles, for example, software, service contracts, prepaid maintenance or other intangible property, when permitted by state and federal law. This presents credit issues (i.e., the lessor must get comfortable with the nonappropriation risk in the absence of essential equipment) and potentially federal tax issues (i.e., is there an obligation under Section 103 of the Code), but UCC questions also come up with some regularity when financing other than goods. One question that may arise in a lease financing transaction financing software-as-a-service (SaaS) agreement or a software license, for example, may be whether a security interest can actually be taken in and perfected in the non-goods financed. Or, when a lease grants a lessor a security interest in an agreement or a license held by the lessee, is it properly treated as a secured

financing of the general intangible type perfected by a financing statement, or does the granting of a security interest create issues with the underlying agreement or license being financed? The purchase money security interest (PMSI) exception is the centerpiece of the equipment leasing and finance industry (without it most financed assets would be subject to a prior lien with an "after-acquired" collateral provision) and a PMSI can only exist in goods and software acquired with goods. If no PMSI can be taken when financing non-goods with a lease, then of what value is the security interest taken by a lessor, or is the lease effectively unsecured? Such questions and many others of this type will require a careful analysis under Article 9 of the UCC as adopted in the governing jurisdiction. The UCC analysis required to answer these questions is beyond the scope of this publication, as are the applicable state law issues (e.g., does the applicable state law financing authority permit the financing of non-goods?).

G. Do Federal or State Securities Laws Apply?

1. Are leases and participations (*e.g.*, COPs) "securities" and if they are "securities," are they exempt from registration and other securities law requirements? Section 2(a)(1) of the Securities Act of 1933 (the "1933 Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 (the "1934 Act") define "security." The 1933 Act defines the term as follows:

> The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The definition of a security contained in Section 3(a)(10) of the 1934 Act is virtually identical to that in Section 2(a)(1) of the 1933 Act except that the 1934 Act definition does not contain the terms "evidence of indebtedness" or "guarantee" and expressly excludes short-term notes and other debt instruments. In general, however, the United States Supreme Court has construed the definitions in the 1933 Act and the 1934 Act as functionally equivalent.

Two Supreme Court decisions are also central to the question of whether a financing instrument, such as a lease, should be considered a security. In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), the Court considered whether

a particular financing arrangement constitutes an "investment contract," which is included in the definition of a "security" under the 1933 Act. Under *Howey*, as modified by its progeny, the Court has held that an investment contract involves (i) an investment of money, (ii) in a common enterprise, with (iii) the expectation of profit primarily from the efforts of others. *See also United States Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The paragraphs below apply the *Howey* test to municipal lease financings. Then, in 1990, the Court set forth a "family resemblance test" for determining whether a note should be considered a security for purposes of the federal securities laws. *See Reves v. Ernst & Young*, 494 U.S. 56 (1990). Per *Reves*, there is a presumption that a note is a security, unless the note bears a strong "family resemblance to" certain types of notes that have been previously determined not to be securities, based on the following factors: (i) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (ii) the "plan of distribution" of the instrument, including whether there is "common trading for speculation or investment"; (iii) the reasonable expectations of the investing public; and (iv) the availability of other regulatory schemes that reduce the risk of the instrument. Tax-exempt leases do not typically include a note that requires analysis under the *Reves* family resemblance test, and most tax-exempt leases are easily recognized as commercial loans rather than securities.

The tax-exempt leasing industry does not routinely evaluate municipal lease financings under the fact-specific *Howey* or *Reves* tests. Instead, practitioners rely on a series of SEC no-action letters directly related to municipal lease financing structures (the "No-Action Letters").[6] This is not to say that a more detailed securities law analysis is not required from time-to-time, based on all the facts and circumstances, and it should not be assumed that every municipal lease financing is not a security. In fact, in the No-Action Letters, the Securities and Exchange Commission (the "SEC" or the "Commission") has been reluctant to take a position as to whether a municipal lease financing is a "security" as defined in the 1933 Act or the 1934 Act (or a "municipal security" as defined in Section 3(a)(29) of the 1934 Act). In the *Walter E. Heller & Company* no action letter, the SEC Division of Market Regulation said that it would not recommend any enforcement action to the Commission if a firm engaged in arranging municipal lease financings (but retaining no interest therein after the sale of the financing interest to a sophisticated individual or financial institution) did not register as a broker-dealer under Section 15(b) of the 1934 Act. The Commission staff, however, specifically took "no position as to whether these lease-purchase transactions are securities as defined in Section 2(1) of

[6] SEC No-Action Letters (1978-1982), *Walter E. Heller & Co.*, Securities and Exchange Commission (Oct. 25, 1982); SEC No-Action Letters (1983 - 2003), *Sanwa Business Credit Corp.*, Securities and Exchange Commission, (May 5, 1985); *James O. Hiltenbrand & Associates, Inc.*, SEC No-Action Letter (May 12, 1985); *Continental Heritage Financial Corporation*, SEC No-Action Letter (Sept. 10, 1987).

the 1933 Act or Section 3(a)(10) of the [1934 Act], or municipal securities as defined in Section 3(a)(29) of the [1934 Act].”

Prior to the *Walter E. Heller* no-action letter, the SEC created considerable uncertainty in the municipal lease financing industry when it released an inquiry from the Office of the Comptroller of the Currency regarding Itel Corporation and the SEC’s response to that inquiry. *Itel Corporation*, SEC Division of Market Regulation Letter to Office of the Comptroller of the Currency, Investment Securities Division (Sept. 1, 1981). The SEC Division of Market Regulation concluded in *Itel Corporation* that fractionalized participation interests in tax-exempt lease-purchase or installment sale financings were “municipal securities” within the meaning of Section 3(a)(29) of the 1934 Act.

The *Itel Corporation* letter was widely reported in the municipal finance and municipal lease finance industries. The publication of *Itel Corporation* raised the prospect that vendors, other financial intermediaries and persons not customarily subject to securities regulation might find themselves subject to the 1933 Act or the 1934 Act as a result of their participation in municipal lease financing transactions.

The uncertainties created by the *Itel Corporation* letter were gradually resolved, largely as a result of the SEC’s no-action position in *Walter E. Heller* and similar requests with respect to the registration of brokers/dealers under the 1934 Act. What has emerged from the series of similar no-action requests and the favorable SEC responses is the practical view that if the conditions described in those letters are followed, the transfer of a whole lease on a non-recourse basis to a sophisticated investor experienced in municipal lease financing investments may not constitute the transfer of a security for purposes of the 1933 Act or the 1934 Act, whereas the fractionalization of that lease interest into COPs will undoubtedly give rise to the issuance of securities for purposes of both the 1933 Act and the 1934 Act.

In requesting the No-Action Letters, each of the firms involved made similar arguments that a tax-exempt lease financing is not a security or a municipal security. First was the argument that the municipal lease financings at issue did not fit expressly within any of the specific statutory definitions set forth in the 1933 Act or the 1934 Act. Transactions not specifically covered by the statutory definitions will generally not be deemed to be securities unless they are “investment contracts” under *Howey*. Thus, the second argument made by the firms was that the municipal lease financings at issue did not create securities or municipal securities in that such financing arrangements could not be considered investment contracts.

The firms requesting the No-Action Letters argued to the SEC that municipal lease financings generally do not involve an "investment" of funds, but rather are commercial transactions excluded from the definition of security. In the transactions described in the No-Action Letters, the lessor or assignee of a whole municipal lease financing merely served as a lender to a municipality which enabled the municipality to purchase property on credit, therefore not involving any common enterprise. The municipality was required pay the lessor or its assignee under a fixed schedule of payments which, when coupled with the municipality's option to purchase the property for a nominal sum at the end of the term of the municipal lease financing, were essentially principal and interest payments. The agreement entered into restricted the municipality's use of the underlying property and required the municipality to maintain, protect and insure the property at its own expense. Although the lessor or assignee could retain title to the property for the term of the lease, the lessor also retained a security interest in the property which served as collateral. The existence of collateral is also strongly suggestive of a commercial rather than an investment transaction. Moreover, the fact that a municipal lease financing finances one or more items of property rather than being a general extension of funds to the municipality also indicates that the transaction is a commercial loan. In addition, the lessors or assignees in the transactions described in the No-Action Letters were not within the class of persons the United States Congress meant to protect under the securities laws. The lessors or assignees described in the No-Action Letters were always sophisticated investors who routinely engaged in financing commercial transactions and were knowledgeable about such transactions. Each lessor or assignee had access to sufficient information and had the experience and financial sophistication necessary to make an informed economic decision.

In the transactions described in the No-Action Letters, the municipal lease financings did not involve "profits," derived from the efforts of others, one of the indicia of an investment contract under *Howey*. The United States Supreme Court has defined "profits" as either capital appreciation resulting from the development of the initial investment or a share of the earnings created by the use of the investor's funds. In the transactions described in the No-Action Letters, the return on a lessor's or assignee's investment could come only from the payments of the municipality under the terms of the lease or the municipality's exercise of its option to purchase the property covered by the agreement. The rental payments represented a fixed stream of revenues that did not depend on or vary with any capital appreciation in the underlying project or the services of a third party. The municipality's option to purchase at the end of the lease term was for a nominal sum or upon payment of all rent due, and hence the lessor's or the assignee's investment had no potential for appreciation. While the receipt of rental payments required that the municipality remain capable of making such payments, this inheres in any lease or commercial loan. Similarly, the lessor's or assignee's rights in the event of default, primarily repossession

of the financed project, was typical of any lease and did not represent anticipated capital appreciation of the lessor's or assignee's investment.

In the transactions described in the No-Action Letters, a lessor could assign, or an assignee could reassign, its interest in the municipal lease financing to a third party, but would only realize revenues consisting of the discounted value of the remainder of fixed rental payments. Such reassignment is closely analogous to that of commercial loans, and the amounts realized do not represent profits. None of the revenues received by assignees were shared with the assignor. In addition, no lessor or assignee had an expectation of profits from the managerial efforts of others. A municipality's obligation as lessee to make its rental payments did not constitute the entrepreneurial efforts required for an investment contract. Courts have held that the assignee of a lease does not anticipate profits from the efforts of others even though its revenues depend solely upon the continued solvency and viability of the lessee. Although the municipality was required to keep the financed property in good condition and insure it, this was merely to preserve the assignee's collateral and not to enhance its value. Assignees did not depend on any managerial or entrepreneurial efforts from prior assignees to realize its expected return. An assignment by a lessor or subsequent assignee was made without recourse, and thereafter the assignor did not retain any interest in the municipal lease financing and was in no way connected with the stream of rental payments (other than in its role as servicer, if any, which ministerial service was not entrepreneurial in nature).

One may reasonably conclude, based upon the No-Action Letters, that a non-fractionalized municipal lease financing, in which a single vendor or investor acquires all of the stream of lease payments (whether represented by a single COP or by the lease-purchase agreement itself) should not be deemed to constitute a "security" within the meaning of the 1933 Act, the 1934 Act, or under *Howey* or *Reves*. Because the issue has not been definitively determined, however, it is very common in single investor / purchaser (as opposed to single vendor) transactions to obtain an investment letter from the single investor / purchaser to the effect that (i) the investor is an "accredited investor" within the meaning of Rule 501 of Regulation D promulgated under the 1933 Act (or some similar indication of financial suitability), (ii) the investor has obtained and reviewed certain documents or summaries of documents, including particularly the municipal lease financing documents, (iii) the investor has obtained, or has had the opportunity to obtain, all such financial and other information as such investor has desired from the governmental entity/lessee, and (iv) the investor is experienced in investing in municipal lease transactions.

Any fractionalized municipal lease financing, including COPs, are considered "securities" for purposes of the 1933 Act, but the question is whether they are governmental securities exempt from registration under

Section 3(a)(2) of the 1933 Act. COPs are usually created by assignment of the lessor's interest in the tax-exempt lease, the assets financed and the rental payments under the lease to a trustee under a trust indenture pursuant to which the interest in the rental payments, assets financed and legal rights are fractionalized to multiple investors. More discussion of COPs is set forth in Part IV of this outline. Since 1977, the SEC, in a series of no action letters has provided guidance that the typical fractionalized municipal lease financing will constitute a governmental security of the underlying governmental lessee if certain conditions are met. *See Smith, Barney, Harris, Upham & Co., Inc.,* SEC No-Action Letter (Jan. 7, 1977). In *Smith Barney*, counsel to Smith Barney argued that the governmental entity should be considered the "issuer" of the certificates, and that the nominal role of the seller of the equipment (as lessor or seller) and the ministerial role of the trustee in the financing should be disregarded in determining the availability of an exemption under Section 3(a)(2) of the 1933 Act. Based upon the facts presented in *Smith Barney*, the SEC agreed not to recommend any enforcement action if the COPs in the financing agreements were offered and sold to the public by the company without compliance with the registration requirements of the 1933 Act in reliance upon the exemption provided by Section 3(a)(2) of the 1933 Act.

Counsel for the State of New Jersey, in the *State of New Jersey* (May 21, 1984) no-action request, relied upon the SEC's conclusions in *Smith Barney* and summarized the factors noted by the Commission staff in *Smith Barney* as being important to a determination that no registration would be required under the 1933 Act in the case of state and municipal equipment lease or conditional sale programs. The relevant factors in *Smith Barney* include the following:

a. the obligation of the public body must be a direct obligation in respect of which a certificate holder would have recourse without the necessity of joining a third party;

b. the obligation of the public body must not be subject to set-off or counterclaim as a result of any dispute between the public body and a third party (*e.g.*, the trustee, lessor or vendor);

c. the obligation of the public body cannot be dischargeable as a result of damage to, or the destruction of, the subject property;

d. the public body must be required to maintain the property at its own expense and to make all payments in respect of insurance premiums;

e. the public body may not be permitted to sell or encumber the property without the consent of certificate holders;

f. the trustee or fiscal agent acting on behalf of a certificate holder may provide only ministerial services as part of the financing transaction; and

g. the rights of certificate holders [can] not be adversely affected by any insolvency proceeding to which the trustee or fiscal agent might become subject.

2. **Do state blue-sky laws apply?** The comfort available at the federal level that whole leases are not securities often is not available under state securities laws. State level securities commissioners may simply not have thought of the question *vis-a-vis* leases. However, in some jurisdictions, statutes and/or case law supports the general position that state securities laws are to be interpreted in accordance with federal law, except as otherwise provided. A separate analysis of applicable state securities laws is advisable in each case.

3. **Are there Dodd-Frank Act issues?** The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L. 111-203, H.R. 4173 (approved July 21, 2010) (the "Dodd-Frank Act"), which amended the 1934 Act, requires a "municipal advisor" to register under the 1934 Act if such municipal advisor (a) provides advice to or on behalf of a municipal entity or an obligated person with respect to (i) "municipal financial products" or (ii) the "issuance of municipal securities," or (b) undertakes the solicitation of a municipal entity or obligated person. The application of these requirements to a lessor of municipal lease obligations presents questions that are similar to the questions facing banks, leasing companies and other investors that purchase municipal obligations for their portfolios.

4. **Does SEC Rule 15c2-12 apply?** Whole leases (unparticipated in the form of COPs or otherwise) are generally not treated as securities as discussed above and thus, a lessor is under no obligation to comply with securities laws as they relate to the offer and sale of the lease. COPs and other fractionalized leases, however, are securities and therefore, Rule 15c2-12 will apply in such instances as it does in the case of other municipal securities transactions (*i.e.*, underwriters will be required to require a continuing disclosure agreement and the lessee will be required to comply therewith). Even where a whole lease is involved, the lease should be considered a financial obligation for purposes of events 15 and 16 under Rule 15c2-12 such that an issuer party to an outstanding continuing disclosure agreement may be required to disclose the incurrence of the lease obligation and any changes thereto.

H. Have Federal Income Tax Considerations Been Addressed?

All the questions that apply to bonds also apply to leases, but with specific nuances and considerations. It is generally assumed, correctly, that the federal tax analysis applicable to tax-

exempt bonds is also applicable to tax-exempt leases, as the arbitrage rebate requirements, private activity bonds tests, and additional rules apply to any debt obligation the interest on which is intended to be exempt from gross income for federal income tax purposes.

New or well-seasoned tax-exempt financing practitioners participating in the tax-exempt leasing sub-industry should be sure to remember the fundamentals of tax-exempt financing and begin any transaction intended to be tax-exempt by focusing on whether a proposed lease is structured as a true lease or operating lease for federal tax purposes or whether the proposed lease is structured as a financing lease or capital lease as only capital leases will have interest eligible to be excluded from gross income for federal income tax purposes. Practitioners should next consider whether and how the entity desired to be the lessee qualifies as a valid issuer of a tax-exempt debt obligation under the state or local bond requirements of Section 103 of the Code and Treas. Reg. Section 1.103-1 thereunder. Practitioners should also consider whether the expenditures proposed to be financed constitute capital or working capital expenditures for federal tax purposes and, if any of the proposed expenditures constitute working capital expenditures, the extent to which those expenditures are eligible to be financed on a tax-exempt basis. Practitioners should also consider how the assets desired to be financed are expected to be used in context of compliance with the private activity bond tests and plans for compliance with the remaining rules applicable to tax-exempt debt obligations under Code Sections 103 and 141-150 and the related Treasury Regulations, rulings and decisions thereunder. The following outline highlights certain of these requirements and provides some discussion of provisions of particular importance but should not be relied upon as a thorough or complete discussion of all federal tax requirements applicable to tax-exempt debt obligations.

1. **Is the Lease a Financing or Capital Lease for Federal Tax Purposes?** A financing or capital lease is treated as a debt obligation for federal tax purposes and only interest on a financing or capital lease is eligible to be excluded from gross income for federal tax purposes. One of the first pronouncements by the IRS that attempted to distinguish true leases and conditional sales contracts for federal tax purposes was Revenue Ruling 55-540. The IRS ruled that whether an agreement is in substance a conditional sales contract or true lease for federal tax purposes depends on the intent of the parties as evidenced by the provisions of the agreement, considering facts and circumstances in existence at that time. Absent compelling persuasive factors of contrary implication, for federal tax purposes, the IRS would infer an intent to treat a transaction as a purchase and sale rather than as a lease or rental agreement if one or more of the following conditions are present: (1) a portion of the periodic payments are made specifically applicable to an equity interest to be acquired by the lessee; (2) the lessee will acquire title upon the payment of a stated amount of rentals required under the agreement; (3) the total amount that the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to acquire title; (4) the agreed rental payments materially exceed the current fair rental value, which may indicated that the payments include an element other than compensation for the use of property; (5) the property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at

the time the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared to the total payments required; and (6) some portion of the periodic payments is specifically designated as interest or otherwise readily recognizable as the equivalent of interest. Revenue Ruling 55-540 further clarified that, for federal tax purposes, agreements are usually indicative of an intent to rent equipment if the rental payments are at an hourly, daily or weekly rate, or are based on production, use, mileage, or similar measure and are not directly related to the normal purchase price, provided if there is an option to purchase, that the price at which the equipment may be acquired reasonably approximates the anticipated fair market value on the option date.

a. **Is the lessee building up equity in the leased property as required by Rev. Rul. 55-540 (see e.g., PLRs 8235056 and 8347058)?** Often, the dollar or nominal purchase option or automatic passage of title at the end of the lease term satisfies this test, but at times lessors will ask for a greater purchase option price, raising the Rev. Rul. 55-540 question of whether the lease is a true lease. The economic useful life of the financed property, the term of the lease financing and other factors (e.g., the payment schedule) should also be considered to ensure that the lease is properly treated as a financing or capital lease for federal income tax purposes rather than a true lease for use of the leased property. In many cases, the build-up of equity in a tax-exempt lease subject to non-appropriation is accomplished through a financing term substantially shorter than the useful life of the equipment.

b. **Is the interest component of the rentals sufficiently distinct and described as required by Rev. Rul. 72-399?** Tax-exempt leases should include either a schedule setting out the principal and interest components of each rental payment, with yet another column setting out any permitted prepayment schedule, or include language permitting ready calculation of such schedules. For instance, some leases may use a formula for expressing interest. In such cases, it is important that the formula enable an investor to demonstrate to the IRS the amount of the interest component of each installment payment.

c. **Is the lease an "obligation" under Section 103(c)(1) of the Code?** In Private Letter Ruling 7821068 (February 23, 1978), the IRS found that an "obligation" existed for purposes of Section 103 of the Code, in the context of an annual appropriation lease even though the lessee's obligation was limited to funds appropriated annually and the lessee was entitled to terminate the lease from year to year. Where a lease is subject to non-appropriation, the build-up of equity in the equipment through a financing term substantially shorter than

the useful life of the equipment (*see* Rev. Rul. 55-540) is also often considered important to create an economic compulsion for the lessee to continue making payments even where the lease arguably does not otherwise rise to the level of a debt obligation for federal income tax purposes. Where no tangible assets are financed it may be appropriate to consider the lack of traditional remedies (e.g., repossession of real or personal property) in the event of a non-appropriation or default, when determining whether an "obligation" exists for federal tax purposes.

Notwithstanding treatment of tax-exempt leases as debt obligations for federal income tax purposes, most leases are structured to avoid treatment as debt under state law (see Part II of this outline).

2. **Is the Lessee an Eligible Tax-Exempt Issuer?** Lease financings present unique legal and practical challenges related to the status of the lessee as a valid issuer of a tax-exempt debt obligation under Section 103 of the Code. Despite such challenges, vendors, lessors and others routinely initiate and consummate tax-exempt lease financing transactions without consulting qualified legal counsel. Practitioners invited to participate in such financings should review the relevant provisions of the Code, Regulations and rulings carefully. On occasion it is necessary that the lease be restructured so that the lessee is a more clearly established political subdivision in order to ensure that the lease constitutes an obligation (i.e., a "state or local bond") eligible for tax-exempt treatment for federal income tax purposes.

   a. **States and Political Subdivisions and "Integral Parts" of States and Political Subdivisions.** Recall that tax-exempt debt falls into two general categories: (a) those issued by a state or political subdivision; and (b) those issued "on behalf of" a state or political subdivision.

   "State" is defined in Section 103(c) of the Code to include the District of Columbia and any possession of the United States. Under applicable rules, a State includes, agencies, boards and commissions which are considered an "integral part" of a state. The term "political subdivision" for purposes of Section 103 of the Code is defined in Treas. Reg. Section 1.103-1(b) and denotes any division of a State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of that unit, and includes, agencies, boards and commissions which are considered an "integral part" of a political subdivision. Treasury Regulation Section 1.103-1(b) notes that political subdivisions may or may not include special assessment districts (road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port, etc.) and similar districts and

divisions if such districts or divisions have not been delegated the right to exercise sovereign powers. Practitioners should become familiar with the sovereign powers tests and IRS guidance on the topic. The sovereign powers referred to in the regulations have been interpreted to be the power to tax, the power of eminent domain, and the police power (s*ee, e.g.,* Rev. Rul. 77-164; *Philadelphia National Bank v. United States*, 666 F.2d 834 (3d Cir. (Pa.) 1981).

It is usually clear when an issuer is a "State" as the term is used in Section 103 of the Code; however, questions do arise as to whether an entity qualifies as a "political subdivision" of a State for purposes of Section 103 of the Code and whether a particular agency, board, commission or body within a State or political subdivision is an "integral part" of the State or political subdivision for these purposes. Entities (*e.g.*, joint planning agencies, library boards, joint powers entities, state senators, justices of the state supreme court and sheriffs) which are not authorized to issue bonds and entities which may have bonding authority but would not likely consider issuing bonds, sometimes find themselves leasing equipment, and when dealing with such uncommon lessees, the threshold question for federal income tax purposes is usually whether the entity enjoys sufficient sovereign powers to qualify as a political subdivision or can be otherwise be treated as issuing "on behalf of" a state or local governmental unit (*see* Rev. Rul. 57-187).

b. **Constituted Authorities and 63-20 Corporations.** Under IRS rulings and interpretations, the rules have evolved into two general classes of entities which generally qualify as issuers acting "on behalf of" a State or political subdivision: (a) entities formed under state law for the express purpose of issuing bonds to effect a public purpose (i.e., "constituted authorities"); and (b) entities formed under applicable state nonprofit corporation law which comply with the requirements of Rev. Rul. 63-20.

(1) *Constituted Authorities.* Constituted authorities are entities specifically authorized by state law to issue bonds on behalf of political subdivisions of a State, among other specific powers granted to such entities in order to further public purposes. The IRS has described the "criteria" which must be present for an entity to be treated as a constituted authority empowered to issue tax-exempt debt on behalf of a political subdivision. *See* Rev. Rul. 57-187 and Rev. Rul. 60-248; *see also* PLRs 8912008, 8906058, 8419029, 8405131, 8232044, 8215025, 8207036, 8139121, 812503, 7911022. In summary, the criteria are: (i) the issuance of debt must be authorized by a specific state statute; (ii) the debt issuance must have a public purpose (which includes promotion of

trade, industry and economic development); (iii) the governing body of the authority must be controlled by the political subdivision; (iv) the authority must have the power to acquire, lease, and sell property and issue bonds in furtherance of its purposes; (v) earnings cannot inure to the benefit of private persons; and (vi) upon dissolution, title to all debt financed property must revert to the political subdivision. Published guidance includes a number of related factors which may also be applicable depending on the specific nature of the proposed lessee and all the facts and circumstances.

(2) *63-20 Corporations.* 63-20 corporations are typically used where applicable state law has not specifically authorized the formation of public corporations which would qualify as constituted authorities under Rev. Rul. 57-187. The criteria required for constituted authorities under Rev. Rul. 57-187 and the five requirements for 63-20 corporations are substantially the same. The most significant difference is the type of authorizing statute under which each is organized.

Rev. Proc. 82-26 identifies circumstances in which the five tests in Rev. Rul. 63-20 will be deemed to have been met and, consequently, the IRS will issue a favorable advance ruling. For example, the requirements that the sponsoring political subdivision have a beneficial interest in the 63-20 corporation while its bonds are outstanding and that it obtain full legal title to the 63-20 corporation's property upon retirement of the bonds will be deemed met under Rev. Proc. 82-26 if (among other requirements): (i) the [sponsoring governmental] unit may not agree or otherwise be obligated to convey a fee interest in the property to any person who was a user of the property or a related person ... within 90 days after the unit defeases the obligations...; (ii) reasonable estimate of a fair market value of the property on the latest maturity date of the obligations ... is equal to at least 20 percent of the original cost of the property financed by the obligations ...; and (iii) a reasonable estimate of the remaining useful life of the property on the latest maturity date of the obligations ... is the longer of one year or 20 percent of the originally estimated useful life of the property financed by the obligations." *See also* PLRs 8649072, 8643050, 8628081, 8615013, 8601045, 8542104, 8506112, 8402026, 8351040, 8340067, 8334081, 9322006, 9335040 and 200019023.

c. **Entities Treated as States and Political Subdivisions for purposes of Section 103 of the Code.** In addition to states and political subdivisions, including "integral parts" thereof, and "on behalf of" issuers (i.e., constituted authorities and 63-20 corporations), the Code allows certain other entities to be treated as eligible tax-exempt issuers.

(1) *Indian Tribal Governments.* Federally recognized Indian tribal governments are permitted to enter into tax-exempt leases for governmental and qualified purposes. Section 7871(a)(4) of the Code provides authority for Indian tribal governments (or a subdivision thereof) to be treated as a State for purposes of Section 103 of the Code if substantially all of the proceeds of the debt obligation are to be used in the exercise of any essential governmental function. Indian tribal governments (or a subdivision thereof) are not generally permitted to issue private activity bonds although Section 7871(c)(3) provides an exception for certain qualified small issue manufacturing bonds. A subdivision of an Indian tribal government is treated as a political subdivision of a State if (and only if) the Secretary of the Treasury determines after consultation with the Secretary of the Interior that such subdivision has been delegated the right to exercise one or more of the substantial governmental functions of the Indian tribal government. Revenue Procedure 2008-55 simplified the process of identifying qualifying tribal governments by recognizing the Federal Register's annually updated Department of the Interior list of tribes as the official list of Indian tribal governments that are to be treated as States for purposes of Section 103. The essential governmental function test is of particular significance since it relates to the status of the entity as a valid issuer of the tax-exempt debt obligation. Section 7871(e), Treas. Reg. Section 305.7871-1(d) and rulings thereunder define and set forth the scope of activities constituting an essential governmental function for this purpose. When reviewing and documenting lease financings for Indian tribal governments, it is important to consider the proper identification of the lessee and the essential governmental functions being financed, waivers of sovereign immunity, tribal authority to enter into the lease and access to tribal lands when exercising remedies under the lease and issues of jurisdiction and governing law.

(2) *Qualified Volunteer Fire Departments.* Section 150(e) of the Code provides authority for debt obligations of certain volunteer fire departments to be treated as a debt obligation

of a political subdivision of a State. Under Section 150(e), an obligation of a volunteer fire department may be treated as tax-exempt if: (1) the fire department is a "qualified volunteer fire department" (usually a nonprofit corporation) organized and operated to provide firefighting or emergency medical services in an area (within the jurisdiction of a political subdivision) which generally is not provided with any other firefighting services (disregarding any other services if they are also provided by a qualified volunteer fire department with which the qualified volunteer fire department borrower has been working together continuously since January 1, 1981), which is required by written agreement to provide firefighting services with the political subdivision; (2) 95% or more of the net proceeds of the tax-exempt issue are used for the acquisition, construction, reconstruction or the improvement of (a) a fire house (including land functionally related and subordinate thereto) or (b) a fire truck to be used by the qualified volunteer fire department; and (3) the public approval (TEFRA) requirements of Section 147(f) are satisfied. It should be noted that the special treatment of debt obligations issued by "qualified volunteer fire departments" as debt obligations of a political subdivision of a State for purposes of Section 103 is only available if the proceeds of the debt obligation are used as provided in Section 150(e) and Treas. Reg. Section 1.103-16. The Regulations provide an example of an obligation issued by an ambulance and rescue squad that is a qualified volunteer fire department but substantially all the proceeds of the obligation are used to provide emergency medical services rather than a fire house or fire truck. The Regulations conclude that the obligation is not treated as an obligation of a political subdivision of a State for purposes of Section 103. This concept may initially seem straightforward but in practice can pose significant challenges.

3. **Is the lease financing capital expenditures?** The allocation and accounting regulations under Section 148 of the Code, generally do not permit a lessee to allocate proceeds of a tax-exempt obligation to any cost that is not a capital expenditure, subject to certain *de minimis* and extraordinary expenditure exceptions, and except in the case of an issue that qualifies for restricted working capital financing. For this purpose, a "capital expenditure" is "[a]ny cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles." Accordingly, with limited exceptions, lease proceeds may only be spent on expenditures that could be

capitalized under general federal income tax principles. Vendors, lessees and lessors may, on occasion, seek to finance property or costs which do not clearly qualify as capital expenditures, such as costs for certain software, maintenance or service contracts, product training, extended warranties, etc. See Part V of this outline for additional discussion of capital expenditure issues becoming increasingly common in the tax-exempt leasing industry.

4. **Is the lease in registered form?** Section 149(a) of the Code requires that a tax-exempt obligation be in registered form, but implementing a registration system can be awkward in the leasing context. It is generally possible to have the lessee agree to keep copies of all assignments with its leasing records to serve as a record of the lease owners. Any participation or division of interests in a lease, however, leads to multiple owners, whose identity the lessee (or its assignee fiduciary) may not always know. The solution has at times been to have the lessor agree to carry out the registration function. The announcement in 26 CFR § 5f.103-1 that the functionary must do so as "agent" of the issuer has led to confusion, as it may appear anomalous to a lessee that a lessor can be its "agent" for anything.

   In PLR 9128034, the IRS ruled that tax-exempt installment sale contracts with governmental entities accepted by the seller of products (or a financing affiliate) in a private placement for the exclusive benefit of the seller and that would not be sold to third parties or pledged as security in financing arrangements of the seller were "not of a type offered to the public" and did not have to be registered. Of course, publicly-offered COPs must comply with the registration requirement.

5. **Private activity obligations.** It is imperative to inquire as to the lessee's intended use of the leased property and customary for the lessee to make certain representations and covenants in the lease which demonstrate that the lease is not and will not become a private activity bond. Covenants against subleases to any nongovernmental entity should be included in the lease to prevent the private business use test from being met. If the lease-financed property meets the private business use test, the "private security" test of Section 141(b)(2) of the Code will be met when the financed property serves as "security" for the lease obligation.

   If the governmental lessee defaults under the lease or does not appropriate base rentals and, therefore does not renew the lease, then federal tax issues will arise concerning continued tax exemption for interest components of the lease payments (that may be evidenced by outstanding COPs) if the real estate or equipment that is the subject of the lease is then subleased to other users that are not governmental entities, thus causing a change in use to "private business use." The special (lease) counsel's opinion on the tax exemption for the interest component of the lease payments should contain an appropriate exception for this situation, and if there is official statement

for the COPs, it should contain appropriate disclosure of the risk of taxability in that situation.

Notwithstanding the private activity considerations described above, it should be noted that leases can be structured and issued as tax-exempt qualified private activity bonds under the Code where private use may be acceptable. For example, a lease might be structured as a qualified 501(c)(3) bond under Section 145 of the Code. Structuring a lease as a qualified private activity bond may require several changes to the provisions of the lease (e.g., to accommodate sublease(s) by the governmental issuer to 501(c)(3) organizations) and of course, it would require compliance with the various tax rules related to qualified private activity bonds (e.g., TEFRA requirements).

6. **Reporting.** A lease may require the filing of IRS Form 8038 (where the lease is structured as a private activity bond), 8038-G or 8038-GC. IRS Forms 8038-G and 8038-GC have instructions specifically applicable to leases. A lease financing may present unique reporting issues that will need to be addressed for purposes of tax reporting requirements. Some of the unique reporting issues a practitioner may encounter are described below. Note, however, that lessees often do not engage counsel to assist with smaller municipal leases, and lessors generally refuse to assist with preparation of the forms in an effort to avoid being treated as a paid preparer (paid preparer requirements have applied to the series 8038 forms since 2009). This can make accurate reporting a challenge in some cases. Lessees should be advised regularly to exercise caution when reporting lease transactions without the involvement of bond counsel or the lessor, as paid preparer.

The instructions for Line 20 of IRS Form 8038-G (and for Line 9 of IRS Form 8038-GC) refer to "municipal leases" as financing structures where property other than cash is exchanged for the lease obligation. For example, the acquisition of a police car, fire truck or other equipment may be accomplished by execution of a lease financing and exchange of the vehicle or equipment for a series of monthly payments. However, not all vehicle and equipment leases should be treated as bonds exchanged for property (i.e., not all leases should be designated as a "municipal lease" for purposes of the series 8038 forms). Local counsel and lessees often improperly designate a lease as a municipal lease when the lease is exchanged for cash rather than property. Where proceeds of a lease are received in the form of cash, as is often the case when an escrow account is established and funded for future spenddown at closing, the lease should be treated as issued for cash. The determination of whether a lease is exchanged for property or for cash should be made taking into account all the facts and circumstances, and the series 8038 form should be completed accordingly.

The instructions to IRS Form 8038-G provide certain special rules with respect to leases satisfying the requirements of Line 20 for completing certain lines calling for computed quantities. Stated Redemption Price at Maturity is not to be reported for such leases ("NA" should be put in its place). In place of reporting the weighted average maturity, one just reports the total number of years that the lease will be outstanding. Instead of reporting the yield on a lease, one reports the effective interest rate. The entire Part IV (used to show a breakdown of the uses of proceeds) for a lease may be omitted with just the insertion of NA in the appropriate place. These special rules generally make it easier to complete an IRS Form 8038-G for a lease that qualifies as a municipal lease exchanged for property under the rules of Line 20.

Also, from time to time, the named lessor may not actually be financing the equipment. For example, the named lessor may be assigning the lease upon closing in a pre-arranged sale to an assignee. That assignee may actually provide the financing. Treas. Reg. § 1.1273-2(e) of the Treasury Regulations states that in determining issue price, sales made to placement agents and similar intermediaries are ignored. Treas. Reg. § 1.148-1(f) similarly ignores purchases by "underwriters." The payment schedule and language of an assigned Lease should make it clear that the named lessor is not financing the equipment itself, but rather is assigning the lease to an assignee that is financing the equipment. In such cases, the lease should appropriately be treated as issued for cash, even if no cash escrow is funded. If the lease is treated as issued for cash, as opposed to property, the issue price should be the price paid by the assignee. It may be necessary to consult with tax counsel to ensure tax reporting is done accurately.

Lease financing transactions sometimes require the lessee to make its first lease payment on the issue date or funding date of the lease (*e.g.*, an advance payment structure or down payment). In other lease financing transactions, a third party (such as a vendor) makes an initial principal payment on the issue date or funding date (a financial incentive from the vendor). In each of these examples, the principal payment on the issue date or funding date results in a reduction of the issue price reported on the appropriate series 8038 form. Original issue discount may also be found in certain lease arrangements where a lease is assigned at closing at a discount.

Some lease financing transactions are facilitated by lease brokers, who introduce potential funding sources to potential lessees in exchange for a fee. The broker is often compensated by the lessor on behalf of lessee out of proceeds of the lease. Generally, the lessor and lessee determine the cost of the equipment or other improvements to be financed with lease proceeds and set this amount as the par amount of the lease. Next, the lessor and lessee agree upon an interest rate and amortization schedule for the lease that is based upon the par amount of the lease. Then, the broker's fee is added as an additional premium on the lease over the par amount of the

lease. When the transaction closes, the lessor pays this amount on behalf of the lessee to the broker as compensation for introducing the lessor to the lessee. The premium generated on the lease must be reported on the appropriate series 8038 form. The premium is included in the issue price of the lease reflecting the additional proceeds generated on the lease. The amount of the broker's fee should be reflected on the series 8038 form as a cost of issuing the lease. As a result of the premium generated on the lease, the lessee in effect has borrowed additional proceeds and used these additional proceeds to pay costs of issuance but the amortization schedule and interest rate on the lease have not changed. This requires the person preparing the series 8038 form to calculate the yield on the lease reflecting the true total proceeds generated based upon the agreed upon amortization schedule. The result is the lessee in effect pays a reduced interest rate to the lessor and the yield on the lease is lower than the interest rate agreed upon between the lessor and borrower. The same concept may apply where the lessor agrees to pay other fees not included in the par amount of the lease.

7. **Is the lease federally guaranteed under Section 149(b) of the Code?** Even if the lease does not mention it, many leases are in fact paid with moneys derived from federal grants or other assistance, such as grants or aid provided for a welfare department's computer, for a state's Medicaid program or for a university's lab. Whether the receipt of a federal grant or other assistance in amounts determined in whole or in part by reference to the lease payments constitutes a federal guaranty is a factual question determined by analyzing the terms of the federal program.

8. **Is the lease an arbitrage bond?** The same basic arbitrage rebate and yield restriction requirements that apply to tax-exempt bonds must be met for tax-exempt leases, but participants in lease financing often lack understanding and expertise in this area and believe the amounts involved are not great enough to merit paying for the expertise needed to comply with the arbitrage rebate and yield restriction requirements. To obtain an exception to the rebate requirement for both equipment and real property lease financings, reliance often is placed on the small issuer (under $5 million with a larger limit for school construction) exception or the 6-month spending exception.

   The arbitrage regulations also contain an 18-month spending exception for any financing eligible for a 3-year temporary period for unrestricted investment of proceeds (generally, where proceeds are used to finance capital purposes or projects, including acquisition of property as well as construction), if all of the gross proceeds are spent according to a required spending schedule over three 6-month spending periods.

   Similarly, in a lease financing of a construction project (including "constructed" personal property), the "available construction proceeds" may be eligible for the 2-year spending exception from the rebate requirement for a "construction issue" (an issue in which at least 75% of the

available construction proceeds will be used for construction expenditures), if all of the available construction proceeds are spent according to a required spending schedule over four 6-month spending periods.

If any gross proceeds are held in a reasonably required reserve or replacement fund for the tax-exempt lease or an issue of COPs therein, those gross proceeds are not required to be spent to satisfy any applicable spending exception, but generally will be subject to the rebate requirement from the issue date. Reference should be made to other outlines on arbitrage-related topics for the specific requirements applicable to rebate exceptions and arbitrage requirements generally.

9. **Is the transaction an "investment trust with multiple classes"?** See discussion of special issues relating to COPs in Part IV below.

10. **Has the lessee properly designated the lease as a "qualified tax-exempt obligation" for purposes of Section 265(b)(3) of the Code?** If a governmental lessee is eligible to designate its lease obligation as a "qualified tax-exempt obligation" for purposes of Section 265(b)(3) of the Code (because the lessee does not reasonably anticipate issuing more than the current maximum threshold allowed of tax-exempt obligations in that calendar year under Section 265(b)(3)) of the Code, it is generally beneficial to the lessee to do so because the designation makes the lease more attractive to banks and other financial institutions which is, in turn, taken into account in pricing. Counsel may be asked to give an opinion that the lease is a "qualified tax-exempt obligation" for banks and other financial institutions. Depending on the circumstances, however, that opinion may be difficult to provide because of the extent of due diligence that may be required to determine the amount of outstanding tax-exempt obligations of the lessee and the basis for the "reasonable expectations" of the lessee regarding its eligibility to designate obligations in any particular calendar year. In most cases, a certification by the lessee should be sufficient for this purpose. In addition, if the issuer of the tax-exempt obligation is an "on behalf of" issuer, it is important to remember that such issuer must take into consideration other tax-exempt obligations (and reasonable expectations) of the state or local government on behalf of which the obligation is being issued, when making a determination as to whether a tax-exempt obligation is a "qualified tax-exempt obligation."

IV. SPECIAL ISSUES RELATING TO COPS

A. Fractionalized Interests.

COPs represent for an investor (the "COP Investor") a fractionalized interest in a lease and rights thereunder, the rental payments and the security for said lease (collectively, the "Assigned Lease"). The mechanism used for such fractionalization of the Assigned Lease is assignment of the lessor's interest in the Assigned Lease by the original lessor to a trustee pursuant to a trust

indenture. The trust indenture establishes the rights of the COP Investors in the Assigned Lease and mechanisms and procedures for enforcement of rights under the Assigned Lease by the trustee for the benefit of all of the COP Investors. The fractionalization of the Assigned Lease can be either vertical, whereby the COP Investor is acquiring rights in the stream of rental payments over the life of the Assigned Lease (for example, purchasing 50% of the rental payments coming due on each and every rental payment date) or horizontally, whereby the COP Investor is purchasing the rights in the principal component of rental payments for just certain rental payment dates, as well as the interest component of rental payments that accrues on the purchased principal component payable on each of the rental payment dates. COPs representing vertical fractionalization usually have one interest rate attributable to each principal component of rental payments (but are not required to), while COPs representing horizontal fractionalization usually have separate interest rates for each principal component maturity date (to avoid large premiums on early maturity COPs and deep discounts on late maturity COPs). Care must be taken to make sure that interest accruing on one principal component of rental payments is not allocated to principal component with a differing maturity date. Doing so creates a separate security for both federal tax and federal securities law analysis with the probable result of loss of tax-exempt status of interest and loss of security law exemptions.

For federal income tax purposes, COP structures should be reviewed to ensure the transaction does not create an "investment trust with multiple classes." In the May 2, 1984 Federal Register, the United States Treasury proposed amendments defining "trusts" for federal tax purposes; the final regulations were published in the March 24, 1986 Federal Register. As the Treasury proposal was originally worded, it was feared that a certificated tax-exempt lease (i.e., COPs) with serial "maturities" bearing different interest rates would be treated as a "trust" with multiple classes of interests, such that the trust would be taxable as a corporation. A press release at about that time relating to a State of New Jersey lease transaction substantiated that fear. The final regulations made it clear that pass-through treatment as a grantor trust would result if the interest rate or rates on the COPs matched those formally set out in the underlying certificated lease.

B. Characterization of the COPs.

Inasmuch as COPs are executed and delivered by a trustee to whom the Assigned Lease has been assigned by virtue of a trust indenture and evidence a direct and proportionate interest of the owner thereof in the rental payments under the Assigned Lease, several questions are raised as to what the COPs are and what they should be to preserve the tax-exempt treatment of distributions which represent the interest component of the underlying lease payments and to maintain the exemption from registration for the COPs under Section 3(a)(2) of the 1933 Act.

1. **Should the lessee be a party to the trust agreement between the lessor-assignor and the trustee and also appear in some fashion as a signatory (whether by authentication or otherwise) on the face of the COPs?** Practitioners differ as to the desirable level of lessee involvement to demonstrate its participation in the COPs process, particularly in light of the paucity of statutory authority as to what actions the lessee is authorized to take in this respect under state law. Generally, it would be advisable to have the issuer-lessee approve, or at least acknowledge, the trust agreement.

It does not appear to be common practice for the issuer-lessee to sign or authenticate the actual COPs and such a practice may cause state law problems in respect of the creation of debt.

2. **Is specific legislation required for COPs transactions?** While specific legislation may be of comfort to those practitioners who render approving opinions with respect to COP transactions, particularly depending upon the nature of the lessee's participation in the certification process, the number of such transactions in a variety of jurisdictions suggests that the lack of specific legislation is not an impediment to these transactions. If achievable, however, specific legislation supporting the lessee's participation in the COPs process would be desirable.

3. **What opinions should counsel render in COPs transactions?** The practice differs widely as to the opinions that counsel should render in a COPs transaction beyond those opinions that are customary as to the validity of the lease and the tax-exempt treatment of the interest component of lease payments. For example, what opinions should special counsel render as to distributions with respect to the certificates or the due authorization, execution and delivery of the trust agreement by the lessor or the compliance of any continuing disclosure undertaking with local law? What, if any, opinions of trustee's counsel should be requested with respect to the due execution and delivery of the COPs themselves.

4. **Does interest payable only from earnings on proceeds from the sale of COPs constitute interest on an obligation of a state or local government?** COPs transactions are often structured so that interest accruing during a construction or installation period is paid from capitalized interest or from interest earnings on the proceeds from the sale of the COPs. In states like California, a lessee generally cannot be obligated to make lease payments before the property is available for the lessee's use. Leases in those states frequently provide that the lessee's obligation to make lease payments during the construction or installation phase is limited to the amount of the capitalized interest or to earnings on the proceeds from the sale of the COPs.

Technical Advice Memorandum (PLR 9721003), dated January 24, 1997, described a transaction in which several local governments (the "Districts") participated in a pool designed to provide funding to meet cash flow needs. Each District executed a promissory note obligating it to pay the principal amount of the note plus interest at a specified rate, but not more than the District's "Payment Obligation," which was defined in the COPs documents. A corporation pooled the notes and assigned them to a trustee. The trustee executed and delivered COPs evidencing undivided interests in the aggregate payments due under the notes. The COPs proceeds were used to purchase an investment agreement at a yield sufficient to pay the interest accruing on the COPs until the Districts drew down the funds to meet operating expenses.

The IRS held that the proceeds of the COPs were not received by the Districts until they were withdrawn from the investment agreement and that prior to the withdrawal the notes were not deemed to be issued. The practical effect of the IRS' conclusion is that interest accruing on the COPs prior to withdrawal of the funds from the investment agreement is not interest on an obligation of a state or local government. The IRS based its position on a determination that prior to a withdrawal from the investment agreement, the notes represented only a right to draw on the funds rather than an interest in the funds themselves. This determination was based on the fact that each District's Payment Obligation, and, thus promise to pay under its promissory note, was equal to zero unless a draw was made. The IRS further supported its conclusion that the Districts did not have an interest in the funds by the fact that the trustee for the COPs was directed to invest the COPs proceeds in an investment agreement, which would not have been a permissible investment for the Districts.

Many lease transactions utilize a structure very similar to the one described in the Technical Advice Memorandum. To avoid the adverse results mandated by the Memorandum, the transaction documents should make it very clear that the proceeds of the COPs are the funds of the lessee from the date the proceeds are received and that the lessee has an unequivocal obligation to make the lease payments. In carefully drafted documents, it should still be permissible for the payment obligation to be satisfied only from specified sources of funds, such as accrued interest or investment proceeds. Consistent with the concept that the proceeds of the COPs are the funds of the lessee, proceeds derived from a COP should be invested only in obligations which are permitted investments for the lessee.

V. CERTAIN OTHER FEDERAL TAX ISSUES IN LEASING

A. Tax-Exempt Financing of Intangibles.

Financing intangible assets (e.g., service contracts, maintenance contracts, support, software licenses, cloud services, software-as-a-service (SaaS) agreements, etc.) on a tax-exempt basis requires careful analysis of all the facts and circumstances surrounding each financing, including, but not limited to, the nature and description of the financed assets, the financing structure and the financing terms. While not unique to leasing, this issue is a common part of the tax due diligence process for tax-exempt lease transactions as vendors, lessors, tax-exempt issuers and others are increasingly seeking to finance myriad types of intangibles using traditional lease and installment sale structures, sometimes revised to eliminate collateral and leasing concepts as the same are not often compatible with financing intangibles.

As stated previously in prior sections, the allocation and accounting regulations under Section 148 of the Code generally do not permit an issuer to allocate proceeds of a tax-exempt obligation, including a tax-exempt lease, to any cost that is not a capital expenditure, subject to certain *de minimis* and extraordinary expenditure exceptions, and except in the case of an issue that qualifies for restricted working capital financing. For this purpose, a "capital expenditure" is "[a]ny cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles." Accordingly, with limited exceptions, tax-exempt proceeds may only be spent on expenditures that could be capitalized under general federal income tax principles.

As of the date hereof, general guidance concerning the capitalization of intangible expenses is available, but practice varies widely among practitioners as to whether or not intangibles can be financed as capital assets on a tax-exempt basis. Some practitioners are comfortable financing only *de minimis* amounts of intangibles on a tax-exempt basis, while others have undertaken a more complete analysis of direct and analogous tax guidance and concluded that a prepayment of expenses for intangibles (e.g., computer software or related maintenance and services) that does not constitute a "purchase" can still be treated as a created intangible and a capital expenditure for purposes of the arbitrage rules applicable to tax-exempt obligations.

In most cases, when it is determined that an intangible can be financed on a tax-exempt basis, the intangible is prepaid. Practitioners should note that the payment of expenses before goods or services are received typically implicates two separate, but similar, rules applicable to tax-exempt obligations: the prohibition on private loan financing and the arbitrage rules applicable to investment-type property. For a further description of these rules, see "Prepayment of Vendors" below.

Federal tax considerations relating to the financing of intangibles are in addition to any state law considerations raised by the financing of intangibles (e.g., whether the applicable state law authority actually permits the financing of intangibles as personal property, whether alternative statutory authorities allow the prepayment of and/or acquisition of intangibles, whether a security interest can be taken and perfected in intangibles under the UCC).

B. Prepayment of Vendors.

Tax-exempt lease proceeds may be used to prepay certain items not provided until a later date. If certain requirements are not met, the Internal Revenue Service may treat any such uses of lease proceeds (for example, but without limitation, the prepayment of intangibles) as investment-type property subject to the arbitrage yield restriction and rebate rules under Treas. Reg. §1.148-1(e), or as a private loan prohibited by the private activity bond rules of Treas. Reg. §1.141-5.

1. **Investment Type Property**. For interest on State or local bonds (including tax-exempt leases) to be excluded from the gross income of the bondholder under Section 103 of the Internal Revenue Code of 1986 (the "Code"), the bonds must satisfy various eligibility requirements, including a requirement that the bonds not be arbitrage bonds as defined in Section 148 of the Code. Section 148(a) generally defines an "arbitrage bond" as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected to be used or are intentionally used to acquire "higher yielding investments" or to replace funds so used. Section 148(b)(1) defines the term "higher yielding investments" as any "investment property" that produces a yield over the term of the issue that is materially higher than the yield on the issue. Section 148(b)(2) defines the term "investment property" to include any security, any obligation, any annuity contract, certain residential rental property, and any "investment-type property." In general, except as otherwise provided in Treas. Reg. §1.148-1(e), a prepayment for property or services, including a prepayment for property or services that is

made after the date that the contract to buy the property or services is entered into, gives rise to investment-type property under the Code if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made.

2. **Private Loan**. Treas. Reg. §1.141-5 provides that bonds of an issue are private activity bonds if more than the lesser of 5 percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. In determining whether the proceeds of an issue are used to make or finance loans, indirect, as well as direct, use of the proceeds is taken into account. In general, any transaction that is characterized as a loan for federal income tax purposes is a loan for purposes of the private loan financing test. In addition, a loan may arise from the direct lending of bond or lease proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of the transaction rather than its form. Under Treas. Reg. §1.141-5(c)(2)(ii), "[e]xcept as otherwise provided [in the regulation], a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller."

3. **Avoiding "investment-type property" and private loans in tax-exempt leasing**. The federal tax requirements that must be satisfied to ensure that using tax-exempt lease financing proceeds for prepayments will not result in arbitrage under Treas. Reg. §1.148-1(e), or private activity bond status under Treas. Reg. §1.141-5, are effectively identical, so compliance with one test resolves the concern of compliance with the other. As a result, the concerns raised by prepayments are often conflated when discussing the issue, notwithstanding the fact that two separate tax rules are implicated.

   Treas. Reg. §1.141-5(c)(2)(ii) states that "Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller."

   Treas. Reg. §1.141-5(c)(2)(ii) and Treas. Reg. §1.148-1(e)(2)(i)(A), state, respectively, that "a prepayment is not treated as a loan for purposes of the private loan financing test" and "a prepayment does not give rise to investment" if any of the following three tests can be satisfied:

a. Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the “Customary Prepayments Test”);

b. The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

c. The prepayment meets the requirements of §1.148-1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

The third test is rarely, if ever, applicable to tax-exempt lease financing transactions and the second test is limited in applicability to prepayments made within 90 days of final delivery of the property or services (in practice, most prepayments are made more than 90 days in advance, limiting the applicability of this provision), requiring the majority of tax-exempt lease financings where proceeds are used to prepay vendors or contractors to meet the Customary Prepayments Test.

Whether a prepayment satisfies the Customary Prepayments Test is generally made based on all the facts and circumstances; however, the regulations provide safe harbors for certain prepayments. See Treas. Reg. §1.141-5(c)(2)(iii)(A) and Treas. Reg. §1.148-1(e)(2)(ii)(A). The Customary Prepayments Test is deemed satisfied under the safe harbors if the prepayment is:

a. made for maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment), or updates or maintenance or support services with respect to computer software; and

b. the same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

Where the facts preclude application of the safe harbor, a practitioner must ensure that prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer of the tax-exempt lease, but who are not beneficiaries of tax-exempt financing.

Note that when a tax-exempt lease financing transaction involves a prepayment it is common for bond counsel or special tax counsel to request a certificate from the vendor or contractor who is the recipient of the prepayment. In the certificate the vendor or contractor makes representations about the terms on which it offers other buyers who are not

beneficiaries of tax-exempt financings, and, where applicable, specific representations can be requested to ensure the terms of the Customary Prepayments Test safe harbor apply to the transaction.

VI. COMMERCIAL FINANCIAL DISCLOSURE LAWS

Commercial financial disclosure laws (each a "CFDL" and together, "CFDLs"), first enacted in 2019, are becoming more common across the nation. CFDLs generally seek to require lenders to provide consumer-type disclosures in commercial loan transactions to allow small businesses to make more informed borrowing decisions. Lessors and lenders, and their counsel, and bond counsel delivering validity opinions in municipal financings, should be aware of any applicable CFDLs. The extent to which CFDLs apply to municipal lease financing transactions varies in each particular jurisdiction where a CFDL has been enacted. As of October 2023, seven states have CFDLs on the books (in some cases, with future effective dates), namely (1) California (California Financial Code, Section 22800, et. seq., and California Code of Regulations, Title 10, Sections 900-956); (2) Connecticut (Public Act No. 23-201); (3) Florida (House Bill 1353); (4) Georgia (Senate Bill 90); (5) New York (Consolidated Laws of New York Annotated Financial Services Law, Section 801, et. seq.); (6) Utah (Utah Code Annotated, Section 7-27-201 et. seq.); and (7) Virginia (Virginia Code Annotated, Section 6.2-2228, et. seq.).

Lenders subject to those laws and regulations are likely required to make compliant disclosures, unless they can avail themselves of certain exceptions. A short summary of enacted CFDLs follows, but practitioners should refer to the referenced statutes and laws for a more complete description of each CFDL and a description of the disclosures actually required:

The California CFDL applies to commercial loans in a principal amount of $500,000 or less, but at least $5,000, and includes certain lease financings. Depository institutions, loans secured by real property, true leases and lease financings subject to termination by the lessee are exempted from the California CFDL.

The Connecticut CFDL requires providers of sales-based financings to provide certain disclosures. Sales-based financings include transactions where repayment is tied to revenues or sales. Banks and certain credit unions are excepted from the Connecticut CFDL. Commercial financing transactions that are secured by real property, that constitute a lease, that involve a provider that consummates no more than five transactions in Connecticut during a twelve-month period or that exceed $250,000 are exempted from the Connecticut CFDL.

The Florida CFDL requires persons who consummate more than five commercial financing transactions in any calendar year to provide disclosures. The commercial financings subject to the Florida CFDL include commercial loans, the proceeds of which are provided to a business or are intended to be used to carry on a business (including a corporation and potentially municipal corporations) and not to be used for personal, family, or household purposes. Providers that are federally insured depository institutions or subsidiaries or service corporations owned and controlled by federally insured depository institutions are exempted from the Florida CFDL, as are financing transactions that are secured by real property, that constitute a lease, that involve a provider that consummates no more than five transactions in Florida during a twelve month period or that exceed $500,000.

The Georgia CFDL requires persons who consummate more than five commercial financing transactions in any calendar year to provide disclosures. The commercial financings subject to the Georgia CFDL include commercial loans to a private enterprise carried on for the purpose of gain or economic profit. Tax-exempt lease financings may not involve a loan to a private enterprise such that the Georgia CFDL may not be applicable.

The New York CFDL applies to loans, leases and other forms of financing in a principal amount of $2,500,000 or less. Certain financial institutions are exempted from the New York CFDL, as are true leases, financings secured by real property, persons lending infrequently (no more than five financings in a 12-month period).

The Utah CFDL is very similar to the Georgia CFDL, but includes a registration requirement, subjecting certain lenders to oversight by state regulators.

The Virginia CFDL is narrow and applies only to sales-based financings, transactions which apply only to merchant cash advance providers.

In addition to the states described above, several other states have proposed and even seen CFDLs progress through the law making process. For example, Maryland's proposed CFDL (Senate Bill 496) has been referred to committee and may be in effect on October 1, 2023. In addition, the following states have proposed various forms of CFDLs: Illinois (Senate Bill 2234 and House Bill 3064), Kansas (Senate Bill 245), Missouri (Senate Bill 187 and House Bill 584), North Carolina (Senate Bill 539), and Mississippi (Senate Bill 2619 and House Bill 1271, both of which have since failed). New Jersey's CFDL remains pending during the carry-over session (Senate Bill 819 and House Bill 2150). Other proposals are expected to be forthcoming.

In 2022, the Consumer Financial Protection Bureau ("CFPB") received a request from an industry trade association to determine whether New York's CFDL is preempted by the Truth in Lending Act ("TILA"). The CFPB's preliminary determination was that the New York law is not preempted by TILA because the New York law regulates commercial financing transactions rather than consumer-purpose transactions. On March 28, 2023, the CFPB announced it had determined that CFDLs in California, New York, Utah, and Virginia are not preempted by TILA. TILA is intended to ensure that credit terms are disclosed in a meaningful way to consumers, so they can better compare lending options. The California, New York, Utah, and Virginia CFDLs require lenders to include disclosures in their commercial financing transactions with businesses. Commercial financing transactions, according to the CFPB, are not covered by TILA.

The Uniform Laws Commission is currently studying the need for and feasibility of a uniform or model act providing for standardization of CFDLs across the states. As with other uniform laws, even if a uniform law is drafted, states are free to choose whether to adopt the uniform law, and whether to customize the law.

To determine whether a particular CFDL relates to a specific financing and the lender or lessor in such transaction, practitioners should carefully review the defined terms, exemptions and/or exceptions, and the regulatory reach of the particular CFDL. To the extent disclosures are required, practitioners representing lenders and lessors should be aware of the requirements, and

practitioners representing the recipient of the financing should evaluate the effect of compliance, or more importantly, non-compliance with any applicable CFDL.

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NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023

October 18 – 20, 2023

TAX HOT TOPICS

Chair:

Barbara Jane League	**Orrick, Herrington & Sutcliff LLP**

Panelists:

Alison Benge	**Pacifica Law Group**
Scott Lilienthal	**Hogan Lovells**

This panel will discuss current federal tax issues, including any recently released notices, rulings, regulations and/or other guidance. In order to address any late-breaking topics, the specific topics are subject to change. However, the panel expects to address the recent hotel management private letter contract ruling with the insights of someone who worked on the ruling request. Final topics that will be addressed will be communicated to attendees via NABL Connect prior to The Workshop.

1. **Legislative Updates**

    a. **Inflation Reduction Act of 2022 updates**

    b. **Advance refunding proposals**

2. **IRS and Treasury Updates**

    a. **Recent PLRs**

    b. **Priority Guidance Plan Relating to Tax-Exempt Bonds**

        i. Final regulations relating to the definition of registered form under §§149(a) and 163(f). Proposed regulations were published on September 19, 2017.

        ii. Regulations under §1001 on the modification of debt instruments, including issues relating to disregarded entities.

3. **Revenue Procedure 2017-13**

    a. Section 5.02(2) of the revenue procedure provides that a management contract must not provide a share of the net profits from the operation of the managed property to the service provider. It then goes on to say "compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) for any fiscal period. For this purpose, the elements of the compensation are the eligibility for, the amount of, and the timing of the payment of the compensation." "Unrelated parties" are defined in Section 4.09 as "persons other than either (1) a related party (as defined in §1.150-1(b)) to the service provider or (2) a service provider's employee."

    b. There appears to be a significant disagreement in the bond counsel community regarding what the parenthetical in Section 5.02(2) means. Section 5.02(1) states that compensation includes payment to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider. In addition, Section 4.09 states that the employees of the Service Provider are now considered unrelated parties to the service provider. Accordingly, does the parenthetical in section 5.02(2) mean that a percentage of gross revenues contract may not provide for the reimbursements of employee salaries? If not, under what circumstances would a reimbursement avoid resulting in the overall compensation being treated as based on a share of net profits?

    c. Hypothetical: A hotel contracts with the management company to manage the hotel facilities. All employees are employees of the management company. The contract provides for the management company to be paid a percentage of gross revenues and to be reimbursed for the costs of employees working at the facility. Does this contract result

in compensation based on a share of net profits? Do we have enough information to answer that question? What additional information is needed?

d. With respect to employee compensation that is reimbursed by an issuer, in PLR 202229002 the issuer reimburses the service provider for operating expenses with respect to the hotel operation including service provider's employee costs, such as employee salaries, fringe benefits, incentive compensation, bonuses, employee performance and service awards from the gross revenue of the hotel operation.

   Incentive compensation and bonuses to senior management employees of service provider are evaluated based on formulas used to measure the performance of the hotel by factors such as the hotel's financial performance, guest experience, and individual goals. Incentive compensation and bonuses to a senior management employee are payable on a yearly basis as a percentage of the respective employee's salary subject to the service provider's discretion.

e. The IRS states that because the compensation to the service provider includes the reimbursement of employee costs of the service provider, the terms of the agreement do not meet the safe harbor conditions set forth in Section 5.02(2) of Rev. Proc. 2017-13, such that a facts and circumstances test must be used to determine if the agreement will result in the service provider's private business use of the hotel.

   The PLR then goes on to state that incentive compensation and performance bonuses to senior management employees of the service provider are determined based on formulas used to measure the performance of the hotel, using factors such as the financial performance of the hotel, guest experience, and individual goals, and are payable as a percentage of the employees' respective salaries, the timing and amount of which are not contingent upon the net profits from the hotel operation.

f. Given that these employee salaries are based at least in part upon the financial performance of the hotel, is it possible to determine what factors led the IRS to getting comfortable that the reimbursement of these employee salaries does not result in private business use of the hotel by the service provider?

4. Bond Counsel Opinions for Qualified 501(c)(3) Bonds When the Charitable Purpose is Lessening the Burdens of Government

a. IRC 501(c)(3) does not include lessening the burdens of government in its list of charitable purposes, which is as follows:

   i. religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals

b. Rather Treas. Reg. 1.503(c)(3)-1(d)(2) defines the term “charitable” as used in IRC 501(c)(3) to include lessening the burdens of government but provides no further guidance on what activities qualify as lessening the burdens of government.

c. The test for lessening the burdens of government is generally provided in Rev. Ruls. 85-1 and 85-2, which establish a two-part test to determine whether an organization lessens a burden of the government.

d. The organization must demonstrate that its activities are actually burdens of the government. The Service has long held that the government is in the best position to determine whether the activity is its burden. Thus, the government must make an objective manifestation that, in effect, declares the activity to be its burden. The following are examples of factors that have been used to establish that the government considers the activity to be its burden:

    i. Legislative creation of the organization intended to carry out the activity and a legislative definition of its structure and purposes.

    ii. Legislative authorization for the creation of the type of organization intended to carry out the activity.

    iii. Direct government involvement in and oversight of the organization.

    iv. Government funding of the organization's activities.

    v. The organization participates with the government in conducting an activity that has actually been performed in the past by the government, acts jointly with the government in conducting an activity, conducts an activity that is an integral part of a larger government program, or takes over an existing government activity.

    vi. The activity performed by the organization is required by statute to be performed by the government or is acknowledged by legislation to be a government responsibility.

    vii. The organization pays the government's obligations.

e. These factors can be difficult to apply to various fact scenarios and arguably require a practitioner with significant 501(c)(3) experience to evaluate

f. Many developers are forming 501(c)(3) entities with a charitable purpose of lessening the burdens of government. The intent is that the 501(c)(3) will build and possibly operate facilities for multiple as-yet-unidentified governmental entities throughout the country. Some of these entities specialize in one type of facility, such as housing, while other entities plan to build any type of entity needed in a community, such as arenas, water facilities and housing all being developed by the same 501(c)(3).

g. In the past, the IRS has viewed such entities with skepticism. Lately, there are reports that the applications for such entities are being approved by the IRS with what appears to be

little formal review. What factors should bond counsel look for before providing or agreeing to rely on a 501(c)(3) opinion for bonds being issued to benefit these entities?

h. NABL's report on The 501(c)(3) Opinion in Qualified 501(c)(3) Bond Transactions (2014) discusses a bond opinion's reliance on the 501(c)(3) opinion of another law firm and notes that "[u]nder general legal opinion principles, by stating reliance upon the opinion of borrower's counsel as to the borrower's 501(c)(3) status in the bond opinion, bond counsel must make a professional judgment that such reliance is reasonable based on the reputation of borrower's counsel for competence in such matters and determine that the opinion of borrower's counsel is responsive to bond counsel's needs.

i. Likewise, Circular 230 section 10.37(b) states

A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when—

i. The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;

ii. The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or

iii. The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.

5. Recent Refunding Proposal

Hypothetical: Financial advisor is proposing to issuer that it refund on a tax-exempt basis outstanding taxable advance refunding bonds issued in 2020. The 2023 refunding would be a portion of a multipurpose new money/refunding issue. The original tax-exempt new money bonds are no longer outstanding. The final maturity of the new money portion of the issue is 2043 and the final maturity of the refunding portion is 2043. The coupons on the 2020 taxable bonds are lower than the coupons on the 2023 tax-exempt bonds, and the yield on the entire multipurpose 2023 issue is between the two. The financial advisor is proposing to refund all maturities of the 2020 taxable bonds, including all noncallable maturities, and to defease to maturity rather than the earliest call date.

If savings are calculated using the yield on the entire multipurpose 2023 issue, savings are generated and the savings are increased the longer the escrow is in place. This is true if the escrow goes to the first call date or to maturity.

If savings are calculated using the yield on the refunding portion of the bond issue only, there are no savings.

How do you advise the issuer? See Treas. Reg. 1.148-10(a)(3).

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

TAX ISSUES IN 501(c)(3) FINANCINGS SHORT OUTLINE

Chair:
Taylor L. Klavan Squire Patton Boggs (US) LLP, Houston, TX

Panelists:

Brian Organ Hawkins Delafield & Wood LLP, San Francisco, CA
Edwin Oswald Orrick, Herrington & Sutcliffe LLP, Washington D.C.
Elizabeth Walker Barnes & Thornburg LLP, Indianapolis, IN

I. OWNERSHIP OF BOND-FINANCED PROPERTY

Section 145(a)(1) of the Code provides that that a "qualified 501(c)(3) bond" is "any private activity bond issued as part of an issue if – all property which is to be provided by the net proceeds of the issue is to be ***owned*** by a 501(c)(3) organization or a governmental unit." Thus, qualified 501(c)(3) bonds cannot be used to finance even $0.01 of property to be *owned* by a private user – even though under the 95% requirement up to 5% of the proceeds of the issue may be *used* for any private business use.

Hypothetical: You are bond counsel for a potential 501(c)(3) financing for a new charter school, which is a corporation and an organization described under Section 501(c)(3) of the Code ("**Charter School**"). National Schools Co. ("**National**") is an affiliate of Charter Schools, which manages administrative tasks of Charter School, and is not an organization described under Section 501(c)(3) of the Code. Charter School wants to finance the costs of the acquisition of land (the "**Land**") and the acquisition and renovation of an existing school facility for its operation (the "**Buildings**," and together with the Land, the "**Bond-Financed Assets**"). The acquisition of the Land would comprise more than 25% of the net proceeds of the issue. Under the law of State A, where the Bond-Financed Assets will be located and the state that gives Charter School its charter, Charter School cannot use state funds to pay debt service on real property. To avoid this issue and other State A property reversionary limitations for charter schools, Charter School wants to structure the financing to have Charter School lease the Bond-Financed Assets from Property-LLC, a single member LLC, the sole member of which is National ("**Property-LLC**"). Property-LLC is not an organization described under Section 501(c)(3) of the Code. Before trying to hammer out how this structure would work from a deal perspective, Charter School comes to you and wants to know if it enters a long-term lease to use the Bond-Financed Assets will the ownership requirement for qualified 501(c)(3) bonds be satisfied.

1. What does ownership mean?

    a. "Ownership" of property for this purpose is determined under federal tax principles and is not based upon who owns title to the property. So, we would need to look at whether Charter School can be considered the owner, under federal tax principles.

b. The IRS can look a number of factors to determine if the burdens and benefits of ownership have transferred from one party to another, including the following seven criteria: (1) Right to possession; (2) An obligation to pay taxes, assessments and charges against the property; (3) Responsibility for insuring the property; (4) Duty to maintain the property; (5) Right to improve the property without the seller's consent; (6) Bearing of the risk of loss; and (7) Right to obtain legal title at any time by paying the balance of the full purchase price.[1]

c. As a general rule, if the 501(c)(3) organization's leasehold interest exceeds the expected economic life of the financed asset,[2] or if the financed asset can readily be removed from the leased space, and such removal is permitted under the terms of the lease, such improvements can be treated as owned by the 501(c)(3) organization, so that they are eligible for tax-exempt financing. This is because during the time that a 501(c)(3) organization is leasing such asset, the benefits and the burdens of ownership of the asset are transferred to the 501(c)(3) organization.

2. Analysis: This could possibly be permitted, if the lease term, including any and all unilateral options to renew by Charter School, is long enough to transfer the benefits and burdens of ownership of the Bond-Financed Assets to Charter School. We would need to do this analysis on an asset-by-asset basis.

a. **The Buildings**:

i. Revenue Procedure 62-21[3] provides that buildings, which includes the structural shell of the building and all integral parts thereof also includes equipment which services normal heating, plumbing, air conditioning, fire prevention and power requirements, and equipment such as elevators and escalators, have a useful life of between 40 and 50 years.

ii. The lease term of the Buildings, including all unilateral renewal options, would need to be at least as long as the estimated useful life of the Buildings (between 40 years and 50 years).

b. **The Land:** Land is a trickier situation.

i. Section 147(b)(3)(B)(ii) provides that if 25 percent or more of the net proceeds of any issue is to be used to finance land, such land shall be taken into account under paragraph (1)(B) and shall be treated as having an economic life of 30 years.

ii. Would a lease of the Land for at least 30 years be sufficient to transfer federal tax ownership of the Land to Charter School? **It doesn't seem like it.**

[1] See *T.C. Summary Opinion 2014-77* determining that ownership, for purposes of claiming a first-time homebuyer tax credit, was transferred when the taxpayers entered into the installment sale contract, not when the title to the property transferred.

[2] It may also be possible to conclude that the property is owned for tax purposes by the 501(c)(3) organization even when the 501(c)(3) organization isn't leasing the property for its full economic life, if there will be so little economic life left for the private business after the lease that the lease has effectively transferred the benefits and burdens of ownership to the 501(c)(3) organization.

[3] Rev. Proc. 62-21; 1962-2 C.B. 418

1. In general, land is not considered a depreciable asset because it is viewed to have an indefinite useful life.

2. It doesn't seem like Section 147(b)(3)(B)(ii) deals with federal tax ownership of land. Instead, this provision is preventing land, which has an indefinite useful life, from being financed in such a way that an issue of bonds can remain outstanding indefinitely.

3. To conclude that the benefits and burdens of federal tax ownership of the Land would be met:

    a. the lease term for the Land would also need to be indefinite;

    b. the lease would need to give Charter School the ability to divest the Land on its own accord, and

    c. the lease would need to convey Charter School the ability to retain the gain or bear the loss of the Land.

4. A lease with an indefinite term that conveys all rights and burdens in the land could include a Fair Market Value buyout provision that the Property-LLC could exercise upon the retirement of the bond issue (or a refunding issue that refinances the original purchase of the land).

5. The requirements are usually not palatable to most entities and may not be legal in some states (think back to law school property law and the rule against perpetuities).

c. **Other Options**: How can this financing be structured?

i. National could become an organization described under Section 501(c)(3) of the Code and then it could elect to treat Property-LLC as a disregarded entity for tax purposes. Then, Property-LLC, by virtue of having a sole member, who treats Property-LLC as disregarded entity for federal tax purposes, would be treated as being a 501(c)(3) organization. Then either National or Property-LLC would own the land for federal tax purposes. It is possible that Charter School could then finance the acquisition.

ii. A Charter School Property-LLC entity could be formed. Charter School could be the sole member of Charter School Property-LLC.

1. Then Charter School could elect to treat Charter School Property-LLC as a disregarded entity for federal tax purposes.

2. Then Charter School Property-LLC could become the Borrower.

3. This might not accomplish certain State law property reversionary issues though.

Hypothetical continued: Charter School comes back to you and decides to finance the Land with taxable bonds. However, it still wants to finance the Buildings with 501(c)(3) bonds. Charter School's counsel

explains that the law of State A requires that State A approve the lease term, and all renewals of such lease. Presently, State A will only approve a 10-year lease, which is contemporaneous with Charter School's charter. Will that be a problem?

1. Analysis: Possibly yes. As mentioned above, the lease term of the Buildings, including all unilateral renewal options, would need to be for at least as long as estimated useful life of the Buildings (between 40 years and 50 years).
    a. Is this a Unilateral Option?
        i. When looking at a unilateral option to renew a lease there isn't a lot to look to. So, sometimes we look to the description of a unilateral option under Regulation § 1.1001-3(ii)(3) by analogy. To be a unilateral option under Regulation § 1.1001-3(ii)(3):
            1. There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the lease to a person who is related (within the meaning of Section 267(b) or Section 707(b)(1)) to Charter School;
            2. The exercise of the option doesn't require the consent or approval of:
                a. The other party (in this case Property-LLC),
                b. A person who is related to that party, whether or not that person is a party to the instrument; or
                c. A court or arbitrator.
            3. The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information.
    b. It seems like State A's ability to approve/reject all renewals of the lease could be considered an intervening step, like the approval of a court or an arbitrator approval, that would make it seem like Charter School's option to renew the lease would not be unilateral.

II. PRIVATE BUSINESS USE OF BOND-FINANCED PROPERTY

Section 145(a)(2) of the Code provides that a "qualified 501(c)(3) bond" is "any private activity bond issued as part of an issue if – such bond would not be a private activity bond if – (A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and (B) paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears."

A. Use by a Governmental Unit

1. Federal government is a private user. Even borrowers that are generally cognizant of private use restrictions often do not realize that the federal government is a private user.

Hypotheticals:

i. A 501(c)(3) health system issues $5,000,000 of 501(c)(3) bonds and uses $500,000 of the proceeds to purchase a CT scanner. A year later, the local Veterans Administration hospital calls the 501(c)(3) health system, and says that their best CT scanner has broken, and that the VA hospital would like to use the 501(c)(3) health system's scanner until the VA hospital can get theirs fixed. The 501(c)(3) health system has multiple CT scanners, and so agrees to rent the bond-financed CT scanner to the VA hospital for $10,000 for month for six months. Is there private use? If so, how much?

ii. Same facts as (i), but at the end of 6 months the VA hospital says that due to supply chain issues their CT scanner cannot be fixed, and it will be another two years before the CT scanner can be replaced. The parties agree to a new two-year contract on the same economic terms, but the rental contract says that it can be terminated by either party upon 50 days' notice. Is there private use? If so, how much?

iii. Same facts as (ii), but one year into the two-year agreement, the 501(c)(3) health system has gotten tired of making due without the bond-financed CT scanner, and the VA hospital is tired of waiting for a replacement to come in, so the 501(c)(3) health system and decides to sell the CT scanner to the VA for its depreciated value of $300,000. Is there private use? If so, how much?

2. Private use as between 501(c)(3) organizations and state and local governments is a one-way street. State and local governments are not private users of 501(c)(3) bonds, but 501(c)(3) organizations are private users of governmental bonds. Given the degree of joint venture activity in the healthcare space, the 10% private business use permitted for governmental bonds may be less useful for governmental healthcare organizations than the 5% private business use permitted for 501(c)(3) bonds (i.e., governmental hospitals may wish to elect to issue 501(c)(3) bonds, rather than governmental bonds).

B. Use by 501(c)(3) Organizations

1. Unrelated trade or business activity is private use. 501(c)(3) borrowers often overlook that they themselves can be private users, depending on the activities performed. This is especially the case if no taxation is owed (UBIT). This is also why review of UBIT reported on 990-Ts may not be sufficient diligence to uncover all unrelated trade or business activity.

Hypothetical: 501(c)(3) hospital has a retail pharmacy located in space financed with tax-exempt bond proceeds that gives rise to 2.8% private business use on an annual basis. The CFO calls you and says that they are planning to double the size of the retail pharmacy and expect to triple the amount of net profits generated by the retail pharmacy. You start to speak, but the CFO cuts you off and says: "I know that this would be too much private business use, but the good news is that Walgreens has agreed to manage the pharmacy for us, for a fixed annual management fee, and we will keep all the revenues, so that is compliant with Rev. Proc. 17-13, and so we won't have any private use moving forward." Is the CFO correct?

2. 501(c)(3) Organizations Unrelated to the Borrower(s). Because 501(c)(3) entities are generally not private users, they frequently allow other 501(c)(3) organizations to use their facilities, such as a 501(c)(3) university that leases out space to another 501(c)(3) university, or a 501(c)(3) hospital that has a management contract that includes payment based on net profits with physicians employed by another 501(c)(3) health system. What level of diligence should bond counsel perform on 501(c)(3) users that are not the borrower?

3. 501(c)(3) Organizations with Unrelated Exempt Purposes. 501(c)(3) organizations are generally created for specific charitable purposes. Section 513(a) of the Code defines "unrelated trade or business" as "any business the conduct of which is not substantially related (aside from the need of the

organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501."

Hypotheticals:

i. A 501(c)(3) private high school, whose charitable purposes are the education of children, used $100,000 of tax-exempt bond proceeds to finance an expansion of its athletic facilities, consisting of a football field, bleachers, and a building that houses locker rooms for the football team and a small kitchen and concession stand for use during football games. An unrelated local 501(c)(3) organization that provides services to unhoused persons approaches the school with a request to lease the locker rooms, kitchen and concession stand from 8-2 on Saturdays and Sundays to provide showers and food service to unhoused persons in the community. As the school only uses the facility for football practice on Mondays and Wednesdays from 3-6, and for games on Tuesdays and Fridays from 3-7, they agree to allow the other organization to use the facilities free of charge. Is there private use? If so, how much?

ii. Two years later, the same school decides to expand its main school building, and to build new locker rooms and kitchen facilities as part of that expansion, so that students can use the facilities for other sports, and for home economics classes. Since the school no longer needs the standalone locker rooms, kitchen and concession stand, it decides to sell those facilities to the 501(c)(3) organization that provides services to unhoused persons for $5,000. Is there private use? If so, how much?

C. For-Profit Entities

Even where there is clearly a private user, in the form of a for-profit entity, questions can arise as to what constitutes use, or how much use there might be.

1. "Licenses." Sometimes agreements that provide a private party with the right to come into bond-financed space and perform services therein are characterized as a "license." This may describe a use of space that is covered by a private use exception (such as the 2.5% nonpossessory incidental use exception, or the 50 day short-term use exception), or it may be used to describe an agreement that is clearly private use, such as a lease. The substance of the agreement controls, rather than the form.

2. No physical use of bond-financed assets. While most forms of private use require a physical use of bond-financed assets, Regulation § 1.141-3(a)(2) provides that indirect use can give rise to private use, and Regulation § 1.141-3(b)(1) provides that both actual and beneficial use may be treated as private business use.

Hypotheticals:

i. A hospital was constructed using $100,000,000 of 501(c)(3) bond proceeds. Its 501(c)(3) owner has been experiencing financial difficulties, particularly due to increased contract labor costs in the ICU and cardiology department. The hospital hires a consultant who specializes in hospital service line practice improvement, who agrees to increase the net profitability of the ICU and cardiology departments by 10-20% in a one-year period. The consultant will be paid 25% of the increased

profits during the one-year period. Other than two on-site meetings, the consultant never sets foot in the hospital. Does the agreement give rise to private use? If so, how much?

ii. Same facts as above, but after the first year, in which the consultant increases net profits of the ICU and cardiology departments by 12%, the hospital wishes to have the consultant continue monitoring changes to the ICU and cardiology departments, but to also decrease the economic losses from the ER department and the hospitalist program. The hospital decides to employ the consultant, pursuant to a 5 year employment agreement, under which the former consultant will be paid 25% of any further increased profits from the ICU and cardiology departments but will also be paid 15% of any net savings from the ER department and hospitalist program. As part of the employment agreement, the hospital agrees to provide the consultant with 5,000 square feet of office space in the hospital's administrative offices. Does this agreement give rise to private use? If so, how much?

III. WORKING CAPITAL AND THE $150 MILLION TEST

Section 145(b) of the Code provides that a bond (other than a qualified hospital bond) shall not be treated as a qualified 501(c)(3) bond if the aggregate authorized face amount of the issue (of which such bond is a part) allocated to any 501(c)(3) organization which is a test-period beneficiary (when increased by the outstanding tax-exempt nonhospital bonds of such organization) exceeds $150,000,000.

A. General Background

1. The $150 million test on outstanding non-hospital 501(c)(3) bonds (Section 145(b)(1)) was enacted as part of the Tax Reform Act of 1986.

2. Prior to the passage of the 1986 Act, the federal tax rules regarding the issuance of government bonds and bonds benefiting 501(c)(3) organizations were essentially identical.

3. In enacting Section 145 of the 1986 Act, Congress treated bonds issued for the benefit of 501(c)(3) organizations as "private activity bonds" and the $150 million test for non-hospital bonds served effectively as a "volume cap" on each 501(c)(3) entity-borrower.

B. 1997 - Partial Repeal of the $150 Million Test

1. In 1997, the $150 million test was repealed – but unfortunately not entirely.

2. Section 145(b)(5) provides that the $150 million test shall not apply to "bonds issued after August 5, 1997, as part of an issue 95 percent or more of the net proceeds of which are used to finance capital expenditures incurred after such date".

3. Under the partial repeal, an issue issued to finance expenditures incurred after August 5, 1997, in which less than 95 percent of the net proceeds are used to finance capital expenditures is subject to the $150 million test.

4. As will be discussed, the above repeal language can cause practical difficulty in structuring transactions involving bonds subject to the $150 million test and bonds financing capital expenditures incurred after August 5, 1997.

5. Given this partial repeal, the $150 million test "lurks like a virus" and presents a range of matters for tax counsel to consider and manage in connection with 501(c)(3) bonds.

C. **How Can the $150 Million Test Arise in New Bond Financings?**

Hypothetical: New money bonds are issued on January 1, 2023, to finance a new dormitory facility for "X" a Section 501I(3) organization. In the wake of the pandemic and uneven enrollment, X is seeking to finance interest on the bonds for as long as possible. It is expected that the dormitory facility will be placed in service March 1, 2024. In addition, X is also seeking to finance working capital for initial operating expenses associated with the new dormitory facility which will arise after the facility is placed in service.

Regulation § 1.148-6(d)(3)(A)(3) provides that it is permissible to finance interest on an issue for a period commencing on the issue date and ending on the later of: (i) 3 years from the issue date, or (ii) 1 year after the placed in-service date, and such expenditures are not subject to the "proceeds spend last" method for working capital expenditures.

Regulation § 1.148-6(d)(3)(A)(5) provides that "initial operating expenses" directly related to capital expenditures that do not exceed 5 percent of the sale proceeds of an issue may be financed and such expenditures are not subject to the "proceeds spend last" method for working capital expenditures.

Questions: What should bond counsel consider in this financing?

i. Under general tax principals, interest is generally capitalized up until the placed in-service date of the project. For the period of March 1, 2024, through January 1, 2026, does bond counsel need to consider the federal tax treatment of interest and whether such amount is a capital expenditure?

ii. Under general tax principles, the financing of "initial operating expenses" are not capital expenditures.

iii. What if X has other bonds outstanding subject to the $150 million test?

Hypothetical: "Y" a Section 501(c)(3) organization which operates a museum is under financial distress. Y is seeking to current refund an outstanding tax-exempt bond issue and is also seeking to refinance an outstanding taxable bridge loan used primarily (but not exclusively) for Y's working capital expenditures.

Given Y's financial distress, bond counsel observes that Regulation § 1.148-6(d)(3)(A)(3) provides that it may be possible to finance interest on the refunding issue for a period ending on the later of: (i) 3 years from the issue date or 1 year after the placed in-service date is not subject to the "proceeds spend last" method for working capital expenditures.

Bond counsel notes that the language of Regulation § 1.148-6(d)(3)(A)(3) refers to "issue" and not new money issue, hence, providing the ability to issue up to 3 years of interest for the refunding bonds.

Questions: What does bond counsel need to consider in this financing?

i. Examine the use of proceeds of the taxable loan – what amount was applied to working capital?

ii. Should bond counsel approve financing 3 years of interest on the refunding bonds and, if so, what are the potential consequences?

iii. What if Y has bonds outstanding which are subject to the $150 million test and the size of the proposed refunding is $200 million?

D. Refinancing Bonds Issued to Finance Pre-8/5/97 Expenditures and Post-Cap Bonds.

1. Given that the $150 million test was partially repealed about 25 years ago, there is a diminishing amount of non-hospital bond issues subject to the $150 million test.

2. Nevertheless, there are circumstances in which non-profit borrower will seek to refund pre 8/5/97 bonds subject to the $150 million test and finance new projects in a single bond issue.

3. Navigating the pre-cap/post-cap tax landscape is made more difficult by the language used in Section 145(b)(5).

4. Section 145(b)(5) provide in part than the repeal applies to -- "bonds issued after August 5, 1997, as part of an issue" 95 percent of more of the new proceeds were used to finance capital expenditures after such date.

5. Taken literally, if more than 5% of the net proceeds of the bonds which are part of the issue financed capital expenditures incurred prior to 8/5/97, the entire issue is subject to the $150 million cap.

6. A goal is to create some sort of "firewall" in the structure so that the new money bonds are not "tainted" by refunding bonds with pre-8/5/97 expenditures in a single bond issue.

Hypothetical: University W, a Section 501(c)(3) organization wants to finance $300 million of new capital improvements and current refund the outstanding $40 million balance of pre-1997 bonds subject to the $150 million test.

The bankers have advised the issuer and the University that to separate the sale dates of the new money and refunding bonds by more than 15 days would be unduly expensive as the $40 million stand along issue would not garner buy-side interest. Accordingly, the bankers want to sell the new money bonds and refunding bonds in a single tax issue.

Questions: What does bond counsel need to consider in this financing?

i. Given the partial repeal language in Section 145(b)(5), the issuer can make a separate issue allocation under Regulation § 1.150-1(c)(3) between the new money and refunding bonds.

ii. This technique creates a "firewall" between the cap and non-cap bonds.

iii. Under Regulation § 1.150-1(c)(3) – the 95% good use test and the 120% economic life test are applied separately to each "issue." That is, no private use blending and no asset blending between each portion.

iv. Given that the transaction involves a partial refunding, Regulation § 1.150-1(c)(3) requires that an eligible multipurpose allocation must be applied under Regulation § 1.148-9(h) to differentiate the refunding portion from the new money portion.

v. For support of this technique, see example 5(iii) of Regulation § 1.141-13(g), in which Regulation § 1.150-1(c)(3) is used to create a firewall within a single bond issue containing both governmental airport bonds issued under Section 141 and private activity airport bonds issued under Section 142.

E. Other Observations.

1. Is all of the above tax engineering and structuring necessary to protect the new money portion from being subject to the $150 million test?

2. Did Congress intend that a firewall be created under Regulation § 1.150-1(c)(3) to protect post-cap bonds issued as part of the same issue as pre-cap bonds?

3. Given the $150 million test is a volume cap limit, provided that a borrower does not exceed the $150 million test for any legacy bonds – should the analysis involve simply keeping track of pre 8/5/97 bonds to make sure that such limit does not exceed $150 million test?

4. This tracking is now made easier given the repeal of advance refundings as there is no ability to "double-up" pre-cap bonds.

5. Has anyone been involved in an audit in which the IRS closely looked at the $150 million test?

NATIONAL ASSOCIATION OF BOND LAWYERS

THE WORKSHOP 2023

October 18–20, 2023

Underwriter's Counsel Roundtable (Intermediate)

Chair:
Karen M. Jordan — Dentons US LLP

Panelists:
Kelly Hutchinson — Katten Muchin Rosenman LLP
Victoria Donohue — Bank of America

This panel will review the duties, responsibilities and potential liability for underwriters in public offerings of municipal securities and the role of underwriter's counsel in representing underwriters. The panel will also include a discussion of best practices in evaluating and documenting the transaction from the outset through closing.

I. **Overview of a Bond Transaction**

A. **Financing Participants**

1. *Bond Counsel* – Attorneys retained by the issuer/obligated person to give an expert and objective legal opinion with respect to the validity of bonds and other subjects, particularly the federal tax income treatment of interest on the bonds

2. *Credit Enhancer* – Bond insurer, commercial bank, or other financial institution issuing an insurance policy or a supporting letter of credit in order to improve an issue's credit rating; distinguish from a liquidity facility which is a letter of credit, standby purchase agreement or other arrangement used to provide liquidity to purchase securities, commonly in the case of variable rate demand obligations that have been tendered to the issuer or remarking agent but cannot be immediately remarketed

3. *Credit Enhancer's Counsel* - Attorneys representing the credit enhancer

4. *Disclosure Counsel* – Attorneys serving as the principal drafters of an issuer's disclosure document; may provide 10b5 opinion to issuer and underwriters

5. *Issuer* – A state, political subdivision, agency, authority or the United States or an agency or instrumentality of the United States that borrows money through the sale of bonds or notes

6. *Issuer's Counsel* – Attorneys representing the issuer

7. *Municipal Advisor* – Person who advises an issuer/borrower (obligated person) on financial matters pertinent to an issue, such as structure, timing, marketing, fairness of pricing, terms, and bond ratings; municipal advisor may also be designated as an independent registered municipal advisor (IRMA), which designation permits an underwriter to provide advice to an issuer or obligated person with respect to municipal financial products or the issuance of municipal securities without being deemed to be a municipal advisor

8. *Obligated Person* - A person legally committed to support payment of all or a part of an issue of municipal securities, other than certain unrelated providers of credit enhancement

9. *Underwriter* – Broker, dealer or bank dealer which purchases a new issue of municipal securities for resale

10. *Obligated Person/Borrower's Counsel* – Attorneys representing the borrower or obligated person

11. *Paying Agent/Registrar* – Entity responsible for transmitting payments to bondholders and maintaining records of the registered owners of the bonds

12. *Rating Agency* – Organization which provides publicly available ratings of the credit qualities of securities

13. *Trustee* – Financial institution which acts in a fiduciary capacity for the benefit of bondholders in enforcing the terms of the bonds

14. *Trustee's Counsel* – Attorneys representing the trustee

15. *Underwriter* – Broker, dealer or bank dealer which purchases a new issue of municipal securities for resale

16. *Underwriter's Counsel* – Attorneys representing the underwriter in connection with the purchase of a new issue of municipal securities

B. **Investors**

Investors have specific preferences for maturity length, credit rating, and bond structure, and varying levels of price sensitivity. Typical municipal bond purchasers include:

1. Retail Investors

    a. Individuals

    b. Bank Trust Departments (On behalf of customers) – see below

    c. Investment Advisers (Professional Retail) – see below

2. Institutional Investors

a. Bond Funds

b. Insurance Companies

c. Arbitrage Accounts

d. Bank Trust Departments

e. Investment Advisers

f. Bank Portfolios

3. Restricted Investors

a. Accredited Investors

b. Qualified Institutional Buyers

C. **Typical Steps in a Transaction**

1. Assemble team

2. Evaluate capital needs and cash flow capacity

3. Develop a financing plan and schedule

a. Type of sale

i. Negotiated, competitive, private placement vs. direct purchase by a bank

ii. Considerations

A. Type of issuer/obligated person

B. Legal authority

C. Credit/reserves for repayment

D. Project type

E. Financing Structure

F. Market

b. Structure

i. Source of repayment (limited or unlimited taxes, revenues, fees, lease payments, etc.)

ii. Amortization schedule

iii. Serial vs. term bonds (current interest, zero coupon or capital appreciation bonds, etc.)

iv. Bond covenants (additional bonds tests, limitations on future taxes, non-impairment provisions, etc.)

4. Credit Enhancements

   a. Credit ratings

   b. Bond insurance

   c. Letter of credit (LOC)

5. Due Diligence (including checking on past Rule 15c2-12 continuing disclosure compliance) - Underwriter may utilize counsel but may not delegate this responsibility

6. Draft documents

   a. Authorizing resolutions/ordinances

   b. Feasibility studies/ Engineering reports

   c. Trust Indentures/Agreements

   d. Notices to bondholders/insurance companies/trustee

   e. Preliminary Official Statement/Official Statement

   f. Preliminary Blue Sky/Final Blue Sky Memorandum

   g. Bond Purchase Agreement/Contract of Purchase

   h. Agreement Among Underwriters

      i. New SIFMA Master Form

      ii. SIFMA Data Base

      iii. Schedule for each transaction

   i. Selling Group Agreement

   j. Accountants

      i. Agreed Upon Procedures

      ii. Consent to use audit

7. Marketing

8. Comply with MSRB Rules

Municipal Securities Rulemaking Board (MSRB) is a non-governmental, self-regulatory organization (SRO) that is charged with primary rulemaking authority over municipal securities dealers and municipal advisors in connection with their municipal securities and municipal advisory activities.

a. Municipal Advisors - Rule G-23

i. *Purpose* - Establishes ethical and disclosure requirements for broker-dealers who act as Municipal Advisors ("Municipal Advisors").

ii. *Municipal Advisory Relationship* - Covers Municipal Advisors or consultant services with respect to the issuance of municipal securities, including advice re: structure, timing, terms or similar matters.

iii. *Excludes Underwriters* - Municipal Advisors relationship shall not exist when underwriter renders advice in connection with a transaction in which the underwriter is performing underwriting services. A broker-dealer that clearly identifies itself in writing as an underwriter and not as a Municipal Advisor from the earliest stages of its relationship with the issuer with respect to that issue will be considered to be acting as an underwriter. Other disclosures must be given.

iv. *Writing Requirement* - Municipal Advisors must have written agreement.

v. *Prohibition on Underwriting Services* - No broker-dealer that has a financial advisory relationship "with respect to the issuance of municipal securities" may acquire all or part of such issue, or act as placement agent.

vi. *Prohibition on Remarketing Activities* - No broker-dealer with a financial advisory relationship, may act as a remarketing agent with respect to the issue; except, if it resigns, then after one-year it may act as successor remarketing agent.

b. Underwriters - MSRB Rule G-17; Interpretive Notice

i. *Rule G-17 General Purpose* - Precludes dealers and municipal advisors, in the conduct of municipal securities or municipal advisory activities, from engaging in any deceptive, dishonest, or unfair practice with any person. Also establishes a general duty to deal fairly with all persons (including, among others, issuers of municipal securities).

ii. *2012 Interpretive Notice* - Primary change is the requirement of additional disclosures, consisting generally of: (i) disclosures concerning the underwriter's role, (ii) disclosures concerning the underwriter's compensation, (iii) disclosures concerning material conflicts of interests, and (iv) disclosures concerning complex municipal securities financings.

iii. *Specific Disclosures*:

A. The underwriter's primary role is to purchase securities with a view to distribute in an arm's-length commercial transaction with the issuer, and it has financial and other interests that differ from those of the issuer;

B. Unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests;

C. The underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable;

D. The underwriter will review the official statement for the issuer's securities in accordance with and as part of its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction;

E. The underwriter must disclose whether underwriting compensation will be contingent on the closing of a transaction, and that compensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest because it may encourage the underwriter to recommend a transaction that it is unnecessary, or to recommend that the size of the transaction be larger than is necessary; and

F. Must disclose other potential conflicts of interest.

iv. *Complex Transactions* - Underwriter must provide additional disclosures for "complex municipal securities financings" if the underwriter recommends the transaction to the issuer.

v. *Timing* - Issuer relationship must be made in the earliest stages of the underwriter's relationship with the issuer with respect to

an issue (*e.g.*, in a response to a request for proposals or in promotional materials provided to an issuer).

II. Bond Structuring and Sizing

A. Types of Sale

1. Public Offering

    a. Competitive Sale

        i. Bonds are advertised for sale (notice of sale)

        ii. Bidding parameters are set

        iii. Any broker-dealer or bank may bid at the designated date and time

        iv. Bonds are awarded to the bidder offering the lowest True Interest Cost ("TIC") or Net Interest Cost ("NIC"). NIC does not take into account the time value of money (as would be done in other calculation methods, such as TIC).

        v. Selling syndicate

    b. Negotiated Sale

        i. Terms of the bonds and of the sale are negotiated with the issuer/ obligated person

        ii. Issuer/obligated person and underwriter agree upon a yield level at which the underwriter will offer bonds to potential investors for each specific bond that is offered across the yield curve

        iii. Initial interest scale may be adjusted depending on investor demand

        iv. Issuer, obligated person and underwriter enter into a bond purchase agreement.

2. Private Placement

    a. Bonds are sold to one or a few investors at negotiated terms

    b. Placement agent finds investors

    c. Securities obligations are different than in competitive or negotiated sale

B. Elements of a Pricing

1. *Coupon* **-** Annual interest rate payable to the bondholder

2. *Discount Bonds* – Coupon is less than yield

3. *Maturity* **-** Date on which principal payments are due

3. *Par Bonds* – Coupon equals yield

4. *Premium Bonds* – Coupon is greater than yield

5. *Price* - Total amount paid by the issuer for the bonds

6. *Principal/Par Amount* - Face value of a bond to be paid back to the bondholder on the maturity date

7. *Yield* - Net annual interest cost to the issuer, taking into account the discount or premium on the purchase price, the interest rate and the length of time the bond is held

C. **Serial vs. Term Bonds**

1. *Serial Bonds* – Specific annual principal maturities scheduled annually over a period of years

2. *Term Bonds* – Mature on a specified date and commonly use sinking fund payments (payments of principal prior to final maturity)

3. *Current Interest* – (interest paid semi-annually over time) vs. Capital Appreciation or Zero Coupon Bonds (interest compounded and paid at maturity)

III. **Marketing a Negotiated Bond Issue**

A. **Underwriting Process**

1. Create investor target plan

2. Develop syndicate with issuer and obligated person

   a. Syndicate vs. selling group

   b. Senior manager vs. co-managers

3. Create allocation policy

4. Establish priority of orders

5. Pre-pricing

6. Order period

7. Bond pricing

8. Award bonds

9. Delivery of bonds (closing)

B. **Underwriting Terms**

1. Underwriting team

a. Sole Managed Underwriting

b. Syndicate – Group formed to purchase new issue. Agreement Among Underwriters – Determines liability and allocable share of liability for each underwriter.

c. Selling Group – Distinct municipal securities brokers and dealers that assist in the distribution of a new issue of securities that are NOT members of the underwriting syndicate, nor do they have liability as underwriters; selling group members are able to acquire securities from the underwriting syndicate at syndicate terms (i.e., less the total takedown), but do not share in syndicate profits nor share any liability for unsold balances.

i. No direct relationship with the issuer/obligated person

ii. Related entity to broker dealer

A. Distribution agreement

2. Compensation/Spread – Syndicate's compensation. With respect to a new issue of municipal securities, the differential between the price paid to the issuer for the new issue and the prices at which the securities are initially offered to the investing public; this is also termed the "gross spread," "gross underwriting spread" or "production." MSRB Rules provide various restrictions.

a. To the extent that the initial offering prices are subsequently lowered by the syndicate, the full amount of the spread may not be realized by the syndicate.

b. The spread is usually expressed in dollars or points per bond.

c. Historically, the spread has consisted of four components, although one or more components may not be present in any particular offering:

i. *Expenses* – The costs of operating the syndicate for which the senior manager may be reimbursed.

ii. *Management Fee* – The amount paid, if any, to the senior manager and/or co-manager for structuring the transaction and/or handling the affairs of the syndicate.

iii. *Takedown* – Normally the largest component of the spread, similar to a commission, which represents the income derived from the sale of the securities. If bonds are sold by a member of the syndicate, the seller is entitled to the full takedown (also called the "total takedown"). If bonds are sold by a broker-dealer that is not a member of the syndicate, such seller receives only that portion of the takedown known as the concession or dealer's allowance, with the balance (often termed the "additional takedown") retained by the syndicate.

iv. *Risk or Residual* – The amount of profit or spread left in a syndicate account after meeting all other expenses or deductions. A portion of the residual is paid to each underwriter within a syndicate on a pro rata basis according to the number of bonds each broker-dealer has committed to sell without regard to the actual sales by each member

v. *Payment* – Generally taken from the purchase price

3. Order Period

a. In a competitive sale, if there are syndicate members, the order period is the period of time following the sale of a new issue during which non-priority orders submitted by syndicate members are allocated without consideration of time of submission. The length of the order period is usually determined by the manager.

b. In a negotiated sale, the order period is the period of time established by the manager during which orders are accepted. The order period in a negotiated sale generally precedes the purchase of the issue by the underwriter from the issuer. At times, order periods are established at subsequent points in the life of a syndicate. Such subsequent order periods may occur when securities are repriced or market conditions change.

c. In some offerings, a "retail order period" may be designated during which orders will be accepted solely for retail customers (or, in some cases, small orders for any type of customers). MSRB Rule G-11 amended to address certain retail order period requirements.

4. Priority of Orders **-** The rules adopted by an underwriting syndicate specifying the priority to be given different types of orders received by the syndicate. MSRB rules require syndicates to adopt priority provisions in writing and to make them available to all interested parties. For competitive underwritings, orders received prior to the sale ("pre-sale orders") generally are given top priority. In some negotiated offerings, retail orders or other restrictions

designated by the issuer are given priority. Once the order period begins for either negotiated or competitive underwritings, the most common priority provision gives group net orders top priority, followed by designated orders and member orders.

a. *Retail Order* – Any order by customers other than institutional customers; "retail" is not defined by the MSRB.

b. *Institutional Order* – Any order by banks, financial institutions, bond funds, insurance companies or other business organizations that possess or control considerable assets for large scale investing.

c. *Group Net Order* – Any order that, if allocated, is allocated at the public offering price without deducting the concession or takedown. A group net order benefits all syndicate members according to their percentage participation in the account and consequently is normally accorded the highest priority of all orders received during the order period.

d. *Designated (Member) Order* – Any order submitted by a syndicate member on behalf of a buyer on which all or a portion of the takedown is to be credited to certain members of the syndicate. The buyer directs the percentage of the total designation each member will receive. Generally two or more syndicate members will be designated to receive a portion of the takedown.

e. *(Non-Designated) Member Order* – Any order submitted by a syndicate member where the securities would be confirmed to that member at syndicate terms (*e.g.*, less the total takedown).

5. Calculation of Issuer Price

   a. Hold-the-price

   b. Super premium/deep discount

   c. Priced to maturity (tax vs. marketing)

C. **Potential Pricing Considerations**

1. Yield curve

2. Bond structure

3. Supply

4. Economic indicators

5. Market psychology

6. Market technicalities

7. Credit

8. Tax statue

9. Redemption schedule

D. **Day of Sale**

1. Pre-pricing call

a. Issuer/Obligated Person, Municipal Advisor and Underwriter discuss

i. Market conditions

ii. Comparable transactions

iii. Proposed interest rates (coupons, yields)

b. Issuer/Obligated Person approves release of the bonds at proposed interest rates

c. Order period begins – investor feedback

d. Repricing – Adjustment of interest rates, if necessary

e. Bond counsel and underwriter check that sales fit within legal parameters

f. Confirmation of insurer premium and verification (if refunding)

g. Bond Counsel/ Underwriter's Counsel finalize bond purchase agreement

h. Issuer, Obligated Person and Underwriter sign bond purchase agreement

i. Underwriter tickets the transaction

E. **Pre-Closing and Closing**

1. Pre-closing Considerations of Underwriter

a. Form G-32

b. Final OS

i. Dated to coincide with bond purchase agreement execution

ii. Distributed to investors within 7 business days of bond purchase agreement execution

c. Closing Memo

i. Cost of issuance

ii. Flow of funds

2. Closing Considerations of Underwriter

a. Receipt of deliverables under bond purchase agreement

i. 10b5 certificates

ii. Transaction documents

iii. Opinions

iv. Evidence of credit enhancement

v. Final Blue Sky memo (contains same information, or a letter confirming as of the closing date the information, contained in the Preliminary Blue Sky Memorandum delivered prior to the circulation of the Preliminary Official Statement)

a. Confirmation of wires

b. Contact Depository Trust Corporation

NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18–20, 2023

Underwriter's Counsel Roundtable (Advanced)

Chair:
Karen M. Jordan — Dentons US LLP

Panelists:
Leslie Norwood — SIFMA
Victoria Donohue — Bank of America

This panel will consider several of the key developments that have affected the obligations of underwriters in the municipal securities market and how those developments should inform appropriate representation of underwriters by their counsel. This panel will focus on appropriate divisions of responsibilities between underwriters and their counsel with respect to due diligence, what underwriter's counsel should be aware of before undertaking a representation, and how to avoid some of the pitfalls that have occurred in the last several years.

The following outline provides background information pertinent to serving as underwriter's counsel. Reference should also be made to other NABL and industry resource materials cited herein, from which this outline draws with appreciation.

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UNDERWRITER'S COUNSEL

I. GENERAL OVERVIEW

A. Scope of Representation. As the role of underwriter's counsel continues to evolve, it is important for counsel to discuss and clearly establish the scope of their representation with the underwriter. Increasingly, underwriters have prepared guidelines and memoranda regarding the scope of services they expect from underwriter's counsel. Counsel should inquire whether the underwriter has such guidelines/memoranda and, if applicable, should review those materials to ensure their services conform or to agree upon deviations.

Generally, underwriter's counsel is expected to perform various tasks, which may include:

1. Advise the underwriter regarding the rules promulgated by the Municipal Securities Rulemaking Board (the "MSRB"), e.g., MSRB G-17 letters.

2. Preparing or reviewing a preliminary official statement (or similar offering document).

3. Delivering a 10b-5 assurance letter in connection with the offering document.

4. Assisting the underwriter in conducting its due diligence investigation.

5. Preparing a bond purchase agreement and ensuring that pre-conditions to closing set forth in the bond purchase agreement are satisfied.

6. Preparing an agreement among underwriters and selling group agreement (though in recent practice, these are typically prepared by the underwriter and/or participating underwriters accept terms of SIFMA's recently revised Master Agreement Among Underwriters).

7. Preparing a "blue sky" memorandum.

8. Reviewing investor presentations.

9. Reviewing bond documents and closing documents.

10. Reviewing bond counsel, supplemental bond counsel, borrower's counsel and other opinions.

B. SIFMA Model Memorandum to Underwriter's Counsel. In September of 2018, the Securities Industry and Financial Markets Association ("SIFMA") released its *Model Memorandum to Underwriter's Counsel*. Some practitioners have viewed the model memorandum as suggesting a scope services that is more expansive than what underwriter's counsel may have traditionally performed. Nevertheless, many underwriters have revised (and continue to further revise) their guidelines and/or their own memoranda to underwriter's counsel, prompted by the new model. These developments underscore the need for underwriter's counsel

to have a common understanding with their client regarding the scope of the underwriter's counsel's representation.

II. WHO IS THE CLIENT OF UNDERWRITER'S COUNSEL?

As discussed in the *Model Letter of Underwriters' Counsel* (NABL, June 2017) identifying the client in transactions with more than one underwriter may be a matter of firm or attorney practice, or of negotiation with the underwriter(s). There are several approaches, including that the client may be considered to be the underwriting syndicate as an entity, the managing underwriters or only the senior managing underwriter. Ideally, the client identification is confirmed in an engagement letter at the beginning of the representation. *See Model Letter* at 4 (quoting William H. McBride, *Who is the Client of Underwriter's Counsel*? 27 THE BOND LAWYER: THE JOURNAL OF THE NATIONAL ASSOCIATION OF BOND LAWYERS, 33 (no. 2, June 1, 2005)).

The above-cited materials highlight the fact that, because all clients of underwriter's counsel may not be identified at the beginning to a transaction, underwriter's counsel may need to address conflicts of interest well after commencement of work on the transaction. Both NABL's *The Function and Professional Responsibilities of Bond Counsel* (Third Edition, 2011) and NABL's *Model Engagement Letters* (1998 Edition) include a discussion of the American Bar Association's *Model Rules of Professional Conduct* as they relate to conflicts of interest.

Such materials also make the point that, depending on who the client is, and depending on arrangements regarding addressees of counsel's Rule 10b-5 negative assurance letter, such letter may be addressed to parties who are not the underwriter's counsel clients. Identification of the client does not control to whom the assurance letter is addressed, and vice-versa.

III. DUE DILIGENCE

A. Background. "The term due diligence refers to the investigation into the business, legal and financial affairs of the company concerned in connection with securities offerings or other corporate transactions. A reasonable investigation can provide a future defense in response to securities law claims or common law claims stemming from a transaction or offering that has gone 'bad.'" *Conducting Due Diligence 1997* at 209. By participating in an offering, an underwriter makes an implied recommendation about the securities it is underwriting[1] and makes a representation that it has a reasonable belief in the truthfulness and completeness of the key representations made in any disclosure document used in the offering.[2]

While the term "due diligence" is not defined in the federal securities laws, it has become an informal shorthand phrase by which to refer to conduct and procedures which, if followed, will (i) establish certain affirmative defenses set forth in the Securities Act of 1933, as amended (the "1933 Act" or the "Securities Act") and the Securities Exchange Act of 1934, as amended (the "1934 Act" or the "Exchange Act"), (ii) tend to negate scienter for purposes of Rule 10b-5 and certain other anti-fraud provisions and (iii) satisfy the general standard of professional

[1] *See* Exchange Act Release No. 34-62184A (May 26, 2010), 75 FR 33100 (June 10, 2010).

[2] *See* Exchange Act Release No. 34.26100 (Sept. 22, 1988), 53 FR 37778 (Sept. 28, 1988) at 37786.

performance expected of the underwriter and certain other professionals. See *Conducting Due Diligence 1985* at 12. See Section III below; however, there is an expanding body of interpretive guidance and enforcement action issued by the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") that is changing the underlying basis of "due diligence" from that of establishing due diligence defenses to the affirmative undertaking of certain due diligence responsibilities (primarily related to disclosure).

The 1933 Act, and Section 11 in particular, does not apply to participants in municipal securities offerings; only the antifraud provisions of Section 17 apply. As a result, the practice of "due diligence" developed under the provisions of the statute and application in case law followed in the corporate sector is a useful guide but is based on law that does not technically apply in the municipal world. In the municipal world, the conduct of all participants is based on the antifraud provisions, which for underwriters and other broker dealers includes Section 15(c) of the 1934 Act.

The SEC's 1988 and 1989 Interpretation of Municipal Underwriter Responsibilities is based on Section 15(c)(1) and (2), the broker dealer antifraud provision, as well as 1933 Act Section 17(a) and 1934 Act Section 10(b) and Rule 10b-5, and not 1933 Act Section 11. Rather than a "due diligence" obligation under 1933 Act Section 11, the SEC points to an underwriter's obligation as a broker dealer under 1934 Act Section 15(c)(1) and (2) to have a reasonable basis for belief in the key representations of the offering document before underwriting an offering of municipal bonds. It is this formation of a reasonable basis, which changes based on the circumstances of an underwriting, that is the legal foundation for the pre offering investigation by an underwriter of municipal securities.

B. Current Guidance. The SEC's Risk Alert, *Strengthening Practices for the Underwriting of Municipal Securities* (March 19, 2012) (the "2012 Risk Alert") continues to be perhaps the SEC's most useful summary of municipal underwriter's due diligence obligation, related supervisory obligations, and key factors the SEC believes are relevant to determining the reasonableness of the underwriter's due diligence. The 2012 Risk Alert remains essential reading for underwriter's counsel in current practice.

C. What Should Conducting Due Diligence Accomplish?

1. <u>Provide the Basis for the Disclosure Document</u>. Extensive document review and interviews with personnel knowledgeable about such matters during the course of preparing the disclosure document.

(a) Frequently, the preparation of disclosure materials occurs in conjunction with the conduct of "due diligence" activities.

(b) It is important to "bring down" due diligence through continued investigation up to the respective dates of the preliminary official statement and final official statement to protect against failure to disclose late breaking news (a "bring down" conference call or some written or electronic form of verification before printing/posting is generally advisable). Ultimately, these "bring down"

matters are handled through the various closing certificates and opinion from various parties of the transaction.

(c) End Result for an Underwriter: Receipt of a 10b-5 letter (i.e., "Underwriter's Counsel" letter or opinion).

2. Review the Basis for the Tax-Exempt Status of the Bonds. Although underwriter's counsel usually assumes no responsibility for the validity or tax-exempt status of the securities in question (because those matters are the responsibility of bond counsel), underwriter's counsel generally does review the underlying support for bond counsel's opinion respecting those matters. In doing so, underwriter's counsel seeks to confirm that the bond counsel opinion:

(a) has a reasonable basis;

(b) addresses the issues necessary to be addressed in the transaction;

(c) is given by competent counsel; and

(d) is an opinion on which the underwriter may reasonably rely.

3. Address Federal and State Law Securities Questions.

(a) Federal securities registration and exemption.

(b) MSRB regulatory provisions and filings.

(c) State blue sky and legal investment laws.

4. Confirm Compliance with Existing Continuing Disclosure Obligations of the Issuer. Confirming the issuer's (or obligated party's) compliance with its continuing disclosure obligations is an essential element of due diligence, in particular in the aftermath of the SEC's MCDC initiative. In light of that initiative, underwriters and their counsel should affirmatively inquire whether the issuer participated in the MCDC program and, if so, whether the issuer entered into a cease and desist order – which, under the terms of the initiative, is required to be disclosed for the subsequent five year period.

(a) The definition of "final official statement" as set forth in Rule 15c2-12 requires that the offering document include a description of any instances in the previous five years in which the issuer or an obligated person failed to comply, in all material respects, with its continuing disclosure obligations as required under any previous continuing disclosure undertakings.

(b) A due diligence inquiry of the issuer's (and/or obligated person's) filings on the MSRB's Electronic Municipal Market Access ("EMMA") and/or a review of third-party vendor reports supports an underwriter's reasonable basis for reliance on the issuer's continuing disclosure representations in the offering document.

(c) Rule 15c2-12 requires that the underwriter determine that the issuer has agreed to provide the disclosure documents to the MSRB in an electronic format. Secondary market disclosure documents will be required to be provided to the MSRB through EMMA.

(d) In 2010, in Adopting Release No. 34-62184A, the SEC provided additional guidance regarding its interpretations under the antifraud provisions of the federal securities laws to require municipal securities underwriters to have a reasonable basis for recommending any municipal securities. The adopting release reaffirms that, to have a reasonable basis to recommend a security, a municipal underwriter must carefully evaluate the likelihood that a municipality will make the ongoing disclosure called for by the amended rule. The adopting release further states that "it is doubtful that an underwriter could form a reasonable basis for relying on the accuracy or completeness of an issuer's or obligated person's ongoing disclosure representations, if such issuer or obligated person has a history of persistent and material breaches and has not remedied such past failures by the time the offering commences… In the Commission's view, it is also doubtful that an underwriter could meet the reasonable belief standard without the underwriter affirmatively inquiring as to that filing history." Adopting Release No. 34-62184A at page 92.

(e) Effective February 27, 2019, the SEC adopted amendments to Rule 15c2-12 (see Adopting Release No. 34-83885), expanding the Rule's "listed events" to include the incurrence of a material "financial obligation" (new event 15) and any default, event of acceleration, modification of terms or other, similar events under the terms of a "financial obligation" reflecting financial difficulties (new event 16). Underwriter's counsel assisting in the performance of due diligence with respect to compliance by an issuer/obligated party with continuing disclosure undertaking(s) entered into after the above effective date should review the issuer/obligated party's financial statements for such financial obligations, and should specifically query the issuer/obligated party regarding financial obligations that may have been entered into after the period covered by the financial statements. Underwriters are also increasingly inclined to encourage issuers/obligated parties to adopt policies and/or establish procedures to identify, monitor and disclose financial obligations; and would likely insist on such policies and procedures to address prior failures and thereby help establish the underwriter's reasonable belief as discussed in subparagraph (d) immediately above.[3]

(f) In March 2020, the SEC hosted a webinar that addressed, among other things, whether and how the COVID-19 crisis affects the obligation of issuers and obligated parties to make continuing disclosure filings. In short, the SEC stated that the pandemic does not change any of the consequences of missing a filing deadline. Issuers and obligated parties that miss a filing deadline should make the

[3] See *Crafting Disclosure Policies* (NABL 2015) and *An Update: Crafting Disclosure Policies* (NABL 2021).

relevant filing(s) as promptly as possible, and for annual filings, must also file a notice of their failure on EMMA (in addition to other contractual obligations that apply under the respective disclosure undertaking). If the failure to file is material, it would also need to be disclosed in subsequent offering documents during the next five years.

In April 2020 and May 2020, the SEC released public statements regarding COVID-19 and the importance of meaningful and forward-looking disclosure:

(1) "The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19" (April 8, 2020) available at: https://www.sec.gov/news/public-statement/statement-clayton-hinman

(2) "The Importance of Disclosure for our Municipal Markets" (May 4, 2020) available at: https://www.sec.gov/news/public-statement/statement-clayton-olsen-2020-05-04

Fundamentally, issuers are not required to make a voluntary disclosure filing. The SEC could not mandate that municipal issuers make disclosure filings regarding the impact of COVID-19. However, the guidance did indicate that "in light of the potentially significant effects of COVID-19 on the finances and operations of many municipal issuers, we increase this focus and request that municipal issuers provide investors with as much information about their current financial and operating condition as is reasonably practicable."

Examples of information municipal issuers could provide include: (i) information regarding the impact of COVID-19 on operations and financial condition; (ii) information regarding sources of liquidity; (iii) information regarding availability of federal, state and local aid; and (iv) reports prepared for other governmental purposes.

While issuer's COVID-19 disclosure filings are not the responsibility of underwriter's counsel, the SEC's comments on the topic are useful tools to help guide due diligence efforts and evaluations regarding the sufficiency of the disclosure.

D. Explaining Due Diligence to Clients and Issuers/Conduit Borrowers.

1. The "Devil's Advocate" Role. It should be established at the beginning of the transaction that it is the underwriter's duty to dig into, probe and cross-check information relating to the issuer, the project and the security for the bonds. An issuer must understand that although the underwriter has been hired by the issuer to complete a successful financing, its interests are adverse to those of the issuer.

(a) It should be pointed out that disclosure documents may be prepared by the financial advisor, disclosure counsel, underwriter or its counsel, but the responsibility for material misstatements or omissions ultimately is the issuer's;

(b) Due diligence will help to identify problem areas, obstacles and "deal breakers" as soon as possible so that the underwriter can make an informed decision about continuing with the transaction;

(c) Generally, diligence will provide a complete picture of the issuer, the borrower (if applicable), the security, the underlying project, etc.; and

(d) The term "devil's advocate" as a description of due diligence originates in the 1933 Act Section 11 case *Feit v. Leaseco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y., 1971). In describing the role of the dealer-manager in an exchange offer, Judge Jack B. Weinstein wrote: "Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate."[4] The term has been used in connection with the description of corporate due diligence ever since. Use of the phrase in the municipal market should be accompanied by an understanding that Section 11 liability, under which the phrase arose, does not apply to the municipal market.

2. What are the risks of inadequate due diligence? (See Section IV below.)

E. Conducting Due Diligence. The goal is to conduct a "reasonable investigation." What is "reasonable" depends on various factors (see Sections IV and V(F) below). At the very least, there should be independent verification of (verifiable) representations of an issuer, a cross-checking of outside sources, a review of internal documents and a physical inspection when appropriate.

1. Developing a "Due Diligence" list.

(a) There is no set of official "due diligence" guidelines or lists; ask the underwriter if his/her firm has a model for the particular transaction.

(b) Prepare it with the transaction "timeline" in mind (i.e., do not wait until the last minute).

(c) After having prepared a due diligence questionnaire and a document request list or checklist, send the documents to the underwriters to afford them an opportunity to review and add questions before providing the questionnaire and request to the issuer.

(d) It is helpful (although not mandatory) to ask for written responses from the issuer in advance of any scheduled due diligence call or meeting, as advance written responses afford underwriter's counsel and the underwriters an opportunity to review for any follow-up questions/inquiries in advance of the due diligence call or meeting.

[4] *Feit v. Leaseco,* at 582.

(e) Think through which items on the due diligence list may be obtained from the issuer's website; however, in that case, underwriter's counsel should ask the issuer to confirm those items.

(f) Visit with underwriter on key issues to review on diligence call.

(g) Modern practice has evolved to regularly include internet searches, in particular with respect to news items, to identify issues which may need to be disclosed. Searches may cover the issuer (or conduit borrower) generally, as well as individual officers, large taxpayers, and the like, all depending on the circumstances. In this regard, notably, on February 7, 2020, the SEC's Office of Municipal Securities issued a Legal Bulletin entitled "*Application of Antifraud Provisions to Public Statements of Issuers and Obligated Persons of Municipal Securities in the Secondary Market*." This bulletin summarizes the SEC's past guidance regarding that the antifraud provisions apply to statements made by issuer officials reasonably expected to reach investors. Accordingly, practitioners would do well to search for and consider reported statements by such officials.

2. Prior to a site visit (if any) - Review the list with the issuer by telephone to make sure that all documents requested and key personnel will be available.

3. Visit with the Issuer (if any) - Review documents (and request that copies of certain documents be made) and discuss questions and answers with issuer.

4. Prepare summary of due diligence findings.

(a) Note that underwriters and their counsel may have different policies with respect to documenting and retaining due diligence findings. Most firms maintain detailed findings. While maintaining records is intended to demonstrate that a reasonable investigation was conducted, those records have the potential to show the opposite. *Conducting Due Diligence 1997* at 230. That said, in light of growing emphasis on conducting diligence and commensurate increased regulatory scrutiny, the modern practice is to maintain diligence materials sufficient to demonstrate the scope of the diligence investigation and to support material representations included in offering materials.

(b) "Underwriters sometimes give little thought to the kind of documentation that should be created and preserved to reflect their due diligence investigation. Some may have a packrat mentality that indiscriminately preserves every piece of paper. Others may throw out virtually everything as a matter of policy. And perhaps most commonly, what gets created and retained is a matter of chance, the habits of individual team members, or the vagaries of post-offering office moves or storage space requirements and costs."[5] In the 2012 Risk Alert, the

[5] Conducting Due Diligence 1997 at 417.

SEC staff identified some non-exclusive examples of due diligence practices, policies and procedures that evidence some due diligence and supervisory review.

(c) Be alert to attorney-client communication issues.

F. Due Diligence Checklists or Memoranda. In the 2012 Risk Alert, the SEC staff identified a variety of approaches to documenting due diligence that evidence some due diligence and supervisory review. In the 2012 Risk Alert, the SEC staff noted, however, that broker-dealers may identify and implement other practices or controls that they believe are reasonably designed to meet their obligations under the federal securities laws.

The Government Finance Officers Association ("GFOA") and the National Federation of Municipal Analysts ("NFMA")[6] have each developed voluntary disclosure guidelines for primary offerings of municipal securities. The GFOA guidelines may be accessed at http://www.gfoa.org and the NFMA guidelines at http://www.nfma.org.

G. Private Placements. Variation of Rule 506 exemption (see Section VI.B.4 below) and Rule 15c2-12(d)(1)(i).

1. In a private placement setting, due diligence is undertaken both by the seller\placement agent\underwriter and the purchaser\buyer\investor of the securities.

(a) From a seller's perspective, there are still 10b-5 concerns, as well as placement agreement liability.

(b) From a purchaser's perspective, the purchaser will want to know whether the seller will be able to satisfy any statutory or contractual liabilities that may arise.

2. Several factors are relevant to the scope of a diligence investigation in the context of a private placement. First, the diligence investigation should investigate material representations in the offering materials (e.g., the private placement memorandum or term sheet). This aspect of the investigation may be narrower than in a public offering (with a customary, fulsome official statement) to the extent that the private placement memorandum contains less information compared to an official statement. Similarly, to the extent Rule 15c2-12 does not apply, related continuing disclosure issues are typically not investigated. Beyond this, however, the customary practice is for the scope of the diligence investigation in a private placement to cover largely the same concerns as are relevant in a public offering. For example, at their client's direction, placement agent's

[6] NFMA is an organization of nearly 1,000 members, consisting mostly of research analysts who evaluate credit and other risks of municipal securities. One of NFMA's main initiatives is to promote timely and complete disclosure of the financial and operating information needed to analyze the credit quality and risk of a municipal debt issue. To that end, NFMA has published the White Paper on Swaps, a draft White Paper on Project Finance Risk Assessment and Disclosure and thirteen sector-specific "Recommended Best Practices in Disclosure" documents, all of which are available at no charge from the NFMA website (www.nfma.org).

counsel typically utilize diligence questionnaires in private placements to identify and confirm matters such as absence of material litigation, the appropriateness of current financial disclosures, and the like.

3. The SEC charged a Rhode Island issuer and a placement agent with defrauding investors in a conduit bond financing, where the borrower was a video game company, and in which the bonds were privately placed. In *SEC v. Rhode Island Commerce Corporation (f/k/a Rhode Island Economic Development Corporation), et al.* (Litigation Release No. 24428, March 20, 2019) (the "38 Studios Bond Offering"), the bonds were offered pursuant to a Private Placement Memorandum as the transaction was not subject to Rule 15c2-12. The primary basis for the SEC's charge was that the Private Placement Memorandum "failed to disclose that the project being financed by the Bonds, the development of a video game, could not be completed with the financing the Bonds would provide. The document did not disclose that even with the proceeds of the loan financed by [the bonds], [the video game company] faced a known shortfall in funding." The litigation garnered considerable press and has stimulated discussion regarding the nature and scope of disclosure required in private placements, with the important take-away that diligence remains vital in a placement.

IV. BRIEF OVERVIEW OF DUE DILIGENCE LIABILITY THEORIES

A. Reference Materials. See 2021 NABLU: The Workshop "SEC Enforcement" and Disclosure Roles of Counsel in State and Local Government Securities Offerings, 3rd Ed. (2009), Section of Urban, State and Local Government Law, American Bar Association.

B. Section 11 of the Securities Act of 1933.

1. For registered securities, Section 11 of the 1933 Act establishes the affirmative due diligence defenses available to an underwriter of securities subject to registration with the SEC ("Corporate Underwriters"). Municipal securities generally are not subject to registration and thus municipal underwriters ("Municipal Underwriters") generally are not subject to liability under Section 11, but Section 11 enforcement actions and case law are instructive.

2. Analysis of Section 11 of 1933 Act. Section 11 of the 1933 Act provides for an express, private right of action (in contrast to the remedies under SEC Rule 10b-5 that have been implied by case law) against every underwriter with respect to a security subject to registration if any part of the registration statement contains material misstatements or omissions.

(a) Even if there were a material misleading statement or omission, however, an underwriter would <u>not</u> be liable if it could sustain the burden of proof that it conducted a proper due diligence investigation.

(1) Elements of a proper due diligence investigation depend on who prepared the portion containing the misleading statement or omission.

(A) If it's an "expertised" portion (e.g., certified financial statement) or a portion "made on the authority of a public official document or statement," it is sufficient to have the negative assurance of no reasonable ground to believe and not believe that a statement is untrue; otherwise, it is necessary to have conducted a *reasonable investigation* and to have reasonable ground to believe and believe that statements are true. (emphasis added)

(B) The court in Escott v. BarChris Construction Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) found that:

> The phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere adequate reporting in the prospectus of 'data presented' to them by the company. . . . In order to make the underwriters' participation in the enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them. Escott v. BarChris Construction Corp. at 697.

(2) Note: The issuer is not entitled to a due diligence defense.

(b) Analogous standards for municipal underwriters: The SEC has stated that it is appropriate to determine "the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts." Municipal Securities Disclosure, Exchange Act Release No. 34-26100 (September 28, 1988). In the 2012 Risk Alert, the SEC staff reiterated prior guidance from the SEC identifying a non-exclusive list of six factors that it believes generally would be relevant in determining the reasonableness of an underwriter's basis for assessing truthfulness of key representations in a final official statement. These factors are: (i) the extent to which the underwriter relied on municipal officials and other persons whose duties have given them knowledge of particular facts; (ii) the role of the underwriter (e.g., manager, syndicate member, selling dealer); (iii) the type of bonds being offered (general obligation, revenue, or private activity); (iv) the past familiarity of the underwriter with the issuer; (v) the length of time until maturity of the securities; and (vi) whether the bonds are competitively bid or are distributed in a negotiated offering.[7]

[7] *See also* Exchange Act Release No. 34-62184A (May 26, 2010), 75 FR 33100 (June 10, 2010)

C. Sections 10(b) and 17 of the 1933 Act.

1. Rule 10b-5 requires proof of scienter.

(a) Rule 10b-5 of Section 10(b) of the Exchange Act makes it unlawful to "make any untrue statement or to omit to state a material fact" in connection with the offer or sale of any securities.

(1) Actions by SEC - The SEC's power to bring enforcement actions against any person involved in the sale of a securities transaction under 10b-5 is broader than in a private action. SEC need only prove three elements: (i) a material misrepresentation, (ii) made in connection with the purchase or sale of security, and (iii) scienter. SEC v. Rana Research, Inc., 8 F.3d 1358, 1364 (9th Circ. 1993)

(2) Private cause of action – A private cause of action can be based on material misrepresentation or omission, but a plaintiff in a private action has a higher burden of proof than the SEC in an enforcement action. The Supreme Court, in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. 128 S. Ct. 761, 768 (2008), held that a plaintiff in a private action must prove six elements, including reliance and causation: "(1) a material misrepresentation or omission; (2) scienter; (3) a connection between misrepresentation or omission and the purchase or sale of a security by the defendant; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."

2. Sections 17(a)(2) and 17(a)(3) - negligence is sufficient for liability, proof of scienter is not required.

(a) Section 17(a)(2) is substantially similar to Rule 10b-5, but requires that a person have obtained money or property by means of the untrue statement of material fact or omission.

(b) Negligence threshold was established by the Supreme Court in Aaron v. SEC, 446 U.S. 680, 695-97. (1980). In 2001, the Ninth Circuit Court of Appeals articulated the negligence threshold for underwriters in SEC v. Dain Rauscher, Inc. 254 F.3d 852, 856-857 (9th Circ. 2001): "Threshold is one of reasonable prudence for which the industry standard is but one factor to consider. Evidence of compliance with custom or industry practice is a relevant, but not a determinative factor, in determining whether the appropriate standard of care has been met."

(c) Most Federal circuit courts do not permit a private implied right of action under Section 17(a) because of express remedies under Sections 11 and 12 of the 1933 Act.

D. MSRB Rule G-17

1. The MSRB issued an Interpretive Notice 2012-25 Regarding the Application of MSRB Rule G-17 to Underwriters of Municipal Securities, which was effective August 2, 2012. The Notice concerns the duties of underwriters to municipal entity issuers of municipal securities (Issuers). The Notice provides for robust disclosure by an underwriter as to its role, its compensation, and actual or potential material conflicts of interest. The disclosure builds on the disclosure already required by the MSRB Rule G-23 interpretive notice approved by the Commission in May of 2011. The Notice also prohibits an underwriter from recommending that the issuer not retain a municipal advisor.

2. The required disclosures must generally be made at the time the underwriter is engaged to provide underwriting services and be made to an official of the issuer with the power to bind the issuer by contract with the underwriter. The disclosure concerning the arm's-length nature of the underwriter-issuer relationship must be made at the earliest stages of the underwriter-issuer relationship, as required by the Rule G-23 interpretive notice. In the case of disclosures triggered by recommendations as to particular financings, the disclosures must be provided in sufficient time before the execution of a contract with the underwriter to allow the official to evaluate the recommendation. The underwriter must attempt to obtain the written acknowledgement of the issuer to the required disclosures and, if the issuer will not provide such acknowledgement, to document that fact.

In practice, the underwriter provides this requisite notice and disclosure through the delivery of the G-17 letter and the incorporation of the requisite disclosures in the bond purchase agreement.

3. The Notice provides that an underwriter of a negotiated issue that recommends a complex municipal securities transaction or product (e.g., a variable rate demand obligation with a swap) to an issuer has an obligation under MSRB Rule G-17 to disclose all financial material risks (e.g., in the case of a swap, market, credit, operational, and liquidity risks) known to the underwriter and reasonably foreseeable at the time of the disclosure, financial characteristics (e.g., the material economic terms of the swap, the material terms relating to the operation of the swap, and the material rights and obligations of the parties during the term of the swap), incentives, and conflicts of interest (e.g., payments received from a swap provider) regarding the transaction or product. Underwriters are also required to inform the issuer that there may be accounting, legal, and other risks associated with a swap and that the issuer should consult with other professionals concerning such risks. Such disclosure must be sufficient to allow the issuer to assess the magnitude of its potential exposure as a result of the complex municipal securities financing. Disclosures concerning swaps are also required to be made only as to the swaps recommended by underwriters. If an issuer decides to accept the recommendation of a swap provider other than the underwriter, the underwriter has no disclosure obligation with regard to that other provider's swap.

4. The disclosures must be made in writing to an official of the issuer whom the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter (i) in sufficient time before the execution of a contract with the underwriter to

allow the official to evaluate the recommendation and (ii) in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer. If the underwriter does not reasonably believe that the official to whom the disclosures are addressed is capable of independently evaluating the disclosures, the underwriter is required to make additional efforts reasonably designed to inform the official or its employees or agent.

E. SEC Interpretative Guidance and Enforcement Actions.

The following lists helpful references for interpretative guidance and enforcement actions from the SEC.

1. SEC Rule 176, "Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act" (1981).

In determining whether or not the conduct of a person constitutes a reasonable investigation or reasonable grounds for belief meeting the standard set forth in Section 11(c), relevant circumstances include, with respect to a person other than the issuer:

(a) The type of issuer;

(b) The type of security;

(c) The type of person;

(d) The office held when the person is in office;

(e) The presence or absence of another relationship to the issuer when the person is a director or proposed director;

(f) Reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);

(g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and

(h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or the document at the time of the filing from which it was incorporated.

2. Washington Public Power Supply System Report (1988).

3. SEC Proposing Release (SEC Release No. 26100) (accompanying Rule 15c2-12) (1988).

4. SEC Adopting Release (SEC Release No. 34-26985) (accompanying Rule 15c2-12) (1989).

5. SEC Proposing Release (SEC Release No. 34-33742) (accompanying Rule 15c2-12 amendments) (1994).

6. SEC Adopting Release (SEC Release No. 34-34961 (accompanying Rule 15c2-12 amendments) (1994).

7. SEC Interpretive Release (SEC Release No. 33-7049, 34-33741 (accompanying Rule 15c2-12 amendments) (1994).

8. SEC Proposing Release (SEC Release No. 34-60332) (accompanying Rule 15c2-12 amendments) (2009).

9. SEC Adopting Release (SEC Release No. 34-62184A) (accompanying Rule 15c2-12 amendments) (2010).

10. **Underwriting**. An underwriting constitutes an implied recommendation about the underwritten securities, and such a recommendation cannot be made without an adequate basis: "In both negotiated and competitively bid municipal offerings, the Commission expects, at a minimum, that underwriters will review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions." *Disclosure Roles* at 128-9.

(a) Negotiated. In negotiated municipal offerings, where the underwriter is involved in the preparation of the official statement, the development of a reasonable basis for belief in the accuracy or completeness of the statements therein should involve an inquiry into the key representations in the official statement that is conducted in a professional manner, drawing on the underwriter's experience with the particular issuer, and other issuers, as well as its knowledge of the municipal markets. *Disclosure Roles* at 131.

(b) Competitive. In a normal competitively bid offering involving an established municipal issuer, a municipal underwriter generally would meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement when it reviewed the official statement in a professional manner, and received from the issuer a detailed and credible explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information available to the underwriter, to be inadequate. *Disclosure Roles* at 131.

11. **Case law and enforcement actions**

(a) According to *Fippinger*, the SEC has developed two independent theories as sources of the affirmative obligation to perform a due diligence investigation. In re: Richmond Corporation, 41 S.E.C. 398 (1963).

(1) "Fair dealing" theory (a standard of conduct developed within the securities industry as a matter of self-regulation). Fippinger at 7-10.

(2) "Implied representation" theory (derived from common law tort).

(b) The South Carolina National Bank v. Stone, 139 F.R.D. 335 (D.S.C. 1991): "It was the underwriter's responsibility, more so than any other party to the bond issue, to conduct 'due diligence' to investigate and disclose all material facts surrounding the issuance of the bonds. Although underwriter's counsel may have acted as the agent for [the underwriter] in connection with the due diligence investigation and preparation of the Official Statement, [the underwriter] remained the principal and cannot delegate away its responsibility under the law."

(c) Note that the SEC may take injunctive action under Section 20 of the 1933 Act for violations of the 1933 Act, and also under Section 21 of the 1934 Act for violations of MSRB Rules.

F. Disclosure Opinion.

1. National Association of Bond Lawyers, Model Letter of Underwriter's Counsel, Second Edition, 2017.

(a) Typical disclosure opinion is directed to the "client of the underwriter's counsel" (see discussion above regarding who is the client of underwriter's counsel).

(b) The Model Letter includes discussion of reliance letters to other parties, and notes that such letters should clearly identify who the underwriter's counsel's client is, to prevent the recipient from assuming an attorney-client relationship that does not exist.

2. "Negative Assurance." The disclosure opinion typically provides "negative assurance" regarding disclosures in the official statement that counsel helped to prepare (no material misstatements or omissions). Negative assurance should be based on specific investigations, and should be given only with respect to those sections of the offering documents that are within the knowledge of underwriter's counsel.

(a) Purpose of negative assurance is to help underwriters establish their due diligence defense. Consequently, negative assurance should only be provided to "underwriters or third parties that can avoid liability in securities offering by

establishing such a defense." It is not appropriate to provide this opinion to parties that do not have liability under the securities law (e.g., ultimate purchasers). *Negative Assurance in Securities Offerings* (2008 Revision) at 398.

(b) Although, commonly referred to as an "opinion", negative assurance is not a legal opinion: "Negative assurance is not a 'legal opinion.' Rather, it is a statement of belief unique to securities offerings, based principally on counsel's participation in the process of preparing and discussing the registration statement or other offering document with the various participants in the process." *Negative Assurance in Securities Offerings* (2008 Revision) at 397.

(c) For more information, see *Negative Assurance in Securities Offerings* (2008 Revision).

G. Reliance on Other Opinions. Duty of underwriter's counsel depends on the scope of the representation made as to the opinion of other counsel.

1. The Collected ABA and TriBar Opinion Reports §5.1 (ABA 2005).

(a) Satisfactory in Form and Scope? Reliance by underwriter's counsel must be "reasonable".

(b) Satisfactory in Form and Substance? Reliance must be reasonable AND underwriter's counsel must make an independent investigation of the law involved.

V. THEORIES OF DUE DILIGENCE AS A DEFENSE

A. Corporate Underwriters. For corporate underwriters, the burden is on the underwriter that it conducted a reasonable investigation or acted with reasonable care.

1. Under Section 11 of the 1933 Act, once a plaintiff has proven that a registration statement contains a material misleading statement or omission, the underwriter is liable for damages unless it can prove that (with respect to the non-expertised, non-official portion) it performed a "reasonable investigation" and had reasonable grounds to believe in the accuracy of the registration statement.

2. Under Section 12 of the 1933 Act, once a plaintiff has proven that a prospectus or oral communication contains a material misleading statement or omission, the underwriter is subject to rescission of the sale of the underwritten security unless it can prove that it did not know and in the exercise of *reasonable care* could not have known of the misleading statement or information. (Emphasis added)

B. Municipal Underwriters. For municipal underwriters, under Section 10(b) of the 1934 Act and Rule 10b-5, the plaintiff must prove not only a material misleading statement or

omission in the disclosure document, but also that the defendant acted with scienter, i.e., with recklessness or intent to deceive.

1. A thorough due diligence investigation therefore would serve to defeat a claim that the underwriter acted with scienter and also that the underwriter was negligent.

2. It would also establish a defense to a Section 17(a) action, whether under 17(a)(1)(which requires a showing of scienter) or 17(a)(2) or (3)(which do not).

3. Howard v. SEC, 376 F.3d 852, 856-857. (9th Cir. 2001): "Reliance on the advice of counsel need not be a formal defense; it simply is evidence of good faith, a relevant consideration in evaluating a defendant's scienter."

C. Two Critical Distinctions. Who bears the burden of proof, and what is the standard of liability?

1. For registered securities: Upon a showing of a material misleading statement or omission in a prospectus, the defendant underwriter must prove that it did not act in a negligent manner.

2. For municipal securities: The plaintiff must prove, among other things, that the defendant underwriter acted with scienter.

If a municipal underwriter has performed procedures which would establish a due diligence defense under Section 11 of the 1933 Act, then those procedures should be sufficient to defeat a claim that the underwriter acted with scienter. A failure to follow those procedures, however, would not result in liability under Section 10b-5 unless each of the elements of a Rule 10b-5 cause of action is proven by a plaintiff.

D. Potential Liabilities of Principals and Their Counsel. Generally, under Rule 10b-5 there is both *primary* liability and *aiding-and-abetting* liability. The difference between the two kinds of liability is important because, while the government may seek redress for both kinds of liability, private plaintiffs have claims only with respect to primary liability. There have been many cases defining and refining the respective scope of, and relationship between, primary and aiding-and-abetting liability, including recently *Lorenzo v. SEC*, 587 U.S., No. 17-1077 (U.S. Mar. 27, 2019).

1. Primary Liability: Antifraud

(a) Section 10(b) and 17(a)(1): Scienter required; reckless conduct may suffice.

(1) In SEC v. Robert Kasirer, SEC Litig. Rel. No. 19131 (N.D. Ill. 2005)(No. 04-CV-04340), the United States District Court for the Northern District of Illinois ruled that underwriter's counsel, Joel T. Boehm, violated Sections 10(b) and 17(a) of the Securities Act for issuing favorable legal opinions despite his knowledge that bond proceeds were being wrongfully diverted. The enforcement action arose out of a series of 11 healthcare

facility financings from 1996-1999. In the related complaint, the SEC alleged that the costs of each financing (including payments to the controlling party of the company developing such facilities) significantly outweighed the bond proceeds. As a result, the SEC alleged that the controlling party of the company, the underwriter, and underwriter's counsel engaged in a "Ponzi type scheme" - diverting bond proceeds from more recent financings to cover the cash shortfalls from earlier financings. In the action against Boehm, the SEC concluded that: he (1) issued favorable legal opinions despite his knowledge that funds were being wrongfully committed and diverted, (2) knowingly or with a reckless disregard for the truth took part in writing, reviewing or disseminating bond prospectuses which misled investors, and (3) personally profited from the scheme. Boehm was ordered to pay disgorgement of his fees plus prejudgment interest.

(2) In a civil action related to Jefferson County, Alabama, SEC v. Langford (N.D. Ala. April 8, 2008)(No. CV-08-B-0761-S), the District Court granted summary judgment in favor of the SEC finding that Larry Langford, the former president of the County Commission of Jefferson County, Alabama; accepted an undisclosed amount of cash and benefits from William Blount, the chairman of broker-dealer Blount Parrish & Co., Inc. In exchange for these cash payments, it is alleged that Langford selected Blount Parrish and Inc., Co. to participate in "$6.4 billion of Jefferson County bond offerings and swap agreement transactions from March 2003 to December 2004." The court permanently enjoined Langford, Blount and Blount Parrish from further violations of Section 17(a) and Sections 10(b) of the Securities Acts. Regarding materiality to investors of the alleged biased selection of underwriters, in Plaintiff's Response to Motion to Dismiss, SEC v. Langford (No. CV-08-B-0761-S (N.D. Ala. July 14, 2008), the SEC asserted that the facts related to the biased selection of underwriters are "not so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." The Court found Langford's conduct egregious and if he was given the opportunity would likely repeat the wrongs.

(3) City of San Diego, SEC. Rel. Nos. 33-8751, 35-54-475 (Nov. 14, 2006). On November 14, 2006, the SEC entered an order sanctioning the City of San Diego for committing securities fraud by failing to disclose to the investing public important information about its pension and retiree health care obligations in the sale of its municipal bonds in 2002 and 2003. In particular, the SEC found that "the City failed to disclose material information regarding substantial and growing liabilities for its pension plan and retiree health care and its ability to pay those obligations in the future in the disclosure documents for its 2002 and 2003 offerings, in its continuing disclosures filed in 2003, and in its presentation to the rating agencies." The Order required the City to cease and desist from committing violations of the antifraud provisions and to retain an independent

consultant for three years to foster compliance with its disclosure obligations under the federal securities laws. In addition, in 2008, the SEC charged five former San Diego city officials with fraud for their involvement in the transactions. The SEC alleged that the officials knew the city had been intentionally under-funding its pension obligations so that it could increase pension benefits but defer the costs. They also were aware that the City would face severe difficulty funding its future pension and retiree health care obligations unless new revenues were obtained, benefits were reduced, or City services were cut. On October 27, 2010, four former officials agreed to settle the SEC's charges without admitting or denying the allegations and consented to the entry of final judgments that permanently enjoin them from future violations of Securities Act of 1933 Section 17(a)(2). Under the settlement terms, penalties ranged from $5,000 to $25,000. This case is the first in which the SEC secured financial penalties from municipal officials in a municipal bond fraud case. Charges are still pending against the fifth official.

(4) In the matter of the State of New Jersey, Admin. Proc. File No. 3-14009 (August 18, 2010). In its first case against a state, the SEC determined that New Jersey had violated securities fraud laws for its failure to disclose to bond investors that it was underfunding the state's two largest pension plans in connection with bond issuances from 2001 to 2007. More specifically, the state did not adequately disclose that it was underfunding the pension plans, why it was doing so, or the potential effects of the underfunding. The SEC concluded that the state made material misstatements and omissions in preliminary official statements, official statements and continuing disclosures regarding the state's underfunding of its pension plans.

(b) Section 17(a)(2) or (a)(3): Negligence sufficient in SEC injunctive actions under (a)(2) or (a)(3). In Ira Weiss v. SEC, 468 F. 3d 849, the United States Court of Appeals for the District of Columbia Circuit, upheld the SEC finding that Ira Weiss, bond counsel, violated Sections 17(a)(2) and 17(a)(3) of the Securities Act for failing to fully inform investors of the substantial risk that interest on general obligation notes issued by a local school district would be deemed taxable. In this case, the local school board issued bonds to finance certain potential school construction projects that never occurred. According to the SEC, "Weiss's failure to look for even minimal objective indicia of the School District's reasonable expectations to spend Note proceeds on projects was *at least negligent.*" (emphasis added)(for further information and details about the Weiss case, refer to BAW 2008 *"Municipal Securities Law 101").*

2. Secondary Liability: Aiding and Abetting.

(a) "Although the focus of the law of disclosure is on the principals involved in a securities law offering, liability under antifraud provisions also exist for (1) secondary actors who commit primary violations (See Section 4.C.1 above),

and (2) <u>in an SEC enforcement action, but not in a private action</u>, secondary actors as aiders and abettors, under the Private Securities Litigation Reform Act." *Disclosure Roles* at 86-87. Section 104 of the Private Securities Litigation Reform Act, among other things, amended Section 20 of the 1934 Act, and provides that "for purposes of any action brought by the Commission under paragraph (1) or (3) of Section 21(d), any person that knowingly provides substantial assistance to another person in violation of a provision of the [1934 Act], or any rule or regulation issued under [the 1934 Act], shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."

(b) In *Lorenzo v. SEC*, 587 U.S., No. 17-1077 (U.S. Mar. 27, 2019), that a person who did not "make" a false statement under Rule 10b-5(b) may nonetheless be liable under Rule 10b-5(a) or (c) if he or she disseminates a false statement with intent to defraud. Prior to the *Lorenzo* decision, several circuit courts held that only "makers" of a false statement were liable under Rule 10b-5, because subsection (b) of that Rule specifically addresses "untrue statement[s]." In *Lorenzo*, an investment banker sent an email to investors authored and directed by his boss that that the banker knew to be false. The Supreme Court ruled that dissemination of someone else's false statement falls within subsections (a) and (c) of Rule 10b-5, which prohibit "devices," "schemes," and "artifices to defraud," as well "act[s], practice[s], or course[s] of business" that "operate . . . as a fraud or deceit." Accordingly, although the Court reaffirmed that only "makers" of a false statement can be primarily liable under Rule 10b-5(b), the Court held that one who with scienter disseminates a false statement that is "made" by another can be *primarily* liable under Rule 10b-5(a) and (c) and may <u>also</u> be secondarily liable as an aider and abettor of the "maker's" primary violation of Rule 10b-5(b).

E. What Should an Underwriter and Their Counsel Do?

1. Recognize that each issue (and thus the methods of verification) in a disclosure document will come under scrutiny.

2. Due diligence is evaluated at the time of the investigation, not with the benefit of hindsight.

3. Independent verification of issuer representations.

(a) Note: It is not unreasonable to rely on management representations re: information that is solely in possession of the issuer and cannot be reasonably verified by third parties.

(b) Should reference outside information sources.

(c) Representations and warranties of issuer (in bond purchase agreement).

4. Follow up on information that doesn't make sense (red flags).

5. "Bring-Down" Due Diligence

6. Delegate to Outside Professional (e.g., "Agreed-Upon Procedures" letter for interim financial statements prepared by internal finance officers). *Conducting Due Diligence 1997* at 399.

(a) Cold comfort letters from independent auditors are intended to demonstrate the reasonableness of the investigation of the requesting party.

(1) When used in conjunction with unaudited financial data, it is expected that they enhance the reliability of the information, but they are not reports by auditors on the unaudited financial statements, but merely confirmations of certain findings resulting from limited investigatory steps taken subsequent to the period covered by the most recent audited statements.

(b) Problem: Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties (1993) requires that accountants receive a written representation from a requesting broker-dealer in an exempt securities offering that the broker-dealer:

> [W]ill be reviewing certain information relating to [issuer] that will be included...in the document...which may be delivered to investors...This review process applied to the information relating to the issuer, is...substantially consistent with the due diligence review process that we would perform if this placement of securities were being registered pursuant to the 1933 Act. We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act.

(c) Compromise: An "agreed-upon procedures" letter, which provides a more limited review.

(d) Consent of auditors to the inclusion of audited financial statements in Official Statements. Because consents of experts and counsel are required to be filed in connection with registered offerings (*see* 1933 Act Rule 436), underwriters are often more comfortable obtaining such consents for inclusion in the municipal bond transcript. These consents are not, however, specifically required in connection with offerings that are exempt from 1933 Act registration.

7. Documentation. Underwriters need to establish through written documentation that they performed an adequate due diligence investigation.

F. Systemic Procedures to Prevent and Detect Securities Law Violations.[8]

1. "Section 15(b) of the 1934 Act authorizes the Commission to impose sanctions on a firm or any person that fails to reasonably supervise a person subject to their supervision that violates the federal securities laws. Section 15(b)(4)(E) provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented with reason to believe that such procedures are not being complied with."[9]

2. A claim that due diligence activities are not "industry practice" or that an underwriter is following advice from counsel are not likely to be sufficient to support a defense.[10]

3. The Commission has provided a non-exclusive list of six factors that would be relevant in determining the reasonableness of an underwriter's basis for assessing truthfulness of key representations in a final official statement:

(a) Extent to which the underwriter relied on municipal officials and other persons whose duties have given them knowledge of particular facts;

(b) The role of the underwriter (i.e. manager, syndicate member, selling dealer);

(c) The type of bonds being offered (general obligation, revenue or private activity);

(d) The past familiarity of the underwriter with the issuer;

(e) The length of time until maturity of the securities; and

(f) Whether the bonds are competitively bid or are distributed in a negotiated offering.[11]

4. To demonstrate compliance, underwriters should have adequate policies and procedures in place to ensure that due diligence is adequately completed and documented and that there is adequate follow-up if issues are detected.

5. Examples of Due Diligence Practices, Policies and Procedures

[8] *See* Securities and Exchange Commission National Examination Risk Alert, Volume II, Issue 3, March 19, 2012.

[9] Id at page 3.

[10] *See* id, footnote 13.

[11] Exchange Act Release No. 34-62184A (May 26, 2010), 75 FR 33100 (June 10, 2010) at 91-92.

(a) Clear Explanation of Regulatory Requirements and Firms' Expectations

(1) Detailed written policies and procedures.

(b) Commitment Committees

(1) Firm-wide, senior-level commitment committees that review and approve underwritings.

(2) Submissions to the committee may include a due diligence memorandum describing the diligence that was done, diligence calls that were completed and certain portions of the official statement.

(c) Diligence Checklists

(1) May require substantial narrative describing due diligence steps or past familiarity with the issuer.

(d) Due Diligence Memoranda

(1) Describing diligence calls, issues noted and how they were resolved.

(2) Include review of final or deemed final official statement.

(3) May be used in conjunction with checklists described above.

(e) Outlines for Diligence Calls

(f) On-Site Examination Activities

(1) Meetings with municipal officials, visits to facilities and examination of issuer's records.

(g) Recordkeeping Checklists

(1) To assist personnel in maintaining records that evidence due diligence was performed.

VI. PREPARATION OF OTHER DOCUMENTS

A. Bond Purchase/Private Placement Contract. Traditionally, the primary responsibility of underwriter's counsel or placement agent's counsel; specifies the various conditions that must exist before the underwriter will accept and pay for the securities; represents the allocation of risks and responsibilities in the transaction and serves to facilitate the

underwriter's allocation of responsibilities in the transaction and the identification of legal issues that may be present in the offering.

1. Representations and warranties contained in the Bond Purchase Contract can help define the scope of due diligence responsibilities.

2. Forms of opinions contained as exhibits to the Bond Purchase Contract should carefully delineate the areas of responsibility for disclosure.

3. Underwriter "out" clauses in the Bond Purchase Contract should be designed to relieve the underwriter of its obligations upon the occurrence of events beyond the underwriter's control, including outbreaks or escalations of hostilities, banking moratoriums and suspensions of trading.

4. Specifies "firm underwriting" or "best efforts" undertaking by Underwriter.

5. In September, 2008, the Securities Industry and Financial Markets Association ("SIFMA") published a Model Bond Purchase Agreement. The SIFMA Model Bond Purchase Agreement is comprised of three parts: (i) terms and acceptance, (ii) general provisions and conditions and (iii) instruction and commentary.

A unique component of the terms and acceptance in the Model Bond Purchase Agreement is the emphasis on the separate roles of underwriters and municipal issuers. In particular, the Model BPA provides for a paragraph "intended to specifically clarify the nature of the relationship between the Underwriters and the Issuer – that the Underwriters and the Issuer are acting on an arm's-length, commercial basis and that no Underwriter is acting as a fiduciary or agent of the Issuer." The SIFMA Model Agreement can be located on the SIFMA website at http://www.sifma.org.

B. Agreement Among Underwriters/Selling Group Agreement. The Agreement Among Underwriters is an agreement setting forth the legal relationships between syndicate members that allows execution of one standardized agreement rather than the execution of separately negotiated legal contracts each time a firm joins a syndicate.

On July 16, 2018, SIFMA's Municipal Securities Division announced implementation of a new structure for its Master Agreement Among Underwriters ("MAAU"). Per SIFMA's website, participating firms sign an acceptance letter to sign on to the MAAU, and SIFMA publishes a list of firms that have accepted the terms of the MAAU. SIFMA has also fully revised the MAAU for the first time in 16 years and released the new version in conjunction with the offering of this new structure.

A selling group agreement is used to form one or more selling groups in connection with the negotiated purchase and public offering of securities. SIFMA similarly maintains a form of master selling group agreement.

VII. OTHER TOPICS

A. Federal Registration and Exemptions. The 1933 Act (codified at 15 U.S.C. § 77a *et seq.*) generally requires that securities must be registered with the SEC before they are offered to investors.

1. The term "security" includes, bonds, notes, certificates of participation, other evidences of indebtedness and investment contracts, together with guarantees of the foregoing. 1933 Act, § 2(a)(1). This definition encompasses not only the primary instruments in most municipal financings—*i.e.* bonds, notes and COPs—but also such collateral documents as guaranteed investment contracts (GICs), letters of credit, bond insurance policies and debt service reserve surety bonds.

2. Section 5 of the 1933 Act is the primary enforcement tool: It generally prohibits any person to use the mail or other forms of interstate commerce to offer to sell, offer to buy, sell, buy or deliver any security unless a proper "registration statement" has been filed with the SEC and is in effect.

3. Most municipal securities are <u>not</u> registered because Section 3(a) of the 1933 Act provides that, for most purposes, certain enumerated classes of securities are not subject to the 1933 Act. These include:

(a) Any security issued or guaranteed by the United States or any Territory thereof. 1933 Act, §3(a)(2).

(b) Any security issued or guaranteed by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories. 1933 Act, §3(a)(2).

(1) Includes most municipal securities, but does not include securities issued by Indian tribes or 63-20 corporations.

(c) Any security issued or guaranteed by a national bank or a banking institution organized under the laws of any State, Territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the state or territorial banking commission or similar official. 1933 Act, §3(a)(2).

(1) Includes most, *but not all*, letter of credit banks; may cover COPs issued by banks.

(2) Letters of credit issued by domestic branches of foreign banks may qualify for a Section 3(a)(2) exemption on the basis of Interpretive Release No. 33-6661.

(d) Any security which is an "industrial development bond" (within the meaning of Section 103(c)(2) of the 1954 Tax Code, *as in effect in 1970*) the interest on which is excludable from gross income under Section 103(a)(1) of the 1954 Tax

Code (other than multi-family housing bonds and bonds issued to finance industrial parks). Watch for taxable IDBs, which aren't covered by this exemption.

(1) Includes most "exempt facility bonds" issued under Section 142 of the 1986 Tax Code and "qualified small issue bonds" issued under Section 144(a) of the 1986 Tax Code. This exemption was added in 1970 to mitigate the impact of SEC Rule 131, which generally provides that the obligations of the ultimate obligor in a conduit bond issue, if an "industrial or commercial enterprise," are deemed to be separate securities (and thus would be subject to the 1933 Act registration requirements).

(2) Multi-family housing bonds were specifically excluded from this exemption. While the bonds themselves will usually qualify under the Section 3(a)(2) exemption, the underlying conduit loan and related guarantees must be analyzed as potential separate securities.

(A) Under Rule 131(b), the obligation(s) underlying bonds, including multi-family housing revenue bonds will not be deemed to be a separate security if: (i) the obligation is payable from the general revenues of a governmental unit specified in Section 3(a)(2) of the 1933 Act; or (ii) the obligation relates to a public project owned and operated by or on behalf of and under the control of a governmental unit; or (iii) the obligation relates to a facility that is leased to and under the control of an industrial or commercial enterprise but is part of a public project that is owned by a governmental unit.

(B) SEC no action letters indicate that housing projects owned and operated by private developers may satisfy the Rule 131(b) requirements set forth in Section VI.B.3.d.(2)(a) above if adequate governmental "control" is demonstrated. Factors showing governmental control include: (i) the right to access to the project; (ii) the right to inspect books and records; (iii) the right to receive periodic reports relating to project operations; (iv) the right to obtain possession of the project in the event of a material default under the mortgage; (v) approval of the timing of construction; and (vi) approval of plans and specifications.

(e) Any security issued by an entity organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder or individual (which should include most 501(c)(3) corporations and 63-20 corporations).

(f) Any insurance policy issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner or other similar officer of a State or Territory or the District of Columbia.

(1) Covers bond insurance policies of major bond insurers.

(g) Securities offered and sold only to persons resident within a single State or Territory by an issuer that is resident of (or incorporated by) and doing business with such State or Territory.

4. Section 4 "Transactional" Exemptions. If the securities being issued do not qualify as exempt securities under Section 3(a) of the 1933 Act (*e.g.* Indian bonds), the issuer must register the securities or qualify the offering and sale of the securities as an exempt transaction under Section 4 of the 1933 Act. Note that separate exemptions under Section 4 are required for each transaction, unlike the "securities" exemptions provided by Section 3.

(a) Section 4(6) exemption: Transactions involving offers or sales by an issuer solely to "accredited investors" if (i) the aggregate offering price is $5 million or less, (ii) there is no advertising or public solicitation in connection with the transaction, and (iii) the issuer files a Form D with the SEC.

(b) Section 4(2) exemption: "transactions by an issuer not involving any public offering." The issuer may either do a "statutory" private placement by utilizing Section 4(2) as interpreted by SEC staff no-action letters or utilize the safe harbor provided by SEC Rules 501 through 508 ("Regulation D").

(1) Exemption for offerings of $1 million or less (a "Rule 504 offering").

(2) Exemption for offerings of $5 million or less sold to not more than 35 purchasers (a "Rule 505 offering").

(3) Exemption for offerings sold to not more than 35 purchasers, regardless of dollar amount (a "Rule 506 offering"). Among the requirements for meeting this exemption is that each purchaser (other than accredited investors) must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." Such securities may be sold to an unlimited number of accredited investors.

5. Section 4 "Purchaser" Exemptions. If the securities being issued do not qualify as exempt securities under Section 3(a) of the 1933 Act (*e.g.* Indian bonds) and have not been registered, the purchaser can qualify subsequent resale of the securities as exempt transactions under Section 4 of the 1933 Act. The exemption afforded by Section 4(2) and the related safe harbor of Regulation D is only available to the "issuer" by the terms of Section 4(2), and therefore each subsequent resale must find its own transactional exemption.

(a) Section 4(1) exemption: "transactions by any person other than an issuer, underwriter, or dealer."

(1) The term, “underwriter” is broadly defined to include any person who (i) has purchased securities from an issuer with a view to distribute such securities, or (ii) offers and sells securities for an issuer in connection with the distribution thereof.

(2) “Dealer” means a person who works as an agent, broker or principal in the business of offering, buying, selling or otherwise dealing and trading in securities issued by another person.

(b) Section 4(3) exemption: Transactions by a dealer (but not in the capacity of an underwriter), so long as the transactions (i) do not take place within 40 days after the initial public offering of the security by the issuer or an underwriter, or (ii) do not take place within 40 days after the effective date of a registration statement, or (iii) do not involve an unsold subscription or allotment to such dealer in connection with the distribution of the securities by the issuer or an underwriter. To qualify for this exemption, investment bankers must avoid activities that will cause them to be “underwriters” within the meaning of Section 2(a)(11) of the 1933 Act. SEC Rules 144 and 144A provide safe harbors in this regard.

(1) If the requirements of Rule 144 are satisfied, the seller of the securities (not including the issuer) will not be deemed to be engaged in the “distribution” of the securities, and thus not an “underwriter.” Rule 144 imposes a one-year holding period on the securities. Once held for that period, a seller is no longer considered an “underwriter”.

(2) The result is the same under Rule 144A—*i.e.* the resale of securities by an investment banker (or other person) will not cause the investment banker to be an “underwriter.”

(A) Rule 144A involves the sale of securities *only* to if a qualified institutional buyers by persons other than the issuer. Rule 144A(d)(1). Rule 144A provides that even if securities are purchased with an intent to resell, such seller will not be deemed an underwriter if sales are limited to QIBs.

(B) The term “qualified institutional buyer” is defined in Rule 144A(a)(1). Most QIBs will qualify as “accredited investors” under Section 2(a)(15) of the 1933 Act and Rule 215, but not all accredited investors will qualify as QIBs.

(C) The seller of the securities is allowed to rely on a certificate from the purchaser, among other things, to determine whether the purchaser is a QIB, and must notify the purchaser that the seller is relying on Rule 144A for an exemption from Section 5 of the 1933 Act. Rule 144A(d)(2).

B. Trust Indenture Act of 1939. Many "supplemental" legal opinions by bond counsel, and most underwriter's counsel letters, include an opinion that the indenture, bond ordinance or bond resolution need not be qualified pursuant to the Trust Indenture Act of 1939 (15 U.S.C. § 77aaa *et seq.*; also known as the "Trust Indenture Act").

1. The Trust Indenture Act applies specifically to notes, bonds, other evidences of indebtedness, certificates of participation in such instruments, and guarantees of debt instruments (Trust Indenture Act, §304(a)(1)), and generally requires that any "indenture" under which securities are issued be qualified by the SEC. Trust Indenture Act, §§305 & 306.

(a) The term "indenture" is broadly defined to include indentures, mortgages, deeds of trust and similar instruments under which debt instruments are issued. Accordingly, bond ordinances and bond resolutions are potentially subject to the indenture qualification requirements.

2. As is the case with the registration requirements of the 1933 Act, certain securities and transactions are exempt from the indenture qualification requirements of the Trust Indenture Act. These include:

(a) Any security exempted from the provisions of the 1933 Act by means of Sections 3(a)(2) through (8), 3(a)(11) or 3(a)(13) of the 1933 Act. These securities are exempted from the Trust Indenture Act in its entirety.

(1) Includes most municipal securities, but does not include securities issued by Indian tribes.

(b) Securities issued under an indenture that limits the aggregate principal amount of such securities to $10 million. These securities are exempted from the Trust Indenture Act in its entirety.

(c) Securities issued in a transaction that is exempted from the requirements of Section 5 of the 1933 Act or by Section 4 of the 1933 Act. These securities are exempted only from the indenture qualification requirements of the Trust Indenture Act.

C. State Blue Sky Laws

1. <u>Introduction</u>

Municipal bonds are subject to regulation by state securities or "blue sky" laws. All 50 states, the District of Columbia, the Commonwealth of Puerto Rico, Guam and the U.S. Virgin Islands have enacted blue sky laws. Among other things, blue sky laws require (a) the registration of broker-dealers who sell municipal bonds and (b) registrations of or notice filings for municipal bonds before they may be offered and sold to the public, unless exemptions from one or more of these requirements are available.

Failure to comply with state blue sky law broker-dealer registration and municipal bond registration and notice filing requirements (collectively, the "Blue Sky Requirements") before offering municipal bonds for sale to the public exposes an underwriter to risks of (a) enforcement actions by state securities commissions, including cease and desist orders and law suits for injunctive relief, and (b) in most jurisdictions, bondholder suits for refunds for the purchase price. Subsequent compliance with Blue Sky Requirements does not cure an offer made prior to satisfying Blue Sky Requirements.

Law firms that represent underwriters provide blue sky memoranda to underwriter clients as part of the their professional services. A blue sky memorandum lists (a) in the "exempt securities" section, those jurisdictions in which action (i.e., registrations and notice filings) must be completed before the bonds may be offered to the public by registered broker-dealers and (b) in the "exempt transactions" section, those types of institutional investors to whom offers may be made by unregistered sellers without the need for registrations and notice filings.

Thus, the blue sky memorandum is a road map of where action needs to be taken before offers are made, so that the underwriter can avoid needless state securities enforcement actions and bondholder suits for refunds.

2. Common Misconceptions

(a) *Misconception #1*. Compliance with state blue sky laws is no longer necessary because the National Securities Markets Improvement Act of 1996 ("NSMIA") completely pre-empted state blue sky laws. *Reality:* NSMIA's pre-emption was only partial, as evidenced by states' continuing ability to impose registration on issuers located within their boundaries, the imposition by various states of notice filing requirements on bonds issued by out-of-state issuers, states' continuing ability to bring enforcement actions to enforce the Blue Sky Requirements and bondholders' continuing ability to sue for a refund when Blue Sky Requirements have not been satisfied.

(b) *Misconception #2.* Variable rate demand bonds that are exempt from the continuing disclosure requirements under SEC Rule 15c2-12 are, by definition, also exempt from state blue sky laws. *Reality:* SEC Rule 15c2-12 and state blue sky laws are grounded in different bodies of law (federal v. state) and no state blue sky law provides an exemption from registration for bonds that are exempt under Rule 15c2-12.

(c) *Misconception #3.* Last year's blue sky memorandum will do just fine for this year's reoffering and conversion of last year's bonds. *Reality:* Blue sky laws – just like other laws – are amended, repealed and revised from time to time, so last year's advice may no longer be accurate. In addition, conversions often result in changes in security (letter of credit v. bond insurance v. no credit

enhancement) and ratings for the bonds, either of which can eliminate previously available exemptions from registration and notice filings.

3. Statutory Framework for Blue Sky Laws

The first blue sky law was enacted in Kansas in 1911, ostensibly to protect investors from unscrupulous promoters who, left to their own devices, "would sell building lots in the blue sky in fee simple." Subsequent to 1911, several states followed Kansas in enacting blue sky laws. In 1956, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") promulgated the Uniform Securities Act of 1956 (the "1956 Act"), which provided an across-the-board exemption from registration for all types of municipal bonds. The 1956 Act was ultimately enacted in 37 jurisdictions.

In response to the increasing issuance of conduit bonds in the 1980s to finance manufacturing plants, health care facilities, etc., in 1985 NCCUSL promulgated amendments to the 1956 Act which provided an exception to the municipal bond exemption from registration for bonds payable from payments to be made by a "nongovernmental industrial or commercial enterprise" (the "1985 Amendment"). The 1985 Amendment exception to the municipal bond exemption, together with comparable exceptions for "industrial bonds" and "industrial development bonds," was ultimately enacted in Arizona, Maine, Minnesota, Montana, New Hampshire, New Mexico, North Dakota, Rhode Island, South Dakota, South Carolina, Texas, Vermont, Washington and Wisconsin.

NSMIA re-wrote Section 18 of the Securities Act of 1933 (the "Securities Act"), and provided a partial, but not complete, pre-emption of state blue sky laws. NSMIA provides that no state may: (a) require registration for, (b) impose conditions on the use of an offering document (for example, official statements) for, or (c) impose merit conditions on the offering or sale of a "covered security."

NSMIA provides for several categories of covered securities. Municipal bonds that constitute covered securities are: (a) municipal bonds which are exempt from registration under Section 3(a)(2) of the Securities Act of 1933 (except that a municipal bond is not a covered security in the state in which the issuer is located), and (b) municipal bonds that are exempt from registration under SEC rules promulgated pursuant to Section 4(2) of the Securities Act, i.e., Rule 506 of SEC Regulation D. The Rule 506 exemption is rarely used for municipal bonds.

Notwithstanding NSMIA's prohibition of states imposing registration, offering document and merit condition requirements on covered securities, NSMIA permits states to impose notice filing requirements on covered securities.

In response to NSMIA, NCCUSL promulgated amendments to state blue sky laws which, among other things, defined the term covered security and authorized state securities commissions to impose notice filing requirements on covered securities (the "1997 Amendments"). Most of the states that enacted the

1956 Act and/or the 1985 Amendments enacted the 1997 Amendments. As of July 1, 2011, NSMIA-inspired notice filing requirements were in effect in Arizona, Maryland, Montana, Nevada, New Hampshire, New York, North Dakota, Ohio and Washington for various types of municipal bonds that derive their covered security status from Section 3(a)(2) of the Securities Act and are issued by out-of-state issuers, unless the bonds are otherwise exempt from the state's registration, offering document and merit condition requirements.

In 2002, NCCUSL promulgated the Uniform Securities Act of 2002 (the "2002 Act"), which reinstated the 1956 Act's across-the-board exemption from registration for municipal bonds and also exempted municipal bonds from NSMIA-inspired notice filings. As of July 1, 2011, the 2002 Act, with occasional local variations, was in effect in Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, the U.S. Virgin Islands, Vermont and Wisconsin. Notice filings for bonds issued by out-of-state issuers are no longer required in those states which had originally imposed notice filings pursuant to NSMIA and subsequently enacted the 2002 Act (for example, Minnesota).

In varying degrees, Illinois, Maryland, Montana, Pennsylvania, Tennessee, Texas and Washington apply the "separate security" analysis, i.e., even though the bonds in question are exempt from the state's registration, offering document and merit condition requirements, some other security that is part of the bond issue must be evaluated to determine if it is exempt from such requirements. The need for separate security analysis typically arises when credit enhancement (for example, a letter of credit or a bond insurance policy) provides security for the payment of the bonds. In many cases, the separate security qualifies for its own exemption from state blue sky law registration, offering document and merit condition requirements or qualifies as a covered security under NSMIA. When the separate security is not a municipal security, covered security status applies in all jurisdictions (i.e., NSMIA's exclusion from covered security status for municipal securities issued by issuers located within the boundaries of the jurisdiction in question does not apply). However, a separate security that is also a covered security may be subject to a NSMIA-inspired notice filing requirement if the separate security does not qualify for its own exemption from state blue sky law registration, offering document and merit condition requirements.

4. Effect of NSMIA on State Blue Sky Laws

State blue sky laws provide (either explicitly or because of federal pre-emption) that it is illegal to sell securities in the state in question unless the security either: (a) is registered, (b) qualifies for a state blue sky law exemption from registration, or (c) constitutes a covered security, for which the applicable notice filing, if any, has been completed.

Because of the enactment of NSMIA, there are now two non-registration routes to blue sky compliance, i.e., (a) qualifying for a state blue sky law exemption

from registration, without taking NSMIA into account, and (b) determining whether the bonds in question enjoy covered security status and, if so, whether they are subject to a notice filing requirement.

Because municipal bonds that derive their federal exemption from registration under Section 3(a)(2) of the Securities Act are not covered securities in the state in which the issuer is located, states may still impose registration, offering document and merit condition requirements on bonds issued by issuers located within their boundaries, i.e., the NSMIA route to compliance is not available to in-state issuers. Florida, New Hampshire, Pennsylvania, West Virginia and Wisconsin have imposed registration, offering document and/or merit condition requirements on various types of bonds issued by in-state issuers.

D. Swaps and VRDOs. Disclosure content varies not only with respect to the type of issuer, but also with respect to the type of security (*e.g.,* fixed vs. variable rate, long-term vs. short-term) and any associated swaps or other derivatives and/or credit enhancements.

1. Some guidance for swap disclosure is provided in the White Paper on Disclosure for Swap Transactions published in February 2004 (the "White Paper on Swaps") by the NFMA. The White Paper on Swaps offers specific guidance with regard to such areas as the issuer's risk management, the issuer's debt profile, swaps summaries and disclosure of economic terms, authorization and ISDA Events of Default and Early Termination Events. Other considerations include the impact of FASB 133 or GASB Technical Bulletin 2003-1, as applicable.

2. Level of issuer-specific disclosure required when a bond issue is credit-enhanced.

(a) The SEC has indicated that the borrower's disclosure in issues that are credit enhanced should be essentially the same as in non-credit enhanced issues. Interpretive Release No. 34-26985 (June 28, 1989).

(b) In the case of credit-enhanced tender option bonds, some practitioners believe and the market accepts that the creditworthiness relevant to investors in these credit enhanced bond issues is that of the credit enhancer and not that of the borrower.

3. Transparency of Municipal Auction Rate Securities and Variable Rate Demand Obligations. Since 2008, the MSRB has issued a series of notices, including MSRB Notice 2008-46 to MSRB Notice 2010-06 (March 10,2010), which has resulted in the creation of the Short-term Obligation Rate Transparency ("SHORT") System Facility, to collect and disseminate information about variable rate securities. Information generally is required to be reported to the SHORT system by no later than 6:30 p.m. Eastern time on the day that an ARS auction or VRDO interest rate reset occurs and all collected information is made available to market participants for free in real-time on EMMA.

E. Disclosure of Conflicts of Interest. The Commission has indicated that investors must be informed of actual and potential conflicts of interest among participants in a bond offering, including among the underwriters, financial advisors, consultants and lawyers. Despite any legal or factual analysis counsel must analyze whether information regarding actual or potential conflicts would be material to investors (as distinguished from taxpayers). "The critical disclosure question is simple to state but not simple to answer: might a reasonable investor believe that the relationship would call into question the objectivity, independence, or competence of the services being provided by a professional in a way adverse to bondholders? When in doubt, disclose." See *Pope* at 46.

1. Distinction of Roles. Pursuant to MSRB Notice 2011-29 (May 31, 2011), the MSRB revised MSRB Rule G-23 to prohibit a broker, dealer, or municipal securities dealer that serves as financial advisor to an issuer for a particular issue from switching roles and underwriting the same issue.

2. Issuer Designation of Underwriter's Counsel. SIFMA has issued a best practices paper recommending that underwriters disclose in an official statement when issuers designate firms to serve as underwriter's counsel. Issuers have a legitimate but limited role in the selection of underwriter's counsel, ensuring that underwriter's counsel is competent, has no conflicts of interest and that the costs are reasonable, but any undue influence can call into question the independence of the underwriter's counsel, creating risk to the issuer and the underwriter because of increased potential of inadequate disclosure.[12]

F. Disclosure of Financial Obligations; Voluntary Disclosure. As discussed above, effective February 27, 2019, the SEC adopted amendments to Rule 15c2-12, expanding the Rule's "listed events" to include the incurrence of a material "financial obligation" (new event 15) and any default, event of acceleration, modification of terms or other, similar events under the terms of a "financial obligation" reflecting financial difficulties (new event 16). Pursuant to the related Adopting Release (No. 34-83885), event notices relating to the incurrence of a material financial obligation "generally should include a description of the material terms of the financial obligation . . . . 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 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." See *Adopting Release* at 33-34.

2. The above-described new listed events apply in the context of continuing disclosure undertakings entered into on or after February 27, 2019. Issuers and obligated parties subject only to continuing disclosure undertakings entered into before that date have been encouraged to voluntarily post information about bank loan financings to EMMA.

[12] *See* SIFMA Best Practice Recommendation on Disclosures Regarding Choice of Underwriters' Counsel in Municipal Securities Transactions (March 2013).

See, e.g., MSRB Notice 2012-18, *Notice Concerning Voluntary Disclosure of Bank Loans to EMMA*.

G. Municipal Advisors as "Placement Agents. "1. On October 2, 2019, the SEC issued a proposed exemptive order that would grant exemptive relief pursuant to Section 15 the Exchange Act to permit a registered Municipal Advisor, acting on behalf of a municipal issuer client, to solicit specified institutional investors (such as commercial banks) in connection with the direct placement of municipal securities without registering as a broker-dealer when certain conditions are met. The proposed order addresses a controversial area of the existing Municipal Advisor regulation. The SEC issued its proposal in response to letters seeking this exemption from both the National Association of Municipal Advisors and PFM**,** a large independent Municipal Advisor firm. Responses were submitted by representatives of the broker-dealer community as well as Securities and Financial Markets Association (SIFMA) and Bond Dealers of America ("BDA"), who have also stated their intention to lobby against implementation of the order. This subject matter should be monitored for continued developments. See 2021 NABLU: The Workshop " Role of the Municipal Advisor."

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