

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION



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CALIFORNIA DEBT ISSUANCE PRIMER

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CALIFORNIA DEBT ISSUANCE PRIMER

ACKNOWLEDGEMENTS

The *California Debt Issuance Primer (Primer)* was originally published in 1988, and was updated in 1990 and 1998. The 1998 edition of the *Primer*, authored by Orrick, Herrington & Sutcliffe LLP, was a major revision, consisting of a reorganization of the sections and the addition of several new chapters.

This document represents a comprehensive review and revision the 1998 version. It includes legislative, legal and tax regulation updates. Changes to the debt issuance landscape including new types of variable rate and synthetic structures that have evolved over the past ten years were also added. In addition, an extensive review of the prior version was performed and updated/corrected to reflect the current environment.

CDIAC staff and the CDIAC Debt Technical Advisory Committee were responsible for the revisions to the *Primer*. CDIAC would like to thank its Debt Technical Advisory Committee for their efforts in this project.

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Kristin Szakaly-Moore and Douglas Skarr of the Commission’s staff served as project coordinators. They contributed editorial and content components to the document as well as participating in the overall management of the project. Douglas Skarr also authored the accompanying *California Debt Issuance Primer Handbook*.

Printed copies of the *Primer* may be obtained from CDIAC by calling (916) 653-3269. There is a charge of \$25 to cover the costs of printing and mailing. In the future, CDIAC intends to periodically update portions of the *Primer* as dictated by changes in law or other events (although CDIAC cannot assure that such updates will always be made). The *Primer* is also available on free of charge on CDIAC’s website, www.treasurer.ca.gov/cdiac. Electronic updates of the *Primer* will be posted to the website and may be downloaded as replacement pages for those affected sections.

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PREFACE

Public agency officials and staff are faced with decisions on a daily basis regarding how to pay for needed capital improvements, facilities, and equipment. In addition, cash flow and working capital borrowings may need to be considered by certain public agencies. Private and nonprofit entities also face decisions about whether or not to avail themselves of opportunities to use public financing to acquire, construct, and renovate facilities for their purposes. The *California Debt Issuance Primer (Primer)* is intended to provide information concerning public debt financing options to public agency officials and potential private and nonprofit borrowers charged with shaping these crucial financial decisions.

OVERVIEW OF THE CALIFORNIA DEBT ISSUANCE PRIMER

The decision to use public debt financing rather than available cash (so-called pay-as-you-go financing) or, in the case of private and nonprofit borrowers, private financing, is a threshold issue that the *Primer* does not address. However, if public debt financing is the preferred option, the *Primer* will provide the reader with a comprehensive overview of the debt financing alternatives available to California public agencies, and through them, to eligible private and nonprofit borrowers. The *Primer* discusses the principal participants in a debt financing, identifies the steps involved in completing a financing, and describes all the major types of debt instruments. In addition, the *Primer* summarizes major state constitutional provisions affecting public finance (including initiatives limiting local revenues and expenditures), outlines disclosure responsibilities and practices, discusses debt structuring, provides a framework for considering investment alternatives for bond proceeds, and provides guidance on working with state agencies.

Most of the original *Primer* was developed by the law firm of Orrick, Herrington & Sutcliffe, LLP, under a contract with the California Debt and Investment Advisory Commission (CDIAC). Additional sections provided in this version were drafted by members of CDIAC's Debt Technical Advisory Committee (TAC), comprised of state and local government policy makers and practitioners, investment and commercial bankers, bond counsel, financial advisors and consultants, and others. The review by CDIAC's Debt TAC helped ensure that the *Primer* was technically accurate and understandable.

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

CDIAC provides information, education, and technical assistance on public debt, investments, and economic development financing tools to local public agencies and other public finance professionals.

In order to carry out its mission of assisting state and local agencies on matters related to debt issuance and management, the investment of public funds, and economic development financing tools, the Commission engages in a wide range of activities and functions.

In compliance with its statutory requirements, CDIAC maintains a debt issuance database. The debt issuance repository is considered the most comprehensive and accessible database of California debt issuance in existence. Depending on the needs of state and local governments and market conditions, the volume of data processing may range from 2,500 to 4,000 individual debt issuance reports received each year. Data from these reports are the basis for debt statistics and analysis released by CDIAC.

CDIAC's mandated duties include some that are intended to improve the market for, and indeed the marketability of, public debt issued in California. Such functions include efforts to maintain contact with participants in the municipal debt industry, to undertake or commission studies of various aspects of the market in order to provide guidance to state and local debt issuers, and to recommend legislative changes in matters affecting public debt issuers. Research staff prepares their findings and recommendations in the form of Issue Briefs, technical reports, and articles for the *Debt Line* monthly newsletter.

CDIAC offers seminars throughout the year at various locations in the state. These seminars are designed to introduce public officials who are new to the field of public finance to the debt issuance and investment process and to strengthen the expertise of public officials who are familiar with the municipal debt issuance process and the investment of public funds. CDIAC also offers a series of seminars that provide public officials with information on state financing programs available to local governments to assist in revitalizing their communities. In addition to the educational seminars, CDIAC has acted as co-sponsor of public finance-related conferences, symposia, and seminars conducted by private companies and statewide associations.

Information regarding CDIAC's seminar programs, research reports, and debt issuance data collection can be found at CDIAC's Internet site, www.treasurer.ca.gov/cdiac or may be obtained by contacting CDIAC at (916) 653-3269.

WHO SHOULD USE THE CALIFORNIA DEBT ISSUANCE PRIMER

Within local government, the individuals faced with public financing questions may have full or partial responsibility for:

- Developing capital improvement plans and budgets
- Utilizing a variety of tools to finance their budgets
- Coordinating, developing, and implementing goals for community and economic development

- Understanding the financial tools and arrangements necessary to implement these types of projects

Within state government, public finance staff may assist in policy making in the California Legislature, oversee the preparation and implementation of the state budget, administer the expenditure of monies raised through state debt financings, or be responsible for structuring and selling debt financing instruments for state agencies and programs.

The *Primer* is a helpful tool for local elected and appointed officials and staff, state officials and their staff, private and nonprofit borrowers who may be eligible for public debt financing, and anyone else who needs a basic overview of California public finance.

The statements in the *Primer* regarding legal and financial principles and rules are, by necessity, summaries of the principles and rules and may have exceptions and nuances not described in detail in this publication. It is therefore imperative that the reader of the *Primer* check with legal counsel regarding any legal provisions relating to debt issuance and consult with competent financial professionals when considering the financial implications of any borrowing program. The goal of the *Primer* is not to provide detailed and complete explanations of all the legal or financial issues involved, but instead to provide interested readers with the tools to ask appropriate questions of professionals and understand the answers they receive.

BOND ISSUANCE: DEFINITION AND PURPOSE

To issue a bond is to borrow money. A bond is simply the evidence of the debt, in the same way that a promissory note is evidence of the obligation to repay an ordinary loan. The issuance of bonds in connection with a borrowing results in the creation of securities evidencing the loan that can be bought and sold, i.e. “traded.” The buyers of bonds are thus investors, both individual and institutional, who loan money to the public agency issuer (or through the public agency issuer to conduit borrowers) through the purchase of bonds.

A bond typically specifies an obligation to pay a stated amount (the “principal”) at a given time (the “maturity”) with interest at a stated rate.

There are many variations on the structure and security for bonds. These include bonds which are general obligations (payable from all general funds of the issuer) and those which are limited obligations (payable from only a specified source of funds), bonds which have one maturity date and those with multiple maturity dates, and bonds with fixed interest rates and those with variable interest rates.

The legal requirements for the issuance of public debt can be visualized as a three-legged stool, with each “leg” representing the following:

- The state law that authorizes the issuance of the debt

- The federal and state tax laws that govern the eligibility of the debt for “tax-exempt” status
- The federal and state securities laws that govern disclosure, sale, and trading of the debt

Public agencies considering the issuance of public debt should be aware that each of these three legs is critical to the integrity of the process and the valid issuance and maintenance of the debt. Moreover, each of these legal areas is in a constant state of change. Notable “watershed” changes in recent years include the complete rewriting of the federal tax law with respect to public finance in 1986, major additions to the federal securities laws imposing continuing disclosure obligations in 1995, and the adoption of important state constitutional changes, such as Proposition 218, enacted by California voters in 1996.

CONSIDERATIONS IN USING BONDS

A primary consideration in any financing plan is the relationship between the term of the financing and the life of the asset being financed. For example, short-term operating needs are generally financed with cash or short-term borrowing, such as a “tax and revenue anticipation note” (TRAN), while a capital asset, such as a library building, is typically financed with a debt instrument having a longer maturity, such as a general obligation bond (GO). While some types of debt can be issued for periods of up to 40 years or longer, most “long-term” assets, such as public buildings and major infrastructure, are financed over terms of 25 or 30 years. On the other hand, equipment, which typically has a much shorter economic useful life, is usually financed over an intermediate term of 3 to 15 years. In addition, certain kinds of bonds can be used for noncapital purposes. Examples include pension obligation bonds (POBs) which fund unfunded pension liabilities, prepaid service contract bonds, used for funding long-term service contracts such as for telephone service, and Teeter Financings, used for funding property tax receivables. Federal tax law contains important limitations on the term of debt, which are described in **Chapter 3, General Federal Tax Requirements**. In addition, special tax considerations applicable to each type of financing are described in the respective sections of **Chapter 6, Types of Financing Obligations**.

Interest rates, terms, and the costs of issuance are factors that can influence the financing decision. In deciding how to proceed, the issuer and/or borrower should consider the following:

- Costs of financing versus the benefit to be gained from the financing
- Relevant public support for the project
- The possibility that political controversy or litigation may arise from the financing

Issuers also must consider the needs of investors for different structural features of a bond issue. To be successful, a bond-financing program must meet the financial needs and limitations of the issuer and at the same time provide an attractive opportunity to potential investors who have

many choices of investment vehicles. Finally, it cannot be overemphasized that careful and thorough preparation is a critical factor in a successful bond issue. This preparation includes:

- Establishment and consideration of policies to guide the issuer's financing
- Careful review of federal, state, and local laws
- Constant attention and supervision of the debt financing from initiation of the financing, through sale and delivery of the bonds to the final maturity of the bonds, which may require the issuing agency's officials and staff may to assume responsibility for resolving any problems that arise
- Advance preparation and education of the governing board of the issuer and, if appropriate, the community at large
- Capital planning to identify funding needs well in advance so that financing can be arranged in an orderly and timely manner
- A comprehensive communications plan to allow for the accurate and timely flow of information to current and prospective investors

The issuing entity's officials should always remember that, although the selection and use of competent professionals is essential to a successful financing, ultimate responsibility for oversight and decision-making cannot be delegated to these professionals. Any debt that is issued (regardless of the source of repayment) has the name of the issuing entity on the issue. In recent years, defaults and repayment problems on some bond transactions have caused added expense and workload for issuers and may have interfered with the ability of the agencies involved to undertake further financings. It is therefore imperative that public agency officials and staff exercise prudence and care in undertaking each financing and ensure that public policy criteria are satisfied—and especially that there is a clearly-defined public purpose for the issue.

DEBT AFFORDABILITY STANDARDS AND DEBT POLICIES

Debt financing through the issuance of bonds should generally not be considered an additional source of revenue. Debt is merely a way of spreading out the cost of a capital improvement or public program over time. In some cases (as with general obligation bonds or land-secured financings), the statutes permitting the issuance of debt also permit the levying of taxes or assessments to pay debt service. Given the significant restrictions in California on local agency revenue sources, especially those imposed under Proposition 218, issuers should be careful to gauge the effect of ongoing debt service on their budgets and fiscal priorities over time.

Issuers should consider adopting debt affordability standards in order to help them evaluate when, why, and how much debt should be issued. These standards can lead to a debt affordability plan that keeps debt levels within acceptable ranges. A debt affordability plan will typically include a set of target ratios for debt, which might be based upon assessed valuation of

property, revenues, population, system users, or other factors relevant to specific types of issues. These ratios may be varied depending on factors such as volatility of revenue streams, concentration of tax or revenue base, overall community policies, and preferences regarding debt and the overall need for capital investment.

In addition to debt affordability standards, issuers should consider adopting a formal debt policy. A debt policy:

- Establishes parameters for issuing and managing debt
- Provides guidance to decision makers so as not to exceed the debt affordability standards
- Directs staff on objectives to be achieved both pre- and post-issuance
- Promotes objectivity in decision-making and limits the role of political influence
- Facilitates the process by considering and making important policy decisions in advance of an actual financing

Debt policies can be helpful in maintaining and improving an issuer's general credit rating and worthiness. The elements of a debt policy will vary for each issuer, and should reflect the scope of activities the issuer is likely to undertake in the debt financing arena. In addition, it is important that the debt policy reflect community standards and attitudes about debt. Debt policies should address such issues as:

- The types of debt that will be issued
- Structural features with respect to the debt
- Method(s) of sale of debt (i.e. circumstances under which negotiated or competitive sales will be used)
- Refundings
- Selection of consultants
- Disclosure practices
- Arbitrage rebate and continuing disclosure compliance
- Investment of bond proceeds

Strategic planning for debt issuance, in light of the issuer's capital outlay program, also should be addressed with a view to giving the issuer the ability to access the market when it expects to need funds while avoiding an unnecessarily high number of issuances in a short period of time.

Planning should take advantage of opportunities to pool financings, where appropriate, to save on costs of issuance as well as building in flexibility in scheduling to avoid being forced to issue in a high interest rate environment.

While a detailed description of how to create and implement debt affordability standards and a debt policy is beyond the scope of this work, readers may wish to refer to the publications and additional information on recommended practices on the Government Finance Officers Association (GFOA) website at www.gfoa.org.

ORGANIZATION OF THE PRIMER

Chapter 1, Overview of a Debt Financing outlines the roles and responsibilities of the major participants in a debt offering and the problems that may arise in connection with the financing. Primary among the roles is that of the issuer. Also included in this chapter is a discussion of the roles of bond counsel, financial advisors, underwriters and their counsel, disclosure counsel, and more. Chapter 1 also summarizes the steps involved in developing a request for proposals to hire members of the financing team and considerations applicable to workouts and troubled transactions. The chapter concludes with a description of most of the basic legal documents encountered in public finance transactions.

Chapter 2, Checklist of Steps in a Debt Financing contains a list of steps, with timeframes and responsibilities, that may be used as a general guideline in undertaking a financing.

Chapter 3, General Federal Tax Requirements is a concise overview of the basic federal tax concepts and rules applicable to public finance. Cross-references to this section are found in **Chapter 6, Types of Financing Obligations** and other chapters where appropriate. Federal tax concepts and rates that relate in a unique way or are only applicable to a particular type of financing instrument are discussed in the section on that type of adjustment.

Chapter 4, State Constitutional Limitations discusses certain important concepts of state constitutional law applicable to debt issuance, including the constitutional debt limitation, the prohibition on gifts of public funds and lending of public credit, initiatives and referenda, and the Jarvis Family of Initiatives (discussing the relevant provisions of Propositions 13, 4, 62, and 218).

Chapter 5, Environmental Issues provides a brief overview of the applicability of environmental law to public finance.

Chapter 6, Types of Financing Obligations provides a detailed description of the principal types of debt financing obligations. Each section describes a particular type of financing vehicle, its legal authority, process for approval and sale, important limitations, method of repayment, and policy considerations. Also included for each type is a discussion of special federal tax issues that need to be considered, as well as appropriate cross-references to sections

within **Chapter 10, Continuing Disclosure and Investor Relations Programs**, **Chapter 4, State Constitutional Limitations**, and **Chapter 3, General Federal Tax Requirements**.

Chapter 7, General Debt Structure Issues discusses the structuring options for bond issues, including maturity schedules, redemption provisions, interest rates and the yield curve, types of bonds, security for bonds, refundings, and related topics.

Chapter 8, Fixed and Variable Interest Rate Structures discusses additional structuring options, specifically the inherent differences between fixed rate and variable rate bond structures. It includes detailed a discussion of the types of variable rate structures, including auction rate securities, commercial paper, variable-rate demand obligations, and other unique structures.

Chapter 9, Synthetic Interest Rate Structures discusses more complex, alternative structuring options. It focuses primarily on interest rate swap structures, although other types of swaps and hedges (including swaptions and interest rate caps, floors, and collars) are briefly discussed.

Chapter 10, Continuing Disclosure and Investor Relations Programs provides an overview of the disclosure roles and responsibilities of public agencies. In addition to a discussion of initial disclosure issues with respect to a new bond issue, this section discusses investor relations programs and ongoing disclosure obligations.

Chapter 11, Investment of Bond Proceeds contains a discussion of factors and issues relevant to decisions concerning the investment of the monies obtained from issuing bonds prior to their expenditure. Topics include investment objectives, the types of bond proceeds that may be invested and the considerations for each, investment policies, evaluation of investment alternatives, and federal tax limitations on the investment.

The **Index** contains a listing of key terms, phrases, and their associated page in the *Primer*, which the reader may find helpful for reference purposes.

In addition, the following appendices are provided:

Appendix A – Working with State Agencies

Appendix B – Resources and Contacts

Appendix C – Debt Financing Terms and Concepts. Most of the technical terms that appear in the *Primer* are described in this appendix.

Appendix D – Legal References. Contains statutory and constitutional citations for the various issue types.

Appendix E – Summary of Financial Obligations. This appendix provides a quick summary of the various financing obligations found in **Chapter 6, Types of Financing Obligations.**

Chapter 1

OVERVIEW OF A DEBT FINANCING

This chapter provides an overview of a debt financing, outlines the roles and responsibilities of the major participants, and describes the various problems that may arise in connection with the financing.

As one might imagine, the issuer is the key figure and major focus of most debt financings.¹ In addition to the role of the issuer, this chapter covers the roles of bond counsel, financial advisors, underwriters and their counsel, disclosure counsel, credit rating agencies, investment advisors and investors, among others. It also summarizes the steps involved in developing a request for proposals to hire members of the financing team and the considerations applicable to workouts and troubled transactions. Finally, this chapter contains a description of most of the basic legal documents encountered in public finance transactions.

The process of issuing bonds is the process of borrowing money. A bond is simply evidence of the issuer's debt, i.e. its obligation to pay—either from its funds generally or from specified resources—a stated amount of money (principal) at a given time (maturity) with interest, payable either periodically or at maturity.

Conceptually, the initial buyer of a bond is “lending” money to the issuer in return for the issuer's obligation to pay (repay) money in the future with interest. Customarily, the owner of a bond may freely sell it to another buyer in the secondary market, resulting in the issuer being obligated to pay the new owner. Building over the years in many ways on each of these simple themes has resulted in today's highly sophisticated municipal bond market, with a myriad of financing techniques available to provide capital to issuers in amounts up to billions of dollars.

The purpose of this chapter of the *California Debt Issuance Primer (Primer)* is to provide an introduction to the process of issuing bonds by describing the functions of each of the principal participants in the process and discussing one of the ways of selecting them—the request for proposal. Also, because the incidence of bond defaults and challenges from government regulators has increased over the past several years, this part of the *Primer* explains the roles of the various participants in resolving problems that may arise in the issuance and repayment of bonds. In addition, the chapter provides a brief discussion of the legal documents encountered in a typical financing. It defines and describes the most common documents generated during debt issuance, who drafts the documents, the most critical sections of the documents, and the documents' purposes.

¹ In the case of a conduit financing, the borrower is often the main player, although the issuer still retains most of its functions and responsibilities.

The authors have made an attempt to describe the principal participants without using too much undefined jargon. For example, “bonds” is used to mean all types of debt obligations, including long-term bonds, short-term notes, certificates of participation, commercial paper, etc. The reader will find unfamiliar terms explained below or in **Appendix C – Debt Financing Terms and Concepts**. Additional participants are also described in **Appendix C**—for example, remarketing agent, yield verification consultant, special tax counsel, escrow agent and feasibility consultant—and in **Appendix A – Working with State Agencies**—for example, the California Debt and Investment Advisory Commission (CDIAC), the California Debt Limit Allocation Committee (CDLAC), and the California Industrial Development Financing Advisory Committee. Finally, **Appendix B – Resources and Contacts** contains listings of agencies and associations that may be useful to the reader.

ROLES AND RESPONSIBILITIES OF PRINCIPAL PARTICIPANTS

ISSUER

Types of Issuers. The tax-exempt status of municipal issuers distinguishes them from other issuers of debt. A municipal debt issuer can be any entity authorized by the Internal Revenue Service (IRS) to issue tax-exempt securities. IRS code subtitle 18, part III, section 103(a) states that “interest on the obligations of a State, a Territory, or a possession of the United States, or any political jurisdiction of any of the foregoing, or of the District of Columbia” is exempt from tax. IRS code defines tax-exempt municipal issuers in a variety of ways, but the main types of municipal issuers are states, counties, cities, and school districts. In addition to these typical government units, there is a category of entities classified as “special districts.” A special district is a limited-purpose government unit with legal authority to tax. California has a myriad of special districts authorized to levy tax assessments. Special districts range from fire and flood districts to financing districts. These special districts are identified, along with the authorizing statute, in **Appendix D – Legal References – Table D-1-2** of this *Primer*.

In some instances the issuer may be controlled by another governmental entity, usually called a statutory authority or agency. These authorities or agencies act as a “conduit” for issuing tax-exempt debt. For example, redevelopment agencies, housing authorities, joint powers authorities, and industrial development authorities may be formed by cities and counties, and the city council or board of supervisors may sit as the governing body of the agency or authority. Similarly, nonprofit corporations have been created by governmental entities to issue bonds on behalf of the governmental entities to accomplish financings that may not be specifically authorized for governmental entities. These governmental entities borrow as a tax-exempt issuer and then pass through the funding and the liability to a private entity borrower. The private entity borrower is obligated to make the debt payments associated with the bonds or notes through a legal agreement. The issuer uses a trustee to transact between the bondholders and the private entity. Other sections of this *Primer* will clearly distinguish between the issuer and any entity that controls the issuer, but in this more general discussion, the two will be treated as “the issuer.”

Legal Authorization. Issuers are authorized by state law to borrow money, i.e. issue bonds for many different specific purposes, and in some cases for their “general corporate

purposes.” For the most part, these purposes are limited to those that in one respect or another benefit the public welfare—so-called public purposes. In the case of chartered cities, debt may be issued for purposes that constitute “municipal affairs.” (See **Chapter 4, State Constitutional Limitations – The 1879 Constitution – Charter Cities and “Home Rule”** for a discussion of the municipal affairs doctrine.) Within these statutory and constitutional guidelines, an issuer determines its own capital improvement program (including the parameters of any lending program), determines the resources that it has available for the payment of capital expenditures (including the repayment of any debt), and is in ultimate control of the process of issuing bonds as a part of that capital improvement program. In addition, in certain limited circumstances, an issuer may determine to issue debt to finance noncapital items. **Chapter 6, Types of Financing Obligations** contains a discussion of the constitutional and statutory authorization for a variety of different types of debt financing programs.

Issuer's Responsibilities. One of the first decisions to be made by an issuer is the selection of the initial members of its debt financing team, including bond counsel (and perhaps disclosure counsel) and either a financial advisor or underwriter, or both. Team members may be selected on the basis of a request for proposals, long-standing relationship with the issuer, reputation, or recommendation by others (see **Using a Request for Proposals to Select Financing Team Members** in this chapter).

The nature of the financing team members may depend upon several factors including:

- The type of debt being issued
- Procedural requirements for that type of debt
- The level of in-house sophistication of the issuer

For example, in a situation in which bonds are to be sold at competitive (or “public”) sale (the opening of bids from prospective underwriters at a time and place specified in a published notice of sale), an issuer will typically hire a financial advisor. On the other hand, in cases in which bonds are to be sold in a negotiated (or “private”) sale, an issuer will customarily select an underwriter or an underwriting team and also may select a financial advisor (see sections in this chapter on **Financial Advisor** and **Underwriter/Placement Agent/Purchaser**).

Having selected a team, an issuer then works with the team to issue debt to finance the capital improvement or working capital program. Subject to legal constraints and considering the recommendations of the team members, an issuer retains ultimate control and responsibility of the overall financing plan and the details of the financing structure. The issuer's staff must consider itself responsible for reviewing all aspects of the financing plan, including all documents that determine or describe aspects of the financing. The issuer's staff (including its general counsel) is in the best position to be aware of the impact of the financing on other areas of the issuer's finances and operations.

In addition, the issuer will be involved in any legal action that may arise with respect to issuance of the bonds. In circumstances where there may be legal uncertainty about some aspect of a

proposed bond transaction, the issuer may pursue a validation action to obtain judicial approval before the bonds are issued. If a bond transaction is controversial and gives rise to a reverse validation action, the issuer will find itself a party to that litigation. Furthermore, after the bonds are issued, the issuer will be ultimately responsible for long-term management and troubleshooting. Such issues may include:

- Supervising, investing, and administering the expenditure of bond proceeds
- Collecting, or monitoring the collection of, revenues
- Use of revenues to pay operating expenses and debt service
- Compliance with all undertakings, covenants, and agreements
- Management of any enterprise funded by the debt
- Filing of any required reports with various governmental regulators, a bond insurer or other credit enhancement provider, if any, and credit rating agencies
- Addressing any problem that may arise with respect to the bonds, such as a shortfall in revenues, a tax audit, or a regulatory issue
- Preparing, reviewing, and filing Annual Reports and Listed Event Notices under SEC Rule 15c2-12

The degree to which members of the issuer's debt financing team are capable of looking out for the issuer's long-term interests, or are motivated to do so, will vary, depending on the relationship that each team member has with the issuer. Ultimately, the issuer must bear responsibility for its own interests. For this reason, the issuer must be an active participant in the debt financing process and not leave it all to the consultants. Even if the issuer selects its consultants with an eye toward providing services that cannot be provided in-house, the issuer must be prepared to examine the consultant's work and ask the questions necessary to assure that the end result is appropriate given the issuer's objectives.

Workouts. The issuer needs to be aware of its responsibilities in the event that a problem arises with respect to the bonds, such as a shortfall in revenues needed to repay the bonds, a tax audit that reveals irregularities, or an investigation by a regulatory agency. The issuer is the participant most likely to be called upon to provide information and coordinate a workout strategy. Because of this, throughout the debt financing process the issuer should remain alert to potential problems, as prompt remedial efforts may avoid a larger problem later on.

Issuers should be aware that there can be substantial costs involved in dealing with a troubled bond transaction. Such costs could include legal fees and litigation expenses, appraisal fees, and the cost of hiring financial advisors and other consultants. In addition, significant staff time can be spent on these matters. Finally, political fallout can result if a transaction goes bad in a way that reflects poorly on elected officials. Although a thorough discussion of defaults and workout

situations is beyond the scope of this *Primer*, issuers are encouraged to be aware of the potential for such events and structure their debt issues prudently so as to avoid problems.

BOND COUNSEL

Bond Counsel Opinion. Bond counsel is the attorney or firm of attorneys that gives the legal opinion delivered with the bonds confirming that the bonds are valid and binding obligations of the issuer and, customarily, that interest on the bonds is exempt from federal and state income taxes. In relatively rare cases, bonds designed to be taxable for federal income tax purposes are issued. In these cases, the tax opinion may be nonexistent, or may run only to exemption for state income tax purposes.

Source of Need for Bond Counsel. Historically, the requirement for the bond counsel's legal opinion began in the second half of the 19th century when a number of issuers of railroad bonds disclaimed liability on their bonds on the basis of their own errors made in the process of issuing the bonds. Buyers of bonds began to require that an independent lawyer or law firm render an opinion that the bonds were validly issued and binding. The issuer of that legal opinion, the bond counsel, was (and is) required by market standards to be nationally recognized for expertise in municipal finance.

Independence of Bond Counsel. Originally, bond counsel rendered their legal opinion very late in the process, sometimes even after the bonds had been issued. Over time, however, to minimize the risk of a negative opinion, bond counsel was hired earlier and earlier in the issuing process. One result of this earlier engagement of bond counsel has been a shift in their role and independence. Originally, bond counsel was required to be "independent" of the issuer and sometimes was actually hired by the bond buyers (a practice occasionally seen even today).

The bond counsel final opinion thus meets a much more rigorous standard than is customary for most legal opinions. Under certain circumstances, where the law on a point is not entirely free from doubt, counsel may render an opinion to the effect that, if the matter were properly briefed and argued to a court of competent jurisdiction, the court "should" or "would" hold as described in the opinion. This is the standard against which many non-bond legal opinions are measured. It requires the reader to understand and appreciate the limitations of the authorities cited in the opinion and to understand that counsel is making some assumptions about the way a court would interpret these authorities if presented with the facts described in the opinion. While these "should" or "would hold" opinions may be used in a municipal finance transaction to address collateral matters from time to time, it would not generally be possible to successfully issue and sell bonds, the validity or tax exemption of which was covered only by an opinion couched in such terms.

Responsibilities of Bond Counsel. Originally, the bond opinion covered only the concept that the bonds were legal, valid, and binding, and were issued in accordance with the law. In the last 30 to 40 years the statement that interest on the bonds is exempt from federal and state income taxes has become a very crucial part of the bond opinion. The legal work that goes into many bond issues is dominated by tax issues, in part because of the constant change in the

tax laws relating to tax-exempt bonds. The bond opinion also may cover the validity of one or more of the legal documents under which revenues are made available to pay the bonds, such as a lease or loan agreement.

Disclosure. The bond opinion does not make financial recommendations or represent a financial judgment as to the acceptability of the bond for the investor. The bond opinion is not intended to be a disclosure document as it does not, in and of itself, represent a judgment that the disclosure available with respect to the bond is adequate under federal or state securities laws. However, as part of its expanding role, bond counsel sometimes agrees to a separate component of responsibility for advising the issuer concerning compliance with federal and state securities laws in the course of the debt issuance process. This is often stated as a separate item in the issuer's agreement with bond counsel for legal services or is stated to be the primary responsibility of some other lawyer (e.g. disclosure counsel) participating in the transaction.

Legal Team. The legal team for a bond issue sold on a negotiated basis generally will include bond counsel, issuer's counsel, underwriter's counsel and/or disclosure counsel, counsel for the company or other nongovernmental borrower, if any, and trustee's counsel. Bond counsel's role in these cases will customarily be as special counsel to the issuer for the financing and not as counsel to the investor. In a negotiated sale, the interests of the investor are indirectly represented by the underwriter and underwriter's counsel.

A listing of bond counsels utilized by the State Treasurer's Office are available on its website at www.treasurer.ca.gov/bonds.

Bond Counsel May NOT be Underwriter's Counsel. Historically, when an issue was to be sold on a negotiated basis and was too small to afford several attorneys, with the consent of the issuer and the underwriter, bond counsel occasionally also acted as underwriter's counsel. In 1985, Section 53593 was added to the Government Code. This new code section prohibited bond counsel (in the case of a bond issue) from also being counsel to the underwriter or other initial purchaser of the bonds. Bond counsel may render opinions to the underwriter or purchaser, but only as bond counsel and not as counsel to the underwriter or purchaser. As described later in this chapter in **Underwriter's Counsel**, a recent development is the increasing use of disclosure counsel, or counsel to the issuer with respect to disclosure and bond sale matters. This type of relationship is not prohibited by Government Code Section 53593.

In the case of bonds sold at competitive sale, no underwriter or underwriter's counsel is involved in the transaction until the financial structure has been determined, the proceedings are basically final, and the bonds are offered at the sale. In that situation, bond counsel and the financial advisor work with the issuer to design a bond issue that will be acceptable to investors. The format of these transactions is usually standard.

Whether the bonds are sold at negotiated or competitive sale, bond counsel is customarily responsible for preparation and review of the legal proceedings for the issuance of the bonds, including election proceedings if an election is required, resolutions of the governing body of the issuer authorizing the issuance of the bonds and otherwise relating to the bond issue, and the documents under which the bonds will be issued and secured. In the case of certain types of

lending programs, bond counsel also may prepare loan agreements, origination and servicing agreements, lease agreements, deeds of trust, and other similar documents relating to the sources of revenues with which the issuer will pay debt service on the bonds.

Finally, bond counsel may address a wide variety of legal issues relating to the financing. In circumstances where there may be legal uncertainty about some aspect of a proposed bond transaction, bond counsel may pursue a validation action to obtain judicial approval before the bonds are issued. If a bond transaction is controversial and gives rise to a reverse validation action, bond counsel will likely be asked to represent the issuer in the litigation or to assist the issuer's general counsel or outside litigation counsel.

Bond counsel is not ordinarily general counsel to the issuer. However, in some cases (especially where the issuer's general counsel is hired on a contract basis rather than as a regular employee), if the issuer's counsel has the requisite expertise, he or she may serve as bond counsel as well. When the issuer's regular counsel also serves as bond counsel, special attention should be paid to conflicts of interest, particularly where a contingent fee for the bond counsel services is involved.

If the issuer's regular counsel is not bond counsel, the issuer's counsel (e.g. the City Attorney) will nevertheless play an important role, typically with respect to conforming the procedures and documents to the special needs of the issuer. In addition, issuer's counsel will often be required to render an opinion with respect to the issue. This opinion is typically limited to the organization and existence of the issuer, the due approval, execution and delivery of documents, the absence of litigation, and other related matters.

Because of the complexities of bond financing, there are several roles that bond counsel may play. It is very important that a clear relationship between the issuer and bond counsel be established early in the transaction and that the issuer establish who bond counsel represents and the purposes for which bond counsel is engaged.

Bond counsel may be compensated in a variety of ways, including an hourly rate proportional to the size of the issue (customarily on a sliding scale representing a smaller percentage of larger issues), a fixed dollar amount, and others. Bond counsel's fee may be payable whether or not the bonds are issued or it may be contingent upon issuance of the bonds. In addition, even if the fee is contingent, bond counsel may be reimbursed for out-of-pocket expenses, whether the bonds are issued or not.

Workouts. Bond counsel is often called upon to resolve any problem that arises after the bonds are issued. Problems may include:

- A shortfall in revenues needed to repay the bonds
- Irregularities revealed by a tax audit
- Regulatory concerns such as a disclosure issue

Where the problem is serious, such as a payment or significant covenant default, the issuer may wish to hire new counsel to provide a fresh perspective.

FINANCIAL ADVISOR

Scope of the Financial Advisory Relationship. A financial advisor is a professional consultant retained (customarily by the issuer) to advise and assist the issuer in formulating and/or executing a debt financing plan to accomplish the public purposes chosen by the issuer. A financial advisor may be a consulting firm, an investment banking firm, or a commercial bank. Some financial advisors identify themselves as “independent financial advisors,” being entities that do not engage in underwriting or trading of municipal securities.

In some cases, issuers have retained financial advisors for the sole purpose of assessing bond market conditions at the time of sale of the bonds to determine the appropriateness of the interest rate and other terms of the underwriter’s offer to buy the bonds. A financial advisor also may be retained to perform a broad variety of functions for the issuer, including surveying the issuer's existing debt structure and capital financing program and designing and assisting in the execution of a total financing plan for the issuer.

The role of or necessity for the financial advisor may depend upon the financial sophistication of the issuer and its staff, the workload capacity of the issuer’s staff, and the division of labor among the staff and other participants in the debt financing. For example, in the case of a negotiated sale of bonds, the underwriter is often selected by the issuer early in the process and may be the issuer’s principal advisor as to the best manner of accomplishing the issuer's ultimate financial objectives. In such cases, the issuer may not select any financial advisor or the role of the financial advisor may be limited to assessing the appropriateness of the underwriter’s recommendations. In other cases, a financial advisor may be selected initially, regardless of the method of sale, and play a key role in assisting the issuer.

Issuers should be aware that if they hire and rely on the advice of an underwriter or a financial advisor, that advice is subject to the biases inherent in the position of these participants. The only true objectivity is that of the informed staff of the issuer who are committed to the established goals and policies of their organization.

Traditional Services of a Financial Advisor. As an example, in a public facilities capital improvement program to be financed by general obligation or revenue bonds required to be sold at competitive sale, the financial advisor will customarily do each of the following:

- Review the financial feasibility of the capital projects
- Assess the available sources of revenue
- Recommend a financing structure (including the nature of the security for the bonds, excess revenue coverage requirements, debt service reserve account requirements, facilities insurance requirements, liability insurance requirements, and the need for credit enhancement)

- Recommend a maturity schedule, redemption terms, and other terms of the notice of sale
- Prepare on the issuer's behalf an Official Statement, for distribution to potential underwriters and investors, describing the issuer, the bonds, the security for repayment of the bonds, and any other matters that would be material to an investor
- Be the primary spokesperson on behalf of the issuer with the credit rating agencies
- Recommend the timing of sale of the bonds
- Arrange for and direct the mailing of the Official Statement and the official notice of sale to potential underwriters and investors
- Contact and answer the questions of potential underwriters and investors
- Analyze bids received at the competitive sale
- Recommend whether to accept or reject such bids
- Assist bond counsel in organizing the closing (i.e. the delivery of the bonds in return for payment for the bonds)
- Recommend appropriate investments for the proceeds of the bonds

Other possible responsibilities include recommending, when the options are available, competitive sale, negotiated sale, or a private placement of the bonds and, in the case of a negotiated sale or private placement, negotiating bond terms on behalf of the issuer.

Specialty Advisory Services – The Swap Advisor. An interest rate swap is a contractual arrangement between two parties, often referred to as “counterparties.” The counterparties agree to exchange interest payments based on a defined principal amount, for a fixed period of time. Interest rate swaps have become a popular, yet complicated tool for municipal issuers to manage interest rate risks and cash flow.

The swap advisor provides a review and analysis of swap alternatives and can assist in the procurement of the swap, including conducting a competitive bid. The advisor provides ongoing monitoring of swap market conditions, advice about rates and structure, and participates in reviewing the closing documentation. The swap advisor also can assist in the development of a swap policy and ongoing monitoring and swap valuation. Issuers should consider the need to obtain a “fair market certificate” from their swap advisor in regard to pricing, and to fully discuss how such certification will be defined.

Workouts. In the event that any problem arises with respect to the repayment of the bonds, such as a shortfall in revenues, a financial advisor typically gets involved in the efforts to resolve the problem. Issuers facing repayment and other problems sometimes turn to the financial advisor who assisted with the original transaction, or bring in a new financial advisor to provide a new perspective. Some financial advisors have acquired substantial expertise in

restructuring bond transactions, negotiating with bondholders and trustees, and carrying out other necessary or appropriate workout steps.

Conflicts of Interest. The relationship between the issuer and the financial advisor should be one of confidence and trust, and is in the nature of a fiduciary relationship. The law emphasizes this by prohibiting certain actions that might create a conflict of interest. Section 53591 of the Government Code prohibits a financial advisor, with respect to an issue of bonds, from acquiring the bonds from the issuer as principal, either alone or as a participant in a syndicate or other similar account unless the issue is sold by the issuer at competitive public sale and the issuer has, prior to the bid, expressly consented in writing. Section 53592 of the Government Code requires each financial advisory relationship to be evidenced by a written document executed prior to or promptly after the inception of the relationship, or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences. The document must describe the basis of compensation for the services to be rendered. With certain limited exceptions, the compensation must be on a basis other than a percentage of the amount of the bonds to be issued. Section 1090 of the Government Code also regulates conflict of interest. The full text of these Government Code sections is set out in **Appendix D – Legal References**.

Rule G-23 of the Municipal Securities Rulemaking Board (MSRB) contains requirements that are similar to, although not quite as stringent as, the requirements of Government Code Sections 53591 and 53592 relating to financial advisory relationships. Rule G-23 includes an express additional requirement that prior to purchasing from an issuer bonds with respect to which a financial advisor has provided advisory services, the financial advisor must terminate its financial advisory relationship with the issuer with respect to that issue.

Neither state law nor the MSRB rules prohibit a financial advisor from purchasing bonds in the secondary market, either for the financial advisor's own trading account or for the account of customers, except to the extent that such purchase is made to contravene the purpose and intent of the above-described requirements.

As these rules emphasize, the financial advisor's professional duty is to the issuer, and the advisor must advance the financial interests of the issuer on the issuer's chosen course.

A listing of financial advisors utilized by the State Treasurer's Office is available on its website at **www.treasurer.ca.gov/bonds**.

UNDERWRITER/PLACEMENT AGENT/PURCHASER

Underwriter vs. Placement Agent. An underwriter purchases bonds from an issuer with the intent to resell the bonds to investors. A placement agent acts as agent for the issuer in selling bonds to a private placement purchaser, and, as such, does not purchase the bonds. The responsibilities and functions of the underwriter will depend primarily on whether the bonds are to be sold at competitive sale or at negotiated sale.

Services in a Negotiated Sale. In the case of a negotiated sale, the issuer will customarily select the underwriter (or the underwriting team) early in the process and the

underwriter may perform many of the services described above for financial advisors. If the issuer has not retained a separate financial advisor, the underwriter may assist the issuer in determining what is to be financed, the method of financing, and the financing structure. The underwriting firm performing these functions is often called the “managing underwriter” or, where there is more than one member of the initial underwriting team, the “lead managing underwriter” or “senior managing underwriter.” In such cases the underwriter will usually hire its own counsel and the underwriter and underwriter’s counsel will take the lead in coordinating preparation of the Official Statement for the bonds. Alternatively, as discussed above, the issuer may elect to retain disclosure counsel for the purpose of preparing the Official Statement and related sale documents. However, regardless of who takes on the primary drafting responsibility, the issuer remains responsible for full disclosure in the Official Statement.

After the design of the financing and the preparation of the Official Statement, the underwriter in a negotiated sale does the following:

- Mails the Official Statement to potential bond buyers and underwriting syndicate members
- Assesses bond market conditions to recommend timing and pricing of the bond sale
- Forms an underwriting syndicate in the case of large issues
- Obtains agreement from the underwriting syndicate to the interest rates and terms of sale for the bonds
- Signs a bond purchase agreement on behalf of itself or the underwriting syndicate, as the case may be
- Ensures that appropriate continuing disclosure undertakings are entered into by the issuer to show compliance with SEC Rule 15c2-12

As an alternative to forming a syndicate, an underwriter may form a selling group. When a syndicate is formed, each syndicate member has, through the Agreement Among Underwriters and as part of the bond purchase agreement, a direct obligation to the issuer to buy the bonds. A selling group member has no such obligation to buy the bonds, and in these cases only the managing underwriter has a direct obligation to the issuer to buy the bonds. A selling group member receives only the bonds the managing underwriter agrees to sell to it (in response to its order for such bonds).

An issuer selling bonds at negotiated sale has the flexibility of advancing or delaying the sale date to respond to market conditions in an effort to obtain the best possible financing terms. In the case of complex or unusual debt financings, the negotiated sale process also permits direct input from the buyer of the bonds as to the desirability of various financing structures or features. Finally, in a negotiated sale, the underwriting syndicate can do a substantial amount of preselling of bonds, thus lowering the underwriting risk and, presumably, lowering the need for compensation for taking underwriting risk.

Services in a Competitive Sale. In a competitive sale, at the time and place specified by the official notice of sale, competing underwriters deliver sealed bids to the issuer, and the issuer selects the underwriter (alone or as representative of an underwriting syndicate or selling group) offering the best terms at that time and place. Bidders are permitted to specify, within the limits specified by the notice of sale, the interest rate for each maturity of the bonds and the price (including premium or discount) at which they will buy the bonds. The notice of sale also specifies the method used to determine the best bid—either the Net Interest Cost method or the net effective interest rate method (sometimes called the True Interest Cost method). (See **Appendix C – Debt Financing Terms and Concepts**.) Because the underwriters in a competitive sale have not been independently involved in the design of the financing structure and only have available to them the Official Statement and other readily accessible information concerning the issuer, bonds sold at competitive sale are relatively standard in design and security. In addition, the potential investors in such bonds are relatively identifiable.

Legal requirements regarding published notice for a competitive sale may sometimes make it difficult for an issuer to remain flexible concerning the timing, terms, and amount of the sale. (See **Chapter 6, Types of Financing Obligations** for a discussion of requirements relating to the process for sale for various debt obligations.) On the other hand, a properly conducted competitive sale gives an issuer reasonable comfort that on the date of sale, given the financial structure chosen, the issuer has received the best possible bid for its bonds. Issuers have begun to include a provision in the notice of sale in a competitive offering that allows the issuer to postpone the sale date for up to a limited number of days or weeks (usually on 24 hours notice by MunifactsSM wire service). This affords the issuer some flexibility to postpone a sale if the market on the sale date does not appear favorable.

Compensation – The Underwriter’s Gross Spread. In both negotiated and competitive sales, the underwriters are primarily compensated by the difference between the price they pay the issuer for the bonds and the price at which they resell the bonds to investors (the “spread”). When a managing underwriter and syndicate members determine the amount to be bid for the bonds and the expected amount of the spread, they take into account a number of factors, including:

- **Management fee:** a fee paid to the managing underwriter for handling the affairs of the syndicate, including, in the case of a negotiated sale, structuring the issue and negotiating with the issuer
- **Expenses:** any advertising and printing costs to the underwriter, fees and expenses of underwriter’s counsel, Blue Sky fees and expenses, computer expenses, travel expenses, MSRB fees, CDIAAC fees, and other similar expenses
- **Takedown:** normally the largest component of the spread, similar to a commission, which represents the income derived by the selling broker or dealer from the sale of the bonds
 - If bonds are sold by a member of a syndicate, the seller is entitled to the full takedown (also called the “total takedown”)

- If bonds are sold by a dealer which 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
- **Risk:** the amount of compensation for risks incurred by the underwriter in underwriting the bond issue, relating to the difficulty of marketing the issue, bond market conditions, and the amount of bonds remaining to be resold after the execution of the bond purchase agreement. It is rare for there to be any risk component in the spread

Underwriting spreads have tended to decline in recent years due to competition, market factors, new mechanisms to limit risk (derivatives), and technology. It is difficult to state a rule of thumb for what an underwriting spread should be or what the components should be relative to each other, because of the variables, which can include the type of financing, the credit quality of the debt, the scope of services to be provided by the underwriter, and other factors. In the process of the final pricing of the bonds, the issuer should request information from the underwriter as to the elements of the expected spread and data on comparable spreads from other recent pricings. Issuers should remember that all of the elements of a spread are negotiable. If a financial advisor is involved in the transaction, the advisor should be prepared to analyze the proposed spread and ensure that it is reasonable under all of the circumstances.

Rules on Conflict of Interest Issues. MSRB Rule G-37 generally prohibits underwriters that have made political contributions to elected officials of an agency from conducting any underwriting business with that agency for a period of two years after the contribution is made. In some cases, state law or local ordinances may impose similar limitations or exclusions.

The MSRB established Rule G-38 to address actual and perceived abuses associated with the awarding of municipal securities business to brokers and dealers. The rule is intended to deter and detect attempts by dealers to avoid the limitations placed on certain dealer activities. It also seeks to provide information to issuers about the relationship between dealers and the persons they have engaged to seek municipal securities business on their behalf.

Rule G-38 was adopted in 1996 and essentially requires dealers to disclose information about consultant arrangements. It defined consultants as individuals used by dealers to obtain business through direct or indirect communication with issuers, in exchange for payment. The rule specifies that this definition does not include people who did "substantive work" on bond issues, such as engineers or accountants.

In 2005, Rule G-38 was amended to bar municipal securities dealers from using anyone other than their employees or affiliated persons to solicit municipal securities business on their behalf. The rule change was adopted because of concern that an increasing number of municipal securities dealers were hiring and paying independent consultants to obtain business for them when the consultants were not subject to any of the same regulatory requirements as the dealers. The change prohibits a municipal securities dealer from making any direct or indirect payment to any person, other than an associated person of the dealer. Solicitation is defined as a direct or

indirect communication with an issuer for the purpose of obtaining or retaining municipal securities business.

Workout. The role of the underwriter varies in workout situations. If new bonds are being issued as part of solving the problem, the original underwriter, or a new underwriter, may be closely involved with the financial advisor and bond counsel in the workout effort. Nonetheless, because many underwriters are concerned about the viability of bonds in which they are involved, they will, if requested, attempt to identify the bondholders and help to facilitate contact with them as part of the workout effort.

UNDERWRITER'S COUNSEL AND DISCLOSURE COUNSEL

Underwriter's Counsel

Selection and Need. Underwriter's counsel is customarily selected by the underwriter to represent the underwriter and its interests in a negotiated sale. Competitive sales generally do not require the retention of underwriter's counsel. Underwriter's counsel customarily review, from the underwriter's perspective, the documents prepared by bond counsel and negotiate matters relating to those documents on behalf of the underwriter.

Disclosure and Securities Laws Compliance. Underwriter's counsel often coordinate preparation of the Official Statement with input provided by other financing team members, including the issuer, issuer's general counsel, the underwriter, bond counsel, the financial advisor (if any), the credit enhancement provider (if any), and the nongovernmental borrower (if any). In addition, underwriter's counsel often prepare the continuing disclosure agreement or certificate to evidence the undertakings of the issuer and other obligated persons with respect to SEC Rule 15c2-12. In so doing, underwriter's counsel will make recommendations concerning the disclosure requirements of federal and state securities laws. Upon the issuance of the bonds, underwriter's counsel give to the underwriters a "10b5 opinion" (named after SEC Rule 10b5) concerning compliance with the disclosure requirements of federal law.

In order to give a "10b5 opinion," underwriter's counsel need to conduct "due diligence" concerning the issuer, the securities, and their sources for repayment. Due diligence is the inquiry made to reveal or confirm facts about the issuer, the issue, and the security for the issue that would be material to a prudent investor in making a decision to purchase the issue. Due diligence inquiries are made by underwriters and lawyers to determine, for example, whether the issue follows the purpose and scope outlined by the enabling legislation, statutes, and resolutions of the issuer and whether all material facts have been accurately disclosed in the Official Statement. This exercise varies depending upon the type of debt being issued and the issuer involved, but typically involves review of documents including financial statements, minutes of meetings, major contracts, licenses, permits and real estate documents and other items relevant to the credit involved. Counsel will typically start this process with a request that specific documents be made available for inspection in the issuer's offices on a particular day. After review of the documents, counsel may need to follow up with interviews or requests for additional information.

Underwriter's counsel also advise the underwriter concerning any registration requirements of federal and state securities laws (so-called Blue-Sky Laws) for sale of the bonds in various jurisdictions.

Compensation of Underwriter's Counsel. Underwriter's counsel is customarily paid by the underwriter from the underwriting expense portion of the spread.

Disclosure Counsel

Disclosure Counsel. Disclosure counsel handles many of the tasks traditionally handled by underwriter's counsel, except when it is clear that the disclosure counsel's client is the issuer and not the underwriter. If underwriter's counsel has been retained, it may be unnecessary to retain disclosure counsel.

Disclosure counsel may prepare the draft Official Statement, the Bond Purchase Contract (or, in the case of a competitive sale, the Official Notice of Sale), the Continuing Disclosure Agreement and any Blue Sky Memoranda. In addition, disclosure counsel may render a "10b5 opinion" to the underwriter for the transaction. In doing this work, the disclosure counsel is representing the issuer and not the underwriter, and all parties must be aware of this role and of the duties disclosure counsel owes to its client, the issuer. If structured in this way, disclosure counsel may be the same lawyer or firm as bond counsel on a particular transaction since the client in both cases is most likely the issuer. Occasionally where disclosure counsel is used, the underwriter also will have its own counsel, but typically that counsel's role is limited to advising the underwriter on negotiation of the purchase contract and on regulatory compliance issues.

Compensation of Disclosure Counsel. Because disclosure counsel works for the issuer, they are paid by the issuer from the proceeds of the bonds. As with bond counsel, compensation arrangements may include hourly rates, fixed or percentage fees, or a combination of methods, and may be contingent upon issuance of the bonds or payable regardless of the success of the transaction.

CREDIT RATING AGENCIES

Credit rating agencies are firms that analyze the probability of the debt instrument returning all of the principal to the investor. Municipal credit ratings are opinions of the investment quality of issuers and issues in the municipal and tax-exempt markets. The municipal bond market has slightly different rating criteria from the corporate debt market owing to the unique characteristics inherent in public debt. Municipal debt ratings are viewed in relation to the general state of the state and national economy, debt levels and mix, revenue and expense cash flows, and the issuer's management strategies.

The credit rating agencies (principally Moody's Investors Service, Inc., Standard & Poor's, and Fitch Ratings) provide, for a fee customarily paid by the issuer, an independent appraisal of the credit quality and likelihood of timely repayment of a bond issue. Normally, when the financing structure is designed and the documents are close to final form, the financial advisor or underwriter will provide all of the documents to the rating agency or agencies selected by the

issuer (with advice from the financial advisor or underwriter) and will provide any other additional information (such as cash flow data or other financial calculations) requested by the rating agency. Rating agency representatives will discuss the financing directly with the issuer. Representatives of the rating agency also may visit the issuer or the project being financed. In the alternative, a financial advisor or underwriter may recommend that representatives of the issuer meet with the rating agency in their offices in San Francisco or New York.

Underwriters and investors rely upon the credit quality judgment made by the rating agencies (expressed as a credit rating). Some mutual funds, institutions, and investment trusts are restricted by law or by the terms of their organizational documents to buying securities at or above specified credit rating levels. Other investors may apply such criteria informally. Investors generally demand higher interest rates with respect to lower-rated bonds. Generally speaking, the credit rating is the most important factor in determining the interest rate on bonds relative to other issues sold at the same time. Tables 1-1 and 1-2 below describe the various credit ratings for Moody's, Standard & Poor's, and Fitch.

Bonds are generally not legally required to be rated. However, in most cases issuers find it to their advantage to obtain bond ratings because of the difficulty of selling unrated bonds. One important exception is land-secured financings, such as assessment or Mello-Roos Bonds, for districts where development has not been substantially completed at the time of the issuance of the bonds, which are commonly issued as unrated bonds. Some conduit issuers require a minimum rating in order to issue bonds as a matter of policy. For example, California's Educational Facilities Authority and Health Facilities Financing Authority require a minimum "A" rating—either through credit enhancement or on a "stand-alone" basis, although on a case-by-case basis they will permit a "BBB" or "Baa" rating if additional collateral (such as a deed of trust) is posted.

Each major rating agency maintains separate rating scales for long-term debt (generally debt with a maturity of greater than one year) and short-term debt (generally debt with a maturity of less than one year). It is possible for an issuer's short-term rating to be of a different category than its long-term rating.

Ratings are reviewed periodically by the rating agencies whether or not requested by the issuer. A review may result in the up- or downgrading of an existing rating. To perform their reviews, rating agencies expect periodic financial and other reports relating to the status of a bond issue. In the absence of such reports, they may suspend the rating of an issue.

Finally, although ratings are generally assigned only in response to a request from the issuer, the rating agencies reserve the right to assign a rating without such a request. The following tables are condensed from the rating descriptions published by each rating agency. More detailed descriptions of the ratings categories for each major rating agency are available on the rating agencies' websites. (See **Appendix B – Resources and Contacts.**)

**Table 1-1
Short-Term Tax-Exempt Debt Credit Rating Definitions**

Rating	Moody's	Rating	S&P	Rating	Fitch Ratings
MIG-1/ VMIG-1	MIG-1 - Superior credit quality. Excellent protection afforded by established cash flows, highly reliable liquidity support, or demonstrated broad-based access to the market for refinancing.	SP-1	Strong capacity to pay principal and interest. An issue determined to possess a very strong capacity to pay debt service is given a plus (+) designation.	F1	Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments.
	VMIG-1 – Superior credit quality. Excellent protection afforded by the superior short-term credit strength of the liquidity provider and structural and legal protections that assure the timely payment of purchase price on demand.	A-1	Degree of safety regarding timely payment is strong. Those issues determined to possess extremely strong safety characteristics are denoted by a plus (+) sign.		
MIG-2/ VMIG-2	MIG-2 -Strong credit quality. Margins of protection are ample although not as large as in the preceding group.	SP-2	Satisfactory capacity to pay principal and interest, with some vulnerability to adverse financial and economic changes over the term of the notes.	F2	Good credit quality. A satisfactory capacity for timely payment of financial commitments, but the margin of safety is not as great as in the case of the higher ratings.
	VMIG-2 – Strong credit quality. Good protection afforded by the strong short-term credit strength of the liquidity provider and structural and legal protections that ensure the timely payment of purchase price on demand.	A-2	Capacity for timely payment on issues with this designation is satisfactory. However, the relative degree of safety is not as high as for issues designated 'A-1.'		
MIG-3/ VMIG-3	MIG-3 - Acceptable credit quality. Liquidity and cash flow protection may be narrow, and market access for refinancing is likely to be less well-established.	SP-3	Speculative capacity to pay principal and interest.	F3	Fair credit quality. The capacity for timely payment of financial commitments is adequate; however, near-term adverse changes could result in a reduction to noninvestment grade.
	VMIG-3 – Acceptable credit quality. Adequate protection is afforded by the satisfactory short-term credit strength of the liquidity provider and structural and legal protections that ensure the timely payment of purchase price on demand.	A-3	Issues carrying this designation have an adequate capacity for timely payment. However, they are more vulnerable to the adverse effects of changes in circumstances than obligations carrying the higher designations.		

(Table 1-1 continued on next page)

**Table 1-1
Short-Term Tax-Exempt Debt Credit Rating Definitions (continued)**

Speculative Grade (SG)	<p>MIG–SG Speculative grade credit quality. May lack sufficient margins of protection.</p> <p>VMIG–SG Speculative grade credit quality. Demand features rated in this category may be supported by a liquidity provider that does not have an investment grade short-term rating or may lack the structural and/or legal protections necessary to ensure the timely payment of purchase price upon demand.</p>	B	Only speculative capacity for timely payment.	B	Speculative. Minimal capacity for timely payment of financial commitments, plus vulnerability to near-term adverse changes in financial and economic conditions.
		C	Doubtful capacity for payment.	C	High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon a sustained, favorable business and economic environment.
		D	Default.	D	Default. Denotes actual or imminent payment default.

**Table 1-2
Long-Term Tax-Exempt Debt Credit Rating Definitions²**

Rating	Moody's	Rating	S&P	Rating	Fitch Ratings
Aaa	Demonstrates the strongest creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	AAA	Highest rating. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.	AAA	Highest credit quality. Assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
Aa	Demonstrates very strong creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	AA	Differs from the highest rated obligation only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.	AA	Very high credit quality. Very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A	Present above-average creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	A	Somewhat more susceptible to the adverse effects of change in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.	A	High credit quality. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
Baa	Demonstrates average creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	BBB	Adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.	BBB	Good credit quality. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.

(Table 1-2 continued on next page)

² Moody's appends the numerical modifiers 1, 2, and 3 to each generic rating category from Aa through Caa. Modifier 1 indicates that the issuer or obligation ranks in the higher end of its generic rating category; modifier 2 indicates a mid-range ranking; and modifier 3 indicates a ranking in the lower end of that generic rating category. Standard & Poor's and Fitch use a +/- or no modifier much in the same way.

**Table 1-2
Long-Term Tax-Exempt Debt Credit Rating Definitions (continued)**

Rating	Moody's	Rating	S&P	Rating	Fitch Ratings
B	Demonstrates weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	B	More vulnerable to nonpayment than obligations rated 'BB,' but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.	B	Highly speculative. Indicates significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
Caa	Demonstrates very weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	CCC	Currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.	CCC	High default risk. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments.
Ca	Demonstrates extremely weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	CC	Currently highly vulnerable to nonpayment.	CC	Default is probable.
C	Demonstrates the weakest creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	C	Subordinated debt that is highly vulnerable to nonpayment. Bankruptcy petition may have been filed, but payments are being continued.	C	Imminent default.
		D	Default.	DDD DD D	Default. The ratings of obligations in this category are based on their prospects for achieving partial or full recovery in a reorganization or liquidation of the obligor.

TRUSTEE/FISCAL AGENT/PAYING AGENT/REGISTRAR/AUTHENTICATING AGENT

An issuer customarily selects one or more commercial banks or trust companies to perform one or more of several administrative duties relating to a bond issue. Historically, an issuer may have received, held, and disbursed the bond proceeds itself, and collected, held, and paid debt service on the bonds with the revenues pledged as security for the bonds. However, today, relatively few issuers have the banking capabilities and relationships necessary to perform those services themselves. In addition, investors are comforted by the involvement of a fiduciary acting on their behalf and holding the funds and accounts relating to the bond issue.

As a result, many bond resolutions and indentures appoint a trustee or fiscal agent to perform a number of duties relating to the bond issue. In performing those duties, a trustee acts in a fiduciary relationship to both the issuer and the bondholders, since both are beneficiaries of the trust established by the bond indenture. By contrast, a fiscal agent or paying agent is not a trustee, but merely acts as an agent of the issuer to perform functions necessary to comply with the requirements of the documents.

A trustee or fiscal agent may perform one or more of the following duties:

- As trustee—establishing and holding the funds and accounts relating to the bond issue, including accounts for bond proceeds and revenues, determining that the conditions for disbursement of proceeds and revenues have been met, and, in some cases, collecting revenues and executing investments
- As bond registrar—maintaining a list of the names and addresses of all registered owners of the bonds and recording transfers and exchanges of the bonds
- As authenticating agent—authenticating bonds upon initial issuance or upon transfer or exchange
- As paying agent—paying interest on the bonds by check or wire to the respective registered owners, and paying principal of the bonds to the registered owners upon surrender of the bonds at maturity or upon earlier redemption
- As trustee—protecting the interests of bondholders by monitoring compliance with covenants and acting on behalf of bondholders in the event of default
- As escrow agent—holding the investments acquired with the proceeds of an advance refunding and using payments on those investments to pay debt service on the re-funded bonds
- As dissemination agent—acting on behalf of the issuer or other obligated person to disseminate annual reports and event notices to repositories under SEC Rule 15c2-12
- In several of the above capacities—mailing required notices to bondholders
- Acting as a liaison to bondholder committees (in the event of a default or workout situation)

These functions are not necessarily always performed by the same bank or trust company and, in some instances, may be performed by more than one such entity.

Workout. In the event that any problem arises with respect to the bonds, such as a shortfall in revenues needed to make the payments, the trustee is usually called upon to play a key role. In particular, because the trustee acts as fiduciary for the bondholders, the trustee must decide the nature, extent, and timing of information to be provided to bondholders concerning the problem. Also, the trustee generally acts as the liaison to the bondholders, particularly when a decision needs to be made about restructuring the debt or making only a partial repayment. Issuers should be aware that trustees have contractual duties to bondholders in the event of a problem and are prepared to act pursuant to the terms of the documents if and when a problem arises.

CREDIT ENHANCEMENT PROVIDER

“Credit enhancement provider” and “credit provider” describe any entity that guarantees or insures in one form or another the sufficiency of revenues to pay the bonds. A credit enhancement provider may be a bank providing a letter of credit, or a bond insurer providing a bond insurance policy or, in the case of certain types of bonds to finance lending programs, the credit enhancement provider may be a savings and loan association, a mortgage insurer, a federal agency, or a private guarantor. In each case the purpose of the credit enhancement is to provide, for a fee, additional security for the bonds that improves the credit rating of the bonds and thereby lowers the borrowing costs to the issuer. In essence, the higher rating of the provider is relied on by investors rather than the underlying rating of the issuer, so that the investors will demand a lower interest rate, more than compensating for the cost of the credit enhancement. Normally, credit enhancement only makes sense where the savings from the credit enhancement exceed the cost of the credit enhancement or where the credit enhancement facilitates the sale of a bond issue that would not otherwise be possible. Normally, the credit enhancement provider is selected by the issuer with advice from the underwriter or financial advisor.

Common types of credit enhancement include:

Bond Insurance. Bond insurance is represented by a bond insurance policy that insures the timely payment of scheduled principal and interest on the bonds. The policy is customarily not subject to cancellation for the entire term of the bonds. The premium for bond insurance is payable at the time the bonds are issued, but also may be payable as an annual fee. Bond insurance often results in a AAA rating for the issue.

Municipal bonds are typically insured by “mono-line providers” or companies that specialize in insuring only investment grade debt securities (as opposed to companies that provide property and casualty or automobile insurance). These companies carry the highest credit ratings because of their financial strength and liquidity. Four long-established guaranty companies—Ambac, FGIC, FSA, and MBIA—control the majority of the market, along with XL Capital Assurance, CDC IXIS Financial Guaranty, ACE Guaranty Corp., and Radian Asset Assurance Inc.

Almost half of the outstanding municipal bond issues in the United States, both fixed and variable, currently have bond insurance. Bond insurance also is utilized in connection with swap and other derivative transactions.

Letter of Credit. A letter of credit issued by a bank will customarily provide that the trustee or fiscal agent may draw on the letter of credit when necessary to make payments of principal and/or interest on the bonds. The issuer (or, in the case of some bond issues for lending programs, the nongovernmental borrower) agrees to reimburse the bank for each such draw. Generally, the letter of credit will be irrevocable for a specified term, which may or may not be the entire term of the bonds. Ordinarily, there is both an initial fee and an annual fee for the letter of credit. In some cases letters of credit are issued by nonbank financial institutions, such as the State Teachers' Retirement System.

Line of Credit. A line of credit is a standby obligation of a bank to make payments with respect to debt service on bonds if the issuer (or borrower in a conduit financing) fails to do so. It is not as secure from a bankruptcy point of view as a letter of credit and therefore is used infrequently except as a liquidity facility (see below) where the issuer or borrower has an underlying investment grade rating.

Mortgage Insurance. An alternative form of credit enhancement in the case of lending programs is mortgage insurance provided by a federal or state agency or a private mortgage insurance company. Mortgage insurance insures payment of principal and interest by the borrowers in a lending program, such as a single-family or multifamily loan program.

Private Guarantor. Similarly, a private guarantor may guarantee payment of principal and interest on a loan agreement under which the principal borrower agrees to pay to the issuer amounts sufficient to pay principal and interest on the bonds. For example, the parent company of a corporate borrower might agree to guarantee the borrower's loan agreement payments.

Liquidity Facility. Finally, credit enhancement should be distinguished from the provision of liquidity. The holders of certain types of variable rate bonds have the option, after a specified notice period, to "put" the bonds (that is, to sell the bonds) back to the issuer or to another specified entity. Often, the issuer will arrange for a bank or other guarantor to provide a liquidity facility, to provide to the issuer the amounts necessary to purchase bonds which are put in this fashion and not able to be resold to another investor. A liquidity facility can take the form of a "standby bond purchase agreement" under which the bank agrees to purchase any bonds that are put by investors but cannot be remarketed.

NONGOVERNMENTAL BORROWER

In California, various issuers are authorized to issue bonds and lend the proceeds to one or more nongovernmental borrowers to finance facilities the development of which is deemed to be a public purpose. Such facilities include, among others:

- Single-family housing

- Multifamily housing
- Student loan programs
- Hospitals and other health care facilities
- Educational facilities
- Pollution control facilities
- Solid waste facilities
- Power facilities
- Airports, seaports, and marinas
- Certain kinds of sports facilities
- Certain other types of industrial or commercial facilities

In each case, the criteria for qualification as a borrower are derived from state constitutional and statutory criteria, the issuer's own policy requirements, and, in the case of federally tax-exempt bonds, federal tax requirements. Such financings are often called conduit financings and the nongovernmental borrowers are often called conduit beneficiaries. Generally, the nongovernmental borrower and any credit enhancement provided by or on its behalf, are the only sources of revenues for repayment of the bonds.

In some cases, the nongovernmental borrower will take a very active role in designing and negotiating the terms of the bonds. In others, for example in the case of single-family lending programs, nongovernmental borrowers are not directly represented, but establish a market in which the lending program must operate. However, in all cases, the issuer is the central figure in a financing.

INVESTORS

A bond financing structure must meet not only the needs of the issuer, but also the needs of the investor. Target investors in a bond financing have considerable influence in determining the features and structure of the bonds.

Over five million households own municipal bonds either directly or through institutional portfolios, including mutual funds, unit investment trusts, and bank trust accounts. The investment market for municipal bonds is one of the world's largest securities markets with approximately \$2 trillion worth of municipal bonds in the hands of investors. There are more than 50,000 state and local entities that issue municipal securities, and two million separate bond issues outstanding. Generally, however, investors in tax-exempt bonds have one characteristic in common—the ability to take advantage of the exemption from federal income taxes customarily applicable to interest on municipal bonds.

Retail Investors. Retail investors typically are individuals with high net worth who achieve the tax exemption from federal and, in some cases, state income taxes. These retail investors tend to be highly sophisticated clients of the organizations involved in the underwriting and remarketing of tax-exempt issues.

Institutional Investors. Institutional investors, such as tax-exempt bond and money market funds, also are major players in the market for municipal securities. National municipal bond funds invest primarily in the bonds of various municipal issuers in the United States. These funds seek interest income free from federal tax. State municipal bond funds invest primarily in municipal bonds issued by a particular state. These funds seek high after-tax income for residents of individual states. Tax-exempt money market funds invest in short-term municipal securities and must have average maturities of 90 days or less. These funds seek the highest level of income—free from federal and, in some cases, state and local taxes—consistent with preservation of capital.

As of 2003, there were 527 state municipal bond funds, 251 national municipal bond funds, and 312 tax-exempt money market funds.

Both retail and institutional buyers may have slightly different investment objectives in the purchase of municipal securities. Thus it is important for the issuer and underwriter to recognize these market nuances when pricing and marketing the bond issue.

Major changes in the composition of the municipal bond market are the result, in large part, of changes in federal tax law which made tax-exempt interest less attractive to certain segments of the market. For example, banks historically constituted a large segment of the market for municipal bonds but they are now denied a federal tax deduction for the portion of interest paid on their own obligations (such as deposits) attributable to the carrying of tax-exempt bonds. Similarly, changes in federal tax law may adversely affect the attractiveness of municipal bonds to property and casualty insurance companies and to corporations and individuals with alternative minimum tax liability. Other entities such as pension funds and certain other tax-exempt entities have never been attracted to municipal bonds because of the inability to take advantage of the tax exemption (since their income is already tax-exempt). Conversely, the segment of the municipal bond market represented by bond funds and bond trusts is growing, as more and more investors take advantage of the ability to invest through mutual funds, including tax-exempt money market funds.

Suitability. In addition to the tax exemption, other criteria that serve as primary determinants of the suitability of a particular bond for a particular investor include the credit quality of the bond (credit rating), its term to maturity, its risk of redemption, and its potential for sale in the secondary market. It is critical that broker dealers offering bonds to investors match up the sophistication, risk tolerance, and economic situation of a potential investor with the structural features, liquidity, and credit quality of the bonds being offered. The securities laws require that broker dealers take these factors into account when offering and selling bonds. It is important for issuers to know what suitability considerations a broker dealer will use in selling the issuer's bonds.

The relative demand by investors for bonds having different characteristics may influence the financial advisor's or the underwriter's recommendations concerning the structure of a financing. For example, in a market where short-term, high credit quality bonds are in great demand, it may be advantageous for an issuer to issue variable rate put bonds rather than long-term fixed rate bonds. Or, in periods of relatively high interest rates, investors may demand that bonds not be redeemable prior to maturity (or be redeemable only after an extended period of time) to assure investors that they will have the benefit of the high interest rate and not run the risk of having to reinvest at a time when the market offers lower interest rates.

Suitability rules play a role in determining what securities a broker-dealer or underwriter may recommend to an investor. Historically the SEC has deferred to self-regulatory organizations to regulate this conduct. Under suitability rules used by the NASD (National Association of Securities Dealers), the NYSE (New York Stock Exchange), and the MSRB the members or the securities dealer must have some basis for believing that any particular security that they recommend is suitable for the customer on the basis of facts disclosed by the customer. The MSRB suitability rule (Rule G-19) is considerably more stringent than those of the NASD and the NYSE and imposes on the municipal securities dealer an affirmative duty to have knowledge or inquire about the "customer's financial background, tax status, and investment objectives and any other similar information."

As a result, in each financing, the issuer and its financing team members must design the financing structure to meet the needs of the issuer in the context of the investor market for the issuer's debt. See **Chapter 10, Continuing Disclosure and Investor Relations Programs** for more information.

INVESTMENT ADVISOR

In many cases, issuers will wish to retain an investment advisor to assist them in investing bond proceeds. (See **Chapter 11, Investment of Bond Proceeds** for more information on the considerations that should be taken into account in determining appropriate investments.) Often the financial advisor or underwriter will act as an investment advisor with respect to the bond proceeds, but the issuer also may use a separate advisor. In some cases, the members of the issuer's staff have substantial investment experience and will handle this task "in-house."

REBATE COMPLIANCE CONSULTANT

Arbitrage Yield Restriction. The tax code generally prohibits municipalities from issuing tax-exempt bonds if the issuer reasonably expects to use the proceeds of such bonds, directly or indirectly, to acquire securities or obligations with a yield materially higher than the yield on such bonds, or to replace funds used to acquire such higher yielding securities or obligations. Thus, the tax code generally restricts the rate of return on investments purchased with gross proceeds to a yield that is not materially higher than the yield on the bonds.

As described in **Chapter 3, General Federal Tax Requirements**, exceeding the arbitrage yield restriction requires the issuer to rebate the difference to the IRS. The rebate requirement applies to most tax-exempt bond financings. Depending on the attributes of the financing, computing the correct amount of rebate to be paid to the Internal Revenue Service (or confirming that

nothing needs to be paid) can be very complicated and time-consuming. Issuers should consider and discuss with members of the financing team the most cost-effective way of satisfying the rebate requirement. Complying with the rebate requirement is a post-closing responsibility of the issuer (or possibly the nongovernmental borrower) and not the responsibility of other members of the financing team. In general, the best economic decision will be to maximize the investment earnings on the proceeds of the bond financing and engage a qualified rebate compliance consultant to perform periodic calculations. In addition, a qualified rebate compliance consultant may be able to suggest ways to avoid paying a rebate while maximizing the investment earnings on bond proceeds, subject to the issuer's investment policies. For more information on arbitrage restrictions and rebate requirements, see CDIAAC's *California Public Fund Investment Primer, Chapter 4: Other (Non-Surplus) Fund Investment*.

USING A REQUEST FOR PROPOSALS TO SELECT FINANCING TEAM MEMBERS

DEFINITION AND PURPOSES

A request for proposals (RFP) is a formalized method of soliciting information concerning the qualifications, experience, and proposed compensation arrangements of the various potential participants in a debt financing. This information is then used by the issuer to select the financing team member for the position under consideration.

RFPs are used for a variety of formal and informal reasons, including:

- Obtaining comparative information on qualifications, experience, and price
- Obtaining information about the availability of particular professionals to participate in the financing
- Providing a selection process that is perceived as fair
- Obtaining new ideas concerning potential financing structures
- Providing a formalized transition from existing consulting relationships to new relationships

Whether an RFP is necessary or not in any given case may be determined by statute, ordinance, or local practice or may be entirely subject to issuer discretion. As discussed below, use of an RFP may in some cases be viewed as unnecessary or inappropriate.

REQUEST FOR PROPOSAL PROCESS

The steps in the RFP process include:

- Preparation of the RFP so that it solicits information relevant to the selection and financing process
- Advertisement of the RFP in a manner designed to produce responses from the target market

- Response by potential respondents consisting of proposals submitted to the issuer
- Evaluation of the written responses
- Interviews of finalists, if necessary
- Negotiation of the final arrangements with the participant selected

COMPONENTS OF AN RFP

The objective of an RFP is to produce responses that will provide the basis for selecting a financing team member. To achieve that objective an RFP should contain at least the following components:

- Scope of work description of the services for which proposals are being solicited and the approximate size of the financing
- Experience of the issuer with similar projects, and the nature of the funding available for the project
- Information submissions from each respondent to enable the issuer to evaluate the respondent's qualifications
- Procedural rules governing responses
- Required contract terms to which the successful respondent will have to agree
- Criteria to be used in evaluating responses
- Evaluation procedure to be used by the issuer

Scope of Work. The description of the services to be provided may be either general or quite specific. If general (for example, “the services customarily provided by an underwriter in a negotiated offering of municipal bonds”), the RFP should ask each respondent to provide a more detailed description of the services to be provided under the proposal. If the description in the RFP is more detailed, the issuer may ask respondents to suggest any modifications in the description of services that the respondents might deem necessary or appropriate. If the services desired vary from what might be called customary, that variance should be clearly specified. The approximate size of the financing provides potential respondents with an idea of the magnitude of the proposed project or program.

Request for Information on Qualifications. This component often contains three subparts:

- Respondents should be requested to provide information concerning the experience and expertise of the firm and the individuals who would be responsible for the work on the financing.

- The issuer may want to formulate a series of specific questions designed to elicit from respondents proposed solutions to unusual (or common, for that matter) problems posed by the financing, or to elicit, more generally, proposed structures for the financing.
- Respondents should be requested to provide proposed compensation arrangements. Issuers may want to specify that certain parameters must be included within such arrangements. For example, must compensation be contingent upon the issuance of the debt? Are certain types of compensation arrangements not considered appropriate by the issuer?

Procedural Rules for Responses. The RFP should specify any requirements concerning the format of each proposal. These requirements might include:

- The number of copies to be submitted
- Whether pricing information should be submitted separately from other aspects of the proposal
- A contact person at the issuer to whom questions concerning the RFP should be directed, a cutoff date for such inquiries, and whether answers will be generally available
- Any published rules by which the RFP process will be conducted
- Limitations on communications between respondents and officials or staff of the issuer during the period prior to completion of the process

Required Contract Terms. The RFP should specify any contract terms required by the issuer, for example, nondiscrimination or affirmative action clauses, conflict of interest covenants, labor certifications, and any standard form contract requirements.

Criteria for Evaluation of Responses. The RFP should specify the criteria to be used to select the winning respondent and should indicate, at least in general terms, the relative weighting to be given to each criterion. The dimensions for evaluation may include the following:

- Qualifications and experience of the proposing firm
- Qualifications and experience of the individuals responsible for the financing
- Quality of responses to questions concerning financing structure or unusual problems posed by the financing
- Responsiveness of the proposal to the unique circumstances and needs of the issuer and the requirements of the financing
- Proposed pricing arrangements

- Results of interviews (if any) of finalists

Description of Procedure for Evaluation of Proposals. The RFP should describe the process by which the issuer will make its selection, include a timetable for selection of finalists (if any), the general period in which interviews will be held (if any), the officials of the issuer responsible for evaluating responses and making the decision, and any period for protest of the intent to award.

SELECTING TEAM MEMBERS WITHOUT AN RFP

Many of the objectives of using an RFP can be accomplished without resorting to the use of an RFP. For example, the issuer can obtain comparative price data by informally asking for it, by calling other issuers who are using other professionals, by asking a financial advisor for a breakdown of underwriting compensation in comparable cases, and so on. Price control can then be achieved by direct negotiation with the professionals with whom the issuer has established relationships, rather than by competition through the use of an RFP. As another example, comparative data concerning experience can be obtained by reviewing CDIAC's calendar of financings published in *Debt Line*, or by reviewing the data published in periodicals, such as the *Bond Buyer*, or by consulting with participants already selected.

The RFP process should not be perceived as a perfect solution to the problem of selecting qualified participants in a debt financing. The information obtained in the course of the RFP process may be incomplete or imperfect in many respects. Respondents may portray themselves in the best possible light and often gloss over their own inadequacies. Not all of the costs of selecting and using a particular participant may be described by that participant when responding to an RFP. For example, the interest costs of an inefficiently designed financial structure may dwarf any savings resulting from differences in the quoted management fee or total underwriting spread. Issuers should be aware that costs associated with any delay resulting from inattention or lack of responsiveness, that in turn results from inadequate compensation, may far outweigh the savings from the lowered compensation if the lowest proposed compensation is the primary selection criterion. Unlike a professional with an established relationship with the issuer, consultants may have a "short-timer's view," which results in a lack of loyalty to the issuer; they may also be short on knowledge of the issuer's circumstances, historical financing programs, and needs.

Finally, the RFP process takes time and, for whatever reason, it may not fit within the issuer's financing timetable.

PERFORMANCE EVALUATION

Evaluation of the performance of members of the financing team is a necessary part of the epilogue to any financing—not just a financing for which team members were selected by an RFP. The ultimate criterion is, of course, the end result. Did the financing accomplish the objective of providing monies for a project or program, with cost and risk appropriately balanced and minimized under the circumstances, taking into account whether the financing was for a governmental purpose or was a conduit issue? The end result necessarily is a product of all of the team members, including the issuer. Individualized criteria need to be used to assess the

contributions of each team member to the financing. Generally, those criteria will be, at least in part, the same criteria that would have been used to evaluate responses to an RFP for that team member. Did the participant demonstrate and apply the expertise and experience necessary to accomplish the tasks at hand?

Certain criteria are, however, generally applicable to each financing team member:

- Was input (documents, information, ideas and so on) timely and responsive to the needs of the situation?
- Were any problems resolved in a timely, cost effective, and appropriate way?
- Was the staff of the issuer kept advised of and involved in the proceedings?
- Were the issuer's interests advanced appropriately?
- Did participants keep the promises they made?
- Was the working group effective, professional, and cooperative?
- Did the appropriate team members demonstrate leadership at appropriate times?
- Was the price of the services provided within the range promised by the participant or was there adequate explanation for any deviation?
- Finally, would the issuer engage the participant again for the same purpose?

The evaluation process can be as formal or informal as the issuer desires (or as may be required by any applicable procedures). Feedback to the participants is important, however, particularly with respect to an established relationship in which problems are encountered. An early mention of any such problems may go a long way toward resolving them. Of course, positive feedback is as warranted as negative. The individuals involved in providing financial and legal services operate in a competitive environment and greatly appreciate (when deserved) an expression of appreciation for a job well done.

BASIC LEGAL DOCUMENTS

Listed in this section of the *Primer* are the basic legal documents found in most public finance transactions, together with an explanation of their purpose, the party who typically drafts the documents, and the most critical sections (from the issuer's perspective) of the documents. The reader should be aware that the wide variety of types of transactions currently undertaken in the public finance arena makes it impossible to describe every possible configuration of legal documentation. In addition, while the roles of the various team members, as discussed above, fall into identifiable patterns, the roles are not inflexible and often change to fit the particular circumstances of the transaction. Accordingly, the following should be viewed as a general guide to the typical documentation, but variations, even substantial ones, are not uncommon nor do they necessarily pose any cause for concern.

Under each type of document, there is a list of the substitute documents that may be employed in a given transaction, the definition and purpose of the document, the principal drafter, the parties, and the critical provisions for issuer review. This last category is included but with a cautionary note, as it is important for each party to a document to carefully review all sections of each document they sign. Moreover, in different financings, different sections may be more or less critical. Therefore, this discussion should only be used as a starting point for issuer review, and not as a shortcut to enable the responsible staff person to skip any section of a document being signed by his or her principals. Parties should always consult with their counsel and bond counsel concerning the effect of provisions in the documents and should not be satisfied unless they completely understand the answers they are given.

INDENTURE

Substitutes: Trust Agreement, Fiscal Agent Agreement, Bond Resolution, or Bond Ordinance

Definition and Purpose: The indenture is the basic security document of a bond transaction. It provides the terms of the bonds, including payment dates, maturities, redemption provisions, registration, transfer, exchange, etc. The indenture creates the legal structure for the security for the bonds, including:

- Creation and granting of the trust estate
- Pledge of revenues and other collateral
- Affirmative negative covenants (e.g. covenant to maintain facilities)
- Negative covenants (e.g. covenant not to pledge facilities/revenues to other debt)
- Default and remedy provisions
- Flow of funds (establishing the priority for uses of pledged revenues)
- Parity debt provisions (for issuance of additional bonds in the future)
- Defeasance provisions (to allow for refunding of the bonds)
- Trustee-related provisions—providing for removal of the trustee and appointment of a new trustee, compensation, indemnification, and rights and obligations of the trustee

Principal Drafter: Bond counsel

Parties: Issuer, trustee

Critical Provisions for Issuer Review: Definitions of permitted investments and revenues; scope of trust estate and pledged collateral; payment and redemption terms of bonds (e.g. interest payment dates, maturities, redemption restrictions); additional bonds test; flow of funds with special consideration to retaining the flexibility needed to use funds not otherwise

needed for debt service; reserve fund provisions; covenants; default and remedy provisions; defeasance provisions.

LOAN AGREEMENT

Substitutes: Installment Sale Agreement, Facilities or Project Lease

Definition and Purpose: The loan agreement is the document under which the bond proceeds are lent or otherwise provided for the project being financed and the user of the proceeds agrees to repay the amount of the bonds, plus interest. Used in certificate of participation (COP) financings (typically an installment sale agreement or lease) or in bond financings where the issuer is not the source of repayment on the debt. Provides for payment of loan, installment sale, or lease payments sufficient in time and amount to pay debt service on the bonds. Contains representations and warranties, covenants, and default and remedy provisions. May contain pledge of revenues and/or other collateral. For installment sale agreements and leases, provides for vesting of title to property.

Principal Drafter: Bond counsel

Parties: Conduit borrower/obligor, issuer

Critical Provisions for Issuer Review: Representations and warranties; covenants (especially financial covenants and insurance coverage covenants); prepayment provisions; pledge provisions; title provisions; abatement provisions (in leases).

AUTHORIZING RESOLUTION(S)

Substitute: Authorizing Ordinance

Definition and Purpose: Authorizes issuance and sale of bonds, authorizes execution and delivery of documents, and directs staff to take other actions necessary to complete financing.

Principal Drafter: Bond counsel or issuer's counsel

Party: Issuer

Critical Provisions for Issuer Review: Parameters for delegation of authority to sell bonds (i.e. maximum interest rate, discount, etc.); maximum par amount and term of bonds. Conformance to issuer's standard form of resolution.

BOND PURCHASE AGREEMENT

Substitutes: Official Notice of Sale and Bid Form (competitive sales), Placement Agreement (private placements)

Definition and Purpose: Provides for the sale of the bonds to the underwriter; specifies discount, interest rates, and terms for payment of purchase price; contains representations and

warranties of the issuer; contains conditions precedent to underwriter's obligation to purchase the bonds at closing; specifies documents to be delivered at closing; specifies who will pay expenses.

Principal Drafter: Underwriter's counsel or disclosure counsel

Parties: Underwriter, issuer, conduit borrower

Critical Provisions for Issuer Review: All those listed under definition and purpose above.

OFFICIAL STATEMENT

Substitutes: Offering Memorandum, Limited Offering Memorandum

Definition and Purpose: The Official Statement is the document that provides disclosure to investors and potential investors. Under federal securities laws, the issuer (and the borrower, if there is one) are obligated to disclose in this document all information that a "reasonable investor" would consider important in deciding whether to purchase a bond. This would include terms of bonds, security, risk factors, financial and operating information concerning issuer, and background information. Most financings are required to have Official Statements under SEC Rule 15c2-12 and must comply with the Rule 10b-5 standard. The Official Statement is dated as of the date the bonds are sold and contains the final terms of the bonds. A Preliminary Official Statement, complete except for interest rates and maturities, is used to presell the bonds.

Principal Drafter: Underwriter's counsel or disclosure counsel

Party: Issuer

Critical Sections for Review: It is very important for the issuer to read the entire Official Statement as the issuer has liability for material misstatements and omissions in this document and, unlike the underwriter, does not have a "due diligence" defense. The most critical sections for issuer review are: security and sources of payment for the bonds; risk factors; financial and operating data regarding the entity responsible for payment; litigation; and general information (background) about the issuer.

CONTINUING DISCLOSURE AGREEMENT

Substitute: Continuing Disclosure Certificate

Definition and Purpose: The continuing disclosure agreement contains the undertakings of the issuer (and any obligated persons) to provide ongoing disclosure in the form of annual reports and event notices pursuant to SEC Rule 15c2-12. The undertakings must be made for the benefit of and be enforceable by the holders of the bonds. The undertakings must remain in place for the life of the issue, with certain exceptions for pool bonds.

Principal Drafter: Underwriter's counsel, disclosure counsel, or bond counsel

Parties: Issuer, obligated persons, trustee

Critical Provisions for Issuer Review: Contents of annual reports; deadline for filing annual reports; listed event notices; amendment provisions.

REIMBURSEMENT AGREEMENT

Substitute: Financial Guaranty Agreement (used for Bond Reserve Surety Policies)

Definition and Purpose: The reimbursement agreement appears in transactions involving a letter of credit or surety policy guaranteeing payment on the bonds or draws against the reserve fund, respectively. The reimbursement agreement contains the obligation to repay the letter of credit bank (or surety provider) amounts drawn on the credit facility. Terms and conditions vary depending upon the type of transaction involved.

Principal Drafter: Bank counsel, surety provider counsel

Parties: Issuer, bank (or surety provider), and trustee in some cases

Critical Provisions for Issuer Review: Representations and warranties; fees payable to bank (including “increased costs” provisions); ability of bank to “participate” the credit facility to other banks; renewals and extensions of the credit facility; default and remedy provisions, including any “term-out” provisions; collateral provisions; choice of law provisions.

TAX CERTIFICATE

Substitutes: Tax Agreement, Arbitrage or Non-arbitrage Certificate

Definition and Purpose: The tax certificate contains certifications required to be made by the issuer, and in case of a conduit issue, the borrower, in order to satisfy the requirements of the Internal Revenue Code and the regulations issued thereunder for the bonds to be tax-exempt. It also may contain certain elections required to be made under the Internal Revenue Code at the time of bond issuance. Tax certificates also describe the rules applicable to the investment of bond proceeds under federal tax law, as well as the agreements of the issuer and obligors as to rebate compliance and investment and use of funds. For a more detailed analysis of these rules, see the chapter entitled **Chapter 3, General Federal Tax Requirements**.

Principal Drafter: Bond counsel

Parties: Issuer, borrower

Critical Sections for Review: Varies greatly depending on type of issue, but always should review “use of proceeds” section. Consult bond counsel.

CLOSING DOCUMENTS

Substitutes: None

Definition and Purpose: Closing documents is the term generally used to describe the certificates, receipts, written directions and requests, requisitions, and similar documents that are delivered at the closing of an issue. These documents generally accomplish the following:

- Document the factual representations required by the purchase contract (generally, these are contained in certificates and letters of representation) and the accuracy and completeness of portions of the disclosure (such as feasibility reports or appraisals)
- Document compliance with the requirements of law and contract for the issuance of the bonds (including effectiveness of resolutions, due execution of documents, etc.)
- Document the flow of funds at closing, i.e. the deposit and receipt of bond proceeds, investments of funds, payment of costs, defeasance of prior bonds (in the case of refundings)
- Instruct parties to take certain actions upon closing, i.e. deposit funds in accounts, record documents, file reports, release security (in the case of refundings), etc.

The closing documentation is designed to document all of the factual issues required in order to allow bond counsel to deliver its opinion.

Principal Drafter: Bond counsel

Parties: All parties to transaction

Critical Provisions for Issuer Review: Accuracy of all amounts for receipt and deposit of funds; accuracy of representations, warranties, and certifications. All requisitions should be reviewed to determine correctness of payments, deposits, and transfers.

Chapter 2

CHECKLIST OF STEPS IN A DEBT FINANCING

This chapter describes the five steps, along with their timeframes and responsibilities, that may be used as a general guideline when undertaking a financing.

The legally required procedural steps vary widely among the different types of public debt financing. For example, some types of debt require voter approval, some require approval by ordinance subject to referendum, while others may be approved by simple resolution of the governing body of the issuer. Some types of debt require action (such as the granting of a Volume Allocation under federal tax rules) by official bodies other than the issuer and others need only be approved by the issuer.

Nevertheless, much of the process is common to virtually all types of public debt. Broadly speaking, the issuer must undertake the following steps:

- Determine that a project or program to be financed is necessary or desirable
- Select the financing team
- Structure the financing
- Obtain formal approval by the governing body of the issuer and, in applicable, conduit borrower
- Market and close the issue

The issuer also must live with the issue after the closing. The post-closing issuer responsibilities include:

- Ensuring that continuing disclosure undertakings are fulfilled
- Responding to investor inquiries
- Calculating and filing arbitrage rebate returns
- Administering any assessments or special taxes securing the issue
- Administering any construction or acquisition programs

- Complying with ongoing covenants
- Dealing with any workout-related issues

These steps are not independent and are not entirely sequential. For example, the legal and financial feasibility of a particular method of securing the bond issue under a proposed financing structure may determine whether the proposed project is feasible, and, therefore, whether the project and financing will be undertaken. The possibility of political controversy or legal action also may play into the feasibility analysis. As a result, a preliminary analysis of the feasibility of each step may be necessary prior to undertaking any of the steps in the proposed financing, and that preliminary analysis may involve informal consultation with experts prior to selection of the project team.

This chapter outlines many of the common steps in a public debt issue. Because of the variables which may be present in different financings, the reader should be aware that steps may be accomplished in a different order and, in some cases, the time required may be more or less than indicated.

The chronology outlined in this section is broadly applicable to financings that are public offerings (not private placements) of debt being issued to finance a project (either governmental or nongovernmental) or a lending program (such as a single-family mortgage program). Although the process for a private placement or for tax and revenue anticipation notes is similar, this discussion does not cover steps that may be unique to those types of financings. In general, the word “project” is used rather than “program” to describe the purpose of the issue.

The description below of each step indicates the members of the team commonly responsible for completing the step by using the abbreviations described in the following table.

**Table 2-1
Responsible Team Members**

I	Issuer
FA	Financial Advisor
SA	Swap Advisor
BC	Bond Counsel
UW	Underwriter
UC	Underwriter's Counsel
NB	Nongovernmental Borrower
T	Trustee/Fiscal Agent
RC	Rebate Compliance Consultant
IA	Investment Advisor

The team members that actually perform the steps in any given financing may vary. For example, if the debt is to be sold at negotiated sale and no financial advisor is engaged by the

issuer, the tasks indicated as being performed by the financial advisor will generally be performed by the underwriter. Conversely, in a competitive sale, the tasks performed by the underwriter (except for the actual purchase and distribution of the bonds) will normally be performed by the financial advisor. Also, if disclosure counsel is employed, they may perform many or all of the tasks indicated as being performed by underwriter's counsel. A nongovernmental borrower will only be present for certain types of conduit financings.

STEP 1

DETERMINATION THAT A PROJECT (OR PROGRAM) TO BE FINANCED IS NECESSARY OR DESIRABLE

(Time: one week to three years)

This initial step in the financing process is potentially the most time-consuming because this when the basic business decisions regarding the project—its scope, cost, and the approach to financing—are made. Issuers should carefully consider their own policies and long-range objectives at this early stage, so that during the actual process of preparing, selling, and closing the issue, these policy decisions are firmly in place. It may be appropriate for the issuer to inquire of other agencies that have financed similar projects to get ideas and obtain the benefit of their experience. Similarly, this is the time at which any constituent input—for example, citizen’s advisory committees or neighborhood groups—should be consulted to help shape the decisions being made. Although listed before Step 2, Selection of the Financing Team, it may be necessary or desirable to identify and retain bond counsel, a financial advisor, and/or underwriter to assist with this first step as these team members may be useful in accomplishing the tasks identified below.

Governmental Projects and Programs	Nongovernmental Projects and Programs (Conduit Financings)
Defining the nature and scope of the projects.	If the financing is proposed by the nongovernmental borrower, is it the kind of project that the issuer wants to encourage and support? (I)
Technological feasibility. (I)	Public purpose (practical as well as legal). (I)
Financeability. (I, FA, UW)	Technological feasibility. (I, NB)
Statutory authorization. (BC)	Financeability. (I, FA, UW, NB)
Project and size of debt issue. (I, FA, UW)	Statutory authorization. (BC)
Available revenues or other security for repayment. (I, FA, UW, BC, SA)	Does issuer need to be created? (I, BC)
Feasibility study. (I, FA, UW)	Size of debt issue. (I, FA, UW, NB)
Credit support. (I, FA, UW)	Available revenues or other security for repayment. (I, NB, BC)
Are other approvals necessary?	Feasibility study. (I, FA, UW)
Voter approval. (I, BC)	Credit support. (I, FA, UW, NB)
Federal permits or grants. (I)	

Governmental Projects and Programs	Nongovernmental Projects and Programs (Conduit Financings)
State permits, allocations or grants. (I, BC)	Should the issuer actively market its ability to finance certain types of projects? (I, FA, UW)
Local land use permits. (I)	Analyze the likelihood of political controversy or litigation in opposition to the financing. (I, NB, BC)
Analyze the likelihood of political controversy or litigation in opposition to the financing. (I, BC)	Environmental impact evaluation. (I, NB)
Environmental impact evaluation. (I)	Private activity bond volume cap (if necessary). (B, FA, UW, BC)
	State (CIDFAC) approval (if necessary). (I, BC, NB)

STEP 2

SELECTION OF THE FINANCING TEAM

(Time: one week to three months)

The second step in the financing process is critical to the ultimate success of the project and should be undertaken carefully. At this stage (unless previously done as discussed above), the issuer should decide whether to hire a financial advisor (whether or not a negotiated sale is expected) or rely on an underwriter to help with the initial structuring of the issue, which may depend upon the decision to sell the bonds through a competitive or negotiated sale. In some cases, issuers who have worked with a particular underwriter on prior projects may work with that underwriter at the earliest stages in shaping the transaction. Similarly, a financial advisor is often called upon very early in the process to help anticipate the financing options available. It also may be advantageous to consult with bond counsel early on in the process to determine the legal avenues available for the project and the financing.

- Determination of the positions to be filled (I)
 - Will a financial advisor or underwriter be initially retained to assist in structuring the issue? (I)
 - Is the debt to be sold at competitive or negotiated sale? (I, FA, BC)
 - If negotiated, will the underwriter adequately perform the advisory role, or will the separate advice of a financial advisor be necessary or desirable? (I)
 - If negotiated, should a single underwriter be selected or a team of managing underwriters? (I, FA)
 - Will the issuer hire a separate disclosure counsel? (I)
 - Is there a need for varying types of banking expertise? (I, FA, UW)
 - Will a feasibility consultant be necessary to demonstrate the financeability of the project or program? (I, FA, UW)
 - If an interest rate swap is used, will a Swap Advisor be utilized? (I, FA, UW)
 - Will special tax counsel be necessary or desirable? (I, UW, BC)
 - Will a credit enhancement provider be necessary? (I, FA, UW, SA)
 - Will a trustee, fiscal agent or paying agent be used? (I, FA, UW, BC)

- ❑ Procedural alternatives for selecting each position on the financing team (I)
 - Does a statute or local ordinance require competitive selection?
 - Reliance upon previously established relationships
 - Use of a request for proposals
 - Appointment of the firm(s) that proposed the financing
 - Recommendations from other issuers or from other team members
 - Competitive sale of bonds (for selecting underwriter)
- ❑ Determination of method of compensation of each team member (I)
- ❑ Determination and selection of post-issuance team members
 - Continuing disclosure
 - Administration (for assessment and special tax issues)
 - Arbitrage rebate compliance services

STEP 3

STRUCTURING THE FINANCING

(Time: one week to three months)

At the third stage in the process, the consultants that have been retained will bring their expertise to bear on the financial and legal structuring issues. Typically, this stage will include several all-hands meetings and discussions as the documentation for the financing takes shape. Issuers need to remain keenly involved in this process so that the structuring alternatives being chosen are well understood and match up as closely as possible with the issuer's goals and objectives. Issuers should understand why each decision is being made and pay particular attention to the covenants, agreements, security features, and other obligations they are undertaking. Similarly, the issuer should be fully involved in reviewing and evaluating the disclosure being developed. Issuers may not rely entirely on the professionals they hire to ensure that adequate disclosure is provided. Similarly, "boilerplate" provisions in the documents, while often needed and appropriate, should not be glossed over by the issuer. If the issuer has concerns over any part of the documents, adequate explanations should be forthcoming from bond counsel and the other team members with respect to the inclusion of each provision being included.

- ❑ Initial organizational meeting (All)
 - Identify security structure alternatives and either select from among them or determine the criteria for selection (All)
 - Determine the approximate size of the issue, taking into account amounts needed for costs of issuance, reserve accounts, and capitalized interest, as well as the project or program being financed
 - Is credit enhancement necessary? (I, FA, UW)
 - Are supplemental revenue sources necessary or available? (I, FA, UW, BC)
 - What should be the terms of any underlying arrangements, including covenants of, and/or security provided by, any governmental entity using the project or any nongovernmental borrower? (I, FA, UW, NB)
 - Is debt service coverage necessary? If so, how much? (I, FA, UW)
 - Is casualty insurance necessary? If so, how much? (I, FA, UW)
 - Are other covenants of issuer necessary or desirable? (I, FA, UW, BC)

- Evaluate legal, political, and regulatory constraints (All)
 - How do federal tax laws affect any or all of above? (BC)
 - How do federal and state securities laws affect any or all of the above? (BC, UC)
 - Are there state statutory constraints and what legal proceedings will be required? (BC)
 - Has an environmental review been satisfactorily completed? If not, will one be completed before an “approval” takes place? (I, BC, UW)
 - What financial and operating data will be included in the issuer’s annual report under SEC Rule 15c2-12? (BC, UC, UW)
 - Will any additional types of listed event notices be required (other than the 11 categories specified in SEC Rule 15c2-12)? (I, UC, UW, FA)
 - Should any steps be taken to resolve or reduce political controversy, or to forestall a possible reverse validation action? (I, BC)
 - Is there a debt policy in place that establishes goals/restrictions for the financing? (I, BC, FA)
- Develop timetable for accomplishing remaining tasks (All)
 - Are any specific filings required? (I, BC, UC, NB)
 - Are approvals necessary other than by issuer (such as private activity bond volume cap)? (BC)
 - Other time constraints (All)
 - Construction constraints
 - Negotiations with other parties, e.g. credit enhancement provider
 - Refunding date
 - Agree upon allocation of responsibilities for tasks to be accomplished (All)
- ☐ Prepare major legal documents relating to the financing, including indenture (or bond resolution), agreements defining any underlying arrangement (such as loan agreements, lease, or credit enhancement agreement), Official Statement, notice of sale or bond purchase agreement, and Continuing Disclosure Agreement (BC, UC, FA, UW, I)
- ☐ Meeting(s) or conference calls to review and negotiate terms of the major legal documents (All)

- Due diligence review of all facts material to the investor's decision to buy the bonds (All, but especially UC)
- Consideration of investment alternatives for bond proceeds. Will a guaranteed investment contract be used? If the issue includes refunding, will the escrow be funded with open market securities or SLGS? (I, IA, FA, UW, BC)
- Credit rating agency review of the major legal documents and other relevant information (I, FA, UW)
- Adoption by the governing body of the necessary resolutions or ordinances authorizing issuance of the bonds and execution of the legal documents either approving the notice of competitive sale or authorizing execution of the bond purchase agreement (I, BC)
- File a validation action if such is determined to be necessary or appropriate (I, BC, or other counsel)
- Advise CDIAC of proposed sale 30 days in advance of proposed sale date (I, BC)

STEP 4

MARKETING AND CLOSING

(Time: one week to three months)

At this point, the financing should be completely structured and all parties should be in agreement as to the ultimate terms of the financing (except the pricing terms themselves). It is important to have worked out any major structuring issues or document provisions necessary to obtain a satisfactory rating or credit enhancement in advance of this stage, so that the final approvals by rating agencies and credit enhancers can go smoothly. Nevertheless, it is possible that as a result of the first few steps outlined below, an issue will surface which requires the team to reassess some of the decisions made in Step 3. Once the rating and/or credit enhancement is in place, it is time to go out into the market and price the issue. At this stage, the final interest rates, sizing, and other financial terms of the borrowing will be determined.

❑ Preparing for marketing

- Obtain the credit rating (I, FA, BC, UW)
 - Provide final information to credit rating agencies
 - Meet with rating analysts (if necessary or appropriate)
 - Site visit by rating analysts (if necessary or appropriate)
- Obtain final commitments from credit enhancement provider (if necessary) (I, FA, UW, NB)
- Obtain commitment for investment of bond proceeds (See text box at right and **Chapter 11, Investment of Bond Proceeds**) (I, IA, FA, UW, T)
- Design the proposed maturity structure and redemption terms of the bonds (I, FA, UW, NB)
- Final review and approval of Preliminary Official Statement (All)

Investment of Bond Proceeds

The process of investing bond proceeds can vary tremendously depending upon the type of investments used. In the case of a simple investment of funds in a money market fund or in a pooled investment vehicle such as LAIF (the Local Agency Investment Fund of the State of California), this step can easily be accomplished at or shortly after the closing of the issue. On the other hand, if open market treasury securities (especially for a refunding escrow) or a guaranteed investment contract will be used, a bidding procedure like the one outlined below for GICs will be required. This should be done in advance of the closing of the issue.

- ✓ Determine appropriate investment vehicles (I, IA, FA, UW, BC)
- ✓ Prepare and circulate for review a request for bids for investments (IA)
- ✓ Evaluate responses (IA)
- ✓ Negotiate final terms of investment agreement with winning bidder (I, BC, T)

- If competitive sale, determine rules for selecting winning bidders (I, FA, BC)
- If negotiated sale, determine whether syndicate or selling group is appropriate and who should be members (I, UW)

□ Marketing

- Mail Preliminary Official Statement to syndicate or selling group members (or potential bidders) and potential investors (if competitive sale, include notice of sale)
- Hold information meetings with investors and dealers, if necessary or appropriate (usually reserved for very large issues)

Competitive Sale	Negotiated Sale
Answer any additional questions from analysts for potential bidders. (I, FA, BC)	Preliminary pricing discussion. (I, UW, FA, NB)
Open bids at time and place specified in Notice of Sale. (I, FA, BC)	Look at comparable sales for rates and prices. Timing of sale.
Determine winning bidder by applying rules specified in Notice of Sale. (I, FA, BC)	What is the supply in the near future of issues that would compete for sales?
If winning bid is acceptable, award bonds to winning bidder, creating, in effect, a Bond Purchase Agreement between the issuer and the winning bidder. (I)	Which direction is market moving? Are certain types of investors noncommittal? Finalize proposed pricing scale.
	Send out pricing wire to solicit orders from target markets. (UW)
	Reprice if too many or too few orders. (I, UW, FA, NB)
	Agree upon the final rates and prices. (I, UW, FA, NB)
	Sign Bond Purchase Agreement. (I, UW, NB)

- ❑ Finalize and print Official Statement, describing final maturity schedule, interest rates, and reoffering prices to the public, as well as conforming descriptions of bonds and project to final design (All)
- ❑ Prepare to close the bond issue (deliver the bonds for payment)
 - Arrange for printing of the bonds (not necessary if book-entry-only issue) (I, BC, T)
 - Prepare closing documents, review (usually by phone), and arrange for execution (All, but especially I and BC)
 - Various certificates, opinions, and other letters
 - Final forms of major legal documents
 - Tax-related filings
 - Execute and/or authenticate bonds (I, T)
 - Inspect executed and authenticated bonds (not applicable for book-entry-only issues) (UW)
- ❑ Pre-close the day before the bonds are delivered and paid for (All)
 - Final meeting to execute documents and ensure that all required documents are present and in the agreed-upon form
- ❑ Close (All)
 - Receipt for bond proceeds
 - Receipt for bonds
 - Execute investment of bond proceeds
 - Payment of necessary fees
 - Recordation of real estate deeds, leases and encumbrances
 - Transmittal of tax roll information to tax-collecting entity (for land-secured financings)
 - Compliance with MSRB requirements for delivery of final Official Statement, escrow agreements (for refundings), and any other post-issuance filings (UW)
 - Notice of final sale to CDIAC

STEP 5

LIVING WITH THE ISSUE AFTER CLOSING

During the busy time of preparing for a bond issue, marketing, and closing, it is easy to forget that the bond issue will usually be in existence for a long period of time. After closing, the issuer and nongovernmental borrower will have to perform many tasks to assure that the financing is ultimately successful. It is important that staff members of the issuer/borrower be designated to take responsibility for the ongoing compliance and monitoring functions described below.

During the initial structuring phases described in the previous steps, the post-issuance compliance issues should be kept in mind. Ideally, the people who will be responsible for post-issuance compliance on behalf of the issuer/borrower should be involved in the early phases of the project as well. The issuer/borrower will need to determine what consultants it will hire to perform these tasks and which tasks it will take on itself. Even when consultants (such as rebate compliance providers, continuing disclosure consultants or counsel, investment advisors, and others) are retained, issuers will need to monitor their performance and work product.

Ultimately, it is the issuer/borrower who is responsible for adhering to these compliance requirements.

- Evaluate performance of financing team (I, NB)
- Monitor the progress of the construction project or lending program (I, NB)
 - Administrative duties of issuer
 - Monitor compliance with tax rules for expenditures and use of project
 - Monitor compliance with program rules for expenditures and use of project.
 - Provide financial and project reports to investors
- Monitor the trustee's performance (I, NB)
 - Collection of revenues
 - Maintenance of accounts
 - Investment of monies
 - Paying agent functions
- Comply with ongoing covenants (I, NB)

- Monitor interest rates and value of swap (if any) (I, NB, SA)
- Annual financial statements (I, NB)
- Annual report filed with Central Post Office and NRMSIRs (I, NB)
- Monitor need for listed event notices (I, NB)
- Other annual reports, such as CDIAC, Mello-Roos, and Marks-Roos Bonds Yearly Fiscal Status Report (I)
- Ensure arbitrage rebate compliance (I, RC)
- Interpret financing documents (I, BC)
 - Covenants, e.g. concerning use of project
 - Additional bonds tests
 - Subordinate financing tests
- Refinancing or refunding (if needed or appropriate) (I, FA, UW)
- Engage in a workout if necessary to resolve any problems in connection with pending or actual default (I, BC, others)
- Respond to any inquiries or audits by the Internal Revenue Service or the Securities and Exchange Commission (I, BC, others)

Chapter 3

GENERAL FEDERAL TAX REQUIREMENTS

INTRODUCTION

This chapter provides an overview of the basic federal tax concepts and rules applicable to public finance. Federal tax concepts that relate in a unique way or are only applicable to a particular type of bond are discussed in **Chapter 6, Types of Financing Obligations** in the applicable section.

Under the Internal Revenue Code of 1986, as amended (the “tax code”), bonds issued by states and local governmental units generally bear interest that is excluded from gross income for federal income tax purposes. The term “bond” includes any evidence of indebtedness, and covers notes, installment sale agreements, or financing leases. Although exempt from federal income tax, interest on bonds may be taken into account in determining other federal income tax consequences, such as personal or corporate alternative minimum tax, interest expense deductions, taxation of Social Security benefits, and the like.

In general, interest on bonds is taxable if:

- The bonds are not treated as obligations of a state or political subdivision of a state (see below)
- The bonds are arbitrage bonds
- The bonds are hedge bonds
- The bonds violate various other prohibitions contained in the tax code

Furthermore, nongovernmental bonds such as private activity bonds used to finance projects that substantially benefit private businesses, generally are not tax-exempt. Certain qualified private activity bonds can be tax-exempt.

The discussion below sets forth the principal federal tax rules in enough detail to give the reader a basic understanding of the concepts and limitations listed above. In addition to the requirements covered in this chapter, the following universal requirements apply to all tax-exempt bonds:

- An information return (Form 8038) must be filed for the bonds
- Bonds must be issued in registered form

- Bonds may not be directly or indirectly guaranteed by the federal government

In many cases, but typically with bonds issued to fund public infrastructure and payable from general governmental revenues, the tax rules discussed in this chapter will not have a significant effect on the way a bond issue is structured—at least from the issuer’s perspective. Bond counsel will analyze the requirements and take steps to help the issuer comply, but the tax aspects of the transaction will not be particularly difficult. In other financings, such as qualified private activity bonds or financings (e.g. single-family housing bonds) involving underlying loans, the tax rules are critical to the structuring and success of the transaction, and much of the effort of the financing team will be devoted to ensuring compliance with these complex requirements. In all financings, care must be taken to comply with all of the requirements of the tax code.

OBLIGATIONS OF A STATE OR POLITICAL SUBDIVISION

In order to be tax-exempt, bonds must be issued by or on behalf of a state or a political subdivision of a state. Political subdivisions are public agencies that can independently exercise a substantial amount of one or more of the following governmental powers:

- Eminent domain
- Police power
- Taxing power

Public agencies such as joint powers authorities that are not political subdivisions but that issue bonds at the direction of, or are completely controlled by, a political subdivision typically are treated as issuing bonds on behalf of a political subdivision. Tax lawyers sometimes refer to these issuers as “on behalf of” issuers. Additionally, under some circumstances bonds issued by nonprofit corporations are treated as bonds issued on behalf of a political subdivision. See the **Special Federal Tax Issues** discussion in **Chapter 6, Types of Financing Obligations – Public Lease Revenue Bonds**.

DEFINITIONS

The following definitions are crucial to an understanding of how the tax law applies to public finance. The reader may wish to refer back to this section as these concepts arise in later discussion.

Issue of Bonds. In general, the various federal tax limitations and requirements apply to an “issue” of bonds rather than to individual bonds. In other words, to determine whether bonds are private activity bonds, arbitrage bonds, or hedge bonds, one must first determine which bonds are part of the same issue. Bonds are part of the same issue if the bonds are sold at substantially the same time (i.e. less than 15 days apart), are reasonably expected to be paid from substantially the same source of funds and are sold pursuant to the same financing plan.

Typically, all of the bonds that are sold pursuant to the same Official Statement are part of the same issue.

Proceeds. Just as the federal tax rules primarily apply to an issue of bonds, the application of the federal tax law requires an analysis of the investment and ultimate use of the “proceeds” of a bond issue. For example, it is the timing and manner of the ultimate use of proceeds that determines whether bonds are private activity bonds, qualified private activity bonds, or hedge bonds. Proceeds are comprised of the following:

- **Sale Proceeds.** The amounts actively or constructively received by an issuer from the original purchasers for the bonds. Receipt includes amounts paid as underwriter’s discount or other compensation and accrued interest on the bonds from their date to the date of delivery, if any.
- **Investment Proceeds.** The amounts constructively received from investing the proceeds of a bond issue.
- **Transferred Proceeds.** When the proceeds of a refunding issue are used to make payments of principal on refunded bonds, any remaining proceeds of the refunded bonds, i.e. the unspent proceeds, “transfer over” to the refunding issue based on a formula set forth in the U.S. Treasury regulations.
- **Replacement Proceeds.** Includes money held by the issuer or a “substantial beneficiary” of the bonds if such amounts have a sufficiently direct relationship to the bond issue or a governmental purpose of a bond issue and the amount invested would be used for a governmental purpose.
- **Gross Proceeds.** All proceeds (sale proceeds, investment proceeds, replacement proceeds, and transferred proceeds) plus amounts that are reasonably expected to be used to repay the bonds, such as revenues deposited in a debt service fund, and amounts that are pledged as security for the repayment of the bonds.
- **Disposition Proceeds.** Proceeds that result from the sale of all or a portion of a bond-financed facility with cash. For arbitrage purposes, disposition proceeds are treated as gross proceeds.
- **Net Proceeds.** The proceeds of the bonds less the amount of a reasonably required reserve or replacement fund.

Expenditure of Gross Proceeds. Understanding whether funds held by an issuer are “proceeds” at any given time requires a comprehension of how funds related to a bond issue are treated as having been spent. The following concepts are important to an understanding of expenditures:

- **Expenditures Related to Purpose of Issue.** Generally, proceeds may be spent only on capital costs of facilities and costs of issuing the bonds and establishing a reserve fund. Once proceeds are allocated to an ultimate expenditure, the use and nature of any facility paid for with the proceeds is tracked for private activity bond and qualified private activity bond purposes. If the purpose of the bonds is to finance working capital expenditures, U.S. Treasury regulations provide that proceeds are spent only at times in which the issuer has no other monies on hand available to cover those working capital expenses (see **Chapter 6, Types of Financing Obligations – Tax and Revenue Anticipation Notes (TRANs)**).
- **Investments.** Gross proceeds are considered not spent if they are used to acquire investment securities. They are simply allocated to those investments temporarily and return to the issuer for ultimate use or reinvestment as the investment securities mature or are sold. During the time gross proceeds are allocated to investment securities they are tracked for arbitrage purposes, as well as to determine the amount of investment proceeds that has accumulated.
- **Payment of Debt Service.** Generally, gross proceeds that are not sale, investment, or transferred proceeds are spent only when they are used to pay debt service on the bonds.
- **Reimbursements.** Issuers and conduit borrowers often wish to use bond proceeds to reimburse themselves for costs paid prior to the issuance of the bonds. Bond proceeds allocated to such “reimbursement costs” will be treated as “spent” only if certain requirements are satisfied (see text box at right). If these requirements are not satisfied, any bond proceeds that the issuer or conduit borrower attempts to allocate to the reimbursement costs will not be treated as spent and will continue to be subject to the arbitrage yield restriction rules and the rebate requirement discussed in more detail below.

Reimbursement Rules

Intent. The issuer must demonstrate that an intent to use bonds to reimburse itself existed at or around the time the cost was paid.

- ✓ The issuer must adopt an official intent resolution no later than 60 days after the reimbursement cost in question was paid.
- ✓ The official intent resolution must contain a description of the project, the maximum amount of bonds expected to be issued for the project, and state the issuer’s reasonable expectation to reimburse itself.

Reimbursable Costs. Generally, reimbursement costs are limited to capital expenditures and cost of issuance items.

Timing of Reimbursement. Reimbursements must be made no later than 18 months after the later of (i) the date the cost is paid, or (ii) the date the project is placed in service or abandoned (but in no event more than 3 years after the cost is paid).

Preliminary Expenditures Exception. “Soft costs” (such as architectural, engineering, surveying, soil testing, costs of issuance, and similar costs) may always be reimbursed whether or not a resolution was adopted and regardless of the timing of the reimbursement.

Yield. The yield on a bond issue is the discount rate or interest rate that allows all of the payments of principal and interest on the bonds (net of payments or receipts from certain interest rate hedging transactions such as swap agreements), plus any payments for credit enhancement,

to equal, on a present value basis and as of the date the bonds are issued, the aggregate amount paid by the original bond holders for the bonds. It is important to remember that an underwriter's discount or fees do not affect the aggregate amount paid by the original bond holders for the bonds and, therefore, do not affect the calculation of yield on the bonds. In other words, although from the issuer's perspective the payment of an underwriter's discount increases borrowing costs, it does not increase the yield on the bonds.

PRIVATE ACTIVITY BONDS

Interest on a private activity bond, cannot be excluded from gross income unless it meets the requirements for one of the categories of qualified private activity bonds. This section describes the conditions under which a bond will be determined to be a private activity bond. The following section describes the categories of qualified private activity bonds.

Basic Private Activity Bond Tests

An issue is considered a private activity bond if the issuer reasonably expects, as of the date of issuance, that either the Private Business Tests or the Private Loan Test is satisfied.

Private Business Use Test. More than 10 percent of the proceeds of the issue are used for any private business use. Any activity carried on by a person (other than a natural person) is treated as a trade or business. Both actual and beneficial use by a nongovernmental person may be treated as private business use. However, in most cases, the Private Business Use Test is satisfied only if a nongovernmental person has special legal entitlements to use the property with bonds proceeds under an arrangement with the issuer. For example, if a nongovernmental person's use is in a business or trade, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and then leased to a governmental person, or leased to a governmental person and then leased to a person.

Private Security or Payment Test. The direct or indirect payment of principal or interest on more than 10 percent of the bond issue is to be secured by or derived from payments in respect of property used for a private business use.

If a facility is used disproportionately by a private business or is used by a private business in a manner that is unrelated to the governmental entity's use, the 10 percent limitation of the Private Business Tests is reduced to a 5 percent limitation.

Private Loan Test. Even if the Private Business Tests are not satisfied, an issue will nevertheless be an issue of private activity bonds if the lesser of 5 percent of the proceeds or \$5 million are used to make or finance loans to persons other than governmental units.

Reasonable Expectations. Generally, the determination of whether an issue of bonds is an issue of private activity bonds is based upon the issuer's reasonable expectations as of the date

the bonds are issued. With certain limited exceptions, it is important that issuers reasonably expect to own and use a bond-financed facility for at least either of the following:

- The shorter of the entire economic useful life of the facility
- The term of the bonds

If the issuer does not have these expectations, special mandatory call provisions may be required, providing for a redemption of bonds at the time of sale or other change in use of the financed property. The average maturity of bonds generally cannot exceed 120 percent of the reasonably expected average useful life of the financed property.

Notwithstanding an issuer's reasonable expectations of governmental use, certain deliberate actions by an issuer or independent actions by third parties may cause the Private Business Use Tests or the Private Loan Test to be satisfied with respect to an issue. A more detailed description of these rules is in the section on **Change in Use** in this chapter.

Private Business Use

Interest on a private activity bond cannot be excluded from gross income under the Internal Revenue Code if more than 10 percent of the proceeds of the bond issue are to be used for any private business use. "Private business use" is defined as any use, both actual and beneficial, in a trade or business carried on by any nongovernmental person. For the purpose of this definition, any activity carried on by any person other than a "natural person" is treated as a trade or a business.

The trade or business use of proceeds or of facilities financed with bond proceeds by a nongovernmental person through indirect means constitutes private business use. Beneficial use is established only if the nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. These entitlements include ownership, actual or beneficial use pursuant to a lease and certain management or service contracts, output contracts, or research contracts.

Use by an employee of the issuer or an individual who is not carrying on a trade or business is not private business use. In addition, use by the general public (e.g. use by individuals and business on the same basis) is not private business use. U.S. Treasury regulations provide useful guidance about facilities that have a close connection to privately-used facilities but with respect to which there is no special legal entitlement by a nongovernmental person—for example, private business use of a governmentally owned and operated parking garage adjacent to an airport, a sports stadium, or a shopping center.

To the extent that no private business user has a special legal entitlement to the facility (e.g. a lease, a management contract, or a priority use right) and the facility is intended to be available and, in fact, is reasonably available to the general public, actual use of the facility by

nongovernmental persons will not constitute private business use. Use by the general public contemplates use by individuals not acting in a trade or business. Any fees charged for such use must be generally applied. Monthly or longer arrangements for use (such as a monthly parking pass) can satisfy this requirement, so long as the term of the arrangement does not exceed 180 days of use, and the arrangement is not required to be renewed at the end of its term.

To the extent a facility is not intended to be available or is not reasonably available to the general public, but no private business user has a special legal entitlement to the facility, the analysis shifts to whether any private business receives a special economic benefit from the facility. Factors taken into account to make this determination include the proximity of the facility to and functional relationship of the facility with any activities of a private business, as well as the number of private businesses receiving any special economic benefits.

De Minimis Private Business Use Exceptions

Certain minor or insignificant (so-called de minimis) private business uses of bond-financed facilities are not deemed to be sufficient to satisfy the Private Business Use Test. The following sections describe these de minimis exceptions:

One Hundred-Day Arrangements with Nongovernmental Persons. Use by a nongovernmental person pursuant to a lease or contract does not constitute private business use if:

- The term of the lease or contract is less than 100 days
- Similar arrangements are generally available to, and expected to be executed with, private businesses on a nondiscriminatory, rate scale basis
- The facility is not financed for the principal purpose of providing it for use by a nongovernmental person

Fifty-Day Use with Nongovernmental Persons. Use by a nongovernmental person is private business use if all of the following are true:

- The term of the use, including all renewal options, is not more than 50 days
- The arrangement is negotiated at arms-length, compensation is at fair market value
- The facility is not financed for a principal purpose of providing it for use by a nongovernmental person

Temporary Use by a Developer. As described in **Chapter 6, Types of Financing Obligations – Assessment Bonds**, certain temporary uses by developers of facilities financed with special tax or assessment bonds are disregarded.

Use by Agents. Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person.

Use Incidental to Financing. Use by a nongovernmental person that is solely incidental to the financing (e.g. bond trustees, loan services, and guarantors are generally not treated as private business users).

Incidental Use. Use that does not exceed 2.5 percent of the proceeds of the bond issue is disregarded if:

- The use does not involve a transfer to nongovernmental persons of possession or control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, except this prohibition does not apply to vending machines, pay telephones, and similar uses
- The same person does not functionally relate the nonpossessory uses of the facility to any other use of the facility
- All the nonpossessory uses of the facility, in aggregate, involve use of 2.5 percent or less of the facility

Qualified Improvements. If bond proceeds are used to make improvements owned by the governmental unit to a building also owned by the governmental unit, then the proceeds are not used for private business if:

- The building was placed in service more than a year prior to the date construction or acquisition of the improvement commenced
- The improvement is not exclusively for private business use
- No portion of the building or any of the payments with respect to the improved building are taken into account under the Private Security Test
- No more than 15 percent of the building is used for a private business use

Anti-abuse Rule. U.S. Treasury Regulations section 1.141-3(g2)(iv) prevents abuse of the Private Business Tests. These regulations permit the IRS to determine the amount of private business use according to the greater percentage of private business use in any one-year period. The issuer establishes the term of the bond issue:

- For a period that is longer than reasonably necessary for the government purpose of the bond issue
- For the principal purpose of increasing the permitted amount of private business use

Measuring Private Business Use

As described above, the Private Business Use Test is met if more than 10 percent (in some cases 5 percent) of the proceeds of the issue are used directly or indirectly in trades or businesses carried on by nongovernmental persons. Private business use generally is measured by determining the average percentage of private business use of the property that occurs during the period of time beginning on the later of the date the bonds are issued or the date the financed facility is placed in service, and ending on the earlier of the date the bonds mature or the end of the reasonably expected useful life of the facility. Average private business use of the facility for any given year is equal to the amount (i.e. number of days) of private business use during that year divided by the amount (i.e. number of days) of total use (private use and governmental use) of the facility during that year.

However, uses may need to be weighted if the fair market value of the uses varies. Periods of nonuse are disregarded for the purpose of computing percentage use.

Simultaneous private business use and governmental use may require more complicated methods of measuring the amount of private business use. Private business use that takes place before or after the measurement period described above is ignored. Special rules exist for measuring the amount of private business use attributable to certain contractual rights to the output of electric and gas generation, transmission and related facilities, and certain water facilities.

If the private business use of a financed facility is the result of ownership of the facility by a private business, then the amount of private business use is determined based on the highest percentage of private business use during any of the annual periods that make up the general measurement period.

Management or Service Provider Contracts

Any contract between a governmental entity and a private business providing services with respect to a bond-financed facility is a potential source of private business use and must be examined when determining whether the 10 percent private business use limitation has been or will be exceeded. Generally, the determination of whether a service contract between a governmental person and a service provider gives rise to private business use is based upon all the facts and circumstances of the arrangement.

Private Business Use Example

A state uses the proceeds from a bond issue with a 20-year term to reimburse itself for the acquisition of a 10-story office building. The facility is used solely for governmental purposes for 18 years. At the end of the 18th year, state officials lease the entire building for two years to a corporation for its private business use. Two years of 100 percent private business use averages over the 20-year measurement period only to 10 percent private business use, and thus the Private Business Use Test is not satisfied. However, if the state sold the building to the corporation, the private business use of the building would be equal to the greatest percentage of private business use for any one-year period. Thus, the facility will have 100 percent private business use for its entire life and will therefore satisfy the Private Business Use Test.

Private Business Use Contracts. Two types of contracts almost always result in private business use:

- A contract that provides for compensation based upon net profits of the bond-financed facility
- A contract under which the service provider is considered the lessee or owner of the bond-financed facility for federal tax purposes

Exempted Contracts. U.S. Treasury regulations provide a list of arrangements that are not considered management contracts. The following contracts are explicitly not included within the definition of management contracts:

- Contracts for services that are solely incidental to the primary governmental function of the facility (e.g. janitorial contracts, equipment repair contracts, contracts for billing services)
- Granting of admitting privileges by a hospital to doctors, even if conditioned on the provision of de minimis services, if available to all qualified physicians in the area consistent with the size and nature of the facilities
- Contracts relating to the operation of public utility property where the only compensation is reimbursement of direct actual and direct expenses of the service provider and reasonable administrative overhead expenses
- Contracts to provide services where the only compensation is reimbursement to the service provider for actual and direct expenses to unrelated third parties

Safe Harbors for Certain Compensation Arrangements

There are certain “safe harbors” for compensation arrangements in management or service contracts. In order to meet the safe harbors, the compensation to the service provider under the contract must not be based on net profits, the service provider must not be in a position to limit the governmental entity’s rights under the contract, and the contract must fall within one of the following six categories:

- **95 percent Fixed Fee Contracts.** At least 95 percent of the compensation is based on a periodic fixed fee, and the contract term does not exceed the lesser of 15 years or 80 percent of the reasonably expected useful life of the managed facility. A one-time, fixed incentive payment based on gross revenue or expense targets is allowed to be paid to the service provider without affecting the fixed fee payment requirement.

What is a Safe Harbor?

A “safe harbor” is a set of requirements that, if satisfied, protect the arrangement from being determined by the IRS from violating a given rule. Being outside the “safe harbor” does not necessarily mean that the rule has been violated, but most tax counsel will not give an unqualified opinion regarding an arrangement that is outside the safe harbor absent obtaining a specific ruling from the IRS.

- **80 percent Fixed-Fee Contracts.** At least 80 percent of the compensation is based on a periodic fixed fee, and the contract term does not exceed the lesser of 10 years or 80 percent of the reasonably expected useful life of the managed facility. A one-time, fixed incentive payment based on gross revenue or expense targets is allowed to be paid to the service provider without affecting the fixed-fee payment requirement.
- **Public Utility Property.** If the facility is predominantly public utility property, the 15 year and 10 year requirements described above are substituted with a 20 year requirement.
- **50 percent Fixed-Fee or Capitation Contracts.** Fifty percent of the compensation is based on a periodic fixed fee, or 100 percent is based on a capitation (per person) fee or a combination of the two, and the contract term does not exceed five years. The issuer must have the power to terminate the contract without penalty after three years.
- **Per-Unit Fee Contracts.** One hundred percent of the compensation is based on a per-unit fee, or a combination of a per-unit fee and a periodic fixed fee, and the contract term does not exceed three years. The issuer must have the power to terminate the contract without penalty after two years.
- **Percentage of Revenue or Expense Contracts.** Applies only to contracts under which the service provider primarily provides service to third parties (e.g. a radiologist) or during the start-up phase of a new facility. One hundred percent of the compensation is based on a percentage of fees charged, or a combination of a per-unit fee and a percentage of revenue or expense fee, and the contract term does not exceed two years. The issuer must have the ability to terminate the contract without penalty after one year.

Renewal Options. For purposes of the six categories above, renewal options by the service provider that are enforceable against the issuer are counted in the term limitation. Renewal options by the issuer and automatic renewal provisions subject to cancellation by either party do not count.

Indexing. The payments under the fixed-fee contract may change over time if tied to an objective external standard, such as the Consumer Price Index.

Prohibited Relationships. The service provider must not have any relationship with the governmental entity that, in effect, substantially limits the governmental entity's ability to exercise its rights under the contract. A safe harbor from this relationship limitation is provided if all of the following three requirements are satisfied:

- The service provider does not control more than 20 percent of the voting power of the board of the governmental entity
- Overlapping board members do not include the chief executive officers of either party

- The service provider and the governmental entity are not related parties

Change in Use

As described above, the private activity bond analysis at the time bonds are issued focuses on the issuer's expectations as to private business use. However, once bonds are outstanding, voluntary or "deliberate" actions by an issuer that allow for the Private Business Tests to be satisfied can cause the bonds to have a retroactive loss of tax-exempt status. A number of specific remedies have been provided for such a "change in use" problem. In general, and subject to a number of detailed limitations, issuers can redeem or defease bonds, can make sure that the new use of the project qualifies for tax-exempt financing on some alternate basis, or, in the case of a sale of the project, can use any consideration paid for the project to finance a new facility that does not satisfy the Private Business Tests.

Private Security or Payment Test

This is the second part of the Private Business Tests. Both the Private Business Use Test and Private Security or Payment Test must be satisfied for a bond to be a private activity bond.

As its name implies, the Private Security or Payment Test looks at the source of the monies paid toward debt service (directly or indirectly) and the security provided for the bonds by nongovernmental persons. The Private Security or Payment Test is met if the aggregate present value of the private payments and private security exceeds 10 percent of the present value of the debt service on the bonds, with certain adjustments. Absent deliberate actions by the issuer, satisfaction of the Private Security or Payment Test is based upon reasonable expectations as of the date on which the bonds are issued. Present values are computed using the yield on the bonds as a discount rate.

Private Payments Example

A state issues 20-year general obligation bonds to finance a new office building which is not pledged to secure the bonds and which is used exclusively by the state through the 18th year. During years 19 and 20, the entire building is leased to a nongovernmental person. If the annual rents during years 19 and 20 equal annual debt service plus annual operating expenses during those two years, the Private Payment or Security Test will not be met because the present value of adjusted lease rentals in years 19 and 20 should be far less than 10 percent of the present value of the debt service on the bonds. What if the rental payments during years 19 and 20 is enough so that the present value of those payments exceeds 10 percent of the present value of the debt service on the bonds? The total percentage of average annual private business use is 10 percent, and the payments to be taken into account under the Private Payment or Security Test are therefore limited to 10 percent of the debt service on the bonds. Thus the Private Payment or Security Test is not satisfied.

Private Security

U.S. Treasury regulations provide only limited guidance in interpreting the private security provisions of the Private Payment or Security Test. They do reiterate that pledged property provided by a user of the proceeds of the bonds need not be financed by the bonds and clarify that property used by nongovernmental persons is to be valued at its fair market value (rather than its historical cost), as of the date when the property first secures the bonds.

Private Payments

In general, U.S. Treasury regulations seem to take into account all payments to the issuer or to any related entity by any nongovernmental person that uses the bond proceeds or bond-financed facilities, even if the payments are made by nongovernmental persons who use the property as members of the general public, to the extent the payments either:

- Are to be used to pay debt service on the bonds, or
- Are to be made in respect of bond-financed facilities

However, the amount of the payments is decreased by the allocable operating and maintenance expenses paid by the issuer with respect to the financed facilities. In addition, the amount of private payments to be taken into account is limited to the amount of private business use.

Exception for Generally Applicable Taxes. Payments of generally applicable taxes are disregarded for purposes of the Private Payment or Security Test. This includes both payments of taxes and “payments in lieu of taxes,” to the extent such taxes are imposed at a uniform rate and are applied to all persons of the same classification in the jurisdiction. Real property assessments, Mello-Roos taxes (with the possible exception of Mello-Roos taxes spread over a large area like an entire city), and payments for a special privilege granted or service rendered generally are not applicable taxes. The amount of payments made by nongovernmental persons required to be taken into account is limited to the amount of debt service attributable to the portion of the bond-financed facility used by such nongovernmental persons.

Private Loan Test

An issue of bonds qualifies as a private activity bond issue if it satisfies either the Private Business Tests or the Private Loan Test.

The Private Loan Test is met if more than the lesser of 5 percent or \$5 million of the proceeds of the issue is used to make or finance loans to nongovernmental persons. In determining if the Private Loan Test is met, all loans must be identified. A loan is any transaction that is characterized as a loan under general federal income tax principles. The substance of the transaction is determinative. For example, a lease or a management contract might be considered a loan if federal tax ownership of the facility is transferred to the lessee or manager. Likewise, an output contract might be considered a loan if the agreement shifts significant burdens and benefits of ownership to the output purchaser. An arrangement is not a loan for purposes of the Private Loan Test if:

- It arises from the imposition of a mandatory tax or other assessment of general application
- The assessment is imposed for essential governmental functions, and

- An equal basis requirement is met

See **Chapter 6, Types of Financial Obligations – Assessment Bonds** for a detailed discussion of the rules relating to assessment bonds.

QUALIFIED PRIVATE ACTIVITY BONDS

As described above, the interest on private activity bonds is not excluded from federal gross income unless such bonds are qualified private activity bonds. There are a number of different types of qualified private activity bonds. Each type is based on the specific manner in which the proceeds of the bonds are used. Most of the types of qualified private activity bonds are comprised of:

- Exempt facility bonds
- Mortgage revenue bonds
- Qualified small issue bonds
- Qualified 501(c)(3) bonds

Exempt Facility Bonds. Exempt facility bonds are bonds of which at least 95 percent of the net proceeds are to be used to finance capital costs of facilities that serve, or are available on a regular basis, for general public use, or are part of a facility that is so used. Exempt facilities are defined as:

- Airport facilities
- Docks and wharves
- Mass commuting facilities
- Facilities for the furnishing of water
- Sewage facilities
- Solid waste disposal facilities
- Qualified residential rental projects
- Facilities for the local furnishing of electric energy or gas
- Local district heating or cooling facilities
- Qualified hazardous waste facilities
- High-speed intercity rail facilities

- Environmental enhancements of hydroelectric generating facilities or qualified public education facilities

Net proceeds are comprised of all proceeds, less amounts in a debt service reserve fund and less investment proceeds earned after completion of the project. Qualified residential rental projects are discussed in detail in **Chapter 6, Types of Financing Obligations – Conduit Revenue Bonds – Multifamily Housing Revenue Bonds**. U.S. Treasury regulations contain specific rules and definitions covering each of these exempt facility categories. In the case of the first three categories listed above, the facilities must be owned by a governmental unit.

Mortgage Revenue Bonds. Mortgage revenue bonds are bonds, the proceeds of which are loaned to certain home-buyers as acquisition financing for an owner-occupied personal residence. A detailed discussion of the federal tax requirements for the various types of mortgage revenue bonds can be found in **Chapter 6, Types of Financing Obligations – Single-Family Mortgage Revenue Bonds**.

Student Loan Bonds. Student loan bonds are bonds, of which at least 90 percent of the proceeds are used to make loans to students for educational purposes. A number of detailed federal tax limitations apply to student loan bonds. Since student loan bonds are not frequently issued and are highly specialized, they are not discussed in detail in this book.

Qualified Small Issue Bonds. Qualified small issue bonds are also known as industrial development bonds (IDBs). They are bonds issued in the aggregate face amount of \$1 million or less and at least 95 percent of the net proceeds are used to finance a manufacturing operation and at least 75 percent of the net proceeds are used to acquire, construct, or improve land or depreciable property or to redeem bonds previously used for such purposes and provide the actual production facilities of the manufacturing operation, as opposed to office and warehouse structures and equipment. A complicated set of requirements, which applies to IDBs, are discussed in some detail in **Chapter 6, Types of Financing Obligations – Conduit Revenue Bonds – Economic Development Bonds**.

Qualified 501(c)(3) Bonds. Qualified 501(c)(3) bonds are bonds the proceeds of which are used to finance facilities owned by an exempt organization described in section 501(c)(3) of the tax code. The most common use of these bonds is to finance health care and higher education facilities. Qualified 501(c)(3) bonds also are used to finance low-income housing projects and various other charitable facilities.

The primary requirements for qualified 501(c)(3) bonds are that any financed facilities must be owned by a public agency or a 501(c)(3) corporation and the Private Business Tests must not be satisfied. For purposes of the Private Business Tests in connection with 501(c)(3) bonds:

- 501(c)(3) corporations are treated as governmental units to the extent their use of the financed facilities is not an “unrelated trade or business” use

- The allowable amount of private business use or private payments or security is limited to 5 percent rather than 10 percent

Additional Requirements Applicable to Qualified Private Activity Bonds

A number of miscellaneous restrictions apply to some or all of the qualified private activity bond categories.

Volume Cap. In general, the aggregate amount of all tax-exempt qualified private activity bonds, including qualified enterprise-zone facility bonds, issued annually by all issuers in a state may not exceed the so-called volume cap. The volume cap for each state is calculated annually and is equal to \$50 multiplied by the population of the state (approximately \$2.8 billion for California in 2005). In order to issue tax-exempt qualified private activity bonds, every issuer must apply to the California Debt Limit Allocation Committee to be assigned a portion of this state ceiling, i.e. the volume cap. See **Appendix A – Working with State Agencies – California Debt Limit Allocation Committee** for more information on CDLAC and its application requirements.

Cities, counties, state agencies, and joint powers authorities (JPAs) may apply directly to CDLAC for an allocation for their own use. Other local agency issuers (such as Industrial Development Authorities) must apply to CDLAC through the city or county of which they are a part for an allocation for each project to be financed by them. For more information, see **Appendix A – Working with State Agencies – California Debt Limit Allocation Committee**.

Exemptions. The following types of qualified private activity bonds do not require a volume cap:

- Any qualified veteran’s mortgage bond
- Any qualified 501(c)(3) bond
- Bonds used for airports, docks and wharves, environmental enhancements to hydroelectric generation facilities, and qualified educational facilities
- 100 percent of any high-speed intercity rail facility bonds, but only if owned by a governmental unit
- 75 percent of any high-speed intercity rail facility bonds, but only if owned by a nongovernmental unit
- Any bond used for solid waste disposal facilities but only if it is owned by a governmental unit
- Bonds issued pursuant to a valid carry-forward election and within three years of the year in which the carry-forward closes

- Bonds issued by Indian tribal governments but only if at least 95 percent of the net proceeds are used for a manufacturing facility and certain other requirements are satisfied

TEFRA Public Hearing Requirements. Prior to the issuance of any qualified private activity bond, a public hearing must be held by or on behalf of an applicable elected public official or elected legislative body. Reasonable public notice must be given in advance, containing certain basic information regarding the nongovernmental borrower, the project to be financed (such as purpose and location), and the amount of bonds to be issued. The notice must be published in a newspaper of general circulation in the locality of the project at least 14 days prior to the scheduled hearing. After the hearing, the elected official or body must formally approve the bond issue. For State of California issuing authorities, this approval is given by the State Treasurer or the Governor and for local agencies, the elected legislative body (city council or board or supervisors) typically gives the approval.

A TEFRA hearing and governmental approval are not necessary for an issue of current refunding bonds unless the average maturity date of the refunding issue is later than the average maturity date of the bonds being refunded. See section on **Refunding Bonds** in this chapter.

Substantial User Restriction. Any private activity bond (other than a qualified 501(c)(3) bond) will cease to be a qualified private activity bond and will lose its tax-exempt status during any period in which such bond is owned by a “substantial user” of the financed facility or by a “related person” of such substantial user. A substantial user is an owner or lessee of the financed facility.

Useful Life Limitations. The average maturity of an issue of qualified private activity bonds may not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with such an issue.

Land and Used Property Limits. No more than 25 percent of the net proceeds of a qualified private activity bond issue (other than an issue of qualified 501(c)(3) bonds) may be used directly or indirectly for the acquisition of land or any interest therein, and no part of the net proceeds of any such issue may be used for the acquisition of previously used property or any interest therein. The latter restriction does not apply, however, with respect to any building (and equipment) if rehabilitation expenditures with respect to the building (and equipment) are at least equal to 15 percent of the cost of acquiring the building (and equipment) financed with the net proceeds of the issue.

Cost of Issuance Limit. No more than two percent of the aggregate face amount of any qualified private activity bond issue may be used to finance the costs of issuance associated with the bonds. Certain costs, such as letter of credit commitment fees, are not treated as costs of issuance for purposes of this limitation. This limitation is particularly important in the case of smaller issues because the actual costs of issuance may often exceed the two percent threshold.

In these cases, the issuer or conduit borrower will have to pay the excess amount out of cash or a separate, taxable borrowing.

Certain Prohibited Facilities. None of the proceeds of qualified private activity bonds may be used to provide any of the following:

- Airplane
- Skybox or other private luxury box
- Health club facility
- Facility primarily used for gambling
- Store, the principal business of which is the sale of alcoholic beverages for consumption off-premises

The prohibition against financing health club facilities does not apply to qualified 501(c)(3) bonds.

ARBITRAGE BONDS

Arbitrage Yield Restrictions

An arbitrage bond is a bond that the issuer reasonably expects, at the time of issuance, that all or a portion of the proceeds will be used to:

- Acquire securities or obligations with a yield materially higher than the yield on such bonds, or
- Replace funds used to acquire such higher yielding securities or obligations

A bond can also be deemed an arbitrage bond if the issuer intentionally uses the proceeds for the above purposes. The tax code generally restricts the rate of return on investments purchased with gross proceeds to a yield that is not materially higher than the yield on the bonds. As with the rebate requirement, in connection with any analysis of the arbitrage yield restrictions, the issuer must be assured that the fair market value rules are applied to determine the yield on any investment. See **Fair Market Value Rules** section in this chapter.

The exceptions to arbitrage yield restrictions only apply to “non-purpose investments.” However, “purpose investments” are allowed to yield either 1/8 percent or 1.5 percent higher than the yield on the bonds depending on certain factors. Furthermore, purpose investments are not subject to the rebate requirements, so that issuers may retain any excess investment return derived from the allowable 1/8 percent or 1.5 percent spread.

Arbitrage Yield Restriction Exceptions

There are several important exceptions to the arbitrage yield restriction rule. Almost all bond issues take advantage of one or more of these exceptions. As a result of the reasonably required reserve or replacement fund exception, the three-year temporary period exception, and the bona fide debt service fund exception, none of the proceeds of a typical, “new money” governmental financing will be subject, at least initially, to an arbitrage yield restriction.

Reserve Funds. A debt service reserve fund will be considered to be a “reasonably required reserve or replacement fund” only if the amount of bond proceeds used to provide the fund is limited to the lesser of:

- Maximum annual debt service on the bonds
- 10 percent of the proceeds of the bonds
- 125 percent of average annual debt service on the bonds

If a reserve fund qualifies as a reasonably required reserve or replacement fund, then amounts on deposit in such a fund may be invested without regard to the arbitrage yield restriction.

(However, as described later in this chapter, unless an exception to the rebate requirement is satisfied, the issuer will have to pay 100 percent of any excess earnings (over the bond yield) to the federal government as rebate.)

Three-Year Temporary Period. Perhaps the most important arbitrage exception is the “three-year temporary period,” during which the arbitrage yield restriction does not apply to the proceeds of bonds to be used to finance the project and to pay the costs of issuing the bonds. The issuer gets a three-year period (from the date of issuance of the bonds) during which proceeds may be invested without regard to yield so long as the issuer reasonably expects to meet the following requirements:

- Spend 5 percent of the net proceeds in six months
- Spend 85 percent of the net proceeds in three years
- Diligently work to complete the project and spend the net proceeds

Net proceeds are the proceeds net of qualified reserve funds. The 5 percent in six months requirement can be satisfied either by expenditure or by entering into a binding contract. To the extent proceeds, other than those held in a qualifying reserve fund, remain unexpended after the end of the three-year period, such proceeds generally may not be invested at a yield in excess of 1/8 percent above the yield on the bonds.

Bona Fide Debt Service Funds. Another significant temporary period is the 13-month temporary period for amounts deposited in a “bona fide debt service fund.” A bona fide debt

service fund is one that is used primarily to achieve a proper matching of revenues and debt service during each year by depositing revenues in the fund until they are needed to pay debt service. The fund must be depleted at least once each year, except for a carryover amount not to exceed one month's debt service on the bonds or one year's earnings on the fund.

Other Temporary Periods. As described in **Chapter 6, Types of Financing Obligations – Tax and Revenue Anticipation Notes (TRANS)**, different temporary period rules apply to proceeds of a working capital borrowing. Additionally, more restrictive temporary period rules apply to certain types of refundings, where the bond proceeds are to be used to retire previously issued bonds (see below). Regardless of the application of a temporary period, the rebate requirement applies to all gross proceeds, including all proceeds, unless an exception is satisfied.

Exemption for Tax-Exempt Investments. Regardless of the availability of any of the arbitrage yield restriction exceptions described in the previous section, gross proceeds generally may be invested in other tax-exempt bonds without regard to the yield on the tax-exempt investments.

Yield Reduction Payments

Yield reduction payments are similar to rebate requirement payments, but may be allowed in additional situations where investing bond proceeds at an unrestricted yield would not otherwise be permitted, thus freeing the issuer from having to artificially restrict the yield on investments. Bond proceeds qualifying for yield reduction payments include proceeds of an issue which initially qualified for one of the temporary periods, but for which the temporary period has expired, amounts held in reserve funds in excess of the limitations described previously, and certain limited types of proceeds arising in refunding transactions.

REBATE REQUIREMENT

Generally, the tax code requires that, to the extent gross proceeds are invested on an aggregate, blended basis, in non-purpose investments at a yield in excess of the bond yield, such excess, often referred to as “arbitrage earnings,” must be rebated to the federal government.

The rebate requirement also applies to arbitrage earnings on investments held in qualifying reserve funds. Periods during which gross proceeds are invested at a yield below the yield on the bonds offset gross arbitrage earnings. Thus, even though, certain exceptions to the arbitrage yield restriction requirement permit gross proceeds to be invested at an unrestricted yield during certain times or when held in certain

Simplified Rebate Example
(Actual payment will be larger due to future valuing of effects)

Bond yield = 6%
\$100,000 proceeds invested at 6.5% for 5 years
Investment earnings = \$32,500
Rebate Payment = \$32,500 (actual earnings)
<u>30,000</u> (earnings at bond yield)
\$ 2,500

funds, the rebate requirement generally requires that all net arbitrage earnings be paid to the federal government.

Rebate Exceptions

There are four important exceptions to the rebate requirement that should be carefully considered by the issuer and bond counsel when structuring a bond issue.

Small Issuer Exception. The small issuer exception allows a public agency to retain all arbitrage earnings realized from the investment of the gross proceeds of certain bond issues that are not qualified private activity bonds. The small issuer exception is available only to issuers that possess general taxing powers (even if those powers may only be exercised after voter approval of the tax). The exception may be applied to a bond issue if the amount of such issue, together with the amount of any other bonds issued or expected to be issued by the issuer and all closely related public agencies during the same calendar year, does not exceed \$5 million. Additionally, the issuer must expect to spend at least 95 percent of the net proceeds of the bonds for the governmental purpose for which the bonds are issued. A recent amendment to the tax code raised the \$5 million limit to \$10 million to the extent the additional bonds are issued to finance construction of public school facilities.

Six-Month Expenditure Exception. Under the six-month expenditure exception, proceeds are not subject to the rebate requirement if the issuer actually spends all proceeds of the issue within six months of the date the bonds are issued. The six-month exception is based on actual expenditures. Solely for purposes of determining compliance with the six-month expenditure exception, amounts held in a qualifying reserve fund are not treated as proceeds. Therefore, the normal rebate requirement applies to amounts held in a reserve fund. The six-month expenditure exception is most likely to apply to acquisition financings (where the project is being acquired rather than constructed), to TRAN financings, to reimbursement financings, and to current refundings.

Eighteen-Month Expenditure Exception. As with the six-month exception, proceeds of an issue that are not held in a reserve fund are not subject to the rebate requirement if all such proceeds (including investment proceeds) are expended within 18 months from the issue date, provided that at least:

- 15 percent of such proceeds are spent within six months
- 60 percent are spent within 12 months, and
- 100 percent are spent within 18 months

Compliance with the 18-month exception, like compliance with the six-month exception, is based on actual expenditures, although the 15 percent and 60 percent expenditure requirements are measured based on the sale proceeds plus the aggregate investment proceeds expected to be

earned during the 18-month period, in accordance with the issuer's reasonable estimate of investment earnings at closing. Additionally, as with the six-month exception, amounts held in a reserve fund are not treated as proceeds for purposes of satisfying the expenditure requirements. The 18-month expenditure exception does not apply to refundings.

Two-Year Expenditure Exception. Under the two-year rule, an issue is not subject to the rebate requirement if all proceeds (including investment proceeds) except for amounts held in a reserve fund are expended within two years from the issue date, provided that at least:

- 10 percent of the such proceeds are spent within six months
- 45 percent are spent within 12 months
- 75 percent are spent within 18 months, and
- 100 percent are spent within 24 months

Compliance with the two-year exception, like compliance with the six-month exception, is based on actual expenditures, although the 10 percent, 45 percent, and 75 percent expenditure requirements are measured based on the sale proceeds plus the aggregate investment proceeds expected to be earned during the two-year period. Additionally, as with the other expenditure exceptions, amounts held in a reserve fund are not treated as bond proceeds for purposes of satisfying the expenditure requirements. The two-year expenditure exception does not apply to refundings.

In order to qualify for the two-year expenditure exception, at least 75 percent of the proceeds of the bond issue must be expected to be expended for construction costs, as opposed to acquisition or refinancing costs. If the 75 percent construction cost requirement is not expected to be met by the bond issue as a whole, the tax code allows the issuer to treat the bond issue as two separate issues. If one of such issues, the construction portion, meets the 75 percent construction cost requirement, then the construction portion is eligible for the two-year expenditure exception. The six-month expenditure exception (but not the 18-month expenditure exception) or the normal rebate requirements would apply to the remaining portion. Special rules apply to pooled financings.

Penalty in Lieu of Rebate. If the proceeds of a construction issue (or construction portion) are not spent as required within the two-year period, the issuer generally will be required to rebate all arbitrage earnings under the normal rebate requirement. However, the tax code allows the issuer to pay a penalty in lieu of such a rebate, if the issuer elects to do so at the time its bonds are issued. The penalty is 1.5 percent of the amount of proceeds of the bond issue that, as of the close of each six-month period, are not spent in accordance with the expenditure schedule. For example, if the issuer was required to spend \$450,000 within 12 months (45 percent), but has spent only \$400,000, the issuer would pay a penalty of 1.5 percent of \$50,000, or \$750. The penalty must be paid within 90 days of the end of the relevant six-month period.

The election to pay the penalty in lieu of rebate may be useful for issuers wishing to avoid the complications normally encountered in calculating rebate. Also, the penalty election permits issuers to retain arbitrage earnings during the temporary period, which may exceed the amount of the penalty even if the proceeds are not spent entirely within the expenditure schedule specified by the two-year expenditure exception. However, the benefit to be gained by balancing penalty payments against potential arbitrage earnings depends entirely on issuer's ability to invest proceeds at interest rates above the bond yield. A delay in construction expenditure together with a drop in interest rates can result in significant penalty payments every six months in a circumstance where no arbitrage earnings are achieved. Extreme caution is therefore advised and issuers should consult with their bond counsel and financial or investment advisor in deciding whether to elect the penalty in lieu of the normal rebate requirement.

FAIR MARKET VALUE RULES

One fundamental requirement of all of the yield related limitations (e.g. the arbitrage yield restriction and the rebate requirement) is that non-purpose investments must be purchased by issuers at a fair market value price. Without this fair market value requirement, issuers could simply direct prohibited investment profits, or profits that would otherwise be paid to the federal government, to entities other than the United States. The process of purchasing investments at an inflated price, known as "yield burning," has received significant attention and enforcement efforts from federal authorities. Issuers must be careful to comply with the fair market value requirement. Reliance on a fair market value certificate of the seller of securities, in circumstances where the seller will profit from an inflated price and the issuer will not be harmed, is inherently suspect.

The federal government has established a special program through the Bureau of Public Debt in which issuers can purchase special U.S. Treasury obligations—State and Local Government Series (SLGS)—at below-market yields in order to comply with the arbitrage yield restriction. SLGS purchased with a below-market yield are deemed to have been purchased at fair market value.

HEDGE BOND RESTRICTIONS

The tax code prohibits tax-exempt bonds from being issued far in advance of the time money is required to construct or acquire the assets to be financed. The temporary period rules exceptions to the rebate requirement (described previously) often provide good reason to issue bonds close to the time when the proceeds will be spent. Similarly, economics dictate this result whenever the short-term interest rates at which proceeds may be invested are lower than the long-term rates at which the bonds accrue interest.

In general, bonds will be considered hedge bonds and will not be tax-exempt unless the issuer reasonably expects either:

- To spend at least 85 percent of the net sale proceeds—generally, sale proceeds less any amounts deposited into a debt service reserve fund—within three years of the issuance of the bonds, and
- 50 percent or less of the proceeds are invested in non-purpose investments with a guaranteed yield format for at least four years. Non-purpose investments are investments in securities, bank deposits, or other investments that have nothing to do with the governmental purpose of the bond.

General Exception. A bond that otherwise satisfies the hedge fund bond test will not be considered a hedge bond if at least 95 percent of the net proceeds are invested in non-Alternative Minimum Tax (AMT) bonds. Amounts in a bona fide debt service fund and amounts held for fewer than 30 days pending reinvestment or redemption are treated as invested in non-AMT bonds. This test is based upon actual investments and not on the reasonable expectations of the issuer.

These expenditure requirements do not apply to refundings, and they do not apply to new money bonds in which virtually all of the proceeds of the bonds are invested in other tax-exempt bonds until such proceeds are expended.

REFUNDING BONDS

Refunding bonds are bonds, the proceeds of which will be used to pay principal, interest, or redemption price on another prior issue of bonds. Refunding bonds often involve complex federal tax issues and invoke a number of technical requirements. Although a complete description of these requirements is beyond the scope of this *Primer*, some of the more important concepts are described generally in this section.

Types of Refundings

For federal tax purposes, there are two important categories of refunding bonds:

- **Advance Refunding.** Refunding bonds issued more than 90 days before the bonds being refunded will be retired
- **Current Refunding.** Refunding bonds issued within 90 days of the date the bonds being refunded will be retired

Advance Refunding Example

City X issued bonds to finance a new library in 1980. City X advance refunded those bonds in 1982, in 1984, and again in 1992. City X may not issue any further advance refunding bonds for this project since it has used up its allowable two advance refundings—the 1982 and 1984 refundings count as the first and the 1992 refunding counts as the second. If the 1992 refunding had instead been completed in 1985, City X would still have one more advance refunding left, since the 1982, 1984, and 1985 refundings would count as only one advance refunding.

Limitation on Number of Refundings

In general, issuers are limited to only one advance refunding of any particular bond issue. This is one of the main reasons that issuers should be concerned about the total savings they are receiving in a refunding, because they only get one opportunity.

For bonds originally issued prior to January 1, 1986, an issuer gets up to two advance refundings, and for this purpose, all advance refundings issued prior to March 15, 1986 are counted as one.

There are no limitations on the number of current refundings. In general, qualified private activity bonds may not be advance refunded at all with tax-exempt bonds. However, private activity bonds may be advance refunded only with taxable refunding bonds.

Limitation on Refunding Noncallable Bonds

In an advance refunding, the tax law generally does not permit refunding any portion of the issue being refunded which is not callable prior to maturity. This is because, except for savings resulting from exploiting the difference between taxable and tax-exempt interest rates, there can be no economic savings from refunding noncallable bonds, since the higher rate of interest they bear will have to be paid to their full maturity. An exception to this rule allows noncallable bonds to be advance refunded for independent business reasons, for example, the need to eliminate a restrictive covenant contained in the indenture for the refunded bonds which can only be eliminated if all bonds issued under that indenture are defeased.

First Call Date Rule

For advance refundings issued for the purpose of debt service savings, the refunded bonds must be paid off with the proceeds of the refunding bonds no later than the first date that they may be redeemed at the option of the issuer. For pre-1986 bonds, this is defined to be the first date at which they can be refunded at a premium of 3 percent or less. Thus if bonds being refunded may be redeemed at a premium of 2 percent on January 1, 2008, 1 percent on January 1, 2009, and 0 percent on January 1, 2010 and thereafter, the proceeds of the refunding bonds must be used to redeem the bonds no later than January 1, 2008. This is true even if it would be financially advantageous to the issuer to wait until January 1, 2010 to avoid paying the 2 percent penalty. The policy behind this rule is to have tax-exempt bonds (in this case the refunded bonds) in the market for the least amount of time possible.

Arbitrage Yield Restriction

Unlike new money financings, refunding transactions—in particular advance refundings—typically pose significant arbitrage yield restriction issues. Proceeds of an advance refunding held in an escrow are not allowed to be invested at a yield that exceeds the yield on the advance refunding bonds. Often, however, the yield of investments purchased in the open market at fair market value will exceed the yield of the advance refunding bonds. This is because even though these investments are typically of a shorter maturity (which tends to lower yield) they are also typically taxable investments, which increases yield—sometimes above the tax-exempt yield on the refunding bonds. For that reason, advance refunding escrows provide significant opportunities for yield burning. (See the discussion under **Fair Market Value Rules** earlier in this chapter.) In order to avoid any yield burning concerns, many issuers purchase SLGS for their advance refunding.

Chapter 4

STATE CONSTITUTIONAL LIMITATIONS

This chapter of the *California Debt Issuance Primer (Primer)* briefly outlines several key state constitutional provisions affecting public finance transactions, including the constitutional debt limitation, the prohibition on gifts of public funds and lending of public credit, initiatives and referenda, and the Jarvis Family of Initiatives (discussing the relevant provisions of Propositions 13, 4, 62, and 218).

The intent of this chapter is to provide the general purpose and effect of the constitutional provisions and thus enable the reader to intelligently consult with legal advisors concerning the impact of these provisions on a particular financing. While the provisions do not represent all of the constitutional provisions that may affect a particular transaction, they are the most commonly-encountered limitations in the public finance arena. The full text of the constitutional provisions discussed in this chapter may be found in **Appendix D – Legal References**.

THE 1879 CONSTITUTION

California’s Constitution was ratified in 1879 at the Constitutional Convention that took place in Monterey the same year. Like many other Western states, California’s Constitution contains limitations on the authority that may be granted to local governments in the area of public debt and other financial transactions. These limitations were in part intended to curb “municipal extravagance” and in part a response to the temptations local officials of the day faced with respect to expansion of the railroads. In a situation not dissimilar to the modern competition among localities for sales-tax generating uses such as “big box” retailers and auto dealerships, the railroads of the late 19th century recognized that they could gain valuable subsidies by playing one locality against another in the competition for the locations of routes and stations. Though of debatable effectiveness, the fiscal limitation provisions of the 1879 Constitution were an attempt to blunt those efforts by limiting the extent to which localities could legally succumb to these temptations—at least without first obtaining supermajority voter approval.

THE DEBT LIMIT

Article XVI, Section 18 of the California Constitution (the “debt limit”) prohibits cities (including chartered cities), counties, and school districts from entering into indebtedness or liability that in any year exceeds the income and revenue provided for such year unless the local agency first obtains two-thirds voter approval for the obligation. This general limitation has several important exceptions as described below. It is important to remember that this limitation applies not only to traditional bonds, but could apply to many forms of indebtedness or liability, such as installment payment obligations, long-term service or construction contracts, letter-of-

credit reimbursement agreements, and other types of arrangements commonly seen in public finance transactions. In determining whether the arrangement under consideration might pose a problem under the debt limit it is useful to ask the following questions:

- Does the arrangement provide for payment in future fiscal years that comes out of revenue generated in those years?
- Does the arrangement call for payments by a city, county, or school district (as opposed to other types of governmental agencies)?

If the answer to these two questions is “yes,” then the analysis should proceed to determine if one of the exceptions to the debt limit applies. There are three major exceptions to the debt limit that have been recognized by California courts—the Offner-Dean lease exception, the special fund doctrine, and the “obligations imposed by law” exception.

The Offner-Dean Lease Exception. Named after the two leading California Supreme Court cases in the area—*City of Los Angeles v. Offner* and *Dean v. Kuchel*—the Offner-Dean lease exception provides that a long-term lease obligation entered into by a city, county, or school district as lessee will not be considered an “indebtedness or liability” under the debt limit if the lease meets the following criteria:

- The obligation to pay rent in each year is contingent upon the lessee having “beneficial use and occupancy” of the leased premises during that year
- If such use and occupancy is not provided, there is an abatement of rent during the period that use and occupancy is not available
- In the event the lessee fails to pay rent when due, there can be no acceleration of the future rent due
- The rent in each year represents the “fair rental value” of the premises

Some courts have recognized an exception to the debt limit provided by the Offner-Dean exception when so-called contingent liabilities are involved. These cases involve fact patterns containing multi-year term contractual obligations the payment for which is contingent upon a service or other consideration being provided in each year. Thus, for example, courts have approved long-term contracts for services where the payment is contingent in each year on the provision of the service by the contracting party. One public finance application of these cases is the financing of pre-paid service contracts, such as telephone contracts.

For a more detailed description of the requirements of a lease financing, see **Chapter 6, Types of Financing Obligations – Public Lease Revenue Bonds.**

The Special Fund Doctrine. The special fund doctrine is another judicially-created exception to the debt limit, which permits long-term indebtedness or liabilities to be incurred

without an election if the indebtedness or liability is payable from a “special fund” and not from the entity’s general revenues. A “special fund” is a fund—such as one consisting of enterprise revenues—which is used to finance an activity related to the source of the revenues, such as the activity of the enterprise. For constitutional purposes, indebtedness to finance the enterprise payable solely from the special fund is not an “indebtedness or liability” of the local agency itself, but merely an indebtedness or liability of the “special fund” in which the revenues are deposited.

To determine if a special fund exception might be available, consider the following questions:

- Is the indebtedness being issued to finance an asset that is part of the project or system that generates the revenues?
- Have the revenues in the fund been artificially segregated by the local agency from other general revenues in order to create the special fund, or are they inherently restricted revenues?
- In the event the special fund revenues are insufficient to pay the debt, is there any obligation of the local agency to make up the shortfall from other funds?

There must be a nexus between the project being financed with the indebtedness and the special fund itself. For example, a new water treatment plant could be financed through indebtedness secured by the revenues of the water system (i.e. water fees and charges), but the use of the water revenue fund to finance an unrelated facility, such as a public parking lot, would not qualify under the special fund doctrine.

It is important to note that the California Supreme Court has not allowed the special fund doctrine to be used to create special funds out of revenues that would otherwise be available to the general fund. In *City of Redondo Beach v. Taxpayers, Property Owners, et al.*, the court held that the creation of a separate fund into which the city would deposit the sales tax revenues generated from within the marina area of the city could not be used to support an indebtedness to finance improvements to the marina area. The court reasoned that, but for the creation of this separate account by the city, the sales tax revenues would have been deposited in the general fund and would have been available for appropriation by the city council for any lawful purpose. The court rejected the argument that there was a nexus between the marina improvements sought to be financed and the general sales tax revenues, noting that this nexus, even if proved, was not sufficient since the revenues themselves were not inherently restricted to marina uses but rather were available to the city for any use.

For a more detailed description of the uses of the special fund doctrine, please see **Chapter 6, Types of Financing Obligations – Public Enterprise Revenue Bonds.**

“Obligation Imposed by Law” Exception. Another exception to the debt limit is the “obligation imposed by law” exception. While not as commonly used as the Offner–Dean lease

and special fund exceptions described above, this exception has gained importance due to its use to support pension obligation bonds and certain types of Teeter Plan Financings.

Courts applying this exception have determined that an indebtedness to finance an obligation which is imposed on the local agency by law—such as a large money judgment against the local agency or a court order to provide a facility required by state law to be provided (like a courthouse or a jail)—is not subject to the debt limit. The theory of this exception is that the obligation is involuntary, and therefore it would be meaningless to put the question to the voters.

Because this exception has been applied in only a handful of appellate cases and is therefore not well-defined, most financings using this exception are subjected to a validation action to provide assurance that they are lawful. For a detailed discussion of the most common applications of this exception, please see **Chapter 6, Types of Financing Obligations – Pension Obligation Bonds and Teeter Plan Property Tax Receivables Financings.**

THE PROHIBITION ON GIFTS OF PUBLIC FUNDS AND LENDING OF PUBLIC CREDIT

Article XVI, Section 6 of the California Constitution prohibits a public agency from making any gift of public funds or from lending its public credit to any person. This provision also prohibits a public agency from becoming a stockholder in any private corporation. The purpose of this limitation is to prohibit the use of public financial resources to benefit private persons or firms. The provision is directly traceable to the expansion of the railroads in the West and the pressures put on public agencies to become financial benefactors of and investors in the railroads as an inducement to obtaining service. In its application to modern public finance transactions, this provision can limit the ability of public agencies to enter into so-called public-private partnerships for projects and activities, and must be carefully considered whenever a private firm or person is involved with a public entity in such a joint venture.

There are several narrow exceptions to this provision contained in the language of the constitutional provision itself. In addition, the courts have created a fairly broad “public purpose” exception which frequently is applied to sanction activities that otherwise might run afoul of the constitution. Under the “public purpose” exception, a transaction that is for a valid public purpose, even though it may provide an incidental benefit to private persons, is not prohibited by Article XVI, Section 6. Another formulation of this exception holds that if the public agency receives valid “consideration” for the payment or provision of value to the private person, there is no gift.

As noted above, this constitutional provision should be carefully considered whenever a “public-private partnership” structure is being used. It also frequently comes up in connection with redevelopment and other economic development activities where public finance transactions are used to provide benefit or inducement to private firms for the purpose of achieving economic advantages to the community.

CHARTER CITIES AND “HOME RULE”

California is what is known as a “Home Rule” state. Article XI, Section 5 of the State Constitution provides that chartered cities (but not general law cities) may operate under separate charters which govern the city with respect to all “municipal affairs,” subject only to the limitations contained in their charters and the constitution. As to matters that are not “municipal affairs”—those that are of “statewide concern”—the general laws of the state (i.e. state statutes and regulations) will apply. Most of the state’s largest and oldest cities are chartered cities, and most newer and smaller cities are general law cities.

A complete exposition of the difference between municipal affairs and statewide concerns is beyond the scope of this book. In general, however, a municipal affair is one that is local in nature, does not affect persons or property outside the jurisdiction of the municipality, and does not implicate any statewide regulatory scheme established by the legislature or in the constitution. Some cases refer to a sort of “preemption” doctrine when assessing whether a state statute is controlling on a chartered city. This approach seems to look a lot like the notion of “occupying the field” applied in federal jurisprudence under the Commerce Clause of the United States Constitution. This analysis is flawed, however, because unlike the U.S. Constitution, which is a limitation on the supposedly plenary powers of states, the State Constitution actually grants powers to chartered cities directly. The power over municipal affairs is therefore not the legislature’s to take away by “occupying the field” but rather does not extend to those areas where statewide action is necessary to accomplish an effective regulatory scheme and the legislature has effected a scheme of such regulation.

The following is a partial list of activities that have been declared municipal affairs in certain contexts:

- Local taxation (except for taxation of banks, insurance companies, alcoholic beverages, and other types of taxes where the state has developed a comprehensive taxation scheme)
- The issuance of debt
- The formation of assessment districts
- Public contracting requirements
- The conduct of local elections

Obviously, many of these areas are quite important to public finance transactions. Because a chartered city does not necessarily have to follow state statutory requirements in conducting its municipal affairs, absent charter limitations or state constitutional constraints, a chartered city may have a great deal of flexibility in how to structure and accomplish its financing activities. For example, a chartered city can establish its own assessment district procedure, following state

statutes where desired and deviating where it needs to, subject only to the limitations contained in the constitution (including Proposition 218).

Some city charters are quite simple and merely give the city's legislative body full authority to enact ordinances (which are like local statutes) covering any area that is a "municipal affair." Other city charters are quite complex, sometimes running into hundreds of pages, and impose detailed restrictions on the exercise of municipal powers. Almost all charters allow the city to follow state statutory provisions if no local ordinance or charter provision exists on a particular subject. Careful review and consideration of the provisions of the city charter is critical to a proper legal analysis of any financing conducted in a chartered city.

THE POWER OF INITIATIVE AND REFERENDUM

Among the hallmarks of the 1879 State Constitution is the power reserved to the people to enact statutes and amend the Constitution by initiative and the power to repeal legislative acts by referendum. These powers are contained in Article II, Sections 8 and 9 of the State Constitution. The courts have held that these powers are available to the electorate of local agencies as well as to the state as a whole.

Initiatives can impact public finance transactions in several ways. Revenue streams needed to pay debt could be subject to interruption through the use of initiatives to limit future taxes, assessments, fees, or charges. See the section in this chapter on **The Jarvis Family of Initiatives – Proposition 218** for a more detailed explanation of initiative powers as they relate to revenues. In addition, initiatives could impose limitations on the power of a locality to issue certain types of debt, such as voter approval requirements or limits on the use of proceeds.

Referendum is the power of the electorate to reject and nullify a legislative act taken by the applicable legislative body. If a legislative body takes an action which is legislative in nature, the people have the opportunity to submit a petition containing the requisite number of signatures (generally 10 percent of the number of voters who voted in the last gubernatorial election) to put the measure on the ballot for ratification. If such a petition is submitted, the legislative body has the choice of either repealing the legislative act or putting the matter to a vote. The petition must be submitted within 30 days of the legislative act. The referendum power should be kept in mind when considering the timing of consummation of transactions that might be subject to referendum.

THE JARVIS FAMILY OF INITIATIVES

Since 1978, California voters have approved four initiative measures, all but one of them constitutional amendments, which have dramatically limited local fiscal flexibility and have been the catalyst for the creation of many of the financing techniques discussed in this book. The most recent of these initiatives—Proposition 218, enacted in 1996—has yet to be tested in the courts and is the subject of a fair amount of uncertainty regarding its application. However, the other initiatives—Proposition 13 (1978), Proposition 4 (1979), and Proposition 62 (1986)—have

all spawned significant litigation that has resulted in a large body of case law. The leading promoter of these initiatives, the late Howard Jarvis, was an anti-tax crusader who tapped into a growing feeling in California that property taxes were too high. This feeling was compounded by the rapid increase in property values in California, which increased the dollars paid in ad valorem property taxes, even for those who had not realized these value increases by selling their property.

The story of the Jarvis family of initiatives is one of action and reaction. The dynamic has roughly occurred as follows:

- The initiative process was used to make changes to the law, attempting to constrain the ability of local governments to raise revenues
- Local governmental entities reacted by:
 - Finding other ways to accomplish their goals, and
 - Initiating litigation to clarify the scope and application of the initiative
- The Howard Jarvis Taxpayers Association responded with another initiative to try to counter the actions taken by local governmental agencies

Feeding this cycle of action and reaction has been the ambiguous language that appears consistently in the Jarvis initiatives. Beginning with Proposition 13 and continuing all the way through Proposition 218, these initiatives have sometimes included incomplete or missing definitions, inconsistent use of terms, unclear effective dates, and the like. All of these attributes have been seized upon by local agencies as opportunities to request judicial clarifications that suit their interests. In many cases these drafting oversights have made it possible for the courts to permit financing and revenue-raising programs that the drafters of the initiatives probably thought they were prohibiting or restricting.

What follows is a brief summary of the provisions of each initiative affecting local government finance, together with an explanation of the reactive events (both case law and practice) that occurred in response. Since Proposition 218 basically recodified much of the law that was based on the earlier initiatives and cases, a more detailed explanation of its provisions is provided.

PROPOSITION 13

Proposition 13 added Article XIII A to the State Constitution in 1978. It marks a watershed in California local government finance. The main point of Proposition 13 was to limit ad valorem property taxes. Prior to the early 1970s, local governments could generally set the property tax rate—i.e. the percentage of assessed value that would be imposed annually as a tax—in accordance with the revenue needs of the local government. Although limitations were adopted by the State Legislature in 1972 on the tax rates imposed by local governmental entities, the average property tax rate prior to Proposition 13 was approximately 3 percent of market value of

the property (although the property tax on many properties varied substantially from this average figure). This, combined with the rapid increase in real estate values (especially among single-family residences), meant that the tax bills of homeowners continued to rise at a rapid rate.

Proposition 13 accomplished property tax relief in two important ways. First, it limited the annual property tax rate to 1 percent of the full cash value of the property. Second, it defined the full cash value to be the value shown on the 1975-76 assessment roll (essentially a two-year rollback of property values) or the actual market value at the time of a later sale of the property. Property that was not sold could only increase in assessed value by an annual maximum of the lesser of the Consumer Price Index or 2 percent. This has resulted in what some have called an acquisition value approach to taxation, which in a rising real estate market requires new buyers to pay dramatically higher taxes as compared to those who have owned their property for longer periods.

By limiting property tax rates to no more than 1 percent of the full cash value, Proposition 13 effectively prevented the approval of new general obligation bonds because even with a two-thirds vote, property tax rates could not be increased above the 1 percent limit to meet required debt service payments. This situation was remedied by a constitutional amendment in 1986 that permits rates in excess of the 1 percent limit to pay debt service on bonded indebtedness approved by a two-thirds vote, but only for the acquisition or improvement of real property. See **Chapter 6, Types of Financing Obligations – Local Agency General Obligation Bonds** for more information.

An important exception to the 1 percent limit on property taxes in Article XIII A is the so-called prior approved indebtedness exception. Under this exception, taxes to pay for indebtedness approved by the voters prior to the enactment of Article XIII A are exempt from the 1 percent limit. Although probably conceived by the Jarvis organization as a limited exception to protect prior debt obligations only, this exception has found relatively wide use in enabling the retention and/or creation of special tax overrides for pension obligations, library support, and other activities besides traditional bonded debt obligations.

With respect to local government finance, the most important section of Article XIII A (and probably the most litigated one) is Section 4. That section states:

“Cities, counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district, except ad valorem taxes on real property or a transaction tax or sales tax on the sale of real property within such city, county or special district.”

As a result of many years of litigation, several Supreme Court decisions, as well as many more court of appeals decisions, this section has produced the following general rules with respect to Section 4 (many of these rules with respect to Section 4 have been modified due to the adoption of Proposition 218, discussed later in this chapter):

- “Special districts” governed by Section 4 do not include entities that do not have property taxing powers
- “Special taxes” are taxes earmarked for a specific purposes, and do not include taxes that are available for the general governmental purposes of the taxing entity as directed from time to time by its governing body
- “Special taxes” do not include assessments for special benefit, fees, and charges for the use of a facility or service or for regulatory purposes or payments made under contracts
- Any compulsory charge not within the above exceptions requires a two-thirds majority vote

Thus many revenue sources were left untouched by Article XIII A, and they became much more popular as a result of the other limitations imposed by Proposition 13. In addition, new revenue sources were established to take advantage of the exceptions to the two-thirds vote requirement described above.

Assessment financing, which had existed for most of this century, became an even more popular tool for new infrastructure finance. Mello-Roos financing was established to allow a new special tax to be created and included the concept of a landowner vote to obtain the requisite two-thirds majority where unpopulated land was concerned. Sales tax revenue financing took advantage of the fact that special districts did not include special-purpose entities without property-taxing power, and later took advantage of the ability to levy general taxes for the general governmental purposes of the taxing entity without voter approval (or with only the majority approval required by Proposition 62, discussed below). Finally, enterprise revenue financing was given a lift through the exemption of fees and charges from the Section 4 two-thirds vote requirement. In addition to these effects, the inability of cities and counties to issue general obligation bonds, together with the ability to levy other types of general taxes to replace property tax revenue lost under Article XIII A, greatly increased the use of public lease revenue bonds and certificates of participation. All of these financing vehicles are discussed in more depth in the **Chapter 6, Types of Financing Obligations**.

PROPOSITION 4

Proposition 4 added Article XIII B to the State Constitution in 1979. Dubbed the Gann Initiative after Paul Gann, a close ally of Howard Jarvis, Proposition 4 was intended to limit the ability of governmental entities to spend money. After the passage of Proposition 13, the state applied a \$5 billion surplus to provide funds to local agencies to soften the revenue blow resulting from the property tax rollback contained in Proposition 13. This “Proposition 13 Bailout” caused the Jarvis organization to believe that a spending limit, applicable to both the state and local governments, was necessary to curb the size of government.

The central feature of Proposition 4 requires each governmental unit, including the state itself, to have a so-called appropriations limit, which is a limit on the amount of expenditures each entity can make in a given year from monies dubbed proceeds of taxes. A detailed discussion of the provisions of Article XIII B is beyond the scope of this book—however, a few important points bear mentioning.

First, as with Article XIII A, there are important exceptions to what constitutes proceeds of taxes. User fees and charges (such as water rate revenues, parking fines, building permit fees and special assessments, etc., to the extent they do not exceed the reasonable cost of service) are not proceeds of taxes. Also, monies expended to pay debt service on voted bonded indebtedness are exempt from the limit. There are other exemptions not noted here.

An entity's appropriations limit is increased each year by the Cost of Living Index and population increases and may be additionally increased for up to a four-year period if the increase is approved by the voters. A new entity (such as a new city or Mello-Roos Community Facilities District) may enact its own appropriations limit when it incorporates.

PROPOSITION 62

Proposition 62, a statutory initiative, was enacted in 1986. Proposition 62 was an attempt to react to the exceptions created under Article XIII A, Section 4 to the two-thirds vote requirement. As a statutory initiative (rather than a constitutional amendment) it did not apply to chartered cities. Many portions of Proposition 62 were ruled unconstitutional by the courts of appeal, and some of those decisions were effectively overturned in the Supreme Court's decisions in the *Rider* and *Guardino* cases. A more detailed explanation of these cases can be found under **Chapter 6, Types of Financing Obligations – Sales Tax Revenue Bonds**.

Although virtually all of Proposition 62 has been superseded by Proposition 218, there are two important provisions that continue to have some application today:

- New general taxes must be approved by a two-thirds vote of the governing body of the taxing entity before they are put on the ballot
- In the event taxes are imposed in violation of Proposition 62, there is a mechanism to reduce the ad valorem property taxes levied in the jurisdiction on a dollar-for-dollar basis to “remedy” the illegal taxation

Except for the above provisions, most of the concepts of Proposition 62 are now embodied in Article XIII C of the State Constitution, added by Proposition 218.

PROPOSITION 218

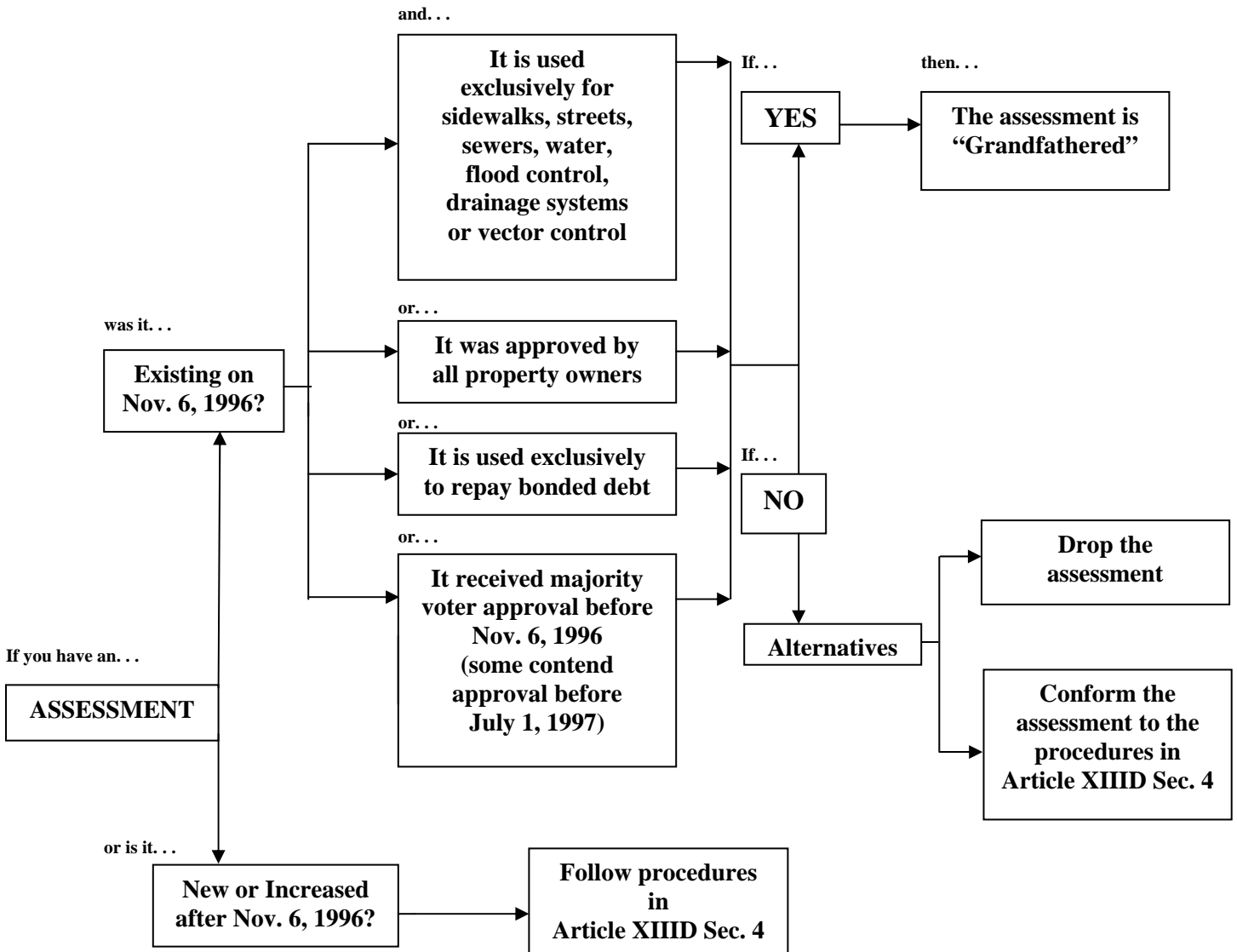
Proposition 218 added Articles XIII C and XIII D to the State Constitution in 1996. Proposition 218 was intended to be a comprehensive set of limitations and restrictions on the methods by which local governments (including chartered cities) can raise revenues through taxes,

assessments, fees, and charges. It imposes both procedural and substantive limitations on these types of revenue sources. The provisions of Proposition 218 are described below. No doubt, future litigation will serve to shape the final contours of this measure, as has been the pattern with all of the Jarvis initiatives.

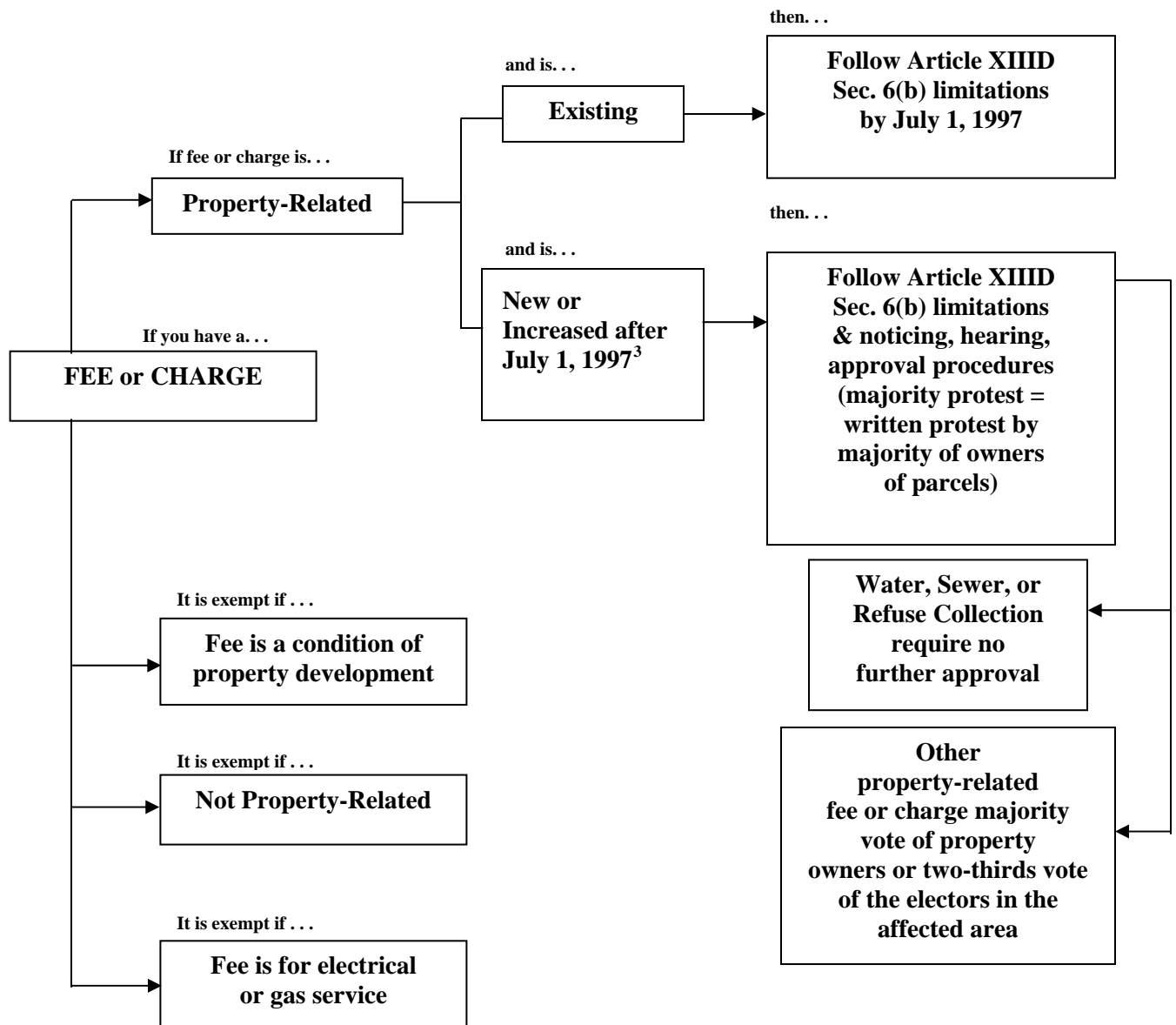
In relation to public finance transactions, it is important to remember that Proposition 218 does not directly affect the ability to enter into debt or other long-term obligations. Rather it has an impact on the ability to impose, increase and maintain revenue sources that may be directly pledged or indirectly used to make payments on such obligations. It is important to remember that these limitations may have indirect, as well as direct, impacts on the credit quality of debt obligations. For example, while it is easy to see that the inability to levy and collect assessments would directly impact the credit quality of an assessment bond, the inability to raise revenue through assessments for ongoing maintenance obligations (such as through a landscape and lighting district) may indirectly have an adverse impact on general fund supported obligations such as certificates of participation. These indirect impacts may require special disclosure in connection with some financing instruments even where the immediate source of repayment is not directly impacted by the restrictions of Proposition 218. For a discussion of the principles applicable to disclosure obligations, see **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

The three flow charts that follow can be useful in beginning the analysis of an exaction under Proposition 218. After reviewing the flow chart with a particular exaction in mind, the reader may turn to the specific sections of text below to obtain further information. The reader should keep in mind that many of the provisions of Proposition 218 are unclear and may be interpreted differently than as set forth below. The State Legislature has weighed in with helpful interpretations of certain provisions of Proposition 218. SB 919, dubbed the Proposition 218 Omnibus Implementation Act, was an urgency bill passed in the summer of 1997. SB 919 contains additional definitions, clarifying sections, and procedural detail in connection with the implementation of Proposition 218. The reader should note that, while SB 919 was “consensus” legislation which was supported by the Howard Jarvis Taxpayers Association, and while the legislature’s contemporaneous interpretation of a constitutional amendment is ordinarily accorded great weight by the courts, it is possible that a court could find that an interpretive or implementing section of SB 919 is inconsistent with the constitutional provisions of Proposition 218 and therefore invalid. An amalgamated version of the texts of Proposition 218 and SB 919 is contained in **Appendix D – Legal References**. Also see the discussion of SB 919 in **Chapter 6, Types of Financing Obligations – Assessment Bonds**.

Proposition 218 Flow Chart Assessments

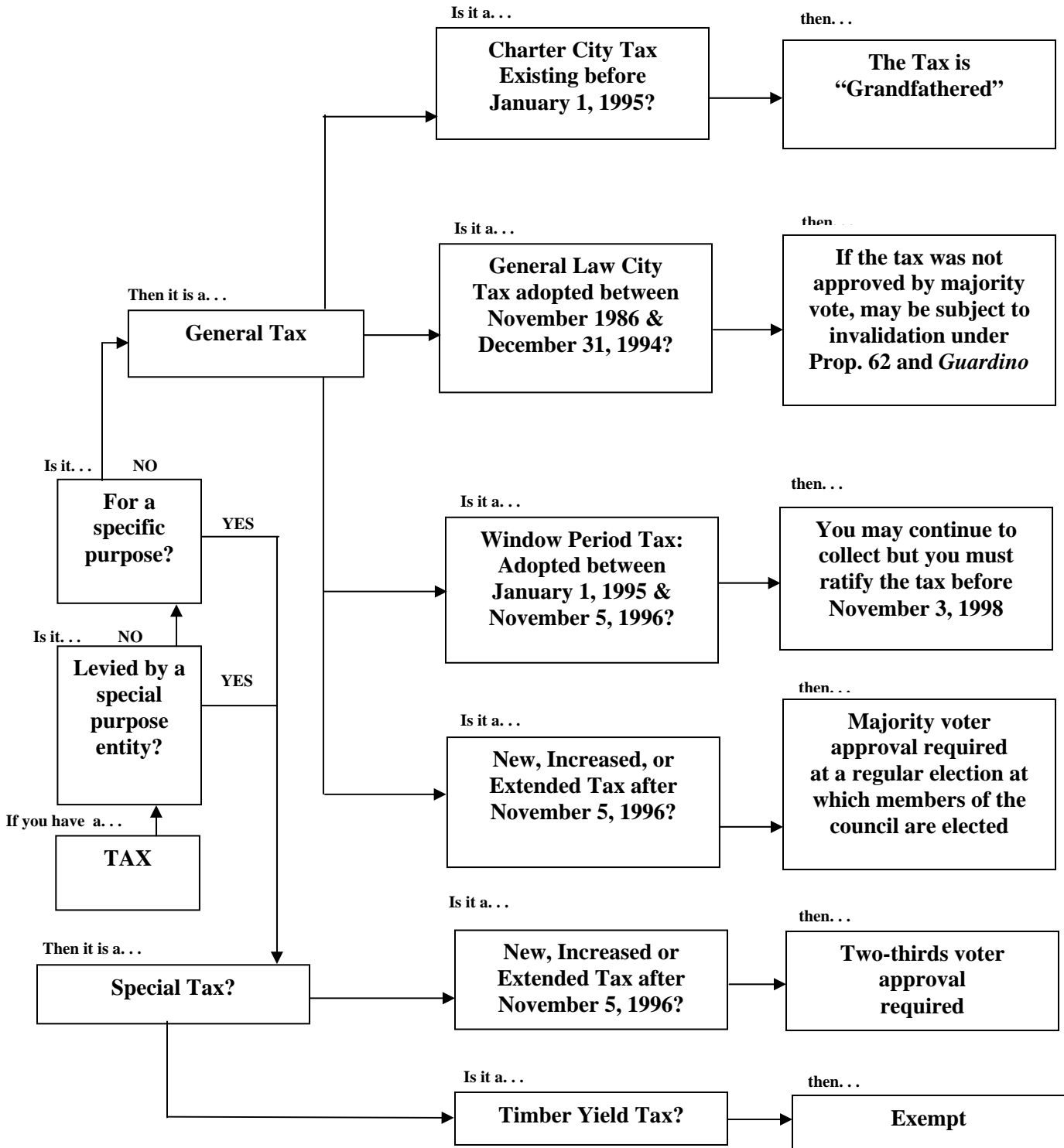


Proposition 218 Flow Chart Property Related Fees and Charges



³ Under some interpretations this date is November 6, 1996.

Proposition 218 Flow Chart Taxes



Types of Exactions

The most important step in determining how to comply with Proposition 218 is deciding what type of exaction is under consideration. In general, governmental exactions fall into three broad categories: taxes, assessments, and fees (which can be property related or nonproperty related). Sometimes governmental revenues also come from private contractual arrangements under which a party agrees to pay something to the government as part of a negotiated agreement. These payments are not governed by Proposition 218. Also, Proposition 218 categorically exempts fees for electric and gas service, and fees that are a condition of development from its restrictions.

Below are general descriptions of the three basic types of exactions governed by Proposition 218. In some situations, it may be difficult to categorize an exaction precisely, and these situations are likely to be the most difficult to analyze under Proposition 218.

Taxes

Taxes are exactions levied for the purpose of raising revenues. They are compulsory and their proceeds may be used for purposes unrelated to the activity or asset being taxed. There are two types of taxes for the purposes of Proposition 218 – general and special. Under Proposition 218, only general-purpose entities (such as cities and counties) may levy general taxes.

A general tax is a tax the proceeds of which are used for general governmental purposes by the taxing entity. Note that, even if the tax is deposited in the general fund of the taxing entity, it is only a general tax if the purposes for which its proceeds may be spent are not limited. In other words, for the tax to be a general tax, the governmental body must be able to appropriate the tax revenues from time to time for any lawful purpose.

A special tax is any tax imposed by a special-purpose entity (such as a school district) or any tax imposed by a general-purpose entity that is earmarked or restricted for a specific purpose.

Proposition 218 effectively overruled the court decisions under Proposition 13 regarding the definition of “special district” by making it clear that the voter approval requirements for special taxes apply to all local entities, without regard to whether they have the power to levy property taxes.

One unresolved question with respect to special taxes is whether a tax, which was levied by a general governmental entity as a general revenue producing measure but with a specific use in mind (as evidenced by the campaign to approve the tax or a nonbinding advisory ballot measure directing the use of the tax), is a special tax. The better view probably is that so long as the governing body can legally appropriate the tax revenues for any lawful purpose of the taxing entity from time to time, the tax is a general tax for purposes of Proposition 218. However, certain taxes approved by a majority of the voters as general taxes in conjunction with advisory measures concerning their use have been challenged in court on the basis that the companion

advisory measure serves to limit the use of the tax revenues to a special purpose and therefore requires a two-thirds vote.

Approval of Taxes. New, extended, or increased general taxes must be submitted to the qualified electors of the taxing entity at a general election at which the governing board members are to be elected (except in case of a unanimously declared emergency). General taxes may be approved by a simple majority of those voting at such an election. A general tax is not deemed increased for purposes of the election requirement if it is imposed within a previously approved maximum rate. General taxes in existence as of January 1, 1995 need not be approved again under Proposition 218. Those imposed, extended, or increased between January 1, 1995 and November 6, 1996 must have been ratified at an election prior to November 6, 1998.

New, extended, or increased special taxes may be submitted to the qualified electors of the taxing entity at any special or general election. Special taxes must receive an affirmative two-thirds vote of those voting at such an election. A special tax is not deemed increased for purposes of the election requirement if it is imposed within a previously approved maximum rate.

SB 919 (Chapter 38, Statutes of 1997) extends the provisions for all-mailed ballot elections to any election conducted under the provisions of Article XIIC or Article XIID (including assessment proceedings). The reader should note that, under Elections Code Section 4000, a mailed ballot election may not be conducted on the same date that a statewide direct primary or general election is held. This provision effectively prevents holding general tax elections by mail when the election date for governing board representatives is the same as statewide elections.

SB 919 also requires that, prior to the submission of any general tax to the electorate, the public entity proposing to levy the tax must conduct a public meeting to hear testimony and a public hearing to consider the action placing the tax on the ballot. The public meeting and public hearing must be noticed by a display advertisement of at least one-eighth page in a newspaper of general circulation and by mailing notice to those persons who have filed a written request for mailed notices of public meetings and public hearings. After the hearing, a majority vote of the legislative body is required to place the measure on the ballot. See the amalgamated version of the texts of Proposition 218 and SB 919 in **Appendix D – Legal References** for more detail on these and other requirements.

Assessments

An assessment is a levy or charge upon real property to pay for a capital improvement or a service that is of special benefit to that property. For a discussion of the various types of assessments that can be used in connection with debt financing, see **Chapter 6, Types of Financing Obligations – Assessment Bonds**. Assessments are levied upon an area of land (an “assessment district”) designated by the levying entity as comprising the land that receives special benefit from the improvement or service. Proposition 218 defines special benefit as:

“A particular and distinct benefit over and above general benefits conferred on real property located in the district or to the public at large. General enhancement of property value does not constitute ‘special benefit.’”

In addition to the above, nearly a century’s worth of case law exists concerning the definition of special benefit. Although sometimes stated a bit differently than in Proposition 218, most observers believe that what constitutes special benefit was not fundamentally changed by Proposition 218. However, Proposition 218 clearly throws a bright spotlight on this issue and the importance of carefully documenting and analyzing the special benefit determination.

Proposition 218 specifically provides that so-called standby charges— charges which are levied on property in respect of the potential or future use of services to the property—are to be treated as assessments for purposes of the approval requirements of Proposition 218.

Approval of Assessments. Article XIID, Section 4 provides requirements for the approval of assessments. The reader should note that in addition to the requirements of Article XIID, assessments must meet all of the statutory requirements for imposition (except that under SB 919, the notice, protest, and hearing requirements of each assessment act are superseded by the requirements of Proposition 218 described below). See **Chapter 6, Types of Financing Obligations – Assessment Bonds** for more detail. The following are the basic procedural steps for approval of an assessment under Proposition 218:

- Preparation of an engineer’s report by a registered professional engineer certified by the State of California
- Mailed notice to all property owners at least 45 days prior to the public hearing on the assessment
- Notice must include a protest ballot that asks each property owner to state whether they support or oppose the assessment
- Conduct a public hearing on the proposed assessment and tabulation of protest ballots
- Assessment may only be imposed if a majority of the ballots returned (weighted by the amount of the assessment for each property) supports the assessment

In addition to these procedural requirements, the assessment must satisfy certain substantive requirements under Proposition 218, as follows:

- Assessment must be proportional to the parcel’s share of special benefits received. Any general benefits must be separated from special benefits and funded from other sources
- Publicly owned parcels within the district must be assessed unless the agency can demonstrate by clear and convincing evidence that such parcels do not receive special benefit

- In any action challenging the validity of the special assessment, the burden of proving special benefit and the proportionality of the assessment shall fall on the agency levying the assessment. Proposition 218 does not appear to change the standard of proof applicable to assessments—sometimes stated as a substantial evidence test—but does require the levying entity to meet that standard in order to satisfy its burden of proof, even if a challenger offers no proof to the contrary.

Proposition 218 exempts certain assessments existing on November 6, 1996, as follows:

- Assessments imposed exclusively to finance the capital costs or maintenance and operation expenses for sidewalks, streets, sewers, water, flood control, drainage systems, or vector control
- Assessments imposed pursuant to a 100 percent property owner petition
- Assessments used exclusively to repay bonded indebtedness
- Assessments previously approved by majority voter approval

SB 919 contains several provisions implementing Article XIID’s assessment provisions. These specific provisions are discussed in **Chapter 6, Types of Financing Obligations – Assessment Bonds.**

Property-Related Fees and Charges

Article XIID, Section 6 relates to “property-related” fees and charges. While it is unclear what a property-related fee or charge is, Proposition 218 indicates that a fee is property-related if the fee is imposed as an “incident of property ownership.” Further, Proposition 218 indicates that if an agency relies on any parcel map, including an assessor’s parcel map, in determining whether the fee or charge is imposed, this is a “significant factor” in determining whether the fee or charge is property related. As with assessments, the burden of proving compliance with the requirements for such fees or charges is on the agency imposing the fee or charge. The California Attorney General has opined that water charges based upon consumption (rather than on a per-parcel or other basis) are not property-related for the purposes of Proposition 218, because they are not an incident of property ownership per se, but rather an incident of use of water. It is likely that this interpretation will be the subject of litigation. Fees and charges for electric and gas service are exempt from Proposition 218.

Proposition 218 imposes substantive restrictions on property-related fees and charges, as follows:

- Revenues from the fee or charge may not exceed the funds required to provide the property-related service
- Fee or charge revenue may not be used for any purposes other than those for which the fee or charge was imposed

- The amount of the fee or charge with respect to each parcel may not exceed the proportional cost of the service attributable to the parcel
- No fee may be charged unless the service is actually used by, or immediately available to, the owner of the property in question
- No fee or charge may be levied for governmental services including, without limitation, police, fire, ambulance, or library services where the service is available to the public at large in substantially the same manner as it is to property owners

Approval of Property-Related Fees and Charges. Proposition 218 imposes new procedural requirements for fees or charges imposed or increased after July 1, 1997, as follows:

- Each record owner of property subject to the fee or charge must be given 45 days mailed notice of a public hearing on the fee or charge (note that SB 919 defines record owner to mean the owner as shown on the most recent equalized assessment roll)
- The notice must specify the amount of the fee or charge to be imposed, the basis on which the amount was calculated, the reason for the fee or charge, and the date, time, and location of the hearing
- A public hearing must be conducted, and if a majority of the property owners file written protests to the fee or charge at the hearing, it may not be approved
- If the fee or charge is for purposes other than water, sewer, or refuse collection, the fee or charge must then be put to a vote of the electorate and must receive a two-thirds voter approval

Fees that are not property-related are unaffected by Proposition 218, except possibly with respect to the initiative power provision discussed below.

Local Initiative Power

Perhaps the most important feature of Proposition 218 from a bond-financing standpoint is Article XIIC, Section 3, which states:

“Notwithstanding any other provision of this Constitution, including, but not limited to, Sections 8 and 9 of Article II, the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment, fee or charge. The power of initiative to affect local taxes, assessments, fees and charges shall be applicable to all local governments and neither the Legislature nor any local government charter shall impose a signature requirement higher than that applicable to statewide statutory initiatives.”

At first blush, this provision seems to threaten the security of any bond the payment of which is dependent upon revenues from taxes, assessments, fees, or charges (in other words, virtually every municipal obligation). However, most observers have viewed this provision as much less

troublesome than it first appears, in that two important legal principles provide protection to revenue streams securing lawfully issued debt.

The first principle is related to the nature of initiatives themselves. An initiative is an exercise of the power reserved to the people to enact legislation directly, rather than through their representatives. An initiative may only be considered if it accomplishes a legislative act. Other types of actions that local legislative bodies may undertake, such as administrative acts (e.g. hiring or firing a city manager) or quasi-adjudicative acts (such as determining eligibility for a welfare program) may not be accomplished by initiative. Thus in order to have a valid local initiative, there must be a legislative power vested in the locality to undertake that which the initiative seeks to accomplish. In the case of many of the revenue streams pledged to bonded indebtedness, once the debt has been lawfully issued, the statutory or constitutional scheme under which the debt is issued provides that there is no further legislative power in the locality to reduce or eliminate the source of the revenue for debt repayment. Examples of this principle are found in assessment bonds, general obligation bonds, Mello-Roos Bonds, and certain revenue bonds. For more detail, see the appropriate sections in **Chapter 6, Types of Financing Obligations**. Because there is no legislative power to reduce the revenues, they may not be reduced by initiative. Thus Article XIIC, Section 3 does not confer any new initiative power but merely prevents the limitation of existing initiative powers through statutory or judicially created exceptions.

The second principle protecting debt repayment sources from interference by initiative is the federal Contracts Clause. This provision of the United States Constitution prevents legislative acts (like initiatives) from substantially impairing the obligation of a contract. Thus if an initiative purported to reduce fees and charges of a water system to an amount below the amount necessary to comply with the rate covenant securing bonded indebtedness, a claim could be made that the initiative violates the federal Contracts Clause.

One important feature of a Contracts Clause analysis is the so-called balancing test under which a court will weigh the governmental interest in the legislative act complained of against the harm to the contracting party (or the degree of impairment). Because of this balancing test, it is impossible to state categorically that any initiative, which adversely affects the revenues from a tax, assessment, fee, or charge securing debt, would be invalid under the Contracts Clause. However, it is very unlikely that an initiative, which so impaired the revenues that the debt could not be repaid in a timely fashion (as opposed to one which merely reduced the coverage for the debt), would survive a Contracts Clause challenge.

SB 919 contains a section dealing with these issues, which states:

“Section 3 of Article XIII C of the California Constitution, as adopted at the November election, shall not be construed to mean that any owner or beneficial owner of a municipal security, purchased before or after that date, assumes the risk of, or in any way consents to, any action by initiative measure that constitutes an impairment of the contractual rights protected by Section 10 of Article I of the United States Constitution [the “Contracts Clause”].”

This section is intended to blunt the argument that a Contracts Clause claim cannot arise with respect to a contractual right, which, under the law in existence at the time the contract was entered into, was subject to modification. For example, one might argue that a rate covenant in a revenue bond financing entered into after November 5, 1996 does not prevent an initiative rollback of rates that would violate the covenant since the contract was made after Proposition 218 was enacted. The quoted provision of SB 919 attempts to negate that argument. As discussed above, while this interpretive section of SB 919 is entitled to be given “great weight” by the courts in interpreting Proposition 218, it is not necessarily binding.

Neither the definition of initiative nor the Contracts Clause would likely prevent the use of the initiative to reduce revenues that only indirectly support debt. Thus, for example, if a city has a general fund lease obligation and the general fund is made up of several sources, including a utility tax, the repeal of that tax by initiative—even though it may substantially harm the security for the lease obligation—would probably not be prevented because the lease does not take away the legislative power to reduce taxes and the lessor does not have a contractual right to receive any particular source of revenue flowing into the general fund.

General Provisions of SB 919

SB 919 contains several general provisions applicable to all taxes, assessments, and property-related fees and charges. For a detailed understanding of these provisions, the reader is encouraged to refer to **Appendix D – Legal References – Amalgamated Edition of Proposition 218 and SB 919**. In addition, some of the specific applications of these sections are discussed in the pertinent sections of **Chapter 6, Types of Financing Obligations**.

Chapter 5

ENVIRONMENTAL ISSUES

This chapter provides a brief overview of the applicability of environmental law to public finance including a discussion of disclosure requirements and potential environmental liabilities.

Environmental issues are becoming pervasive in financial transactions of all kinds—including financings by public entities. Public financings often present many such issues because the facilities involved are either sizable, of high-visibility, or are highly regulated. The law requires that potentially significant environmental impacts from a public project must be appropriately analyzed and resolved before the project may proceed.

Environmental issues may arise in many contexts, but most often relate to the potential environmental liabilities of the issuer and other parties, or to the environmental status of a project, or to the real property that is the subject of a financing. “Environmental status” refers to environmental regulatory compliance that must precede the financing or to the physical condition of the real property and fixtures related to the financing. Failure to address any of these issues may expose the financing participants to significant liabilities or adversely affect a financing.

Three basic environmental issues must be addressed in most tax-exempt financings:

- Compliance with all environmental laws governing public projects, the main one being the California Environmental Quality Act (CEQA)
- Full disclosure of environmental risks in Official Statements and other documentation
- Potential environmental liabilities associated with an issuer’s role in financing

Participants in tax-exempt financings should approach environmental issues in precisely the same fashion as parties to other financial transactions—namely by undertaking due diligence to identify environmental risks and by structuring the transaction to minimize or eliminate such risks. The following brief outline of how that approach can be followed is not exhaustive. Because of the complexity of environmental laws and the technical or scientific nature of many environmental investigations, it is important for issuers to retain qualified consultants, including legal counsel, engineers, and other professionals.

COMPLIANCE WITH ENVIRONMENTAL REGULATORY REQUIREMENTS

Most financings involve a project or undertaking for which a permit, license, or certificate must be obtained before any actual work on the project can lawfully begin. Major public works projects typically will require multiple permits and entitlements covering the siting, construction,

and operation of the proposed facilities. The failure to obtain one or more necessary permits or certifications not only presents disclosure problems, but also may raise issues relating to the basic feasibility of the project.

In California, environmental review of projects is accomplished under CEQA (Public Resources Code Sections 21100 et seq.). CEQA is an extremely broad act and applies to all public agencies that “approve” or carry out “projects” where such projects “may have significant effects on the environment.” Each of these key terms is expansively defined by regulation and by case law. For example, a “project” includes not only actual construction activity, but also any “action” that may potentially result in a physical change in the environment. A public agency may trigger CEQA merely by approving or issuing a permit for activities by private parties. Financing for a project can, and generally does, constitute an approval under CEQA.

The procedures for complying with CEQA are both complex and lengthy. The preparation of an environmental impact report, which is required in some instances, can entail months of work. As a general matter, CEQA requires environmental review as early as possible in the decision-making or approval process. Unless a project is exempt from CEQA, environmental review should take place when the project is well-defined and prior to the first decision that might constitute an approval. CEQA does contain numerous statutory and categorical exemptions and those should be checked carefully in the review. Some state agencies, including the California Health Facilities Financing Authority (Government Code Section 15455) the California Educational Facilities Authority (Education Code Section 94212), and the California Pollution Control Financing Authority (Health & Safety Code Section 44561), have specific exemptions from CEQA for their financings. All other issuers must ensure that their financings are preceded by the appropriate environmental review. Noncompliance with CEQA is a serious matter because the remedy for CEQA violations, including violations of “technical” or procedural provisions, is voiding of the offending agency’s actions.

Initial Queries Relating to CEQA Compliance

Obtaining the answers to some relatively simple questions when a financing is initiated can establish whether CEQA has been satisfied. Again, it is important to conduct an inquiry as early in the process as possible. Questions that might be asked include:

- What is the issuer’s position on CEQA compliance for the particular project? Does the issuer believe that it has complied with CEQA or believe that the project is exempt?
- Are proceeds of the proposed financing to be used to construct a project or to further any other activity that may have an adverse effect on the environment?
- Has a CEQA “document,” i.e. an environmental impact report or negative declaration? If so, when was that document prepared?

- Has the issuer officially reviewed the CEQA document on the record and made any required CEQA findings?
- If a CEQA exemption is claimed, are there credible arguments or facts suggesting such an exemption does not apply?

These types of questions are merely a starting point when evaluating CEQA compliance for a project. In fact, considerable time and effort should be expended on this process. In financings for large or controversial projects it may be appropriate to have legal counsel and/or an independent consultant review the environmental documents and administrative findings to verify that all procedural questions and deadlines were met. Information on CEQA and its requirements is available at www.ceres.ca.gov/ceqa.

DISCLOSURE OF ENVIRONMENTAL RISKS

Disclosure of environmental risks in tax-exempt financings is often difficult because the risks are not easily identified and are not easily characterized or quantified.

Environmental risk often refers to the financial liabilities and other effects related to the presence of hazardous substances or hazardous waste in, on, or below real property. Other risks, of course, may be presented by noncompliance with environmental regulations, as discussed above. Determining hazardous substance liability in any environmental due diligence is critical because such liability is widespread and is potentially enormous in magnitude. Any tax-exempt financing, which involves a defined parcel of real property or major facilities, has the potential for a hazardous substance risk.

Although there are guidelines for disclosure in Official Statements, generally little or no emphasis is placed on environmental risks. However, issuers can look to the standards applied in commercial findings for more specific standards about the disclosure of environmental risks. A series of SEC regulations and releases details the information that must be disclosed about environmental liabilities in financings of private securities. For example, SEC Regulation S-K, Item 103 requires disclosure of all proceedings pending against a registrant and any contemplated proceedings and administrative orders while Item 101 requires disclosure about expenditures for environmental compliance, including the cleanup of contaminated properties. Together the SEC regulations require registrants to provide a complete picture of their environmental liabilities, compliance and enforcement record and relevant environmental policies (such as planned expenditures for environmental matters).

The current standard of commercial practice is to make a preliminary assessment of the potential for environmental risks before the close of any real estate related transaction. Such an assessment involves gathering recorded data and information from knowledgeable individuals but does not involve physical testing of a property. These preliminary assessments are sometimes referred to as “Phase 1” assessments, although that term can be misleading because it has no common definition.

A Phase 1 assessment evaluates a property to identify historical uses, owners, tenants, or other data that might indicate whether the property should be investigated further. For example, a rural property historically used for grazing a few animals usually has little potential for environmental problems, although in certain heavily agricultural areas, pesticide residues may present problems. On the other hand, an urban parcel formerly occupied by a foundry or by another business that typically uses hazardous materials or processes definitely should be investigated.

There are several standards for preliminary site assessments, none of which have yet been adopted by the federal government or by the State of California. The most widely followed and recognized standard is the ASTM (American Society For Testing & Materials) Standard E.1527, “Standard Practice For Environmental Site Assessments.” A committee of industry, government, and academic professionals developed the ASTM standard with the ultimate objective of incorporating it into environmental laws.

The ASTM Standard consists of two separate types of inquiries:

- During the transaction screen process a series of questions are asked of property owners and others to determine whether a more focused inquiry is needed. A typical question is, “To the best of your knowledge, has the property or any adjoining property been used in the past as a gasoline station, motor repair facility, commercial printing facility, dry cleaners, photo developing lab, junkyard or landfill, or as a waste treatment, storage, disposal, processing or recycling facility?”
- If any questions in the transaction screening process are answered in the affirmative, a full Phase 1 Environmental Site Assessment is conducted. The ASTM Standard specifies the types of records, e.g. abstract of title, federal and state lists of leaky underground tanks, that should be disclosed and the nature of the visual inspection of the property that should be undertaken.

A Phase 1 assessment is relatively inexpensive and generally may be required as a standard part of the due diligence for tax-exempt financings. Additional investigation may be undertaken before disclosures are drafted if a Phase 1 assessment reveals prior uses or particular areas of a property are potentially contaminated, thus actual sampling of soils or groundwater may be advisable. When a financing is of an operating facility, a comprehensive inspection or audit of the facility also may be advisable. Any testing of this sort is often referred to as “Phase 2” work. Unlike a preliminary assessment, Phase 2 investigations are potentially costly and time-consuming. The scope of work for any phase of environmental assessment should be clearly spelled out in a written contract and qualified consultants must be chosen for the work. As with any disclosure, the objective is not to accumulate quantities of useless or confusing information, but rather to generate material that is revealing and relevant to investors and, insofar as is possible, protects the issuer and developer from further liability.

Additional information and updates to ATSM policy and procedural guidelines can be accessed through the ASTM website at www.atism.org.

ISSUERS' POTENTIAL ENVIRONMENTAL LIABILITIES

The critical questions presented by a tax-exempt financing are whether or not the issuer should be classified as a party covered by environmental laws and, if so, to what extent might the circumstances create significant liabilities for the issuer. Often there is no simple answer to these questions because the participants in financings are not readily characterized in the terms used in many environmental statutes nor are the potential liabilities readily allocated among the parties.

Most environmental laws create obligations for any party that can be classified as the owner or operator of a facility (referring to both operating facilities and real property). For example, the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA, otherwise referred to as the Superfund law) creates liability for current owners and operators of facilities as well as anyone who owned or operated a facility at the time of a disposal of any hazardous substances. California's equivalent Superfund law, the Hazardous Substance Account Act (HSAA), is similarly broad in its reach. HSAA liability for hazardous substance releases attaches to any "responsible party" or "liable person."

The Superfund law, HSAA, and similar laws involve strict liability for hazardous substance releases that applies retroactively and on a joint and several basis. Liability may even attach in seemingly innocent circumstances, such as when an owner fails to remedy pre-existing pollution and the contaminants migrate beyond the property (sometimes referred to as passive leaking). Although a court may recognize equitable factors that pertain to apportioning liability among multiple parties, if other parties are not financially viable, a governmental owner or a developer who has minimal involvement may find its liabilities vastly increased.

Lease financings, certificates of participation, and industrial development bonds are all financings where governmental entities may acquire a security interest in property which might be classified as an "owner" or "operator's" interest. In conduit financings the governmental entity will typically purchase or lease the property and then sell or lease back to a private entity. A similar structure may be present in other tax-exempt financings, e.g. facilities such as waste treatment plants, transportation facilities, manufacturing facilities, and other facilities that present environmental risks. At least one federal court has held that such interests qualify for a "security interest exemption" under the Superfund law, but the law is still unsettled and the analysis may not apply to other laws. Both the Superfund law and the HSAA have been amended recently to clarify that holders of security interests will incur clean-up liabilities only under extraordinary circumstances.

A financing participant who falls into one or more of the following categories should consider undertaking environmental due diligence and analyze its potential liabilities:

- Any party acquiring an interest which can be characterized as an ownership interest, leasehold interest, or a security interest in real property at any point in the transaction, even where such interest is held for a brief period of time
- Any party that will be operating or directing the operation of a facility that uses hazardous materials
- Any party relying upon the credit of another party

Where environmental risks are actually identified or where the potential exists, issuers as a policy matter may seek contractual protections from developers. For example, an issuer may specify that it has no operational control over a facility and will retain the right only to inspect and monitor environmental compliance. Or an issuer may require that a developer enter into an agreement to remedy known conditions and to indemnify the issuer against any claims. The law as it relates to environmental liability will continue to be quite dynamic and, increasingly, developers should expect that environmental due diligence will be an essential feature of many tax-exempt financings.

In sum, certain public projects are subject to numerous federal, state, and local environmental requirements. As with any due diligence, time, care, and expertise are key to assuring that environmental issues will not delay or adversely affect a financing.

Chapter 6

TYPES OF FINANCING OBLIGATIONS

INTRODUCTION

This chapter provides a detailed description of 15 principal types of debt financing obligations. Each section describes a particular type of financing vehicle, the projects that it may be used to finance, its legal authority, process for approval and sale, important limitations, method of repayment and policy considerations. Also included for each type is a discussion of special federal tax issues which need to be considered, as well as appropriate cross-references to subsections within **Chapter 10, Continuing Disclosure and Investor Relations Programs**, **Chapter 4, State Constitutional Limitations**, and **Chapter 3, General Federal Tax Requirements**.

Variable rate debt and interest rate hedging products have become popular and important tools for many issuers in providing additional flexibility to better manage their debt programs. Following the review of the principal debt obligations in this chapter, the *California Debt Issuance Primer (Primer)* includes a basic overview of two popular approaches to variable rate debt and hedging: Auction Rate Securities are discussed in **Chapter 8, Fixed and Variable Interest Rate Structures** and Interest Rate Swaps are discussed in **Chapter 9, Synthetic Interest Rate Structures**.

Appendix E – Summary of Financing Obligations provides a quick reference to each of the debt financing obligations set out in a comparative format.

ASSESSMENT BONDS

DEFINITION AND PURPOSE

As defined by Proposition 218 and its implementing legislation, an assessment is any levy or charge imposed upon real property by a local agency for a special benefit conferred upon the real property from a public improvement. The term “special benefit” is likewise defined to mean “a particular and distinct benefit over and above general benefits conferred on real property located in the assessment district or to the public at large.” Assessment bonds are issued upon the security of the assessments and are payable as to principal, interest, and redemption premiums, if any, from either:

- Scheduled installments respecting unpaid assessments, collected either by a direct billing to the property owner or by posting to the secured property tax roll of the county in which the real property is located, or
- Proceeds of prepayments of assessments made by property owners to discharge the lien of the unpaid assessment on a specific parcel

By far the most common assessment bonds in California local agency debt financing are those issued under the Improvement Bond Act of 1915 (Streets and Highways Code Sections 8500 et seq., the “1915 Act”). In addition to 1915 Act assessment bonds, most local agencies are authorized to issue assessment bonds pursuant to the Improvement Bond Act of 1911 (Streets and Highways Code Sections 5000 et seq., the “1911 Act”), and many charter cities have established their own assessment bond authorizing procedures under their municipal affairs powers. For a more detailed discussion of municipal affairs, see **Chapter 4, State Constitutional Limitations**. Both the 1915 Act and the 1911 Act are more fully discussed later in this chapter.

Issuance of assessment bonds is preceded by assessment proceedings in which the governing body of the local agency:

- Establishes the scope of the improvement project to be financed, in whole or in part, with assessment bond proceeds
- Identifies the parcels of land that are perceived to receive a special benefit from the subject improvements
- Establishes the estimated cost and expense of constructing the subject improvements and providing for the assessment proceedings and bond financing
- Determines a fair and equitable allocation of the estimated cost and expense to the benefited parcels in proportion to such benefit

- Following a public hearing, imposes and records the assessments as enforceable liens against the respective benefited parcels and provides an opportunity for property owners to prepay the assessment, without interest, prior to bond issuance

It is common practice to refer to the established area of benefit as an assessment district, but the assessment district is not a separate legal entity—it has no separate governing board and no authority to act independently of the local agency that establishes it, it cannot sue or be sued, and it is not a special district akin to a community services district, water district, or public utility district.

As discussed in more detail below, the proceeds of sale of assessment bonds may be used to finance a reasonably broad range of local public improvements, provided that the local agency can legitimately make a finding that such improvements impart special benefit to the parcels of land to be assessed. Examples of local public improvements that are commonly financed, in whole or in part, with assessment bond proceeds are local streets, streetlights, landscaping, sidewalks, sanitary sewers, water supply and distribution facilities, flood control and drainage improvements, and parking facilities.

LEGAL AUTHORITY; ISSUERS

California has many laws that permit assessment districts to be established to finance public improvements. Some of the laws combine the provisions governing issuance of bonds with the provisions for establishment of the assessment district in the same statute. Other laws only specify the procedures necessary to establish the assessment district and incorporate by reference another statute for the issuance of the assessment bonds.

Three general state statutory schemes are most commonly used in California assessment district financing and are discussed in detail in this section. They are:

- The 1911 Act, which contains both provisions for establishing assessment districts and for the issuance of bonds
- The Municipal Improvement Act of 1913 (Streets and Highways Code Sections 10000 et seq., the “1913 Act”), which contains only provisions for establishing assessment districts
- The 1915 Act, which contains only provisions for the issuance of bonds, and requires use of another statute to establish the assessment district, authorize the public improvements, and impose the assessments

In addition to these three general statutory schemes, which are available to local agencies generally, charter cities may enact their own procedures for assessment district formation and assessment bond issuance, and many charter cities have done so.

With the adoption of Proposition 218, Article XIID was added to the California Constitution (see the discussion of Proposition 218 in **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives**). Section 4 of Article XIID specifies both procedural requirements and various limitations applicable to all assessments, irrespective of whether they are imposed pursuant to a general statutory scheme or a charter city procedure, and Section 3 of Article XIID provides that no assessment may be imposed by a local agency (including a charter city) except in conformity with Article XIID in general and Section 4 in particular.

Article XIID was added to the constitution without any provision being made in Proposition 218 for the amendment or repeal of pre-existing statutory provisions which were in conflict with the provisions of Section 4. Effective July 1, 1997, Sections 53750 et seq. were added to the California Government Code to begin the process of addressing such conflicts. The statutory provisions are discussed in more detail below. In summary, Government Code Section 53753, which closely follows the language of Section 4 itself, first specifies requirements for notice, protest, and hearing in assessment proceedings and, second, provides that any local agency complying with the Section 53753 provisions shall not be required to comply with any other statutory notice, protest, and hearing requirements that would otherwise apply, whether or not such other statutory requirements are in conflict with the corresponding provisions of Section 53753. See **Appendix D – Legal References – Amalgamated Edition of Proposition 218 and SB 919** for more detail on these provisions.

In 2003, the California Legislature enacted SB 392, which was signed into law by the Governor as Chapter 194, Statutes of 2003. Chapter 194 provided for the amendment or repeal of various pre-existing statutory provisions of the 1911 Act and the 1913 Act, primarily related to notice, protest, and hearing procedures, which were in conflict with the provisions of Government Code Section 53753. As a result, the notice, protest, and hearing provisions of the 1911 Act and 1913 Act are now consistent with the provisions of Section 4. Further legislation may be introduced as additional experience is gained in conducting assessment proceedings in light of the requirements and limitations of Section 4. In the meantime, local agencies considering the use of assessment bond financing will need to consider the practical and legal effects of these new provisions early in the planning process for any such proposed financing program.

In addition, all assessment district proceedings leading to assessment bond issuance (unless they are specifically exempted) must comply with the provisions of two other statutory schemes—the Special Assessment Investigation, Limitation and Majority Protest Act of 1931 (Streets and Highways Code Sections 2800 et seq., the “1931 Act”) and Streets and Highways Code Sections 3100 et seq. (the “Notice and Foreclosure Provisions”). See further discussion in the section entitled **Process for Establishing Assessment Districts and Levying Assessments**.

The California courts have consistently distinguished assessments from taxes for purposes of both Articles XIII A and XIII B of the California Constitution. See the discussion of Articles XIII A and XIII B in **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives**. Accordingly, assessments are not subject to the limitation respecting ad valorem

taxes imposed by Section 1 of Article XIII A, are not subject to the voter approval requirements respecting special taxes imposed by Section 4 of Article XIII A, and are not subject to the appropriations limit of Article XIII B, which applies only to proceeds of taxes.

See **Appendix D – Legal References – Table D-1-1** for a list of various statutes that authorize assessment districts to be established, including whether those statutes also authorize bonds to be issued and, if so, the type of bonds authorized.

See **Appendix D – Legal References – Table D-1-2** for a list of some of the local agencies that are authorized to establish assessment districts and issue assessment bonds. Where applicable, reference to the statute that authorizes that particular local agency to establish an assessment district is also provided in **Table D-1-2**.

IMPROVEMENTS THAT MAY BE FINANCED

The public improvements that are authorized to be financed by assessments levied under the 1911 Act and the 1913 Act are listed below. The reader should note, however, that even though these categories of improvements are expressly authorized by statute, the local agency will be required, in the course of the particular assessment proceeding with its own particular facts and circumstances, to make findings of special benefit to the parcels to be assessed and distinguish between the special benefit to those parcels and general benefit to the public at large. To the extent that the subject improvements are perceived to impart some degree of general benefit to the public at large, a corresponding portion of the cost and expense of the improvements must be financed from other sources legally available for such purposes. Section 4 of Article XIID provides added emphasis to this issue by specifically providing that a local agency must separate the general benefits from the special benefits conferred by the improvements and only special benefits are assessable.

Many of the local agencies shown in **Appendix D – Legal References – Table D-1-2** that are authorized to levy assessments are authorized by their enabling statute to finance public improvements in addition to those public improvements authorized by the 1911 Act and the 1913 Act. Therefore, this list is not exhaustive. Furthermore, in appropriate circumstances, certain expenses deemed incidental to the improvement project, legal proceedings, and bond financing may be included in the assessments levied and therefore in the bond financing. See Section 5024 in the 1911 Act for illustrations of such incidental expenses.

Improvements Authorized by the 1911 Act. Section 5101 in the 1911 Act authorizes the following types of work and improvements:

- Grading and paving of streets and roads
- Construction of sidewalks, parks, bridges, tunnels, subways, or viaducts
- Sanitary sewers and related facilities

- Storm drains and related facilities
- Street lighting facilities and electrical and telephone service facilities, including the underground placement of existing overhead facilities
- Pipes and hydrants for fire protection
- Breakwaters, levies, and other flood or erosion protection
- Wells, pumps, dams, reservoirs, pipes, and other domestic water supply facilities
- Tanks, mains, pipes, and other domestic or industrial gas supply facilities
- Bomb or fallout shelters
- Wharves, piers, docks, and other navigation facilities
- Retaining walls, ornamental vegetation, land stabilization, and all other work auxiliary to any of the above

Improvements Authorized by the 1913 Act. Section 10102 in the 1913 Act authorizes assessments for any of the work and improvements enumerated in the 1911 Act, and Section 10100 supplements the 1911 Act list as follows:

- Water supply
- Electric power supply facilities
- Gas supply facilities
- Lighting facilities
- Transportation facilities designed to serve an area not to exceed three square miles and designed to operate on rails or similar devices
- Any “other works and improvements of a local nature”

With limited exceptions, the public work and improvements financed by assessment bonds issued on the security of assessments imposed under either the 1911 Act or the 1913 Act must be performed and constructed on public property, defined to include easements and rights-of-way that have been dedicated to and accepted by the local agency. An example of an exception relates to work on private property undertaken for the purpose of grade adjustment or to remedy a geologic hazard (including retaining walls or seismic safety work and improvements).

Acquisition of Improvements. Both the 1911 Act and the 1913 Act authorize the acquisition of previously constructed improvements under certain circumstances. Care is required to assure compliance with the specific requirements for such acquisition.

PROCESS FOR ESTABLISHING ASSESSMENT DISTRICTS AND LEVYING ASSESSMENTS

Preliminary. As indicated above, Proposition 218 added Article XIID to the California Constitution, and Section 4 of Article XIID contains important new assessment procedures and other provisions which may conflict with pre-existing statutory provisions, (the assessment procedures of the 1911 Act and the 1913 Act were not harmonized with Section 4 until 2003). Pursuant to Section 3 of Article XIID, whenever such conflicts exist, the provisions of Section 4 govern. Aside from this supremacy provision of Section 3, Proposition 218 did nothing to further alleviate the resulting conflicts.

As a first step in resolving this situation, the California Legislature enacted SB 919 in June 1997, and it was signed into law by the Governor on July 1, 1997, as Chapter 38, Statutes of 1997, and took immediate effect as urgency legislation. Following is a brief discussion of those provisions of Chapter 38 that apply to assessment procedures and assessment bond issuance.

Section 53753. Section 5 of Chapter 38 added Sections 53750 et seq. to the California Government Code under the title of the Proposition 218 Omnibus Implementation Act (the “Implementation Act”). Section 53750 provides definitions of numerous terms utilized in Proposition 218. Section 53753.5 confirms that once a local agency has conducted assessment proceedings in compliance with the notice, protest, and hearing provisions of the Implementation Act, then those provisions shall not apply to any subsequent annual assessment procedure which may be required by the specific statutory scheme being utilized, unless that subsequent annual procedure entails an increase in assessments, as defined by Section 53750.

The most significant provisions of the Implementation Act for this discussion of assessment procedures are set forth in Government Code Section 53753, summarized as follows:

- ❑ The hearing on the engineer’s report must be preceded by at least 45 days mailed notice to the affected property owners, and the notice must include:
 - The total amount proposed to be assessed and the amount proposed to be assessed on the specific parcel
 - The duration of the payments
 - The reason for the assessment and the basis upon which the amount was calculated
 - The date, time, and place of the public hearing
 - A summary of the procedures for completion, return, and tabulation of the newly-required assessment ballots, the central feature of the new protest procedures mandated by Proposition 218
 - A statement that the assessment shall not be imposed if the assessment ballots submitted in opposition to the assessment exceed those submitted in favor, with each

ballot weighted according to the amount of the proposed assessment on the parcel to which the ballot pertains

- ❑ The mailed notice must be accompanied by the assessment ballot, which must include:
 - The address to which the completed ballot may be returned, whether by mail or in person
 - Identification of the parcel to which the ballot pertains or a place where the property owner can identify the parcel
 - Identification of the property owner or a place where the owner can indicate his or her name, together with a signature line where the ballot can be signed prior to being returned
 - A place where the property owner can mark the ballot to indicate either support for or opposition to the proposed assessment
- ❑ The use of punchcard or bar-coded ballots is expressly permitted
- ❑ The marked and signed ballots must then be returned to the local agency in some manner that assures receipt prior to the close of the hearing. Each assessment ballot must be in a form that conceals its contents once it is sealed by the person submitting the ballot. Inclusion of a return envelope with the mailed notice and ballot is optional. If return envelopes are utilized, the local agency should provide a clear statement of the deadline for receipt of the marked and signed ballots.
- ❑ At any time prior to the conclusion of the public testimony at the hearing, any ballot previously filed may be changed or withdrawn by the person who submitted the ballot
- ❑ At the conclusion of the hearing, the ballots must be tabulated, using the weighted tabulation by amount of assessment. In the event co-owners of a parcel submit conflicting ballots, those ballots are allocated weight in accordance with the proportionality of ownership interests.
- ❑ A majority protest exists if ballots in opposition to the assessment exceed ballots in support, and in the event of a majority protest, the proposed assessment cannot be imposed. Unlike the pre-2003 provisions of both the 1911 Act and the 1913 Act, there is no authority to override a majority protest under any circumstances.

Because neither Proposition 218 nor the Implementation Act provides many of the essential components of a workable statutory scheme for imposing assessments and issuing assessment bonds, local agencies will still be required to select both a procedural act and a bond issuance act. As discussed above, both the 1911 Act and the 1913 Act are now consistent with Proposition 218 and Government Code Section 53753. However, to the extent that local agencies other than

charter cities seek to utilize assessment bond financing under a statutory scheme which is not yet consistent with Proposition 218 and Government Code Section 53753, they will be required to conduct the specified assessment proceedings in a manner which complies with the “overlay” of Proposition 218 and Section 53753.

The most widely used assessment procedure in California is the 1913 Act, and a summary of its provisions follows. The 1913 Act’s provisions pertaining to notice, protest, and hearing are now expressly superseded by the corresponding provisions of Government Code Section 53753, as summarized above. Of particular significance is the introduction of the assessment ballot for measuring protest, the change from land area to amount of assessments in measuring protests, and the elimination of any ability to override a majority protest.

1913 Act. With the exception of developer-oriented assessment proceedings, public improvements constructed under the 1913 Act are constructed by public works contracts of the local agency, awarded after competitive bidding. Unless the local agency chooses otherwise and makes provision for construction financing to come from another source (such as bond anticipation notes, which are expressly authorized by the 1915 Act), the assessment bonds are sold prior to construction, and the monthly progress payments are made to the contractor from bond proceeds. The procedures for establishing an assessment district and imposing the assessments under the 1913 Act are summarized as follows:

- The legal proceedings start with approval of the boundary map, acceptance of petitions (if utilized), and adoption of the Resolution of Intention, which among other things directs the preparation and filing of the engineer’s report. The boundary map is then recorded.
- The engineer’s report containing the matters prescribed by the 1913 Act (as supplemented by Proposition 218) is filed and preliminarily approved, the hearing is scheduled, and the improvement project is put out to bid. The hearing schedule must allow for preparation of notices and assessment ballots and the completion of mailing them at least 45 days prior to the hearing.
- As assessment ballots are returned prior to the hearing, the responsible person (typically, the county clerk) compiles a record of ballots received and places them in safekeeping as public documents
- Prior to the hearing, project bids are opened, results analyzed, and the apparent best bidder identified. If the apparent best bid is below the cost estimate, consideration should be given to preparing an amended engineer’s report to reflect reduced costs and reduced assessments, if appropriate. On the other hand, if the apparent best bid results in increased estimated costs and thus the need to increase assessments, a new cycle of notice, ballots, and hearing will be required.
- The hearing is conducted (and continued if appropriate) and at its conclusion ballots are tabulated and results announced. As indicated above, a majority protest, as

defined by Government Code Section 53753, precludes imposing the assessments. Otherwise, the local agency may approve the engineer's report (as initially filed or as modified), impose the assessments, and order the work and improvements to proceed.

- The assessments are recorded and become liens, and cash payment notices are mailed to the property owners. At the conclusion of the 30-day cash payment period, the local agency determines the amount of unpaid assessments.
- The local agency authorizes issuance of the assessment bonds and concurrently or later approves the Official Statement, if any, sells the bonds by either competitive or negotiated sale, and awards the construction contract
- Upon receipt of bond sale proceeds, a notice to proceed is given to the contractor and project construction commences. Upon completion of construction, leftover construction funds, if any, are distributed in accordance with the 1913 Act.
- Annually, over the life of the assessment bonds, installments on account of unpaid assessments, with interest, are collected from property owners (either by direct billing or by posting to the county property tax roll, depending on which kind of assessment bonds have been issued) and the monies collected are used to pay the bonds' principal and interest

1911 Act. Before 2003, a distinguishing feature of 1911 Act proceedings was that the hearing process was bifurcated. The subjects of the first hearing were limited to establishment of the boundary and the scope of the improvement project. The critical subjects of total costs and individual assessments were deferred to the second hearing, which was conducted following completion of the authorized work and improvements. Of particular significance was the fact that while the 1911 Act provided a majority protest procedure, it was tied to the first hearing, prior to a determination of total costs and individual assessments.

Clearly, this last feature of the 1911 Act was problematic under Proposition 218 and Government Code Section 53753. First, compliance with Section 53753 required that the proposed individual assessments be determined and that mailed notice of them be given to the affected property owners before the protest procedures were conducted. Second, assuming that a local agency chose, pursuant to Section 53753, to conduct protest procedures in connection with the second 1911 Act hearing (which was held after the improvement work is completed) this course of action ran the risk that the local agency would be precluded from imposing the assessments, by virtue of a majority protest, but with the improvement work already completed.

The 2003 amendments to the 1911 Act resolved these issues by amending or repealing those notice, protest, and hearing provisions that were inconsistent with the provisions of Proposition 218 and Government Code Section 53753. Now, the provisions of the 1911 Act concerning notice, protest, and hearing procedures expressly mandate that these procedures be conducted in accordance with the provisions of Government Code Section 52753.

All Assessment Proceedings. In addition to Proposition 218 and Government Code Section 53753, all assessment proceedings are subject to the provisions of the 1931 Act and the Notice and Foreclosure Provisions. The requirements of these two sets of provisions are detailed, and a full description of them is beyond the scope of this discussion. However, a brief summary follows.

The 1931 Act establishes a procedure for giving notice and holding a public hearing that essentially parallels the procedures contained in the 1911 Act and the 1913 Act, contains a limitation on the assessment that can be levied against any parcel, as measured by the value of the parcel, and establishes a procedure for a majority protest against the assessment. The 1931 Act also provides for a number of methods for dispensing with its requirements. The property owner petition is the most common of these.

The Notice and Foreclosure Provisions require that a boundary map and an assessment diagram be created according to the detailed specifications in the statute and filed with the county recorder. A notice of assessment in the form prescribed by the statute also must be recorded. The assessment lien becomes effective only upon the recordation of the notice of assessment in the office of the county recorder. Whenever assessment proceedings are abandoned, the resolution abandoning the proceedings must be filed with the county recorder.

Assessments (or the installments thereon) that are not paid when due become delinquent and subject the property on which the assessment lien is placed to foreclosure proceedings to recover the delinquent amounts, including late charges, penalties, and costs and expenses of foreclosure. Notice of any pending foreclosure proceedings must be given as provided by the Notice and Foreclosure Provisions. This notice is in addition to any other notice that may be required by the statutes that authorize the assessment districts.

PROCESS OF ISSUING ASSESSMENT BONDS

1911 Act Bonds. Under the bond issuance provisions of the 1911 Act (Sections 6400 et seq.), an assessment bond may be issued for the amount of each unpaid assessment of \$150 or more on a particular parcel. The security for each assessment bond issued under the 1911 Act is the unpaid assessment lien on a particular parcel, and the principal amount of each bond is equal to the unpaid assessment on that parcel. Thus, one assessment bond may be issued in the amount of \$1,500 and another may be issued in the amount of \$265. Assessments under \$150 may be collected upon the tax roll if the legislative body so determines.

1911 Act assessment bonds provide for payment of a principal installment to the bondholder annually, on January 2. The governing body may provide for the annual principal installments to be payable in other than equal annual amounts and may provide for the classification of assessments into different maturities so that some assessments (and, correspondingly, some of the assessment bonds) mature over a shorter period of time than others. Interest is payable semiannually on January 2 and July 2.

Local agencies considering the issuance of 1911 Act bonds should be aware of the following:

- At the present time, services of paying agent, registrar, and transfer agent are not generally available from outside service providers
- Billing and collection of installments of principal and interest on account of unpaid assessments to pay 1911 Act bonds cannot be made on the county property tax rolls, as with 1915 Act bonds

Accordingly, the treasurer of the local agency must handle these duties, and the staffing for and costs of performing these duties needs to be a part of the preliminary planning for the issuance of 1911 Act bonds. Furthermore, 1911 Act bond provisions (unlike those of the 1915 Act) contain no authorization to include administrative costs in the installments billed to property owners, so those costs must be estimated and provided for either as up-front incidental costs, which are funded directly from bond proceeds, or as annual administrative costs authorized under the statutory scheme for imposing the assessments.

Another important feature that distinguishes 1911 Act bonds from 1915 Act bonds is that foreclosure proceedings for enforcement of delinquent installments of principal or interest must be brought by and in the name of the bondholder, rather than that of the issuer as is the case with 1915 Act bonds. This feature is generally regarded as material in the determination of suitability of 1911 Act bonds for some investors who may not have the time or resources to pursue foreclosure on their own behalf.

For these and other reasons, issuance of 1911 Act bonds is relatively uncommon and generally regarded as suitable for only a limited segment of the investor community.

1915 Act Bonds. As stated earlier in this section, by far the more common assessment bond in California is the 1915 Act bond. The structure of a 1915 Act assessment bond issue is very different from the 1911 Act bond and much more closely resembles the structure of the other common debt instruments described in the succeeding sections of this chapter. Rather than issuing each individual bond upon the security of a specific unpaid assessment, 1915 Act bonds are issued in a pooling arrangement, with the security for all bonds of the issue being the aggregate of the liens on all the parcels within the assessment district. The entire principal amount of a specific 1915 Act bond matures on a specific September 2, and principal denominations are typically \$5,000 or integral multiples thereof, with authority to depart from the \$5,000 norm when appropriate. Interest is payable semiannually on March 2 and September 2. The maturity schedule for a 1915 Act bond issue is customarily structured to provide for equal annual debt service, although alternatives are authorized.

1915 Act bonds are customarily sold on a negotiated basis. The Resolution of Intention generally specifies a maximum interest rate and a maximum maturity. The final interest rate or rates, together with the maturity schedule, is customarily established when the bonds are sold.

Under the 1915 Act, certain determinations regarding terms of 1915 Act assessment bonds must be resolved and a determination stated in the Resolution of Intention. These are:

- Whether the local agency will obligate itself to advance available funds of the local agency to cure any deficiency that may occur in the bond redemption fund
- Whether a 2 percent delinquent penalty may be charged per month on the amount of a delinquent assessment, rather than the customary one-time late charges and the lower monthly penalties applicable to property tax delinquencies
- Whether the local agency will preclude itself from refunding the bonds for some stated period of time following issuance (not to exceed 10 years after the date of issuance)

LIMITATIONS ON TERMS OF BONDS

1911 Act assessment bonds are subject to the following limitations and requirements, imposed by statute:

- The maximum stated interest rate is 12 percent per year
- No authorization for capitalized interest
- Interest is required to be payable on January 2 and July 2
- Principal is required to be payable on January 2
- Bonds must provide a redemption premium of 5 percent over the life of the bond
- Property owners may prepay the entire outstanding assessment at any time upon payment of a premium to the bondholder
- The maximum maturity is 25 years
- The bonds must be serial bonds
- No authorization is provided for establishment of a reserve fund

1915 Act assessment bonds are subject to the following limitations and requirements by statute:

- The maximum stated interest rate is 12 percent per year
- Two years of capitalized interest is authorized
- Variable interest rate bonds are permitted
- Interest is required to be payable March 2 and September 2

- Principal is required to be payable on September 2
- Redemption premiums must be at least 3 percent for the first five years, but after that the local agency, at the time of bond issuance, may provide for redemption without premium
- The maximum maturity is 40 years
- The bonds may be serial bonds, term bonds, or any combination thereof
- Certain amounts may be collected each year to reimburse the local agency for the expenses of collection and administration
- Express authorization is provided for establishment of a reserve fund

METHOD OF REPAYMENT AND SECURITY FEATURES

Each 1911 Act bond is payable solely from the installments paid on account of a particular parcel, and payment of such installments is secured solely by the lien on that particular parcel, whereas 1915 Act bonds of a single issue are secured on parity by the pooled assessments on all of the parcels assessed for the improvements financed by the issue. 1915 Act bonds also may have a reserve fund for the benefit of bondholders and though rarely done, issuers of 1915 Act bonds are authorized to obligate themselves to advance available funds of the issuer to compensate for delinquent installments from property owners.

Assessments that are not paid when due become delinquent and the parcels upon which the delinquent assessments are levied are subject to judicial foreclosure or, where 1911 Act bonds have been issued, to an administrative foreclosure procedure known as the “treasurer’s foreclosure.” Delinquent assessments accrue penalties under the 1911 Act at the rate of 2 percent per month for assessment bonds and under the 1915 Act at either the same rate or the rate established for general taxes (currently, an immediate 10 percent late charge and, commencing July 1 after the delinquency, 1.5 percent per month). The first month’s penalty under the 1911 Act may be kept by the treasurer as a cost of servicing the delinquency.

When 1911 Act bonds have been issued, the foreclosure accelerates the remaining unpaid principal, with the foreclosure sale price established on that basis. The 1911 Act bond in question is actually surrendered and canceled following completion of the foreclosure sale, and the former bondholder receives either cash, if a third party submitted the winning bid at the sale, or title to the property. When 1915 Act bonds have been issued, there is no acceleration of unpaid principal, and the foreclosure sale price is based upon only the delinquent installments of principal and interest, together with penalties, late charges, and attorneys’ fees and costs of foreclosure. Assuming a bid in excess of the minimum, the winning bidder takes title to the parcel subject to the continuing lien of future installments as they come due and payable. In the event no adequate bid is received, further proceedings are required, a discussion of which is beyond the scope of this *Primer*.

Property upon which there are assessment liens may be divided. Both the 1911 Act and the 1915 Act contain provisions by which the remaining unpaid assessment can be apportioned among the new parcels in accordance with the benefits received. Costs associated with the procedure to reapportion the assessment may be paid by the property owner or included in the amended assessment. Under the 1911 Act, except under limited circumstances, the bondholder must generally approve any division of land that secures a bond and new assessment bonds corresponding to the new liens and parcels must be issued to the bondholder.

Generally, assuming the ratio of the value of the land to the amount of the assessment is sufficiently high, no additional security such as a letter of credit or bond insurance is necessary or, if available, cost effective for assessment bonds. In certain circumstances, primarily property development situations where the project land is undeveloped and the assessments are comparatively high, issuers or bond underwriters may require the developer to provide a letter of credit to assure timely payment of assessment installments until such time as the credit risk is reduced through development and sale of at least substantial portions to third parties or the general public. To date, bond insurance has been found to be cost effective only with respect to refunding of assessment bonds after significant portions of the assessed property have been developed and sold.

SPECIAL FEDERAL TAX CONSIDERATIONS

In addition to the special federal tax considerations discussed in this section and relating to whether assessment bonds are private activity bonds, the other limitations and requirements described in **Chapter 3, General Federal Tax Requirements** (such as limitations relating to arbitrage bonds and hedge bonds) continue to apply.

General. Assessment bonds may, under certain circumstances, be private activity bonds, the interest on which is taxable. Each assessment district proceeding that includes property owners who do not constitute the general public (e.g. commercial enterprises, businesses, or developer districts) or that will allow the public improvements financed by the bonds to be used in a special manner by a business entity must be analyzed to determine whether the Private Business Tests or the Private Loan Test are satisfied. These issues must be analyzed with particular care when there is only one property owner, such as a developer.

The Private Loan Test and the “Tax Assessment Loans” Exception. As described in **Chapter 3, General Federal Tax Requirements**, an issue of bonds is an issue of private activity bonds if such issue satisfies the Private Loan Test. For federal tax purposes, assessments paid over time are generally deemed to be loans. Accordingly, assessment bonds would satisfy the Private Loan Test and would be private activity bonds. However, the tax code contains an exception for certain tax assessment loans, which are the deemed loans that arise when a governmental unit permits or requires its residents to pay a tax or assessment over a period of years.

U.S. Treasury regulations explain that tax assessment loans are not treated as loans for purposes of the Private Loan Test if:

- The loans arise from the imposition of a mandatory tax or other assessment of general application
- The assessments are imposed for one or more specific, essential governmental functions, and
- Owners of both business and nonbusiness property benefiting from the financed improvements are eligible or required to make deferred payments on an equal basis

The equal basis rule does not prohibit the use of due on sale clauses in connection with assessment or special tax financings, so long as the due on sale clause does not single out certain sales for special treatment. The equal basis rule does prohibit the guarantee of payment of assessments by a deemed borrower if it is reasonably expected that payments will be required under the guarantee.

Additionally, U.S. Treasury regulations provide some significant guidance on the types of activities or facilities that qualify as “essential governmental functions.” In general, utility or system improvements owned by a governmental entity and used by the general public (e.g. streets, telephone, electric and cable television systems, and sewage or water facilities) serve essential governmental functions. Otherwise, the service provided by the financed facilities must be customarily performed by governmental entities and the facilities must be owned by a governmental entity.

Private Business Tests. Even if an assessment bond is not a private loan bond, it still may be a private activity bond if it meets the Private Business Tests.

In general, the special rules for assessment bonds cause the Private Payment or Security Test to be satisfied whenever the Private Business Use Test is satisfied. This follows from a rule that provides “special assessments paid by property owners benefiting from financed improvements are not generally applicable taxes.” Payments made in respect of privately used property, even if made by the general public, are “private payments” that count against the Private Payment or Security Test unless the payments are generally applicable taxes. Presumably a broadly spread assessment, such as a city-wide or school district-wide assessment, will be a tax of general application. Otherwise, the Private Payment or Security Test is meaningless for assessment bonds.

Notwithstanding the loss of flexibility as a result of the obsolescence of the Private Payment or Security Test, the Private Business Use Test provides flexibility. Subject to the essential governmental function requirement, governmentally owned facilities will not have private business use to the extent the financed facilities are intended to be available and in fact are reasonably available to individuals as well as businesses. Even a special economic benefit to a

limited number of private businesses and limited actual use by the public will not pose a problem. For example, a governmentally owned dead-end road into a private business park or a remote business location, or a cul-de-sac for an industrial park, is not treated as used in a private trade or business, so long as use of the road is not restricted in any fashion.

Three criteria can be used to determine whether assessment bond proceeds will be treated as governmentally used and not as used in the “trade or business” of a commercial entity or business:

- The facilities are designed to serve and are available for use by members of the general public in the governmental unit on an equal basis
- The ultimate ownership and operation of the facilities is with the governmental unit, and
- Development of the land within the district and transfer of the public improvements to the governmental entity is expected to occur with reasonable speed and in fact occurs promptly upon completion of the public improvements

Although it may not be necessary to satisfy each of these three criteria in every instance, the possibility that any one of them may not be satisfied should trigger a particularly detailed federal tax analysis of the financing transaction. Recently released U.S. Treasury regulations provide significant new guidance for analyzing these issues.

POLICY CONSIDERATIONS

The decision to issue assessment bonds may involve a number of competing policy considerations. Many of the types of improvements that may be financed with assessment bonds also may be financed with Mello-Roos bonds, general obligation bonds, or revenue bonds. Financing improvements with assessment bonds results in distributing the project cost to the parcels deemed specially benefited by the project work and improvements. As an overall strategy for financing certain types of improvements, this may be fair. On the other hand, if similar improvements for other parts of the issuer’s jurisdiction were financed with bonds that spread the cost of those improvements more widely, it may be appropriate to finance new improvements of the same type in the same way as before.

Second, once the decision to use assessment bonds has been made, the determination of the method for spreading the assessments is a often a sensitive and contentious matter, especially if the owners of some of the parcels to be assessed object to one or more aspects of the assessment proceeding. Managing the objections of unhappy property owners, especially in light of Proposition 218, may entail a determination by the local agency to pay some portion of the project cost and expense from other sources.

Finally, assessment proceedings often are considered in connection with new land development within the jurisdiction of the local agency, and the question arises as to whether the local agency

should support or encourage the development or the developer in such a manner. Many local agencies have adopted formal policies and guidelines to assist in making these sensitive policy determinations.

COMMERCIAL PAPER

See information in **Chapter 8, Fixed and Variable Interest Rate Structures.**

FINANCING LEASES AND CERTIFICATES OF PARTICIPATION

DEFINITION AND PURPOSE

A financing lease provides a public agency with an alternative to issuing bonds to finance capital assets over a multi-year period.

A tax-exempt lease financing typically falls into one of two general categories:

- A public agency may finance a capital asset by leasing it directly from the vendor or leasing company, with the lessor receiving a portion of each rental payment as tax-exempt interest, or
- In the event the public agency wishes to utilize a tax-exempt lease in connection with the sale of municipal securities, certificates of participation, representing undivided interests in the rental payments under the tax-exempt lease, may be sold to the public

A typical certificate of participation (COP) financing for a construction project might be structured as follows. A public agency that wishes to undertake a construction project enters into a tax-exempt lease with a nonprofit corporation, JPA, leasing company, bank, or other lessor. The lessor acquires the applicable site, either by purchasing it from a third party or by leasing it from the public agency. The lessor, with the assistance of the public agency, undertakes the construction of the project to be located on the site and leases the improved site to the public agency pursuant to a financing lease. The lessor's rights to receive payments under the lease are assigned to a trustee, which executes and delivers to an underwriter, COPs in the lease payments. A portion of each lease payment is designated as tax-exempt interest. The proceeds of the sale of the COPs are used to pay the costs of acquiring and constructing the improvements.

PROJECTS THAT MAY BE FINANCED

A tax-exempt lease may be used to finance any property that the public agency has the statutory authorization to lease. As a general matter, only land and depreciable property may be leased. Generally, the leased property is a capital asset to be used by the public agency in its own operations.

However, some public agencies, such as redevelopment agencies and charter cities may use tax-exempt lease financing to provide a facility for the use of a nongovernmental borrower. The public agency acquires the property by lease or installment purchase and then leases or sells it to the nongovernmental borrower. The public agency's obligation to pay rent or installments is structured as a special fund obligation, limited to the payments it receives from the nongovernmental borrower. Often, the stream of payments from the public agency is sold to investors through the issuance of COPs.

Asset Transfer Financing. So-called asset transfer financings follow the basic pattern of a tax-exempt lease financing. However, in this type of financing, the property that is the subject of the lease (typically an unencumbered public improvement such as a city hall, police station, or other government building) is already owned by the public agency lessee. The lessee leases or sells the property to a lessor (purchaser) and immediately leases (or repurchases) the property back. Often, the funds derived from an asset transfer financing are deposited into a capital improvement fund or other building or construction fund to pay the cost of construction or acquisition of various public improvements. In addition, the lessor (purchaser) will often raise funds to purchase the property by assigning the right to receive payments to a trustee, without recourse, who will execute and deliver COPs.

The asset transfer structure allows a public agency to meet current capital requirements by realizing cash from the value of existing, unencumbered assets. In the event the leaseback is structured as a long-term lease, the public entity can begin making lease payments immediately since it has immediate use and occupancy of the existing improvements, and thus there is no need to capitalize interest during the construction period for the project to be financed and no risk associated with noncompletion of the construction project.

POLICY CONSIDERATIONS

Historically, financing leases and COPs have been used when bond financing was determined to be unavailable or undesirable for a variety of reasons, including:

- The election requirements of the California Constitution, the relevant statutes, or a city charter could not be met
- The facility to be financed generated no revenues on its own (e.g. a city administrative office building) and local general obligation bonds were not permitted (1978 through 1986)
- A statutory interest rate limitation applicable to bonds was below the market rate
- A statute authorizing bonds required a competitive sale in a market in which negotiated sale was more appropriate
- Other restrictive conditions on the use of bond proceeds or the procedures of issuance were contained in the bond statute

The asset transfer financings are essentially methods of leveraging public assets and borrowing all or a portion of the value of the public agency's equity in those assets in order to finance other desired assets. A public agency must determine as a policy matter whether such a use of existing assets is appropriate in meeting present and future capital requirements. For a complete discussion of the policy considerations for lease revenue bonds, see *Guidelines for Leases and Certification of Participation* (CDIAC 1993).

SECURITY AND SOURCES OF REPAYMENT

Long-term Leases. Payments made by a public agency pursuant to a long-term lease may be made from any lawfully available funds of the public agency. Security for a long-term lease may be impaired, however, due to:

- The possibility that failure to complete a project may result in the legal inability to pay rent
- The abatement of rent during the lease term if beneficial use and occupancy of the leased property is unavailable because of calamity or otherwise, and
- The absence of any right to accelerate rental payments and the corresponding requirement of bringing a lawsuit for annual rental payments as they come due in each year

See **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit.**

To reduce these risks, a long-term lease often includes the following protections:

- In the event the leased project is to be constructed, interest is capitalized during the construction period. In addition, the construction contractor is often required to provide payment and performance bonds, and “all-risk” insurance in an amount equal to 100 percent of the replacement cost of the project. In certain circumstances, earthquake and flood insurance may be required. Liquidated damages for late completion of the project also may be required in a daily amount equal to daily rental on the tax-exempt lease.
- After the completion of construction of the project, the lessee is often required to maintain the insurance described above, plus rental interruption insurance
- A bond reserve fund may be required in an amount equal to the maximum annual rental payment under the lease and held by an independent trustee for the COPs
- A title insurance policy in an amount equal to the aggregate principal amount of the tax-exempt lease may be required in a lease of real property

Non-appropriation Obligations. Rating agencies have treated non-appropriation obligations with caution, requiring that any property financed on this basis be “essential to a governmental purpose” and that if the right not to appropriate payments is exercised (and the property is therefore returned to the control of the lessor), the public agency covenants not to replace the property for some period of time. This sort of a nonreplacement covenant may not be valid under California law. Additionally, the rating agency often requires that non-appropriation obligations also incorporate a covenant to include the installment payments in annual budgets submitted to the obligor’s governing board. This is simply a promise by the obligor to have its legislative body consider appropriating funds to pay the installments under the obligation

annually—it is not a covenant to adopt the budget so submitted. Publicly marketed California leases are ordinarily not non-appropriation obligations and usually include a covenant to budget and appropriate lease payments as long as the leased property can be used.

While a tax-exempt lease may simply involve a lease of personal or real property from a private entity to a public agency as lessee, a tax-exempt lease financing may be structured in such a manner that the governmental entity not only acquires property, but also disposes of property. If the financing structure involves a disposition of property by the public agency, two major concerns regarding statutory authority are raised—statutory procedures for disposing of property and the public purpose requirement.

Statutory Procedures for Disposition of Property. Special limitations and authorizations relating to dispositions of property are sometimes contained in the organic acts of the governmental entity. In certain instances, public agencies may be required to publicly bid the lease or other disposition of publicly owned property pursuant to so-called surplus property statutes. (See, for example, Government Code Sections 25363 and 25526 for counties.) This may be of special significance in certain sale-leaseback financings. Other procedures in particular circumstances may be required, such as the publication of the notice of intention to convey property.

Exemptions from public bidding requirements are available to, among others, parking authorities leasing a parking facility to a city in which the authority is located (Streets & Highways Code Sections 32952 and 32957), certain redevelopment agency contracts (Health & Safety Code Sections 33430 et seq.), and joint powers authorities (Government Code Sections 6500 et seq.). In addition, counties may, pursuant to a four-fifths vote of the board of supervisors, sell or lease county-owned property without complying with any competitive bidding requirements if the county repurchases or leases back the property as part of the same transaction.

Public Purpose Requirement. Any lease by a public agency (whether to acquire or dispose of property) must be in furtherance of a proper public purpose. California courts have invalidated leases of municipal property to private persons as unconstitutional uses of public property, where a predominate public purpose for the lease could not be identified.

PROCESS FOR APPROVAL

The particular statutory leasing authorization must be reviewed to determine the approval requirements in connection with entering into a tax-exempt lease. In some instances, it may be necessary to competitively bid the lease or other disposition of property pursuant to laws affecting the acquisition or disposition of publicly owned properties.

PROCESS FOR SALE

Certificates of participation can be sold at either competitive or negotiated sale.

LIMITATIONS ON TERMS

Interest Rate. Statutory interest rate limitations applicable to bonds are not applicable to the principal and interest components of a tax-exempt lease when the statute authorizing the lease has no interest rate limitation. Therefore, many tax-exempt leases have no statutory interest rate limit.

Lease Term. The statute authorizing the lease may limit the maximum lease term. Additionally, in the event a long-term lease is utilized, the term of the lease will generally be limited to the useful life of the property.

Variable Rate Leases. Certain types of tax-exempt leases may contain an interest component that varies during the lease term. However, if a long-term lease is used, rental payments may not satisfy the fair rental value requirement if they fluctuate with market interest rates.

LEGAL AUTHORITY

In analyzing a tax-exempt lease financing, it is important to remember that the public agency is using its authority to acquire or dispose of property, rather than its authority to incur debt. While the terms “tax-exempt lease” or “financing lease” will be used herein, the tax-exempt obligation may be structured as an installment purchase agreement, installment sale agreement, or lease-purchase agreement, as explained below.

Constitutional Considerations. Generally, the California Constitution requires voter approval for issuance of long-term debt paid from the general fund of a city, county, school district, or the state. In a tax-exempt lease, the public agency’s obligations under the lease are designed to avoid classification as “debt” for purposes of the constitution. This can be done in several ways using judicially created exceptions to the constitutional debt limit.

Long-term Lease. A long-term lease containing an obligation to pay fair-market rental in each year in which beneficial use and occupancy is tendered to the public agency—a long-term lease—is outside the constitutional debt limit. The most significant aspects of a long-term lease are as follows:

- Rentals may only be paid in those periods in which beneficial use and occupancy of the leased property is available to the lessee
- Acceleration of rental payments is not permitted
- The obligation to pay rental payments may be from any lawfully available funds of the lessee, which may covenant to place in its annual budget the rentals that are due and payable during the fiscal year

- The terms and conditions in the lease must be similar to lease terms found in a commercial context for similar types of facilities
- The lease term should not extend beyond the anticipated useful life of the leased property and fair market rental should be paid

Non-appropriation Obligation. In certain circumstances a public agency may determine to obligate itself only for payments due in the then current fiscal year without treating the obligation as “debt” for constitutional purposes. Such obligations, which may be leases, installment sales agreements, or lease-purchase agreements, are referred to herein as non-appropriation obligations. The name given the obligation is immaterial. What is important is that the contract be terminable by the public agency in its sole discretion at least once during each fiscal year.

Special Fund Obligation. Certain contracts may be called leases but, like a non-appropriation obligation, do not rely upon the long-term lease exception to the constitutional debt limitation. In such cases, the rental or installment payments due under such obligations are payable exclusively and solely from a designated special fund of the public agency identified in the contract. This special fund must be derived from activities related to the purposes for which the special fund obligation is issued. It may not be additionally secured by recourse to the general fund or taxing powers of the public agency. As is the case with a non-appropriation obligation, the obligation need not be called a “lease”—the key element is the limited source of funds from which periodic payments can be made by the public agency. Such obligations may provide for acceleration of payments upon default.

Statutory Considerations. Any public agency with the authority to acquire or dispose of either real or personal property can enter into a tax-exempt lease. California statutes contain a multitude of provisions authorizing various public entities to acquire a variety of specific kinds of property. A listing of the most commonly used of these statutory provisions is provided in **Appendix D – Legal References – Table D-5-1.**

FEDERAL TAX ISSUES

Apart from the issues discussed immediately below, financing leases and certificates of participation do not present many unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply. The federal tax issues relating to lease financings are identical for financing leases and COPs.

If the interest paid pursuant to a lease is to be exempt from federal income taxes, the interest must be separately stated and designated as “interest.” Additionally, and in direct contrast with the constitutional debt limitation analysis discussed above, the lease must be recharacterized, for federal tax purposes, as a borrowing transaction (e.g. as a financing lease, conditional sales agreement, or installment purchase contract) rather than as a true lease. In other words, in order

to have tax-exempt interest, one must first have interest, and in order to have interest, one must have a debt. The federal and state tax legal authorities that characterize an obligation as a debt when that obligation is called a lease are well-established and represent an analysis that is completely separate from the characterization of the obligation as a lease for purposes of avoiding the constitutional debt limitation.

Among the circumstances articulated by the Internal Revenue Service that would warrant characterization of a transaction as a debt (also called a conditional sales agreement or a finance lease) are the following:

- Portions of the periodic payments are made specifically as applicable to equity to be acquired by the lessee
- The lessee will acquire title upon the payment of a stated amount of “rentals” under the contract
- 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 secure the transfer of the title
- The agreed “rental” payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property
- 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 when 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 with the total payments required to be made
- Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest

SPECIAL STATE TAX ISSUES

State Income Tax Exemption for the Interest Component of Financing Leases. The general provision in the California Constitution stating that “bonds issued by the State or a local government in the State” are exempt from personal income tax applies to installment sale contracts and leases. Several Franchise Tax Board General Counsel opinions have been issued concerning the exemption of the interest component of installment sale contracts and leases under the constitutional provision.

Property, Sales, and Transfer Taxes. Whether or not property tax and sales tax may be payable in a particular transaction depends largely upon the facts surrounding the transaction. Generally, ad valorem property tax need not be paid by a public agency, however, it may be that a private entity leasing property to a public agency retains some taxable interest in the leased property. Typically, it is necessary for a public agency leasing property to covenant, to the

extent permitted by law, to indemnify the lessor for the cost of ad valorem property taxes, sales, or transfer taxes, if any, that may be levied in connection with the leased property.

Insofar as sales taxes are concerned, public agencies must pay sales tax on personal property that they purchase, and if real property is the only property sold, no sales tax is payable. In some instances, a resale license might be utilized to document the fact that no additional sales tax is payable upon both segments of a sale/saleback transaction.

LOCAL AGENCY GENERAL OBLIGATION BONDS

DEFINITION AND GENERAL FEATURES

General obligation (GO) bonds are the simplest bond security type. In California, they require a supermajority voter approval and as a result are utilized infrequently by many local governments. General obligation bonds are secured either by a pledge of the full faith and credit of the issuer or by a promise to levy property taxes in an unlimited amount as necessary to pay debt service, or both. The State of California's general obligation bonds are full faith and credit bonds, to which the state's General Fund, rather than any particular tax revenue, is pledged. The various general obligation bond programs of the State of California are described in **Appendix A – Working with State Agencies**.

With very few exceptions, local government agencies are not authorized to issue full faith and credit bonds. The general obligation bonds of such agencies are typically payable only from ad valorem property taxes, which are required to be levied in an amount sufficient to pay interest and principal on the bonds coming due in each year. These property tax revenues are distinct from general property tax collections and are dedicated to debt service payment and cannot be levied or used for any other purpose. Some local agencies may also pledge revenues of the facilities financed by the bonds as additional or even primary security for the bonds. Interestingly, relatively few statutes (other than those relating to the state's bonds) use the designation, “general obligation bonds” and it may be more accurate to think of these obligations as “unlimited tax bonds.”

Under Article XVI, Section 18 of the State Constitution, no county, city, town, or school district may incur indebtedness without a two-thirds popular vote. This article was modified in 2000 through the enactment of Proposition 39, which authorizes bonds for repair, construction, or replacement of school facilities, classrooms (if approved by 55 percent local vote for projects evaluated by schools), community college districts, and county education offices for safety, class size, and information technology needs.

Some other local government agencies may be authorized by statute to issue bonds without voter approval, or with a simple majority vote. However, under Section 1(b) of Article XIII A of the constitution, any new indebtedness to be repaid from an ad valorem tax levied against real property must be approved by a two-thirds vote of the qualified electors, and the bonds may only be used to finance “the acquisition or improvement of real property.” Therefore, whenever a local agency considers using general obligation bonds to finance projects, it is important to understand what constitutes real property, and what is an acquisition or improvement thereof. In other words, what types of projects and property may and may not be financed with general obligation bonds?

PROJECTS THAT MAY BE FINANCED

There is no direct legal authority defining what is and what is not “real property” for purposes of

Article XIII A, and therefore the language of Article XIII A, “for the acquisition or improvement of real property” is subject to interpretation in each instance. There is general agreement among practitioners and issuers that the limitation to “real property” means that vehicles, equipment, furnishings, supplies, and labor may not be financed with general obligation bonds. Generally, anything that is truly portable or can be removed from land or a building without causing damage to the land or building, may not be financed.

“Improvement” does not include ordinary repairs, maintenance costs, or supplies, and these may not be financed with proceeds of general obligation bonds. Fixtures, equipment, and materials that become part of or are affixed to land or to a building in the course of making legitimate improvements to real property are probably appropriately considered real property improvements, although direct legal authority for financing each of these particular items is lacking. Similarly, labor costs, professional fees (such as for general contractors, architects, real estate appraisers, and brokers), real estate closing costs, and other costs directly connected to real property acquisition and improvement are probably also appropriately financed from general obligation bonds.

While ongoing maintenance may not be financed with general obligation bonds, even though it contributes to the physical condition of real property and its improvements, deferred maintenance probably may be financed, especially as that term is used by school administrators. So long as deferred maintenance refers to projects that involve replacement of major systems or building components, such that the project is properly classified as an improvement to real property, it can be financed with general obligations bonds. For example, if a roof is so badly deteriorated that it must be replaced rather than patched, this is properly deemed an improvement to real property.

Not every interest in land is “real property” for purposes of Article XIII A. For example, while local agencies may acquire permanent ownership in a fee and lesser interests such as easements, it is doubtful that acquisition of a leasehold interest is a permitted use of general obligation bond proceeds. Therefore, payment of rent—the price of a leasehold interest—without acquiring some more permanent interest probably would not be permitted.

Interest earnings on bond proceeds generally also must be applied to approved real property purposes, unless an issuer has specific authority permitting another use. If authorized by statute, costs incidental to issuing the bonds, including costs of conducting the bond election, may be paid from the proceeds of the bonds.

While the State Constitution permits general obligation bonds to be issued to finance any real property acquisition and improvements, additional limitations may be specified by the authorizing statutes for the various entities permitted to issue general obligation bonds. Local agency general obligation bonds are customarily used to finance publicly owned facilities, including public office buildings, school buildings, utility system improvements, and infrastructure. Local agencies also may use general obligation bonds to finance privately owned

facilities that sufficiently advance a public purpose. The legislature has authorized cities and counties, for example, to make loans to private landowners for seismic safety improvements to real property. Unless it is for a public purpose, the giving or lending of a local agency's credit or public funds is prohibited by Article XVI, Section 6 of the State Constitution. Even if appropriately authorized under state law, when private parties directly and specially benefit from public financing, the interest on the general obligation bonds may be taxable. See **Chapter 3, General Federal Tax Requirements**.

Each Local Agency Has Its Own Authority To Finance Various Projects. Many of the statutes authorizing local agencies to issue general obligation bonds have not been updated to conform with the restrictions of Article XIII A, discussed above. Thus some issuers would appear to have the authority to issue bonds for equipment or operating costs, and to do so when authorized by a simple majority vote or without any popular vote at all (see text boxes below for each issuer type).

City Projects

General law cities may use general obligation bonds to finance the acquisition, construction, or completion of the real property portion of any "municipal improvement," which includes:

- ✓ Hospitals
- ✓ Convention halls
- ✓ Veterans' homes
- ✓ Parks and boulevards
- ✓ Toll bridges
- ✓ Seismic strengthening of unreinforced masonry buildings
- ✓ Redevelopment projects
- ✓ Sewage treatment plants
- ✓ Airports
- ✓ Flood control
- ✓ Acquisition of land for conveyance to the federal government
- ✓ The real property portion of any "municipal improvement"
- ✓ "Works, property or structures necessary or convenient to carry out the objects, purposes and powers of the city"

A charter city may also issue general obligation bonds to finance the real property portion of any project that is determined to be a "municipal affair", subject to any financing limitations specified in such charter or elsewhere in the State Constitution. See **Chapter 4 –State Constitutional Limitations – The 1879 Constitution – Charter Cities**.

County Projects

Counties may finance the real property portion (including improvements) of any purpose for which the board of supervisors is authorized to expend the funds of the county. Explicit authority also exists for funding:

- ✓ Highways
- ✓ Toll bridges
- ✓ Airports
- ✓ Seismic safety improvements (including making loans for that purpose)
- ✓ Redevelopment projects
- ✓ Acquisition of land for conveyance to the federal government for military bases and for other federal purposes
- ✓ Improvement of nonnavigable streams

School District Projects

School districts may use general obligation bonds for:

- ✓ The purchase of school lots
- ✓ Building or purchasing school buildings
- ✓ Making alterations or additions to school buildings other than as necessary for current maintenance
- ✓ Repairing, restoring, or rebuilding school buildings damaged by fire or other public calamities
- ✓ Permanent improvement of school grounds
- ✓ Carrying out of sewer projects
- ✓ Demolition of any school building to replace it with another school building, whether or not in the same location
- ✓ Refunding outstanding indebtedness

Special District Projects

General obligation bonds may be issued by a large number and variety of special districts in California, for an equally varied number of purposes. Because of the differences in statutory authority among these districts, a detailed list of the specific features of special district bonds, what they may be used for, how they are approved and issued, or the limitations characterizing each type is beyond the scope of this section. For information about the particular entities and where the legal authority for their general obligation bonds may be found, see **Appendix D – Legal References – Table D-2-1**.

Interpretation of Voter Authorization. General obligation bonds may be used only for the purposes approved by the voters. Taken together, the statutes (or charter provisions) authorizing the election and the issuance of the bonds, the resolution calling the election, and the specific language contained in the ballot measure itself, create a manner of contract which is binding upon the local agency once the voters have given their assent.

The ballot measure proposed to the voters must recite the purposes for which the proceeds will be used, but the local agency's governing body may choose how precisely or how generally to state those purposes. Courts have held that a general statement of the question reserves to the issuer the flexibility to spend bond proceeds as it wishes, within the terms of the authorization. This is true despite any specific promises or assertions made by public officials or bond supporters at the time of the election, including those made in official plans, ballot arguments, or campaign propaganda. On the other hand, if the ballot measure is too specific with regard to the projects to be financed (e.g. “a two-lane steel and concrete bridge 300 feet in length traversing the railroad tracks at 14th Avenue”), the local agency may be bound to build what the voters have approved, and may not be able to change its plans in the future despite changes in circumstances or spending priorities.

A ballot measure that is specific as to the purposes for which the proceeds will be used also may trigger the California Environmental Quality Act. For more information on the application of environmental laws to public finance transactions in general, see **Chapter 5, Environmental Issues**.

POLICY CONSIDERATIONS

Advantages. General obligation bonds have historically provided issuers with the lowest borrowing costs because the broad security pledge yields the highest possible bond rating and widest investor acceptance. Also, bond insurance can be less costly or even unnecessary. A reserve fund is usually not required (or even permitted), leaving more bond proceeds for project purposes (or keeping bond par to the minimum necessary.) Many financing terms are dictated by statute, often allowing the legal documentation to be less complex than for other types of bond issues. Lastly, local GO bond issuers are guaranteed that their operating funds will not be diverted to pay debt service on the bonds.

Disadvantages. On the other hand, local agencies may find certain of the legal and procedural requirements of general obligation bonds to be disadvantageous if not insurmountable:

- **Supermajority Needed.** Voter approval (two-thirds for most entities) is difficult to obtain, costly, and time-consuming
- **Timing Requirement.** A minimum of 88 days is required to call an election for most agencies and at least 123 days is required for a school district. Additional time is needed to certify the election results before the local agency may even begin proceedings to authorize the debt issue.
- **General Fund Cost.** The county registrar of voters should be able to provide the estimated cost per voter. If the election fails, the local agency's general fund will normally have to bear this cost. In any event, no taxpayer funds may be used to support the bond measure campaign.
- **Limited Financing Options.** Statutory restrictions on the financing terms for some local agencies, such as requirements for level amortization of debt, competitive sale, and maximum number of years to repay, may be undesirable compared to alternative financing methods
- **Incomplete Financing.** Projects that require significant investment in furnishings and equipment for their ordinary use, such as school desks and chairs, computers, office equipment, police cars, fire engines, and other personal property, cannot be completed without additional alternative financing for those components

Table 6-1
Statutory Debt Limits
(as percentage of assessed value of all taxable property)

Issuer Type	Bonding Capacity
General Law Cities	3.75 percent
Counties	1.25 percent, generally 3.75 percent, for water conservation and flood control projects and the construction of select county roads
Unified School Districts	2.5 percent
Other School Districts	1.25 percent

Other Public Policy Issues. Property taxes securing GO bonds are levied on all nonexempt property in a municipality, which may not be appropriate or ideal if a project only or more directly benefits a specific area. Alternate taxing structures can be crafted (within reason) to provide exemptions for certain taxpayers, or to tax other types of property differently, or to redistribute the tax burden. These taxes can be pledged to the repayment of a different type of tax-exempt bonds and may be a preferred financing mechanism (see the section on **Mello-Roos Bonds** in this chapter).

It should be noted that each local agency authorized to issue GO bonds receives its own bonding capacity or debt limit, usually expressed as a fixed percentage of the assessed value of taxable

property in the jurisdiction of the issuer (see the section on **Process for Approval**). This limitation is distinct from and additional to the constitutional debt limit (see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**). Even with voted bond authorization, an issuer may not issue bonds if its outstanding debt is at or exceeds its statutory debt limit. Since there are now many special districts overlapping the traditional boundaries of counties, cities, and school districts, the potential has increased for the general obligation debt of these various overlapping entities to each be within their legal limit, and yet in combination impose an unacceptable tax burden on the owners of taxable property.

SECURITY AND SOURCES OF PAYMENT

General obligation bonds are secured by the legal obligation to levy an ad valorem property tax upon taxable property in the jurisdiction of the issuer in an amount sufficient to pay the debt service. In the case of certain revenue-producing facilities, the bonds may be additionally, or even primarily, secured by or paid from revenues generated by those facilities financed from the bonds. Certain special districts have old statutory authority to issue bonds secured by what are called ad valorem “assessments,” but under Article XIII A, it is not clear if these statutes authorize the levy of ad valorem taxes to pay the bonds. Issuers should consult with bond counsel to determine if such bonds may still be issued and if taxes or assessments may be levied to pay them.

PROCESS FOR APPROVAL

For local agencies not covered under Proposition 39, the approval process for general obligation bonds must include an election at which at least two-thirds of the qualified electors approve the issuance of bonds, and in doing so approve the levy of an ad valorem tax to pay the bonds. Proposition 39 related entities require a 55 percent majority (see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit** and **The Jarvis Family of Initiatives – Proposition 13**). Each local agency may have its own additional requirements, as described below:

Cities. The process for approval of a general obligation bond issue by a city includes the following steps:

- The city council must pass a resolution by a two-thirds vote of all of its members (*not* just two-thirds of a quorum) determining that the public interest or necessity demands the acquisition, construction, or completion of any municipal improvement
- At any subsequent meeting, the city council must adopt an ordinance on its second reading by a two-thirds vote of all of its members (again, *not* of a quorum) which places a bond proposition specifying the amount and purposes of the bonds before the city's electors
- Publication or posting of the ordinance is required

- The election is usually conducted on behalf of the city by the county registrar of voters
- Following passage, the city council adopts a resolution specifying the terms under which all or a portion of the authorized bonds will be issued

Counties. The process for approval of a general obligation bond issue by a county includes the following steps:

- The board of supervisors adopts a resolution calling a bond election and specifying, among other things, the purposes for which the indebtedness is to be incurred and the maximum amount of bonds proposed to be issued
- The election is conducted by the county registrar of voters
- Following passage, the board of supervisors adopts a resolution specifying the terms under which all or a portion of the authorized bonds will be issued

School districts. The usual process for approval of a general obligation bond issue by a school district includes the following steps:

- The school board adopts a resolution ordering the county superintendent of schools to call a bond election in the school district. The order must specify the purposes for which the indebtedness is to be incurred, the maximum amount of bonds proposed to be issued, and the maximum interest rate permitted to be paid
- Notice of the election must be posted in the district
- The election is conducted by the county registrar of voters
- Following passage, the school board adopts a resolution requesting the board of supervisors of the county and the county superintendent that has jurisdiction over the school district, to issue the bonds on behalf of the school district
- The board of supervisors of the county adopts a resolution ordering the sale and specifying the terms of the school district's bonds

An alternative sale and issuance procedure is permitted if the school board elects to issue bonds under the Government Code rather than under the Education Code. In that event, following a successful election, the school board authorizes and issues the bonds directly, and the board of supervisors of the county is not required to take action. It is important, however, for the school district to coordinate its efforts with county officials, especially in order to ensure that the board of supervisors approves the levy and collection of the ad valorem tax by county tax officials.

PROCESS FOR SALE

Cities. Competitive sale is required. After the receipt of bids, the bonds are awarded to the maker of the best bid (see text box on **Calculating the Winning Bid** for more on the best bid). The award is usually made by an officer authorized to act on the city council's behalf. If no bids are received (or no bids conform to the bid requirements) or if the city council determines that no bid is satisfactory or that no bidder is responsible, the bonds may be sold at negotiated sale. The bonds must be sold for not less than par.

Counties. Either competitive or negotiated sale of the bonds is permitted. The statute provides that county general obligation bonds be “sold at the times, in the amounts, and in the manner prescribed by the board (of supervisors), but for not less than par.”

Calculating the Winning Bid

At competitive sale, the winning or best bid (confusingly also called the “highest bid” and the “lowest bid,” referring to either the price paid for the bonds or the interest rates) is the bid that provides the issuer with the lowest interest cost, typically calculated by the Net Interest Cost (NIC) or True Interest Cost (TIC) method. The TIC method is generally preferred to the NIC method, because it also adjusts for the time value of money. However, because the TIC cannot be easily calculated without a computer, NIC was commonly used when personal, and particularly portable, computers were less available. See **Appendix C – Debt Financing Terms and Concepts** for an explanation of the NIC and TIC methods.

School districts. Either competitive or negotiated sale of the bonds is permitted (unless the alternative Government Code provisions are used, in which case only competitive sale is permitted). The bonds may be sold at a discount of no greater than 5 percent.

OTHER LIMITATIONS ON TERMS OF BONDS

The terms of bonds of each local agency may be further limited by the statutes governing the issuance, as shown in Table 6-2. It also is important to remember that the statutes for each local agency's general obligation bonds may be superseded by the provisions contained in the Government Code, which are intended to apply to the bonds of all local agencies. Thus, for example, many issuers would appear to be limited to annual interest rates of 8 percent and below, however, there is an overriding provision in Government Code Sections 53530 et seq. which allows rates of up to 12 percent per annum for all local agency bonds. Similar exceptions may affect the permitted term of the bonds, sale procedures, publication requirements, permitted uses of proceeds, etc. In addition, most—but not all—statutes prescribing an issuer's debt limit as a percentage of assessed valuation have not been updated to take into account the provisions of Article XIII A, Section 1(a), which requires property to be assessed at its full cash value, rather than one-fourth of that value. Rather than taking the stated debt limit literally when a statute has not been updated, the better view is to read such a limit in light of Article XIII A. Thus, for example, a city's limit of 15 percent (Government Code Section 43605) should now be read as 3.75 percent.

**Table 6-2
Local Agency Bond Term Limits**

Issuer	Maximum Maturity	Amortization Limitations
City	40 years	Approximately level debt service Capital appreciation bonds permitted (effective yield may not exceed 12 percent)
County	40 years	Approximately level debt service Capital appreciation bonds permitted (effective yield may not exceed 12 percent)
School District (under Education Code)	25 years	Principal amortized as board of supervisors provides Capital appreciation bonds permitted (effective yield may not exceed 12 percent)
School District (under Government Code)	40 years	Approximately level debt service Capital appreciation bonds permitted (effective yield may not exceed 12 percent)

LEGAL AUTHORITY

Legal Authority in General. The California Constitution contains several provisions governing the issuance of general obligation bonds:

All Issuers

- Article XVI, Section 18—two-thirds favorable vote required for bonds of cities, counties, and school districts
- Article XIII A, Section 1(b)—exception from 1 percent real property tax limit for taxes to pay voter-approved general obligation bonds to finance the acquisition or improvement of real property
- Article XIII B, Sections 8(g) and 9(a)—exception from appropriations limit for debt service on general obligation bonds
- Article XIII, Section 20—power of legislature to provide maximum property tax rates and bonding limits for local governments
- Article XIII, Section 26(b)—exemption from state income taxes for interest on local government bonds

Cities

- The general authorization and procedures for issuance are found at Government Code Sections 43600 et seq. Alternative procedures for issuance are found at Government Code Sections 53506 et seq.
- The charter of any charter city may contain special authorization, limitations, and procedures pursuant to “home rule” powers granted under Article XI, Section 5 of the California Constitution

Counties

- The general authorization and procedures for issuance are found at Government Code Sections 29900 et seq. Alternative procedures for issuance are found at Government Code Sections 53506 et seq.

School districts

- The general authorization and procedures for issuance are found at Education Code Sections 15100 et seq. Alternative procedures for issuance are found at Government Code Sections 53506 et seq.

Special districts

- The general authorization and procedures for issuance vary for each issuer. See **Appendix D – Legal References – Table D-2-1.**

SPECIAL FEDERAL TAX ISSUES

General obligation bonds do not present many unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply.

REFUNDING BONDS

Local agencies have statutory authority to refund and redeem their outstanding general obligation bonds prior to the stated maturity date, provided that the bonds were issued following the enactment of such authority. Bond owners are then assumed to have purchased their bonds with the knowledge that they could be redeemed. Usually the bonds also must contain a statement to this effect, giving notice to bondholders. The issues that arise in refunding of general obligation bonds are much the same as those for refunding of other bonds, with the following important differences:

- The benefits to the local agency of issuing refunding bonds are indirect since the debt service savings achieved must be passed on to taxpayers rather than retained by the

issuing entity. That is, a municipality may not levy property taxes to repay GO bonds in excess of the principal and interest due to bondholders. As a result, when the debt cost is reduced through a refunding, the property tax levy must also be lowered.

- General obligation refunding bonds may be issued without voter approval, and the principal amount of the bonds will not count against the voted authorization, because the bonds being refunded have already been approved and the refunding is deemed to be merely a change in form of the indebtedness. This assumes, however, that the issuance of refunding bonds does not create any additional debt burden on the taxpayers, which has not been approved by the voters. Therefore, the general obligation bond refunding statutes require the refunding to produce debt service savings—the total principal plus net interest cost to maturity on the refunding bonds must be lower than that of the bonds to be refunded. Any costs of issuance paid from sources other than refunding bond proceeds (and interest earned thereon) must be added to the costs of the refunding bonds. If refunding was not one of the originally authorized purposes for the bonds, then a new election must be held to approve the refunding bonds.

MARKS-ROOS BONDS

DEFINITION AND GENERAL PURPOSES

The Marks-Roos Local Bond Pooling Act of 1985 (Article 4 of the Joint Exercise of Powers Authority law, Government Code Sections 6584 et seq., the “Marks-Roos Act”) provides joint powers authorities (JPAs) with broad powers to issue bonds for a wide variety of purposes. As the name of the act implies, the law was originally enacted to facilitate local bond pooling efforts, which allowed local agencies to achieve lower costs of issuance through spreading fixed costs across a number of small issues. Its usage has been substantially more broad, however, as its flexibility allows it to be used for single project financings as well.

Prior to the adoption of the Marks-Roos Act, JPAs had been commonly used to accomplish public financings under Article 2 of the Joint Exercise of Powers law, typically for public utility financings. Article 2 is still used by a number of these issuers for public power, water, wastewater, and other utility-type financings. However, due to the extra procedural requirements of Article 2 (such as the requirement that the local agency approve each financing by ordinance subject to referendum), Article 4 has become a much more popular tool for JPA financings.

The most common uses of the Marks-Roos Act with respect to bond issuance are:

- To finance “public capital improvements” (defined in Government Code Section 6546) directly
- To create “pooled” bond issues
- To finance working capital or insurance programs

Marks-Roos bonds may only be issued by JPAs, which are special governmental entities created under the Joint Exercise of Powers Authority law (Government Code Sections 6500 et seq.) by agreement between two or more “public agencies” (as defined in Government Code Section 6500). The parties to the joint exercise of powers agreement are called members of the JPA. Some JPAs are “captive” entities of a jurisdiction—for example, a JPA made up of a city and its own redevelopment agency. Other JPAs are multi-jurisdictional and issue bonds for all or some of their members. For example, the California Statewide Communities Development Authority has over 200 member agencies and issues bonds for a wide array of projects. Once a JPA is formed, it has all of the powers specified in the Marks-Roos Act. That is, a JPA issuing bonds under the Marks-Roos Act (and in some circumstances the local agency contracting with the JPA) need not follow other bond act requirements in the issuance of the bonds.

Marks-Roos bonds are bonds of the JPA that issues them, as opposed to bonds of the member agencies. The member agencies are not liable or otherwise obligated on the bonds unless they expressly agree to assume such liability.

Marks-Roos bonds are issued for the purpose of assisting local agencies with their financing needs. “Local agencies” are defined to include the sponsoring member of the JPA (or any agency or subdivision of that member) or any city, county, city and county, authority, district, or public corporation of the state.

In order to use the Marks-Roos Act, the local agency for which the bonds are being issued must determine that there are significant public benefits for taking that action. “Significant public benefits” are defined to mean:

- Demonstrable savings in effective interest rate, bond preparation, bond underwriting, or bond issuance costs
- Significant reductions in effective user charges levied by a local agency
- Employment benefits from undertaking the project in a timely fashion
- More efficient delivery of local agency services to residential and commercial development

These determinations are typically made by resolution of the legislative body of the local agency at the time that the local agency approves the financing.

In addition, California Government Code Section 6586.5(a)(2) states that an authority may not issue bonds unless a member of the authority within whose boundaries the public capital improvement is to be located has approved the financing, among other things. This requirement provides a “nexus” between the members of the JPA and the project.

PROJECTS THAT MAY BE FINANCED

Public Capital Improvement Bonds

Marks-Roos bonds may be issued to directly pay the cost of public capital improvements. Direct financing of these improvements under Marks-Roos Act generally takes the form of bonds issued by the JPA and secured by payments to be made under a loan agreement, installment purchase agreement, or lease between the JPA and the local agency which is paying for the project. Under this type of arrangement, the JPA is acting as a conduit issuer for the local agency and has no obligation on the bonds other than to make payment from the payments received under the underlying agreement with the local agency. The source of revenues for the underlying agreement with the local agency can vary greatly and will determine which type of agreement will likely be used.

Public capital improvements include the following:

- An exhibition building or other place for holding fairs
- A coliseum, stadium, sports arena, or sports pavilion

- Any other public buildings
- A regional or local public park, recreational area, or recreational center
- A facility for the generation or transmission of electrical energy (but not a retail distribution system)
- A facility for the disposal, treatment, or conversion to energy and reusable materials of solid or hazardous waste or toxic substances
- Facilities for the production, storage, transmission, or treatment of water or wastewater
- Local streets, roads, and bridges
- Bridges and major thoroughfares construction
- Mass transit facilities or vehicles
- Publicly owned or operated commercial or general aviation airports and airport-related facilities
- Police or fire stations
- Public works facilities, including corporation yards
- Public health facilities owned or operated by a city, county, city and county, special district, or authority
- Criminal justice facilities, including court buildings, jails, juvenile halls, and juvenile detention facilities
- Public libraries
- Publicly owned or operated parking garages
- Low-income housing projects owned or operated by a city, county, city and county, or housing authority
- Public improvements authorized in a project area created pursuant to the Community Redevelopment Law (see the section on **Tax Allocation and Other Redevelopment Bonds** in this chapter)
- Public improvements authorized pursuant to certain assessment acts and the Mello-Roos Act (see the sections on **Assessment Bonds** and **Mello-Roos Bonds** in this chapter)
- Telecommunication systems or service

- Programs, facilities, rights, properties, and improvements for the management, conservation, reuse, or recycling of electric capacity or energy, natural gas, water, wastewater, or recycled water, including demand side or load management and other programs and facilities designed to reduce the demand for, or permit or promote the efficient use of, those resources
- Certain equipment related to the above facilities

If the local agency is a city, county, or school district and the payments are to be made from the local agency’s general fund, the agreement will likely be a lease. For more detail on lease financing, see the section on **Public Lease Revenue Bonds** in this chapter. If the source of payment is a local enterprise fund (such as a water system enterprise fund), the agreement will probably be an installment purchase agreement or loan agreement.

Pooled Financings

The most basic purpose of the Marks-Roos Act is to enable the issuance of so-called pooled” bonds. Pooled bonds are issued for the purpose of acquiring bonds or other obligations of a local agency (usually called “local obligations”). The act provides that the JPA may purchase, with the proceeds of its bonds or its revenue, local obligations issued by any local agency at public or negotiated sale. Local obligations purchased pursuant to the Marks-Roos Act may be held by the JPA or sold to public or private purchasers at public or negotiated sale, in whole or in part, separately or together with other bonds issued by the authority. The projects that may be financed with the proceeds of the local obligations acquired by the JPA in the pooled financing must be projects eligible for financing under the law governing the issuance of the local obligations. See the appropriate section in this chapter for more information regarding the permitted uses of proceeds of specific local obligations.

Large-Scale Pools

The pooled bond provisions of the Marks-Roos Act have spawned a number of large-scale pooled financings, including large TRAN pools for school districts, cities and other local agencies (see text box on **Large Scale TRAN Pools – 2004**). For more

What are Local Obligations?

Local obligations eligible for acquisition by the JPA include:

- ✓ Bonds (including, but not limited to, assessment bonds, redevelopment agency bonds, government issued mortgage bonds, and industrial development bonds)
- ✓ Notes (including bond, revenue, tax, or grant anticipation notes)
- ✓ Commercial paper, floating rate, and variable maturity securities
- ✓ Any other evidences of indebtedness
- ✓ Certificates of participation
- ✓ Lease-purchase agreements

Large Scale TRAN Pools – 2004	
California Statewide Communities Development Authority (CSCDA)	\$803,750,000
California School Cash Reserve Program Authority	\$754,330,000
San Diego County School District (SDCSD)	\$404,315,000
California Community College Finance Authority (CCCFA)	\$188,690,000
Los Angeles County Schools (LACS)	\$60,890,000
South Coast Local Education (SCLE)	\$59,500,000
Santa Barbara Schools Financing Authority (SBSFA)	\$21,200,000

information on TRAN financings, see the section in this chapter on **Tax and Revenue Anticipation Notes (TRANS)**. While less common, the Marks-Roos Act also has been used to establish pooled financing programs for long-term borrowing. In these types of financings, the local agencies participating in the pool will issue their underlying local obligations simultaneously for sale to the JPA, which will then sell its Marks-Roos bonds for the purpose of acquiring the local obligations.

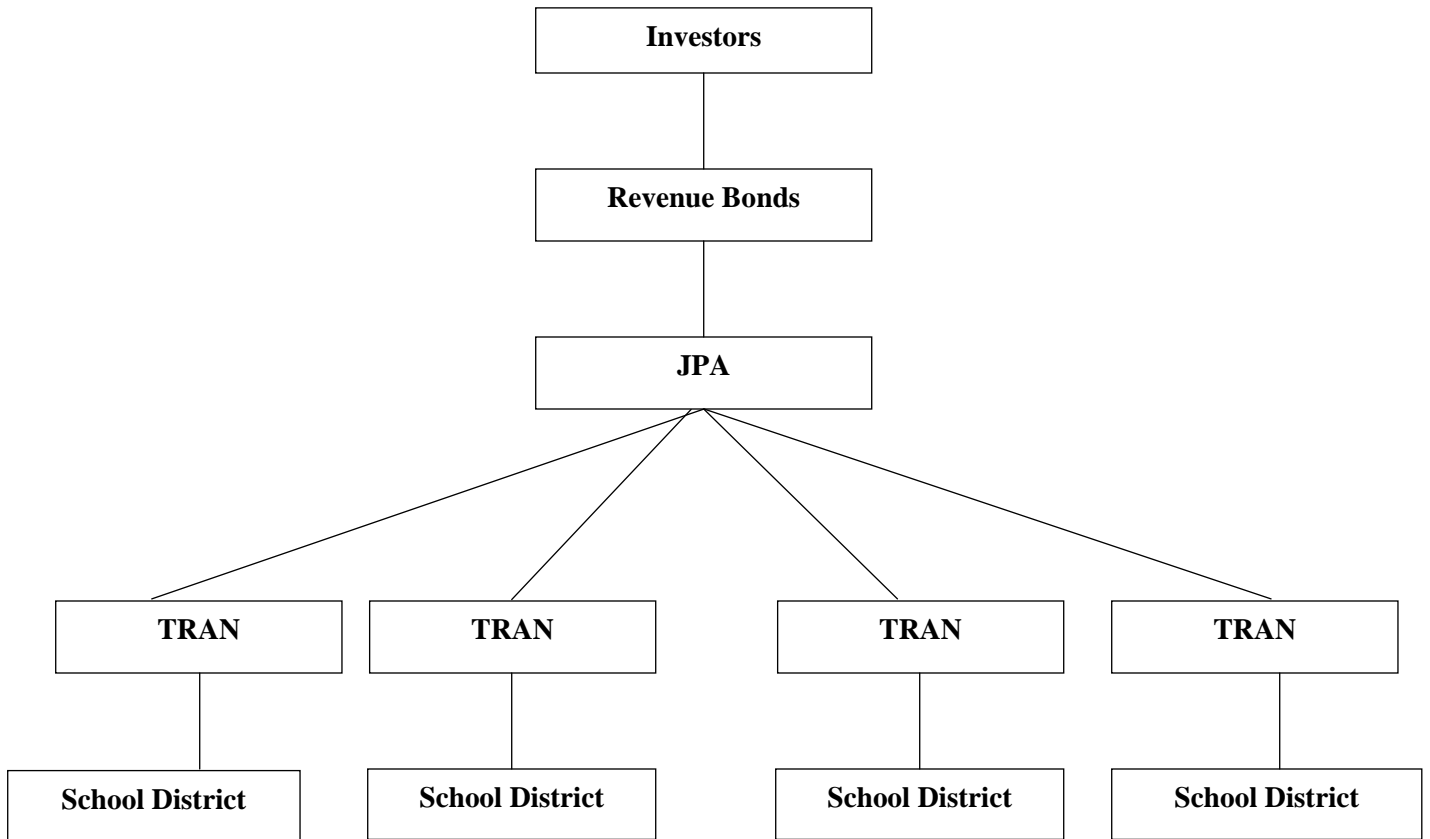
Captive Pools

In addition, the Marks-Roos Act has been used to accomplish pooled financings for JPAs, in which the projects being financed relate to one or a small number of related local agencies, such as a city and its own redevelopment agency. In this type of financing, the Marks-Roos bond proceeds are used to acquire one or more local obligations from the one or more of the interrelated local agencies that are members of the JPA. These local obligations are typically acquired at the same time as the issuance of the Marks-Roos bonds. This type of financing might be used when an entity has two or more small financings to do at the same time—for example, a city lease financing of building rehabilitation and a redevelopment agency financing of infrastructure for the project area. If each financing is so small that it would not be particularly efficient on its own, combining them into a pooled financing issued by a JPA may make sense. Care should be taken, however, to assure that the credit quality of one of the pooled financings is not so weak as to drag down the credit of the overall issue, thus increasing the interest rate for the relatively stronger financing.

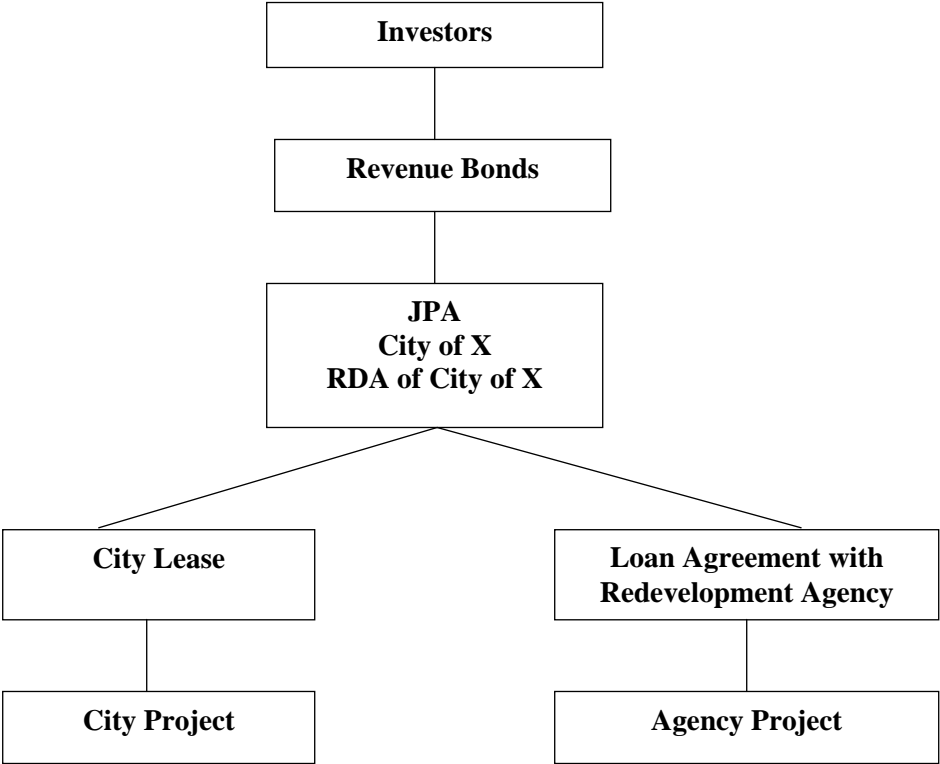
Blind Pools

A blind pool financing is one in which the JPA does not have firm commitments from local agencies for the underlying projects (and the local obligations financing them). The pooled bonds are issued, and the funds are used at a later time (not to exceed 90 days after issuance) to acquire local obligations for projects. If there is a lag (not to exceed 90 days) between the time of the issuance of the Marks-Roos bonds and the time local obligations are acquired, the proceeds of the Marks-Roos bonds are typically invested in a guaranteed investment contract which earns enough interest, in addition to any capitalized interest, to pay interest on the Marks-Roos bonds until the local obligation payments commence. In the event that the local obligations are not acquired, the proceeds of the Marks-Roos bonds are used to retire the Marks-Roos bonds. These financings create a number of difficulties, because the identity of the local obligations acquired and projects financed may change during the 90-day origination period to make loans. Disclosure can be difficult, and federal tax issues (such as the reasonableness of the expectation that the bond proceeds will be spent) abound. Issuers should be exceedingly cautious in approaching any blind pool financing and carefully weigh the risks against the benefits.

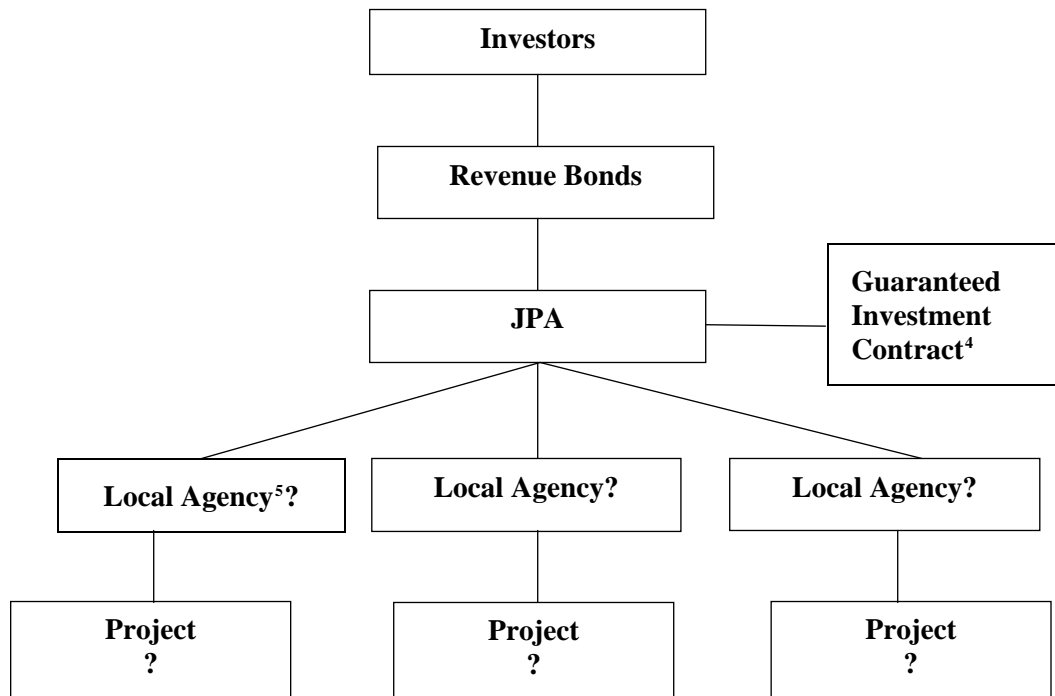
**Flow Chart 6.1
Large-Scale Pool**



**Flow Chart 6.2
Captive Pool**



**Flow Chart 6.3
Blind Pool**



⁴ A Guaranteed Investment Contract holds bond proceeds until loans are made to local agencies. If all the money is not loaned, the contract is liquidated and the bonds are redeemed.

⁵ Typically, several local agencies have indicated interest in borrowing from the pool, but have not made binding commitments. The identity of local agencies and projects may change.

Working Capital and Insurance Programs

The Marks-Roos Act also permits JPAs to issue bonds to finance a working capital or insurance program. Working capital programs financed with Marks-Roos bonds are generally structured in the form of pooled financing for TRAN issues. In addition, Marks-Roos bonds may be used to finance the capitalization of captive insurance entities providing liability and other forms of insurance to the members of the JPA. A detailed description of these insurance programs is beyond the scope of this *Primer*.

POLICY CONSIDERATIONS

Public Capital Improvement Bonds

The Marks-Roos Act is a very useful and flexible tool for financing public capital improvements. Essentially, the policy considerations governing Marks-Roos bonds are the same as those related to the underlying form of repayment arrangement (i.e. to lease financing if the underlying arrangement is a lease, or to enterprise revenue financing if the underlying arrangement is a loan or installment purchase agreement payable from enterprise revenues, and so on). In these situations, the act is merely a tool to allow bond issuance.

Often, the alternative to using Marks-Roos bonds for these types of projects is to use certificates of participation (COPs). Some financial advisors and underwriters believe that there may be a marketing advantage to issuing Marks-Roos bonds secured by an underlying lease or installment purchase agreement over COPs in those same agreements. While the economic security for each structure is practically identical, some financial advisors believe that the market perceives a bond to be a stronger instrument than a COP.

Pooled Bonds

Because of the wide range of pooled financings that may be accomplished under the Marks-Roos Act, it is difficult to arrive at general policy guidelines for these types of issues. The policy issues relevant to a large multi-jurisdictional pooled issue may be quite different than those relevant to a captive JPA pool financing.

Multi-jurisdictional Pooled Issues

From a local agency's perspective, deciding whether or not to participate in a pooled financing along with other agencies involves balancing a number of factors. The following advantages and disadvantages should be carefully considered:

Advantages:

- Typically lower costs of issuance due to economies of scale
- Interest rate may be lower due to “diversification” effect of the pool (this is more likely to be true if the local agency's credit strength is average or below average)

compared to all pool participants or if the pool obtains bond insurance which could not be obtained on a stand-alone basis)

- Some structures allow reduced reserve fund size
- The financing team and structure of the financing (including the documentation) is typically in place, which means that the local agency does not have to start from scratch

Disadvantages:

- Timing of issue dictated by pool organizer, which may not coincide with local agency's preferred timing
- Little flexibility to alter arrangements to suit particular local agency concerns
- Interest rate may be higher than stand-alone financing (this is more likely to be true if the local agency's credit strength is higher than the average for the pool participant)
- Agencies with a large borrowing compared to the average pool participant may not be able to maximize the terms of the bonds for their own situations

Other Pooled Financings

As described above, Marks-Roos bonds may be issued to pool any local agency obligations. This flexibility has resulted in a wide variety of pooled structures including:

- Pools only issued to acquire local obligations of one local agency—for example, a lease obligation and a redevelopment obligation to finance separate projects pooled together and financed through a single issue of Marks-Roos bonds
- Pools that finance infrastructure for separate assessment districts through the acquisition of assessment bonds issued for each district
- Pools that finance projects for private developers (even outside the geographic boundaries of the JPA's members) or for local agencies, which are not even members of the JPA and have no connection to the entities that formed the JPA other than their participation in the pooled financing

While the Marks-Roos Act has been used to great advantage by local agencies to successfully finance a wide variety of projects, some Marks-Roos bonds have been structured in abusive ways and have been the source of several defaults and controversial financings. These troubled financings have typically involved:

- Projects that do not have any relationship to the JPA or its members

- Pooled issues that relied on overly optimistic predictions of the ability to fund local obligations, and
- Inadequate safeguards with respect to the credit quality of the local obligations being acquired

When considering participation in this type of structure, a local agency should ask itself the following questions:

- Is there a real advantage in transaction cost savings to doing the pooled financing?
- Does the pool appropriately take advantage of diversification of credit to the benefit of all projects?
- Is there a public purpose for this JPA (and its members) to finance a project for an unrelated local agency?
- If the local obligations are not being acquired simultaneously with the issuance of the Marks-Roos bonds, are there adequate assurances that the local obligations will in fact be acquired?
- Do the pooled bond documents provide adequate safeguards with respect to additional debt so that the credit quality of the Marks-Roos bonds will not be compromised in the future?

PROCESS FOR APPROVAL

Marks-Roos bonds must be authorized by a resolution adopted by the JPA at a regular or special meeting of the JPA board. In addition, the local agency or agencies participating in the financing must approve the documents they are entering into as required for the particular type of agreement or local obligation involved. (See the appropriate section in this chapter for more detail on these requirements for the particular type of underlying obligation.) Finally, the local agency that is participating in the financing must make the determination of “significant public benefits” discussed above. This is accomplished by a resolution of the local agency, which may be combined with the resolution approving the other local agency documents. Written notice of the proposed sale must be given to the California Debt and Investment Advisory Commission, no later than 30 days prior to the sale of any Marks-Roos bonds, as required by Government Code Section 8855.

PROCESS FOR SALE

Marks-Roos bonds may be sold at public or private sale, as determined by the governing body of the JPA, after giving due consideration to the recommendations of any local agency to be assisted from the proceeds of the bonds.

In addition, the JPA may enter into a bond purchase agreement with a local agency or agencies. The bond purchase agreement must specify the maximum rate of interest, the cost of issuance, the amount of required reserve, and the procedure to be used in case of default. Notwithstanding any other provision of law, local agencies may sell their bonds to the JPA on a negotiated basis without compliance with any public sale requirement included in the statutes under which the bonds are issued. This provision allows local agencies, which otherwise would be required to sell their bonds at public sale, to sell their bonds at negotiated sale to the JPA, which can then either resell those same bonds at negotiated sale to an underwriter or use the bonds as local obligations to secure Marks-Roos bonds sold at negotiated sale to an underwriter.

OTHER LEGAL REQUIREMENTS

The Marks-Roos Act has been amended several times in recent years and new requirements and restrictions have been imposed on Marks-Roos bonds as a result. The more important of these limitations are as follows:

Loan Restriction. Loans may not be made to local agencies for working capital or insurance, unless that purpose is first approved by unanimous vote of the governing body of the JPA.

Investment Criteria. In the case of bonds issued by a JPA to acquire local obligations, the offering documents for the bonds must clearly delineate the types of local obligations and minimum credit standards.

Suitability. A financial advisor, investment advisor, underwriter, broker, dealer, or municipal securities dealer may not recommend the purchase, sale, or exchange of a municipal security to a JPA unless they have reasonable grounds to believe and do believe that the recommendation is suitable for the JPA in light of the JPA's investment criteria and responsibility to safeguard public funds.

Self-Dealing. In the case of bonds issued by an authority to acquire local obligations, the underwriter of the bonds, and the financial advisor and investment advisor to the authority, may not sell to the authority any security or obligation issued by a state or local government from its dealer inventory or that it underwrote or otherwise placed on behalf of another client.

Conflict of Interest. A broker, dealer, municipal securities dealer, or other firm that underwrites a bond issue of a JPA cannot serve as financial advisor or investment advisor to the JPA on decisions relating to the investment of the proceeds of that bond issue.

Yield Restriction. Bonds issued by any local agency cannot be purchased by a JPA at a price to yield in excess of 1 percent of the yield of the issue of Marks-Roos bonds issued to purchase the bonds of the local agency.

Limit on Excess Cashflow. At least 95 percent of the receipts by the JPA from bonds of a local agency purchased by the JPA shall be used for one or more of the following purposes:

- To pay principal, interest, redemption prices, or fees for credit enhancement on the issue of Marks-Roos bonds used to acquire those bonds of the local agency
- To pay or reimburse administrative costs of the bonds of the JPA used to acquire those bonds of the local agency
- To pay or reimburse a local agency for principal, interest, or redemption price on bonds of that local agency
- To establish reasonable reserves for the payment of debt service on the Marks-Roos bonds
- To purchase other bonds of a local agency
- To pay or reimburse fees and expenses charged to the JPA by third parties, excluding any member of the JPA, for services relating to administration of the Marks-Roos bonds or of the program established by the JPA for purchase of local agency bonds

Required Filing. The JPA law (see Government Code Section 6503.5) requires that when a joint powers agency is created or its joint powers agreement is amended, an information filing must be made with the California Secretary of State before the agency may issue bonds.

Reporting. Government Code Sections 6586.5 and 6586.7 specify that, prior to issuing Marks-Roos bonds, any agency whose project does not meet certain defined exemption criteria must send a notice to CDIAC and the State Attorney General advising them of its intention to hold a public hearing concerning the proposed project. This notice must include the date, time, and location of the hearing, as well as the names and contact information for members of the financing team, geographic location of the project being financed, and a brief description of the project. In addition, the Government Code requires a JPA adopting a resolution of intent to issue bonds to send a copy of the resolution to CDIAC and the State Attorney General. Authorities exempted from the public hearing notification requirement are also exempted from this filing requirement. In addition, those issuing bonds under Article 1 of the Joint Powers Authority section of the Government Code are exempt as well.

In addition, each year, after the sale of any Marks-Roos bonds for the purpose of acquiring local obligations, the JPA is required to supply certain information to CDIAC.

Marks-Roos Advice. Local agencies may request advice from CDIAC regarding the formation of local bond pooling authorities and the planning, preparing, insuring, marketing, and selling of Marks-Roos bonds.

REFUNDING BONDS

The Marks-Roos Act permits a JPA to issue refunding bonds for the purpose of refunding any bonds, notes, or other securities of the authority then outstanding. Refunding bonds also may pay any redemption premiums, accrued interest, or costs of issuance.

SPECIAL FEDERAL TAX ISSUES

In general, Marks-Roos bonds do not present many unique federal tax issues. To the extent the debt service payments on the local obligations matches the debt service payments on the Marks-Roos bonds, the various federal tax limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply.

Pooled Financings

One type of Marks-Roos financing, however, can present a number of unique federal tax concerns. The use of Marks-Roos bond proceeds to acquire two or more local obligations can cause certain additional federal tax requirements to apply. Principally, these additional requirements limit the period of time that proceeds of the Marks-Roos bonds can be held and invested at the JPA level, prior to acquiring the local obligations. So long as the local obligations to be acquired are known on the date the Marks-Roos bonds are issued and will be acquired within the 90-day origination period authorized under the Marks-Roos Act, these additional federal tax limitations should be satisfied. If, however, the local obligations to be acquired are not known on the date of issuance of the Marks-Roos bonds, particular care must be taken to comply with the additional federal tax requirements.

Also, where local obligations will be acquired, it is not necessary to assure that the local obligations themselves are tax-exempt, because only the Marks-Roos bonds need be tax-exempt in order to allow investors to exclude interest thereon from income for federal tax purposes. As a practical matter, the issuance of the local obligations without complying with all of the requirements for tax exemption (the filing of Form 8038, for example) does not release the local agency from all tax law requirements, for they still must comply with requirements necessary to assure the tax-exempt status of the Marks-Roos bonds (for example, private business use restrictions, investment limitations, expenditure of proceeds requirements, etc.).

MELLO-ROOS BONDS

DEFINITION AND PURPOSE

The Mello-Roos Community Facilities Act of 1982 (the “Mello-Roos Act”) provides a mechanism by which certain public entities, such as cities, counties, special districts, school districts, joint powers entities, and redevelopment agencies, can finance the construction and/or acquisition of facilities and the provision of certain services. The Mello-Roos Act authorizes such a public entity to form a Community Facilities District (a “CFD” or “district”), otherwise known as a Mello-Roos district. Once formed, the district can finance facilities and provide services. Upon approval by a two-thirds vote of the registered voters or landowners within the district, the district may issue bonds secured by the levy of special taxes.

The special taxes are not assessments, and there is no requirement that the special tax be apportioned on the basis of benefit to property. This affords greater flexibility in designing the special tax. A special tax levied by a district is not an ad valorem property tax under Article XIII A of the California Constitution, however, the lien of the special taxes has the same priority as property taxes.

PROJECTS THAT MAY BE FINANCED

A district may finance the purchase, construction, expansion, improvement, or rehabilitation of real or other tangible property with an estimated useful life of five or more years, or planning and design work that is directly related thereto. The financed facilities do not need to be physically located within the district. In general, a district may finance the purchase of facilities that are completed before the resolution of formation to establish the district is adopted. A district also may finance the purchase of facilities that are completed after the adoption of the resolution of formation, so long as such facilities were constructed as if they had been constructed under the direction and supervision, or under the authority of, the local agency creating the district. This means, at a minimum, that the prevailing wage law applies if the resolution of formation is adopted before the public improvement is completed. In addition, a district may finance facilities to be owned or operated, or services to be provided, by an entity other than the entity that created the district, pursuant to a joint community facilities agreement or a joint exercise of powers agreement entered into pursuant to the Mello-Roos Act.

Facilities. Examples of the types of facilities that may be financed are as follows:

- Local park, recreation, parkway, and open-space facilities
- Elementary and secondary school sites and structures that meet the building area and cost standards of the state Allocation Board
- Libraries
- Childcare facilities

- Facilities to transmit and distribute water, natural gas pipeline facilities, telephone lines, facilities to transmit or distribute electrical energy and cable television lines for customers that do not have those services or to mitigate existing visual blight
- Facilities, whether publicly or privately owned, for flood and storm protection purposes, including storm drainage systems and sandstorm protection systems
- Any other governmental facilities the legislative body creating the district is authorized by law to contribute revenue toward, construct, own, or operate
- Work to bring buildings or real property, including privately owned buildings and real property, into compliance with seismic safety standards and regulations, if such work is certified as necessary by local building officials
- Work deemed necessary to repair damage to real property caused by the occurrence of an earthquake within any county or area designated by the President of the United States or the Governor as a disaster area (subject to certain limitations in the Mello-Roos Act)
- Work deemed necessary to repair and abate damage caused to privately owned buildings and structures by soil deterioration (subject to certain limitations in the Mello-Roos Act)

A district may not own any facilities for the transmission or distribution of natural gas, telephone service, or electrical energy and may only operate and maintain those facilities pursuant to an agreement with a public utility.

A district may be used to eliminate fixed special assessment liens on property within the district and to repay any indebtedness secured by any tax, fee, charge, or assessment levied within the area of the district, or may pay debt service on that indebtedness.

The legislative body may enter into an agreement for the construction of discrete portions or phases of facilities to be constructed and purchased. The agreement may include any provisions that the legislative body deems necessary or convenient. However, the agreement must identify or specify all of the following:

- The specific facilities or discrete portions or phases of facilities to be constructed and purchased
- Procedures to ensure that the facilities are constructed pursuant to plans, standards, specifications, and other requirements as determined by the legislative body
- A price or a method to determine a price for each facility or discrete portion or phase of a facility

- Procedures for final inspection and approval of facilities or discrete portions of facilities, for approval of payment, and for acceptance and conveyance or dedication of the facilities to the local agency

Services. Types of services that may be provided by a district are as follows:

- Police protection services
- Fire protection and suppression services and ambulance and paramedic services
- Recreation program services, library services, maintenance services for elementary and secondary school sites and structures, and the operation and maintenance of museums and cultural facilities
- Maintenance of parks, parkways, and open space
- Flood and storm protection services including, but not limited to, the operation and maintenance of storm drainage systems and sandstorm protection systems
- Removal or remedial action services for the cleanup of any hazardous substance released or threatened to be released into the environment

The Mello-Roos Act contains restrictions on services authorized by landowner election. Such services may only be paid for by a CFD to the extent that they are in addition to those provided in the territory of the CFD before it was created. The services to be paid for by the CFD may not supplant services already available within that territory when the CFD was created. In addition, a landowner election may not authorize the levy of a special tax for recreation program services, library services, school maintenance services, or museum and cultural facility maintenance services. Such restrictions do not apply, however, to services authorized by registered voter election.

POLICY CONSIDERATIONS

The nature of the facilities and services to be financed or paid for largely determines whether special taxes are levied instead of special assessments. Special taxes permit the financing of general benefit facilities such as libraries and schools, which are not authorized by the special assessment statutes. In addition, the financed facilities are not required to be located in the district, which allows a district to finance regional facilities. Finally, the flexibility allowed in structuring a Mello-Roos tax formula (also known as the rate and method of apportionment) may make a Mello-Roos financing a more attractive alternative than an assessment district financing. Because of the election requirement, the Mello-Roos Act has been used as a financing vehicle primarily where the voters are landowners rather than registered voters.

Compared to special assessment financings, most Mello-Roos district financings are complicated. Because of the flexibility provided by the Mello-Roos Act, special tax formulas are

often quite complex and specific, making it difficult for a property owner to understand the nature of the burden on his property. Great care must be taken in designing the special tax formula to reduce political concerns and to provide clear and complete disclosure to homebuyers of the burden imposed by the special tax.

SECURITY AND SOURCES OF REPAYMENT FEATURES

Mello-Roos bonds are payable from and secured by special taxes, which are levied upon the property in the district according to the rate and method of apportionment approved by the voters in the district. Like assessments, special taxes are levied upon real property and are not a personal debt of the property owners. The remedy for delinquencies is foreclosure. The general fund of the local agency that created the district is not obligated to pay debt service on the bonds. A bond reserve fund is permitted, and the special tax may be levied to replenish the bond reserve fund so long as the tax rate does not exceed the maximum special tax rate approved by the voters in the district.

The proceeds of a special tax may only be used to pay the cost of providing the facilities, services, and incidental expenses authorized by the election. Special taxes are generally collected in the same manner as ad valorem property taxes. They are also subject to the same penalties and the same procedure, sale, and lien priority in the case of delinquency as ad valorem property taxes. However, the legislative body may adopt another collection procedure, including direct billing of property owners, if circumstances so require.

The legislative body may provide additional security for the bonds by covenanting on behalf of the bondholders that it will commence foreclosure proceedings by a specified time if a special tax installment is delinquent. Because the foreclosure process can be lengthy, the legislative body also may provide for special tax alternate procedures, such as the waiver of delinquency and redemption penalties and the acceptance of bonds tendered in payment of special taxes or at a foreclosure sale.

The legislative body may require additional security for the bonds in the form of a letter of credit or a guaranty where the land in the district is largely undeveloped and is owned by a few persons. The additional security is typically only required until the district is fully developed and the property is sold to the general public. Bond insurance may be available for bonds issued by substantially developed districts, but is not commonly available for bonds issued by new, undeveloped districts.

The formula for levying special taxes may be based upon a variety of factors, including density of development, square footage of construction, acreage, or zoning. Unlike special assessment districts, there is no requirement that the special tax be based upon the benefit a parcel receives from the facilities or services to be financed, however, the tax must be levied on a reasonable basis, as determined by the legislative body of the district.

PROCESS FOR APPROVAL – ESTABLISHING COMMUNITY FACILITIES DISTRICT AND LEVYING SPECIAL TAX

Adoption of Local Goals and Policies. Local agencies that initiate proceedings to establish districts on or after January 1, 1994 must first adopt local goals and policies concerning the use of the Mello-Roos Act. The policies must at least include:

- A statement of the priority that various kinds of facilities will have for financing through the use of the Mello-Roos Act, including public facilities to be owned and operated by other public agencies (such as school districts)
- A statement concerning the credit quality to be required of bond issues, including criteria to be used in evaluating the credit quality
- A statement concerning the steps to be taken to ensure that prospective property purchasers are fully informed about their taxpaying obligations under the Mello-Roos Act
- A statement concerning the criteria for evaluating the equity of tax allocation formulas, and the desirable and maximum amounts of special tax to be levied against any parcel
- A statement of the definitions, standards, and assumptions to be used in appraisals required by the Mello-Roos Act

In addition, the local goals and policies adopted by school districts must include a priority access policy that gives priority attendance access to students residing in a school district whose residents have contributed to the financing of the construction of school district facilities.

Initiation of Proceedings. Proceedings to establish a district may be instituted in any of the following ways:

- By initiative of the legislative body
- By written request signed by two members of the legislative body containing the information required by the Mello-Roos Act
- By petition signed by not less than 10 percent of the registered voters residing within the proposed district
- By petition signed by the owners of not less than 10 percent of the area of land within the proposed district

If the facilities to be financed by the district will be owned or operated by an entity other than the local agency creating the district, the local agency and the entity must enter into a joint community facilities agreement or a joint exercise of powers agreement prior to the adoption of

the resolution of formation creating the district. No local agency that is a party to a joint community facilities agreement or a joint exercise of powers agreement may have primary responsibility for formation of the district unless that local agency is:

- A city, a county, or a city and county
- An agency created pursuant to a joint powers agreement that is separate from the parties to the agreement, is responsible for the administration of the agreement, and is subject to certain notification requirements under the Government Code
- An agency that is reasonably expected to have responsibility for providing facilities or services to be financed by a larger share of the proceeds of special taxes or bonds of the district created pursuant to the joint exercise of powers agreement or the joint community facilities agreement than any other local agency

Resolution of Intention. A resolution of intention to establish a district must be adopted within 90 days after a written request or a petition to create the district is filed with the legislative body of the local agency that will form the district. The resolution of intention must:

- State that the district is being formed pursuant to the Mello-Roos Act
- Describe the proposed boundaries of the district (which need not be contiguous)
- State the name of the proposed district
- Describe the facilities or services to be financed in a manner sufficient to allow a taxpayer within the district to understand what district funds may be used to finance
- Describe any financing plan, lease, lease-purchase, or installment-purchase arrangement that will be used to finance the facilities
- Identify any completed facilities to be purchased or incidental expenses to be incurred
- State that except where funds are otherwise available, a special tax will be levied annually to pay for the facilities and services and that it will be secured by recordation of a continuing lien against all nonexempt property in the district
- Specify the rate and method of apportionment and manner of collection of the special tax in sufficient detail so each landowner or resident is able to estimate the maximum annual amount to be paid, and if the special taxes will be levied against property used for private residential purposes, specify:
 - the dollar amount of the maximum special tax, and state that such amount will not be increased by more than 2 percent per year

- the tax year after which no further special tax will be levied or collected (except that a special tax levied in or before the final tax year and that remains delinquent may be collected in subsequent years), and
- that under no circumstances will the special tax levied against any parcel be increased as a consequence of delinquency or default by the owner of any other parcel within the district by more than 10 percent
- Specify the conditions under which the obligation to pay the special tax may be prepaid and permanently satisfied
- Fix a time and place for a public hearing not less than 30 days or more than 60 days after the resolution of intention is adopted
- Describe any adjustment in property taxation to pay prior indebtedness
- Describe the proposed voting procedure

Report. When the resolution of intention is adopted, the legislative body must direct each officer responsible for providing one or more of the proposed facilities or services to file a report at or before the time of the hearing that contains:

- A brief description of the type of facilities or services required to adequately meet the needs of the district
- An estimate of the cost of providing the facilities or services
- If the district proposes to purchase completed facilities or to pay incidental expenses, an estimate of the fair and reasonable cost of those facilities or expenses
- If the district proposes to finance removal or remedial action for the cleanup of any hazardous substance, either:
 - A remedial action plan, or
 - A determination that the remedial action plan is not required—however, the legislative body may condition financing of the removal or remedial action upon approval of a remedial action plan

Notice. The clerk of the legislative body is required to publish a notice of the public hearing once, in a newspaper of general circulation in the proposed district, at least seven days before the public hearing, containing the information required by the Mello-Roos Act. Notice of the public hearing also may be given by first-class mail to each registered voter and to each landowner within the proposed district, sent at least 15 days before the public hearing.

Protests. Oral or written protests may be made at the public hearing by any interested persons or taxpayers against the establishment of the district, the extent of the district, the type of

facilities or services to be provided, or the regularity or sufficiency of the proceedings. Protests about the regularity or the sufficiency of the proceedings must be in writing and filed with the clerk of the legislative body prior to the hearing, and must specify the irregularities or defects. Written protests may be withdrawn at any time before the conclusion of the hearing.

Majority Protest to Formation of District. If 50 percent of the registered voters or six of the registered voters (whichever is more) residing in, or the owners of one-half or more of the nonexempt land in, the territory proposed to be included in the district protest against the establishment of the district, the proceedings to create the district or to levy the special tax must be discontinued for a period of one year. If the majority protest is only against the furnishing of a specified type of facility or service, that facility or service must be eliminated. If the protest is against levying a specified special tax, that special tax must be eliminated.

At the public hearing, the resolution of intention may be modified by eliminating proposed facilities or services, reducing the special tax, or removing territory from the proposed district. Any modification of the resolution of intention that would increase the probable special tax must be preceded by a report analyzing the impact of the proposed modification on the special tax, which report must be considered prior to approval of the modification.

Resolution of Formation. If, at the conclusion of the public hearing, the determination is made to establish a district, a resolution of formation must be adopted. The resolution of formation must:

- Contain all of the information contained in the resolution of intention
- State that the proposed special tax to be levied in the district has not been precluded by majority protest
- Identify the facilities and services to be funded
- State the name, address, and telephone number of the entity responsible for preparing the annual roll of special tax levy obligations by assessor's parcel number and for estimating future special tax levies
- State that upon recordation of a notice of special tax lien, a continuing lien to secure each levy of the special tax will attach to all nonexempt real property in the district and will continue until the special tax obligation is permanently satisfied or the legislative body ceases collection of the special tax
- State the county of recordation and the recording information for the boundary map of the proposed district
- Determine by a specific finding whether the proceedings were valid and in conformity with the Mello-Roos Act

Election. The levy of a special tax must be approved by two-thirds of the votes cast by the qualified electors of the district in a general or special election held at least 90 days, but not more than 180 days, after the public hearing. These time limits may be waived with the unanimous consent of the qualified electors and the concurrence of election officials, and this action is typically taken in a developer (i.e. landowner vote) district.

Determining Who Votes. The vote on the special tax must generally be by registered voters residing in the district. However, if fewer than 12 persons have been registered to vote within the district for any of the 90 days preceding the close of the public hearing, the vote must be made by the landowners within the district. Similarly, if the special tax will not be apportioned on any then-residential property, the vote may be by the landowners within the district. Each of such landowners must be granted one vote for each acre or portion of an acre owned within the district.

Manner of Conducting Election. The election may be conducted by mail, or ballots may be delivered by personal service to the voters. A ballot proposition may combine the questions relating to the levy of a special tax, the incurring of bonded indebtedness, and the establishment or change of an appropriations limit. If the vote is to be by the landowners of the district, analysis and arguments may be waived with the unanimous consent of all of the landowners, and such waiver must be stated in the order for the election.

Recordation and Notice of Special Tax Lien. Upon a determination by the legislative body that the requisite two-thirds of votes cast in the election are in favor of levying the special tax, the clerk of the legislative body must record a notice of special tax lien in the office of the county recorder for each county in which the district is located, whereupon the lien of the special tax will attach as provided in Section 3114.5 of the Streets and Highways Code.

Levy of Special Tax. The provisions of Streets and Highways Code, Sections 3100 et seq. apply to any proceedings taken under the Mello-Roos Act. The special tax must be levied initially by an ordinance adopted by the legislative body, and thereafter (assuming the tax is levied at the same or a lower rate than in the ordinance) it may be adjusted annually by the adoption of a resolution. Reasonable administrative costs incurred in collecting the special tax may be deducted by the tax collector.

Annual Report. Any CFD formed after January 1, 1992 must prepare, if requested by a resident or landowner of the district, an annual report within 120 days after the last day of each fiscal year. The district may charge a fee for the report not in excess of the actual costs of preparing the report. The report must include the following information for the fiscal year:

- The amount of special taxes collected for the year
- The amount of other monies collected for the year and their source, including interest earned

- The amount of monies expended for the year
- A summary of the amount of monies expended for facilities, services, costs of bonded indebtedness, costs of collecting the special tax, and other administrative and overhead costs

Extension of Authorized Facilities and Services and Changes in Special Taxes. After adoption of the resolution of formation, the legislative body, 25 percent or more of the registered voters residing in the district or the owners of 25 percent or more of the land in the district may institute proceedings to change the types of public facilities or services financed by the district, change the rate and method of apportionment, or levy a new special tax, as specified in the Mello-Roos Act.

Disclosure Requirements. In addition to the continuing disclosure requirements under SEC Rule 15c2-12, the Mello-Roos Act requires the legislative body to supply certain information to CDIAC by October 30 of each year after the sale of any bonds, until the final maturity of such bonds. The information required to be supplied to CDIAC includes:

- The principal amount of the bonds outstanding
- The balance in the bond reserve fund
- The balance in the capitalized interest fund, if any
- The number of parcels which are delinquent with respect to their special tax payments, the amount that each parcel is delinquent, the length of time that each has been delinquent, and when foreclosure was commenced for each delinquent parcel
- The balance in any construction funds
- The assessed value of all parcels subject to special tax to repay the bonds as shown on the most recent equalized roll

In addition, the Mello-Roos Act requires the legislative body to notify CDIAC within 10 days upon the occurrence of either a failure of the local agency or the paying agent or fiscal agent to pay principal and interest due on the bonds on any scheduled payment date, or withdrawal of funds from a reserve fund to pay principal and interest on the bonds beyond the levels set by CDIAC.

Proposition 218. Proposition 218 added Article XIIC and Article XIID to the California Constitution. Article XIID has no direct application to bonds issued under the Mello-Roos Act, because they are authorized by a two-thirds vote of the qualified electors of the district. Article XIIC states, among other things, that “. . . the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment, fee or charge.” As discussed above, the Mello-Roos Act provides for a procedure, which includes

notice, hearing, protest, and voting requirements, to alter the rate and method of apportionment of an existing special tax. However, the Mello-Roos Act also prohibits the legislative body from adopting any resolution to reduce the rate of any special tax or terminate the levy of any special tax pledged to repay any debt incurred pursuant to the Mello-Roos Act unless the legislative body determines that the reduction or termination of the special tax would not interfere with the timely retirement of that debt. Consequently, although the matter is not free from doubt, it is likely that Proposition 218 has not conferred on the voters the power to repeal or reduce special taxes if such reduction would interfere with the timely retirement of any bonds issued by a district. For more information regarding Proposition 218, see **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives.**

PROCESS FOR APPROVAL – ISSUING BONDS

The legislative body may generally only sell Mello-Roos bonds if it determines, prior to the sale of the bonds, that the value of the property in the district that would be subject to the special tax will be at least three times the principal amount of bonds to be sold plus the principal amount of all other bonds outstanding and secured by a special tax or a special assessment on the property in the district. However, if the legislative body concludes that the proposed bonds do not present any unusual credit risk (due to credit enhancement or for other reasons), or that the bond issue should proceed for specified public policy reasons, then such determination need not be made.

The proceedings to issue bonds secured by the levy of a special tax are usually combined with proceedings to establish a district. In such cases, a resolution of intention to issue bonds is adopted at the same time as the resolution of intention to establish the district. The local agency is required to hold a public hearing regarding the proposed bond issuance and to publish notice of the hearing, which actions are typically combined with the public hearing and notice published in connection with the establishment of the district. At the public hearing, any interested person may appear and present any matters material to the question of issuing the bonds. After the public hearing, a district may authorize the issuance of bonds by adopting a resolution of necessity to issue bonds, and a resolution to incur bonded indebtedness.

Resolution of Necessity. The resolution of necessity must:

- Contain a declaration of the necessity for the indebtedness
- State the purpose for which the proposed debt is to be incurred
- State the amount of the proposed debt
- State the time and place for a hearing by the legislative body on the proposed debt issue

Resolution to Incur Bonded Indebtedness. The resolution to incur bonded indebtedness must:

- State that the legislative body deems it necessary to incur the bonded indebtedness
- State the purpose for which the bonded indebtedness will be incurred
- State that either the whole of the district or a portion of the district will pay for the bonded indebtedness, as previously determined by the legislative body
- State the amount of debt to be incurred
- Describe the maximum the bonds to be issued will run before maturity, which term may not exceed 40 years
- State the maximum annual rate of interest to be paid, payable annually or semiannually, or in part annually and in part semiannually
- State the date of the election (which may be consolidated with the election to levy the special tax), the polling hours if the election will not be conducted by mail, or the hour when the mailed ballots must be returned to the election officer if the election is conducted by mail

If more than two-thirds of the votes cast at the election are in favor of incurring the indebtedness, the legislative body may, by resolution, provide for:

- The form, execution, and issuance of the bonds
- The appointment of a paying agent or bond registrar
- The execution financing documents securing the bonds
- The pledge or assignment of any revenues of the district to the repayment of the bonds
- The investment of bond proceeds and other revenues, which investment provisions must comply with the restrictions in the Mello-Roos Act
- The date or dates to be borne by the bonds, maturity date(s) of the bonds, and the place(s) and time(s) that the bonds are payable
- The denominations, forms, and registration privileges of the bonds
- Any other terms and conditions determined to be necessary by the legislative body

PROCESS FOR SALE

Mello-Roos bonds may be sold at negotiated sale if the governing body determines that a negotiated sale would result in a lower overall cost. Otherwise, the bonds must be sold at competitive sale.

MAXIMUM AMOUNT; OTHER LIMITATIONS ON TERMS OF BONDS

The maximum amount of the bonds that may be issued is the amount approved by the qualified electors at the bond election. Bonds may bear fixed or variable interest at a rate not exceeding 12 percent per year. Interest on the bonds may be paid annually or semiannually.

The maximum maturity of any bond may not exceed 40 years.

SPECIAL FEDERAL TAX CONSIDERATIONS

The federal tax considerations that apply to a community facilities district are identical to the tax considerations that apply to assessment districts. See the section in this chapter on **Assessment Bonds**.

PENSION OBLIGATION BONDS

DEFINITION AND PURPOSE

Pension obligation bonds (POBs) are typically issued to pay some or all of a pension plan's unfunded accrued actuarial liability (UAAL).

In order to achieve the expected budgetary relief, the issuer hopes to invest the bond proceeds at a rate higher than the total cost of borrowing. The desired result is that the transaction reduces the annual pension contribution required to fund the plan by more than the total cost of borrowing.

The proceeds of the bonds are transferred to the issuer's pension system as a prepayment of all or part of the unfunded pension liabilities of the issuer, and the proceeds are invested as directed by the pension system. The payment of debt service on pension obligation bonds is typically an unconditional obligation of the issuer, payable from its general fund. The debt service payments replace the obligation of the issuer to make annual contributions for the unfunded liability financed with the pension bonds.

In California, issuers of pension obligation bonds have included both cities and counties. Pension obligation bonds payable from an issuer's general fund are based on the theory that the payment of the unfunded liability to the issuer's pension plan is an "obligation imposed by law" which is, therefore, not subject to the constitutional debt limit. Because of limited case law authority on this exception to the debt limit, a judicial validation action is required in order to establish the validity of the obligation.

MECHANICS AND ACTUARIAL ASSUMPTIONS OF DEFINED BENEFIT PLANS

The defined benefit pension fund's main objective is to determine the current and future benefit payments (liabilities) versus the level of current contributions and future investment income (assets) needed to satisfy the benefit payments. Pension fund management's goal is to determine the optimum level of contributions to fully fund the promised benefits. The text box **Pension Funding Formula** provides pension fund math reduced to its simplest form.

Pension Funding Formula

$$C + I = B + E$$

Where:

C = Contributions (Employer, Employee, or both)

I = Income from investments

B = Benefits paid

E = Expenses for plan administration

Based on complex actuarial calculations, a contribution amount (C) is determined, which will allow for the accumulation of the assets and investment income, "I," needed to pay for "B." Expenses (E) will be a variable, based on the plan's business policy.

If “B” is predicted accurately but “T” is less than expected, the only alternative for bringing the formula back into balance is to increase “C.” If “T” is greater than expected, “C” will be reduced. In most cases, the variable “C” is the responsibility of the employer and employee. The employer takes the risk if “T” is less than expected, and thus must increase contributions, and conversely is rewarded with lower contributions if “T” is greater than expected.

Unfunded Actuarial Accrued Liability

The UAAL is calculated as the actuarial present value of all future benefits, less the actuarial present value of all future normal costs, less the current actuarial value of assets. The resulting UAAL may either be positive (under-funded) or negative (over-funded). The UAAL is not an accounting liability. The UAAL is the actuarial liability associated with prior years under the entry age cost method, assuming that the plan will continue into the future.

In terms of benefits, it reflects expected future pay increases for current members and expected future service for those members. UAAL also can be created by program improvements such as increases in the multiplier and retiree benefit increases. With the investment and contribution side of the equation, it reflects current and expected future returns on investments along with contributions by employees and their employer. Actuarial gains and losses also will impact the UAAL. Gains and losses represent the difference between the actual experience of the program and its assumed experience. Changes in actuarial assumptions and/or methods also impact the UAAL. A complete discussion of pension fund policy and mechanics is described in the California Debt and Investment Advisory Commission’s *California Public Fund Investment Primer*.

PROJECTS THAT MAY BE FINANCED

Pension obligation bonds are issued to finance all or part of the unfunded pension liabilities of the issuer. The amount of unfunded liability is the difference between pension system assets and expected revenues and the expected pension benefits previously earned by and payable to employees. This amount is estimated by the pension system’s actuary on the basis of assumptions regarding:

- Mortality
- Valuation of current assets
- Rate of return on investments
- Projected salary increases attributed to inflation
- Across-the-board raises and merit raises
- Increases in retirement benefits

- Age at retirement and any cost of living adjustments

These actuarial assumptions will change from time to time and may have a large impact on the amount of the unfunded liability. Thus the amount of unfunded liability could become greater or smaller than that financed with pension obligation bonds. The amount of unfunded liability is generally treated as debt in (footnotes to) the financial statements of the issuer.

POLICY CONSIDERATIONS

Economics of Pension Obligation Bonds and Potential Risks. Pension obligation bonds are typically issued during periods of historically low taxable interest rates (as explained below, interest on pension obligation bonds is generally subject to federal income taxation). At low interest rate levels there is an opportunity for interest rate savings when comparing the rate on the bonds with the assumed rate of return on investments (the “assumed rate”) assigned by the pension system to unfunded liabilities. The actuary for the pension system determines the assumed rate based on a conservative estimate of the pension system's projected reinvestment rate (the frequency of this determination depends on the total membership of the pension system). The expected economic benefit to the issuer is the spread between the interest rate on the bonds and the assumed rate.

Issuing a POB involves risks that should be considered before issuance. First, the UAAL is just a “snapshot” at a specific point in time. As new benefits are added or factors affecting the underlying actuarial estimates change, the UAAL may become positive or negative. Issuing a POB does not eliminate this potential risk. Second, there is no guarantee that pension fund investments will earn or exceed actuarial assumptions. To achieve any real saving from issuing a POB, the issuer needs to earn an investment return that exceeds the total cost of borrowing during the period the POB is outstanding. Theoretically, investing bond proceeds from a POB in higher risk investment instruments should produce a rate of return sufficient to service the debt and add to the pension fund portfolio. However, short-term market downturns producing low or negative investment returns can cause the public agency’s UAAL to rise to the pre-POB issuance level or higher. An employer hoping to reduce or eliminate its UAAL amortization payment by using a POB may find itself in the undesirable position of owing a pension contribution (including UAAL amortization payment) at the same time the POB debt payments are due. Moreover, issuing POBs to fund annual pension contributions can have a negative impact on the issuer’s credit rating if the projected returns fail to materialize and the issuer needs to increase pension contributions along with servicing the POB debt.

Still another component of the economics of most pension obligation bond financings is that the term and the amortization schedule of the unfunded liability can be changed to more closely match the budgetary needs of an issuer. For the pension system, however, it may be disadvantageous from an investment point of view to receive substantial lump sum prepayments (compared with regular periodic payments), particularly at a time when reinvestment rates are relatively low. For more information regarding the policy considerations with respect to pension

obligation bonds, see GFOA Recommended Practice: *Evaluating the Use of Pension Obligation Bonds (1997 and 2005) (DEBT & CORBA)* at www.gfoa.org.

Federal Reimbursement Question. Most pension system costs are treated as overhead for purposes of seeking federal reimbursement for indirect costs. After the first county pension obligation financing at the end of 1993, a question was raised by the Office of Management and Budget (OMB) about whether interest on bonds issued to refund unfunded pension obligations for covered employees will be an “allowable cost” for reimbursement in the same manner as interest on the unfunded liability previously paid to the pension system at the assumed rate, under OMB Circular No. A-87 (relating to federal reimbursement of certain costs of state or local governments in administering federal programs). On January 31, 1994, OMB issued a letter that resolves this question favorably in most cases. However, attention should be paid to compliance with the conditions set forth in that letter or otherwise confirming with OMB that federal reimbursements will not be jeopardized.

SECURITY AND SOURCES OF PAYMENT

Pension obligation bonds are issued as unconditional, general fund obligations of the issuer. The taxing power of the issuer, however, is not pledged and bondholders do not receive liens on property of the issuer. The bondholders, therefore, are unsecured, general fund creditors of the issuer. While issuers typically provide pension obligation bondholders with very few financial covenants, issuers often covenant to deposit the annual debt service on the bonds with the bond trustee at the beginning of each fiscal year. There is no bond reserve fund for pension obligation bonds.

Ratings. Because POBs replace existing pension obligations, they are not generally viewed as adding to the debt burden of the state or local government issuer (much like a conventional refunding). In general, rating agencies consider the effects of pension obligation bonds within the general overall long-term credit ratings. They do not view POBs as a credit weakness if approached with a reasonable, conservative, and attainable long-term strategy for managing the UAAL within their current financial plan.

PROCESS FOR APPROVAL

The issuance of pension obligation bonds is typically authorized by resolution of the governing body of the issuer, and the bonds are usually issued pursuant to Government Code Sections 53580 et seq. (the “Local Agency Refunding Law”). For the full text of the Local Agency Refunding Law, see **Appendix D – Legal References – State Statutes of General Application – Overriding Bond Authorizations.**

Validation Action. Article XVI, Section 18 of the State Constitution prohibits cities and counties from incurring indebtedness exceeding one year without an election. Pension obligations do not fit into any of the well-recognized exceptions to this constitutional debt limitation, such as the special fund exception for revenue bonds or the lease exception, but do

qualify for the lesser known exception for “obligations imposed by law.” For more information, see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**. Because there is relatively scarce authority for this exception in the law, the validity of the debenture/contract as an obligation imposed by law is validated pursuant to Sections 860 et seq. of the Code of Civil Procedure and so is the validity of the bonds issued to refund the debenture/contract.

The validation action also may include such other matters as the size of unfunded liability, using the bonds to extend the term of original amortization of the unfunded liability, including costs of issuance in the amount of bonds (including in the bond issue the current and/or next fiscal year's normal annual contribution related to current employment at a discount for prepayment) and derivative products. The validation action generally requires approximately 45 days from the date of filing, and can be run concurrently with other work on the financing so that little additional time is required. Validation also has been considered crucial by the rating agencies, which generally require the 30-day appeal period to run before closing the bond issue. A typical pension obligation financing, including the validation action, takes roughly four to five months.

PROCESS FOR SALE

Pension obligation bonds issued pursuant to the Local Agency Refunding Law may be sold at either public or private sale or on a negotiated sale basis. The purchase price of the bonds may be either above or below par, as the issuer determines. In the event the issuer determines to sell the bonds at public sale, the issuer is required to advertise the bonds for sale and invite sealed bids on the bonds by publication of a notice once at least ten days before the date of the public sale in a newspaper of general circulation circulated within the boundaries of the issuer. If one or more satisfactory bids are received, the bonds are required to be awarded to the highest responsible bidder. If no bids are received or if the issuer determines that the bids received are not satisfactory, the issuer may reject all bids received.

To date, most pension obligation bonds have been sold on a negotiated, rather than competitive bid, basis.

OTHER LIMITATIONS ON TERMS OF BONDS

Since pension obligation bonds rely on the “obligations imposed by law” exception to the constitutional debt limit, the aggregate principal amount of bonds should not exceed the obligation imposed by law plus incidental expenses. Thus, in order to qualify under the “obligations imposed by law” exception to the constitutional debt limit, the aggregate principal amount of pension obligation bonds should not exceed an amount equal to:

- The unfunded liability of the pension system (as calculated by an actuary), and
- Costs of issuance of the bonds

Pension obligation bonds are not sized to include a bond reserve fund (as a reserve fund is neither imposed by law nor an incidental expense). As the practice has developed, it has become common to fund the issuer's normal contribution in the current year (and according to some counsel, the next fiscal year), under the logic that these amounts are legally required payments and thus are "obligations required by law." Sizing of a pension obligation bond is usually one of the issues that is validated in the validation action discussed above.

The Local Agency Refunding Law imposes few additional restrictions on the terms of the bonds. The bonds can either be serial or term bonds, bear such date and mature on such dates as determined by the issuer, bear interest at either a fixed or variable rate, and contain redemption provisions as determined by the issuer.

LEGAL AUTHORITY

The taxable pension obligation bonds issued in California have been structured as refunding bonds issued pursuant to the Local Agency Refunding Law. The existing unfunded liability to the pension system is first evidenced by a written debenture (or, in the case of PERS, a written contract), which "evidence of indebtedness" is then eligible for refunding under the Local Agency Refunding Law. In addition to the Local Agency Refunding Law, charter cities also may issue POBs pursuant to an ordinance adopted by the city council.

Alternative financing structures exist, including issuance, by or at the direction of the pension system, of certificates of participation in the unfunded liabilities and other structures that might permit the system to undertake a financing without the public entity's participation or benefit. So far, such alternative structures have not been pursued in California.

The 1937 Act Counties. Twenty-one California counties, including the first three to issue pension bonds, have established retirement systems that are subject to the County Employees Retirement Law of 1937 (the "1937 Act"). The 1937 Act provides that the county has an obligation (the "obligation imposed by law") to make payments to the pension system that, together with the required employee contributions, will be sufficient to provide for the payment of all prospective benefits. This obligation has two components:

- Payments toward future pension benefits associated with current employment
- Payments toward the unfunded liability

The 1937 Act permits the unfunded liability to be amortized over a period of not to exceed 30 years, with an "assumed interest rate" based on the assumed future earnings rate of the pension system.

Charter Cities. A number of charter cities also have substantial unfunded pension liabilities to the retirement systems established by their respective charters. Although not subject to the 1937 Act, analogous "obligations imposed by law" can usually be found in the charter.

The structure of the pension obligation bond financings so far used for cities is essentially identical to that for counties.

PERS. Public entities that are members of the California Public Employees' Retirement System (PERS) are authorized by the Government Code to participate in and to make all or part of their employees members of PERS by contract. Thereafter they are obligated to make contributions to PERS as provided in the Government Code, including payments in respect of unfunded liability as determined by an actuary, amortized over periods particular to each public entity not exceeding 40 years, with interest at an assumed rate. Accordingly, these public entities also may engage in pension obligation financings.

SPECIAL FEDERAL TAX ISSUES

The Tax Reform Act of 1986 changed the federal tax law as it relates to pension obligation bonds making it virtually impossible to structure a new, tax-exempt, pension obligation bond financing. Except for refinancings of pension obligation bonds originally issued prior to the Tax Reform Act of 1986, all of the pension obligation bond financings that have closed in California in recent years have been issued on a federally taxable basis. The interest on these bonds, however, is exempt from State of California personal income tax.

PUBLIC ENTERPRISE REVENUE BONDS

DEFINITION AND PURPOSE

Public enterprise revenue bonds are bonds that finance facilities for a revenue-producing enterprise and are payable from the revenues of that enterprise. Examples of such enterprises include an airport, a water system, a power system, a sewer system, a single power plant, or a bridge. Revenues may include such items as service charges, tolls, connection fees, admission fees, and rents. This section discusses the issuance of public enterprise revenue bonds by cities, counties, and joint powers authorities.

As described in this section, voter approval is required for revenue bonds issued under the Revenue Bond Law of 1941 (Government Code Sections 54300 et seq., the “1941 Act”). This requirement and others in the 1941 Act have resulted in many issuers using alternative revenue bond financing structures when financing improvements to their revenue-generating enterprises. See the sections in this chapter on **Marks-Roos Bonds** and **Financing Leases and Certificates of Participation – Legal Authority – Special Fund Obligations**.

LEGAL AUTHORITY; ISSUERS

Constitutional Considerations for Cities and Counties. California courts have determined that revenue bonds of cities and counties are not required by the California Constitution to be approved by a two-thirds vote in a bond election because the revenue bonds are not payable from taxes or from the general fund of the issuer. Rather, they are paid solely from a special fund consisting of enterprise revenues. To qualify for the special fund exception, the revenues must relate to or be derived from the enterprise that is financed in whole or in part by the bonds.

Statutory Authorization. Cities and counties generally may issue public enterprise revenue bonds under the 1941 Act. Bonds may be issued for water conservation, treatment and supply, garbage collection, treatment and disposal, sewage collection, treatment and disposal, parking, ferries, airports, harbors, hospitals, golf courses, and electric energy generation and transmission (but not distribution).

Charter cities may, unless limited by their charters, adopt ordinances establishing their own procedures for the issuance of revenue bonds for enterprises authorized (or not prohibited) by their charters or which incorporate certain of the procedures set forth in the 1941 Act without being bound by the restrictions therein (e.g. the 1941 Act requirement for a majority vote election may be eliminated).

See **Appendix D – Legal References – Table D-3-1** for a list of other statutory authorizations for the issuance of public enterprise revenue bonds.

Public agencies also are authorized to join together to create a separate entity—a joint powers authority (JPA)—to issue revenue bonds for a project. The Joint Exercise of Powers Law (Government Code Sections 6500 et seq.) authorizes the establishment of these joint powers authorities and the issuance of revenue bonds by them for a wide variety of projects and programs.

The following projects and programs can be financed and undertaken with a JPA:

- Public buildings (generally)
- Working capital programs
- Insurance programs
- Fair and exhibition facilities
- Stadiums, sports arenas, parks, and recreational centers
- Electric generation and transmission facilities
- Solid waste disposal, treatment, or conversion facilities
- Water facilities and wastewater facilities
- Streets, roads, bridges, and mass transit or vehicles facilities
- Airports, police stations, and fire stations
- Public works facilities (including corporation yards)
- Public health facilities
- Criminal justice facilities (including court buildings and jails)
- Public libraries
- Public parking garages
- Low income housing projects
- Redevelopment improvements
- Telecommunications systems or services
- Computers
- Service vehicles

- Public improvements authorized by the various special assessment and Mello-Roos statutes

PROJECTS THAT MAY BE FINANCED

Revenue bonds may be used to finance generally any type of revenue producing improvement subject to any limitations that may appear in the statute pursuant to which the issuer is proceeding. Charter cities with proper charter authority can establish through ordinances revenue bond procedures for almost any public facility that is of a revenue producing nature.

PROCESS FOR APPROVAL

Under the 1941 Act, the process for the approval of bonds includes the following steps:

- A resolution is adopted by the majority vote of the governing body of the local agency that:
 - States the purpose of the proposed issue
 - Estimates the cost of the project
 - States the principal amount of bonds, the maximum interest rate, and the date and manner of the election to vote on the issuance of the bonds, and
 - Specifies that the bonds shall be revenue bonds payable exclusively from the revenues of the enterprise and are not to be secured by the taxing powers of the local agency
- The resolution is published either:
 - Once a day for at least seven days if the newspaper is published at least six days a week
 - Once a week for two succeeding weeks if the newspaper is published less than six days a week, or
 - If there are no such newspapers, the resolution is posted in three public places in the local agency for two succeeding weeks
- A majority vote must be obtained at the election on the proposition of issuing bonds for the stated purpose
- Issuance and sale of the bonds is authorized by resolution of the governing body of the local agency

Certain requirements with respect to the process for approval of bonds under other revenue bond laws are specified in **Appendix D – Legal References – Table D-3-1**.

For JPAs, the first step is the creation of the JPA by the execution of a joint exercise of power agreement among the public entity members. The JPA is required to file a notice with the Secretary of State within 30 days of the effective date of the agreement, setting forth the name, date, and purpose of the JPA.

The agreement must specify the purpose for the agreement or the powers to be exercised by the JPA. In addition, the manner of exercising such powers must be specified as being subject to the restrictions upon the manner of exercising power of a designated member.

Revenue bond issuances by a JPA must, in certain cases, be approved by ordinances enacted by all of the parties to the JPA or those who will have projects financed by the bond issuance. The ordinance is required to be published and is subject to referendum for the 30-day period (60 days where a county is a public agency) following publication.

PROCESS FOR SALE

Under the 1941 Act, the issuer may sell the bonds at a price above or below par in a manner, at public or private sale, as it determines by resolution.

Certain sale process requirements for public enterprise revenue bonds issued under other statutes are covered in **Appendix D – Legal References – Table D-3-1**.

For JPAs, certain bonds may be required to be sold at par at competitive sale. Other JPA bonds, such as bonds for the generation and transmission of electric energy, the disposal or conversion of solid waste, an intermodal container transfer facility, or for a fair and exhibition facility, and projects financed under the Marks-Roos Local Bond Pooling Act of 1985 (Government Code Sections 6584 et seq.), may be sold at negotiated sale or at a price less than par, or both.

LIMITATIONS ON TERMS OF BONDS

Under the 1941 Act, the maximum stated interest rate is 12 percent per year and the bonds may have a term of up to 40 years. The issuer may specify any premium payable upon early retirement of the bonds.

Certain limitations on the terms of bonds issued under other statutes are listed in **Appendix D – Legal References – Table D-3-1**.

For JPAs, the interest rate may be either fixed or variable and interest may be payable at the times specified in the bond resolution.

METHOD OF REPAYMENT AND SECURITY FEATURES

As described above, public enterprise revenue bonds are secured by a lien upon, and from, the revenues of the revenue producing enterprise or facility. Commonly, an operating history of the enterprise or feasibility studies are used to determine that projected revenues will be sufficient to

pay operation and maintenance expenses of the enterprise or facility, revenues on the bonds and an additional amount known as coverage. In addition, the issuer will generally covenant in the bond resolution or indenture to establish rates and charges for the products or services provided by the enterprise or facility sufficient to provide revenues to pay such amounts and to provide coverage. Coverage is generally expressed as the ratio of net revenues (i.e. revenues less operation and maintenance expenses other than depreciation) to debt service (e.g. 1.2 times coverage).

SPECIAL FEDERAL TAX CONSIDERATIONS

As described in **Chapter 3, General Federal Tax Requirements**, the federal tax limitations and requirements for tax-exempt debt apply to public enterprise revenue bonds. For example, in order to be tax-exempt, public enterprise revenue bonds must not be arbitrage bonds or hedge bonds.

However, tax-exempt public enterprise revenue bonds may be issued to finance airport, port, mass commuting, water, sewer, solid waste disposal, and certain other facilities even if the bonds are private activity bonds, because each of these types of facilities are a category of qualified private activity bonds. As described in the private activity bond discussion in **Chapter 3, General Federal Tax Requirements**, the Private Business Tests may be satisfied on the basis of a private business owning, leasing, managing, or acquiring output from a particular facility. It is very common for airport revenue bonds or port revenue bonds to be private activity bonds.

Because public enterprise projects tend to be large and expensive, the most significant practical federal tax limitation for qualified private activity bond financing is the volume cap requirement. In California, volume cap is a scarce resource. The good news on this front is that qualified private activity bond financing for airport, port, and solid waste disposal facilities that are owned by a public agency are exempt from the volume cap requirement. In fact, ownership of the financed facilities by a public agency is a requirement for all airport and port qualified private activity bonds. Among other things, this ownership requirement typically limits any lease of such facilities to a private business to a maximum term of 80 percent of the useful life of the facility. For a more detailed discussion of the types of facilities that constitute airport, port, mass commuting, water, sewer, and solid waste disposal facilities and the other limitations relating to qualified private activity bonds, the reader should review the discussion on qualified private activity bonds in **Chapter 3, General Federal Tax Requirements**.

Additionally, an increasing number of public enterprises are considering various forms of “privatization.” To the extent the business arrangements relating to privatization cause bonds already issued or to be issued to be private activity bonds, tax-exempt financing may not be available and remedial action may be required to preserve the tax-exempt status of outstanding bonds. As described in the discussion on management or service provider contracts in **Chapter 3, General Federal Tax Requirements**, however, it is often possible to allow for privatization

by way of a service or management contract without causing bonds to become private activity bonds.

REFUNDING BONDS

Public enterprise revenue refunding bonds are generally authorized to be issued without an election and by means of a negotiated sale (see, generally, the Local Agency Refunding Bond Law (Government Code Sections 53580 et seq.)). If the local agency determines to sell the bonds pursuant to the Local Agency Refunding Bond Law at negotiated sale, the local agency must, on the Report of Final Sale filed with the California Debt and Investment Advisory Commission, explain the reasons why the local agency determined to sell the bonds at negotiated sale instead of at competitive sale.

PUBLIC LEASE REVENUE BONDS

DEFINITION AND PURPOSES

Public lease revenue bonds are issued by a public entity (such as a JPA) or on behalf of a public entity (such as by a nonprofit corporation on behalf of a city) and provide a means to finance capital improvements to be leased to a public agency. The bonds are payable solely from lease payments paid by a public agency other than the issuer.

Unlike a certificate of participation (COP) financing (see the section in this chapter on **Financing Leases and Certificates of Participation**), the lease to the public entity need not be a financing lease because the bonds themselves, which are issued by or on behalf of a public entity, are the tax-exempt obligations and the lease simply provides the security for payment of the bonds.

PROJECTS THAT MAY BE FINANCED

Joint Powers Authorities. Perhaps the most frequent type of issuer of lease revenue bonds is a JPA. JPA lease revenue bonds may be used to finance the projects or programs listed in this chapter in the section on **Marks-Roos Bonds – Projects That May be Financed with Marks-Roos Bonds – Public Capital Improvement Bonds**.

Nonprofit Corporations. Nonprofit corporation lease revenue bonds may be used to finance virtually any facility or project that can be leased to a public agency, including equipment. Historically, they have been used to finance schools, public administrative buildings, stadiums, convention centers, airport facilities, entire water distribution or sewer systems, and other similar projects.

Redevelopment Agencies. Redevelopment agency lease revenue bonds may be used to finance publicly owned buildings or facilities that are of benefit to the project area or its immediate neighborhood if no other reasonable means of financing such buildings or facilities are available to the community.

Parking Authorities. Parking authority lease revenue bonds may be used to finance parking facilities and structures.

Public Works Board. A variety of state-funded projects—instructional, research, and medical facilities, prisons, state office buildings and equipment—may be authorized by the State Legislature for financing through Public Works Board lease revenue bonds.

For a listing of the statutory references for each of these types of lease revenue bonds, see **Appendix D – Legal References – Table D-4-1**. In each case, authority also must exist for the public agency lessee to enter into the lease. A listing of the most commonly used of these statutory provisions is provided in **Appendix D – Legal References – Table D-5-1**.

POLICY CONSIDERATIONS

Generally, public lease revenue bond financing is expensive compared to general obligation bond financing and, for that reason, may be a less desirable alternative.

Historically, public lease revenue bonds have been used to finance several different types of projects:

- Projects, such as stadiums or parking facilities, which were intended directly or indirectly to pay their own way, but with respect to which revenues were either sufficiently uncertain or sufficiently indirect as to not provide an adequate basis for bondholders' security. Thus the public agencies' general fund credit was placed behind the project.
- Projects, which were permitted to be financed by general obligation bonds of local agencies or the state, but were either not sufficiently popular to obtain a favorable two-thirds vote at an election or for which timing considerations did not permit the delay attendant in calling and holding an election
- Projects, which were necessary and desirable, but for which no other method of financing reasonably existed, frequently because the financed facilities do not house activities that generate revenues—for example, the building and equipping of a fire station

For a complete discussion of the policy considerations for lease revenue bonds, see *Guidelines for Leases and Certification of Participation* (CDIAC 1993).

SECURITY AND SOURCE OF REPAYMENT

The pledged revenues for a public lease revenue bond are the payments made pursuant to the lease by the public agency lessee. The “lease” may take the form of a beneficial use and occupancy lease (payable from the general fund of the lessee), a non-appropriation lease (which also may be payable from the general fund of the lessee, subject to the right of the lessee to terminate the agreement in any fiscal year), or a special fund lease (payable solely from certain limited revenues relating to the project). These three types of lease obligations, and their security features, are discussed in more detail in this chapter in the section on **Financing Leases and Certificates of Participation**. Also, see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**.

PROCESS FOR APPROVAL

Joint Powers Authorities. Under the Joint Exercise of Powers Act (Government Code Sections 6500 et seq., the “JPA Act”), two or more public agencies may agree to jointly exercise any power common to each of the contracting agencies as authorized by their legislative or governing bodies. A public agency is defined as including federal, state, and local agencies.

A JPA, created pursuant to a joint powers agreement, is an entity separate and apart from the public agencies that are parties to the joint powers agreement. The joint powers authority is required, within 30 days after the effective date of the joint powers agreement, to cause a notice of the joint powers agreement to be prepared and filed with the office of the Secretary of State.

A JPA may generally issue lease revenue bonds without an election. However, if the lease revenue bonds are issued pursuant to Article 2 of the JPA Act, the public agency lessee must approve the financing by ordinance subject to referendum. The ordinance takes effect 60 days after its date of adoption, and during this time opponents of the project may circulate referendum petitions on the ordinance. If the required number of voters signs the petition, lease revenue bonds cannot be issued until after the ordinance has been approved at an election. On the other hand, if the lease revenue bonds are issued pursuant to Article 4 of the JPA Act, no ordinance is required.

Nonprofit Corporations. Generally, after determining to finance a particular facility or project with nonprofit corporation lease revenue bonds, the first step is the creation of a nonprofit corporation under the Nonprofit Public Benefit Corporation Law (Corporations Code Sections 5110 et seq.). A group of “public spirited citizens” may form a nonprofit corporation by filing articles of incorporation with the Secretary of State. To avoid treatment of the nonprofit corporation as the “alter ego” of the public agency, the governing body of the public agency does not directly appoint members of the board of directors of the nonprofit corporation. However, board members may be subject to the approval of the governing body of the public agency.

Nonprofit corporations are often utilized in a public leaseback financing governed by Government Code Sections 54240 et seq. Such a financing is typically structured as follows:

- The public agency leases the site to the nonprofit corporation, which agrees to construct the project and subleases the site and project back to the public agency
- The project is financed with the proceeds of bonds issued by the nonprofit corporation and the bonds are payable from and secured by a lien on the rental payments made by the public agency pursuant to the sublease
- A sublease (or lease if the nonprofit corporation owns the site outright) with a term of five years or more must be approved by ordinance of the lessee, subject to referendum
- If a sufficient number of voters petition to place the matter on a ballot, and a majority of those voting oppose the leaseback, all proceedings must be terminated

Redevelopment Agencies and Parking Authorities. In each case, the lease, which provides the revenues to pay the bonds, must be approved by ordinance subject to referendum in the same manner as for nonprofit corporations.

In each of the above cases, the actual issuance and sale of the bonds is authorized by resolution of the governing body of the issuer.

State Public Works Board. Lease revenue bonds issued for a particular facility or project by the State Public Works Board must be authorized by a particular statute. Once authorized by statute, the lease, which provides the revenues to pay the bonds, must be approved by legislative or administrative action of the public agency leasing the financed facility. For example, a lease for a community college facility must be approved by resolution of the board of directors of the community college district. Similar actions are taken by the Regents of the University of California and the Board of Trustees of the California State University to authorize their leases with the Public Works Board. Finally, state departments such as the Department of General Services, the Department of Corrections, and the Franchise Tax Board may authorize the lease by administrative action. The authorization of the lease takes effect immediately and is not subject to referendum.

Following the authorization of the lease, the State Public Works Board authorizes the issuance of lease revenue bonds or bond anticipation notes by resolution approving the form and authorizing the execution of a bond indenture and the lease.

PROCESS FOR SALE

Generally, public lease revenue bonds issued by nonprofit corporations and parking authorities must be sold at competitive sale held after publication of a notice once at least ten days before the date of the sale in a newspaper of general circulation circulated within the boundaries of each public agency to be aided by the project (see Government Code Sections 5800 et seq.).

Redevelopment agency public lease revenue bonds must be sold at not less than 95 percent of par, at a competitive sale held after notice published once at least five days prior to the sale in a newspaper of general circulation published in the community.

JPA lease revenue bonds may generally be sold on a negotiated basis at a price determined by the authority after due consideration of the recommendations of the public agency lessee.

Parking authority lease revenue bonds must be sold at a price not less than 92 percent of par.

Public Works Board lease revenue bonds must be sold by the State Treasurer, either at competitive or negotiated sale and at a price as determined by the State Treasurer.

OTHER LIMITATIONS

Nonprofit Corporations. There are no statutory limitations on the maximum maturity or interest rate for nonprofit corporation lease revenue bonds, nor are there any other statutory specifications of payment terms of such bonds.

Joint Powers Authorities. The maximum interest rate is 12 percent per year. Interest may be fixed or variable, and may be payable at the times determined by the authority. The maximum maturity is 50 years.

Redevelopment Agencies. The maximum interest rate is 12 percent per year. Interest may be fixed or variable, payable at the times determined by the agency. No maximum maturity is specified.

Parking Authorities. The maximum interest rate is 12 percent per year. Interest is required to be payable semiannually. The maximum maturity is 40 years.

Public Works Board. There are no limits on either the maximum interest rate or maximum maturity. Similarly, interest may be fixed or variable and may be payable at the times determined by the board.

LEGAL AUTHORITY; ISSUERS

Generally, the California Constitution requires voter approval for issuance of long-term debt paid from the general funds of cities, counties, school districts, and the state. In a public lease revenue bond financing, the governmental lessee's obligations under the lease are designed to avoid classification as "debt" for purposes of the constitution. Therefore, voter approval is generally not necessary. See the following section on **Financing Leases and Certificates of Participation** and **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**.

SPECIAL FEDERAL TAX ISSUES

Except for lease revenue bonds issued by a nonprofit corporation on behalf of a public agency, lease revenue bond financings do not present many unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply.

Nonprofit Corporations. In the event public lease revenue bonds are issued by a single purpose nonprofit corporation on behalf of a public entity, the nonprofit corporation's purposes and activities must comply with IRS Revenue Ruling 63-20. In addition, IRS Revenue Procedure 82-26 identifies specific circumstances and fact situations in which the tests outlined in Revenue Ruling 63-20 will be deemed met. In general, the following conditions must be met by the nonprofit corporation for interest on its bonds to be tax-exempt:

- The nonprofit corporation must engage in activities that are essentially public in nature
- The corporate income may not benefit any private person

- The governmental unit must have a beneficial interest in the corporation while the indebtedness remains outstanding
- The governmental unit must obtain full legal title to the property with respect to which the indebtedness was incurred upon retirement of the indebtedness

Furthermore, a number of special, detailed limitations and requirements are set forth in Revenue Procedure 82-26 and apply to these types of financings. These limitations and requirements do not apply to the other lease revenue bonds structures and can make this structure quite cumbersome and limiting.

SPECIAL STATE TAX ISSUES FOR NONPROFIT CORPORATIONS

Bonds issued by a nonprofit corporation on behalf of a public agency are not covered by the state constitutional exemption from taxation. Accordingly, and unlike the other lease revenue bond structures, unless a specific statute exempts the interest on such bonds, it is taxable income under state law.

SALES TAX REVENUE BONDS

DEFINITION AND PURPOSE

Sales tax revenue bonds are bonds that are payable from and secured by revenues received by the issuer from the imposition of a sales and use tax, or a transactions and use tax, on retail transactions within the issuer's boundaries. While sales tax revenue bonds may be used to finance projects that are similar in many respects to the projects financed by public enterprise revenue bonds discussed in a prior section on **Public Enterprise Revenue Bonds**, sales tax revenue bonds are useful for financing projects that will not generate revenues for some time or will not generate revenues sufficient to cover the costs of the project, such as mass transit facilities. Sales tax revenue bonds may be used for general purposes, depending on the nature of the tax and the agency collecting them. For a broader discussion of general and special taxes, see **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives**. Sales tax revenue bonds should not be confused with tax and revenue anticipation notes, which are discussed above in **Tax and Revenue Anticipation Notes (TRANS)**.

POLICY CONSIDERATIONS

The primary policy issues raised by proposals to issue sales tax revenue bonds relate to the use of a tax-based revenue source to finance an enterprise or system, which, although it collects revenues, cannot support itself fully from those revenues. For example, in the case of a transportation district financing, all retail buyers of goods in the district (a relatively broad spectrum of the population) are supporting a transportation system used by a smaller segment of the population. Nevertheless, the benefits of the use of public transportation—lower required expenditures on the streets and highways, lower pollution levels, etc.—benefit all of the population and may justify the use of a broadly based tax.

LEGAL AUTHORITY; ISSUERS

To issue sales tax revenue bonds, an issuer must have the power to impose a sales tax. The California Revenue and Taxation Code authorizes local sales taxes in addition to the state's 6.25 percent sales and use tax on all retail sales within the state (the “state sales tax”). Of the 6.25 percent state sales tax, 5 percent is allocated to the state’s General Fund. Of the remaining 1 percent of Statewide Sales Tax, 0.25 percent is allocated for county transportation purposes and the other 0.75 percent is allocated for city and county operations.

Basic State & Local Sales Tax* (as of January 1, 2005)	
State	
General Fund	5.00%
Fiscal Recovery Fund	0.25%
Local Revenue Fund	0.50%
Local Public Safety Fund	0.50%
State Total	6.25%
Local	
County Transportation Funds	0.25%
City and County Operations	0.75%
Local Total	1.00%
Statewide Basic Rate	7.25%
*Source: California State Board of Equalization	

The imposition of a sales and use tax by local governments in an amount not to exceed, in the aggregate, 1.25 percent is authorized by Sections 7200 et seq. of the Revenue and Taxation Code (commonly referred to as the “Bradley-Burns Uniform Local Sales and Use Tax”), 0.25 percent of which sales tax is dedicated to county transportation purposes. Under the terms of Proposition 57 (approved by the voters in March 2004), 0.25 percent of the Bradley-Burns Uniform Local Sales and Use Tax rate is diverted to the State Fiscal Recovery Fund for purposes of repayment of the deficit-financing bonds issued in 2004. These local funds are replaced by a shift of property tax revenues from schools, which are reimbursed by the state's General Fund. The diversion of local sales tax revenues to the Fiscal Recovery Fund will remain in effect until the deficit-financing bonds are paid off.

With respect to the sales tax only (not the use tax), the tax imposed by a city is offset by any sales tax imposed by a redevelopment agency, the governing body of which is identical to the city council, at a rate up to 1 percent. The Community Redevelopment Law Reform Act of 1993 (commonly referred to as “AB 1290”) eliminated the authority for a redevelopment agency to issue sales tax bonds.

In addition to the Bradley-Burns Uniform Local Sales and Use Tax, the imposition by certain districts authorized to impose transactions and use taxes in an aggregate amount not to exceed 1.5 percent is authorized by Sections 7251 et seq. of the Revenue and Taxation Code.

The organic acts of certain specified transportation or transit districts, cities, educational agencies and other entities provide for a transactions and use tax in excess of 1.5 percent. By definition, there may be more than one district within a county. The combined rate of all taxes imposed under Sections 7251 et seq. of the Revenue and Taxation Code within any county may not exceed 1.5 percent unless specifically authorized by legislation.

Sales Tax Districts

Any county, transit district, rapid transit district or any local transportation authority created or designated pursuant to Division 19 of the Public Utilities Code, as well as:

- ✓ Los Angeles County Transportation Commission
- ✓ Tahoe Transportation District
- ✓ San Diego County Regional Transportation Commission
- ✓ Fresno County Transportation Authority
- ✓ Tuolumne County Traffic Authority
- ✓ San Diego County Regional Justice Facility Financing Agency
- ✓ San Joaquin County Regional Justice Facility Financing Agency
- ✓ San Bernardino County Transportation Commission
- ✓ Riverside County Transportation Commission
- ✓ Orange County Regional Justice Facilities Commission
- ✓ Metropolitan Transportation Commission
- ✓ Certain other county regional justice facilities financing agencies

Sales Tax Generally

In general, the statewide sales tax applies to the gross receipts of retailers from the sale of tangible personal property, and the statewide use tax is imposed on the storage, use, or other consumption in the state of property purchased from a retailer for such storage, use, or other consumption. The statewide use tax does not apply to cases where the sale of the property is

subject to the statewide sales tax, therefore the statewide use tax is generally applied to purchases made outside of the state for use within the state or to sales between individuals for items such as automobiles. Local sales taxes are generally imposed upon the same transactions and items subject to the statewide sales and use tax, with the same exceptions. Many categories of transactions are exempt from the sales tax (see text box on **Items Exempt from Sales Tax**).

Items Exempt from Sales Tax

- ✓ Food products for home consumption
- ✓ Prescription medicine, newspapers, and periodicals
- ✓ Edible livestock and their feed
- ✓ Seed and fertilizer used in raising food for human consumption
- ✓ Gas, electricity, and water when delivered to consumers through mains, lines, and pipes
- ✓ Certain “occasional” sales
- ✓ Sales of property to be used outside the county which are shipped to a point outside the county

Action by the state legislature or by voter initiative could change the transactions and items upon which the sales tax is imposed. Such changes could have either an adverse or beneficial impact on the level of sales tax revenues. For example, a voter initiative approved in 1992 eliminated taxation for candy, gum, bottled water, and confectionery (referred to as the “snack tax”).

Sales Tax Litigation

There has been a great deal of litigation regarding sales taxes in California. Historically, sales taxes have been relied on extensively for financing transportation projects. Following Proposition 13, there was an increasing reliance on sales taxes for transportation purposes, and a proliferation of local transportation authorities levying an additional half-cent sales tax in counties for such purposes. The half-cent sales taxes as levied by these authorities were approved by majority vote as general taxes under the authority of the *Los Angeles County Transportation Commission v. Richmond* case decided by the California Supreme Court shortly after the passage of Proposition 13. The imposition of these taxes through a majority vote came under attack.

On December 19, 1991, the California Supreme Court rendered its opinion in *Rider v. County of San Diego (Rider)*. The *Rider* decision invalidated a 0.5 percent retail transactions and use tax that had been imposed by the county through an authority for justice facility purposes. In *Rider*, the California Supreme Court held that taxes levied by special districts require two-thirds voter approval. Special districts are government entities created to circumvent the limitations on taxation embodied in Article XIII A of the California Constitution, and an entity may be deemed a special district if it was created after the adoption of Article XIII A and it is “essentially controlled” by an entity with the power to levy property taxes.

On September 28, 1995, the California Supreme Court rendered its opinion in *Santa Clara County Local Transportation Authority v. Guardino (Santa Clara)*. The *Santa Clara* decision held invalid a half-cent sales tax to be levied by the Santa Clara County Local Transportation Authority because it was approved by a majority, but not two-thirds of the voters in Santa Clara

County voting on the tax. The California Supreme Court decided the tax was invalid under Proposition 62, a statutory initiative adopted at the November 4, 1986 election that required (among other matters) that any new taxes for general governmental purposes imposed by local governmental entities be approved by a two-thirds vote of the governmental entity's legislative body and by a majority vote of the voters of the governmental entity voting in an election on the tax. It also requires that any special tax (defined as taxes levied for other than general governmental purposes) imposed by a local governmental entity be approved by a two-thirds vote of the electorate of the governmental entity voting in an election on the tax.

In deciding *Santa Clara* on Proposition 62 grounds, the California Supreme Court rejected the Court of Appeals decision in *City of Woodlake v. Logan*, which had held portions of Proposition 62 unconstitutional as a referendum on taxes prohibited by the California Constitution. The Supreme Court determined that the voter approval requirement of Proposition 62 is a condition precedent to the enactment of each tax statute to which it applies, while referendum refers to a process invoked only after a statute has been enacted.

Many existing special district sales taxes that were adopted by majority vote are protected from being challenged under the *Santa Clara* decision by statutes of limitation. Moreover, Public Utilities Code Section 99550 has made the decision in *Rider* inapplicable to any action or proceeding wherein the validity of a retail transactions and use tax is contested, questioned, or denied if the ordinance imposing the tax was adopted by a transportation agency and approved by a majority of the electorate voting thereon prior to December 19, 1991.

Proposition 218 has made more definitive the voting requirements for special taxes. See the discussion in **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives – Proposition 218**.

PROCEDURES

Power to Issue Bonds

For transit and transportation authorities, statutory authorization for the issuance of sales tax revenue bonds is in **Appendix D – Legal References – Table D-6-1**.

Article XVI Section 18 of the State Constitution appears to prohibit cities and counties from issuing sales tax revenue bonds. Redevelopment agencies cannot issue sales tax revenue bonds because of AB 1290 (the Community Redevelopment Law Reform Act of 1993).

In addition to the express power to issue sales tax revenue bonds, many transportation and transit districts have the power to issue revenue bonds on the basis of a provision in their respective organic acts giving them the authority to exercise such power pursuant to the Revenue Bond Law of 1941 (Government Code Sections 54300 et seq.). Others have their own revenue bond provisions in their organic acts, while others have a combination of both.

A district must have more than the power to impose the transactions and use tax and the power to issue revenue bonds under the Revenue Bond Law of 1941 to be able to issue bonds secured solely by the transactions and use tax, because the Revenue Bond Law of 1941 only authorizes the pledging of tax revenues as additional security, with revenues from the “enterprise” being the main security. As a result, to issue bonds secured only by the transactions and use tax, a district must have separate statutory authorization or rely on the general pledge statute (Government Code Section 5451). See **Appendix D – Legal References – Table D-6-2** for a listing of statutory authorities for the various transportation and transit districts.

Projects That May Be Financed

For cities and counties, authorized projects include the acquisition, installation, construction, or improvement of public works or improvements, and the acquisition of lands and easements therefor.

For local transportation authorities created under the local transportation authority act, sales tax revenue bonds may be issued to finance capital outlay expenditures as may be provided for in the applicable county transportation expenditure plan. These capital outlay expenditures include:

- The construction and improvement of state highways
- The construction, maintenance, improvement, and operation of local streets, roads, and highways
- The construction, improvement, and operation of public transit systems

Transit and transportation districts other than local transportation authorities created under the local transportation authority act generally may issue sales tax revenue bonds to finance transit facilities, additions, extensions, and improvements to them, and all other facilities authorized to be acquired, constructed, or completed by the district. The statutory provisions authorizing the tax, however, may have separate limitations on the purposes for which the tax can be imposed. A listing of such code sections is in **Appendix D – Legal References – Table D-6-2**.

Process for Approval

Local Transportation Authorities. Local transportation authorities created under the local transportation authority act obtain initial authorization for the issuance of sales tax revenue bonds as part of the ballot proposition approving the imposition of a transactions and use tax by such authority under Section 7251 et seq. of the Revenue and Taxation Code. The proposition must be approved by the majority (two-thirds following *Guardino*) of the electors voting at a special election called for that purpose by the county's board of supervisors. Sales tax revenue bonds are then issued pursuant to a resolution adopted at any time by a two-thirds vote of the authority.

Transit and Transportation Districts. A majority of the districts (other than local transportation authorities created under the local transportation authority act) issue sales tax revenue bonds pursuant to the Revenue Bond Law of 1941. The process for approval by the issuer is similar to that outlined in the preceding paragraph with two key differences. First, the initiating resolution must be published a specified number of days in a newspaper in the district or, if that is not feasible, be posted in three public places in the district. Second, the proposition presented to the voters need only receive a majority vote of the governing body of the district to adopt the authorization resolution because there is no debt limit issue.

Districts issuing sales tax revenue bonds pursuant to statutory authority other than the Revenue Bond Law of 1941 may have different process requirements. Key variations are summarized in **Appendix D – Legal References – Table D-6-2.**

Process for Sale

For local transportation authorities created under the local transportation authority act, either competitive or negotiated sale is authorized. In both cases, the sales tax revenue bonds may be sold at a price below par.

For transit and transportation districts, other than local transportation authorities created under the local transportation authority act, bonds issued under the Revenue Bond Law of 1941 may be sold at competitive or negotiated sale.

Districts issuing sales tax revenue bonds pursuant to statutory authorization other than the Revenue Bond Law of 1941 may have different sale process requirements. Key variations are summarized in **Appendix D – Legal References – Table D-6-2.**

Limitations on Terms of Bonds

For local transportation authorities created under the local transportation authority act, the maximum maturity may not extend beyond the date of termination of the transactions and use tax. That date of termination may not be more than 20 years from the date the tax is imposed following the approval of the tax by the electors.

For transit and transportation districts, other than local transportation authorities created under the local transportation authority act, under the Revenue Bond Law of 1941 the maximum stated interest rate is 12 percent per year and the maximum maturity is 40 years.

Districts issuing sales tax revenue bonds pursuant to statutory authorization other than the Revenue Bond Law of 1941 may have different limits on payment terms. Key variations are summarized in **Appendix D – Legal References – Table D-6-2.**

METHOD OF REPAYMENT AND SECURITY FEATURES

Sales tax revenue bonds are limited obligations of the issuer and are payable solely from the sources described in the bond resolution. The sales tax revenue bonds are secured by a lien upon the sales tax revenues. In a “pure” sales tax revenue bond financing, such revenues will consist solely of the sales and use tax or transactions and use tax revenues received by the issuer. This is the common structure employed in sales tax issues.

Sales tax revenues are highly dependent, however, upon the economic conditions and demographic characteristics of the issuer and its service area. Fluctuations in these economic conditions and/or these demographic characteristics could cause unpredictability and instability in the stream of sales tax revenues. To ensure the interest of underwriters in purchasing the bonds, it may be necessary for the issuer to retain a consulting firm to analyze these conditions and characteristics and to project the sales tax revenues into the future.

If the analysis shows that there may be instability in the sales tax revenues, an issuer may have to designate another source of revenues for repayment of the bonds and give the bondholders a security interest in that source to make the bonds marketable. If the proceeds of the sales tax revenue bonds are being used to finance a revenue-generating enterprise, such as a transit system, a logical source of such additional revenues would be the facility.

Another source of concern with respect to sales tax revenue bonds is that the rates that may be imposed on the sales and use tax or the transactions and use tax are essentially fixed by statute and cannot be raised by the issuer during the life of the bond issue. This raises the question of quality and quantity of debt service coverage. Underwriters and potential investors will want to see provisions in the bond documents restricting new liabilities, specifically future debt issuance. A key provision will be a covenant by the issuer referred to as the “Additional Bonds Test” which restricts the issuance of additional sales tax bonds only to situations where historical revenue collections cover by a specified ratio the future maximum annual debt service. Such coverage is estimated to be an amount sufficient to protect against possible fluctuations in sales tax revenues. The Additional Bonds Test, by limiting the amount of bonds issued, insures that sales tax revenues are more likely to be sufficient to pay debt service on the outstanding bonds.

Before an issuer can impose a sales and use tax or a transactions and use tax it must enter into a contract for administration with the state Board of Equalization (BOE). The contract provides that the BOE will perform all functions incident to the administration or operation of the sales and use tax or the transactions and use tax ordinance of the issuer. The issuer must pay the BOE its costs of preparation to administer and operate the tax. In addition, the city, county, redevelopment agency, local transportation authority, district, or other entity must pay ongoing fees (determined by the BOE) to the BOE for administration of the tax. In the context of a sales tax revenue bond financing, the contract for administration is often assigned to the bond trustee and the BOE is requested to transmit sales tax revenues directly to the bond trustee.

SPECIAL FEDERAL TAX CONSIDERATIONS

The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply. However, sales tax revenue bonds generally will not be private activity bonds because such bonds will never satisfy the Private Payment or Security Test if the issuer of the bonds does not receive significant nonsales tax revenues with respect to the financial facilities.

REFUNDING BONDS

Sales tax revenue refunding bonds are authorized under the Revenue Bond Law of 1941, under the local transportation authority act, and by the Local Agency Refunding Bond Law (Government Code Sections 53580 et seq.). Cities and counties are, of course, subject to constitutional procedural requirements for an election.

SINGLE-FAMILY MORTGAGE REVENUE BONDS

DEFINITION AND PURPOSE

Single-family mortgage revenue bond programs assist individuals and families of low and moderate income to acquire, improve, or rehabilitate homes by providing mortgage loans with interest rates lower than the rates on conventional mortgage loans. The bonds are limited obligations of the issuer payable primarily from payments received with respect to the mortgage loans.

PROGRAMS THAT MAY BE FINANCED

A description of a typical local agency single-family mortgage bond program follows. Many variations are possible, particularly where the program is for home improvement or rehabilitation rather than home acquisition. In a typical local agency program, the issuer (through the bond trustee) uses bond proceeds to purchase mortgage loans (or mortgage-backed securities backed by mortgage loans) originated by one or more mortgage lenders selected by the issuer to participate in the program. A program may include either or both of the following elements:

- A “first-come, first-served” program in which the issuer commits to purchase a mortgage loan only if and when a lender has received an application for the loan, or
- A “forward commitment” program in which the issuer commits to lenders (and/or housing developers) for a specified period of time to purchase specified amounts of loans originated by the lenders (or on homes located in approved developments built by the developers)

The period during which the lenders can make mortgage loans and sell them to the issuer is typically 6 to 24 months long, and may be extended if certain conditions are met. The homes financed must be within the jurisdiction of the issuer.

The mortgage loans are generally 30-year, fixed-rate mortgage loans with a mortgage interest rate determined at the time of issuance of the bonds. However, issuers have designed programs with graduated payment mortgage loans and mortgage loans of less than 30 years. The mortgage interest rate for a particular program depends upon a number of factors, including the interest rates borne by the bonds, the amount of lender and developer fees or issuer contribution, and the interest rates obtained on the investment of bond proceeds prior to the purchase of the mortgage loans.

For cities, counties, housing authorities, and joint powers authorities, the mortgagor income limits are the following:

- 120 percent of median income for mortgages made for improving a home or for homes where the purchaser will be the first occupant, and
- 100 percent of median income where the mortgagor will not be the first occupant (with one-half of the monies for such purposes allocated for mortgagors whose income does not exceed 80 percent or 90 percent of median income, depending upon certain findings)

Each mortgagor must intend to occupy the home for a period of at least two years.

In addition, for the bonds to be federally tax-exempt, the additional income limits, purchase price limits, and other requirements of federal tax law must also be met (see below in this section).

Although the redevelopment law authorizes redevelopment agencies to issue single-family mortgage revenue bonds, there is no apparent advantage to using a redevelopment agency for this purpose. In fact, there are a number of significant limitations on redevelopment agency programs when compared with city and county programs—for example, with certain exceptions, redevelopment agencies may only make loans within redevelopment project areas.

POLICY CONSIDERATIONS

The primary policy consideration for a single-family mortgage revenue bond program, as for any program that finances a private activity, is whether the activity proposed to be financed merits governmental support. Bonds can be used to assist or encourage any or all of the following:

- Housing construction generally
- The construction of particular types of housing
- The construction of particular housing developments
- Home improvement and rehabilitation
- Owner-occupied housing as opposed to rental housing
- Housing affordability for low- and moderate-income families

In each case, the limitations placed on tax-exempt single-family mortgage revenue bonds by federal law will affect the ability of the issuer to accomplish its objectives.

In some cases, the viability of a program may be dependent upon the issuer committing some of its own monies to the program to make it work. Although single-family mortgage revenue bond programs are generally intended to be administered by the private parties involved (the bond trustee, the mortgage lenders, and the mortgage servicers) and are not supposed to be a burden upon the issuer or its general fund, such programs do generally require some attention from the issuer. Issuer involvement can include efforts such as helping to conduct an initial training and

information session for lenders and developers, fielding questions to be answered by bond counsel or the investment banker, and troubleshooting when a problem arises (e.g. when one of the private parties makes a mistake).

SECURITY AND SOURCES OF PAYMENT

California law requires local agency single-family mortgage revenue bonds to be limited obligations of the issuer, payable solely from program revenues and various reserves held as security for the bonds. Bonds are paid primarily from mortgage loan payments and prepayments, mortgage insurance proceeds, and investment earnings on funds held under the indenture.

The mortgage loans (or mortgage-backed securities backed by mortgage loans) are owned by the bond trustee (on behalf of the issuer) to secure payment of the bonds. Mortgage lenders generally service the mortgage loans they originate, although the issuer may engage a master servicer. Mortgage lenders are permitted to collect from mortgagors a loan origination fee and a loan-servicing fee. Mortgage lenders may be required to pay a fee to participate in the program and each developer is usually required to pay a commitment fee for the bond proceeds reserved for the purchase of mortgage loans on homes built by the developer. Developer fees (and in some instances lender fees) are essential to the economics of a bond program and are sometimes supplemented by an equity contribution from the issuer's own funds.

Mortgagors are generally required to maintain mortgage insurance and standard hazard insurance. Mortgage insurance protects the bondholders and the issuer against losses resulting from payment defaults on a mortgage loan and may be in the form of Federal Housing Authority (FHA) insurance, Veterans Administration (VA) guarantee or insurance provided by a private insurance company (private mortgage insurance or PMI). Mortgage-backed securities are commonly guaranteed by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation.

PROCESS FOR APPROVAL

General

Local agency issuers must establish a home mortgage financing program by ordinance prior to issuing single-family mortgage revenue bonds and also must enact rules and regulations governing lender participation in their programs and the qualifications of mortgagors, mortgage loans, and homes.

Unless otherwise required by the charter of a charter city, bonds may be authorized to be issued and the various other agreements to be entered into may be authorized, by resolution of the governing body of the issuer.

Volume Cap

As described in **Chapter 3, General Federal Tax Requirements**, single-family mortgage revenue bonds are required to obtain an allocation of volume cap from the California Debt Limit Allocation Committee (CDLAC). When evaluating applications from local issuers for allocations for single-family housing assistance, CDLAC's current procedures consider the following matters:

- The potential for special program implementation by local issuers
- The need for competition between the California Housing Finance Agency (CalHFA) and local issuers
- The relative past performance of CalHFA and local issuers
- The proportionate amount of single-family allocation remaining for a county (based on the county's population in relation to the total state population) after subtracting the CalHFA reservation allocable to that county
- When there is more than one local single-family issuer in a county, each local issuer's share of the allocation shall be based upon the population served by each issuer at the time of application, or as agreed upon by the local issuers in that county
- With respect to any remaining single-family allocation, the extent to which lower income households will be served and the extent to which new construction or substantial rehabilitation will be financed
- With respect to programs using "forward commitments" to developers, the draw-down schedules and the programs' ability to fully use allocations

In a competitive environment, other public purpose factors specified by the CDLAC procedures may also be considered. The CDLAC procedures are normally updated each year. See **Appendix A – Working with State Agencies** for more information.

PROCESS FOR SALE

Single-family mortgage revenue bonds may be sold at competitive or negotiated sale and the resolution authorizing the issuance of the bonds may delegate to officials of the issuer the power to approve the final principal amount, maturity schedule, interest rates, and other terms, all within specified limits.

OTHER LIMITATIONS ON TERMS OF BONDS

For cities, counties, and joint powers authorities, there is no maximum bond issuance amount specified by state law, and no maximum interest rate. Variable interest rates are permitted. The maximum maturity for bonds issued is 45 years.

For redevelopment agencies, there is no maximum bond issuance amount specified by state law and no maximum interest rate. Variable interest rates are permitted and the maximum maturity for bonds issued is 50 years.

For housing authorities, there is no maximum bond issuance amount specified by state law. The maximum interest rate is 12 percent per year and the maximum maturity is 45 years.

LEGAL AUTHORITY

See **Appendix D – Legal References – Table D-7-1** for a list of statutes applicable to local agencies authorized to conduct home mortgage financing programs through the issuance of bonds.

SPECIAL FEDERAL TAX ISSUES

Federal tax law contains a number of requirements applicable to single-family mortgage revenue bond programs for the bonds to be tax-exempt. Restrictions on mortgage loans and mortgagors include the following:

- A principal residence requirement
- A first-time home-buyer requirement
- A residence acquisition cost limitation
- A mortgagor income limitation, and
- A new mortgage requirement

These requirements must be satisfied with respect to each mortgage loan purchased with bond proceeds and must be satisfied by any purchaser of a home who desires to assume an existing bond-financed mortgage loan. Program-wide limitations include a targeted area set-aside requirement, arbitrage restrictions, and volume cap allocation requirements.

To satisfy the residence requirement, a home financed must be a single-family residence that is, or will within a reasonable time become, the principal residence of the mortgagor. No more than 15 percent of the total area of the residence may be used in a trade or business.

The first-time home-buyer requirement is satisfied if:

- The mortgagor did not own his or her principal residence within the preceding three years, or
- The home is in a “targeted area”

Targeted areas are census tracts in which 70 percent of the families have incomes that are not more than 80 percent of statewide median family income and certain census tracts designated as areas of chronic economic distress.

The acquisition cost requirement is satisfied if the acquisition cost of a home does not exceed 90 percent (110 percent if the home is in a targeted area) of the average purchase price in the metropolitan statistical area.

The income requirement is satisfied with respect to a home that is not in a targeted area if the mortgagor's family income does not exceed 115 percent (100 percent in the case of one- or two-person families) of the greater of the median gross income in the metropolitan statistical area or the statewide median gross income. For two-thirds of the financing for homes in targeted areas, the mortgagor's family income may not exceed 140 percent (120 percent in the case of one- or two-person families) of the applicable median family income. There is no federal law income limitation with respect to the balance of homes in targeted areas.

The new mortgage requirement is satisfied if the mortgage loan is not for refinancing (other than refinancing of temporary initial financing or refinancing in the case of certain rehabilitation loans).

Additional special rules apply with respect to the financing of qualified home improvement loans, qualified rehabilitation loans, and loans for certain homes in federally designated disaster areas. These provide relief from one or more of the first-time home-buyer requirements, the acquisition cost limits, and the income limits but contain certain additional requirements.

To satisfy the targeted area set-aside requirement, the issuer must reserve for a one-year period, for the purchase of mortgage loans with respect to homes in targeted areas, an amount equal to 20 percent of the lendable proceeds of the bond issue (or, if less, an amount equal to 40 percent of the average annual aggregate principal amount of mortgages made in targeted areas during the three preceding calendar years).

For the arbitrage requirement to be satisfied, the effective rate of interest on the mortgage loans may not exceed the yield on the bond issue by more than 1.125 percentage points. In determining the effective rate of interest on the mortgage loans, commitment and origination fees paid by the mortgagor or the seller of the home are taken into account. No adjustment to bond yield is permitted for underwriters' discount, costs of issuance, or administrative costs. Unless the issuer contributes money of its own, these costs and mortgage pool insurance and special hazard insurance premiums (if any) must be recovered within the permitted 1.125 percent spread. Arbitrage earnings on nonmortgage investments must be rebated to mortgagors or to the federal government. Costs of issuance (including underwriter's discount) funded with bond proceeds may not exceed 2 percent of the proceeds of the bond issue (3.5 percent if the amount of the bond issue is less than \$20 million).

Single-family mortgage revenue bonds are private activity bonds and, therefore, as described in the discussion regarding qualified private activity bonds in **Chapter 3, General Federal Tax Requirements**:

- Issuers must obtain a volume cap allocation from CDLAC
- The requirement for public approval following notice and public hearing (the Tax and Equity Fiscal Responsibility Act of 1982, the “TEFRA” requirement) must be satisfied, and
- Certain information must be reported after bond issuance

In addition, issuers must submit to annual reports to the IRS that contain data with respect to the beneficiaries of bond programs (i.e. the mortgagors).

Finally, if a mortgagor sells the home within 10 years, a portion of the subsidy provided by tax-exempt financing may be subject to recapture by the federal government.

TAX ALLOCATION AND OTHER REDEVELOPMENT BONDS

DEFINITION AND PURPOSE

In general, a redevelopment agency created by a city or a county may issue bonds for any of the corporate purposes of a redevelopment agency. These purposes include the acquisition of real property, the development of any real property whether owned or acquired as a building site, the construction or reconstruction of streets, highways, and sidewalks, and the installation of public utilities, all for the purpose of redevelopment of blighted areas within the jurisdiction of the agency.

As a general rule, an agency cannot itself construct or finance the construction of buildings but must instead sell or lease property for private development. Under some circumstances (see Health and Safety Code Section 33445) an agency may construct buildings that are to be publicly owned. Agency bonds may be made payable from any revenue source available to the agency, including the portion of ad valorem taxes on property in the redevelopment project area in excess of the taxes relating to the value of such property at the time of approval of the redevelopment plan. This excess portion is sometimes called the tax increment or tax allocation.

The Community Redevelopment Law Reform Act of 1993 (“AB 1290”) comprehensively examined and substantially changed the manner in which redevelopment agencies operate in California. The most significant problem areas addressed by AB 1290 were:

- The unlimited duration of most redevelopment plans
- The use of redevelopment authority and financing capabilities for general economic development purposes rather than the elimination of blight
- The use of redevelopment resources to compete for sales tax generating businesses, and
- The inability of redevelopment agencies to properly and expeditiously spend redevelopment funds to generate or rehabilitate low and moderate income housing in the community

The changes made by AB 1290 apply to all redevelopment plans adopted (or amended to add new territory) on or after January 1, 1994. Some provisions apply to redevelopment plans adopted prior to that date. Determining which rules apply is sometimes complicated but it is important to review them prior to issuing bonds to ensure that the term of the debt to be issued does not exceed the limits prescribed by AB 1290. The following section will attempt to differentiate the pre- and post-AB 1290 law, however, the reader is cautioned to carefully review any redevelopment plan adopted prior to January 1, 1994 to see how its specific provisions are affected by AB 1290.

LEGAL AUTHORITY; ISSUERS

California Constitution Article 16, Section 16 and California Health and Safety Code Sections 33670 et seq. provide for the division of certain portions of property tax revenues between redevelopment projects and other taxing agencies. Health and Safety Code Sections 33640 et seq. authorize tax allocation bonds and a variety of other types of bonds secured by virtually any combination of revenues of a redevelopment agency.

A redevelopment agency also has authority to issue certain other types of debt obligations, (discussed in this chapter in the sections on **Single-Family Mortgage Revenue Bonds** and **Conduit Revenue Bonds: General**, respectively (see Health and Safety Code Sections 33750 et seq.)) and certificates of participation in leases or installment sales contracts, pursuant to its powers to acquire and dispose of real or personal property (discussed in the section on **Financing Leases and Certificates of Participation**). AB 1290 eliminates the authority for a redevelopment agency to issue sales tax bonds.

A chartered city may enact its own procedural ordinance and exercise the powers granted by statute to redevelopment agencies, including the issuance of tax allocation bonds (See Health and Safety Code Section 33204).

PROJECTS THAT MAY BE FINANCED

Health and Safety Code Section 33640 authorizes a redevelopment agency to issue bonds for any of its corporate purposes in furtherance of the exercise of any of its powers, including refunding bonds.

Some powers of a redevelopment agency may be exercised in its territorial jurisdiction, and some only in a survey area or a project area. The territorial jurisdiction of a county redevelopment agency is the unincorporated area of the county, and that of a city redevelopment agency is the territory within the city limits. A survey area is designated by a resolution making a finding that the area requires study to determine if a redevelopment project within the area is feasible. A project area is included within a survey area and is a “predominantly urbanized area” (unless the project area is included in a redevelopment plan adopted prior to 1984 and not amended after 1983) of a community that is a blighted area needing redevelopment.

Blight Determination. A blighted area is an area that is predominately urbanized. The area has a combination of statutorily described physical and economic conditions that are so prevalent and so substantial that there is a reduction in, or lack of, proper use of the area to such an extent that it constitutes a burden on the community, which cannot reasonably be expected to be reversed or alleviated by private enterprise or governmental action without redevelopment. In order to form a redevelopment project area, the legislative body of the community must hold a public hearing at which they can make a finding that blight exists in the project area. The blight determination is a critical point in the adoption of a redevelopment plan and has frequently been the subject of litigation and controversy. AB 1290 significantly tightened the blight finding

requirements in an attempt to ensure that only qualified projects were adopted through the redevelopment process.

Tax allocation revenues may only be used to finance redevelopment projects located in a project area, or projects that, though located outside of a project area, produce a special benefit to the project area and are essential to the implementation of a redevelopment plan. Examples of projects outside of a project area that may qualify for financing would include replacement housing (as a result of dislocation of project area residents), a freeway interchange (that directly feeds into a project area), and a sewer system expansion (the increased capacity of which is required for project area redevelopment).

Within a survey area, for purposes of redevelopment, an agency may acquire or lease real or personal property, including acquiring real property by eminent domain, and may sell or lease any real or personal property.

Other agency activities frequently financed by the issuance of bonds include clearing or moving buildings, developing as a building site any real property owned by the agency, and installing or constructing streets, utilities, parks, playgrounds, and other public improvements.

An agency is not generally authorized to construct buildings for residential, commercial, industrial, or other use contemplated by the redevelopment plan. However, agencies may:

- Construct buildings in connection with the relocation of displaced persons
- Construct publicly owned buildings of benefit to the project area, and if no other reasonable means of financing such building is available to the community
- Construct foundations, platforms, and other structural forms necessary for the utilization of air rights for buildings contemplated by the redevelopment plan

AB 1290 limited the financing activities of redevelopment agencies in several significant ways. To address the problems of communities competing to attract sales tax-generating businesses, AB 1290 prohibited any form of direct assistance to an automobile dealership that is or will be on a parcel of land, which has not previously been developed for urban use, and to any development that will be or is located on a parcel of land of five acres or more, which has not previously been developed for urban use and that will consist principally of a retail use that generates sales tax. In addition, AB 1290 specifically prohibits the use of tax increment to construct or rehabilitate a city hall or a county administration building. AB 1290 specifically authorized redevelopment agencies to provide assistance in connection with certain commercial building rehabilitation and the acquisition of certain industrial or manufacturing facilities or equipment. In 1996 the California Legislature further prohibited redevelopment assistance to any development or business involved in gambling or gaming.

PROCESS FOR APPROVAL

The redevelopment law provides that a redevelopment agency that was not authorized to transact business by a resolution adopted prior to September 15, 1961 must be activated by an ordinance, subject to referendum, of the legislative body of the city or county declaring a need for the redevelopment agency to function in the community. The members of the agency may be appointed or the legislative body of the community may declare itself to be the redevelopment agency.

Upon designation of a survey area and identification of one or more proposed project areas within the survey area, the planning commission of the city or county, with the cooperation of the redevelopment agency, prepares a preliminary redevelopment plan for each project area. This plan need not be detailed and will be sufficient if it contains

- A description of the project area boundaries
- A general statement of land uses
- The layout of principal streets
- Information on population densities
- A statement of proposed building standards and intensities
- A description of how the purposes of the project will be attained by conformance with the preliminary plan
- A description of how the proposed redevelopment is consistent with the community's general plan
- A description of the impact of the redevelopment upon the area's residents and the surrounding neighborhood

During the period following receipt of the preliminary plan through adoption of the final redevelopment plan by ordinance of the legislative body, the redevelopment agency and the legislative body are each required to follow a number of procedural steps, too numerous and detailed to describe here, but essentially designed to ensure that relevant information is collected and reviewed and that persons and entities with potentially adverse interest are informed and given the opportunity to present their views on the proposed redevelopment plan. In particular, local taxing agencies may be substantially affected by the proposed redevelopment plan because of lost tax revenues, and as a consequence, the redevelopment law requires that redevelopment agencies consult with affected taxing agencies regarding the allocation of taxes.

Ultimately, a redevelopment plan considerably more detailed than the preliminary plan must be prepared. The following provisions are required to be included in plans adopted prior to January 1, 1994:

- A limitation on tax dollars to be allocated to the redevelopment agency
- A time limit on financing the redevelopment project
- A time limit, not to exceed 12 years, for commencement of eminent domain proceedings to acquire property within the project area
- A limit on the amount of bonded indebtedness which can be outstanding without amendment of the plan

The legislative body must adopt the redevelopment plan by ordinance, subject to referendum.

AB 1290 imposes certain additional limitations on pre-1994 plans, as follows:

- The outside limit for incurring debt with respect to the project area cannot be greater than 20 years after adoption of the plan or January 1, 2004, whichever is later
- Redevelopment activities must terminate no later than 40 years from adoption or January 1, 2009, whichever is later
- The receipt of tax increment must terminate no later than 10 years after the date redevelopment activities terminate, except with respect to certain pre- January 1, 1994 debt and certain housing activities

AB 1290 also significantly modified the required plan provisions for plans adopted, or in connection with plan amendments adding new territory to existing project areas, on or after January 1, 1994:

- The time limit for incurring debt with respect to a project area cannot exceed 20 years from adoption of the plan
- Redevelopment activities must cease no later than 30 years after adoption of the plan
- Tax increment cannot be received later than 45 years after adoption of the plan
- The time limit for exercising eminent domain powers remains 12 years from adoption of the plan

There are no limits on the amount of debt that can be outstanding or the amount of tax increment that can be received with respect to a project area formed on or after January 1, 1994. The reason for this is that AB 1290 drastically altered the way tax increment is allocated between a redevelopment agency and other affected taxing agencies. This is discussed later in this section under **Method of Repayment and Security Features**.

AB 1290 requires that each redevelopment plan submitted by a redevelopment agency to its legislative body contains an implementation plan that describes, among other things, the specific goals and objectives of the agency, specific projects then proposed by the agency, a program of actions and expenditures proposed for the first five years of the redevelopment plan, and a description of how these projects will improve or alleviate the conditions of blight. This implementation plan must then be updated every five years, in this way linking redevelopment activities with the elimination of blight. Redevelopment plans adopted prior to January 1, 1994 also are required to adopt a series of five-year implementation plans, and the first such plan must have been adopted by December 31, 1994.

A redevelopment agency may authorize the issuance of bonds by resolution adopted by a majority of the members of the agency, subject to the approval of the legislative body of the community by resolution (city council or board of supervisors depending upon whether it is a city or county redevelopment agency).

PROCESS FOR SALE

Competitive sale is required for redevelopment agency bonds (other than refunding bonds, bonds sold to the federal government, and housing bonds).⁶ The notice of sale must be published once at least five days prior to the sale in a newspaper of general circulation published in the community, or, if there is none, in a newspaper of general circulation published in the county. In addition, at least 15 days prior to the sale of an issue in excess of \$1 million, the agency must publish notice of its intention to sell in a financial publication generally circulated throughout the state.

Maximum Amount; Limitations on Terms of Bonds

Redevelopment agency bonds (other than housing bonds) are subject to the following limitations:

- The maximum amount of bonds may not exceed the limit specified in the redevelopment plan, if the plan was adopted on or after October 1, 1976
- The maximum stated interest rate is 12 percent per year
- Interest may be fixed or variable, simple or compound, and may be made payable at the times specified by the agency
- Interest payable to the federal government, or on bonds guaranteed by the federal government, may be at such higher rate as is established by the federal government
- Bonds may be sold at a discount not to exceed 5 percent

⁶ The Marks-Roos Local Bond Pooling Act of 1985 (Government Code Sections 6584 et seq.) permits, under certain circumstances, the negotiated sale of redevelopment agency bonds to a joint powers authority which may in turn sell such bonds (or its own bonds secured by such bonds) to an underwriter on a negotiated basis.

- Redevelopment agencies may issue variable rate obligations, including so-called put or tender option bonds, however, the requirements that bonds be sold at competitive sale makes it difficult to use these financing methods

METHOD OF REPAYMENT AND SECURITY FEATURES

A redevelopment agency may issue bonds, payable from a variety of sources described below (however most revenue available to redevelopment agencies is traceable to tax increment revenue):

- Exclusively from the income and revenues of the redevelopment projects financed with the proceeds of the bonds, or with such proceeds together with financial assistance from the state or federal government in aid of the projects
- Exclusively from the income and revenues of certain designated redevelopment projects whether or not they were financed in whole or in part with the proceeds of the bonds
- In whole or in part from tax allocations
- In whole or in part from certain transient occupancy taxes
- From its revenues generally
- From any contributions or other financial assistance from the state or federal government
- From any combination of these sources

Tax allocations are derived as follows. First, the assessed value of the taxable property in the project area prior to adoption of the redevelopment plan is determined and becomes the “base roll.” Thereafter, except for any period during which the assessed valuation drops below the base level, the taxing agencies, on behalf of which taxes are levied on property within the project area, will receive the taxes produced by the then current tax rate applied to the base roll and, after January 1, 1989, taxes produced by any increase in the tax rate to pay certain voter-approved debt applied to the entire roll. Taxes collected upon any increase in the assessed value of the taxable property over the base roll (except taxes attributable to an increase in the tax rate to pay certain voter-approved debt) are allocated to the redevelopment agency to pay indebtedness incurred to finance the redevelopment project. An agency is only entitled to these allocated tax revenues to the extent it has incurred indebtedness.

Prior to the adoption of AB 1290, the availability of tax increment to a redevelopment agency would depend in large part upon the terms of “pass-through agreements” negotiated between a redevelopment agency and the affected taxing entities for the sharing of tax increment revenue. Absent such a negotiated pass-through agreement, prior to adoption (after 1976) of a redevelopment plan providing for tax-increment financing, an affected taxing agency may

elect—and every school and community college district is required to elect—to be allocated, in addition to applicable taxes on the base roll, all or any portion of the taxes allocated to a redevelopment agency which are attributable either to any increase in the rate imposed for the benefit of the taxing agency or to any increase in the assessed value of taxable property on the base roll in the project area as a result of application of the inflation factor (not to exceed 2 percent under Article XIII A of the State Constitution) pursuant to the California Revenue and Taxation Code. This is sometimes called the “2 percent election.”

In addition, a redevelopment agency will be required, unless certain findings are made annually, to set aside 20 percent of all tax allocation annually in a low and moderate income housing fund to be used within the jurisdiction of the agency to increase, improve, and preserve the supply of low and moderate income housing. Under certain circumstances, housing set-aside revenues may be pledged as security for tax allocation bonds if proceeds of such bonds are used for housing purposes.

One of the most fundamental changes made by AB 1290 was the elimination of the fiscal review committee process and the negotiation of pass-through agreements with affected taxing agencies. While AB 1290 does not affect pass-through agreements entered into prior to January 1, 1994, it replaces the ad hoc negotiation of such agreements with a statutory formula for sharing tax increment for all project areas established on or after January 1, 1994. AB 1290 eliminates the 2 percent election and creates three overlapping tiers of payments to all affected tax on entities. These payments are expressed as a percentage of the net tax increment after making the required housing set-aside deposit (the “net tax increment”). During each year an agency receives tax increment, the agency is required to pay affected taxing entities 25 percent of the net tax increment. Beginning in the eleventh fiscal year that the agency receives tax increment, and continuing so long as the agency receives tax increment, the agency is required to pay affected taxing entities an additional 21 percent of the net tax increment generated by increases in the project area assessed value occurring after the tenth fiscal year in which the agency receives tax increment. Commencing with the 31st fiscal year and continuing through the last fiscal year that the agency receives tax increment, the agency is required to pay affected taxing agencies an additional 14 percent of the net tax increment generated by increases in the project area assessed value occurring after the 30th fiscal year in which the agency receives tax increment. Payments made to affected taxing entities are divided on the same basis as property taxes generated by the base year value are divided.

AB 1290 also provides for certain additional payments to certain basic aid school or community college districts. Basic aid districts are those that receive property tax revenues in an amount that results in their receiving only a de minimis amount of state subvention. These additional payments are calculated so that basic aid districts receive approximately 100 percent of their share of the tax increment.

The payments described above are the exclusive payments that are required to be made by a redevelopment agency to affected taxing entities during the term of a redevelopment plan.

AB 1290 provides a statutory procedure for subordination of the automatic pass-through payments to debt service on bonds issued by a redevelopment agency. In general, such a subordination can be obtained unless the affected taxing entity can show, based upon substantial evidence, that the agency will not be able to pay the debt payments and the amount required to be paid to the affected taxing entity.

In recent years redevelopment agencies have issued tax allocation bonds secured in part by a portion of the bond proceeds deposited into an escrow fund. A particular maturity of bonds (commonly called the “escrow bonds”) will be associated with the deposit of monies in the escrow fund. The amounts deposited in the escrow fund are then periodically released to the redevelopment agency as tax allocations increase, in an amount sufficient to adequately secure an amount of escrow bonds equal to the amount released from such fund to the agency. Rating agencies and/or bond insurers will typically specify the terms for release of monies from the escrow fund and require that amounts on deposit in the fund be invested in a high quality investment agreement that provides a rate of return sufficient to pay interest on the escrow bonds. Any redemption of escrow bonds with funds on deposit in the escrow fund will result in the remaining bonds outstanding being adequately secured by tax allocations.

The use of escrow bonds permits an agency to issue tax allocation bonds in anticipation of future growth in tax allocations within a project area. If growth does not occur as anticipated, bondholders are nevertheless protected by the deposit and investment of amounts in the escrow fund. Escrow bond structures raise significant federal tax issues, which should be thoroughly discussed with bond counsel early in the process.

POLICY CONSIDERATIONS

Redevelopment agencies and other taxing agencies whose property tax bases overlap are in competition for the same tax revenues. This gives rise to the policy question of whether a redevelopment agency should be permitted to use all of the tax revenues in an area to eliminate blight when one result of this is to take revenue away from other deserving agencies. Since the middle of the 1970s, this fiscal conflict has resulted in the introduction of state legislation, the intent of which is to stabilize and protect the tax revenues of local agencies. Much of this legislation has become part of redevelopment law and many of the particular provisions are discussed in the preceding pages because they resulted in significant limitations on the ability of redevelopment agencies to issue tax allocation and other redevelopment bonds.

AB 1290 was by far the most significant legislation affecting the redevelopment process. As discussed previously, AB 1290 addressed redevelopment on a comprehensive basis focusing specific attention on local agency competition for tax revenues. From the perspective of the redevelopment agencies, such legislation may be seen as reducing their principal source of revenues and restricting the types and extent of redevelopment activity that may be undertaken. From the perspective of other taxing agencies, the legislation may be seen as providing a more equitable distribution of tax revenues, particularly to those taxing agencies whose public

functions may be increased considerably through the redevelopment process itself but whose principal source of revenues is still tied to a tax rate applied against an historic base year of assessed valuation. From the perspective of bondholders, any legislation that affects property tax rates (e.g. the addition of Article XIII A to the California Constitution) or any other adjustment of tax rates by local taxing agencies affects the amount of tax allocations available to the redevelopment agency, but is not under the control of the redevelopment agency. As a result, a major factor affecting the security for tax allocation bonds is not under the control of the issuer of those bonds.

From a policy perspective, local agencies considering using tax allocation financing for a project should be aware that the money used to repay the bonds will come in part from the local agency's general fund (to the extent that a portion of the property tax increment would otherwise have been allocated to the local agency itself as a taxing agency) and from other local entities in the same geographic area.

SPECIAL FEDERAL TAX CONSIDERATIONS

Many tax allocation and other redevelopment bond financings do not present unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply. In some circumstances, however, because redevelopment agency financings often relate to transactions with private business, the private activity bond limitations take a prominent role in structuring these financings.

As described in the discussion regarding private activity bonds in **Chapter 3, General Federal Tax Requirements**, general tax revenues (including tax allocations) are disregarded for purposes of the Private Payment or Security Test. However, property tax revenues are *not* general tax revenues, and therefore may be private payments, to the extent any special arrangement for the payment of the tax exists between the taxpayer and taxing jurisdiction. U.S. Treasury regulations provide examples of special arrangements that cause otherwise general tax revenues to become private payments. These examples include certain guarantees of payment, agreements as to minimum assessed value, and agreements not to challenge the amount of the tax. The amount of any tax revenues with respect to which such special arrangements are made are then aggregated with any other private payments—for example, payments from developers, commercial property owners, or other nonexempt persons for the purchase price of land or in the form of fees with respect to the facilities financed with the bond issue—to determine the total amount of private payments. If the present value of the private payments exceeds the present value of 10 percent of the principal of or interest on the bonds, the Private Payment or Security Test is satisfied even though such payments are not directly pledged to the payment of the bonds.

A second significant private activity bond issue is the possible characterization of tax allocation and other redevelopment bonds as satisfying the Private Loan Test. This test can be satisfied, for example, when bond proceeds are used to acquire land for redevelopment or to provide streets,

lighting, and other infrastructure land or improvements with the expectation that some or all of the land or improvements will be sold to developers pursuant to installment sales contracts.

Under the 1986 Internal Revenue Code, certain redevelopment bonds which otherwise would be private activity bonds can nevertheless be tax-exempt as “qualified redevelopment bonds.” These bonds are very rarely issued, however, because of the difficulty in complying with the tax requirements. See the following text box titled **Qualified Redevelopment Bond Requirements**.

Qualified Redevelopment Bond Requirements

- ✓ At least 95 percent of the bond proceeds must be used to acquire real property located in a designated blighted area by a governmental unit with the power of eminent domain, to clear and prepare such land for development once acquired, to rehabilitate real property so acquired, and to relocate the former occupants of such property.
- ✓ No new construction may be financed.
- ✓ The bonds must be issued pursuant to a redevelopment plan adopted with respect to the blighted area.
- ✓ The blighted area may not exceed 20 percent of the value of all assessed property in the jurisdiction of the issuer.
- ✓ The blighted area must have a minimum area of 100 acres (if no more than 25 percent of the financed area is to be provided to one person, the minimum size of the blighted area may be reduced to as little as 10 acres).
- ✓ Payment of the bonds must be secured primarily by taxes of general applicability, and any incremental tax revenues attributable to the redevelopment must be reserved exclusively for debt service on the bonds.
- ✓ Any property that is acquired by the governmental unit with the proceeds of the issue and is transferred to a private person must be transferred at its fair market value.
- ✓ No special charges or fees may be assessed on owners or users of property located in the financed area.
- ✓ No proceeds of a qualified redevelopment bond may be used to provide any golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any package liquor store.
- ✓ No more than 25 percent of the proceeds may be used to provide a facility with the primary purpose of retail food or beverage services, automobile sales or services, or the provision of recreation or entertainment or used to provide an airplane, a skybox or other private luxury box, or health club facility.

TAX AND REVENUE ANTICIPATION NOTES (TRANS)

DEFINITION AND PURPOSES

Market participants generally call municipal securities short-term if they have maturities of less than three years or if they have features that shorten their effective maturities to less than three years. The municipal market includes several short-term financing vehicles. Notes such as tax and revenue anticipation notes (TRANS), bond anticipation notes (BANs), tax anticipation notes (TANs), and grant anticipation notes (GANs) provide funds for short periods. Short-term notes are repaid from the proceeds of bond issues, taxes, or revenue-producing projects.

Characteristics

Municipalities usually issue short-term notes in anticipation of collecting some form of revenue, tax, or bond proceeds. A TRAN is a combination of tax and revenue anticipation. A GAN is a popular type of municipal discount note. It is issued in conjunction with an expectation of revenue, usually from the state or federal government, and it is paid off from the receipt of the revenue. GANs would be issued prior to construction of the project, expended on the construction, and retired from the grant proceeds received as reimbursement for such project expenditures. TANs are issued in anticipation of receiving taxes payable, and are paid off from the tax receipts. BANs are issued prior to a bond issuance by a municipality. They are considered to be the riskiest short-term municipal note because they are contingent on the municipality's ability to issue bonds.

The most widely-issued note in California is the TRAN. TRANS are issued by public agencies to fund cash flow deficits in a fiscal year. Typically, they would be issued at the beginning of the fiscal year and mature at the end of such fiscal year.

Notes generally have minimum denominations of \$5,000. Maturities are usually less than one year, though some have maturities of up to three years. Repayment comes from funds available on or before the maturity date. TRANS can mature in either the same fiscal year as issued or in the following fiscal year. They are reported as a fund liability in the fund receiving the proceeds.

QUALIFIED EXPENDITURES FOR TRANS

TRAN proceeds may be used and expended by the public agency for any purpose, including current expenses, capital expenditures, repayment of indebtedness, and investment and reinvestment. The proceeds of the TRANS are commonly deposited in the public agency's general fund.

POLICY CONSIDERATIONS

TRANS are primarily perceived as a cash management tool. They enable a public agency that receives revenues, such as property taxes, on an uneven basis throughout the year, to access

funds for needed expenditures in anticipation of such revenues. They “iron out” the wrinkles in the agency's cash flow revenues.

Generally, proceeds of working capital borrowings are only allowed to be spent at a time when the issuer has no money available to spend, other than a reasonable working capital reserve. Thus the process of sizing a working capital borrowing involves identifying all of the money of the issuer, both on hand and expected, that is generally available for working capital expenditures and developing a cash flow projection, typically based on prior years' actual cash flow results, that estimates the deficit and surplus periods. The size of the note borrowing is then limited to the largest actual cash flow deficit expected in the 13 months following the issuance of the notes, plus the amount of the reasonable working capital reserve. Depending on various factors, the allowable amount of the reasonable working capital reserve typically ranges between 11 percent of the largest projected deficit and 5 percent of the issuer's working capital expenditures during the fiscal year prior to the fiscal year of the borrowing. Transactions that qualify for the small issuer exception from the rebate requirement described in **Chapter 3, General Federal Tax Requirements** always qualify for the 5 percent amount.

SECURITY AND SOURCES OF PAYMENT

Short-term municipal securities can be either general obligation securities or revenue securities. General obligation securities are backed by the full faith and credit of the issuer, which uses taxes and other possible sources of income to meet debt payments. The ability to tax may be limited by law, in which case the general obligation security is called a limited tax security. Revenue securities are generally backed by revenues associated with the projects the securities finance and not by the full faith and credit of the issuers. The revenues are usually earnings generated by projects—for example, as tolls from roads or connection fees and charges paid by users of water systems. In some cases, however, the revenues are funds from specific taxes, receipts from bond sales, or transfers from the federal government.

Many districts and authorities cannot tax, so they do not have the ability to make general obligation pledges. Consequently, most of the securities issued by special districts and statutory authorities are backed by revenues from the projects the securities finance. At times, however, the securities of such districts and authorities are backed by general obligation pledges from the state or local governments that founded them.

PROCESS FOR APPROVAL

TRANS may be authorized by a simple resolution of the governing body of the local agency. If the local agency desires a trustee or fiscal agent to hold the repayment funds for the TRANS, a trust agreement or similar trust document may be used. The resolutions authorizing the TRANS may be adopted in the fiscal year prior to the fiscal year in which the TRANS is issued, however, the TRANS cannot be issued until after the commencement of the fiscal year. It is common for many TRANS borrowings to occur in July, at the beginning of the fiscal year. When a school district or community college district is issuing notes and those districts do not have fiscal

accountability status, the notes may be issued by the board of supervisors of the county containing such school or community college districts on their behalf. An exception for pooled note issues allows the school district or community college district to issue the TRAN directly, if the county prefers not to be the issuer.

PROCESS FOR SALE

Tax and revenue anticipation notes may be sold by competitive or negotiated sale subject to the limitations contained in the statutory authority pursuant to which the tax and revenue anticipation note is being issued.

OTHER LIMITATIONS ON TERMS OF BONDS

Consistent with their short-term nature, the term of the tax and revenue anticipation notes is limited to 15 months, and the amount that can be borrowed shall not exceed 85 percent of the estimated daily amount of the uncollected taxes and common revenue cash receipts and other monies of the local agency that will be available for payment of the notes and the interest thereon (Government Code Section 53858). Although the note is payable only from the revenues of a single fiscal year, the note may mature 15 months after the date of issue, and, therefore, in a subsequent fiscal year.

LEGAL AUTHORITY

Articles 7, 7.5, 7.6, and 7.7 of Chapter 4, Part 1, Division 2, Title 5 of the Government Code (Sections 53820 to 53859.08, inclusive) are the basic authorizations for the issuance of tax and revenue anticipation notes, tax anticipation notes, and grant anticipation notes by local agencies.

SPECIAL FEDERAL TAX CONSIDERATIONS

The interest income earned on most of the debt issued by states and municipalities is exempt from federal taxes. The tax exemption allows states and municipalities and whatever private entities they finance to obtain funding more cheaply than they otherwise could. It is, in effect, a subsidy from the federal government. The U.S. Congress has taken steps to limit access to the subsidy—and to prevent states and municipalities from taking advantage of it by investing the proceeds of tax-exempt securities in taxable securities that pay higher rates—by placing greater and greater restrictions on who can issue tax-exempt obligations and for what purposes. In the Tax Reform Act of 1986, Congress took steps to limit the ability of tax-exempt issuers to earn profits from investing the proceeds of tax-exempt issues in higher interest rate taxable securities. It required that such arbitrage profits be returned to the federal government.

Because working capital borrowings do not finance capital facilities, the main federal tax constraints on such borrowings are the arbitrage bond limitations. U.S. Treasury regulations generally limit the term of working capital financings to two years, although longer maturities are allowed with additional restrictions. In order to qualify for a “temporary period” (an exception to the arbitrage yield restriction limitation discussed in **Chapter 3, General Federal**

Tax Requirements) in which to invest proceeds of notes at rates in excess of the yield on the notes, all of the proceeds of the notes must be reasonably expected to be spent within 13 months of the date the notes are issued.

Typically, issuers of TRANs hope to achieve investment returns that exceed all of the costs of the borrowing. In order to retain these arbitrage profits, the issuer must satisfy an exception to the rebate requirement. The exceptions to rebate requirement are discussed in **Chapter 3, General Federal Tax Requirements**. Unless the transaction qualifies for the small issuer exception, the only exception from the rebate requirement available to working capital financings is the six-month expenditure exception. This exception requires all of the proceeds of the borrowing to be spent within six months of the issuance date and, for TRANs, establishes the minimum reasonable working capital reserve amount of 11 percent of the largest deficit projected in the six-month period.

U.S. Treasury regulations no longer provide specific guidance relating to GANs, but the general arbitrage bond limitations continue to apply. Therefore, it is impossible to generalize about the federal tax limitations and requirements for GANs.

TEETER PLAN PROPERTY TAX RECEIVABLES FINANCINGS

DEFINITION AND PURPOSE

In 1949, an alternative method for the distribution of secured property taxes, known as the “Teeter Plan”, was enacted in California. Upon adoption and implementation of this method by a county board of supervisors, local agencies for which the county acts as “bank” (including the county) and certain other public agencies located in the county will receive annually the full amount of their share of property taxes on the secured rolls regardless of the amount of delinquencies experienced by the county in collecting such taxes. The electing county bears the risk of loss of collection and in return receives interest and the delinquent penalties. Thus the Teeter Plan provides to the participating local agencies stable property tax receipts, eliminates collection risk, and provides an electing county with potential increased revenues from the delinquent penalties and interest collection. The Teeter Plan provisions are set forth in Sections 4701-4717 of the California Revenue and Taxation Code.

POLICY CONSIDERATIONS

External or Internal Financings

Many counties have been financing the distributions of “Teetered” delinquencies through loans from their treasurers’ investment pools (i.e. the investment pools maintained by county treasurers for counties and others who deposit funds with the county). This raises some issues for treasurers since these loans may have to run for as long as nine years and are likely to run, on average, three to three and one-half years. This type of maturity requires treasurers to consider whether the investment provides adequate liquidity for a treasurer’s pool. Also, a treasurer must consider what interest rate or rates to charge the host county for that type of borrowing and be sure that the rate charged is a market rate for the duration and quality of the proposed loan. In other words, the treasurer should do a credit analysis for a loan to the host county just as for any other investment. Generally speaking, a treasurer should be seeking to obtain *taxable* rates of interest on loans which he or she makes since earnings on the treasurer’s pool is normally not subject to income tax.

The policy consideration for the county, on the other hand, is whether it is cheaper to finance the property tax delinquencies through external or internal financing by the treasurer’s pool. All other things being equal, these financings, which can be done at least in part on a tax-exempt basis, should be cheaper when done through external borrowings since a treasurer’s pool should be charging a taxable market rate of interest for pool borrowings.

Duration of Financings

Another policy consideration for counties is the duration of financings if they do multi-year financings. Absent extraordinary circumstances, the financings should not extend longer than

the time necessary to collect the delinquent property tax receivables since issuers will then have lost their source of repayment. To extend the maturities out longer effectively converts the borrowings from those financing delinquent property tax receivables to those financing general working capital requirements of a county.

EXTERNAL FINANCING METHODS

TRANS

Some counties have been including the cost of financing delinquent property tax receivables in their annual TRANS financings. While this works mechanically, it is not the most efficient way to finance property tax receivables since it requires the issuer to come up with money each year for the pledge fund beyond its expected current year revenues, as property tax delinquencies can extend up to nine years. For example, if a Teeter county has \$25 million in property taxes delinquent, which it must fund, and issues TRANS in an amount reflecting this, at the end of the TRANS year, it will not have received enough payment on the delinquent property taxes to fully repay the \$25 million. Therefore, counties would have to find some other internal source of funds to repay the balance and refinance that with the next year's TRANS issue. Thus if a TRANS financing method is used, it will be necessary to "roll" uncollected delinquencies into future years' TRANS. For more information on TRANS financings, see the section on **Tax and Revenue Anticipation Notes (TRANS)** in this chapter. See also the section on **Federal Tax Implications** below for limits on doing tax-exempt financings to finance the carrying of delinquent property tax receivables.

Teeter Plan Bond Law of 1994

The Teeter Plan Bond Law of 1994 (Sections 54773 to 54783 of the Government Code, the "Bond Law") provides a comprehensive procedure for financings backed by "Teetered" property taxes:

- A current year's delinquencies may be financed by the issuance of bonds
- The bonds can be sold at public or private sale and repaid from the delinquent property taxes when received and "other legally available funds of the county"
- The bonds can have maturities of not exceeding seven years and, since "bonds" are defined to include commercial paper, maturities as short as one day are permissible
- While bonds may be initially issued only for the current fiscal year's delinquencies, bonds may be refunded by the issuance of refunding bonds and the provisions limiting the aggregate principal amount of bonds that may be issued in any fiscal year, to the delinquencies of that year, do not apply to refunding bonds

See the following section, **Legality of Multi-Year Teeter Borrowings Under the California Constitution** for a discussion of California constitutional issues applicable to the bonds issue under the Bond Law and other multi-year securities.

Transfer of Accounts Receivable Pursuant to Section 26220(c) of the Government Code

Section 26220(c) of the Government Code permits the assignment by a county of delinquent property taxes to secure financing of delinquent receivables whether or not a Teeter Plan is in effect in that county. The statutory authorization appears to permit multi-year commitments to repay. However, the obligation to repay under this section appears to be limited to only the property tax receivables themselves.

Judicially Validated Generic Financing

Judicial validation actions have been brought to validate the proposition that the authority to finance the transfers to local agencies of delinquent, uncollected property taxes is a necessarily implied power of a county that has elected to be governed by the Teeter Plan method of secured property tax distributions. Since this is not a well-developed theory, a county validating the constitutionality of multi-year obligations, as described below, also can validate the use of generic refunding bonds. Utilizing this theory, a county could then refund the primary obligation to transfer delinquent, uncollected property taxes to local agencies utilizing the general statutory refunding bond provisions.

LEGALITY OF MULTI-YEAR TEETER PLAN BORROWINGS UNDER THE CALIFORNIA CONSTITUTION

As indicated above, both the Bond Law and Section 26220(c) of the Government Code permit multi-year commitments backed by delinquent property taxes. Generally speaking, borrowings by a county which are repayable from the general fund, or a general fund source such as property taxes, and from more than the current year's general fund budget would require two-thirds voter approval in order to be constitutionally permissible. See **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit** for more information on this legal limitation. Thus a multi-year borrowing payable from a county's general fund, or secured by delinquent property taxes that are not budgeted or collected in the year the debt is incurred, would ordinarily be an unconstitutional borrowing unless voter approval was obtained, absent an exception to the constitutional limitation.

One exception to the constitutional limitation on pledging future receipts of delinquent property taxes, as well as for multi-year general fund commitments, is for "obligations imposed by law." Certain counties have validated the proposition that upon the election to be governed by the Teeter Plan method of property tax distribution, there is imposed upon the electing county an obligation to make the transfer of uncollected delinquencies to local agencies (including itself) and this is an obligation imposed by law. An obligation imposed by law does not require voter approval. However, since this exception is not well-developed in the law, in particular with

respect to debt financing obligations, it may be necessary for each issuing county to conduct its own judicial validation action before undertaking any multi-year financing. If properly validated, a county could legally commit its general fund for future year payments as well as the delinquent property taxes to be collected in future years.

SALE OF TAX CERTIFICATES

Chapter 189, Statutes of 1995 (AB 946) (the “Law”) established a new part (Part 7.5) of the Revenue and Taxation Code (commencing with Section 4501) that creates a power to sell tax certificates. The Law applies to Teeter and non-Teeter counties. A tax certificate is defined in the Law as being “the right to receive all amounts in respect of a delinquency in connection with secured roll property or property on supplemental roll.” By following the procedures, a county may sell, at public or private sale, tax certificates for defaulted taxes no earlier than the date the property is declared in default. These sales are held by the tax collector and, except in certain limited circumstances, the price to be received for the tax certificate must not be less than the amount of taxes and assessments being assigned.

Certificates are sold for a current year’s defaulted taxes together with defaulted taxes for prior years that have not been sold. Holders of tax certificates on a parcel have varying rights of first refusal to purchase a subsequent year’s tax certificate on the same parcel and the holder can force the tax collector to sell the new tax certificate on the same terms and conditions as those of the outstanding certificate. Proceeds from the sale of tax certificates are deposited first into a Tax Certificate Redemption Fund in an amount equal to at least 3 percent of the proceeds from the sale, and the balance is distributed as amounts received from the collection of taxes, assessments, costs, fees, and penalties. If the amount in the Tax Certificate Redemption Fund is equal to or greater than 3 percent of the then current amount of taxes and assessments assigned under outstanding tax certificates, the excess amount shall be distributed as part of the other proceeds from the sale. The return to the investor is the difference between the amount paid for the certificate and the amount of taxes and assessments repaid, and is a taxable return. The tax collector of the county issuing and selling tax certificates is required to keep a tax certificate record very much like those of a transfer agent for registered bonds.

The Law establishes the procedures for payments to certificate holders when defaulted taxes are paid either completely or in installments. In addition, upon the occurrence of certain enumerated events, the tax collector must repay the purchase price for a tax certificate from amounts deposited in the Tax Certificate Redemption Fund. These events include such occurrences as the taxes and assessments having been paid prior to sale of the tax certificate, taxes and assessment being canceled after issuance of a tax certificate and the lien on the parcel having been removed, or upon the occurrence of waste on the property, even though without fault of the county. The county’s only exposure is to make the payments out of the Tax Certificate Redemption Fund.

The Law appears more tailored to a private “factoring” type of financing with a single buyer or a limited group of buyers rather than for a conventional public offering. It is believed that the first

refusal rights might chill the bidding for subsequent delinquencies and the requirement that the tax collector receive the face amount of the defaulted taxes and assessments as the purchase price for a tax certificate, and set aside a portion of proceeds in a redemption fund, could adversely affect the overall pricing which a county could obtain as compared to other types of financings.

FEDERAL TAX IMPLICATIONS

A borrowing to finance the carrying of delinquent property tax receivables would be deemed a working capital financing and, in order to be done on a tax-exempt basis, would have to comply with the federal tax code provisions and U.S. Treasury regulations relating to working capital financings. In addition, the financing of delinquent tax receivables, which arose prior to opting in to the Teeter Plan, could probably only be financed on a taxable basis. A prospective issuer should review these matters very carefully with a bond counsel who is experienced in complex working capital financings.

CONDUIT REVENUE BONDS: GENERAL

INTRODUCTION

Certain types of nongovernmental borrowers are entitled to take advantage of tax-exempt financing through the use of conduit revenue bonds. This section of the *Primer* describes conduit revenue bonds in general and then outlines four specific types of conduit revenue bonds:

- Economic development (so-called small issue industrial development bonds)
- Educational facilities
- Health facilities
- Multifamily housing

Other, less frequently issued conduit revenue bonds not discussed in this book include, for example, bonds for solid waste projects, bonds for noneducational 501(c)(3) nonprofit corporation projects (such as museums and research facilities), and bonds for certain energy facilities (so-called two-county rule or local furnishing financings). The federal tax requirements relating to these other financings are described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**.

DEFINITION AND PURPOSES

Conduit revenue bonds are issued by a governmental agency and the proceeds are loaned to the nongovernmental borrower for purposes that are permitted for qualified private activity bonds. Borrowers can be natural persons, for-profit corporations, partnerships, and other legal entities (in the case of economic development bonds and multifamily housing bonds), or nonprofit 501(c)(3) corporations (in the case of educational or health facilities bonds and certain multifamily housing bonds).

A conduit revenue bond is an obligation issued by the governmental agency, but payable solely from the loan repayments (the “revenues”) received by the governmental issuer under the loan agreement with the borrower. The governmental issuer normally has no liability for debt service on the bonds except to the extent it actually receives such revenues. In the typical structure, the loan repayments are assigned directly to the bond trustee, so that the governmental issuer never actually receives any money from the borrower but instead, the money goes directly to the trustee to be held in the trust estate for ultimate distribution to bondholders.

Many types of governmental agencies can issue conduit revenue bonds, including state financing authorities (see **Appendix A – Working with State Agencies**), chartered cities, counties, joint powers authorities, redevelopment agencies, and local housing and industrial development authorities, among others.

There are certain features that are applicable to all conduit revenue bonds, which are discussed in the following sections. Other features specific to the particular types of conduit revenue bonds covered in this *Primer* are discussed under the separate headings for each of those types of obligations.

POLICY CONSIDERATIONS

Because conduit revenue bonds do not involve the direct credit of the governmental issuer of the bonds and because they are for projects not owned or operated by the governmental issuer, the policy considerations in connection with their issuance are quite different than for governmental bonds. Most conduit issuers do have guidelines, however, concerning what types of conduit bonds they will issue and what criteria will be applied to each application for a conduit issue by a nongovernmental borrower. While these guidelines vary from issuer to issuer, most of them cover at least two basic areas—credit quality and the public purpose/benefits of the facility.

Regarding credit quality, many issuers require a minimum rating (typically at least “A”) for any conduit issue, either on a stand-alone basis or as the result of obtaining credit enhancement. Exceptions are sometimes made for projects that have a particularly strong public purpose or benefit, or where additional collateral (such as a deed of trust or other security interest) is provided which strengthens the issue.

An alternative approach for otherwise worthy projects that cannot meet the minimum rating standards is to require a private placement of the bonds. This ensures that only a small number of sophisticated investors will own the bonds and helps insulate the issuer from liability for misleading disclosure and adverse publicity if the issue does run into problems. For further information regarding private placements, see **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

The reason for a minimum rating requirement is that even though the governmental issuer has no legal liability to make debt service payments, the issuer believes that its good name will be tarnished if an issue it is involved with goes into default or has difficulties, even though the default is not the fault of the issuer. Moreover, a defaulted issue will inevitably drag the issuer into proceedings for a workout—or even litigation—concerning the bonds, which will cost the issuer time and effort, as well as out-of-pocket costs that may not be able to be recovered from the borrower. Setting minimum rating standards, while not a guarantee that nothing bad will happen, does insulate the issuer from the more risky transactions.

As to the facilities being financed, many issuers require that the project is not only eligible for tax-exempt financing, but that it also will meet other socially desirable goals of the issuer. For example, some issuers require a showing that the issue will create jobs, provide affordable housing (maybe even in excess of the required minimums), or assist the community in other tangible ways. The tax code and the process of allocating volume cap (discussed later in this section) implement these criteria to some extent, but many conduit issuers also impose their own requirements.

While many communities actively encourage private companies to use conduit financing, others—particularly small cities or counties—may not have the staff time or believe they have adequate expertise to supervise a conduit bond issue. Such concerns have been heightened by recent publicity about increasing federal government scrutiny of the tax law and securities law compliance by municipal bond issuers. Fortunately, in every case California law allows several types of issuers to handle conduit revenue bonds, so a project sponsor should always be able to find an appropriate conduit issuer.

PROCESS FOR APPROVAL (INCLUDING FEDERAL TAX PROCEDURAL REQUIREMENTS)

General

In general, conduit revenue bonds are approved by resolution or ordinance of the governmental issuer. They do not require voter approval in most cases. More detail about each specific type of conduit revenue bond is provided in the following sections of this chapter.

Reimbursement Resolution

In order for bond proceeds to be used to finance amounts expended on the project prior to the issuer's adoption of the resolution authorizing issuance of the bonds, the issuer would normally adopt a reimbursement resolution (or "inducement resolution") while the financing is still in the planning stages, which would allow for reimbursement of such expenditures from bond proceeds, if any, but would not obligate the issuer to issue bonds. The rules relating to reimbursement resolutions are described in the discussion titled **Use of Proceeds to Reimburse Prior Expenditures in Chapter 3, General Federal Tax Requirements**.

Public Hearing

Federal tax law also requires that such private activity bonds satisfy the Tax Equity and Fiscal Responsibility Act (TEFRA) requirement. The rules relating to this requirement are described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**.

Volume Cap

Under the tax code, all qualified private activity bonds, with certain exceptions, including 501(c)(3) corporations, airports, ports, and governmentally owned solid waste disposal facilities, require an allocation of volume cap. The rules relating to this requirement are described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**. Every issuer must apply to the California Debt Limit Allocation Committee (CDLAC) for a volume cap allocation. See **Appendix A – Working with State Agencies** for more information on CDLAC.

PROCESS FOR SALE

Most conduit revenue bonds are sold at negotiated sale but also can be sold competitively. Generally, there are no price restrictions on the sale of conduit revenue bonds.

OTHER FEDERAL TAX CONSIDERATIONS

For a discussion of the many requirements applicable to qualified private activity bonds generally, see **Chapter 3, General Federal Tax Requirements**.

CONDUIT REVENUE BONDS: ECONOMIC DEVELOPMENT BONDS

DEFINITION AND PURPOSE

Economic development conduit revenue bonds (EDCRBs) are a category of bonds created by special provisions of the Internal Revenue Code that allow private, for-profit companies to utilize the proceeds of tax-exempt bonds—but only if the bonds are used to finance very carefully delineated types of projects. The allowable purposes are generally for acquisition or construction of:

- Small manufacturing plants—these bonds generally are referred to interchangeably as industrial development bonds (IDBs), industrial revenue bonds, or industrial development revenue bonds
- Facilities for pollution control or abatement, particularly in connection with disposal of solid wastes—these are often referred to as pollution control revenue bonds (PCRBs)
- Certain other narrowly defined categories, such as airport or port facilities, water furnishing facilities, mass commuting facilities, and facilities for local furnishing of electricity or gas

As their common designations imply, EDCRBs are primarily used to provide below market interest rate financing for industrial development and related projects for private enterprise. EDCRBs are authorized to be issued by various state and local government entities and the benefits derived by such issuance (primarily, the federal income tax exemption for the interest), as well as the obligation to make payments sufficient to pay the bonds, are passed through to the nongovernmental borrower, with the issuer acting as a “conduit” for that purpose. EDCRBs are limited obligations of the issuer.

PROJECTS THAT MAY BE FINANCED

An overview of the different types of projects that may be financed with tax-exempt EDCRBs requires consideration of both federal tax regulations and the various provisions of state law, which have created a number of different agencies at both the state and local level, that can act as an issuer for different kinds of EDCRBs. For a list of legal authorities to issue EDCRBs, see **Appendix D – Legal References – Table D-8-1**.

With respect to each of the categories of projects described below, a “facility” can consist of land, buildings, equipment, and associated development costs.

Industrial Development Bonds (IDBs)

One active category of EDCRBs are IDBs, which are used to finance the acquisition, construction, and/or equipping of small manufacturing facilities to be owned and operated by private companies. Manufacturing facilities must be primarily involved in the assembling,

fabrication, renovation, or processing of goods or agricultural products (at least to the extent there is a change in the condition of such goods or property). A limited portion of the facility may be dedicated to ancillary uses, such as office or warehousing space. IDBs are most commonly issued by:

- Industrial development authorities (IDAs), which can be created by any city or county, and act as a subordinate entity of the city or the county
- Joint powers authorities (JPAs) made up of two or more cities or counties, which can exercise the powers of an IDA—the most active such JPA is the California Statewide Communities Development Authority, headquartered in Sacramento
- California Economic Development Financing Authority (CEDFA), a state agency with statewide jurisdiction, which operates under the auspices of the California Trade and Commerce Agency in Sacramento.

Pollution Control Revenue Bonds (PCRBs)

EDCRBs can be issued to finance projects that provide for reduction or abatement of pollution, and which are owned and/or operated by a private company. Because of federal tax law restrictions imposed after 1986, most PCRB financings now relate to facilities for the collection, treatment, processing, or final disposal of solid wastes. PCRBs also can be used to finance certain hazardous waste disposal facilities and privately owned or operated sewage facilities. In very limited situations, a small manufacturing company can use a PCRB for facilities that treat or reduce air or water pollution generated by the factory. PCRBs are most often issued by:

- California Pollution Control Financing Authority (CPCFA), a state agency with headquarters in Sacramento, which has over \$4.5 billion in outstanding bonds (CPCFA has a knowledgeable staff, and has special programs to assist small businesses)
- California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA), a state agency which shares staff with CPCFA—its jurisdiction is limited and it has fewer than \$120 million in outstanding bonds
- JPAs

Other Types

Under federal tax laws, there are a number of other types of “exempt facility” bonds that can be issued for the benefit of private companies. The following list summarizes these other categories of EDCRBs and the most common issuers for those types of bonds:

- Facilities to furnish water to the general public
 - CPCFA

- JPAs
- Charter cities acting under their charter powers over municipal affairs
- Privately-used or leased facilities at airports and ports, provided they are owned by a governmental entity
 - Cities
 - JPAs
 - Port or airport districts or authorities
- Privately owned facilities which provide for the generation, production, or transmission/transportation of electricity or gas to a service area of a utility company, which is not greater than two counties (called “local furnishing” facilities)
 - Charter cities
 - JPAs

POLICY CONSIDERATIONS

Since EDCRBs are conduit obligations, without any pledge of the credit or taxing power of the issuer entity, there are no questions about the proper use of public funds or resources. However, issuers do have to consider several policy questions before approving an EDCRB financing.

Statutory Purposes

Most EDCRB issuers operate under a specific grant of authority contained in state law, and so must determine that a proposed project is within the proper scope of the issuer’s powers. For issuers with broadly defined authority, like a charter city, a determination must be made that some public policy benefits will accrue to the issuer or its citizens, so that it would be desirable to allow the nongovernmental borrower to reap the advantages of tax-exempt financing.

Public Benefits

In most cases, issuers look to see that some demonstrable benefits will accrue from the construction of the facilities to be funded with the EDCRB. In most cases, but most especially for IDBs, it is necessary to show that jobs will be created or retained (if the company is in danger of failing or moving out of state). Special care must be taken in demonstrating public benefits if the project involves the relocation of a manufacturing facility from one community to another within the state, unless the existing jobs can be transferred and/or there is other strong justification for the move. Most IDB issuers follow the guideline that there must be 20 jobs created or retained for each \$1 million of bonds issued.

Other types of EDCRBs need to demonstrate public benefits appropriate to the nature of the financing. For PCRBs, there is normally a clear environmental benefit, plus assistance to local entities in meeting recycling goals mandated by state law (AB 939). The other facilities described above normally also can show benefits to the public deriving from the construction of needed new infrastructure.

Borrowers who are regulated public utilities (as in the case of PCRBs for utility companies or water furnishing facilities) or who serve a public function, such as solid waste disposal, also can demonstrate a benefit by assuring that the cost savings from using tax-exempt bonds are passed through to the public ratepayers who use or are served by the facilities.

Under federal tax laws, most tax-exempt EDCRBs must obtain an allocation of volume cap from the California Debt Limit Allocation Committee (CDLAC). (See **Special Federal Tax Requirements** later in this section.) In recent years, CDLAC has had much greater demand than the limited amount of cap provided each year under federal law. As a result, CDLAC has paid particular attention to demonstrations of public benefit in deciding which projects will receive allocations.

Credit Considerations

Although EDCRBs are not backed by any credit or public funds of the issuer, most such issuers believe their name on the face of the bonds exposes them to some residual risk of adverse publicity or involvement in litigation if the bond issue were to default. Therefore, most issuers insist that the bond issue must be financially sound on its own. This is most commonly accomplished by having credit enhancement from an investment-grade financial institution, or insisting that the nongovernmental borrower itself have an investment-grade credit rating from a national rating agency.

In those cases where an issuer may agree to issue nonrated, or low or below-investment-grade debt, special structures may be used (such as limiting sales of bonds to large institutional investors and requiring large minimum denominations) and special supervision carried out (by engaging legal counsel or feasibility consultants) to ensure the viability of the project and the completeness of disclosure to investors.

METHOD OF REPAYMENT AND SECURITY FEATURES

EDCRBs are limited obligations of the issuer payable solely from revenues derived from a loan agreement pursuant to which the issuer loans the proceeds to the nongovernmental borrower, subject to repayment terms which are identical to the terms of payment of the bonds. The nongovernmental borrower must agree to pay fees and costs of the issuer and the bond trustee as well. The same effect is sometimes achieved by casting the financing agreement in the form of an installment sale agreement or a lease providing for the sale or lease of the project (purchased with bond proceeds) by the issuer to the nongovernmental borrower, with the installment

purchase payments or rental payments equaling the amounts due as principal and interest on the bonds.

The financing documents will provide that the bonds are payable only from payments made by the nongovernmental borrower under the financing agreement. The EDCRB issuer will not be liable for making any payment due on the bonds from its own funds.

In addition to its general corporate pledge, the nongovernmental borrower often provides some form of additional collateral security to secure its payments under the financing agreement. The most common form of security provided by the nongovernmental borrower is a deed of trust on the project itself, and a security agreement covering equipment to be located at the project. Guaranties of the nongovernmental borrower's principals or its corporate parent or other entity related to the nongovernmental borrower also are common security devices.

Third-party credit enhancement devices also are common to secure EDCRB issues, particularly publicly marketed, as opposed to privately placed, issues with credit enhancement. Credit enhancement may take the form of a letter of credit from a highly rated bank, a bond insurance policy, or a surety bond.

EDCRBs are sometimes issued as composite issues. This means that an issuer will combine the bond offering for two or more separate private borrowers in a single Official Statement using a master letter of credit or other device to make the security for the bond uniform across all the issues. In this way, an issuer can prepare an offering large enough to make public marketing economically feasible and take advantage of economies of scale. This can be particularly beneficial to borrowers with small financing needs.

PROCESS FOR APPROVAL

Certain federal tax and state law procedural requirements apply to all EDCRBs, regardless of the issuer. Of course, if the financing is not intended to be tax-exempt, the federal tax law requirements are irrelevant. Additional procedural requirements are imposed on certain EDCRB issuers by their respective authorizing statutes.

Federal Tax Law Procedural Requirements

The tax code requires that procedural requirements relating the TEFRA requirement and volume cap allocations must be satisfied for EDCRBs to be qualified private activity bonds. Facilities for airports and ports that are required to be owned by public agencies and public agency-owned solid waste disposal facilities do not require volume cap allocations. The requirements are described in the qualified private activity bond discussion below entitled **Special Federal Tax Requirements**.

State Law Procedural Requirements

Each issuer of EDCRBs discussed elsewhere in this section has its own set of legal requirements under its governing laws, as well as its own regulations or procedures. The *Primer* will not attempt to review them all in detail. As a generalization, however, most EDCRB financings follow a similar course, which is outlined below:

- The nongovernmental borrower must file an application with the issuer that generally describes the proposed project and financing. The issuer may charge application or other fees.
- The issuer will either accept or reject the application
- Upon acceptance, the issuer adopts a resolution stating its intention to finance the project. This is the reimbursement resolution for federal tax purposes.
- In the case of IDBs issued by IDAs or JPAs, the state law has additional detailed procedural requirements, including publication of local notice, and review and approval of the issuer's inducement resolution by the IDA's "sponsor" governmental body, and approval by a state agency called the California Industrial Development Financing Advisory Commission
- Following the inducement resolution, the project sponsor must complete all the legal and economic steps needed to be able to start construction of the project, including environmental reviews, contracts for engineering, design, and construction of the project, obtaining any supply or output contracts, and obtaining credit enhancement in most cases. Once the legal and financial package is complete, which will allow a bond issue to be successfully marketed, the final steps in financing take place. This intermediate development period can range from a few months to several years, and many projects never get out of this phase even if they obtain an inducement resolution.
- A few months before planned bond issuance, the issuer applies to CDLAC for volume cap and arranges for a TEFRA hearing
- Once all the financial terms of the bonds are set, usually around the time of CDLAC action, the issuer adopts a resolution to authorize the issuance of the bonds. The final resolution authorizes the general terms of the financing and approves the forms of the documents to be used in the financing.

PROCEDURES FOR SALE

As authorized by all the laws governing issuance of EDCRBs, these bonds are virtually always sold at a private sale in which the interest rate and other terms of the bonds are negotiated between the issuer, nongovernmental borrower, and underwriter. In some cases, a financial institution will act as a placement agency rather than an underwriter, but the procedures and documentation are almost identical. As is customary for negotiated sales of bonds, there is no

requirement for giving or publishing any notice of the proposed sale (except for filing the Notice of Proposed Sale with CDIAC).

Since no public credit is involved, many issuers, at least at the local level, do not participate in any substantive fashion in the sale of EDCRBs, limiting their role to, at most, review of the bond purchase contract to ensure that they are adequately indemnified against liabilities. However, in the case of state agency issuers, such as CPCFA, the State Treasurer is by law designated as the “agent for sale” of all state bonds, thus the Treasurer’s office will be actively involved in the final pricing of the bonds as well as approval of the bond purchase contract.

OTHER LIMITATIONS ON TERMS OF BONDS

For IDAs and JPAs issuing IDBs, the maximum stated interest rate is 12 percent per year (except in the case of federally taxable bonds, for which the maximum is 16 percent). Most state agency issuers, like CPCFA, do not have statutory interest rate limits but set a limit in the indenture. Variable interest rate qualified and put bonds are permitted by all the issuers. The maximum amount of any IDB issue through an IDA is \$10 million (except in the case of federally taxable bonds, which are subject to a per issue maximum of \$50 million). Most other issuers have no specific dollar limits, however, ability to obtain volume cap is a real constraint in most instances. The maximum maturity is 40 years for IDAs and most other issuers have no limits.

For charter cities, the only limitations on the terms of bonds are those that may be imposed by the charter or bond ordinance of the particular city in question.

SPECIAL FEDERAL TAX REQUIREMENTS

The Tax Reform Act of 1986 limited the issuance of tax-exempt EDCRBs in many ways. It made EDCRBs, even if tax-exempt, unattractive investments for banks, which previously had been the major purchaser of relatively small (e.g. less than \$5 million) EDCRB issues, because it denies the interest deduction, previously enjoyed by banks, of their interest expense allocable to tax-exempt bonds. Interest on all private activity bonds is in the calculation of individual and corporate alternative minimum taxes as a tax preference item, which usually adds 20 to 25 basis points to the interest rate for these bonds.

Each of the EDCRB issuers discussed in this section may issue taxable bonds for any of the projects or purposes for which they are authorized to issue bonds. The issuance of EDCRBs (which are subject to full federal income taxation although still exempt from state and local income taxation) has not been very frequent since 1986, but may be appropriate in particular circumstances.

The following section outlines a very brief description of the most important federal tax laws applicable to EDCRBs.

Introduction; Private Activity Bonds

As described in **Chapter 3, General Federal Tax Requirements**, the relevant sections of the tax code first provide that interest on bonds issued by state or local governments is not included in the gross income of the owner of such bonds for federal tax purposes. Such exemption does not apply to private activity bonds, however, unless they are qualified private activity bonds. EDCRBs are clearly private activity bonds since bond proceeds are used for private business purposes and the repayment thereof is secured by a private business. Therefore, to be tax-exempt, EDCRBs must fit into one of the categories of qualified private activity bonds. For purposes of this section, qualified private activity bonds are of two types—exempt facility bonds and qualified small issue bonds.

Exempt Facility Bonds

As described in the section on qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**, exempt facility bonds are bonds of which at least 95 percent of the net proceeds are to be used to provide:

- Airports
- Docks and wharves
- Mass commuting facilities
- Facilities for the furnishing of water
- Sewage facilities
- Solid waste disposal facilities
- Qualified residential rental projects
- Facilities for the local furnishing of electric energy or gas
- Local district heating or cooling facilities
- Qualified hazardous waste facilities
- High speed intercity rail facilities
- Environmental enhancement and hydroelectric generating facilities

Qualified residential rental projects are discussed later in this chapter in the section on **Conduit Revenue Bonds: Multifamily Housing Revenue Bonds**. The tax code and U.S. Treasury regulations contain specific rules and definitions covering each of these exempt facility

categories. In the case of the first three categories listed above, a governmental unit must own the facilities.

Qualified Small Issue Bonds

Qualified small issue bonds (also referred to as IDBs) are bonds issued in an aggregate face amount of not more than \$1 million, 95 percent of the net proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation. However, a number of categories of facilities are prohibited, as described further below. Most significantly, qualified small issue bonds are only permitted for manufacturing facilities.

The \$1 million limitation on issue size may be increased to \$10 million if certain requirements are met. Most issues of qualified small issue bonds are between \$1 million and \$10 million in size. To qualify for the \$10 million limit, the sum of the following items may not exceed \$10 million during the six-year period beginning three years prior to the date of issuance of the EDCRBs and ending three years after such date:

- All capital expenditures made by:
 - The nongovernmental borrower or any related person for any facilities located within the political jurisdiction in which the project is to be located
 - Any other principal user of the facility being financed
 - Any person (whether or not a principal user) to benefit from the EDCRB-financed facility, plus
- The face amount of the bonds to be issued, plus
- The remaining principal amount of all prior outstanding qualified small issue bonds issued to finance facilities located in the same incorporated municipality (or in the same county but not in any incorporated municipality) as the project being financed, a principal user of which is the nongovernmental borrower for the project being financed

If this capital expenditure limitation of \$10 million is exceeded, the bonds will lose their tax-exempt status from the date such limit is exceeded.

A principal user of an EDCRB financed project is generally considered to be any private user of more than 10 percent of such project. For federal tax law purposes there may therefore be more than one principal user of a project.

A single nongovernmental borrower cannot simultaneously issue a package of several qualified small issue bonds for different projects relying on a separate \$10 million limit for each issue.

Additionally, a single project cannot be divided into condominium units and financed with separate issues for unrelated nongovernmental borrowers.

A nongovernmental borrower may not be the beneficiary of a qualified small issue bond financing if the total amount of all private activity bonds allocated to such nongovernmental borrower, plus the amount of the proposed issue, will exceed \$40 million.

Requirements Applicable To All Private Activity Bonds

As described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**, all qualified private activity bonds, including exempt facility bonds and qualified small issue bonds, are subject to the limitations described in this section.

Any private activity bond will cease to be a qualified private activity bond and will lose its tax-exempt status during any period in which such bond is held by a “substantial user” of the EDCRB-financed facility or by a “related person” of such substantial user.

The average maturity of an issue of qualified private activity bonds may not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with such issue.

Twenty-five percent or more of the net proceeds of a qualified private activity bond issue may not be used directly or indirectly for the acquisition of land or any interest therein and no part of the net proceeds of any such issue may be used for the acquisition of previously used property or any interest therein. The latter restriction does not apply, however, with respect to any building (and equipment) if rehabilitation expenditures with respect to the building are at least equal to 15 percent of the cost of acquiring such a building (and equipment) financed with the net proceeds of the issue.

No more than 2 percent of the aggregate face amount of any qualified private activity bond issue may be used to finance the costs of issuance thereof.

CONDUIT REVENUE BONDS: EDUCATIONAL FACILITY BONDS

DEFINITION AND PURPOSE

Educational facility conduit revenue bonds are debt instruments issued by a governmental entity to provide below market interest rate financing of facilities for private higher educational institutions operated by nonprofit corporations or trusts.

LEGAL AUTHORITY; ISSUERS

The California Educational Facilities Authority Act (Sections 94100 et seq. of the Education Code) authorized the California Educational Facilities Authority (CEFA) to issue educational facility conduit revenue bonds.

Charter cities, under their constitutional powers concerning municipal affairs, may issue educational facility revenue bonds, provided the city's charter contains appropriate provisions authorizing the issuance of such bonds. If a charter city were to exercise this power, the considerations demonstrating that the financing is a municipal affair, relating to process, concerning the security for the bonds and relating to the federal tax exemption would be substantially identical to those considerations for hospital/health care facility conduit revenue bonds.

See **Appendix A – Working with State Agencies** for a description of CEFA and its programs.

POLICY CONSIDERATIONS

CEFA issues revenue bonds to assist private nonprofit institutions of higher education in the construction and expansion of nonsectarian educational facilities and to assist students of both private and public institutions of higher education within the state in financing their costs of attending such institutions. CEFA may issue bonds to refund existing bonds, mortgages, or other obligations incurred by private colleges for the acquisition or construction of educational facilities. CEFA also may issue bonds to refund its own bonds.

ELIGIBLE FACILITIES

For purposes of CEFA bond issues, facilities which may be financed include structures suitable for use as a dormitory, dining hall, student union, administration building, academic building, library, laboratory, research facility, classroom, or health care facility, as well as other related structures, facilities, and equipment required or useful for the instruction of students, the conducting of research, or operation of the institution. Eligible facilities do not include any facility used or to be used for sectarian instruction or as a place for religious worship.

STUDENT LOANS

CEFA also may finance student loan programs. Student loan means any loan having terms and conditions acceptable to CEFA that is made to finance or refinance the costs of attendance at any private nonprofit institution of higher education, or a public college provided that the college is approved by CEFA and the loan is originated pursuant to a program approved by CEFA.

OTHER LIMITATIONS

CEFA's bonds may bear interest at a rate or rates specified in the documents of issuance, but may not exceed statutory usury limits. Bonds may not mature later than 50 years from their date of issuance. Variable interest rates, put options, and commercial paper bonds are feasible under the CEFA statute.

SPECIAL FEDERAL TAX LIMITATIONS

Educational facility conduit revenue bonds for nongovernmental entities will be exempt from federal income taxation only if they are qualified Section 501(c)(3) bonds. A detailed discussion of qualified 501(c)(3) bonds is in **Chapter 3, General Federal Tax Requirements**.

CONDUIT REVENUE BONDS: HOSPITAL AND HEALTH CARE FACILITIES; CERTIFICATES OF PARTICIPATION

DEFINITION AND PURPOSE

Hospital/health care facility conduit revenue bonds are debt instruments issued by a governmental entity (the issuer) to provide tax-exempt interest rate financing for general acute care hospitals and other health care facilities that are owned and operated by nonprofit corporations. The issuer of these bonds acts as a conduit, issuing bonds and lending the proceeds thereof to the beneficiary (the nonprofit corporation), which makes payments to the issuer equal to the debt service on the bonds. The bonds are limited obligations of the issuer. As described in this section, hospital and health care facilities financings also may be accomplished through the delivery of certificates of participation.

LEGAL AUTHORITY; ISSUERS

County/Health Care District Financings

In cases where the hospital or health care facility is owned and operated by a governmental entity (such as a county or health care district), such entities have the statutory power to issue bonds directly, without the necessity for a conduit financing. A complete description of this financing instrument type is beyond the scope of this *Primer*.

California Health Facilities Financing Authority

The California Health Facilities Financing Authority Act (Sections 15430 et seq. of the Government Code, the “CHFFA Act”) authorizes the California Health Facilities Financing Authority (CHFFA) to issue hospital and health care conduit revenue bonds. See **Appendix A – Working with State Agencies** for a description of CHFFA and its programs.

Charter Cities

Under its constitutional powers concerning municipal affairs, a charter city also may issue hospital/health care conduit revenue bonds to finance hospital or other health care facilities to benefit its residents, unless its charter limits or restricts that power. Charter cities exercise this power under a bond ordinance or resolution adopted by the city council.

Joint Powers Authorities

Under the Joint Powers Act (Sections 6500 et seq. of the Government Code) and in accordance with the stated purpose and powers provided in the applicable joint exercise of powers agreement, joint powers authorities (JPAs), composed of cities and counties that possess the common power to purchase and sell property for public purposes, may finance hospital/health care facilities through certificates of participation financings. With this structure, the nonprofit

corporation sells its property to the joint powers authority pursuant to an installment purchase agreement. In consideration for this sale, the JPA sells the same property back to the nonprofit corporation pursuant to an installment sale agreement. Pursuant to the installment sale agreement, the nonprofit corporation will make payments to the bond trustee, as assignee of the JPA, in satisfaction of the JPA's installment payment obligations under the installment purchase agreement. The financings also may be structured as lease-leaseback financings.

PROJECTS THAT MAY BE FINANCED

California Health Facilities Financing Authority

The CHFFA Act authorizes the issuance of hospital and health care facility conduit revenue bonds for the purposes of financing and refinancing the construction, expansion, remodeling, renovation, furnishing, or equipping of the types of facilities listed in the Act, including:

- General acute care hospitals
- Acute psychiatric hospitals
- Skilled nursing facilities
- Life care facilities
- Intermediate care facilities
- Outpatient facilities
- Facilities for the developmentally disabled
- Community clinics
- Adult day health centers

CHFFA also may issue bonds to refund bonds issued for such purposes.

Charter Cities

The city charter and the bond ordinance or resolution of a charter city determine the limitations imposed by that city on its issuance of hospital and health care facility conduit revenue bonds. In determining whether a charter city may proceed with a particular financing, it is necessary to assess whether the financing of that facility will constitute a "municipal affair." To make this determination, the services provided by the facility, and the extent to which patients at the facility are residents of the city, must be analyzed. Generally, the facility must be located within the city limits, although a facility located immediately adjacent to a city and providing significant health care services to the residents of the city may be financed.

To ensure that a municipal affair is advanced by the financing, it is necessary for the city and the hospital to enter into an agreement pursuant to which the hospital agrees to provide certain specified services to the city and its residents. In certain situations, such as a sole provider in a rural area, it may be appropriate for the hospital to agree to provide basic services as an acute care hospital. In other instances, such as a large medical center in an urban area, it may be necessary for the hospital to enter into an agreement to provide specified services to the city.

Charter cities may finance the same types of projects as are described above for CHFFA.

Joint Powers Authorities

Unless otherwise limited by its joint exercise of powers agreement or the resolution under which the certificates of participation will be delivered, a JPA may finance the same types of projects as charter cities and CHFFA.

METHOD OF REPAYMENT AND SECURITY FEATURES

Hospital and health care facility conduit revenue bonds or certificates of participation are payable solely from the loan or installment payments made by the hospital/health care facility beneficiary of the issue. Debt service on the bonds may be secured in addition by bond insurance, a letter of credit from a bank, a deed of trust on hospital property, or a guarantee by a parent organization, or other similar devices.

PROCESS FOR APPROVAL

All of the conduit financings described in this section require a Tax and Equity Fiscal Responsibility Act of 1982 (TEFRA) hearing to be exempt from federal income tax. As described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**, the bonds or certificates of participation must be approved by an appropriate elected official or body after a public hearing has been conducted (the TEFRA requirement). For a CHFFA issue, CHFFA holds the public hearing in Sacramento, and the State Treasurer acts as the “applicable elected representative” of the State of California. For a charter city, the public hearing will customarily be held either by the staff or in front of the city council and the city council will approve the bonds for this purpose. If the mayor is elected at large in the city, the mayor may approve the bonds for this purpose. For JPAs, a TEFRA hearing must be held in each city or county where the proceeds of the certificates of participation will be used and approved by the city council or county board of supervisors, as applicable.

In addition to the federal tax law requirement for a TEFRA hearing, CHFFA, the charter city, and the joint powers authority must approve the financing and the execution of the financing documents. For charter cities and JPAs, the charter or the joint exercise of powers agreement and the bond ordinance or resolution may impose additional procedural requirements on the issuance by the city or JPA of hospital and health care facility conduit revenue bonds or certificates of participation.

PROCESS FOR SALE

California Health Facilities Financing Authority

Conduit revenue bonds issued by CHFFA may be sold by the State Treasurer by competitive or negotiated sale, after giving due consideration to the recommendation of the applicable nonprofit corporation, upon such terms and conditions as CHFFA shall determine. The CHFFA Act allows the State Treasurer to sell bonds to be issued by CHFFA at a price below the par value thereof, provided that, with certain exceptions, the discount on any such bonds shall not exceed 6 percent of the par value.

Charter Cities

Unless otherwise limited by its charter or the bond resolution or ordinance under which the bonds will be issued, a charter city may sell its bonds by competitive or negotiated sale, within whatever price limits are approved by the city council.

Joint Powers Authorities

Unless otherwise limited by its joint exercise of powers agreement or the resolution under which the certificates of participation will be delivered, a JPA may sell its bonds by competitive or negotiated sale, within whatever price limits are approved by such JPA.

OTHER LIMITATIONS ON TERMS OF BONDS

California Health Facilities Financing Authority

The CHFFA Act limits the terms of bonds issued by CHFFA to 40 years. Otherwise, CHFFA may issue its bonds on any terms that are approved by CHFFA. Variable interest rates, put bonds, and commercial paper may all be feasible.

Charter Cities

Unless otherwise limited by its charter or the bond ordinance or resolution under which the bonds will be issued, the terms of charter city hospital and health care facility conduit revenue bonds may be quite flexible, subject to the approval of the city council. As with CHFFA, variable interest rates, put bonds, and commercial paper may all be feasible.

Joint Powers Authorities

Unless otherwise limited by its joint exercise of powers agreement or the resolution under which the certificates of participation will be delivered, the terms of hospital and health care facility conduit revenue certificates of participation may be quite flexible, subject to the approval of the JPA. As with CHFFA, variable interest rates, put bonds, and commercial paper may all be feasible.

SPECIAL FEDERAL TAX CONSIDERATIONS

Conduit revenue bonds issued for hospitals and other health care facilities owned and operated by nongovernmental entities will be exempt from federal income taxation only if they are qualified Section 501(c)(3) bonds. A detailed discussion of qualified 501(c)(3) bonds is in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**.

CONDUIT REVENUE BONDS: MULTIFAMILY HOUSING REVENUE BONDS

DEFINITION AND PURPOSE; ISSUERS

Multifamily housing revenue bonds are issued to finance the acquisition, construction, rehabilitation or development of, or to refinance rental housing developments (apartment buildings) by private developers. Generally, all or a portion of the units in the housing development must be reserved for occupancy by individuals and families of very low, low, or moderate income. The advantages to developers include below market interest rates and other features not available in the conventional multifamily mortgage market, such as long-term fixed rate financing.

Multifamily housing revenue bonds may be issued by cities, counties, joint powers authorities (JPAs), redevelopment agencies, and housing authorities.

PROJECTS THAT MAY BE FINANCED

Any multifamily rental housing development may be financed, provided that various restrictions relating to the income of tenants and rental of units, depending upon the issuer of the bonds, are satisfied. The following paragraphs summarize certain of these requirements.

Occupancy Requirements and Income Limits

Under the statute applicable to cities and counties, which also applies to JPAs, the issuer must elect to have either 20 percent of the units occupied by tenants whose income does not exceed 50 percent of area median income, or 40 percent of the units must be occupied by tenants whose income does not exceed 60 percent of area median income, all for the period required by, and determined in accordance with the definitions set forth under the federal Tax Code. In projects financed by cities, counties, and JPAs, the units occupied by low income households must be of comparable quality and offer a range of sizes and number of bedrooms comparable to those available to other tenants. It is not clear whether these requirements apply to charter cities issuing bonds under their charter powers.

The general rule for housing authorities and redevelopment agencies under state law is that at least 10 percent of the units in a project must be set aside for tenants of very low income (50 percent or less of area median income), and another 10 percent of the units must be set aside for tenants of low or moderate income (80 percent or less of area median income) until the bonds are retired.⁷ In each case the figure for median income is adjusted for family size. In projects financed by housing authorities (but not redevelopment agencies), the income of tenants must be redetermined every two years, and if any increase in a tenant's income would result in the project

⁷ See also **Other Federal Tax Considerations** discussion later in this chapter.

no longer complying with the requirements described above, the next available unit must be rented to an individual or family whose income meets the qualifying level.

In projects developed by any private or public entity (other than the redevelopment agency) specifically in order to replace units removed from the housing market because of a redevelopment project, at least 15 percent of the units must be available at affordable housing cost to persons and families of low or moderate income (120 percent of area median income), and not less than 40 percent of these units must be available at affordable housing cost and occupied by very low income households. This requirement increases to 15 percent the very low income set-aside requirement, which would otherwise be only 10 percent for multifamily housing projects in redevelopment areas. Note also that projects for this purpose financed by a redevelopment agency must provide at least 30 percent of the units at affordable housing cost to low or moderate income households, and half of these units must be available to very low income households.

Under the Tax Code, for the issuance of tax-exempt bonds at least 40 percent of the units in the project must be set aside for families whose income does not exceed 60 percent of area median income, or 20 percent of the units must be set aside for families whose income does not exceed 50 percent of area median income, in each case adjusted for family size. Income levels, in each case, are to be redetermined annually. If, as a result of an increase in any tenant's income or as a result of a reduction in the tenant's family size, the tenant's income is more than 140 percent of the qualifying limit, the next available unit must be leased to qualifying tenants. A developer may elect to set aside 15 percent of the "low income" units for tenants whose income does not exceed 40 percent of area median, in which case a tenant's income may increase to 170 percent of the qualifying limit before that tenant's unit ceases to qualify. If the developer makes this election, the project is subject to rent limits as described below.

Rent Limits

Projects financed by housing authorities and redevelopment agencies are subject to state statutory rent limits applicable to the 10 percent of the units required to be set aside for very low income households. The general rule is that the rent paid by the tenant (excluding any supplemental rental assistance from the state or federal government or other public agencies) for any unit may not exceed 30 percent to 50 percent of area median income, adjusted for family size in accordance with Table 6-3. In the case of projects financed by cities, counties, and joint powers authorities, rents paid by tenants of the set-aside units are limited to 30 percent of the applicable income limit (50 percent or 60 percent of area median income) selected by the issuer as described above.

There are no rent limits under federal tax law, unless a developer elects to set aside 15 percent of the low income units for tenants whose income does not exceed 40 percent of area median, in which case the rent charged for all low income units may not exceed 30 percent of the income limit and may not exceed one-third of the average rent charged for other units in the project.

Table 6-3
Rent Limits Adjustments for Projects Financed By
Redevelopment Agencies and Housing Authorities

Size Of Unit	Assumed Size of Occupying Family
Studio	1 person
1 bedroom	2 people
2 bedrooms	3 people
3 bedrooms	4 people
4 bedrooms	5 people

Term of Restrictions

Under state laws applicable to housing authorities and redevelopment agencies, both the income limits and the rent limits must remain in effect until the bonds are retired. Under state law applicable to cities, counties, and joint powers authorities, and under federal tax law, the income limits must generally remain in effect for the “Qualified Project Period,” which period is the longer of 15 years, or so long as any bonds remain outstanding, or so long as the project (as opposed to individual tenants) receives assistance under the federal “Section 8” rent subsidy program.

Other Requirements

The restrictions applicable to multifamily housing projects financed by general law cities, counties, and JPAs must be set forth in a regulatory agreement, which must be recorded in the records of the county where the project is located. Moreover, following the expiration or termination of the Qualified Project Period, with respect to projects financed with the proceeds of bonds issued by a city, county or JPA, other than a termination due to a foreclosure or similar involuntary transfer, units reserved for low income tenants must remain available to any eligible tenants occupying such units at such time, at a rent not greater than the amounts described in **Rent Limits** above, until the earliest of:

- The household's income exceeds 140 percent of the maximum eligible income specified earlier in this section
- The household voluntarily moves or is evicted for good cause
- Thirty years after the date of the commencement of the Qualified Project Period, or
- The owner pays the relocation assistance and benefits to households as provided under state law

In addition, the statute applicable to general law cities and counties prohibits the syndication of new or existing multifamily rental housing without the written approval of the city or county. Such approval may be given only upon the making of certain findings, essentially to assure that the project will continue to comply with the law.

Projects financed by redevelopment agencies must be located in a redevelopment project area, unless the units in the project are “committed, for the period during which the loan is outstanding, for occupancy by persons or families who are eligible for financial assistance specifically provided by a governmental agency for the benefit of occupants” of the project or the issuer operates in a jurisdiction with a population greater than 600,000. Thus, for most projects outside a redevelopment project area, all of the tenants must be eligible for Section 8 assistance or similar financial assistance from a federal, state, or local governmental agency.

Individual issuers also may impose additional requirements, such as lower rent limits or income limits or other eligibility or project restrictions, or special compliance or reporting requirements, or various fees or other amounts to be paid to the issuer, so long as these requirements are in addition to, and not in conflict with, those imposed by state law or necessary to maintain the tax-exempt status of the bonds.

Additional Powers

In addition to the power of housing authorities to finance projects for private developers, as described above, a housing authority also may, pursuant to the same statute and subject to the same restrictions, own and operate such a project itself, as well as provide the financing to develop the project. Moreover, under the general provisions of state law relating to housing authorities, other than those described above, housing authorities may finance, own, and operate rental housing projects subject to different restrictions, including the requirement that all units in a project be rented only to persons of low or moderate income (80 percent of median income) and only at rentals “within their financial reach.” Other sections specify preference categories to be applied in selection of tenants, such as displaced persons, veterans, and citizens. There is no comparable enabling legislation for projects to be financed, owned, and operated by cities, counties, or redevelopment agencies, although charter cities may have sufficient authority pursuant to individual charter provisions.

Cities, counties, and JPAs are authorized to finance, in addition to multifamily rental housing, the development of commercial property for lease, subject to certain conditions, which include:

- No more than 10 percent of the proceeds of the bonds may be used for such purpose
- The commercial property must be located on the same parcel or a parcel adjacent to the multifamily housing development, and

- Excess lease payments, determined as set forth in the state law, must be used to reduce the rents applicable to low income units within the development

SECURITY AND SOURCES OF PAYMENT

Bonds issued pursuant to the statutes listed in **Appendix D – Legal References – Table D-9-1** are revenue bonds, payable directly or indirectly from the revenues of the project or lending program. Charter cities also could finance multifamily housing through the issuance of certificates of participation, in which case the project would be subject to certain of the provisions of state law (as described below under **Legal Authority**).

Bonds are sometimes secured by a mortgage on the project, which may, but is not required to, be insured by FHA or a mortgage insurance company or other insurer. Bonds also might be payable from amounts received under a pass-through certificate, for instance from the Federal National Mortgage Association (FNMA) or the Government National Mortgage Association (GNMA), under which the issuer of the certificate agrees to pay to the issuer of the bonds the payments due on the mortgage note of the developer, whether or not such mortgage payments are received from the developer.

A more commonly used structure is one in which bonds are paid directly from amounts drawn under a letter of credit issued by a bank or savings association, which are then reimbursed by payments from the developer derived from revenues of the project. A mortgage on the project then secures both the bonds and the reimbursement obligation. Frequently, bonds supported by a letter of credit bear interest at a variable rate, and bondholders have the right to demand purchase of the bonds at any time—the purchase is made either with amounts drawn under the letter of credit or with proceeds of remarketing of the bonds to another investor.

PROCESS FOR APPROVAL

Bonds for multifamily rental housing are revenue bonds and as such do not require an election, except in the case of charter cities whose charters require such an election. Under certain circumstances, it may be necessary to obtain voter approval of the project being financed pursuant to Article XXXIV of the California Constitution, particularly if 50 percent or more of the units are to be reserved for low income tenants or if the project is to be partially or fully exempt from real property taxes.

Cities, counties, and joint powers authorities may authorize the issuance of bonds by ordinance or resolution, and housing authorities and redevelopment agencies may authorize the issuance of bonds by resolution. In the case of cities, counties, joint powers authorities, and housing authorities, the resolution or ordinance, as the case may be, must set forth a finding of public purpose and a declaration that it is being adopted pursuant to the particular authorizing statute. The resolution authorizing issuance of the bonds typically also authorizes the sale of the bonds and delegates to specified officers of the issuer the authority to sign a bond purchase agreement.

Volume Cap

Multifamily housing revenue bonds are typically issued as qualified private activity bonds. Therefore an allocation of volume cap is required. The California Debt Limit Allocation Committee's (CDLAC) current policies for allocating volume cap provide top priority to multifamily housing projects. In evaluating multifamily housing projects in connection with applications for volume cap, CDLAC's current procedures ask the following questions:

- Are more than the statutorily required number of units restricted for very low or low income households?
- Are rents restricted at a lower level than the statute requires?
- Are the income or rent restrictions required to remain for a period of time longer than the statute requires?
- Does the project provide protection for tenants at the time the units are converted to market rate rents?
- Are the issuer and/or applicant participating financially in the project?
- Does the project respond to needs resulting from a natural disaster?
- Does the project meet other clearly defined local, regional, or statewide goals?

To the extent these questions can be answered affirmatively, the project will have a better chance of receiving favorable consideration by CDLAC. The CDLAC guidelines and procedures are normally updated each year. See **Appendix A – Working with State Agencies** for more information.

LIMITATIONS ON TERMS OF BONDS

Bonds of cities, counties, JPAs, and housing authorities must mature not later than 45 years from their dates of issuance, and bonds of redevelopment agencies must mature not later than 50 years from their dates of issuance. The interest rate on bonds of housing authorities may not exceed 12 percent per year and bonds of cities, counties, JPAs, and redevelopment agencies are not subject to any specific interest rate limitation. The statutes governing the terms of multifamily housing bonds issued by all issuers are sufficiently broad to permit variable interest rates and put bonds. Commercial paper also would be permitted under each of the statutes.

LEGAL AUTHORITY

Cities, counties, joint powers authorities, housing authorities, and redevelopment agencies may issue multifamily housing revenue bonds. See **Appendix D – Legal References – Table D-9-1** for a list of statutory provisions authorizing the issuance of multifamily housing revenue bonds.

In addition, charter cities may issue such bonds pursuant to their powers under the California Constitution and their respective charters, subject to any restrictions imposed by such charters and subject to certain requirements set forth in Sections 52097.5 and 52098 of the Health and Safety Code.

Under the laws governing the issuance of multifamily housing revenue bonds by cities, counties, JPAs, and redevelopment agencies, such issuers are authorized to use bond proceeds to make or acquire construction loans and mortgage loans to finance multifamily rental housing. The statute governing housing authorities is broader, and would permit a housing authority to purchase, sell, lease, own, operate, or manage a project itself as well.

OTHER FEDERAL TAX CONSIDERATIONS

In addition to the federal tax law requirements described above relating to occupancy requirements and volume cap, all of the other requirements and limitations for qualified private activity bonds apply to the issuance of bonds for multifamily rental housing. To the extent such bonds are not private activity bonds, for example in the case of governmentally owned and operated housing, or to the extent such bonds are qualified 501(c)(3) bonds, for example in the case of 501(c)(3) corporation owned and operated housing, only the limitations applicable to such types of financings apply. All of these various requirements are described in **Chapter 3, General Federal Tax Requirements**.

Chapter 7

GENERAL DEBT STRUCTURE ISSUES

INTRODUCTION

An important step in the process of issuing debt involves making choices about how the debt will be structured. These choices are to some extent constrained or even dictated by the facts and circumstances of the issuer and its project, and have significant influence in achieving the issuer's goal of minimizing the total cost of its debt. A working knowledge of the structural alternatives that are available is indispensable to the manager of public debt.

Simply stated, the structure of a debt issue refers to the features of the issue, regardless of the type of financing instrument chosen. It generally includes:

- The maturity structure of the bonds
- The provisions for redemption
- The debt service schedule
- Interest rate levels
- The manner in which interest is calculated
- The security for the issue

Debt can be structured in very simple or very complex fashions, depending upon the requirements of the project and the preferences of the issuer.

BASIC CONSIDERATIONS

As noted in **Chapter 2, Checklist of Steps in a Debt Financing**, the primary point of departure in the debt issuance process is the determination by the public agency that the project under consideration is either necessary or desirable. Ideally, the need for the project has been identified in the agency's capital improvement plan. In reviewing the project, officials should recognize that any capital improvement project has a wide range of costs associated with its maintenance and operation, costs that will substantially exceed the debt service to be paid. The full range of costs must be considered by the public agency to ensure that the project can be supported from an operational perspective.

From the investor's perspective, a project's essentiality is often a critical factor in the assessment of its risks of nonpayment. The more that the project is seen as supporting a critical function of the issuer, the less an issuer is perceived as likely to default on the financing. Investors may demand additional security features for projects that are perceived as less essential, at a greater cost to the issuer.

The particular facts and circumstances of the project will largely determine the type of financing instrument chosen, and will have considerable influence on how the debt is structured. For example, a project that generates cash flows upon the completion of construction is likely to be financed as a revenue bond, and will require that interest payments for the construction period be capitalized in the bond issue. The initial efforts of the issuer and its financing team will be to define the nature and scope of the project in some detail so that this information can be brought to bear upon the structuring decisions.

Some of the basic facts and circumstances of a project that have an impact on structural decisions include:

- **Project Timing.** The timing of anticipated project expenditures can range from almost immediately, as in the case of an acquisition, to many years, in the case of a large construction project. For projects with extended construction periods, it may be necessary to fund capitalized interest or to issue the debt in phases as construction milestones are achieved.
- **Certainty of Project Revenues.** A debt service reserve fund is typically established in revenue bond transactions in order to mitigate potential revenue shortfalls
- **Project Life.** The expected life of the project generally determines the maximum maturity for the bond issue. When the expected life of a project is anticipated to be very long, or when rapid technological changes may render the project obsolete at an earlier date, then legal, market, and political conditions will determine the maximum maturity.

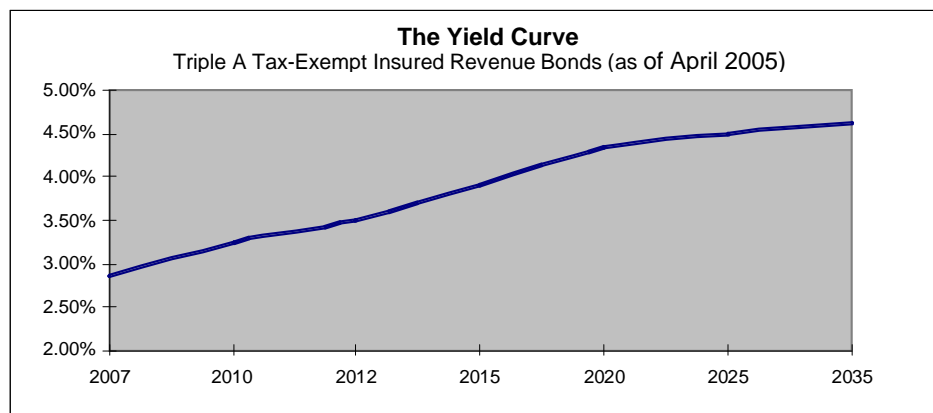
CAPITAL MARKET CONSIDERATIONS

Issuers and their financing teams will expend considerable effort attempting to match the structural features of the bond issue to the current conditions in the capital markets, especially the preferences of investors. Issuers must rely to great extent upon their underwriters and financial advisors to identify these conditions and suggest appropriate structural features that will take advantage of or mitigate these conditions. However, issuers must take the final responsibility for these decisions, and should have an adequate understanding of and basic level of comfort with them.

Interest Rates and the Yield Curve. The general level of interest rates is probably the most important factor affecting the issuer's goal of minimizing borrowing costs on a bond issue.

Interest rate levels tend to fluctuate over time, in response to business cycles, government policy and major economic events. While debt issuance levels do tend to go up in low interest rate environments, governmental agencies' capital project financing needs dictate that debt issuance occur in higher interest rate environments as well. Bonds issued in higher interest rate environments are often refunded when interest rates decline to more favorable levels.

Interest rates also tend to vary as a function of how long money is borrowed or loaned. This relationship of interest rates and maturity is known as the “yield curve,” and is graphically depicted in the figure below. For municipal bonds of similar credit quality, interest rates tend to be higher for longer maturities relative to shorter maturities. At different points in the business cycle, this relationship may be more or less pronounced, causing a more steeply sloped curve or a curve that is relatively flat. In general, the slope of the yield curve reflects investors' expectations about the behavior of interest rates in the future. In tax-exempt capital markets, investors' expectations about the prospect for federal tax reform and other technical factors also play a large role. The yield curve determines the interest rate or yield at which bonds of differing maturities will be offered to the public by the underwriters.



Fixed and Variable Rate Bonds. Most municipal bonds are issued as fixed rate bonds, which mean that the rate of interest to be paid is “fixed” at the time of issuance and never changes. In recent years, however, a significant proportion of municipal bonds have been issued as variable rate bonds, which do not have a fixed rate of interest. Instead, the interest rate is re-set periodically to match current market conditions—often daily, weekly, or monthly. The most common forms of municipal variable rate obligations are variable rate demand obligations (VRDOs) and auction rate securities (ARS). For an in-depth discussion of fixed and variable rate structures, see **Chapter 8, Fixed and Variable Interest Rate Structures**.

STRUCTURING THE BOND ISSUE

The financial advisor in a competitive sale normally carries out the task of structuring the bond issue. In a negotiated sale, the issuer may direct the underwriter or the financial advisor, or both

parties, to determine the structure. The issuer may have policies that proscribe some of the available alternatives, and certainly the more sophisticated public agencies will have a great deal of input in these decisions. One common requirement of issuers, for example, is that the amount of annual debt service be approximately level over the life of the bonds. Structuring the issue also involves identifying the preferences of investors for bonds of particular maturities and features, and selecting the combination of those maturities and features that will best enable the issuer to achieve its goal of minimizing interest costs.

In structuring the bond issue, issuers must keep in mind that there is a trade-off between shorter maturities and higher interest costs. Because shorter-term interest rates are lower, \$10 million of bonds with 5 year maturities will generally have a lower True Interest Cost (TIC) than \$10 million of bonds with 30 year maturities, all else being equal. However, the annual debt service on the shorter maturity bonds may be several times the amount of annual debt service on the longer maturity bonds, rendering the shorter maturity bonds less affordable to the issuer.

Security Features. Bond issues incorporate different types of security features or covenants to preserve issuer flexibility, to increase the comfort level of investors and/or to enhance the marketability of the bonds (see **Appendix C – Debt Financing Terms and Concepts** for a listing of typical covenants.) Some of the more common security features are:

- **Debt Service Reserve Funds.** In situations where there is significant uncertainty about the fulfillment of expectations concerning project revenues, it is common to include additional funds when sizing the bond issue to provide for the funding of a debt service reserve fund. These reserve funds are available to the trustee to make principal and interest payments to bondholders in the event that other available funds are insufficient to do so.
- **Sinking Funds.** A sinking fund is commonly used to accumulate debt service funds in order to retire term bonds at or before their scheduled maturity. The funds paid into the sinking fund each year may be used at that time to retire a portion of the term bonds (selected at random) ahead of their scheduled redemption. Investors like the security of knowing that the issuer appropriately budgets and accounts for its expected future payments. The sinking fund also ensures that the payment of funds at maturity does not overtax the issuer's resources at that time.
- **Coverage.** A common feature in enterprise revenue bonds, coverage covenants require the issuer to maintain its revenues at a level sufficient to pay its operating costs and debt service, plus a margin of safety. Coverage is usually expressed as a multiple of the debt service payment, such as "1.2 times debt service." In some cases, the excess revenues must be used for early redemption of bonds if certain conditions are met. Often a coverage requirement is expressed as a "rate covenant" under which the issuer is required to maintain rates and charges such that the net revenues will meet the coverage requirement.

- **Additional Bonds Test.** This feature specifies the conditions, if any, under which additional bonds may be issued where those bonds will rely upon the same source of repayment funds as the existing outstanding bonds. The conditions may be expressed in terms of coverage requirements that must be met prior to additional issuance, as simple dollar limitations, or as project progress requirements.
- **Acceleration.** Acceleration is a provision that requires or permits the trustee to declare all future payments of principal to be immediately due and payable upon an event of default. In some cases, this may be triggered only upon the request of a set percentage of the bondholders. If the issue is guaranteed by any form of credit enhancement (such as bond insurance or a letter of credit) the credit enhancement provider typically has control over whether or not the bonds may be accelerated.
- **Credit Enhancement.** Credit enhancement generally provides a back-up source of repayment that may be relied upon if the primary source of repayment becomes unavailable. The most common form of credit enhancement is bond insurance, whereby the issuer purchases an insurance policy that guarantees principal and interest payments to bondholders if required to avoid default. Other forms of credit enhancement include letters of credit, surety bonds, and intercept programs. Credit enhancement providers often ask for specific covenants to be included in the transaction, such as acceleration provisions.
- **Lien Structure.** Bonds that rely on the same revenue repayment source can be structured on different liens based on the relative priority of their claim on that repayment revenue source. Senior and junior lien bonds have, as the names imply, a greater or lesser claim on resources than do other bonds sold for the same project. Parity bonds have an equal claim on those resources. A senior/junior bond structure is often chosen to enhance the overall interest rate and/or bonding capacity for a project, especially in land-based financings.

Debt Service. Issuers must consider a number of factors in selecting the schedule and other requirements for the retirement of their debt. As noted earlier in this chapter, project-specific factors will play a large role in these decisions, and the selected retirement pattern can have a major impact on the cost of the funds being borrowed. The services of financial advisors and underwriters are indispensable in the consideration of these factors. However, the issuer also must understand how the debt service pattern will affect its aggregate obligations for payment of debt service, the affordability of the proposed debt in the context of other budgetary commitments, and a host of other technical factors. Issuers also should be careful about the selection of the date on which interest and principal payments are due and payable—generally it is not a good idea to schedule debt service payments on tax-supported issues for a date prior to the December and April property tax payment deadlines.

There are many different ways that debt service can be structured to achieve the issuer's objectives. From a purely economic perspective, it is appropriate for debt service to be charged equally over the life of the bonds, so that payment of the debt service costs matches the

consumption of the project benefits. This type of pattern also allows the issuer to budget on the basis of a stable flow of funds. Many issuers insist on level annual debt service (both principal and interest) or level annual principal repayment structures for this reason. However, it is often the case that an issuer wishes to delay the initial payment of debt service for a short period until it anticipates additional resources will become available, such as when other outstanding bonds are paid off. On the other hand, excessive “backloading” of debt service can be a sign of fiscal distress or other problems, increases the cost of the borrowing, and tends to reduce the perception of the issuer’s creditworthiness.

In the case of serial bonds, the selection of the maturity dates and principal amounts for those maturity dates defines the debt service schedule. Generally accepted accounting principles (GAAPs) provide that the charge for debt service is recognized when cash is transferred to make the payment, as opposed to taking the charge on an accrual basis as the liability is generated. When issuing term bonds, however, the principal amounts and maturity dates are less determinative. This is because the issuer typically agrees to a schedule of mandatory sinking fund payments that are used either to pay the principal and interest in full on the scheduled maturity date or to redeem the bonds on an accelerated basis. The sinking fund payment schedule can be set up on a level payment or ascending payment basis, as long as it produces sufficient funds to completely retire the bonds at the appropriate time. The credit considerations discussed above about backloading and other nonlevel debt structures apply equally to serial and term bonds.

Measuring Interest Costs

The two key measures of interest costs are Net Interest Cost (NIC) and TIC.

Net Interest Cost. NIC is the average annual interest rate for a bond issue. For bonds issued with serial maturities, it can be computed using the following:

$$\text{NIC} = \frac{\text{Total Coupon Interest Payments} - \text{Original Issue Premium} + \text{Original Issue Discount}}{\text{Bond Year Dollars (i.e. Sum of Principal of Each Serial} * \text{Maturity of Each Serial)}}$$

The numerator in the formula represents the sum of interest payments to be made over the life of the bond issue, minus or plus any original issue premiums or discounts for the individual serial bonds.⁸ The denominator in the formula, bond year dollars, measures the total principal amount of the bonds outstanding over the time the bonds are outstanding. It is computed by multiplying the principal of each serial in the bond issue by the serial in the bond issue by the principal of each serial in the bond issue by the serial in the bond issue by the number of years to its maturity and adding up the total bond years for the series.

⁸ Accrued interest may be treated as a premium in the computation of NIC.

Example: 5 Year - \$25,000,000 Serial Issue Sold at 99% of par				
Years to Maturity	Principal Maturing	Interest Rate	Bond Years	Coupon Interest Payments
1	\$5,000,000	1.5%	\$5,000,000	\$75,000
2	\$5,000,000	2.0%	\$10,000,000	\$200,000
3	\$5,000,000	2.5%	\$15,000,000	\$375,000
4	\$5,000,000	3.0%	\$20,000,000	\$600,000
5	\$5,000,000	3.5%	\$25,000,000	\$875,000
Total	\$25,000,000		\$75,000,000	\$2,125,000

Using this formula, the text box above provides an example from which NIC can be calculated. In the example shown, the serial bond is sold at a discount. The amount of the bond can be calculated as follows:

$$\text{Total Bond Issuance} - (\text{Total Bond Issuance} * \text{Percent of Par Sold}) = \text{Discount Amount}$$

or

$$\$25,000,000 - (\$25,000,000 * 0.99) = \$250,000$$

Using the NIC formula above, the NIC for the example is:

$$\frac{\$2,125,000 + \$250,000}{\$75,000,000} = 3.167\%$$

Despite its widespread use, there is a fundamental weakness in the use of NIC as the measure of total financing costs as it ignores the time value of money. In essence, this concept states that the value of a dollar paid earlier is greater than the value of a dollar paid later. This is because inflation erodes the value of the dollar paid later, and because the dollar paid earlier can be reinvested to generate additional dollars. In addition, the market demands higher rates of interest for longer maturity borrowings. As bond issues may be structured to provide repayment at different points in time, similarly sized bond issues of comparable credit quality may have significantly different interest costs.

Unless appropriate bidding constraints are used, the reliance upon NIC to award bids can lead to more costly results. For example, a bid requiring high coupons on initial maturities and very low coupons on later maturities could represent the lowest dollar amount of interest among competing bids, but at the same time be the highest cost bid on a time value of money basis. NIC continues to be a widely used method of presenting the cost of a municipal bond issue.

True Interest Cost. A popular technique in common usage that takes into account the time value of money or net present value (NPV) is called the TIC method. TIC is generally

regarded in municipal finance practice as the preferred method of determining the effective cost of a bond issue. The TIC method calculates an issuer's borrowing interest cost while considering the present value of the debt service payments. It is defined as the interest rate necessary to discount the debt service payments (compounding semiannually) to the purchase price received by the issuer at the time of bond closing.

TIC is computed by calculating the interest rate that equalizes the present value of the issuer's future cash payments (i.e. principal and interest payments) with the net proceeds of the bond issue (i.e. total proceeds of the serial bonds adjusted for fees, sales charges, administrative expenses and any original issue premiums or discounts). Using the example above the TIC would be calculated as follows (assuming no adjustments for fees, sales charges, etc.), where Σ is the sum and n is the number of periods.

$$\text{Net Proceeds of Bond Issue} = \Sigma \frac{(\text{Interest} + \text{Principal})^n}{(1 + \text{TIC})^n}$$

Years to Maturity (A)	Principal Maturing (B)	Interest Payments (C)	Total Outflows (D)	TIC Rate (E) [*]	Discounted Outflows (D*E)
1	\$5,000,000	\$75,000	\$5,075,000	(1+.0305645) ¹	\$4,924,483
2	\$5,000,000	\$200,000	\$5,200,000	(1+.0305645) ²	\$4,896,128
3	\$5,000,000	\$375,000	\$5,375,000	(1+.0305645) ³	\$4,910,803
4	\$5,000,000	\$600,000	\$5,600,000	(1+.0305645) ⁴	\$4,964,630
5	\$5,000,000	\$875,000	\$5,875,000	(1+.0305645) ⁵	\$5,053,956
Total	\$25,000,000	\$2,125,000			\$24,750,000

* Numbers are rounded.

$$\begin{aligned} \text{Net Proceeds} &= \$25,000,000 \text{ @ } 99\% \text{ Par} &&= \$24,750,000 \\ \text{Future Cash Payments} &&&= \$24,750,000 \end{aligned}$$

The formula yields a TIC rate of 3.05645 percent, which discounts Future Cash Payments to equal the Net Proceeds.

By incorporating the time value of money, this measure gives more weight to earlier payments than to later payments, arriving at a TIC that is lower than the NIC calculated above. Thus the TIC appropriately measures the effects of changes in the maturity patterns of serial bonds and differences in the structure of coupon rates.

RESTRUCTURING DEBT SERVICE

A substantial amount of long-term debt issuance (over 50 percent in recent years) consists of debt issued to refund other existing outstanding debt. In simple terms, new debt is issued to pay off old debt, normally to achieve cost savings associated with lower interest rates.

Advance vs. Current Refundings. There are generally two types of refundings that are used. In an advance refunding, the issuer sells new bonds and places the proceeds into an escrow account. These proceeds, along with the interest earnings that result from their investment, are used to pay off the bonds at their scheduled maturity or first call date (which is more than 90 days after the date of issuance of the refunding bonds). Federal tax law generally provides that a bond issue may be advance refunded only once (although bonds issued prior to 1986 may be advance refunded twice). Issuers should be comfortable that the savings to be generated by the advance refunding if it is done now significantly exceed the potential savings that could be generated if it is done at a later date—possibly in a more favorable interest rate environment.

A current refunding is a transaction in which the outstanding bonds to be refunded are called and paid off within 90 days of the date of issuance of the refunding bonds. There is no federal limitation on the number of times that a bond issue can be refunded on a current basis. For a general discussion of the rules applicable to refundings, see **Chapter 3, General Federal Tax Requirements – Refunding Bonds**.

There are a number of reasons issuers may wish to restructure their debt, including:

- **Achieve Cost Savings.** The primary reason issuers refund their debt is to achieve cost savings by replacing debt issued in higher rate environments with debt issued at lower rates. Issuers typically seek to achieve present value savings, after accounting for all expenses of sale including underwriter’s compensation, relative to the debt service costs of the outstanding debt. Many issuers use present value savings thresholds in order to ensure that the transaction generates significant savings relative to the issuer’s investment of time and effort, or to ensure that the transaction is “safely in the money” given the volatility of these calculations. Common savings thresholds are 3 to 5 percent of debt service costs, on a present value basis. In some cases issuers have also insisted that these present value savings exceed the amount of compensation to be earned by all financial professionals in conducting the transaction, in order to ensure that the issuer’s savings are clearly seen as the motivation for the transaction.
- **Mitigate Irregular Debt Service Patterns.** Another reason for conducting a refunding transaction is to alter the yearly debt service pattern on outstanding debt. For example, an issuer may find that it faces a “spike” in its debt service requirements in a coming year that will place a fiscal burden on its ability to maintain other programs. By refunding that debt with new debt structured to level out its upcoming expenses, that situation can be avoided.

- **Lower Annual Debt Payments.** By refinancing their debt over a longer time horizon, an issuer may be able to lower the dollar level of its annual debt service requirements. This strategy may be useful in coping with adverse changes in an issuer's financial condition.
- **Free Up Reserve Funds.** In some cases, issuers can free themselves from the requirement that a reserve fund be maintained for an outstanding bond issue through a refunding
- **Eliminate Restrictive Covenants.** Finally, an outstanding bond issue may contain restrictive covenants that interfere with an agency's ability to carry out its programs or finance another project. By issuing new debt without those restrictive covenants, the old covenants have no further effect.

Issuers also have the option to retire bonds through secondary market purchases or through optional tender programs. Under a secondary market purchase program, the issuer may use any available funds to purchase outstanding bonds from willing sellers and then retire them. Issuers may be motivated to do this by favorable market conditions that allow the bonds to be purchased at prices below par, thereby realizing savings relative to the cost of retiring those bonds on their scheduled maturity date. They also may be motivated by the desire to reduce outstanding debt in order to meet requirements for the issuance of new debt. Optional tender programs are a more formal mechanism to achieve the same goals. Under these programs, the issuer actively solicits bondholders to "tender" or turn in their bonds at specific prices, commonly conditioned upon a sufficient number of bonds being tendered.

Chapter 8

FIXED AND VARIABLE INTEREST RATE STRUCTURES

FIXED INTEREST RATE STRUCTURES

A fundamental belief of public finance is that the debt maturity should approximately match the useful life of the project being financed. This maturity matching principle helps ensure that those benefiting from a public project are the ones paying for it.

Usually a single bond issue will consist of a series of bonds with different maturities. Because investors demand varying maturities, the structure of an issue can be a significant factor in the marketing and sale of the bond. Among the reasons that many investors prefer shorter-term tax-exempt investments are:

- Added certainty about future tax rates
- Tax laws that favor institutional investment in short-term securities
- Less chance of default or credit downgrades
- Lower price variability due to the overall changes in long term interest rates

There are two approaches to structuring the maturity of bonds:

- A serial bond issue is an issue consisting of a series of bonds that mature in a regular pattern, usually annually over the entire life of the issue
- A term bond issue has a single final maturity date when the entire principal will be repaid for all the bonds in the issue

Term bonds, which allow greater flexibility for the issuer than the prearranged payment schedule of serial bonds, are often used for entities with fluctuating revenue sources and are popular with some investors due to the active secondary market for them. Municipal bond issues often will have both serial and term securities in the same issue to benefit from their respective advantages.

Bonds can be structured so that the issuer has the option to buy back the bond prior to the stated maturity date. This option is called a call provision and is the mechanism that allows refunding to occur. Callable bonds typically will carry a higher interest rate (10 to 50 basis points) to offset

the risk to the bondholders of having their investment cashed out. Most call provisions require the issuer to pay a call premium to compensate the investor for the early retirement of a debt. The call premium is usually 2 percent to 5 percent above the par value of the bond and will often decrease as the bond ages. Therefore, when analyzing the decision to call debt, the issuer must weigh the cost of the call premium, the magnitude of the difference in interest rates, and the length of interest savings.

FIXED RATE DEBT

Serial and Term Bonds. Long-term fixed rate bond issues typically consist of serial and term bonds. Serial bonds mature in consecutive years, so that each year a portion of the principal amount of the bond issue is retired. Term bonds refer to a bond whose principal is nominally due on a single date, but the issuer is required to make annual payments to a sinking fund that partially redeems the term bond in pre-specified amounts at par on specific dates over a few years (“mandatory redemption”). The last sinking fund installment is on the final maturity date of the term bond. The mandatory redemption schedule is provided in the Official Statement for the bonds. It is common for a bond issue to incorporate both serial and term bonds to meet the preferences of different types of investors. For example, retail investors tend to prefer serial bonds with relatively short maturities, while institutional investors (such as mutual funds) tend to prefer longer maturity term bonds. This structure allows issuers to take advantage of the yield curve during the early years when it is typically the steepest. Investor preferences tend to evolve in broad cycles, however, so this may be less true in the future.

Discount and Premium Bonds. The stated interest rates—known as coupon rates—on any particular maturity of a bond issue may differ significantly from the rates indicated on the yield curve. Fixed rate bonds may be sold at par, at a discount, or at a premium. A par bond has the same coupon and yield with a price at 100 (i.e. par), discount bonds have coupons that are lower than the yield and are therefore sold at a price below par (i.e. below 100), and premium bonds have coupons that are higher than the yield and are therefore sold at a price above par (i.e. above 100). At the extreme are deep discount or capital appreciation bonds (CABs). CABs are structured to sell at a significant discount from their par value. These types of bonds typically pay all or part of their return to investors when they mature at par, through an accretion of value over time to maturity. CABs are typically incorporated into a bond structure if the revenues available to meet debt service are expected to grow over time. Any bonds sold at a significant discount are treated as original issue discount (OID) bonds for federal income tax purposes with interest accreting annually to the investor.

Call Provisions. Most fixed rate tax-exempt bond issues contain provisions that allow the issuer to redeem all or a portion of its bonds prior to maturity at specific prices. Issuers frequently want the option to refund previously issued bonds to obtain interest rate savings in lower interest rate environments than when the bonds were issued. On the other hand, some investors prefer the certainty of a fixed maturity with no possibility of a call.

The standard call provision for tax-exempt municipal bonds provides 10-year call protection to investors. This provision enables an issuer to redeem its bonds beginning 10 years from the date of issue. The most common redemption price for general government issuers is at par (price at 100) but that price is subject to market conditions as well as the type of municipal bond. For example, tax allocation bonds often carry redemption prices of 102. Under current market conditions, the standard 10-year call provision for general government bonds also incorporated a premium of 2 percent (a price of 102 declining to 100 percent of par over a subsequent period of years). Because of the likelihood that the call option will be exercised, bond prices are commonly calculated on the basis of their yield to the first call, or the yield to maturity, whichever results in a lower price to the investor.

On balance, call provisions provide investor protection against early redemption as well as issuer flexibility to achieve savings through refunding. In evaluating whether to issue bonds with a nonstandard call provision, issuers should undertake a cost-benefit analysis. Call provisions in the taxable market differ substantially from those in the tax-exempt market. In general, taxable bonds are noncallable or incorporate “make-whole” calls where the call price is determined at the time of exercise to make the investor “whole” based on their expected return at initial pricing.

In the taxable municipal market, a variety of call features exist that range from standard tax-exempt-type call provisions (typically for smaller transactions) to noncallable or make-whole call provisions (typically for larger transactions such as pension obligation bonds).

VARIABLE INTEREST RATE STRUCTURES

Variable rate obligations offer issuers access to long-term capital at short-term variable interest rates. In recent years, a significant portion of municipal bonds, both tax-exempt and taxable, have been issued as variable rate securities. Unlike securities that provide a fixed rate of interest, the interest rate on variable rate securities is reset periodically to match current market conditions—most often daily, weekly, or monthly—at the discretion of the issuer within the parameters of the governing documents. Longer reset period options can also be included if desired.

Issuers incorporate variable rate obligations into their capital structure for a variety of reasons including:

- Diversifying their debt structure and investor base
- Achieving a lower all-in cost of funds, and
- Matching their assets and liabilities

In a variable rate financing, the actual cost of funds depends on market conditions over time and is not known until the bonds mature. An issuer must consider that short-term interest rates may

increase dramatically and raise the issuer's costs correspondingly, so caution is required in analyzing the appropriate use of variable rate obligations. In general, issuers who have little or no control over the level of their revenues (such as with redevelopment agency tax allocation bonds) may find it difficult to use variable interest rate debt instruments without appropriate hedges or other financing strategies. The rating agencies' rule of thumb traditionally had been that variable rate obligations should represent no more than 15-20 percent of an issuer's outstanding debt. However, they will consider other credit factors including the amount of variable rate assets an issuer has to naturally hedge its variable rate obligations in determining an appropriate amount of variable rate debt for a particular issuer.

The most common forms of long-term variable rate obligations in the municipal market are variable rate demand obligations (VRDOs) and auction rate securities (ARS). In addition, tax-exempt commercial paper (TXCP) is a variable rate product that is typically used as an interim variable rate financing vehicle rather than as a more permanent layer of long-term variable rate debt. The dominant investors for both VRDOs and TXCP are money market mutual funds. ARS, however, are not money market eligible and are primarily bought by corporations and individuals. Legal documentation for variable rate obligations can accommodate a variety of interest rate modes and types of products. This can provide issuers with the flexibility to change, for example, interest rate reset periods or product type relatively easily without developing new documentation. The following discussion presents descriptions of these three basic municipal variable rate products.

VARIABLE RATE DEMAND OBLIGATIONS

A VRDO—also called a "low-floater"—is typically referred to as a variable rate demand note (VRDN) or variable rate demand bond (VRDB). VRDOs are long-term taxable or tax-exempt bonds that bear a floating interest rate and provide investors with the option to tender or "put" securities back to the remarketing agent for repayment at par plus accrued interest after notice to the remarketing agent, which may be anywhere from immediate (for dailies) to seven days (for weeklies), or longer. The rate is reset periodically (usually mirroring the notice period required for the put) at a level required to sell the bonds at par. Indexes include:

- The U.S. Treasury index
- The London Interbank Offered Rate (LIBOR), which is typical in the taxable market
- The Bond Market Association (BMA) Index, which is typical in the municipal market

Because this reset period is very short, and because investors have the option to "put" the bonds back to the issuer at the time the interest rate is changed, the interest rates are similar to those of short-term notes. The bonds tendered are then resold by the remarketing agent in the secondary market to other investors.

Using this mechanism, issuers can borrow long-term at cheaper short-term rates if the rate environment is favorable. Since short-term interest rates may increase dramatically and raise the issuer's costs correspondingly, caution is required when using variable-rate bonds. However, a VRDO can be converted to a long-term fixed rate bond upon appropriate notice by the issuer as defined in the legal documents. In general, issuers who have little or no control over the level of their revenues may find it difficult to use variable interest rate debt instruments.

VRDOs are designed to meet the needs of investors who require liquidity, flexibility, and competitive short-term rates. The reset rate is based on comparable securities with similar maturities and credit ratings, as well as on supply and demand. Investors continually earn the market interest rate because of the reset feature and are guarded against principal loss because of the par tender feature. Bondholders have the right to tender their bonds for payment at par plus accrued interest at any time with appropriate notice to the remarketing agent.

Most VRDOs are highly rated due to credit enhancement typically in the form of a letter of credit (LOC) or bond insurance along with a liquidity facility. The credit enhancement guarantees the principal and interest, as well as the liquidity for the bonds. Occasionally, VRDOs are issued without external credit enhancement but carry self-liquidity provided by a very highly rated issuer. However, to qualify to provide self-liquidity, an issuer must demonstrate to the rating agencies sufficient liquid assets and creditworthy procedures to provide timely and sufficient liquidity for the VRDOs.

General Terms and Structures for Variable Rate Demand Notes

- **Maturity.** Bond maturity is typically long term over 15 to 30 years. Interest rates are normally reset every seven days but can be flexible depending on the permitted strategies outlined in the legal documents. Investors have the option to demand purchase of bonds at par on any business day with seven days' notice to the tender agent through the remarketing agent.
- **Issued.** VRDOs can be private or public issues placed to corporate and institutional investors, and high net worth retail clients
- **Quoted.** VRDOs are quoted on a yield basis
- **Interest.** Usually paid monthly or quarterly. Interest on these securities is ordinarily reset every Wednesday. While rate setting occurs weekly, interest payments do not occur at that time (in those cases, the securities trade with accrued interest).
- **Ratings.** VRDOs are typically supported by an irrevocable LOC from a rated banking institution or bond insurance from a municipal bond insurer. In these cases, the VRDOs carry the short- and long-term ratings of the credit enhancement provider.

- **Tax Status.** Tax-exempt VRDOs are usually exempt from federal tax and, if the investor resides in the state of issuance, state tax as well. Taxable VRDOs are subject to federal tax and may be subject to state tax.
- **Denominations.** Typically require a minimum purchase of \$100,000, with \$25,000 increments thereafter

Roles and Responsibilities of Principal Participants

The principal participants in the issuance of VRDOs include the following:

- Investment banking firm
- Remarketing agent
- Credit enhancement provider—typically a major bank, with a short-term and long-term investment grade rating—that provides an LOC or a standby purchase agreement
- Bond counsel
- Underwriter’s counsel
- Credit enhancer’s counsel
- Trustee
- Credit rating agency
- Bond insurer in some structures
- Financial advisor

The broker/dealer that underwrites the initial placement of the VRDO also normally serves as the remarketing agent for the obligations, although there is no requirement that both parties be the same entity.

The remarketing agent sets the interest reset rates within the parameters of the remarketing agreement and related documents based on market conditions and the requirements of the issuer. The remarketing agent is instrumental in maintaining demand for the outstanding VRDO, although it bears no legal responsibility to protect the issuer in the case of a failed auction. In current practice, however, in the rare cases of a failed remarketing effort, the remarketing agent has underwritten the balance of any VRDO within its responsibility for the subsequent required remarketing period in lieu of drawing down on the credit enhancement facility (LOC or standby bond purchase agreement), which legally could be done. Because both the issuer and credit enhancement provider wish to have a liquidity facility in place at all times with minimal risk of a

failed remarketing effort due to market disruptions, other causes, or a legal draw on the securing LOC or standby bond purchase agreement, great care is given to structuring the criteria and the selection of the remarketing agent so they are satisfactory to all parties.

Standby bond purchase agreements are utilized in VRDO programs that have bond insurance in place for the term of the bonds, while LOCs use reimbursement agreements and rely upon the creditworthiness of the LOC provider. Typically the LOC has a term of five to seven years and the issuer is subject to renewal or replacement risk and, in some cases, price adjustments.

Legal Documents

In addition to the basic legal documents found in any public finance transaction (see **Chapter 1, Overview of a Debt Financing - Basic Legal Documents**), the following documents will be executed and delivered in connection with the issuance of a VRDO:

Remarketing Agent Agreement

Parties: Remarketing agent and trustee, and acknowledged by the issuer

Definition and Purpose: Specifies the duties and liabilities of the parties within the parameters outlined in the Offering Memorandum and supporting documents. The agreement incorporates the rate-setting, settlement, and reimbursement procedures specified in the indenture or trust agreement and reimbursement agreement. The agreement also specifies the compensation to be paid to the remarketing agent.

Settlement procedures, form of notice of payment default, and form of notice of cure of payment default are generally attached to the agreement as exhibits. In many cases, the trustee is authorized and directed in the indenture or trust agreement to enter into, on behalf of the issuer, the remarketing agent agreement. Some issuers may prefer to be a party to this agreement if they have specific contracting policies or procedures that are required to be incorporated.

Principal Drafter: Typically underwriter's counsel; sometimes bond counsel (never disclosure counsel)

Critical Sections for Review: Issuers should carefully review the indemnification provisions, negligence standards, liability for damages, and governing law and venue.

Reimbursement Agreement

Parties: LOC provider, borrower, and trustee

Definition and Purpose: Specifies the duties, requirements, and liabilities of all parties involved in the remarketing of VRDO.

Principal Drafters: LOC counsel and bond counsel

Critical Sections for Review: Issuers should review the duties, requirements, and liabilities associated with the reimbursement requirements mandated in the document based on successful and failed remarketing efforts.

Standby Bond Purchase Agreement

Parties: Credit enhancer provider (liquidity), borrower, and trustee

Definition and Purpose: Provides liquidity as needed during the remarketing period and specifies the requirements and liabilities of the credit enhancer and the borrower within the covenants and provisions of the document.

Principal Drafters: Credit enhancer provider's counsel and bond counsel

Critical Sections for Review: Issuers should review the duties, requirements, and liabilities associated with the reimbursement requirements mandated in the document based on successful and failed remarketing efforts.

Letter of Credit Agreement

Parties: LOC provider, borrower, and trustee

Definition and Purpose: Specifies the requirements and liabilities of the credit enhancer and the borrower within the covenants and provisions of the document.

Principal Drafters: LOC provider's counsel and bond counsel

Critical Sections for Review: Issuers should review their duties, requirements, and liabilities associated with both their responsibilities and those of the credit enhancement provider as outlined within the provisions and covenants of the agreement.

AUCTION RATE SECURITIES

Auction Rate Securities (ARS) are a type of variable rate obligation that were introduced into the municipal market in the early 1990s, but have existed in other markets since the 1980s. Since that time, a wide variety of municipal issuers, including state and local governments, utilities, housing agencies, and hospitals, have issued ARS to finance a broad array of projects.

ARS are long-term securities with interest rates that reset periodically through a Dutch auction process. ARS are sold by the issuer to underwriters through a negotiated sale, usually in denominations of \$25,000 (for tax-exempt or taxable securities), and can mature in any number of years. Typically, 28-day and 35-day ARS are sold principally to institutional investors, and 7-day ARS are sold principally to retail investors.

Investors actively participate in setting ARS rates through the Dutch auction process, in which investors bid rates at which they are willing to buy, hold, or sell the ARS. The rate resets at the level that clears the market (see the section on **Structure and Mechanics** later in this chapter for a complete discussion). Reset periods can be set to almost any duration, however, the most common reset periods range from daily to 35 days—each reset period is known as an auction period.

The Dutch auction process is similar to that used by the U.S. Treasury in selling treasury bills and notes. The indenture or trust agreement authorizing the issuance of the ARS often contains multimodal provisions that allow for the conversion of the ARS to different modes, including varying auction periods, VRDOs, or fixed-rate bonds. The interest payment date for ARS depends upon the rate reset period. Daily reset ARS usually pay interest on a monthly basis while weekly and longer reset ARS typically pay interest on the day after an auction. Regardless of the reset mode, ARS are callable at par on any interest payment date.

Unlike holders of VRDOs, purchasers of ARS do not have a right to tender their bonds for immediate payment (a put or tender option). Instead, liquidity is provided by the secondary market through the sale of the ARS pursuant to an auction. If desired, an existing holder can submit a sell or bid order of the ARS for the next auction date. If a new investor purchases the ARS at the auction, the sale is completed and the proceeds of the sale are distributed to the former holder. If the auction does not result in a sale, the existing ARS holder must retain their ARS and place further orders to sell them on successive auction dates until the auction is successfully completed.

Because ARS lack a put or tender option, there is no need for the issuer to secure a liquidity facility (i.e. a LOC or standby bond purchase agreement). However, this lack of liquidity may be viewed as a negative aspect in an ARS investment. For that reason ARS investors tend to be more sensitive to credit risk and require higher credit ratings, thus ARS tend to be insured and rated in the highest rating category (i.e. AAA).

The market for ARS differs substantially from the market for VRDOs. The largest purchasers of VRDOs are money market funds. However, Securities and Exchange Commission Rule 2a-7 prohibits money market funds from investing in securities with conditional demand features, therefore, money market funds cannot invest in ARS. Tax-exempt ARS instead are sold to retail, corporate, and institutional investors, and taxable ARS are sold to corporate and institutional investors.

From 2001 to 2004, ARS have traded with interest rates similar to VRDOs, based on an all-in interest rate that includes credit enhancement, liquidity, remarketing fees, and/or broker/dealer fees.

Legal Authority

Various statutes provide authorization for local agencies to issue variable rate bonds, which would include ARS. See Government Code Section 53508 with respect to the issuance of general obligation bonds and Sections 54300 et seq. for the issuance of revenue bonds.⁹

Definitions

Table 8-1 provides the common terms and definitions used in connection with ARS financings.

Table 8-1
ARS Selected Definitions

All-Hold Rate or Hold Rate	Interest rate on any auction date equal to a percentage of a variable index specified in the indenture or the trust agreement (typically the Bond Market Association (BMA) or the London Interbank Offered Rate (LIBOR) provided such rate does not exceed the maximum auction rate specified in the indenture or the trust agreement).
Applicable Auction Rate	Rate per annum at which interest accrues on the ARS for any auction rate period.
Auction	An electronic competitive process through which the ARS are sold at the lowest yield rate (priced at par) at which sufficient bids are received to sell all securities offered. ARS are sold at the clearing yield established by the auction to the investors placing bids at or below the clearing yield. All ARS of a series will bear interest at the clearing auction rate for the next auction period.
Auction Agent	A third-party institution responsible for conducting the auction used in connection with the periodic reset of the interest rate.
Auction Date	Business day immediately preceding the first day of each auction rate period for the ARS.
Auction Procedures	Process and timing for conducting the auction as set forth in the indenture or trust agreement and summarized in the auction agreement.
Auction Rate	Rate of interest per annum resulting from the implementation of the auction, provided such rate does not exceed a maximum rate specified in the indenture or trust agreement.
Auction Rate Period	Initial period established by the underwriter at the time of issuance of the ARS and, subsequently, each period during which a specific auction rate is in effect as a result of an auction. The auction rate period commences on the business day after the auction date and ends and includes the day preceding the next interest rate reset date.
Broker/Dealer Agreement	An agreement between the issuer or auction agent and a broker/dealer specifying the procedures for conducting the auction of the ARS and the settlement procedures for the payment and delivery of the ARS.
Clearing Rate	Lowest interest rate bid at which all shares can be sold at par. The rate is paid on the entire issue for the upcoming period.

(Table 8-1 continued on next page)

⁹ State law does not specifically mention ARS in statute.

Table 8-1
ARS Selected Definitions (continued)

Failed Auction	Due to a lack of demand for the ARS on the auction date, insufficient clearing bids were received. In the event of a failed auction, existing holders maintain their positions (or some pro rata portion) in the ARS at the maximum rate until a subsequent successful auction. Failed auctions are rare and to the extent they do occur are usually associated with downgrades in the credit ratings of the issuer or the insurer.
Market Agent	An investment bank retained for the purpose of adjusting the applicable percentage used in determining the maximum auction rate, the percentage used in determining the all-hold rate, and the percentage used in determining the interest rate in the event of a payment default. Generally, the market agent and the broker/dealer will be the same party for each series of ARS issued. A market agent may or may not be required on a transaction depending on document structure. If an ARS program does not require a market agent, the broker/dealer assumes these responsibilities. There is no fee for this service.
Maximum Auction Rate	On any auction date, the interest rate per annum specified in the indenture or trust agreement, or the maximum rate, if any, established under the laws of the state for obligations of public agencies, if less than the rate specified in the indenture or trust agreement
Winning Bid Rate	Lowest rate specified in the bids submitted by potential holders for the ARS which, if selected by the auction agent as the auction rate, will result in the sale of all of the ARS subject to the bid orders

Roles and Responsibilities of Principal Participants

The same principal participants in a bond issuance are found in an ARS issue. These include:

- Bond counsel
- Disclosure counsel
- Underwriter
- Underwriter’s counsel
- Trustee
- Credit rating agency

A complete discussion of the role of these participants may be found in **Chapter 1, Overview of a Debt Financing—Roles and Responsibilities of Principal Participants**. In addition, the following participants have specific roles in an ARS issue:¹⁰

- **Broker/Dealer.** The broker/dealer serves in a similar capacity to the remarketing agent for a VRDO issuance. The broker/dealer for the ARS does not actually set the reset rate—though the rate determined by the auction agent is wholly dependent on

¹⁰ An ARS program does not require any liquidity support nor does it carry short-term credit ratings.

the aggressiveness of the bids that the broker/dealer solicits. On reset rates, the broker/dealer processes bids from investors and provides them to the auction agent, who processes them to determine the reset rate (see the section on **Structure and Mechanics** later in this chapter for a complete discussion). Despite this important difference, the broker/dealer is instrumental in gathering and maintaining demand for the ARS. The broker/dealer actively seeks customers who fit the ARS investor profile and encourages them to buy the securities being offered. The broker/dealer also may choose to bid on the program for its own account.

- **Auction Agent.** The auction agent oversees bidding, processing, and ranking orders as they arrive. In doing so, it acts on behalf of the issuer and the trustee. As described below, the auction agent ranks the bids to determine the reset rate and notifies the broker/dealers on the transaction, who then notify the investors.
- **Auction Agent Counsel.** Auction agent counsel advises the auction agent with respect to the auction agent agreement

Legal Documents

In addition to the basic legal documents found in a public finance transaction (see **Chapter 1, Overview of a Debt Financing — Basic Legal Documents**), the following documents will be executed and delivered in connection with the issuance of the ARS:

Auction Agent Agreement

Parties: Auction agent and trustee, and acknowledged by the issuer

Definition and Purpose: Specifies the duties and liabilities of the parties in preparing and conducting each auction, maintaining the register of existing owners of the ARS, notifying the trustee and the securities depositories of the auction rates, and the termination provisions. Incorporates the auction and settlement procedures specified in the indenture or trust agreement and specifies the compensation to be paid to the auction agent. Typically, the auction agent is paid an annual fee in an amount equal to 0.5 to 1.0 basis points of the principal amount of the ARS.

Settlement procedures, form of notice of payment default, and form of notice of cure of payment default are generally attached to the auction agent agreement as exhibits.

In many cases, the trustee is authorized and directed in the indenture or trust agreement to enter into, on behalf of the issuer, the auction agent agreement. Some issuers may prefer to be a party to this agreement if they have specific contracting policies or procedures that are required to be incorporated.

Principal Drafter: Bond counsel, disclosure counsel

Critical Sections for Review: Issuers should carefully review the indemnification provisions, negligence standards, liability for damages, and governing law and venue.

Broker/Dealer Agreement

Parties: Broker/dealer(s) and issuer or auction agent

Definition and Purpose: Specifies the duties and liabilities of the parties in preparing and conducting each auction, including the timing for determining the variable rate indices (i.e. the all-old rate, the maximum auction rate, the minimum auction rate, etc.) and the submission of orders. Incorporates the auction and settlement procedures specified in the indenture or trust agreement and specifies the compensation to be paid to the broker/dealer. Typically, the broker/dealer is paid an annual fee equal to 25 basis points of the principal amount of the ARS placed. In programs with multiple broker/dealers, each broker/dealer only gets paid for the bonds it actually places (i.e. the 25 basis points is split and paid to the firms placing the most aggressive bids).

Settlement procedures, order forms, form of notice of transfer, form of notice to deliver, form of notice of failure to deliver, and listing of existing owners are generally attached to the broker/dealer agreement as exhibits.

Issuers may enter into an agreement with more than one broker/dealer with respect to a series of ARS to foster competition in the auction.

Principal Drafter: Bond counsel, disclosure counsel

Critical Sections for Review: Issuers should carefully review the compensation, termination, and substitution sections.

Market Agent Agreement¹¹

Parties: Market agent and trustee

Definition and Purpose: Specifies the duties and liabilities of the market agent in adjusting the spread of the variable rate index, if any, used in determining the maximum auction rate, the percentage used in determining the all-hold rate, and the percentage used in determining the nonpayment or default rate, as the agent of the trustee. Market agent is usually the same party as the broker/dealer of the series of ARS and generally performs this function at no charge.

¹¹ The market agent agreement may or may not be required.

Many firms do not require a market agent as the agent's responsibilities can be rolled into the broker/dealer agreement for simplification.

Principal Drafter: Bond counsel, disclosure counsel

Critical Sections for Review: Issuers should review the duties and liabilities associated with adjusting the spread of the variable rate index in determining the maximum auction rate.

Structure and Mechanics

Auctions. Existing and prospective investors bid on ARS in periodic auctions. A bid has two components: a rate and the number of shares. ARS generally sell in increments of \$25,000 (tax-exempt or taxable). As an example, an investor would bid 1.5 percent for 10 shares to buy \$250,000 of ARS principal paying 1.5 percent interest.

The outcome of the auction determines the interest rate that will be payable for the next auction period (i.e. the lowest rate at which there is a buyer for each ARS offered for sale). Investors who commit irrevocably to holding their ARS or who bid at or below the clearing rate will purchase the ARS on the auction date. Those investors bidding above the clearing rate will not have their orders filled on the auction date.

Each bid and order size is ranked from lowest to highest minimum bid rate. The lowest bid rate at which all the shares can be sold at par establishes the interest rate, otherwise known as the clearing rate, paid on the entire issue for the upcoming period. Investors who bid at a rate above the clearing rate receive no bonds, while those whose bids were at or below the clearing rate receive the clearing rate for the next period. The following bid types are available:

Holders of existing ARS have the option to:

- **Hold at Market.** Hold an existing position regardless of the new interest rate (these shares are not included in auction)
- **Hold at Rate.** Bid to hold an existing position at a specified minimum interest rate
- **Sell.** Request to sell an existing position regardless of the interest rate set at the auction

Potential buyers have the option to:

- **Bid.** Submit a bid to buy a new position at a specified minimum interest rate

Although the process may vary somewhat in the details, the following is a general description of a typical ARS auction:

- Existing ARS holders submit orders to bid or sell a specific par amount of ARS at a particular interest rate to the broker/dealer or to bid, hold, or sell the ARS regardless of the interest rate determined at the auction
- The broker/dealer continuously solicits indications of interest from existing and potential ARS holders during the auction process and then submits the actual orders to the auction agent by the predetermined deadline
- The broker/dealer conveys the bids to the auction agent by the predetermined deadline
- The auction agent collects all the orders from the broker/dealer to determine the par amount of ARS available for sale
- The auction agent assembles the bids in ascending rate order and determines the clearing bid
- The bids that are lower than the acceptable clearing rate will receive the ARS. In the event that multiple bids at the acceptable rate are received, the auction agent will either allocate the ARS on a pro rata basis or allocate them to existing owners, as specified in the auction procedures.
- Following the auction, the auction agent notifies the broker/dealer of the results of the auction
- The broker/dealer records and settles the trades for settlement on the next business day. The following Table 8-2 illustrates the bidding at a typical ARS auction.

Table 8-2
ARS Auction Bidding

\$50 million ARS Auction (2,000 shares)				
Investor Type	Action	Rate	Shares	Result
Existing	Hold at Market	-	500	Holds 500 shares at 1.49%
Existing	Sell	-	250	Sells 250 shares
Existing	Hold at Rate	1.50%	750	Sells 750 shares
Existing	Hold at Rate	1.47%	500	Holds 500 shares at 1.49%
Prospective	Bid	1.48%	500	Buys 500 shares at 1.49%
Prospective	Bid	1.49%	700	Buys 500 shares at 1.49%
Prospective	Bid	1.50%	300	Receives no ARS
Outcome: \$50,000,000 ARS reset at 1.49%				

On rare occasions, a downgrade in an issuer's credit or a major market disruption may erode demand for an ARS issue enough to cause a failed auction, which occurs when there are insufficient bids or holds to meet all sell orders. Existing investors retain all or a portion of their bonds regardless of their orders, and are paid the maximum interest rate defined in the ARS'

Official Statement (e.g. 125 percent to 150 percent of 1-month LIBOR). Conversely, if all existing owners wish to hold, they receive an “all-hold” rate defined by the bond documents until the next auction.

ARS are Sold by Negotiated Sale. Like other variable rate obligations, ARS are sold on a negotiated basis due to the broker/dealer’s ongoing managerial responsibility. The periodic auction reset mechanism, in which the broker/dealer plays an important role, demands that the broker/dealer and issuer have an ongoing relationship. The issuer and broker/dealers negotiate the details of their relationship prior to the initial sale, and those agreements relate to future auctions. The issuer has the option to change its broker/dealers after initial issuance at its discretion.

Credit Facilities

Because of the high credit demands of ARS investors, historically approximately 90 percent of all ARS issued are rated AAA due to municipal bond insurance or over-collateralization. However, since 2004 some very highly rated municipal entities (AA or AAA category) have issued ARS without credit enhancement. Insured ARS are considered to have lower credit risk, and thus are less likely to have a credit related failed auction, than an uninsured program. Both types are subject to noncredit related market disruptions which could result in a failed auction.

Disclosure Considerations

Unlike VRDOs, ARS do not have a put option, so an ARS issuer must comply with traditional disclosure standards for long-term municipal bonds. These standards include sufficient initial disclosure to obtain an SEC Rule 10(b)5 opinion from bond counsel, disclosure counsel, and/or underwriter’s counsel and ongoing disclosure to meet the requirements of SEC Rule 15(c)(2)12.

The Official Statement includes disclosure language that speaks to the broker/dealer placing orders for its own account. Generally accepted market practice calls for respective broker/dealers to place bids in auctions from time to time in order to prevent what would otherwise be a failed auction should not enough bids be placed during a particular auction period. It is important to note, however, that there is no contractual obligation for the broker/dealer to do so. Without the broker/dealer bids, the result could translate into an issuer paying the maximum auction rate during the interest reset period.

Considerations for Issuing ARS

The following points weigh the advantages and disadvantages of issuing ARS.

Advantages

- ARS can provide a cost effective way to access the capital market for variable rate debt

- ARS have offered, on a historical basis, a lower interest cost than fixed rate debt, however, there is no guarantee for the future as ARS are subject to interest rate risk just like any other variable rate instrument
- No LOC fees or stand-by facility fees
- No rating risk due to a downgrade in the rating of the LOC bank
- No risk of nonrenewal of a LOC or standby facility
- No risk of an increased cost of the LOC upon renewal
- No annual bond rating fees, since ARS are considered long-term bonds
- Flexibility to change the interest rate mode of the securities to tailor the duration of the debt to meet financing objectives
- For many issuers, including those for whom LOCs are more expensive, the all-in cost of ARS may be lower than the all-in cost of VRDOs

Disadvantages

- Broker/dealer fees for ARS are higher than the fees for a remarketing agent on a VRDO
- The issuer has an interest rate risk because ARS are a variable interest rate product
- Money market funds cannot invest in ARS

ARS may not be appropriate for issuers that do not have financial flexibility or revenues to withstand adverse interest rate movements.

COMPARISON OF AUCTION RATE SECURITIES TO VARIABLE RATE DEMAND OBLIGATIONS

ARS are an alternative to VRDOs. A VRDO is a security for which the interest rate is reset periodically, typically through a remarketing process, or according to a specified index. The bond's demand feature permits the bondholder to require the purchase of the bonds by the issuer or by a specified third party, either periodically, at a certain time prior to maturity, or upon the occurrence of specified events or conditions. This process is often referred to as "putting" a bond or exercising a "tender option." Interest rates generally are based on market conditions and the length of time until the bondholder can exercise the put option. Because of the put feature, a VRDO normally requires a bank LOC.

Costs

The interest rate (including broker/dealer fees) on ARS may be sometimes higher than that of VRDOs.

However, when the cost of obtaining a letter of credit in connection with the issuance of VRDOs is considered, the all-in costs of ARS may be lower than the all-in cost of VRDOs. Also, letter of credit renewal risk and renewal pricing should be

factored in to determine the best value when comparing ARS to VRDOs. The text box describes the components of all-in costs for various transactions.

Type of Cost	ARS	VRDO	Fixed Rate Bonds
Interest Rate	X	X	X
Remarketing Agent Services		X	
Broker/Dealer(s) Services	X		
Insurance	X	X*	X
Letter/Line of Credit		X	
Auction Agent Services	X		
Trustee Services	X	X	X
Annual Rating Agency Fees		X	

* VRDOs may be insured, though not necessarily in all cases.

Features

While a VRDO generally would require an LOC, ARS do not because the investor does not possess a put option but rather relies on the liquidity generated by the Dutch auction process and the creditworthiness of the issuer or insurer. Although no LOC is required, most issues carry bond insurance to elevate them to the highest credit rating. The following text box describes typical differences in the features of ARS and VRDO bonds.

The interest rate on ARS is usually slightly higher than that of VRDOs, which generally results in a higher cost of funds for the

borrower. In addition, the up-

front fee (e.g. initial placement fee) associated with ARS generally is higher than that of VRDOs. However, the cost of obtaining an LOC in an issuance of VRDOs, along with risks associated with the elimination and/or renewals of the LOC, can make the cost of funds for an issuance of VRDOs on par or even more expensive than that of an ARS issuance.

Characteristic	VRDOs	ARS
Interest Rate Reset Periods	Daily; 7-Day	7, 28, or 35-Day
Rate Reset Process	Remarketing	Auction
Ongoing Investment Banking Role	Remarketing Agent	Broker/dealer
Investor "Put" Feature at Par	Yes	No
Liquidity Requirements	Yes	No
Investor Base	Money Market Funds; Individuals	Corporations; Individuals
Denominations	\$100,000	\$25,000
Interest Rate Reset Periods	Daily; 7-Day	7, 28, or 35-Day

ARS have additional unique and required costs. The nature of the instrument requires a broker or remarketing agent to solicit investors, an auction agent to facilitate the periodic auctions, a trustee to manage payments and, in most cases, bond insurance to elevate the credit quality of the issue to an AA or AAA rating.

Borrowers contemplating issuing either a VRDO or an ARS also should consider the following factors:

- **LOC Risk with VRDOs.** Issuers or conduit borrowers who have the option to raise funds in a VRDO issuance should consider the risks associated with the LOC. LOCs require periodic renewal. If the bank issuing the LOC does not renew it, then, generally, a new solicitation will need to be pursued or the issuer of the bonds will need to draw on the LOC and call the bonds. The issuer or the conduit borrower is required to reimburse the banking institution, usually with fees and at a higher interest rate, and for a shorter interval (e.g. daily) than the tax-exempt market was charging on the outstanding amount owed. Since ARS do not require the security of an LOC, these costs and risks are eliminated.
- **Relationship of Borrower and ARS Holders.** Holders of ARS do not have an immediate right to tender their securities as would be the case if the holders had purchased VRDOs. ARS holders do face the possibility of a period of time when the securities are difficult or impossible to liquidate.

TAX-EXEMPT COMMERCIAL PAPER

DEFINITION AND PURPOSE

TXCP consists of notes in denominations of \$100,000 or more with maturities from 1 to 270 days. Maturing TXCP notes are repaid from the proceeds of the sale of new TXCP notes or bonds or from other funds provided by the issuer. The state or local government issuer of TXCP engages one or more commercial paper dealers (banks or broker/dealers) to negotiate the sale of its notes to investors. Credit rating agencies may require the issuer to arrange a bank LOC for liquidity support or a bank letter of credit and reimbursement agreement for credit and liquidity support for the commercial paper program if the issuer does not have sufficient liquid assets to support the program. TXCP notes are usually book-entry securities registered in the name of a nominee of the Depository Trust Company, but a Wall Street area issuing and paying agent is necessary to clear transactions.

Commercial paper originated in the corporate finance market in the 19th century and began appearing in the municipal finance market in the 1970s. TXCP programs have become increasingly popular—California, Connecticut, New York, Pennsylvania, Texas, and Wisconsin and many local issuers began TXCP programs in the mid-1990s.

TXCP notes have a number of attractive features:

- They can generate quick cash because investors pay for TXCP notes on the day they are sold
- TXCP interest rates are typically lower than long-term fixed rates
- TXCP notes can be sold with an Offering Memorandum, a simpler document to complete than an Official Statement

In recent years TXCP dealers have been pressing issuers to take responsibility for disclosure and investors are also requiring regularly updated information from the issuer regarding the TXCP program and other outstanding debt.

Investors like TXCP notes because they are able to negotiate note amounts and maturities that fit their investment objectives and portfolio needs. Investors include mutual fund managers and corporate treasurers.

PROJECTS THAT MAY BE FINANCED

There are two basic types of TXCP programs: those for operating expenses and those for capital expenditures.

TXCP programs to fund operating expenses consist of tax anticipation notes or revenue anticipation notes tailored for the TXCP market. For example, instead of issuing a fixed rate 10-month revenue anticipation note, an issuer may sell notes in the commercial paper market with a variety of maturities and repay maturing notes with new notes or cash on hand.

TXCP programs to fund capital expenditures may be issued at the beginning of construction phases of large projects and may be retired with long-term bonds when the project is nearly complete. This “ramp up” approach permits an issuer to avoid the sale of long-term bonds at the outset of the project, which might be desirable if unexpended bond proceeds were expected to be invested at a rate of return lower than the interest rate on the bonds or if the issuer did not anticipate being able to spend all of the bond proceeds within the required time frame.

POLICY CONSIDERATIONS

Dealers are generally unwilling to undertake a TXCP program unless a minimum amount (\$25 million) of notes will be outstanding. Consequently, smaller borrowers do not have access to the TXCP market and small programs generally are not cost effective.

An issuer that has little or no variable rate or short-term debt could consider a TXCP program as a method of diversifying its interest rate risk. Credit rating agencies generally are not troubled if an issuer has 15 to 20 percent of its interest rate exposure in the short-term market.

TXCP programs require issuer staff time on an ongoing basis. An issuer with an active TXCP program should expect that a staff member will spend significant time in communication with its dealers and issuing and paying agent and in recordkeeping activities.

SECURITY AND SOURCES OF PAYMENT

TXCP notes are usually unsecured obligations payable from a specified source of funds. For example, a municipal water utility may issue unsecured TXCP notes payable from its water system revenues after provision for debt service on revenue bonds.

Buyers of TXCP notes do not seek or require a pledge of assets or funds by the issuer as security. If buyers have concerns about the issuer they simply do not buy the notes or they will only buy notes that are backed by a bank LOC. However, in lieu of the cost of an LOC, an issuer may consider providing a pledge of assets or funds as security, which may increase the investor base willing to purchase the notes. When issuing TXCP notes without an LOC, an issuer should be aware that investors will likely require regularly updated disclosure, which could take the form of an annually updated TXCP Offering Memorandum that is distributed to investors by the issuer's dealers.

PROCESS FOR APPROVAL

The governing body of the issuer adopts a resolution authorizing the issuance of TXCP notes and the execution of companion documents, including the dealer agreements, the bank line or LOC agreements, and the issuing and paying agent agreement.

PROCESS FOR SALE

Prior to the first sale of TXCP notes, bond counsel assembles a transcript of executed documents authorizing the program—a TXCP transcript is similar to a bond transcript and includes the approving opinion of bond counsel. When the issuer decides to sell TXCP notes, a representative of the issuer confers by telephone with the dealer's commercial paper sales staff. They discuss the issuer's cash needs and the probable interest rates for various TXCP maturities. The following morning, TXCP notes are marketed by the dealer and the issuing and paying agent collects the proceeds of sale for the issuer at midday. This process is repeated for each day that the issuer elects to sell TXCP notes. If an issuer has two or more dealers for its TXCP program, it may be able to obtain lower rates than if it works with only one dealer. However, this would require a larger program to meet dealer minimum size requirements, and requires more staff time to manage the dealers.

OTHER LIMITATIONS ON TXCP

Commercial paper (corporate and tax-exempt) is exempt from registration with the Securities and Exchange Commission and is traditionally sold without a disclosure document prepared by the issuer. Instead, each dealer prepares a brief description of the issue, which it circulates to its

customers as marketing material and usually updates annually. In recent years dealers have requested issuers to prepare and take responsibility for offering circulars or other disclosure documents to be used by dealers in marketing commercial paper and to provide the dealer with Rule 10b-5 disclosure representations and an accompanying 10b-5 opinion of the issuer's counsel. Some TXCP issuers have agreed to comply while others have declined. TXCP issuers who decline to prepare a disclosure document note that Securities and Exchange Commission Rule 15c2-12 (the rule that requires brokers, dealers, and municipal securities dealers to obtain Official Statements from municipal issuers) contains an exemption covering TXCP notes and thus there is no legal requirement that dealers obtain an Official Statement or other disclosure document from the issuer. Many TXCP issuers have been convinced that the simplicity of documentation for a TXCP program is one of its most attractive features and if issuer-prepared disclosure documents accompanied by 10b-5 representations and legal opinions become the industry norm, issuance may become more complex and less attractive. However, investors are increasingly concerned with regular disclosure from issuers and are far less inclined to purchase notes from issuers that do not provide updated disclosure. This applies to programs with bank lines of credit or where the issuer is providing its own liquidity. It does not apply to programs that use bank LOCs as the issuer regards its exposure to be to the bank, not the issuer. In any case, programs that have liquidity support typically must provide fairly regular disclosure of changes to or extensions of the bank line of credit. These updates are an obvious opportunity for the issuer to provide an overall update of its financial position for investors.

LEGAL AUTHORITY

In order to undertake a TXCP program, an issuer must have statutory authority to:

- Issue notes in an unlimited principal amount (although a limitation on the aggregate amount of notes outstanding at any one time is fine)
- Sell notes in a negotiated sale

It is unnecessary for the statute to authorize “commercial paper” notes (although some statutes make specific reference to commercial paper notes). The concept is that notes are sold in the commercial paper market and not that the notes are a special type of note called commercial paper.

Issuers without the requisite statutory authority to sell TXCP notes have another possible way to access the commercial paper market if they can issue bonds bearing variable interest rates. Multi-modal bonds are sometimes issued with a “commercial paper mode” enabling the remarketing agent for those bonds to structure interest rates and maturities to emulate TXCP notes.

SPECIAL FEDERAL TAX ISSUES

The federal tax limitations and requirements for tax-exempt debt, described generally in **Chapter 3, General Federal Tax Requirements**, apply to TXCP and the manner in which proceeds of TXCP are invested and spent. In addition, TXCP presents some challenging federal tax questions in defining the issue of notes to which the federal tax laws apply. Generally, TXCP issued from time to time under the same program documents and increasing in amount or “ramping up” over a period of no more than 18 months can be treated as a single aggregate issue of notes, paying varying interest rates over time. This conclusion is possible, and usually desirable, based on certain elections provided in the U.S. Treasury regulations. If no election is made or available, the TXCP will be treated as an ever increasing number of separate small issues and, in the absence of satisfying certain exceptions, complying with the rebate requirement and arbitrage yield restriction can be virtually impossible. The complexity of these and related issues depends on a variety of factors such as the issuer’s need to ramp up and ramp down the TXCP and the time it will take to spend proceeds of the TXCP.

Chapter 9

SYNTHETIC INTEREST RATE STRUCTURES

INTEREST RATE SWAPS

Issuers of tax-exempt debt (referred to in this chapter as agencies) in the current municipal capital marketplace have more financing options and greater access to innovative instruments tailored to achieving specific financing goals than ever before. One such instrument is the interest rate swap. The global interest rate swap market is remarkably vast, both in terms of size and scope of products, and it continues to grow rapidly. Within the U.S. public finance sector, the use of interest rate swaps and their close relatives is becoming more common as increasing numbers of governmental entities utilize them to reduce their borrowing costs, better manage or limit their interest rate risk, and effect better matching of assets and liabilities.

Although a swap does not itself represent debt, it is usually tied to one or more debt issuances. As such, swaps are used to change the economics of existing or future debt without changing the size or structure of the debt itself. When used as part of a coherent strategy, swaps provide access to different markets and more flexible structures than have been historically available to agencies when straight fixed rate or variable rate debt were the only options. Swaps also can be entered into for any term, and therefore can be useful for addressing near-term cash flow and other liability management needs, for example, during the construction period of a debt-financed project in which an agency does not wish to change the underlying structure of outstanding long-term debt. This chapter provides an overview of the common types of swaps and discussions of how they work. Additional topics addressed are transaction mechanics and documentation, potential benefits and risks, legal and tax issues, and post-trade management.

DEFINITION AND PROCESS

An interest rate swap is a contractual agreement between two parties who agree to exchange (or swap) certain cash flows for a defined period of time. Generally, the cash flows to be swapped relate to interest to be paid or received with respect to some asset or liability. Accordingly, the swap is designed to generate a net change in the interest rate cash flow related to that asset or liability (typically investment securities or bond indebtedness, respectively), but neither impacts the principal of that asset or liability nor results in the creation of any new principal. As a result, the “size” of a swap, for purposes of describing the computational base on which the swapped payments are calculated, is referred to as the notional amount. As part of any swap, both parties agree to:

- The notional amount
- The rate or rate formula each party will use to compute the amounts to be paid to the other on that notional amount
- The dates on which cash flows will be exchanged, and
- The term of the swap

Interest rate swaps typically do not generate new funding like a loan or bond sale; rather, they effectively convert one interest rate basis to a different basis (e.g. from a floating rate to a fixed rate). Additionally, there are swap variations that are structured to achieve altogether different financing goals, such as generating an up-front cash payment. Regardless of the circumstances, agencies should note that issuing variable rate bonds and then entering into a fixed rate swap (thereby creating a synthetic fixed rate debt) is more complex than issuing fixed rate bonds, even though the agency's future debt service obligations should be similar under both. The same is true for agencies that issue fixed rate bonds and then enter into variable rate swaps.

BASIC STRUCTURE

Each swap transaction has its own terms and features, but the typical interest rate swap used in the municipal marketplace provides that one party's payments are calculated using a fixed rate (the "fixed leg") while the other party's payments are calculated using a variable rate (the "floating leg"). The swap documentation identifies the following:

- The set fixed rate
- The specific variable rate index
- The notional amount
- The dates of cash flow exchange
- The conditions of optional and mandatory termination, and
- The scheduled termination date, which defines the term (sometimes referred to as the tenor)

The fixed rate is generally set for the term of the swap. The variable rate can be based on any index (e.g. the Bond Market Association (BMA) Index or London InterBank Offered Rate (LIBOR)), or even a specific security (e.g. an agency's variable bond rate). The underlying index, or other instrument, from which the floating leg payments are calculated is known as the underlying.

If scheduled to occur on the same dates, the fixed payment by one party is netted against the floating payment by the other, such that only a “net settlement” is made by one of the parties on a given payment date. These exchanges take place on the pre-established payment dates and reflect the differences between the two rates during the applicable period.

The Counterparties’ Perspective. In the municipal marketplace, the two parties to a swap are an agency—or, in the case of a conduit bond deal, the conduit borrower—and a financial institution (the provider), typically a commercial bank, an investment bank, or an insurance company. While the agency accomplishes some financial goal (e.g. hedging variable rate exposure, improving asset/liability matches, reducing borrowing costs, etc.) by entering into the swap, the provider will be compensated for establishing its own hedges and the ongoing costs of carrying the swap on its books.

The Agency’s Perspective. Unlike a provider making its business from earning the “bid/ask” spread on a transaction, an agency generally enters into a swap in order to achieve a specific financial objective, such as achieving a lower borrowing cost or hedging interest rate exposure. For example, the most commonly used swap structure—the synthetic fixed rate transaction—is attractive when the net synthetic fixed rate (the fixed swap rate plus the ongoing costs associated with variable rate debt, taking into account reasonable assumptions for basis spread and other risks) is lower than the fixed rate on a traditional fixed rate bond structure. In this scenario, the agency achieves an important financial objective—lowering its borrowing cost—while maintaining the predictability of a fixed interest rate. However, as with any financing structure, the agency must first evaluate the risks associated with a swap and conclude that they can be adequately managed and that the swap is otherwise suitable for the agency.

Regardless of structure, an agency should go beyond the financial analysis required to determine if a swap will achieve its economic objective and review a proposed swap transaction with the same level of diligence it would apply to the consideration of any bond issue. Issues such as rate exposure, basis risk, transaction costs, covenant obligations, security, redemption or refunding flexibility, termination risk, counterparty creditworthiness, and other similar issues should all be carefully considered prior to entering into a swap.

The Provider’s Perspective. Providers typically enter into particular interest rate swaps as part of a large, hedged portfolio. To illustrate, a provider might enter into swap transactions with two different agencies of similar credit, with matching variable interest rates, notional amounts, and terms. The provider would be the receiver of the variable interest rate in one transaction and the payer in the other. However, for the transactions to be economically feasible for the provider, there needs to be a difference in the fixed rate components of the swaps. For example, if in the first transaction the provider is obligated to make payments computed using a fixed rate of 5 percent, the provider would look to structure the second transaction to receive 5 percent plus a spread. This way, the provider will earn that fixed spread (or bid/ask spread) between the two agreements.

The rate an agency will receive from a provider depends on a variety of factors, including the provider's perception of the degree of risk inherent in the transaction. This perception of risk can come from an agency's credit rating, or from provisions in the swap agreement itself that make the arrangement less attractive to the provider. Thus, for many of the same reasons that a lower credit rating may require an agency to issue debt at higher interest rates, an agency's swap rate also can be higher than that of other agencies. The greater the risk perceived by the provider, the higher the interest rate that will be charged to the agency.

TYPES OF SWAPS AND OTHER HEDGES

Interest rate swaps can be used to achieve goals beyond creating synthetic fixed or variable rate debt. Agencies seeking to achieve a variety of financing objectives have a choice among several interest rate swap structures in use today, each having its own set of features and variations. Additionally, because swap agreements are generally flexible as to form, specific provisions can be included to help an agency achieve very certain goals or protect itself against specific risks.

Some of the more common types of swaps include (but are not limited to) the following:

Floating-to-Fixed Rate Swap (Fixed Rate Swap). As an alternative to issuing fixed rate bonds, an agency can instead sell floating rate bonds and simultaneously enter into a fixed rate swap. The goal is to create, on a net basis, a fixed rate obligation. A key consideration for the agency will be the formula and floating rate index (e.g. percent of LIBOR, percent of LIBOR plus a fixed spread, BMA Index, or Cost of Funds Index) to be used in computing its receipts on the floating leg of the swap. The goal is to select a formula and index that will best match, or hedge, the agency's bond interest payments. To the extent the floating leg receipts do not match the variable rate bond interest payments, the agency's net debt service will vary over time and, accordingly, will result in somewhat higher or lower net debt service payments from period to period. This risk of a mismatch between an agency's floating receipt from a swap and its floating payment obligation on the underlying debt is referred to as basis risk, which can result from both the use of different underlying securities or ones of differing maturity terms. The fixed rate achieved through a floating-to-fixed rate swap structure can be lower than the fixed rate that can be attained through a traditional fixed rate bond offering. This is especially true if an agency structures its swap using a LIBOR-based floating payment in exchange for a fixed payment. The rate advantage of a LIBOR-based swap is the result of a combination of factors, including the greater liquidity and efficiency of the taxable swap markets and the agency's assumption of basis risk.

Fixed-to-Floating Rate Swap (Floating Rate Swap). As an alternative to issuing variable rate bonds, the agency can instead sell fixed rate bonds and simultaneously enter into a floating interest rate swap. The goal is to create, on a net basis, a floating rate obligation. An agency may choose to enter into this type of swap arrangement if it wishes to increase its variable rate debt in an effort to cure a mismatch between its fixed and variable rate exposure.

Floating-to-Floating Rate Swap (Basis Swap). In a basis swap, the agency enters into a floating interest rate swap where, for example, the underlying for the first floating leg is the BMA Index and for the second floating leg is the one-month LIBOR rate. Basis swaps are often used to reduce risk associated with potential changes in tax law. Whenever an agency issues floating rate bonds, it takes on the risk that a change in tax law (e.g. a reduction in marginal income tax rates) will decrease the spread between tax-exempt and taxable rates and thus force the agency to pay a higher rate on its outstanding tax-exempt variable rate obligations. If an agency enters into a basis swap with an underlying based on an index that is less affected by changes in tax law (e.g. LIBOR), it can effectively reduce some of the risks associated with changes in tax law.

Forward Swap. Forward swaps are interest rate swaps in which the accrual and exchange of cash flows commences at a later date (the effective date) rather than the current date (on or around the trade date), thereby affording the opportunity to lock in rates today while accruals begin in the future. While forward swaps allow rates to be locked in, the rates will be determined via the “forward rate curve,” which is not the same as the current yield curve. These types of transactions are often used to approximate the benefits of an advance refunding when one is not otherwise permitted under tax law. The forward swap locks in a fixed rate, and then variable rate bonds are issued in the future as current refunding bonds upon the effective date of the swap.

Swaption. A swap option—or “swaption”—is similar to a forward swap in that it outlines the terms of a swap to be entered into in the future. However, in a swaption, one party, usually the provider, has the right but not the obligation, to enter into (or modify or cancel) that swap with the other party (the agency) at a specified fixed rate and floating rate formula, on a specified date or during a specified period in the future. In exchange for that right, the provider will pay an option premium to the agency on the trade date, which can be months or years prior to the swap’s potential effective date.

As with forward swaps, this structure is sometimes used in connection with the refinancing of debt that cannot be advance refunded because of tax law restrictions. In such a case, the fixed rate on the swap that underlies the option is the “strike rate” (which might be structured to equal the average coupon on the outstanding bonds) and the provider may only have a limited time frame (on or just before the first call date of the bonds) to exercise its option. If the provider exercises its option, the agency will issue variable rate bonds at that time, call the outstanding bonds, and on a net basis have created synthetic fixed rate debt as a result. The payments associated with that fixed rate will be approximately the same as prior to the swap. The option premium received by the agency then would be reflective of the agency’s refunding savings. If the provider does not exercise its swaption, the agency will have received its premium while retaining the ability to call the old debt at a later date and, therefore, may have yet another opportunity to refund those bonds.

Interest Rate Caps, Floors, and Collars. An interest rate cap is a hedging tool that protects the agency from rises in short-term interest rates through receiving a payment from the provider when the interest rate on the underlying exceeds a specified strike rate (the “cap rate”). By contrast, in the case of an interest rate floor, the agency would receive a premium and would be obligated to make payments to the provider to the extent the strike rate (the “floor”) exceeded the rate on the underlying. An interest rate collar is a combination of both an interest rate cap and interest rate floor that can be structured such that the cap premium and floor premium offset each other and, therefore, on a net basis, no premiums are paid by the agency.

USES AND BENEFITS

Swap structures are most commonly explored because of the potential reduced borrowing costs, but entering into a swap agreement can benefit an agency in other ways. Beyond any cost savings, the uses and benefits of debt-related swaps by agencies generally can be described as falling into the following four categories:

Asset/Liability Matching. Agencies are becoming increasingly attentive to comprehensive asset/liability management strategies. Historically, debt and investment decisions often were made independently of each other, and governmental agencies typically borrowed at long-term fixed rates and invested at short-term rates. Particularly in an interest rate environment where the yield curve is steep, agencies with significant funds invested short-term have felt the adverse impact of a debt strategy that does not account for such an environment. With their relative ease of structuring, implementation, and termination, swaps can be a useful tool in restructuring the debt side of an agency’s balance sheet to better reflect certain asset positions. Such a unified and coordinated strategy can allow an agency to use either side of the balance sheet to more readily anticipate uncertain cash flow needs that might be presented by the other side.

Hedging of Interest Rate and Market Risks. The most common types of debt-related swaps are floating-to-fixed and fixed-to-floating rate swaps. In the first scenario, a swap is used to create a synthetic fixed rate obligation where the underlying debt is variable. This presents an alternative to issuing true fixed rate debt by allowing the agency to utilize the short-term capital markets while not exposing it to interest rate risk. Under certain market conditions, influenced by factors such as the steepness of the yield curve, credit spreads, and current or expected income tax rates, true fixed rate debt will carry a higher interest cost; therefore, a floating-to-fixed rate swap can serve to lower the borrowing costs of debt. Such swaps also are useful when an agency wishes to convert existing variable rate debt to a fixed rate obligation without the time and costs of a bond refunding. This is particularly common when an agency anticipates a future period of rising interest rates, and wishes to limit its variable rate exposure in connection with given debt for a certain period of time.

In the fixed-to-floating rate swap scenario, synthetic variable rate debt is created where the underlying debt is fixed. In this context, an agency is able to create variable rate debt exposure

without the traditional costs of true variable rate debt (e.g. liquidity, letter of credit, or remarketing fees, etc.) and without exposure to the risk the bonds will be tendered by their holders and not remarketed. In this way, an agency also can achieve a better matching of a given bond issue's short-term assets with the debt, thereby mitigating the risk of significant negative arbitrage on large cash balances. Additionally, this structure is useful for certain borrowers that are unable to easily acquire the necessary insurance or liquidity support for true variable rate debt.

When structured on a forward basis, a floating-to-fixed swap can be used to hedge against rising interest rates, which can be particularly valuable in the context of large or long-term debt restructurings. For example, a forward funding swap can enable an agency to achieve a synthetic advance refunding of fixed rate debt when it is otherwise precluded from doing so by the tax rules limiting advance refundings. Upon entering into a forward swap, an agency can lock in that day's fixed rates, while the swap payments do not actually begin until after the call date of the old bonds. At that point, variable rate current refunding bonds are issued, and the agency has thereby replaced the old true fixed rate debt with synthetic fixed rate debt at current rates (but determined via the forward yield curve). This provides an effective hedge against interest rate risk if an agency considers the current environment to be favorable, and is concerned that such an environment may not exist once the call date of the old debt is reached.

Achieving Access to Different Interest Rate Markets. Swaps are frequently used to lower an agency's borrowing costs by providing access to interest rate markets otherwise unavailable or unattractive with traditional debt structures. While the traditional tax-exempt fixed income market generally provides governmental issuers access to cheaper capital than its taxable counterpart, the greater liquidity and flexibility of the swap market can often present even more borrowing cost savings opportunities. Also, in certain interest rate environments (e.g. historically low rates), the "compression" between taxable and tax-exempt rates can increase the pricing advantage of synthetic fixed rate bonds over traditional fixed rate bonds. Further, swaps can allow an agency to diversify its exposure to different markets, which is often a goal in and of itself.

The creation of synthetic fixed rate or variable rate debt also can enable an agency to maintain some characteristics of one type of debt while accessing some characteristics of another. This allows the agency to optimize its debt positions while also simplifying its overall asset/liability position.

Generating Cash Payments. While most swaps contain defined commencement and maturity dates, it can be advantageous for an agency to sell one or more options to the provider relating to a swap or potential swap. Two examples of these are options to extend and options to cancel (or suspend) the swap. In either case, the option gives the provider increased flexibility in the future management and maintenance of the swap, which may be valuable in certain changing interest rate environments. The benefit to the agency may come in the form of an increased rate

on its receipt under the swap (or decreased rate on its obligation under the swap). Alternatively, these options can be monetized in whole or in part in the form of a cash payment to the agency upon execution of the swap.

Another way to generate cash is through the use of a basis swap with an up-front payment. This can be a stand-alone structure or it can be layered on top of a floating-to-fixed rate swap. This is most appropriate when the agency either is comfortable that the up-front payment outweighs the basis risk being assumed, or already has a basis position to be neutralized by the basis swap. A final tool used to generate a cash payment is to enter into a swaption, under which the provider is sold the option to enter into a swap over a given term.

The agency should note that credit rating agencies may view negatively the use of swaptions and other derivative products solely to generate an up-front cash payment. The use of these products in such a manner may indicate financial weakness, unless the funds are set aside for future derivative-related uses.

BUSINESS RISKS

When entering into a swap, the agency anticipates that the provider will honor its obligations for the full term of the swap—unless the agency exercises its early termination option. Further, when entering into a synthetic fixed rate swap, to convert variable rate debt to a fixed rate obligation, the agency expects that the variable rate payments it receives under the swap will closely approximate the interest rate on the related debt. There are risks, however, that such expectations will not be fulfilled.

Provider/Counterparty Risk. Counterparty risk is the risk that the counterparty will not honor its payment obligations under the swap contract because the counterparty has defaulted. If that happens, the issuer no longer receives payments from the counterparty. This risk can be addressed through the establishment of guidelines for exposure levels, ratings thresholds, and, particularly, establishing collateralization requirements. Many entities attempt to mitigate this risk by swapping only with counterparties with ratings of AA or higher.

Basis Risk. Basis risk occurs in situations when the variable rate paid by the issuer on its bonds is different than the floating interest rate received under the swap. Swaps commonly use an index such as LIBOR or the BMA Index. Historically, 67 percent of LIBOR or 100 percent of the BMA Index approximates an issuer's cost of variable rate borrowing, but at certain times, the discrepancies between the actual cost of the issuer's variable rate and the index rate it receives can be significant. In the event that an unfavorable significant difference occurs, the issuer, who expected to pay a fixed rate on the swap, also must cover the spread or difference between the variable rate it pays and the variable rate it receives.

Termination Risk. Termination risk is the risk that a swap may terminate or be terminated prior to its planned expiration. This risk can be managed by assessing possible events

that could trigger the early termination of a swap. If a swap is terminated earlier than expected due to the default of the counterparty, the issuer still may be required to make a termination payment. The termination payment is the economic value of the difference between current rates and the contracted swap rate for the remaining life of the swap.

Rollover Risk. Rollover risk occurs when the term of the bond or asset being hedged does not coincide with the term of the swap. Rollover risk refers to the possibility that the issuer is unable to enter into a satisfactory new contract when the original one expires. For example, the issuer may enter into a 5-year swap contract after issuing bonds, but the bonds may have been issued for a 20-year period. Thus, after 5 years, a new swap would have to be initiated at prevailing rates for the remaining 15 years.

Amortization Risk. Amortization risk is defined as the mismatch of the expiration of the underlying obligation and its hedge, the swap agreement. Amortization risk is the possibility that, as a result of an early redemption of the underlying bonds, the repayment schedule of the bonds differs from the underlying notional amount of the swap agreement. This risk will only arise if the issuer wants to redeem the bonds ahead of schedule.

Tax Risk. Tax risk is the risk associated with changes to the marginal tax rate. Interest rates on tax-exempt municipal bonds are, in part, a function of the marginal income tax rate for current and potential bondholders. For example, as the marginal tax rate increases, municipal bonds become more attractive, and conversely, as tax rates fall, tax-exempt bonds become less attractive.

ACQUIRING A SWAP

The emergence of swaps has introduced an additional complexity to the issuance of public debt, which is already complicated by a myriad of federal and state rules and regulations. Along with the real world benefits of the prudent use of swaps comes the responsibility of understanding the mechanics, benefits, and perhaps most important, the risks. Thus, because of the added intricacies that a swap can bring to tax-exempt financing, there are additional issues that an agency must consider when entering into a swap agreement beyond those of a traditional issue of tax-exempt debt.

Subject to the caveat that there is a limit to the amount of the “unhedgeable” risk a provider can and will take on, swap agreements are very flexible. As mentioned previously, features that are difficult for the provider to hedge (or cannot effectively be hedged) come at a “cost,” and there may be features, if analyzed separately, that cost the provider more than they can benefit the agency and therefore may not be to the agency’s advantage. Thus, in evaluating and negotiating a proposed swap transaction, it is important that the agency be able to delineate the cost components of the swap and understand not only its own needs and objectives, but also the needs and objectives of the provider.

When an agency undertakes to issue new tax-exempt debt, one of its first and most important tasks is to assemble the appropriate financing team. In the case of a traditional offering, a financing team usually consists of the following:

- Agency
- Underwriter(s)
- Bond counsel
- Financial advisor
- Disclosure counsel
- Trustee

However, given the unique and specialized nature of swaps, if a swap is utilized in a debt offering, the agency may wish to add a swap advisor and/or swap legal counsel to the financing team. A swap advisor can offer an agency a diverse line of services tailored to help the agency analyze, develop, and implement a comprehensive swap strategy.

Developing a Swap Policy. It is increasingly considered prudent financial management for governmental entities considering the use of an interest rate swap to put into place a written swap policy. The purpose of a swap policy is to establish guidelines for the execution and management of the swap program. A swap policy confirms the commitment of management, staff, advisors, and other decision makers to adhere to sound financial and risk management practices, including achieving the lowest possible cost of capital within prudent risk parameters. The entity's governing body should approve the swap policy prior to entering into an interest rate swap. Issuers should review, analyze, and modify swap policies to include the following:

- **Overall Strategy.** Describes how and why swaps will complement the overall debt management plan. A key ingredient to the overall strategy is to prohibit swaps to be used for speculative purposes.
- **Authorization.** Provides information on the types of swaps allowed and who has the authority to approve their use
- **Risk Analysis.** Requires a comprehensive risk analysis of individual swaps and their impact on the total debt portfolio. This would include a detailed analysis of counterparty, basis, termination, amortization, and tax risks described earlier in this chapter.
- **Third-Party Relationships/Bid Process.** Dealings with banking partners should be structured and executed in a manner consistent with standing practices for procuring

investment banking and other similar services, so as to achieve the highest level of service at the best available terms

- **Monitoring, Reporting, and Disclosure.** Documents should follow International Swaps and Derivatives Association, Inc. (ISDA) guidelines and be prepared and updated to provide accurate and appropriate information to credit rating agencies, bondholders, and the issuer's governing body. The Government Finance Officers Association (GFOA) issued a recommended practices document titled *Use of Debt Related Derivatives Product and the Development of a Derivatives Policy* in 2003 that outlines many of these elements. Issuers should assess the monitoring and disclosure workload and system requirements as part of developing a swap policy.

A swap advisor and legal counsel expert in swap transactions can assist in the development and implementation of swap policies.

The Bidding Process. An agency has two basic approaches to acquiring, or entering into, an interest rate swap:

- Conduct a competitive bid process, or
- Negotiate the terms with a pre-selected provider

As with the sale of bonds or other governmental debt, the advantages and disadvantages of the competitive versus negotiated transaction are debatable and difficult to quantify given the complexities of today's financial markets. With appropriate prudence and safeguards, an agency can acquire a fairly priced swap with either approach. A general discussion of the competitive and negotiated bid process can be found in **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser.**

LEGAL ISSUES

California was one of the first states in the nation to enact clear legislative authority for public entities to enter into swaps and other hedging instruments—first in 1986 for use in conjunction with taxable bonds (Government Code Section 5903) and again in 1987 for use in connection with any state or local government bonds or in connection with any investment or investment program (Government Code Section 5922). Government Code Section 5922 reads as follows:

“Notwithstanding any other provision of law, all of the following apply:

In connection with, or incidental to, the issuance or carrying of bonds, or acquisition or carrying of any investment or program of investment, any state or local government may enter into any contracts which the state or local government determines to be necessary or appropriate to place the obligations or investment of the state or local government, as represented by the bonds, investment or program of investment and the contract or contracts, in whole or in part, on the interest rate, currency, cash flow, or other basis desired by the state

or local government, including, without limitation, contracts commonly known as interest rate swap agreements, currency swap agreements, forward payment conversion agreements, futures, or contracts providing for payments based on levels of, or changes in, interest rates, currency exchange rates, stock or other indices, or contracts to exchange cash flows or a series of payments, or contracts, including, without limitation, interest rate floors or caps, options, puts or calls to hedge payment, currency, rate, spread, or similar exposure. These contracts or arrangements also may be entered into by state or local governments in connection with, or incidental to, entering into or maintaining any agreement that secures bonds, including bonds issued by private entities. These contracts and arrangements shall be entered into with the parties, selected by the means, and contain the payment, security, default, remedy, and other terms and conditions, determined by the state or local government, after giving due consideration for the creditworthiness of the counterparties, where applicable, including any rating by a nationally recognized rating agency or any other criteria as may be appropriate.”

The "in connection with" bonds or investments requirement is intended to prohibit use of swaps as a speculative investment vehicle as distinguished from an instrument to hedge certain types of risk or exposure associated with bonds or investments, to lower the cost of borrowing, or to increase the expected yield on investments. The statutory authorization generally has been viewed by counsel as broad enough to cover forward swaps—for example, an interest rate lock or a swap that is part of a synthetic advance refunding—even if the bonds are not to be issued until months or years later or if the bonds are not issued at all (so long as they are expected to be issued at the time the swap is entered into). The statutory authority also is broad enough to cover almost any type of financial hedging instrument, and authorizes security (e.g. pledges) and other terms that are determined by the state and local government to be appropriate.

While the foregoing California Government Code provisions provide clear statutory authority for swaps applicable to all state or local governments, the state, a city, a county, or a school district may not enter into a swap if the swap constitutes an "indebtedness" or "liability" within the meaning of State Constitution Article XVI, Section 1 (applicable to the state) or Section 18 (applicable to cities, counties, and school districts). There is little case law in California or other states analyzing how swaps are to be treated for such purposes. However, counsel can generally render a qualified opinion to the effect that the swap would/should not constitute an indebtedness or liability for purposes of these constitutional debt limitations, and such opinions have generally been acceptable to providers.¹² Entities other than the state, a city, a county, or a school district—such as agencies and authorities, including joint powers authorities and districts other than school districts—are not subject to these constitutional debt limitations.

¹² On the other hand, counsel may not be able to render even a favorable qualified opinion if the public entity subject to these constitutional debt limitations receives an up-front payment from the swap provider for entering into the swap, which is reflected in the above market interest rate on the swap, because such factors may appear to have the attributes of a loan for the purposes of the constitutional debt limitations.

Sources of Payment and Security. It is common and generally appropriate for an agency's obligations under a swap agreement to be payable from the same source as the debt or asset to which the swap relates. If a swap is entered into in connection with an agency's general fund debt or with respect to the investment of general fund assets, for example, the agency's obligations on the swap are usually payable out of the agency's general fund. If the swap is entered into in connection with debt issued under an agency's master trust indenture, it is appropriate for the agency's obligations on the swap to be secured by such master indenture, and if a swap is entered into in connection with the debt or investments of an agency's enterprise fund, the agency's obligations on the swap would normally be payable solely out of the revenues of such enterprise. Swap documents should limit the agency's obligations accordingly. Similarly, cross-default and credit events (usually included in termination events) generally should be limited to the same source of funds.

Integration with Bond Documents. Provisions relative to payments and receipts on swaps entered into in connection with bonds or other debt obligations should be integrated into the bond documents. An indenture executed and delivered in anticipation of a swap should provide for regular swap payments on a parity with debt and should treat amounts received on swaps as a reduction in debt service (as opposed to an addition to revenues). Otherwise, debt service coverage calculations will not reflect the integration accurately.

TAX ISSUES

A swap entered into in connection with an issue of tax-exempt bonds may impact certain tax matters relating to those bonds. Specifically, the nature of the swap structure will determine if the agency may or must take into account the payments under the swap in its determination of arbitrage rebate liability in connection with the bonds.

Section 103 of the Internal Revenue Code of 1986 (the "tax code") provides generally that income on a state or local government bond is exempt from gross income for federal tax purposes so long as, among other things, the bond in question is not an "arbitrage bond" within the meaning of Section 148 of the tax code. An "arbitrage bond" is generally defined by the tax code 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 to acquire higher yielding investments...." Therefore the relevant benchmark in determining whether a bond is an "arbitrage bond" is the yield on the bond.

U.S. Treasury regulations under Section 148 of the tax code provide detailed rules for determining the yield on an issue of bonds, whether fixed or variable rate. In determining that yield, the agency is permitted to take into account certain payments associated with a qualified

hedge.¹³ A hedge is a contract entered into primarily to modify the agency's risk of interest rate changes, such as an interest rate swap contract.

Amounts paid or received by an agency pursuant to a swap contract that meets the definition of a qualified hedge have the effect of increasing or decreasing, respectively, the yield on the bonds and will impact the agency's potential arbitrage rebate liability and yield restriction limitations. Amounts paid by an agency pursuant to such a swap contract will permit the agency to invest the proceeds of the bonds at a higher return. Conversely, amounts received by an agency will lower the rate of return an issuer agency may earn on investments made with bond proceeds.

In general, only liability hedges are taken into account for tax purposes. Asset hedges are not covered by the regulations, although there is at least one Private Letter Ruling permitting a swap to be integrated with an investment for purposes of determining arbitrage compliance.

DOCUMENTATION AND NEGOTIATION

Documentation. Swap agreements are generally based on the ISDA Master Agreement, which was developed with the aim of creating uniformity within the market. The ISDA Master Agreement itself is a pre-printed form, and is accompanied by a Schedule and, if applicable, a Credit Support Annex. The Schedule designates the parties' elections among options presented in the ISDA Master Agreement, amends ISDA Master Agreement provisions as negotiated by the parties, and addresses additional deal terms not covered by the ISDA Master Agreement. The Credit Support Annex, when present, details collateralization requirements, terms, and mechanics. A Confirmation, detailing the terms of that particular transaction, is entered into in connection with each trade. The ISDA Master Agreement, Schedule, and Credit Support Annex are designed to apply to all of a series of swaps entered into between the parties, while the Confirmation relates to each specific transaction.

Swap documentation can be difficult to read and understand because the basic documentation forms do not address precisely the legal and business issues particular to public agencies and tend to be oriented toward the provider. Additionally, swap documentation can cover termination event/payment and other real financial risks to the agency, which can be narrowed or eliminated through careful negotiation. It is, therefore, essential that an agency considers a swap as seriously as the issuance of bonds and be assisted by legal and financial advisors experienced with municipal swap agreements.

¹³ There are several factors that must be considered in order to determine if a swap can qualify as a qualified hedge. Therefore, an agency wishing to integrate its payments made under a swap should consult with appropriate counsel to determine if the swap meets the required definition. An agency must also consider that upon the termination of a swap that is a qualified hedge, the agency must treat any payments received or paid in connection with the termination as payments made or received on the hedged bonds for purposes of determining bond yield. If such payments are made by the agency, bond yield will be increased, and if such payments are received by the agency, bond yield will be decreased.

Major Points of Negotiation. As with any negotiated contract, understanding the needs and perspectives of the other party, as well as one's own, is essential to reaching a mutually satisfying outcome. The process of such negotiations will reflect the relative values assigned by each party to various structures, with the optimal result that the needs of both parties are addressed. The following is a brief list of some of the points that are often subject to negotiation:

- **Downgrade Termination.** Swap agreements generally allow one party to terminate the swap at its market value if the other party's long-term, unsecured debt rating falls below a given level. This provision allows the non-downgraded party an opportunity to exit the swap and eliminate its credit exposure to the downgraded party. The threshold level can vary (below "A-/A3" and below "BBB-/Baa3" are common).
- **Cross-Default Termination.** Swap agreements generally allow one party to terminate the swap at its market value if the other party defaults on other obligations of particular types ("specified indebtedness") above a specified size (the "threshold amount"). Specified indebtedness should be limited to obligations relevant to the sources from which the agency is obligated to make payments on the swap. The specified indebtedness and threshold amount should reflect an order of magnitude indicating significant financial difficulty in the case of default. It is, therefore, not uncommon for the threshold amount for the provider (generally a large financial institution) to be significantly greater than the threshold amount for the agency.
- **Incipient Illegality.** Swap agreements may contain provisions allowing the provider to terminate the swap upon the occurrence of an "incipient illegality"—for example, introduction or enactment of legislation, a public declaration by the agency, etc. challenging the validity of swaps similar to the agency's swap. The rationale is that if an event occurs that would make the swap agreement invalid, the provider should be empowered to take action before such "illegality" is in fact formalized. The agency must be certain that the definition of "incipient illegality" is not so broad as to result in an unwarranted termination of the swap.
- **One-way Termination; Two-way Termination.** Two-way termination—non-defaulting party required to pay defaulting party on termination if non-defaulting party is "out of the money"¹⁴—is the norm for swap transactions. However, given that it can be politically unpalatable for a public agency to make a potentially very large unexpected payment to a defaulting provider, an agency may wish to negotiate for a one-way termination—that is, only a defaulting party is obligated to pay a termination payment.

¹⁴ A party may be "out of the money" if market interest rates have changed to its disadvantage (e.g. an agency that enters into a swap as the fixed rate payer and interest rates subsequently decline).

- **Optional Termination.** An agency should have the right to optionally terminate a swap “at market” at any time. The particular mechanics, though, can be the subject of further negotiation. Typically, providers can unilaterally terminate the swap agreement only upon the occurrence of agency downgrade or default.
- **Collateralization.** Swap agreements may require a party that is “out of the money” above a certain threshold to post collateral or provide for collateralization as an alternative to termination for credit downgrade. Points of negotiation include the thresholds at which collateralization will be required (which generally depend upon the long-term, unsecured debt rating of the party at the time), the types of collateral permitted, the level of collateralization, and the frequency of valuation. An obligation to post collateral may present significant financial, and in some cases legal, difficulties for an agency.
- **Set-off.** A set-off provision enables a party that is entitled to a payment under the swap agreement (e.g. a termination payment) to satisfy that obligation by reducing the amount it owes the other party in another transaction. Accordingly, a set-off provision is a way to manage credit exposure. A set-off provision would allow a provider to debit any deposit accounts the agency has with the provider or an affiliate of the provider to satisfy amounts payable to the provider. For an agency, for whom monies are not necessarily interchangeable, a set-off provision can complicate the agency’s other business dealings with the provider.
- **Term Out.** A term out provision allows the agency to make payments over time for any amount it may be required to pay upon termination of a swap
- **Transfer or Assignment.** The parties’ ability to assign their rights and obligations under a swap (e.g. to an affiliate or to another bond indenture) are often negotiated since an assignment can have major credit implications
- **Swap Insurance.** Swap insurance provides that the agency’s payment obligations under the swap are insured. The terms of such insurance are fairly standardized, however, the presence of swap insurance can have a significant impact on negotiations relating to other credit related points described above.
- **Dispute Resolution Points.** In addition to the negotiation points related to termination and credit issues discussed above, dispute resolution points are often negotiated between the parties as well. For example, the parties will agree how any settlement amounts will be calculated (e.g. market quotation versus firm bid), what state law will govern the transaction (typically New York), and the jurisdiction and venue that would settle any dispute that might arise. Additionally, providers often ask the agency to waive its sovereign immunity and its right to a jury trial. When negotiating, an agency should be aware of its own internal policies as well as applicable state law to determine if such waivers are allowed.

AFTER THE CLOSE: POST-TRADE MANAGEMENT

Part of any decision to incorporate interest rate swaps into an agency's overall debt management plan should be a strategy for managing the swap on an ongoing basis. This includes:

- Monitoring the performance and effectiveness of the swap
- Accounting for a changing valuation and position of the swap, and
- Periodically disclosing the associated terms and risks

Financial Management. When initially structured, a given swap will contain a stated termination date. This is the date through which the swap will remain in effect in the absence of any voluntary or involuntary termination under the swap documents. However, an agency should not simply assume that all will go as planned, or that the scheduled termination date will or should be reached. Rather, procedures should be in place to monitor the potential advantages of a negotiated (voluntary) termination and to monitor the risks and consequences of any other kind of early termination. Thus, it is important that an agency that makes use of swap structures have a strategy in place for monitoring changes in the interest rate environment. As with other financing structures, swaps are very sensitive to changing market conditions and a successful swap strategy should allow for quick action to take advantage of favorable market conditions while those conditions still exist.

Risk Monitoring. An agency also should monitor changing business risks. While the risks to a swap agreement are considered at the time a swap is structured, changes in market conditions, counterparty creditworthiness, and even the tax and regulatory environments might effect a change in how the agency values and accounts for the swap. An agency should develop a plan of action to continually monitor and deal with these risks so that it is not caught off guard should a problem arise. Markets and circumstances can change rapidly, and it can be costly for an agency to be caught reacting to changes after they occur (even if they directly affect only the provider) without monitoring procedures and plans in place.

Accounting and Disclosure. With the introduction of Financial Accounting Standards Board (FASB) 133 and Government Accounting Standards Board (GASB) Technical Bulletin No. 2003-1, an agency using swaps in connection with the issuance of tax-exempt debt should be aware of the additional accounting and disclosure requirements for swaps and the potential impact on its balance sheet. Unlike in the case of accounting for traditional outstanding bonds, an agency using swaps must generally account for and reflect the performance of its swap portfolio in its financial statements.

Under FASB 133, agencies reporting financial results under FASB guidelines must report payments made and received under a swap with interest expense on the balance sheet. Furthermore, all swaps must be recorded as assets or liabilities (depending on whether the swap

is in a gain or loss position) at fair market value. Unrealized gains or losses for a given period must be reflected in the earnings for that period. In volatile environments, this can result in large differences from one period to the next.

For agencies reporting under the guidance of GASB, GASB Technical Bulletin No. 2003-1 outlines a number of items that should be disclosed in the financial statement notes for swaps not reported at fair market value on the balance sheet on a given reporting date. These items include:

- The agency's objective in entering into the swap
- The significant terms of the swap
- The fair market value of the swap
- Updated exposure to any relevant risks, and
- The net cash flow of the swap as it relates to the obligations of the underlying debt

Swaps may have a significant impact on an agency's overall financial position and may present risks material to the holder or purchasers of an agency's bonds. An agency must take care, therefore, to insure that its swaps and attendant risks are adequately disclosed in Official Statements and continuing disclosure reports. In order to comply with their financial reporting obligations, agencies need to have in place a mechanism to periodically value (mark-to-market) swaps for annual and internal accounting purposes.

Chapter 10

CONTINUING DISCLOSURE AND INVESTOR RELATIONS PROGRAMS

In order to issue debt, an issuer is required to provide disclosure (usually in the form of an Official Statement) to actual and potential investors at the time the debt is originally issued. Descriptions of the process of preparing this initial disclosure are provided in **Chapter 1, Overview of a Debt Financing** in the sections titled **Roles and Responsibilities of Principal Participants** and **Basic Legal Documents**. In addition, issuers are required in most cases to provide certain ongoing disclosure to investors and the market regarding their outstanding issues. This chapter of the *California Debt Issuance Primer* discusses these ongoing disclosure requirements and the related topic of investor relations programs.

When an Official Statement is prepared, issuers and their teams make line-by-line decisions about whether information is material to investors. However, despite the customary emphasis placed on the Official Statement, new issue disclosure in an Official Statement should be understood to be just one part of an overall program of continuing disclosure provided by each issuer in response to:

- Legal requirements
- The issuer's governmental functions, and
- The need for efficiency in transmitting material information to investors

Regardless of the requirements of the Securities and Exchange Commission's (SEC) securities laws and rules, issuers should determine whether it is in their financial interest and the interest of the public they serve to:

- Provide continuing disclosure on a periodic basis more frequently than required by securities laws
- Establish a procedure for the communication of material new developments in a format appropriate for investors, and
- Create an investor relations program

In considering these possibilities for extending investor disclosure, it is important for issuers of municipal securities to review the existing legal requirements for continuing disclosure. In

addition, it is useful to understand the separate legal requirements for private corporations in making continuing disclosure and to recognize the differences between corporate finance and public finance. The corporate model is based on distinct requirements of the securities laws and the stock exchanges, however the corporate rules are based on practical experience and thus provide useful insights for municipal issuers who are developing voluntary disclosure programs.

CONTINUING DISCLOSURE REQUIREMENTS

SEC Rule 15c2-12 requires issuers of municipal securities and certain other “obligated persons” to make contractual promises to provide continuing information to the marketplace during the life of securities’ issues. An underwriter is not permitted to purchase or sell municipal securities in connection with a primary offering of \$1 million or more unless it has “reasonably determined” that an issuer of municipal securities or an obligated person has undertaken in a written agreement for the benefit of holders of the securities to provide (by filing with certain specified national and state information repositories) the following four categories of information:

- Certain annual financial information for each obligated person for whom financial information or operating data is presented in the final Official Statement, or for obligated persons meeting certain objective criteria
- If not provided with the annual financial information, then when and if available, the audited financial statements of the obligated person(s)
- Timely notices of the occurrence of any of the 11 events described later in this chapter, if material to bondholders
- Notice of any failure to file the required annual financial information

An obligated person is defined to mean “any person who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold,” and will be required to provide continuing disclosure. In pure conduit financings, the borrower/obligor will often undertake the full responsibility for continuing disclosure.

The annual financial information for the annual report is to be “financial information or operating data . . . of the type included in the final Official Statement with respect to such obligated person” Generally, this will be quantitative data derived from the obligated person’s records. Financial information is described by the SEC as the type of information that is provided in the financial statements of a corporation subject to generally accepted accounting principles. Nonetheless, it is recognized that many governmental entities do not report their financial information in the form of a corporate balance sheet, income statement, or changes in fund balances.

The operating data required to be provided annually, like the financial information, is operating data of the type set forth in the Official Statement. The SEC uses a hospital financing to illustrate the intended requirements. An Official Statement for a hospital financing describes the hospital, its administration and management, economic base, service area, and capital plans. This information is not operating data. Operating data includes such statistics as bed utilization, admissions, categories of admissions (such as coronary care, pediatrics, etc.), and payor information (such as percentages of Medicare, Medicaid, and private insurance). It is this information, which varies from year to year, that is considered operating data subject to the annual disclosure requirements.

To summarize, the final Official Statement—a disclosure document drafted in light of the requirement of the federal securities laws to disclose material facts—is the determining source of the financial information and operating data to be provided annually. Nonquantitative information disclosed in the final Official Statement that is neither financial information nor operating data is not subject to annual disclosure regardless of its materiality unless its disclosure is necessary to prevent the quantitative disclosure from being misleading. Although there is no legal duty to disclose nonquantitative material information annually, issuers may find that it is in their best interests to undertake voluntarily a program of more comprehensive annual disclosure. The full text of SEC Rule 15c2-12 is set out in **Appendix D – Legal References**.

DisclosureUSA; Central Post Office

On September 7, 2004, SEC staff issued an Interpretative Letter expressing the view that an issuer that chooses to satisfy an existing undertaking under SEC Rule 15c2-12 by transmitting continuing disclosure filings, either directly or indirectly, through an indenture trustee or a designated agent to DisclosureUSA for submission to the Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) and any applicable State Information Depository (SID), is acting in a manner consistent with the intent of Rule 15c2-12. Accordingly, local agencies may now make continuing disclosure filings under Rule 15c2-12 electronically at a single location through the use of the website or “central post office” created for this purpose at **www.DisclosureUSA.org**. DisclosureUSA is an Internet-based electronic filing system whereby issuers and other filers may upload documents for immediate transmission, together with Committee on Uniform Securities Identification Procedures (CUSIP) numbers and other indexing information, to each NRMSIR and any appropriate SID.

The DisclosureUSA website is a “central post office” that forwards local agency filings to each NRMSIR and any applicable SID. By filing with DisclosureUSA, local agencies need not file directly with the NRMSIRs and SIDs. DisclosureUSA provides an electronic return receipt to filers as evidence that a filing has been received by each NRMSIR and, if required, each SID. The website also includes an optional electronic “tickler” system to notify persons and agencies of upcoming filing deadlines.

If a local agency is unable to submit its filings electronically, it may submit paper filings for a fee. The filings will be converted to electronic format, indexed, and forwarded to the NRMSIRs and any appropriate SIDs. Electronic filings made on the DisclosureUSA website are free of charge.

Distinguishing Corporate Periodic Disclosure

The requirement that annual financial information be determined by reference to the final Official Statement is highly significant and is best understood by comparison with corporate requirements. The regulatory model for corporate finance, based on Congressional enactment of Sections 12, 13, and 15 of the Securities Exchange Act of 1934 (“1934 Act”), authorizes the SEC to define line item continuing disclosure rules directly mandating the use of Forms 10-K and 10-Q by 1934 Act reporting companies. SEC Regulation S-K provides specific line item disclosure requirements of general applicability for all reporting companies regardless of variations in the industries they represent.

For public finance, the SEC has determined that rules of general applicability would be unworkable as the issuers of municipal securities are simply too diverse. In addition, Section 103 of the Internal Revenue Code of 1986, as amended, permits tax-exempt financings by states and political subdivisions in which capital is raised for persons other than the governmental issuer of the securities. These various “obligated persons” compound the diversity in public finance. The SEC concluded that for public finance it would be necessary to modify the line item regulatory model contained in SEC rules and regulations that are applied to 1934 Act reporting companies.

Rule 15c2-12(b)(5) developed a standard of annual disclosure that was designed to provide flexibility for each offering of municipal securities. The line items for continuing disclosure are derived from the information set forth in the Official Statement. The Official Statement is prepared under the standard of care required by Section 17 of the Securities Act of 1933 and by Section 10 of the 1934 Act, including Rule 10b-5. The full text of these provisions is set out in **Appendix D – Legal References**.

An Official Statement must contain all information that is material to the offering in light of the circumstances in which the information is given. Rule 15c2-12(b)(5) requires that the financial information and operating data, determined at the time of preparation of the Official Statement to be material, is to form the basis of the line item annual disclosure drafted into the continuing disclosure agreement.

The public finance model accordingly establishes a set of line item continuing disclosure requirements unique to each financing. The method for determining the line items is found in the rule, but the line items dictating the content of annual disclosure must be drafted into a contract for each financing—the continuing disclosure agreement—in order to bind the issuer or other obligated persons.

The SEC's recognition that municipal issuers cannot be subjected to the rules of general applicability that apply to for-profit private corporations should be fully appreciated when developing a voluntary program for more frequent or more extensive continuing disclosure than required by Rule 15c2-12, and for developing an investor relations program. Like the Official Statement and the continuing disclosure obligation, voluntary programs are apt to vary among the different types of municipal issuers.

Continuing Disclosure Agreement

The contractual undertaking required by Rule 15c2-12—the continuing disclosure agreement—must:

- Include the name(s) of the entity or entities that will provide the annual reports and event reports, either by name or by describing objective criteria
- Specify the type of financial information and operating data that will be included in the annual report
- Specify the accounting principles to be used for any financial statements, and whether they will be audited
- Indicate the date in each year by which the annual report for the preceding fiscal year will be provided

The promise to make the annual reports and the event reports must be included in the trust indenture, bond resolution, loan or lease agreement, or some other document that is enforceable by bondholders, and also must be reflected in the bond purchase contract or notice of sale for competitively bid issues, and described fully in the Official Statement. Noncompliance must be reported to the repositories and disclosed in future Official Statements for five years, thus adversely affecting the market for the issuer's bonds.

Event Disclosure

The 11 events that must be disclosed, when they occur, are:

- Principal and interest payment delinquencies
- Nonpayment related defaults
- Unscheduled draws on debt service reserves reflecting financial difficulties
- Unscheduled draws on credit enhancements reflecting financial difficulties
- Substitution of credit or liquidity providers, or their failure to perform

- Adverse tax opinions or events affecting the tax-exempt status of the security
- Modifications to rights of security holders
- Optional or unscheduled bond calls
- Defeasances
- Release, substitution, or sale of property securing repayment of the securities
- Rating changes

Exemptions from Rule 15c2-12

Certain exemptions apply to Rule 15c2-12. The primary market and continuing disclosure provisions of Rule 15c2-12 do not apply to a primary offering of bonds in authorized denominations of \$100,000 or more if:

- Sale is made to no more than 35 sophisticated investors (as defined)
- Bonds have a maturity of nine months or less
- Bonds have tender rights at par at least every nine months

In addition, there are two partial exemptions for the continuing disclosure rules only:

- The requirement to provide annual reports will not be applied to issues with 18 months or less maturity (but they must undertake to make the event disclosures)
- Certain “small issuers” (i.e. no obligated person with respect to more than \$10 million in outstanding bonds at the time of the issuance) may make less specific annual reports, and file them in fewer places. These small issuers must still make the event disclosures.

Reasons Not to Expand Continuing Disclosure

Unless one of the listed 11 events occurs, continuing disclosure under SEC Rule 15c2-12 is on an annual basis and is limited to predetermined financial information and operating data contained in the Official Statement. The continuing disclosure requirement therefore does not necessarily include all material information. In determining whether to voluntarily expand continuing disclosure to quarterly or semiannual periods or to cover more extensive information, an issuer of municipal securities should consider the following reasons not to provide more information:

- If the issuer is exempt under SEC Rule 15c2-12, it is arguable that continuing disclosure is not material to the marketplace. For example, securities of an issuer

subject to the small issuer exemption may not actively trade and therefore the benefit to the market may be outweighed by the cost to the issuer. However, while unenhanced issuers of variable rate demand obligations (VRDOs) technically qualify for the exemption, the marketplace—particularly money market funds—does need regular updates of financial and operating data, and many investors may not purchase an unenhanced VRDO if continuing disclosure is not available.

- If the issuer is a conduit issuer, continuing information about the issuer may not be material. For example, if the issuer finances hospitals, universities, private companies, etc., material continuing disclosure is more likely to be based on information about the underlying borrower.
- The issuer may not be able to prepare financial information and operating data at intervals more frequently than annually. The 1934 Act requires reporting companies to bear the cost of preparing the quarterly financial information included in Form 10-Q, but the expense of quarterly or semiannual accounting procedures may not be justified for a municipal issuer of debt that trades relatively infrequently when compared to a corporate issuer of stock.
- Material misstatements or omissions in the annual or event reports may be the basis for claims of securities fraud under Rule 10b-5 and other federal or state securities laws, actionable by the SEC or private plaintiffs (bondholders or other investors), with potential liability for issuers or other obligated persons

Reasons for Expanding Annual Continuing Disclosure

The diversity of the municipal securities market necessitates that any decision to bear the cost of voluntarily expanding the continuing disclosure obligation will require consideration of a number of factors including:

- The amount of debt outstanding
- The size of the issuer
- The type of securities issued
- The volatility of secondary market prices
- The volume of trading activity
- Whether material information about the issuer or its securities frequently changes
- The practicality of preparing periodic information

The following points illustrate why many issuers may choose to expand disclosure:

- The preparation of regular periodic information provides the issuer with opportunities for managerial control of information. Preparation of disclosure information at the time of drafting an Official Statement may be a highly inconvenient time for the issuer to assemble information. Furthermore, the pressures from underwriters and lawyers in the context of a new distribution to gather information may result in a loss of control of the substance and format of the disclosure. If market information is prepared outside the context of a new offering, the issuer is in a better position to time the preparation of disclosure to the receipt of internal information, such as the annual audit.
- If, for example, an information package is prepared each February 1 and August 1, staff can be organized on key dates before the information package is delivered to assemble the necessary information
- Periodic updates allow the possibility of Official Statements cross-referencing the information already in the marketplace. This is the corporate model. New corporate issues for many reporting companies incorporate by reference the information previously filed on Forms 10-K and 10-Q. SEC Rule 15c2-12 was drafted to allow new issue disclosure in Official Statements to reference existing disclosure in the marketplace. An Official Statement that cross-references periodic disclosure can therefore be an abbreviated document requiring considerably less time to prepare than is ordinarily the case.
- A portion of the Official Statements of many frequent issuers contains information that is relatively constant and can be reviewed at periodic intervals without the necessity of review each time an Official Statement is prepared
- There are circumstances in which a variety of issuers have the same “obligated person” providing security. The obligated person can control the disclosure about itself by periodic filings at the national repositories. The various issuers cross-reference the information periodically filed by the obligated person.
- The SEC and many scholars prefer the corporate model of emphasizing regular, periodic disclosure rather than disclosure when capital is formed by the issuance of bonds. The information transmitted to investors is said to be more efficiently communicated to the benefit of both the marketplace and the issuers.

Reasons for Expanding Event Disclosure

The timely disclosure of the listed 11 events does not require timely disclosure of all material information—an approach that follows the corporate requirements of the federal securities laws. Reporting companies under the 1934 Act are required to file timely reports on specific events on Form 8-K, otherwise there is no general securities law requirement to disclose material information until the filing of the next Form 10-Q or 10-K.

Many private companies, however, trade on exchanges or are subject to National Association of Securities Dealers (NASD) rules for over-the-counter trading. For example, the New York Stock Exchange (NYSE) Manual provides as follows:

- A listed company is expected to release quickly to the public any news or information that might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement that the company enters into with the NYSE.
- A listed company also should act promptly to dispel unfounded rumors that result in unusual market activity or price variations
- It should be a company's primary concern to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to the facts. Any projections of financial data, for example, should be soundly based, appropriately qualified, conservative, and factual. Excessive or misleading conservatism should be avoided. Likewise, the repetitive release of essentially the same information is not appropriate.
- Few things are more damaging to a company's shareholder relations or to the general public's regard for a company's securities than information improperly withheld. On the other hand, volumes of press releases are not useful since important items can become confused with trivia.

The SEC does not address timely disclosure of material information because it is extensively covered by self-regulatory agencies, such as the stock exchanges. The NYSE Manual deals with the means of timely disclosure in the following manner:

“The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press ‘For Immediate Release.’”

The need for immediate disclosure may not be as apparent in the less volatile municipal debt market as it is in the more unpredictable corporate stock market. However, the corporate disclosure system sets a standard that should be evaluated in light of the issuer's circumstances. The Government Finance Officers Association (GFOA) urges prompt disclosure of material information but suggests that filing with a repository rather than a press release ordinarily will be an appropriate channel of communication.

A major reason the NYSE and other self-regulatory organizations that govern disclosure of private corporations are adamant about timely disclosure of material financial news is managerial control. It is in the best interest of both the corporation and investors for the corporation to control the flow of information to the marketplace. If management does not release material

information promptly, it is likely to find itself responding to rumors and attempting to correct misinformation.

The problem of rumor and misinformation is particularly significant in the public sector. The news media is likely to uncover information, or politicians with their own agendas are likely to leak information, if it is not released in an orderly manner by officials responsible for communications with investors. Neither the media nor politicians should be the primary source of dissemination of material information.

INVESTOR RELATIONS PROGRAM

An investor relations program has two purposes. First, it is designed for the orderly dissemination of material information to the marketplace. Second, it establishes an effective means for responding to requests for information from investors. Both purposes serve to prevent misinformation from circulating in the marketplace.

To achieve the first purpose, an issuer should designate a specific person to be responsible for making or reviewing statements that are calculated to reach investors. The phrase “calculated to reach investors” is legally significant because such statements are subject to the antifraud standards of the securities laws. If such statements are materially misleading or they omit information that make the statements appear disingenuous in light of the circumstances in which they are made, there is a potential for antifraud liability. In the context of a press release, this standard is not difficult to meet—it simply requires that, relative to the topic under discussion, the spokesperson does not intend to mislead the recipient of the information by either misinformation or omission of information. The spokesperson also should “adhere to the facts,” an expression used by the SEC in describing the standard for press releases, and not engage in speculation.

When a specific person is designated to make investor communications, the designation should be made known generally to the financial press, analysts, rating agency personnel, or any other person likely to act as a conduit between the issuer and investors. This information puts the media on notice that statements made by others—particularly politicians running for office—and rumors should be verified with the financial spokesperson. The responsibility for any misinformation is thereby shifted to the person who fails to verify statements with the financial spokesperson.

The designation of a specific person for financial communications is also the basis for an investor relations program that focuses on inquiries to the issuer outside the context of information being disseminated by the issuer. Inquiries to the issuer from rating agencies, analysts, investment bankers, the press, institutional investors, and individual investors should be channeled to a specific office, and the telephone number of that office should be made readily available. Copies of written reports, including the annual continuing disclosure, any periodic disclosures, any recent Official Statements, and other materials likely to be requested by

investors, financial intermediaries, or the financial press should be available in sufficient quantities for prompt mailing.

Responses to questions by investors, financial intermediaries, or the financial press generally do not create a duty for the issuer to transmit the same information to others. Such an obligation would have a stifling effect on the free communication of informal information between issuers and investors. This obligation also would limit one of the benefits of the securities laws, which encourages efficient markets by allowing investors to make inquiries of issuers. Such a policy promotes diligence by investors and should not be impeded by a contrary policy that would inhibit an issuer from responding to questions from investors. If, however, such inquiries result in the discovery of a material mistake in an Official Statement, an annual report, or similar document intended for investors, there is a securities law obligation to correct the mistake by sending the correction by a means reasonably likely to be received by those acting on the incorrect information. Other than this duty to correct, however, the fact that the inquiring investor has more up-to-date information than other investors is not problematic under the securities laws.

GFOA recommends that governmental issuers use their websites to disseminate information to the municipal securities market regarding their debt, financial condition, and other related information. The Internet, in general, and issuers' websites, in particular, provide a powerful tool for communicating with, and disclosing information to, credit analysts, investors, underwriters, and other municipal market participants. Some of the benefits of using websites are:

- Issuers can augment their means of communicating with the municipal market
- Preliminary Official Statements and other documents used in connection with bond sales are available electronically
- Ongoing disclosure information is accessible to the market, serving the same purposes as required annual filings
- They can be used to archive or store historical documents such as audited financial statements, comprehensive annual financial reports, continuing disclosure filings, and Official Statements so that they are available to investors for reference purposes

Informal communications with investors—such as responding to telephone inquiries—also allows the issuer to control the information about itself that is in the marketplace. This advantage should generally outweigh any perceived disadvantages based on concerns about liability due to misleading statements. The issuer should be forthright and remember the SEC's admonition to "adhere to the facts." If the facts are not clear, a simple "no comment at this time" is appropriate. Sophisticated investors and intermediaries are accustomed to short, factual statements and responses, such as "we do not ordinarily prepare or release that information" when requesting more information than is available. In general, being available but not deviating

from known facts should work to the advantage of the issuer in having good relations with the customers of its debt, the investors.

Chapter 11

INVESTMENT OF BOND PROCEEDS

INTRODUCTION

This chapter contains a discussion of issues relevant to decisions concerning the investment of the monies obtained from issuing bonds prior to their expenditure. Topics include investment objectives, the types of bond proceeds that may be invested and considerations for each, investment policies, evaluation of investment alternatives, and federal tax limitations on investment.

Proceeds of a municipal bond offering are usually available for investment prior to being disbursed for project purposes. The proceeds received from the underwriter(s) at the time of issuance may be invested until such time as contractor or other project payments become due. For example, a construction project may call for progress payments to contractors over a two to five year period, while bond proceeds in a debt service reserve fund (DSRF) usually remain unspent until the bonds are redeemed or defeased. Bond proceeds investment earnings are a direct offset to financing costs, so designing and implementing an investment strategy that maximizes earnings within appropriate safety, liquidity, and federal tax law constraints is an important component of minimizing overall, or “net,” borrowing costs.

It is often unclear as to exactly who is responsible for devising and implementing a bond proceeds investment strategy, so it is important to address this question directly and as early in the financing process as possible. Ideally, issuers will have adopted a policy to guide this activity in advance of a financing with input from their own investment staff. Issuers should not solely depend on an underwriter or financial advisor to focus attention on this matter, although these financing team members often view investment advice as within the scope of their services. Issuers also should not expect a trustee or fiscal agent to exercise discretion on bond proceeds investments. Unless specifically contracted to provide investment advisory or management services, trustees act as custodians only and limit their investment activities to executing instructions provided by duly authorized representatives of the issuer. Finally, confusion or poor communication between finance and treasury staff personnel should be avoided. If treasury staff will be responsible for bond proceeds investment management, they should be notified early in the process and given ample time and access to the financing team to make informed decisions.

As is the intent with the *California Debt Issuance Primer (Primer)* in general, this chapter is not intended to provide all of the information necessary to make informed decisions in this area. It should, however, provide a solid foundation for further education and for better utilization of financing team members, other consultants and advisors, and internal finance and investment

staff. For further information on investment of bond proceeds, interested readers should consult the California Debt and Investment Advisory Commission's (CDIAC) *California Public Fund Investment Primer*.

This chapter discusses each of the major considerations for designing and implementing an appropriate bond proceeds investment strategy. The topics are interrelated, and therefore are not perfectly suited to a linear discussion, so some cross-referencing and/or rereading is advisable. The sections that follow discuss:

- Investment objectives
- Investment policy and permitted bond proceeds investments
- Proceeds available for investment
- Evaluating investment alternatives
- Federal tax limitations on investing bond proceeds

Generally, bond proceeds investments and other post-issuance debt management considerations are areas of municipal finance to which comparatively little issuer and financing team focus (either from a credit or liquidity standpoint) is brought to bear. This may result in strategies that are either inappropriately risky or illiquid given the expected use of funds or strategies that produce in unnecessarily low investment yields. The direct and/or opportunity costs associated with either of these situations can run to the hundreds of thousands or millions of dollars. Consequently, education and appropriate resource allocation in this area can pay handsome dividends.

INVESTMENT OBJECTIVES

Any investor, whether a governmental entity, individual, or corporate entity, would be pleased to earn very large amounts of risk-free investment income while retaining immediate access to invested balances. In reality, there are often tradeoffs among safety, liquidity, and yield that each investor must balance according to overall objectives and specific circumstances. For a public funds investment manager, this balance is heavily weighted toward avoiding risk and, accordingly, "safety first, liquidity second, and yield third" has long been the rallying cry for public funds managers. While this guidance is initially helpful, in practice, it is seldom applied in the absolute sense. Instead, it serves to narrow the scope of potentially appropriate investment options, but still leaves public fund managers significant discretion in balancing the inherent tradeoffs. The challenge specific to the bond proceeds investor lies in achieving the optimal balance between risk and yield in the context of how each dollar of bond proceeds is to be used, the characteristics of each investment option, and the impact of federal tax law provisions on net, or after-tax, earnings. All of these items are addressed in this chapter.

It is important to establish basic, or working, definitions for the terms safety, liquidity, and yield. In the public funds context, safety refers to credit risk, particularly to principal. Because creditworthiness is essentially the ability to repay fully an obligation on a timely basis, the only investment considered to be absolutely safe is one unconditionally guaranteed by the United States. While other obligors do not enjoy the ability to print any money they might require for debt repayment, there are other governmental agencies, financial institutions, and financial products that possess extremely strong underlying creditworthiness. The degree of credit risk actually incurred by relying upon obligors other than the U.S. Treasury is a function of both current financial strength and the passage of time. In practical terms, a financial institution rated by a nationally recognized statistical rating agency (e.g. Moody's Investor Services, Standard & Poor's, Fitch Ratings, etc.) as "most creditworthy" (i.e. AAA or Triple A) on a given day will, with certainty, be able to meet its obligations on the following day.

Liquidity refers to an investor's access to invested balances, and this has two components. The first is mechanical in nature and relates to how long an investor must wait to transfer an investment into usable cash. A checking account or money market fund usually has immediate liquidity, while a mutual fund manager may require several days' notice to redeem shares and wire or mail the resulting cash. Some types of investments allow absolutely no access to cash for a lock-up period. Because bond proceeds expenditures are relatively predictable or are accompanied by at least several days' notice, problems accessing the funds on a timely basis should be preventable. The second component of liquidity relates to so-called market risk or exactly how much cash is derived from turning an investment into cash. An investment the cash value of which is always close to its original purchase price plus accrued interest is said to be more liquid. Conversely, an investment the cash value of which changes substantially based on interest rate fluctuations or other financial market factors cannot be liquidated without due consideration to its current value. In the case of a treasury bond maturing in 20 years for which a local agency paid \$1,000 exactly one year ago, its current market value could be substantially more or less than \$1,000 depending upon interest rate movements over the past year. So while such an investment contains virtually no credit risk if held to maturity, a forced sale poses substantial market or liquidation risk to the principal of the originally invested amount. Liquidity risk is primarily a function of remaining time to maturity, so relatively short-term investments have less market value volatility and, consequently, better liquidity.

Yield in the public funds context is no different than in other contexts. It includes interest earnings, amortized discount or premiums, and capital gains, if any.

A bond proceeds investment strategy should, therefore, first focus on acquiring securities that contain no appreciable credit risk and that are adequately liquid in both mechanical and market value senses. Within the universe of securities that meet these first two criteria, those producing higher yields should be emphasized. In practice, intelligent use of the various investment vehicles available for bond proceeds investment can result in a strategy that maximizes after-tax earnings while being devoid of real world credit or liquidity risk.

INVESTMENT POLICY AND PERMITTED BOND PROCEEDS INVESTMENTS

Local agencies in California may, according to Government Code Section 53646, maintain and update annually a local investment policy (LIP). If the local agency chooses to maintain its LIP, its legislative body and any oversight committee must consider the proposed LIP at a public meeting. (For counties, the proposed LIP must be reviewed and approved at a public meeting.) The purpose of the LIP is to establish investment program objectives, define rules, establish benchmarks, and reduce both the investment staff's and the governing board's liability exposure. California Government Code Sections 16429.1, 53601 et seq., 53635, and 53638 address eligible investments for money in a sinking fund or money in the treasury not required for the immediate needs of the local agency. Government Code Sections 53601(l), 5903(e), and 5922(d) allow bond proceeds to be invested in accordance with the controlling provisions of bond resolutions and/or indentures. Section 53601(l) applies when corporate trustees or fiscal agents have custody of funds whereas the latter two sections apply regardless of where the funds are held. The flexibility afforded by these statutes places the onus on local agency finance staff to consider carefully the interplay between its LIP and bond proceeds permitted investments policies. To some extent, this flexibility may be mitigated by other considerations in the sale process, such as conformity to the criteria for eligible investments that may be required to obtain acceptable bond ratings. The full text of these Government Code sections is set out in **Appendix D – Legal References**.

Greater flexibility may allow a skilled investment manager to increase earnings without undue risk or to utilize investment products in the future that have yet to be developed. Conversely, overly permissive provisions may result in inappropriate investments and substantial loss of principal. It is incumbent upon each local agency to evaluate the benefits and risks of each component of its LIP and bond proceeds investments in the context of overall objectives, staff capabilities, and internal controls.

The Spectrum of Permitted Investments

Drafting the permitted investments section of a bond resolution or indenture presents an opportunity to focus on what would be appropriate investments for bond proceeds derived from a particular financing and expected to be used for particular purposes. Treating this drafting process as a purely legal or procedural matter instead of the starting point for deciding what investments will actually be purchased is a missed opportunity. It is not uncommon for bond counsel to provide a first draft of permitted investments language used in a prior financing and that may not be well suited to the current financing. Because bond counsel will have no role in investing funds and generally relies upon other financing team members for guidance on economic aspects of debt issuance, one or more appropriately skilled financing team members should assume responsibility for appropriateness of permitted investment provisions, with input from the investment staff of the issuer.

As described in detail in the section titled **Evaluating Investment Alternatives**, there are three major classes (and many subcategories) of financial products available for the investment of bond proceeds:

- Individual securities or a portfolio comprised of such securities
- Mutual, or pooled, investment funds, and
- Investment agreements (IAs)

Within these classes are a wide variety of instruments that have very different risk profiles and administrative or mechanical characteristics. Whether a particular type of security or an entire class of financial products is considered the appropriate tool for achieving a stated investment objective should be addressed in the permitted investments section. Because bond proceeds are not all used for the same purpose, it is logical to first list all eligible securities and then to address which of those investments may be used in each distinct bond fund—construction, reserve, capitalized interest, and other fund distinctions are addressed in detail in the section titled **Proceeds Available for Investment**. The fund level is also the appropriate place to limit the duration of each type of investment. For example, while a U.S. Treasury note maturing in five years may be an appropriate investment for a reserve fund, it could be entirely inappropriate in a capitalized interest fund that is expected to be depleted fully within two years.

Because new financial products are constantly being created by governmental entities and financial institutions, local agencies should consider including language in the permitted investments sections that leaves open the possibility of utilizing such products if they are deemed beneficial. This can be accomplished with general phrasing as to credit quality and other characteristics, or by open-ended provisions. For example, bond issues carrying insurance generally provide for utilizing any investment approved by the bond insurer, usually with a notice to the rating agency. Language also might allow any investment permitted under one or more sections of the California Government Code, as it is amended from time to time.

PROCEEDS AVAILABLE FOR INVESTMENT

Exactly what amounts of bond proceeds will be available for investment, and for what period of time, are key considerations in determining which investment securities will be appropriate. In particular, the dates on which monies are expected to be needed generally dictates the appropriate liquidity characteristics of a security or securities. For example, monies set aside for the purpose of making monthly progress payments to a contractor over a three-year period would be subject to market risk if invested in five year U.S. Treasury notes. Likewise, if a financially healthy local agency maintains a contingency reserve fund that is unlikely to be accessed for several years, investing 100 percent of those monies in a fully liquid, but low yielding, money market fund may be inadvisable (although unexpected draws on a contingency reserve fund reinvested in nonliquid securities could result in a loss of principal). In part because federal law

requires that tax-exempt borrowings be appropriately sized and otherwise justified, bond documents, projected draw schedules, and financing team numerical analyses generally are very specific as to expected uses of funds.

Typically, monies which are to be used for distinctly different purposes are segregated into separate accounts, or funds, for financial, accounting, and general administrative purposes. In fact, the person or firm responsible for determining how much money to borrow—a process referred to as sizing the bond issue—calculates the amounts needed in each fund separately and then aggregates them to determine the overall borrowing need. The amount required to be deposited at issuance in any particular fund is usually less than the total costs expected to be paid from that fund. The remaining expenditure requirements are expected to be met by investment earnings realized in the fund. This approach to sizing an issue is known as net funding because initial deposits are “net of” expected investment earnings. It is important to remember that although the particular characteristics of a fund go far in suggesting an appropriate investment strategy, all funds should be considered as a part of a larger whole because for arbitrage rebate purposes, investments of all bond proceeds are aggregated. The major categories of funds utilized in municipal finance transactions are as follows:

- Project or construction fund
- Debt service reserve fund
- Capitalized interest fund
- Refunding escrow
- Debt service fund (DSF)

Project or Construction Fund. These funds generally receive the lion’s share of bond proceeds deposits in all but refunding transactions. As their names suggest, monies in these funds are used to pay primary project costs such as land and equipment acquisitions, architectural and other planning costs, site preparation, and construction costs. Developing an expected expenditure, or draw schedule, for monies in these funds is usually an integral part of sizing and otherwise structuring a local agency debt financing. Draw schedules are the logical place to start in developing an investment plan for a construction fund as they estimate how much money will be needed at what time over the life of the project. Unfortunately, actual expenditures seldom resemble original projections, especially over the course of a large multi-year project, so some flexibility (i.e. additional liquidity) might need to be built into the investment plan if expenditures have any chance of occurring earlier than projected.

Project schedules usually range from one to four years and, as described above, are relatively unpredictable. Because the zero to five-year portion of the yield curve can be relatively steep at times, substantial yield is sacrificed if investments are overly liquid. Investments which mature

before monies are actually needed must be reinvested for relatively short periods of time and, generally, that translates into a lower investment yield. It is important, therefore, to understand how reliable a projected draw schedule is and whether deviations are likely to cause delays in or speed up expenditures. With this information in hand, the appropriate investment vehicles can be evaluated for yield and liquidity. As described later in this section, investment agreements can be tailored to eliminate liquidity and reinvestment risk in a project fund, but safety and yield also must be evaluated. A series (or portfolio) of treasury securities purchased with the vast majority of proceeds and supplemented by a money market fund to address liquidity concerns also is usually worth consideration for a project fund. These are two of many options that should be evaluated on a circumstance-specific basis.

Debt Service Reserve Fund. A DSRF is common in the municipal market for all but general obligation bonds, variable rate obligations secured by a direct pay letter of credit, and obligations that utilize a surety instrument (a form of insurance policy). DSRFs are designed to address temporary financial difficulties on the part of the obligor and, consequently, usually contain amounts equal to maximum annual debt service. While investors derive substantial comfort from the existence of a DSRF, local agencies with strong underlying credits are unlikely ever to access this reserve. When a DSRF is accessed, it is usually preceded by a period of financial deterioration that serves as a liquidity warning. Also, because monies in a DSRF are used only on debt service dates, liquidity concerns are limited to such dates.

While this analysis must be undertaken in a circumstance-specific context, these factors generally suggest that DSRF investments can be of longer duration than other bond proceeds investments. This longer duration usually translates into greater yield. Because project and other fund investments tend to have short average lives and commensurately low investment yields, they tend to produce so-called negative arbitrage. In other words, their investment yield is lower than the borrowing cost of the funds. DSRF investments frequently present an opportunity to earn positive arbitrage, i.e. the investment yield is greater than the borrowing cost on the monies deposited into the fund. Federal tax law generally prohibits tax-exempt issuers from retaining arbitrage earnings but because positive and negative arbitrage offset each other from fund to fund and over time (for the life of the bond issue), DSRF investments often present a valuable opportunity to fully offset negative arbitrage in other funds.

Capitalized Interest Fund. Many projects financed by local agencies produce revenue that is the primary source of repayment for the obligations. When such revenues will not be available until some time after project construction is completed, an alternative source must be established to pay interest to bondholders. A common solution is to borrow as part of the original financing an amount that, together with interest earnings thereon, will be sufficient to pay interest during the construction phase. Because this process essentially turns construction period interest into a project cost, it is said to be “capitalized.”

Capitalized interest fund investments (assuming the local agency obligations are not variable rate) are among the simplest because the investor knows at the time of issuance exactly how much money will be needed at exactly what time. Investments should be selected to mature on or just prior to an interest payment date on the bonds and in an amount that, together with interest earnings thereon, will be sufficient to pay the interest on the agency obligations.

Refunding Escrow. Refunding escrows are designed to pay debt service on prior obligations that cannot be redeemed immediately. Because most municipal issues are not subject to voluntary redemption, or “call,” by the issuer prior to an agreed upon number of years (usually 10) from the issue date, refunding escrows are necessary to take advantage of interest rate reductions and to otherwise effectuate a refinancing of “call protected” obligations. Refunding escrows are usually the only source of repayment available for the holders of prior bonds and, therefore, are almost always comprised of a carefully selected portfolio of U.S. Treasury securities that generate cash flow sufficient to pay debt service on the refinanced bonds. Refunding escrows also are subject to especially complex and restrictive federal tax law limitations. For all of these reasons, they are almost always structured by professional investment bankers, financial advisors, and tax lawyers and then verified for tax law compliance and cash flow sufficiency by an independent certified public accountant.

Debt Service Fund. A municipal bond DSF is typically composed of interest, principal, and/or redemption accounts, and is intended to facilitate proper matching of revenues and debt service obligations. Generally, DSFs are required to be funded in advance of actual principal and interest payment dates, typically on a monthly basis—for example, one-sixth of the next interest requirement and one-twelfth of the next principal requirement). Additionally, for DSFs that are not required to be funded in advance, monies to be used for principal and interest payments are usually on hand and identifiable several months prior to the date on which they are needed. This advance funding pattern effectively imposes a relatively short maturity (and commensurately low yields) on DSF investments.

The predictability of when monies will be needed to make debt service payments suggests that issuers purchase, or instruct their trustee to purchase, securities with DSF deposits, which mature on or about the debt service requirement date. However, even if appropriate securities are purchased directly, the average life of such investments is less than six months, and the investment yield is consistent with this point on the yield curve. Consequently, tailored investment agreements, forward purchase agreements, and certain pooled investment funds (other than money market funds) can provide additional yield with little to no additional safety or liquidity risk.

EVALUATING INVESTMENT ALTERNATIVES

There are three major classes of financial products available for the investment of bond proceeds:

- Individual securities or a portfolio comprised of such securities

- Investment agreements
- Mutual, or pooled, investment funds, including money market funds

As described below, there are subcategories of these major classes, which, in the aggregate, provide the municipal investor with adequate tools to design and implement a bond proceeds investment strategy that accomplishes the investment objectives described earlier in this chapter.

Individual Securities or Structured Portfolios

Generally, these securities are limited to direct obligations of the U.S. Treasury, obligations of federal agencies that are directly or indirectly guaranteed by the United States, and debt obligations of other entities—including corporate for-profit entities—that are of exceedingly high credit quality and relatively short duration. In addition, in most circumstances equity or stock investments are prohibited for municipal issuers under Article XVI, Section 6 of the California Constitution. It is important to remember, however, that while these securities generally contain little credit risk, they can be subject to substantial market value volatility if purchased with an inappropriately long remaining time period to maturity. Because the value of equity securities is inherently volatile, they run afoul of the safety first rule and are seldom permitted for bond proceeds or public funds investments.

As with the other financial products available as investment alternatives, individual securities work better or worse according to the fund in which they are contained and other circumstance-specific factors. However, a strategy of combining several types of securities with varying maturity and interest payment dates can often provide almost perfect credit safety with minimal liquidity risk and adequate yield performance. Combining individual securities with other financial products affords even greater flexibility to address specific circumstances. Finally, how individual securities are purchased can affect the balance between safety, liquidity, and yield.

Investment Agreements

As the name suggests, an IA is a contract providing for the lending of issuer funds to a financial institution, which agrees to repay the funds with interest under predetermined specifications. However, this description is often as much as two IAs will have in common as security, liquidity, yield, and administrative provisions can vary significantly among members of this very broad category. It is this flexibility in creating IA terms that often allows a properly structured IA to be an attractive vehicle for investing bond proceeds. Under favorable market conditions, IAs can offer:

- A fixed interest rate in excess of otherwise appropriate individual securities
- Daily or otherwise appropriate liquidity
- Virtual elimination of reinvestment risk and administrative and brokerage costs and fees

- Credit quality at least equal to that of seven-day primary dealer repurchase agreements

However, lack of industry standardization among IAs and limited investor familiarity may result in poorly structured agreements that are problematic and generally unsafe for the issuer. By familiarizing themselves with IA types and terms, issuers can avoid pitfalls and, when such an investment vehicle is appropriate, structure the IA that best meets a given set of circumstances.

An IA type is largely determined by its security provisions, especially those related to collateralization, its withdrawal and payment provisions, and by the type of financial institution providing the IA. Examining each determinant provides useful insight into the advantages and disadvantages of various types of investment agreements.

Security Provisions. Because an investment agreement is essentially a promise to repay funds at specified times and rates of interest, the single most important consideration with respect to purchasing an IA is the provider's ability to make good on these promises. Most IA providers, especially those qualifying under the permitted investments section of a bond indenture, are insurance companies, banks, or primary U.S. government securities dealers with repayment ability for both short-term and long-term obligations that are rated by firms such as Moody's Investor Services, Standard & Poor's or Fitch Ratings.

Credit Rating. While the credit rating is the best place to start in evaluating the safety of a particular IA, it is important to note that repayment ability may change subsequent to executing the agreement. There have been defaults on IAs that, when originally structured, were considered safe and prudent investments. Safeguards against default include both selecting only the strongest providers and limiting contract length thus making an unforeseen quick and deep deterioration in financial condition much less likely. Determining the longest safe IA term is a job for hindsight. Recent history suggests that drastic changes in institutions and national economies can take place over the course of weeks or even days. Because shorter term IAs can bear less than attractive interest rates and expose an issuer to reinvestment risk upon maturity, providers and issuers alike often turn to forms of collateralization to provide the requisite security on longer term IAs. Another option is to include termination provisions, which allow an issuer to liquidate the security in the event the provider's credit rating is downgraded or to require the provider to post additional collateral.

Collateralization. Collateralization can vary according to the amount and type of collateral, the frequency of its valuation (i.e. how often it is marked to market), and the holder of the collateral. The safest type of collateral arrangement involves a third-party collateral agent who holds securities backed by the full faith and credit of the United States for the benefit of the issuer. The collateral requirement can be equal to or somewhat in excess of the IA balance and determined weekly (or less frequently) by the collateral agent. Most collateral agreements require the provider to cure collateral deficiencies within seven days. In the event of default under the IA, the collateral agent will liquidate the collateral and remit to the issuer amounts

equal to the then outstanding IA balance. If properly structured, the collateral agreement will create a perfected third-party interest in the collateral, thereby avoiding the possibility that a bankruptcy court could attach the collateral as an asset of the IA provider. This structure is less prone to market risk than the purchasing of treasuries and/or agencies with comparable maturities.

It should be noted that collateralization is a cost to the IA provider and is passed on to the issuer in the form of lower yields on its investment. However, if an IA collateralized as previously described still yields in excess of the bond yield, the issuer should be indifferent to such cost. To the extent the collateralized yield is below the bond yield, the issuer must weigh the increased risk versus higher yield. Compromises between fully collateralized IAs and uncollateralized IAs also are possible. These include reduced collateral requirements and less frequent mark-to-market provisions, but more often employ a downgrade provision. Downgrade provisions are used with initially uncollateralized IAs and require the provider to post collateral upon its credit rating being downgraded below a specified level. This approach reduces costs during periods of continued financial strength while securing the issuer at the first sign of trouble. While solid conceptually, these provisions are dependent upon sufficient advance notice of financial trouble. Notice can come too late for the provisions to be enforced prior to default.

Withdrawal and Interest Payment Provisions. Among an IA's greatest strengths is the ability to tailor withdrawal and interest payment provisions to exactly meet bond proceeds expenditure requirements while eliminating reinvestment risk and the costs associated with monitoring investments and paying brokerage and management fees. Of course, greater flexibility for the issuer will always come at the expense of yield. The issuer hopes that a full flexibility IA will still bear an interest rate in excess of the bond yield. If not, a tradeoff of liquidity for yield must be evaluated. This tradeoff can be mitigated if a reasonably accurate construction schedule is available. Obviously, IAs work well for capitalized interest and reserve funds that require little or no flexibility since the cash requirement dates and amounts for these funds are known factors. The range of available withdrawal and interest payment provisions in decreasing order of flexibility—and increasing order of yield—can be characterized as follows:

- **Full-Flex.** This choice provides for daily withdrawals up to the full amount of the IA (for project purposes, not alternative investments), any desired interest payment dates or frequency, and automatic reinvestment of interest earnings at a specified yield. Any of these terms, including notice requirements for withdrawals, can be relaxed in an effort to create additional yield. Full-flex is most useful strategy for construction funds.
- **No Sooner, No Greater.** This choice provides that the issuer may make withdrawals only after a specified date in a not-to-exceed amount, and may or may not provide for reinvestment of interest earnings. The increased average life and predictability of repayment requirements usually results in higher yields but can expose an issuer to the possibility of cash flow shortages. No sooner, no greater is often used in

conjunction with small deposits to money market funds or similarly liquid investment vehicles to address this concern. This type of provision is best suited to construction funds for phased projects or where highly accurate draw schedules are available.

- **Bullet Draws.** This choice provides for pre-determined withdrawal and interest payment amounts and dates. Exceptions are limited to indenture requirements such as default, mandatory redemption of bonds, and a reserve fund draw. Bullet draws provide the highest yield available, but have little flexibility. They are almost always used in conjunction with more liquid investments, or when there exists an extremely high degree of confidence in cash flow requirements such as in capitalized interest and reserve fund applications.
- **Investment Agreement Providers.** The following is a list of typical IA providers:
 - **Insurance Companies.** These were among the first institutions to make IAs available for bond proceeds investment. Often referred to as guaranteed insurance contracts (GICs), these securities are typically guaranteed only by the repayment ability of the insurance company. While these institutions often have huge asset bases, there have been instances of default among providers of these uncollateralized IAs.
 - **Banks.** Often referred to as bank investment contracts (BICs), these securities can be thought of as a flexible series of certificates of deposit (CDs). They may or may not be collateralized and are typically issued only by the largest and most creditworthy banking institutions.
 - **Primary U.S. Government Securities Dealers.** These institutions issue repurchase agreements (repos), which, by their nature, are collateralized. A repo involves an issuer's purchase of a security backed by the full faith and credit of the United States government and the provider's agreement to buy the security back from the issuer on a specified date and price, with the interest rate of the agreement being a function of the repurchase price and other payment terms. While the securities subject to the repo (or flex-repo, which can be thought of as a more flexible series of repos or a repo with respect to a pool of securities) belong to the issuer during the term of the repo, collateral valuation and holding is subject to negotiation.

Obtaining an Investment Agreement. Once a decision to explore the investment of bond proceeds in an IA is made, an issuer should authorize an experienced IA intermediary to present alternative investment strategies. This should involve a thorough analysis of the following factors:

- Guidelines established in the issuer's investment policy
- Permitted investments allowed under the bond indenture

- Maximum allowable yield under arbitrage restrictions and rebate requirements
- Expected cash flow requirements of all funds
- Prevailing interest rates on permitted IAs

The IA intermediary will then work with the issuer to develop a structure that best meets the requirements of the bond issue in terms of security, liquidity, and yield. If all the investment objectives cannot be met in the current interest rate environment, the issuer may decide to make tradeoffs in terms of the structural criteria or to wait until the IA market improves. It should be noted that normally the IA intermediary's fee is paid by the IA provider upon successful completion of a transaction and therefore an issuer will not incur any costs if this process is delayed or never completed.

If the issuer is satisfied with the structure of the IA, authorization to proceed with bidding process is given to the IA intermediary who will draw up a request for IA bids or bid form, which carefully states all the requirements of the desired IA structure and explains the bidding procedure. The bid form also should state any other conditions that the winning provider must meet to complete the transaction. These requirements include:

- Circulating a draft of the actual IA contract within a specified time
- Providing a legal opinion as to enforceability of the contract
- Payment by the winning provider of all of its own legal fees
- Supplying the issuer with monthly status reports and any other requirements the issuer deems necessary

There are two steps a prudent IA intermediary can take that should eliminate any risk of future regulations causing an issuer to incur any additional arbitrage rebate liability:

Bidding Yield. Since the U.S. Treasury has indicated that the terms of an investment should be based on the reasonable and realistic needs of an investor without regard to the arbitrage rules, the criteria for selecting the winning IA provider should be based on the highest yield rather than fixing the yield and bidding some form of the liquidity or security features. A permissible variation on this concept is to set the interest rate on the IA to the arbitrage rate on the bonds and to bid for an up-front premium payment (assuming that IA yield is higher than the bond rate). This premium represents an approximation of the present value of the issuer's rebate liability on that particular investment.

No-Fee Bidding. The IA should be bid in a manner that will eliminate the possibility that the fee, which the IA intermediary receives from the IA provider, could be considered additional yield to the issuer, and therefore increase its arbitrage rebate liability. Although the

fee is paid directly by the provider, there is a risk that the IRS may determine that the IA intermediary is acting as agent for the issuer, which would make the fee a nonrecoverable expense. The final U.S. Treasury regulations published in 1993 do provide some explicit guidance as to what may be paid as a brokerage commission and still not be treated as additional yield to the issuer. The maximum allowable fee is equal to the present value of five basis points times the expected invested balance for each year that the contract is in effect. It is generally advisable that in connection with obtaining an IA, the issuer request written confirmation from the IA intermediary detailing fees paid to the IA intermediary by the selected IA provider.

The bid form will be sent out several days in advance of the anticipated bid to all potential IA providers who can meet the issuer's security criteria. The IA intermediary will contact all potential bidders to answer any questions regarding the proposed structure and will provide additional information about the issuer, if necessary. At the time of the bid, the IA intermediary will receive all the bids from the providers and then inform the issuer of the results. A decision to accept the winning bid or to reject all bids should be made promptly. The IA intermediary then informs all bidders of the final result. If all bids are rejected, the issuer can elect to change the bidding criteria and solicit bids again or to put the whole process on hold.

If a satisfactory bid has been received, the winning IA provider will circulate a draft of the IA contract which the issuer and its counsel will review and comment on until all parties are satisfied with its form. Finally, at the settlement of the transaction, the issuer will direct its trustee to send a federal funds wire to the IA provider who will release the IA contract as well as the required enforceability opinion. Additionally, the IA intermediary will provide a certificate assuring that the IA provider was selected in an arm's length transaction. As part of this certificate, it is important that the issuer receive written confirmation from the IA provider and the IA intermediary disclosing all fees paid to the interested parties in connection with obtaining the IA.

IAs are extremely flexible instruments which, when properly structured, can be excellent bond proceeds investment vehicles. Not only can a single IA be a safe, liquid, high yielding investment, several IAs can be used in concert to further these objectives. An example would be to obtain individual IAs for construction, capitalized interest, and reserve funds with the expectation that the less liquid and/or longer term IAs would offset relatively lower yields in the full-flex construction fund. IAs also may be used concurrently with other investments when beneficial.

The market for IAs has become much more competitive and sophisticated in recent years. Among the results of the proliferation of IAs are enhanced security and yield to issuers, as well as the development of innovative structures designed to comply with permitted investments limitations and other restrictions.

Pooled Investment Funds

Pooled investment funds available for local agency bond proceeds investment include commercial, for-profit mutual funds and public sector, not-for-profit pools. Both types of pooled investment funds attempt to leverage economies of scale in professional management, purchasing power, transaction costs, credit risk diversification, and liquidity requirements to improve upon what a smaller or less experienced investor could accomplish through purchases of individual securities.

Commercial mutual funds can be broken down further into money market funds and all others. Money market funds are, by federal law, designed to maintain a constant share price of one dollar for every one dollar invested, and no money market fund has ever failed to do so. Money market funds generally buy only U.S. Treasury and agency securities, repurchase agreements for those securities, and the highest credit quality corporate commercial paper and other short-term indebtedness. The average life of investments in a money market fund may not exceed 90 days. Money market fund mechanical liquidity ranges from zero to three days. Not all money market funds are permitted investments under Government Code Section 53601, local investment policies, or traditional permitted investments language.

Commercial mutual funds that are not money market funds are seldom permitted investments for bond proceeds. They may contain highly volatile securities and, consequently, pose significant credit and market risk concerns. Pooled investment funds that are sponsored or managed by counties, large cities, and the State Treasurer's Office have widely varying characteristics. While they often offer an administratively simple option for smaller local

agencies, it is important to understand the credit, liquidity, and yield characteristics of each fund. Because these funds are not highly regulated, their managers may have very different philosophies that impact net asset value, liquidity, and, ultimately, safety. Before investing in such pools, local agencies should study the type and average life of underlying investments and fully understand deposit, withdrawal, interest payment, and interest allocation provisions. There are many types of pooled investment providers—see text box on **Pooled Investment Providers**. Local agencies should not assume that a pooled investment fund is managed in a manner consistent with the local agency's specific investment policies simply because it is sponsored by a larger, more sophisticated public agency.

- Pooled Investment Providers**
- ✓ State Local Agency Investment Funds (LAIF)
 - ✓ County treasurer pooled investment funds
 - ✓ JPA pooled programs
 - ✓ Bond insurer-sponsored pools
 - ✓ Bank-sponsored pools

FEDERAL TAX LIMITATIONS ON INVESTING BOND PROCEEDS

Sections 103 and 148 of the Internal Revenue Code and related regulations and rulings generally describe the requirements (the “federal requirements”) that must be met for the interest paid on state and local governmental debt to be excluded from gross income for federal income tax

reporting purposes. Among the federal requirements are those related to arbitrage (the “arbitrage considerations”) and those related to use of tax-exempt financing by private individuals or entities (the “private activity considerations”). The rationale for and basic mechanics and principles of the arbitrage considerations are described later in this chapter.

Regulatory Rationale

The federal government considers the exclusion of interest received on state and local governmental debt from gross income for federal income reporting purposes to be a very large subsidy, or revenue transfer, program. The benefit of lower tax-exempt borrowing costs are paid for by foregone federal income tax receipts from bondholders who otherwise would have paid income tax on their interest earnings. Relative to most federal revenue transfer or subsidy programs, tax-exempt borrowing works with minimal federal regulation and bureaucracy. The federal government believes, however—and with some justification—that the subsidy is rife with potential for benefits accruing to particular jurisdictions and private individuals/entities in a manner disproportionate to the costs borne by those entities or persons.

For example, a local agency that issues tax-exempt bonds at a five percent interest cost for the sole purpose of investing those proceeds in identical duration U.S. Treasury bonds yielding six percent would have the one percent positive interest differential left over as an additional revenue or income source. While the one percent difference would benefit the constituents of the agency, its cost would be borne by all federal taxpayers and, as such, would be considered unfair and, from the federal government’s perspective, abusive. Similarly, if the benefits of tax-exempt interest rates are provided through a conduit financing to a private entity, from the federal government’s perspective, that entity would have otherwise borrowed in the taxable market, producing income tax revenue to the federal government.

In order to keep the costs and benefits of the federal interest subsidy in some semblance of proportion, the federal requirements have evolved primarily to limit tax-exempt financing to projects and uses that are of a size and scope closely related to the needs of the local constituency.

Arbitrage Considerations

In the public finance context, arbitrage is most easily understood as borrowing at one rate and investing at another. Because state and local governmental entities can borrow at relatively low, tax-exempt rates and do not pay income taxes on earnings from relatively high, taxable rate securities, they are often in a position to earn so-called positive arbitrage—i.e. they earn more than they are paying. Historically, the relationship between long-term (greater than 10 years) tax-exempt borrowing rates and short-term (less than 3 years) taxable investment rates generally allowed tax-exempt borrowers to earn positive arbitrage even on bond proceeds that were spent relatively quickly. These circumstances gave tax-exempt issuers and their financing teams an

incentive to modify transaction structures to maximize arbitrage benefits, even if these modifications caused bond issues to be:

- Larger than necessary
- Issued earlier than necessary
- Left outstanding longer than necessary to accomplish the immediate public purpose of the project being financed

In response to what it perceived as costly abuses, in 1979 the U.S. Treasury began imposing restrictions designed to curb these abuses. As part of the Tax Reform Act of 1986, the U.S. Congress imposed the arbitrage rebate requirement on issuers of tax-exempt bonds, effectively requiring them to pay, or rebate, to the United States any positive arbitrage they did earn. The rebate requirement, while arguably unnecessarily burdensome for particular issuers that were not engaging in abusive arbitrage transactions, has dramatically reduced arbitrage-related abuses industry wide. With the rationale and effectiveness of the arbitrage considerations firmly established, issuers and the U.S. Treasury have focused recently on real world implementation of arbitrage-related laws and regulations.

Mechanically, the rebate amount, if any, periodically due to the United States is the difference between amounts earned on investment property allocable to gross proceeds (as that term is defined in the federal requirements) of a bond issue and the amount that would have been earned had such gross proceeds been invested at the borrowing cost (the “arbitrage yield”) of that bond issue. It follows then that to comply with the arbitrage considerations, an issuer must first be able to identify the particular bond issue to which monies or investments are allocable and calculate the arbitrage yield of that bond issue.

A second aspect of public finance arbitrage is so-called negative arbitrage, which is incurred when investment rates are lower than borrowing rates. While negative arbitrage is not a compliance issue, it is a very important economic consideration. In general, tax-exempt issuers incur much more negative arbitrage than is necessary in any given interest rate environment. This is due to a variety of reasons, not the least of which is difficulty in knowing when an economically advantageous investment strategy is running afoul of arbitrage considerations from a compliance perspective. In other words, an accounting system that allows for accurate tracking of bond yields, amounts that are allocable to particular bond issues, and accumulated positive and/or negative arbitrage is required before investment strategies can be optimized from an after-tax perspective. Further, an issuer should always be cognizant of the fact that for a specific bond issue, negative arbitrage on a fund that requires liquidity can be offset by positive arbitrage on another fund where liquidity is not as essential. Please see CDIAC’s *California Public Fund Investment Primer* for additional information on arbitrage considerations.

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Appendix A

WORKING WITH STATE AGENCIES

The primary purpose of this appendix is to briefly describe how the State of California is organized to manage or coordinate debt, and to list certain programs for which bonded debt is issued. Also noted are the state agencies that either issue debt and/or administer bond programs. Where applicable, the potential for local agencies to utilize state bond funds for local programs is noted.

This appendix is divided into two sections. The first section describes the state agencies that monitor or assist in the management of public debt. These agencies provide information and assistance, as well as review and approve certain types of financings. Also included is a description of a division of the State Treasurer's Office and its activities affecting state debt issuance. The State Treasurer's Office is essentially the official banking agency for the State of California. The State Treasurer administers the sale of several billion dollars a year of state revenue and general obligation bonds and notes, and services outstanding bonds and notes in excess of \$24 billion.

The second section of Appendix A very briefly describes the state's general obligation bond programs, certain revenue bond programs and/or issuers, and certain state financing authorities that issue conduit revenue bonds.

Theoretically, the proceeds of general obligation and revenue bonds may be used to finance substantially the same types of activities. General obligation bonds are secured by the full faith, credit, and taxing power of the issuer and can be repaid from general fund revenues. Revenue bonds are secured by a specified source of revenue streams, not by the general fund of the issuer.

There are two principal types of revenue bonds issued by state agencies and instrumentalities. First, certain state agencies issue revenue bonds that are generally payable from enterprise funds of the issuing agency. Second, various state financing authorities issue conduit revenue bonds to provide private entities with a low-cost source of financing for facilities deemed to be in the public interest. The state has no financial obligation of any kind for this debt—it is secured by the credit of private entities and is customarily administered by trustees independent of the state.

The state also utilizes other types of debt instruments, such as certificates of participation and public lease revenue bonds. These debt instruments are distinguished from general obligation bonds in that their repayment is secured by an annual appropriation or a lease obligation, rather than the full faith, credit, and taxing power underlying general obligation bonds. They are similar in that they may also be secured either directly or indirectly by state General Fund

revenues. For this reason, certificates of participation and lease revenue debt are often included by rating agencies in figures for total debt when they analyze total state tax-supported debt.

The two sections of this chapter are organized as follows:

Name of Program or Agency	Names the state program or agency being described.
Statutory Authorization	Cites the section commencing the statute creating or authorizing the state program or bonding authority.
Purpose	Briefly describes the primary purpose and activity of the debt issuance or assistance program.
Members	Lists the members of the governing body, such as a commission or financing authority.
Contact	Lists the principal contact person's title, address, and telephone number.

Where applicable, certain general obligation and revenue bond programs will contain additional information identifying the agency that administers the expenditure of the bond proceeds (for general obligation bonds only).

DEBT INFORMATION, ASSISTANCE, AND OVERSIGHT

The four state agencies that monitor or assist in the management of public debt and are described in this appendix are:

- California Debt and Investment Advisory Commission (CDIAC)
- California Debt Limit Allocation Committee (CDLAC)
- California Industrial Development Financing Advisory Commission (CIDFAC)
- Public Finance Division, State Treasurer's Office

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

Statutory Authorization

Government Code Section 8855

Purpose

The nine-member CDIAC is the state's center for information on public debt issuance. The commission collects and analyzes information on the issuance of debt by public agencies, provides technical assistance concerning the issuance of debt, and researches policy issues. Public agencies that issue tax-exempt or taxable debt are required to report certain information to CDIAC under state law.

No later than 30 days prior to the sale of any proposed public debt issue, the issuer must give written notice of that sale to the commission. Standardized reporting forms are available from the commission. The commission's staff compiles submitted data such as proposed sale date, name of issuer, type of debt issue, and estimated principal amount into a "Calendar," published in the monthly periodical *Debt Line*, as well as in annual reports of the commission. Additional statutory reporting requirements relate to local agency issues of housing revenue bonds and negotiated refunding issues.

CDIAC provides technical assistance to issuers by means of information provided in *Debt Line*, by responding to individual inquiries, and by the provision of timely information to issuers through contact with underwriters, credit rating agencies, statewide associations, and others. Additionally, the commission sponsors seminars on such topics as the "Fundamentals of Debt Issuance."

CDIAC also monitors trends and policy developments relating to debt issuance and issues periodic reports.

The commission meets on the call of its chairperson, normally three or four times per year.

The commission is funded out of the CDIAC Fund, mandated by California Government Code Section 8856. The CDIAC Fund is supported by fees levied on public issuance reported to the commission. Specifically, the Government Code authorizes CDIAC to charge a fee to

the lead underwriter or purchaser of a debt issue equal to 2.5 basis points or not more than \$5,000 for each issue.

Members

State Treasurer, Chairman

Governor or Director of Finance

State Controller

Two members of the Assembly appointed by the Speaker

Two members of the Senate appointed by the Senate Rules Committee

Two local government finance officers appointed by the State Treasurer

Contact

California Debt and Investment Advisory Commission

915 Capitol Mall, Room 400

Sacramento, CA 95814

(916) 653-3269

www.treasurer.ca.gov/cdiac

CALIFORNIA DEBT LIMIT ALLOCATION COMMITTEE

Statutory Authorization

Government Code Section 8869.80

Purpose:

CDLAC computes the annual private activity bond limit in accordance with the Tax Reform Act of 1986 and provides private activity bond allocations to cities, counties, state agencies, and local development authorities, among others. The committee also maintains records on the use of private activity bond allocations throughout the state.

At periodic meetings, the committee releases a portion of the state ceiling for allocation to state and local applicants for programs or projects that achieve the highest public purposes. Detailed procedures for CDLAC can be obtained from the office listed below.

Application Process

An application for a portion of the volume cap by any local agency or by any state agency must be accompanied by evidence that an escrow account equal to one-half of 1 percent of the amount of allocation requested has been established. This deposit is typically paid by the nongovernmental borrower. If bonds are not issued in the amount that was reserved, a pro rata portion of the deposit will be forfeited to CDLAC. If no bonds are issued, the entire deposit is forfeited. Any allocation granted by CDLAC expires in 85 days. In this manner, CDLAC hopes to ensure that the state's limited volume cap is efficiently utilized by borrowers who are actually ready to proceed with their transactions. The primary basis on which competing applications for portions of the volume cap are judged is the public benefit to be derived from the financed project (e.g. number of jobs to be produced, benefit to lower income persons, increase in local or state tax revenues, contribution to other articulated state or local policies). CDLAC revises its application procedures and fees periodically.

Members

State Treasurer, Chairman
Governor or Finance Director
State Controller
Three nonvoting Advisory Members

Contact

California Debt Limit Allocation Committee
915 Capitol Mall, Room 308
Sacramento, CA 95814
(916) 653-3255
www.treasurer.ca.gov/cdlac

CALIFORNIA INDUSTRIAL DEVELOPMENT FINANCING ADVISORY COMMISSION

Statutory Authorization	Government Code Section 91550
Purpose	CIDFAC reviews and approves local taxable and tax-exempt bonds— industrial development bonds (IDBs)—issued by local industrial development authorities to finance the expansion, acquisition, construction, and rehabilitation of manufacturing facilities. For further information on these bonds, see Chapter 6, Types of Financing Obligations – Conduit Revenue Bonds: Economic Development Bonds.
Members	State Treasurer, Chairman State Controller Director of Finance Director of State Department of Commerce California Commissioner of Corporations
Contact	California Industrial Development Financing Advisory Commission 915 Capitol Mall, Room 457 Sacramento, CA 95814 (916) 653-3843 www.treasurer.ca.gov/cidfac

STATE TREASURER'S OFFICE—PUBLIC FINANCE DIVISION

Statutory Authorization

The Public Finance Division carries out the State Treasurer's duties as agent for sale on all state obligations (Government Code Sections 5700 et seq.) and may carry out duties as trustee, paying agent, and registrar for various debt obligations (Government Code Sections 12333, 16720 et seq., and individual bond authorization statutes).

Purpose

The State Treasurer is the agent for the sale of all debt issued by the State of California and its instrumentalities. The State Treasurer's duties in this respect are customarily performed by the Public Finance Division.

The Public Finance Division arranges the sale of general obligation bonds and notes, oversees the scheduling and the sale of all other types of state debt, oversees and protects the state's bond credit rating, and acts as trustee, registrar, and paying agent for the state's general obligation bonds and certain revenue bond programs.

The process varies depending on the type of debt instrument being issued. In the case of general obligation bonds and public revenue bonds, once the bond authorization has been approved, the administering state agency or department presents a bond proposal to the relevant finance committee or approving agency. A resolution is adopted which authorizes the treasurer—the Public Finance Division—to sell the bonds.

In the case of conduit revenue bonds, the financing authority reviews bond proposals and authorizes the sale. After this has been completed, the authority authorizes the State Treasurer's Office to schedule the bond sale.

Contact

Public Finance Division
Office of State Treasurer
915 Capitol Mall, Room 280
Sacramento, CA 95814
(916) 653-3451
www.treasurer.ca.gov/bonds

STATE REVENUE BOND PROGRAMS

Certain revenue and conduit revenue bond programs administered by state agencies or instrumentalities are described in this section of Appendix A. Certain characteristics common to many of these programs are described below.

There are two principal types of revenue bonds issued by state agencies and instrumentalities:

- Certain state agencies issue revenue bonds whose principal and interest are generally payable from enterprise funds of the issuing agency. The state general fund has no legal liability for repayment of these bonds.
- Various state financing authorities issue conduit revenue bonds to provide private entities with a low-cost source of financing for facilities deemed to be in the public interest. The state has no obligation for this debt as it is secured by the credit of private entities and administered by trustees independent of the state.

CALIFORNIA HOUSING FINANCE AGENCY (CalHFA)

Statutory Authorization	Health and Safety Code Section 50900
Purpose	The agency issues revenue bonds to provide below-market interest rate capital to finance single-family mortgages for qualified borrowers and loans for multi-family construction and rehabilitation.
Process	The agency's board of directors authorizes the issuance of all agency debt obligations, establishes the terms of its loan programs, and specifically grants all loan commitments for multifamily housing projects.
Members	The agency's board of directors includes: State Treasurer Secretary of the Business, Transportation and Housing Agency Director of Housing and Community Development Six members appointed by the Governor One member appointed by the Speaker of the Assembly One member appointed by the Senate Rules Committee Director of Finance (nonvoting) Director of State Office of Planning and Research (nonvoting) Executive Director of the Agency (nonvoting)
Contact	California Housing Finance Agency Sacramento Headquarters P.O. Box 4034 Sacramento, CA 95812-4034 (916) 322-3991 www.calhfa.ca.gov

**DEPARTMENT OF VETERANS AFFAIRS
(VETERANS BONDS)**

**Statutory
Authorization**

Military and Veterans Code Section 1000.1

Purpose

The Department of Veterans Affairs issues bonds to finance low-interest mortgage loans for California military veterans. This bonding authorization supplements that of the veterans bonds described in general obligation bonds. The Veterans Debenture Finance Committee authorizes the sale of bonds.

Members

The Veterans Debenture Finance Committee includes:

State Treasurer, Chairman
Governor
State Controller
Director of Finance
Director of Department of Veterans Affairs

Contact

Chief, Bond Finance Division
Department of Veterans Affairs
1227 O Street
Sacramento, CA 95814
(916) 653-2081
www.cdva.ca.gov

DEPARTMENT OF WATER RESOURCES

**Statutory
Authorization**

Water Code Section 11100

Purpose

The Department of Water Resources uses bonds to finance the construction of certain Central Valley Project facilities that are part of the State Water Resources Development System. The Director of Water Resources authorizes the sale of the bonds.

Process

The Department of Water Resources constructs water and power facilities of the State Water Project. Payments by local public agencies under water supply contracts comprise revenue to operate and maintain the facilities and retire the debt.

Contact

Department of Water Resources
P.O. Box 942836
Sacramento, CA 94236-0001
(916) 653-9836
www.dwr.water.ca.gov

State Conduit Revenue Bonds

The following section describes California's conduit revenue bond programs as of September 30, 2005. These programs are discussed in alphabetical order by the name of the issuing financing authority. In most cases, more information about the financing program is set out in substantive sections of the *California Debt Issuance Primer (Primer)*.

**CALIFORNIA ALTERNATIVE ENERGY AND ADVANCED TRANSPORTATION
FINANCING AUTHORITY (CAEATFA)**

Statutory Authorization	Public Resources Code Section 26000
Purpose	CAEATFA issues revenue bonds to finance loans to businesses to encourage use of alternative energy technologies, such as co-generation and small hydroelectric projects.
Members	State Treasurer, Chairman State Controller Director of Finance Chairman of State Energy Commission President of Public Utilities Commission
Contact	California Alternative Energy and Advanced Transportation Financing Authority 304 S. Broadway, Suite 550 Los Angeles, CA 90013 (213) 620-4467 www.treasurer.ca.gov/caeatfa

CALIFORNIA EDUCATIONAL FACILITIES AUTHORITY (CEFA)

**Statutory
Authorization**

Education Code Section 94100

Purpose

CEFA issues revenue bonds to assist private nonprofit institutions of higher education in the construction and expansion of nonsectarian educational facilities. The Authority may issue bonds to refund existing bonds, mortgages, or other obligations incurred by private colleges for the acquisition or construction of educational facilities. CEFA may also issue bonds to refund its own bonds and may issue bonds to fund student loans. All assets, obligations, and authority from the former California Student Loan Authority have been transferred to CEFA.

Educational facility means a structure suitable for use as a dormitory, dining hall, student union, administration building, academic building, library, laboratory, research facility, classroom, or health care facility. It does not include any facility used or to be used for sectarian instruction or as a place for religious worship.

Members

State Treasurer, Chairman
State Controller
Director of Finance
Two members appointed by the Governor

Contact

California Educational Facilities Authority
915 Capitol Mall, Room 590
Sacramento, CA 95814
(916) 653-2872
www.treasurer.ca.gov/cefa

CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY (CHFFA)

**Statutory
Authorization**

Government Code Section 15430

Purpose

CHFFA issues bonds to make loans to private, nonprofit corporations, such as acute-care hospitals and skilled nursing facilities. CHFFA also makes loans to clinics and to public hospitals (city, county, and district) to finance capital projects and for working capital. Bonds to finance working capital must be rated by either of the top two rating categories of a nationally recognized rating organization. CHFFA may also issue bonds to refund its own bonds.

A health facility is defined as any facility for the diagnosis, care, prevention, and treatment of human illness to which individuals are admitted for a 24-hour stay or longer. County outpatient facilities, community clinics, and child daycare facilities are also eligible.

A health facility can include the following facilities, if operated in conjunction with one or more of the above types of facilities: a laboratory, laundry, nurses' or interns' residence, physicians' facility, administration building, research facility, maintenance, storage or utility facility, and all structures or facilities related to or required for the operation of a health facility.

A health facility does not include any institution or building used primarily for sectarian instruction as a place for devotional activities or religious worship.

Members

State Treasurer, Chairman
State Controller
Director of Finance
Two members appointed by Senate Rules Committee
Two members appointed by Speaker of the Assembly
Two members appointed by the Governor

Contact

California Health Facilities Financing Authority
915 Capitol Mall, Room 590
Sacramento, CA 95814
(916) 653-2799
www.treasurer.ca.gov/chffa

CALIFORNIA INDUSTRIAL DEVELOPMENT FINANCING ADVISORY COMMISSION

Statutory Authorization	Government Code Title 10
Purpose	CIDFAC provides technical assistance to city and county authorities that issue IDBs, independently reviews IDB applications for compliance with federal and state requirements, and approve the sale of IDBs by local authorities. The program is intended to benefit economically distressed areas and to provide an alternative method of financing capital outlays that will increase employment or otherwise contribute to economic development.
Members	State Treasurer, Chairman State Controller Director of the Department of Finance Secretary of the Technology, Trade & Commerce Agency Commissioner of the Department of Corporations
Contact	California Industrial Development Financing Advisory Committee 915 Capitol Mall, Room 457 Sacramento, CA 95814 (916) 653-3843 www.treasurer.ca.gov/cidfac

CALIFORNIA POLLUTION CONTROL FINANCING AUTHORITY (CPCFA)

**Statutory
Authorization**

Health and Safety Code Section 44500

Purpose

CPCFA approves and issues taxable and tax-exempt environmental improvement revenue bonds (EIBs) to finance the expansion, acquisition, construction, or installation of pollution control and waste disposal systems to facilitate compliance with pollution control and environmental standards.

CPCFA may issue taxable and tax-exempt EIBs to finance equipment and facilities that control, reduce, or prevent pollution, including hydrostatic control facilities, dust collectors, smoke bags, settling ponds, filtration plants, sewage disposal facilities, garbage disposal facilities, recycling facilities, dumps, filling grounds, chlorination ponds, treatment works, and cooling towers.

CPCFA also issues EIBs for the prevention or reduction of environmental pollution resulting from the disposal of solid or liquid waste, including projects utilizing resource recovery or energy conversion processes. Such projects may include refuse removal vehicles, transfer stations, resource recovery, or energy conversion plants.

Members

State Treasurer, Chairman
State Controller
Director of Finance

Contact

California Pollution Control Financing Authority
915 Capitol Mall, Room 457
Sacramento, CA 95814
(916) 654-5610
www.treasurer.ca.gov/cpcfa

CALIFORNIA SCHOOL FINANCE AUTHORITY (CSFA)

**Statutory
Authorization**

Education Code Section 17870

Purpose

CSFA issues bonds to finance loans or leases to local school and community college districts to finance the acquisition of equipment, such as school buses, and computers, or the construction of public school facilities. CSFA may also provide working capital loans.

Members

State Treasurer, Chairman
Director of Finance
Superintendent of Public Instruction

Contact

915 Capitol Mall, Room 576
Sacramento, California 95814
(916) 651-7710 (Sacramento Office)

304 S. Broadway, Suite, 550
Los Angeles, CA 90013
(213) 620-4467 (Los Angeles Office)
www.treasurer.ca.gov/csfa

**CALIFORNIA URBAN WATERFRONT AREA RESTORATION
FINANCING AUTHORITY (CUWARFA)**

Statutory Authorization	Public Resources Code Section 32000
Purpose	CUWARFA issues revenue bonds to finance coastal improvement projects, such as waterfront restoration projects, when no other source of financing is available.
Eligible Facilities	<p>Eligible facilities include any urban waterfront restoration activity located wholly or partly within the coastal zone for which a plan of urban waterfront restoration has been approved. An urban waterfront restoration activity located within the territory of the Sacramento-Yolo Port District, the Stockton Port District, or on a river, lake, or reservoir located within a metropolitan statistical area with an approved urban waterfront-restoration plan is also eligible.</p> <p>Projects that may be financed include visitor-serving commercial facilities, transient-visitor accommodations, coastal or inland waterfront-dependent industry, public utility systems, mass transit facilities, and public recreation, and shoreline access facilities. Projects may not include new permanent residential structures, office structures for nonmaritime purposes on lands subject to public trust, or other noncoastal-related uses, or industrial facilities. Projects must demonstrate economic viability and demonstrate public access.</p>
Members	State Treasurer, Chairman State Controller Director of Finance Secretary of the Resources Agency Executive Director of Coastal Conservancy

Contact

California Urban Waterfront Area Restoration
Financing Authority
915 Capitol Mall, Room 457
Sacramento, CA 95814
(916) 654-5610
www.treasurer.ca.gov/cuwarfa

Appendix B

RESOURCES AND CONTACTS

This appendix provides listings for frequently used resources in the public finance area, as well as contacts for organizations and other sources of more information. Descriptions of organizations are largely taken from the organization's own literature and have not been independently verified. Internet addresses are also included for websites related to public finance.

The websites included in this appendix contain a wealth of information related to public finance. Textbooks, articles, current events, and legislative updates are common within the websites of these nationally recognized organizations.

WEBSITES

The following websites contain useful links and content in the public finance area.

State of California home page www.ca.gov	Includes links to California officials, local governments, agencies, and laws.
California Legislative Analyst's Office www.lao.ca.gov	Includes budget and other related California news.
California Legislative Information www.leginfo.ca.gov	Maintained by the Legislative Counsel of California, this site includes information about new legislation and the ability to search for information about bills.
California Secretary of State www.cal-access.ss.ca.gov	Contains the Secretary of State's directory of lobbyists, lobbying firms, and lobbyist employers with links to contact information.
California State Assembly www.assembly.ca.gov	Includes information on current legislation and other political links.
California State Senate www.sen.ca.gov	Includes information on current legislation and other political links.

<p>Association of Financial Guaranty Insurers www.afgi.org</p>	<p>Trade association of the insurers and reinsurers of municipal bonds and asset-backed securities.</p>
<p>The Bond Market Association www.bondmarkets.com</p> <p>Electronic Municipal Statistics www.emuni.com</p>	<p>Provides documents, news, developments, and financial information about the municipal bond market.</p>
<p>California Association of Realtors www.car.org</p>	<p>Provides real estate pricing and home ownership trends, real estate economics and legislation.</p>
<p>DisclosureUSA www.disclosureusa.org</p>	<p>A one-stop “Central Post Office” in which issuers and other filers can upload disclosure documents, together with CUSIP numbers and other indexing information. This information is then immediately transmitted, with indexing information to each of the Nationally Recognized Municipal Securities Information Repositories (NRMSIR) and State Information Depositories (SID).</p>
<p>Federal Reserve Board of San Francisco www.frbsf.org</p>	<p>Economic data, description, and analysis of municipal bonds/public finance and community development.</p>
<p>Government Finance Officers Association www.gfoa.org</p>	<p>Comprehensive resource on issues of public finance including policy, financial analysis and management, legislation, administration, and reporting.</p>
<p>International Swaps and Derivatives Association www.isda.org</p>	<p>Legislative, regulatory, legal, documentation, accounting, tax, operational, technological, and other issues related to derivative products.</p>
<p>Municipal Securities Rulemaking Board www.msrb.org</p>	<p>Contains an extensive glossary and cross-reference tool for finance related terms.</p>

<p>MuniNet Guide www.muninetguide.com</p>	<p>An online guide and directory to websites for state, county, and local governments and other municipal related matters including municipal finance, municipal bonds, regional economies, urban development, and public policy.</p>
<p>Orrick, Herrington & Sutcliffe LLP www.orrick.com</p> <p>National Association of Bond Lawyers www.nabl.org</p>	<p>Provides users with information concerning legal and political issues shaping the municipal bond market.</p>
<p>Stone & Youngberg LLC www.styo.com</p>	<p>Provides links to numerous finance and related sites.</p>
<p>Thomas thomas.loc.gov</p>	<p>Thomas is the Library of Congress's website for providing legislative information on the Internet.</p>

CREDIT RATING AGENCIES

National Headquarters	West Coast Office
<p>Fitch Ratings One State Street Plaza New York, NY 10004 (800) 75-Fitch www.fitchratings.com</p>	<p>Fitch Ratings 650 California Street, 8th Floor San Francisco, CA 94108 (415) 732-1754 / (800) 95-Fitch</p>
<p>Moody's Investors Service 99 Church Street New York, NY 10007-2796 (212) 553-0300 www.moody.com</p>	<p>Moody's Investors Service Public Finance Regional Office One Front Street, Suite 1900 San Francisco, CA 94111 (415) 274-1700</p>
<p>Standard & Poor's Ratings Group 25 Broadway New York, NY 10004 (212) 208-1723 www.standardandpoors.com</p>	<p>Standard & Poor's Ratings Group 555 California Street, 21st Floor San Francisco, CA 94104 (415) 765-5000</p>

GOVERNMENTAL OFFICES

<p>California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) 304 S. Broadway, Suite 550 Los Angeles, CA 90013 (213) 620-4467 (213) 620-6309 (Fax) www.treasurer.ca.gov/caeatfa</p>	<p>CAEATFA finances facilities that use new energy sources and technologies, and finances development of advanced transportation technologies. CAEATFA is comprised of the State Treasurer (Chair), the Director of the Department of Finance, the State Controller, the Chairperson of the Energy Commission, and the President of the Public Utilities Commission.</p>
<p>California State Controller P.O. Box 942850 Sacramento, California 94250-5872 (916) 445-2636 www.sco.ca.gov</p>	<p>The Controller accounts for receipts and disbursements of state funds, reporting on the financial condition of state and local governments etc.</p>
<p>California Debt and Investment Advisory Commission (CDIAC) 915 Capitol Mall, Room 400 Sacramento, CA 95814 (916) 653-3269 (916) 654-7440 (Fax) www.treasurer.ca.gov/cdiac</p>	<p>CDIAC is the state’s clearinghouse for information on public debt and investment information. The commission collects and analyzes information on the issuance of debt by public agencies and provides technical assistance concerning debt issuance and the investment of debt proceeds and related policy issues.</p>
<p>California Debt Limit Allocation Committee (CDLAC) 915 Capitol Mall, Room 308 Sacramento, CA 95814 (916) 653-3255 (916) 653-6827 (Fax) www.treasurer.ca.gov/cdlac</p>	<p>CDLAC is a three-member body comprised of the State Treasurer (Chair), the Governor, and the State Controller. CDLAC was created in 1985 by Governor proclamation in response to the 1984 Tax Reform Act, which imposed an annual limit on the dollar amount of tax-exempt private activity bonds that may be issued in a state. Private activity bonds included student loan bonds and industrial development bonds (including exempt facility bonds, small-issue industrial development bonds, and bonds for industrial parks).</p>

<p>California Department of Corporations 320 West 4th Street, Suite 750 Los Angeles, CA 90013-2344 (213) 576-7500 (866) 275-2677 or (866) ASK-CORP (Additional offices are located in San Francisco, San Diego, and Sacramento) www.corp.ca.gov</p>	<p>The California Department of Corporations regulates health care service plans, securities transactions, franchise regulation, investment advisors, broker/dealers, and various financial transactions.</p>
<p>California Department of Finance 915 L Street Sacramento, CA 95814 (916) 445-3878 www.dof.ca.gov</p>	<p>Part of the executive branch of the state, the Department of Finance establishes fiscal policies, prepares the state’s annual financial plan, and analyzes legislation that has a fiscal impact.</p>
<p>California Department of Financial Institutions (DFI) 111 Pine Street, Suite 1100 San Francisco, CA 94111-5613 (415) 263-8500 (415) 989-5310 (Fax) www.dfi.ca.gov</p>	<p>DFI is responsible for administering state laws regulating state-licensed financial institutions such as banks, credit unions, industrial banks, savings associations, trust companies, offices of foreign banks, issuers of travelers checks and payment instruments (money orders), and transmitters of money abroad.</p>
<p>California Department of General Services Procurement Division 707 Third Street, 2nd Floor West Sacramento, CA 95605 (800) 559-5529 www.dgs.ca.gov</p>	<p>The Department of General Service’s mission is to increase the efficiency and effectiveness of state government by providing high quality business and support services to state and public agencies.</p>
<p>California Department of Transportation (Caltrans) 1120 N Street Sacramento (916) 654-5266 www.dot.ca.gov</p>	<p>Caltrans’ mission is to provide Californians with safe, efficient, and effective transportation systems while planning for the state’s transportation future.</p>

<p>California Department of Water Resources (DWR) 1416 Ninth Street Sacramento, CA 95814 (916) 653-5791 www.dwr.water.ca.gov</p>	<p>DWR provides technical and financial assistance to local water communities and operates and maintains the State Water Project.</p>
<p>California Educational Facilities Authority (CEFA) 915 Capitol Mall, Room 590 Sacramento, CA 95814 (916) 653-2872 www.treasurer.ca.gov/cefa</p>	<p>CEFA was created for the purpose of issuing revenue bonds to assist private nonprofit institutions of higher learning in the expansion and construction of educational facilities.</p>
<p>California Health Facilities Financing Authority (CHFFA) 915 Capitol Mall, Room 590 Sacramento, CA 95814 (916) 653-2799 www.treasurer.ca.gov/chffa</p>	<p>CHFFA is the state’s vehicle to provide financial assistance to public and nonprofit health care providers through loans funded by the issuance of tax-exempt bonds.</p>
<p>California Housing Finance Agency (CalHFA) Sacramento Headquarters P.O. Box 4034 Sacramento, CA 95812-4034 (916) 322-3991 www.calhfa.ca.gov</p>	<p>CalHFA manages the process of selling bonds in order to use the proceeds to make low-interest loans to first time home purchasers.</p>
<p>California Industrial Development Financing Advisory Commission (CIDFAC) 915 Capitol Mall, Room 457 Sacramento, CA 95814 (916) 653-3843 www.treasurer.ca.gov/cidfac</p>	<p>CIDFAC assists California manufacturing businesses in funding capital expenditures for acquisitions or expansions.</p>

<p>California Infrastructure and Economic Development Bank 1001 I Street, 19th Floor Sacramento, CA 95814 (916) 322-1399 (916) 322-6314 (Fax) www.ibank.ca.gov</p>	<p>The California Infrastructure and Economic Development Bank (I-Bank) was created in 1994 to promote economic revitalization, enable future development, and encourage a healthy climate for jobs in California. The I-Bank is located within the Business, Transportation and Housing Agency and is governed by a five-member Board of Directors.</p> <p>The I-Bank has broad authority to issue tax-exempt and taxable revenue bonds, provide financing to public agencies, provide credit enhancements, acquire or lease facilities, and leverage state and federal funds. The I-Bank's current programs include the Infrastructure State Revolving Fund (ISRF) Program and several revenue bond financing programs.</p>
<p>California Integrated Waste Management Board 1001 I Street PO Box 4025 Sacramento, CA 95812-4025 (916) 341-6000 www.ciwmb.ca.gov</p>	<p>The Board is responsible for managing California's solid waste stream.</p>
<p>California Local Agency Investment Fund (LAIF) 915 Capitol Mall, Room 106 Sacramento, CA 95814 (916) 653-3001 www.treasurer.ca.gov/laif</p>	<p>This voluntary program allows participating agencies to take part in the state's investment portfolios, serving as an investment alternative for the state's local governments and special districts.</p>
<p>California Pollution Control Financing Authority (CPCFA) 915 Capitol Mall, Room 457 Sacramento, CA 95814 (916) 654-5610 www.treasurer.ca.gov/cpcf</p>	<p>CPCFA uses its Small Business Assistance Fund to pay for the costs of issuance of tax-exempt bonds issued by small businesses for the acquisition, construction, or installation of pollution control, waste disposal, and resource recovery facilities.</p>

<p>California School Finance Authority (CSFA) 304 S. Broadway, Suite, 550 Los Angeles, CA 90013 (213) 620-4467 (Los Angeles Office) (916) 651-7710 (Sacramento Office) www.treasurer.ca.gov/csfa</p>	<p>CSFA oversees the statewide system for the sale of revenue bonds to reconstruct, remodel, or replace existing school buildings, acquire new school sites and buildings to be made available to public school districts (K-12) and community colleges, and to assist school districts by providing access to financing for working capital and capital improvements.</p>
<p>California State Treasurer's Office (STO) 915 Capitol Mall Sacramento, CA 95814 (916) 653-2995 www.treasurer.ca.gov</p>	<p>STO invests temporary surplus operating funds, coordinates the collection of state revenues, provides for the custody of the state's money, administers the state's bond debt program, and performs other fiscal functions.</p>
<p>California Tax Credit Allocation Committee (TCAC) 915 Capitol Mall, Room 485 Sacramento, CA 95814 (916) 654-6340 www.treasurer.ca.gov/ctcac</p>	<p>TCAC administers two low-income housing tax credit programs for low and lower income families and individuals.</p>
<p>California Urban Waterfront Area Restoration Financing Authority (CUWARFA) 915 Capital Mall, Room 457 Sacramento, CA 95814 (916) 654-5610 www.treasurer.ca.gov/cuwarfa</p>	<p>CUWARFA issues revenue bonds for urban waterfront development projects in designated coastal zones.</p>
<p>U.S. Internal Revenue Service (IRS) West Coast Regional Office 1650 Mission Street San Francisco, CA 94103 (800) 829-1040 www.irs.ustreas.gov</p>	<p>The IRS collects approximately \$1.5 trillion in taxes each year.</p>

<p>U.S. Securities and Exchange Commission (SEC) 5670 Wilshire Boulevard, 11th Floor Los Angeles, CA 90036-3648 (323) 965-3998 www.sec.gov</p>	<p>The SEC is an independent, nonpartisan, quasi-judicial regulatory agency with responsibility for administering the federal securities laws.</p>
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ASSOCIATIONS

<p>American Public Power Association (APPA) 2301 M Street, NW Washington, D.C. 20037 (202) 467-2900 www.appanet.org</p>	<p>APPA is a trade association representing municipal and other state and local government owned electric utilities.</p>
<p>Association of California Water Agencies (ACWA) 910 K Street, Suite 100 Sacramento, CA 95814-3512 (916) 441-4545 www.acwanet.com</p>	<p>ACWA aims to assist its members in promoting the development, management, and reasonable beneficial use of good quality water at the lowest practical cost in an environmentally balanced manner.</p>
<p>The Bond Market Association (TBMA) 360 Madison Ave. New York, NY 10017-7111 (646) 637-9200 www.bondmarkets.com</p>	<p>TBMA speaks and advocates for securities firms and banks that underwrite, trade, and sell securities.</p>
<p>California Association of County Treasurers & Tax Collectors (CACTTC) 1414 K Street, Suite 300 Sacramento, CA 95814 (916) 441-1850 www.cacttc.org</p>	<p>The purpose of the CACTTC is to promote the interests of its members and to strive for higher standards.</p>
<p>California Association of School Board Officials (CASBO) 600 N. 10th Street, Suite 150 Sacramento, CA 95814 (916) 447-3783 www.casbo.org</p>	<p>CASBO is the statewide association of school board officials.</p>
<p>California Building Industry Association (CBIA) 1215 K Street, Suite 1200 Sacramento, CA 95814 (916) 443-7933 www.cbia.org</p>	<p>The purpose of the CBIA is to represent the building industry at the state level.</p>

<p>California Statewide Communities Development Authority (CSCDA) 2175 North California Blvd. Suite 550 Walnut Creek, CA 94596 (925) 933-9229</p>	<p>CSCDA, more commonly known as "California Communities" or "Cal Statewide," is a joint powers authority sponsored by the California State Association of Counties and the League of California Cities. California Communities was created to provide local governments and private entities access to low-cost, tax-exempt financing.</p>
<p>California Municipal Treasurer's Association (CMTA) 1400 K Street, Suite 400 Sacramento, CA 95814 (916) 658-8209 www.cmta.org</p>	<p>CMTA aims to enhance the role of the governmental treasurer as a key official in local government.</p>
<p>California Municipal Utilities Association (CMUA) 1225 Eighth Street, Suite 440 Sacramento, CA 95814 (916) 441-1733 www.cmua.org</p>	<p>CMUA monitors the activities of regulatory agencies, presents testimony, and participates in rulemaking on behalf of its utility members.</p>
<p>California Redevelopment Association (CRA) 1400 K Street, Suite 204, Sacramento, CA 95814 (916) 448-8760 www.calredevelop.org</p>	<p>CRA monitors legislative matters, lobbies, and seeks to provide education for and on behalf of redevelopment agencies and consultants.</p>
<p>California School Boards Association (CSBA) 3100 Beacon Blvd. West Sacramento, CA 95691 (800) 266-3382 www.csba.org</p>	<p>CSBA provides policy analysis and advocacy on behalf of public education and children.</p>
<p>California Society of Municipal Finance Officers (CSMFO) 1400 K Street, Suite 400 Sacramento, CA 95814 (916) 658-8210 www.csmfo.org</p>	<p>CSMFO is a statewide organization aiming to serve all municipal finance professionals.</p>

<p>California Special Districts Association (CSDA) 1215 K Street Sacramento, CA 95814 (916) 442-7887 www.csda.net</p>	<p>CSDA is the statewide association for special districts.</p>
<p>California State Association of Counties (CSAC) 1415 L Street, Suite 300 Sacramento, CA 95814 (916) 321-9000 www.sacog.org</p>	<p>CSAC is a nonprofit organization representing all 58 California counties to the state and federal legislatures and to other levels of local, state, and national government.</p>
<p>California Transit Association (CTA) 1400 K Street, Suite 301 Sacramento, CA 95814 (916) 446-4656 www.catransit.org</p>	<p>CTA is an advocate for public transit in California.</p>
<p>Coalition for Adequate School Housing (CASH) c/o Murdoch, Walrath & Holmes 1130 K Street, Suite 210 Sacramento, CA 95814 (916) 448-8577 www.cashnet.org</p>	<p>CASH promotes, develops, and supports the enactment of new statewide and local funding alternatives for public K-12 school construction, maintenance, and modernization.</p>
<p>Council of Development Finance Agencies (CDFA) 301 NW 63rd Street, Suite 500 Oklahoma City, OK 73116 (405) 848-6059 www.cdfa.net</p>	<p>CDFA is a nationwide organization of development authorities and their partners. It provides information and technical assistance on issues impacting economic development finance.</p>
<p>Education Finance Council (EFC) 1155 15th Street, NW, Suite 801 Washington, D.C. 20005 (202) 466-8621 www.efc.org</p>	<p>EFC is a nonprofit association organized to promote the common interests of tax-exempt education loan secondary market organizations.</p>

<p>eMuni 5460 College Avenue Oakland, California 94618 (510) 658-2655 www.emuni.com</p>	<p>eMuni is an organization created to provide documents, news, developments, and financial information about the municipal bond market.</p>
<p>Government Finance Officers Association (GFOA) 203 N. LaSalle St., Suite 2700 Chicago, IL 60601-1210 (312) 977-9700 www.gfoa.org</p>	<p>GFOA is the professional association of state/provincial and local finance officers of the United States and Canada.</p>
<p>League of California Cities (League) 1400 K Street, Suite 400 Sacramento, CA 95814 (916) 658-8200 www.cacities.org</p>	<p>The League provides education and training programs for California's city officials.</p>
<p>Municipal Securities Rulemaking Board (MSRB) 1900 Duke Street. Suite 600 Alexandria, VA 22314 (703) 797-6600 www.msrb.org</p>	<p>MSRB is a self-regulatory organization established by Congress to develop rules to regulate the municipal securities industry.</p>
<p>National Association of Bond Lawyers (NABL) 250 S. Wacker Drive, Suite 1550 Chicago, IL 60606-5886 (312) 648-9590 www.nabl.org</p>	<p>NABL educates its members and others in the law relating to state and municipal bonds and aims to improve the state of the art in the field.</p>
<p>National Association of Housing and Redevelopment Officials (NAHRO) 630 Eye Street, NW Washington, D.C. 20001-3736 (202) 289-3500 www.nahro.org</p>	<p>The goal of NAHRO is to be a housing and community development advocate for the provision of adequate and affordable housing.</p>

<p>National Association of Securities Dealers (NASD) 525 Market Street, Suite 300 San Francisco, CA 94105-2711 (415) 882-1200 (415) 546-6991 (Fax) www.nasd.com</p>	<p>NASD develops rules and regulations and disciplines members with the ultimate objective of protecting investors.</p>
<p>National Association of State Auditors, Comptrollers and Treasurers (NASACT) 2401 Regency Road, Suite 302 Lexington, KY 40503-2914 (606) 276-1147 www.nasact.org</p>	<p>NASACT aims to represent state views on a variety of financial management topics.</p>
<p>National Association of State Budget Officers (NASBO) 444 North Capitol Street, NW, Suite 642 Washington, D.C. 20001-1511 (202) 624-5382 www.nasbo.org</p>	<p>NASBO is the professional membership organization for state financial officers and provides research, policy development, education, training, and technical assistance.</p>
<p>National Association of State Treasurers (NAST) 2760 Research Park Drive P.O. Box 11910 Lexington, KY 40578-1910 (606) 244-8175 www.nast.org</p>	<p>NAST, the professional organization for state treasurers, provides a forum to exchange information and developments on matters of public finance.</p>
<p>National Association of Counties (NACO) 440 First Street, NW Washington, D.C. 20001 (202) 393-6226 www.naco.org</p>	<p>NACO was created in 1935 when county officials wanted to have a strong voice in the nation's capital. NACO's membership totals more than 2,000 counties, representing over 80 percent of the nation's population.</p>

<p>National Council of State Housing Agencies (NCSHA) 444 N. Capitol Street, Suite 438 Washington, D.C. 20001 (202) 624-7710 www.ncsha.org</p>	<p>The nation’s state Housing Finance Agencies (HFAs) created NCSHA as a nonprofit organization nearly 30 years ago to coordinate and leverage their federal advocacy efforts for affordable housing. NCSHA’s members are the HFAs of every state and over 350 affiliate member companies that work in the affordable housing field.</p>
<p>National League of Cities (NLC) 1301 Pennsylvania Ave., NW Washington, D.C. 20004 (202) 626-3000 www.nlc.org</p>	<p>NLC is the oldest and largest national organization representing municipal governments throughout the United States. Its mission is to strengthen and promote cities as centers of opportunity, leadership, and governance.</p>

**NATIONALLY RECOGNIZED MUNICIPAL
SECURITIES INFORMATION REPOSITORIES (NRMSIRs)**

This list is current as of February 22, 2006. See the SEC website at www.sec.gov/info/municipal/nrmsir.htm for an up-to-date list.

Bloomberg Municipal Repository
100 Business Park Drive
Skillman, New Jersey 08558
(609) 279-3225
(609) 279-5962 (Fax)
www.bloomberg.com/markets/rates/municontacts.html
Munis@Bloomberg.com

DPC Data Inc.
One Executive Drive
Fort Lee, NJ 07024
(201) 346-0701
(201) 947-0107 (Fax)
www.dpcdata.com
nrmsir@dpcdata.com

Standard & Poor's Securities Evaluations, Inc.
55 Water Street, 45th Floor
New York, NY 10041
(212) 438-4595
(212) 438-3975 (Fax)
nrmsir_repository@sandp.com

FT Interactive Data
Attn: NRMSIR
100 William Street, 15th Floor
New York, NY 10038
(212) 771-6999; (800) 689-8466
(212) 771-7390 (Fax)
www.ftid.com
NRMSIR@interactivedata.com

Appendix C

DEBT FINANCING TERMS AND CONCEPTS

This appendix is designed to provide definitions drafted in plain English for terms and concepts used in connection with debt issuance. To be consistent with customary industry practice, the term bonds is used to mean either long-term bonds or, more generally, bonds, notes, commercial paper, certificates of participation, and other types of evidence of debt. The index to the *California Debt Issuance Primer (Primer)* may contain cross-references to terms not defined here in alphabetical order.

ACCELERATION

A remedy provided in many security agreements (including many indentures and bond resolutions) by which the trustee may declare all future payments of principal immediately due and payable after the occurrence of certain specified events—usually called events of default.

In some security agreements the trustee may be required to accelerate upon the occurrence of an event of default. Sometimes acceleration can occur only upon the consent or direction of a credit enhancement provider or only upon the request of the holders of a specified percentage of the bonds (often 25 percent).

Generally, unless the security agreement provides otherwise, acceleration results in available monies being used first to pay interest pro rata on all the bonds and, if interest is fully paid, to pay principal pro rata on all maturities. As a result, all the bonds are placed on an equal footing, regardless of their scheduled maturity.

ACCRUED INTEREST

In general, interest that has been earned on a bond but not yet paid—usually because it is not yet due.

More specifically, this term is often used to refer to interest earned on a bond from its dated date to the closing date.

ADDITIONAL BONDS

Additional bonds is a term found in indentures, trust agreements, bond resolutions, and other bond issuance documents referring to bonds that may be issued in the future in addition to the bonds being issued under the current document. Almost always, these bonds are on a parity with the bonds being issued initially and may not be issued without meeting certain conditions

involving the level of revenues available to repay the initial bonds and additional bonds, maximum amount limitations, and other conditions. These conditions are often referred to as the additional bonds test. See **Parity**.

AD VALOREM TAXES

An annual tax that is a uniform percentage of the value (or assessed value) of property.

ADVANCE REFUNDING

See **Refunding**.

ALL-HOLD RATE OR HOLD RATE

The interest rate on any auction date equal to a percentage of a variable index specified in the indenture or the trust agreement—typically the Bond Market Association (BMA) Index or the London Interbank Offered Rate (LIBOR)—provided such rate does not exceed the maximum auction rate specified in the indenture or the trust agreement.

ALTERNATIVE MINIMUM TAX (AMT)

An income tax based on a separate and alternative method of calculating taxable income and a separate and alternative schedule of rates.

With respect to bonds, the interest on certain types of qualified private activity bonds—not including qualified 501(c)(3) bonds—is included in income for purposes of the individual and corporate alternative minimum tax.

In addition, the interest received by a corporation on all bonds held by it is included in federal corporate adjusted net book income and adjusted current earnings, a portion of which may increase the alternative minimum taxable income of such corporation.

AMORTIZE

To retire the principal of an issue by periodic payments either directly to bondholders, or first to a sinking fund and then to bondholders. Compare to **Balloon** and **Bullet**.

ANNUAL REPORT

The annual report is the report containing annual financial and operating data prepared and filed with the Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) and state information depository (SID)—if any—pursuant to Securities and Exchange Commission (SEC) Rule 15c2-12.

APPLICABLE AUCTION RATE

The rate per annum at which interest accrues on an auction rate security for any auction rate period.

ARBITRAGE BONDS

See **Chapter 3, General Federal Tax Requirements**.

ARBITRAGE YIELD RESTRICTION

With respect to municipal bonds, arbitrage is the profit made by issuing bonds bearing interest at tax-exempt rates, and investing the proceeds at materially higher taxable yields.

The Internal Revenue Code limits the opportunity for borrowers to use monies associated with tax-exempt bonds to acquire materially higher yielding taxable investment property. However, certain exceptions are provided—in particular for reserve accounts and for investments during temporary periods.

To the extent arbitrage is legally earned in respect of tax-exempt bonds issued after August 15, 1986, it may be required to be paid over to the federal government pursuant to the rebate requirement.

If it is necessary for the yield on the investment of proceeds to be limited, the yield restriction may not be used as a device to transfer the benefits of arbitrage to another person or entity. As a result, the yield-restricted investment must be in either state and local government series (SLGS) or tax-exempt bonds or must be in taxable investments that are purchased at a market price and which are of an appropriate maturity (without regard to yield).

ASSESSMENTS

Assessments are charges in the nature of taxes upon property owners to pay the costs of facilities or improvements that benefit the property.

Payment of the amount assessed (together with interest if not paid upon assessment) is secured by a direct fixed lien on the property. The assessed payments are either used directly to pay the costs of the facilities and improvements or, if paid over time, are used to repay bonds issued to finance such costs. Special assessment financing proceeds are used for improvements relating to the property, such as sidewalks, streets, gutters, sewers, and water systems. Benefit assessment financing proceeds are used for items with a less tangible relationship to the assessment and are based on a determined benefit to the landowner (i.e. parking and flood control projects).

See also **Chapter 6, Types of Financing Obligations – Assessment Bonds**.

AUCTION

An electronic competitive process through which auction rate securities (ARS) are sold at the lowest yield rate (priced at par) at which sufficient bids are received to sell all securities offered. ARS are sold at the clearing yield established by the auction to the investors placing bids at or below the clearing yield. All ARS in a series will bear interest at the clearing auction rate for the next auction period.

AUCTION AGENT

A third-party institution responsible for conducting the auction used in connection with the periodic reset of the interest rate.

AUCTION DATE

The business day immediately preceding the first day of each auction rate period for an ARS.

AUCTION PROCEDURES

The process and timing for conducting the auction as set forth in the bond indenture or trust agreement and summarized in the auction agreement.

AUCTION RATE

The rate of interest per annum resulting from the implementation of the auction, provided such rate does not exceed a maximum rate specified in the bond indenture or trust agreement.

AUCTION RATE PERIOD

The initial auction rate period established by the underwriter at the time of issuance of the ARS and, subsequently, each period during which a specific auction rate is in effect as a result of an auction. The auction rate period commences on the business day after the auction date and ends and includes the day preceding the next interest rate reset date.

AUCTION RATE SECURITIES

See **Chapter 8, Fixed and Variable Interest Rate Structures – Variable Interest Rate Debt – Auction Rate Securities.**

AUTHENTICATING AGENT

The agent of the issuer appointed to authenticate bonds (i.e. to sign them as being authentic) upon initial issuance or upon transfer or exchange.

See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Trustee/Fiscal Agent/Paying Agent/Registrar/Authenticating Agent.**

BALLOON

Principal of an issue to be paid in a single final maturity that constitutes a large percentage of the total principal of the issue. See also **Bullet.**

BANK ELIGIBLE BONDS

Bonds (including certificates of participation or COPs) that are eligible under federal banking law—the Glass-Steagall act—to be underwritten by commercial banks.

Bank eligible bonds generally include bonds that are directly or indirectly the obligations of the general fund of a city, county, or state and bonds for single-family or multifamily housing.

BANK QUALIFIED BONDS

Tax-exempt bonds that are issued by certain qualified small issuers and which do not need to be taken into account for purposes of determining the portion of certain financial institutions' interest expense, which is disallowed as a deduction for federal tax purposes, because such interest expense is allocable to debt (including deposits) deemed to have been incurred by the financial institution to carry tax-exempt bonds.

BASIS POINT

See **Point/Basis Point.**

BLIND POOL ISSUE

See **Pooling of Debt Issues.**

BLUE SKY LAWS/BLUE SKY SURVEY OR MEMORANDUM

Blue Sky laws are the state statutes that regulate the manner of offering and selling of securities, bonds, investment contracts, and stocks.

These statutes are commonly referred to as Blue Sky Laws because their purpose is to prevent, as the U.S. Supreme Court posited in 1917, “speculative schemes which have no more basis than so many feet of blue sky.”

Generally, in a public offering, a memorandum called a Blue Sky Survey is prepared, which summarizes the treatment of the issue under the securities laws of each state and, occasionally, the laws of Puerto Rico, Guam, the District of Columbia, and the U.S. Virgin Islands. The

preliminary form of this memorandum specifies the states in which the issue need not be registered in a manner similar to SEC registration (i.e. no filings need be made), those states in which action will be taken by the issuer to register the offering, and those states in which registration is required but not contemplated and in which the securities are not, therefore, permitted to be offered or sold. The final Blue Sky Survey generally reports that the registration actions contemplated by the preliminary survey have been taken.

Certain types of securities are usually exempted from registration under most Blue Sky Laws on the theory that the issuer either is a government organization or is supervised by a government organization (even if the government organization has not approved the specific security to be issued). One common exemption is for municipal bonds. However, several states do not exempt some or all conduit financings from registration unless there is an independent exemption for the nongovernmental borrower (e.g. the exemptions for exchange-listed or “blue chip” companies or public utilities).

Certain transactions are also exempted, whether or not the securities being sold are exempted securities. The most familiar are the private placement exemption and the exemption for offers and sales to broker/dealers and institutional investors such as banks, savings institutions, trust companies, insurance companies, investment companies, and pension or profit-sharing trusts.

The above exemptions—whether for certain securities or transactions—are only exemptions from registration of the issue and not exemptions from the anti-fraud provisions of the state law or from the requirement for a broker/dealer to register as such.

BOND COUNSEL

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Bond Counsel.**

BOND INSURANCE

Noncancellable insurance purchased by the issuer from a bond insurer pursuant to which the insurer promises to make scheduled payments of interest, principal, and mandatory sinking fund payments on an issue if the issuer fails to make timely payments.

Bond insurance is never a substitute for the underlying creditworthiness of the issuer.

Payment of an installment by the insurer does not relieve the issuer of its obligation to pay that installment. The issuer remains liable to pay that installment to the insurer.

Insurance agreements are subject to negotiation. Often, insurers will require that the indenture or bond resolution treat the insurer as if it were a major owner of the bonds. The insurer's consent is often necessary to amend the financing agreements. In addition, the insurer is sometimes

given the right to accelerate the payment of principal if the insurer is ever required to make a payment.

See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Credit Enhancement Provider.**

BOND PRINTING

The printing of bonds on special paper designed to be difficult to counterfeit.

BOND PURCHASE CONTRACT OR AGREEMENT

In a negotiated sale, the bond purchase contract is an agreement between an issuer and an underwriter or a group of underwriters—a syndicate or a selling group who have agreed to purchase the issue.

A bond purchase contract generally contains the following:

- The purchase price to be paid by the underwriter (including any premium or discount). See also **Underwriter's Gross Spread (Underwriter's Discount).**
- Certain terms of the bonds, such as interest rates, maturities, redemption provisions, and original issue discount
- The circumstances under which the underwriter may cancel its obligation to purchase the issue (e.g. changes in the tax treatment of the bonds and other events that would make it substantially more difficult for the underwriter to sell the bonds to investors)
- The good faith deposit, if any
- The conditions to the closing of the issue, which often include documents, certificates, and opinions that are to be delivered on the closing date
- Any restrictions on the liability of the issuer

Other common terms for a bond purchase contract are contract of purchase or bond purchase agreement.

In a competitive sale, the notice of sale, the underwriter's bid, and the issuer's acceptance of the bid together constitute a bond purchase contract. Generally, these three items taken together contain items similar to those in a negotiated bond purchase contract.

See **Chapter 1, Overview of a Debt Financing – Basic Legal Documents.**

BOND RESOLUTION

See **Indenture/Bond Resolution (General, Supplemental, and Series)**.

BOOK ENTRY ONLY REGISTRATION

A form of registration of the ownership of registered bonds in which the owners of bonds are not entitled to the receipt of printed bonds. Rather, the terms of the bonds are specified by the indenture or bond resolution or by the form of a single bond delivered to a securities depository, and the beneficial ownership of bonds is determined by entries on the registration books of the registrar or by the records of members of the securities depository.

The sale of a bond issued in book entry form is evidenced by a receipt provided by the broker/dealer to the investor and not by the issuance of a new registered bond with the owner's name.

BROKER/DEALER AGREEMENT

An agreement between the issuer or auction agent and a broker/dealer specifying the procedures for conducting the auction of the ARS and the settlement procedures for the payment and delivery of the ARS.

BULLET

Principal of an issue to be retired in a single final maturity that constitutes the entire principal of the issue.

A bullet issue has no amortization of principal or sinking fund redemption prior to its final maturity. There may, however, be a sinking fund to accumulate the amount necessary to make the final maturity payment.

CALL

To give notice of redemption; to redeem.

CAPITAL APPRECIATION BOND

See **Compound Interest Bond**.

CAPITALIZED INTEREST (FUNDED INTEREST)

Bond proceeds reserved to pay interest on an issue for a period of time early in the term of the issue—also called funded interest. Capitalized interest may also refer to the interest to be so paid.

Commonly, in a project financing, interest is capitalized through the date on which it is anticipated that construction of the project being financed with the proceeds will be completed and the date when the project will be operating and capable of providing revenues for repayment of debt service.

CASH FLOW

A comparison of cash receipts (revenues) to required payments (generally, debt service and operating expenses).

A cash flow may demonstrate that receipts by an issuer from a project's revenues or a mortgage portfolio, or from collection of a tax, fee, or other charge will be sufficient to equal or exceed, in each year the sum of payments of principal and interest on an issue and related expenses, generally on the basis of specified assumptions, which may include a "worst case" scenario.

A cash flow may also be used in the context of showing that payments of principal and interest received on investments held in an escrow will be received at such times and in sufficient amounts to equal or exceed debt service on the issue for which the escrow fund has been established, such as is required for an advance refunding.

Finally, in a tax and revenue anticipation note financing, a cash flow may be used to determine the amount of the issuer's operating deficit, which is a factor in determining the permitted size of the issue under federal tax rules. See **Chapter 6, Types of Financing Obligations – Tax and Revenue Anticipation Notes (TRANS)**.

CASH FLOW FINANCING

A financing in which the proceeds of the issue are used to pay current expenses of the issuer when the issuer's current income is temporarily insufficient for that purpose.

Also sometimes called TRANS, TANS, or RANs (tax and revenue anticipation notes). The issue is customarily scheduled to be repaid when current income exceeds current expenses. The issue typically has a term of one year or less. See **Chapter 6, Types of Financing Obligations – Tax and Revenue Anticipation Notes (TRANS)**.

CERTIFICATE OF PARTICIPATION (COP)

A certificate (which looks very much like a bond) representing an undivided interest in the payments made by a public agency pursuant to a financing lease (or an installment purchase agreement).

A portion of each lease payment (and, therefore, a portion of each interest in a lease payment) is designated as being principal and the remainder as interest. Even though COPs are not treated as indebtedness of the issuer under state law (particularly the California Constitution), the federal

tax law treats the lease obligation as if it were a debt, and, as a result, the interest component of each lease payment may be treated as tax-exempt interest.

See also **Chapter 6, Types of Financing Obligations – Financing Leases and Certificates of Participation.**

CLEARING RATE

The lowest interest rate bid at which all ARS shares can be sold at par. The rate is paid on the entire issue for the upcoming period.

CLOSING DATE (DELIVERY DATE)

The date on which an issue is delivered by the issuer to, and paid for by, the original purchaser (often an underwriter). Also called the delivery date.

This may be a different date than the sale date or the dated date.

COMFORT LETTER

A letter provided by the issuer's (or sometimes in a conduit financing by the nongovernmental borrower's) certified public accountant at the time the bond purchase contract is signed and on the closing date. The letter confirms that specified financial information regarding the borrower contained in the Preliminary Official Statement or final Official Statement is presented in conformity with generally accepted accounting principles and that no changes in the financial position of the borrower since the date of the last audited financial statements, other than those changes disclosed in the comfort letter or in the Official Statement, have occurred.

The comfort letter often contains items of “special comfort,” which generally confirm that financial information presented in the Official Statement (preliminary or final) is accurately presented or calculated. The content of comfort letters is regulated by the American Institute of Certified Public Accountants and, as a result, the content and style differ only minimally among accounting firms.

COMMERCIAL PAPER

Notes of varying very short-term maturities (generally one to ninety days), which are intended to be rolled over in a series of current refundings as portions of the issue mature from time to time.

Generally, the maturity of the commercial paper sold on each rollover is determined by market conditions at the time of rollover. See also **Line of Credit** and **Letter of Credit**.

COMPETITIVE SALE

The sale of bonds to the bidder presenting the best sealed bid at the time and place specified in a published notice of sale (also called a public sale).

When bonds are to be sold at a competitive sale, the issuer typically specifies all the terms of the issue other than interest rates and purchase price. When the issue is ready to market, the issuer solicits bids by placing a notice of sale in one or more industry publications such as *The Wall Street Journal* or *The Bond Buyer* and, if required by law, in a local newspaper of general circulation. In the notice of sale, the issuer announces that it will accept sealed bids until a certain date and time. Prior to presenting bids the underwriters evaluate the credit quality of the issue and the municipal market and may form syndicates or selling groups. The bonds are awarded to the underwriters presenting the best bid based on the criteria specified in the notice of sale. Possible criteria include the Net Interest Cost (NIC) method or the net effective interest rate or True Interest Cost (TIC) method of comparing the cost to the issuer of the financing. See also **Negotiated Sale**.

COMPOSITE ISSUE

Two or more issues having substantially identical terms and which are sold and delivered at the same time (by one or more issuers).

Generally, each issue is used to finance a separate project or purpose. The proceeds are not pooled but instead, the issues are pooled into a composite issue for purposes of marketing. A single Official Statement is used to sell the issues. These issues usually require bond insurance or a letter of credit to guarantee each issue so that the credit rating and marketing of the bonds is based on the insurance company or bank. This equalizes unlike credits in the eyes of investors. See also **Pooling of Debt Issues**.

COMPOUND

To treat accrued interest as if it were principal, so that interest thereafter accrues on the sum of the principal and the compounded interest.

COMPOUND INTEREST BOND

A bond on which interest is not payable until maturity (or earlier redemption), but compounds periodically to accumulate to a stated maturity amount.

These bonds are also called capital appreciation bonds or CABs and are sometimes misnamed zero coupon bonds.

CONDUIT FINANCING

A financing in which the proceeds of the issue are loaned to a nongovernmental borrower who then applies the proceeds for a project financing or—if permitted by federal tax law for a qualified 501(c)(3) bond—for working capital purposes.

Typically, the project financed is owned and operated by the borrower, but projects may also be financed for lease to the private user or for sale pursuant to an installment sale contract. Statutes authorizing conduit financings generally specify the nature of the projects that may be financed and limit such projects to those with a specified public purpose. See also **Chapter 6, Types of Financing Obligations – Conduit Revenue Bonds: General**.

CONDUIT ISSUER

A governmental agency that issues bonds in connection with a conduit financing.

CONTINUING DISCLOSURE

The ongoing disclosure provided by an issuer or obligated person pursuant to an undertaking entered into to allow the underwriter to comply with SEC Rule 15c2-12. See **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

CONTINUING DISCLOSURE AGREEMENT

An agreement (sometimes a certificate) of an issuer or an obligated person containing undertakings to provide annual reports and event notices pursuant to SEC Rule 15c2-12. See **Chapter 1, Overview of a Debt Financing – Basic Legal Documents**.

COP

See **Certificate of Participation (COP)**.

COSTS OF ISSUANCE

Costs of issuance are the expenses paid by or on behalf of the issuer in connection with the sale and issuance of bonds.

These expenses may include, but are not limited to, bond counsel's fees, disclosure counsel fees, trustee's fees, financial advisor's fees, feasibility consultant's fees, accounting fees, costs of printing the bonds, costs of printing the Official Statement or other disclosure documents, costs associated with obtaining a credit rating, and underwriter's gross spread. For some types of bonds the costs of issuance can be paid from the proceeds. For other types of securities, for example qualified private activity bonds, the costs of issuance borrowed as part of the issue are limited to 2 percent of the proceeds.

COUPON BOND

A bond that generally has a number of interest coupons attached to it and which is transferable merely by delivering it to its new owner.

Each coupon is a negotiable instrument representing interest to be paid on the bond for a specified period, usually six months. To receive an interest payment on a coupon bond, the holder must detach the coupon and present it at the office of the trustee or paying agent—or at the holder's own bank if the bank is willing to provide the service of presenting the coupon for payment.

Coupon bonds are sometimes referred to as bearer bonds, since payment may be made to any bearer of the bond or coupon, rather than to a particular registered owner. Coupons that represent less or more than six months' interest are sometimes referred to as short coupons or long coupons, respectively.

Tax-exempt coupon bonds with maturities longer than one year may no longer be issued. However, the interest rate on a bond is still sometimes referred to as the coupon rate. Compare to **Registered Bond**.

COVENANTS

Contractual obligations in financing agreements whereby the party making the promises agrees to perform or refrain from performing certain actions or to comply with certain requirements.

Most issuer covenants are found in the indenture or bond resolution pursuant to which the bonds are issued. However, in a conduit financing, the covenants of the nongovernmental borrower are often set forth in a loan agreement. The following covenants are typical issuer covenants:

- Payment of bonds—a covenant that the issuer will punctually pay the principal of and interest on the bonds from the revenues that have been pledged to pay the bonds
- Extension of payment of the bonds—a covenant that the issuer will not extend or consent to the extension of the maturity of the bonds
- Offices for servicing bonds—a covenant that the issuer will maintain a relationship with an agency, such as a paying agent, in a designated location where bonds may be presented for payment, registration, transfer, or exchange
- Further assurances—a covenant, to the extent authorized by law, to comply with reasonable requests of the trustee to perform, execute, or deliver such acts as may be necessary to confirm the pledge under the indenture

- Rate covenant—a covenant that the issuer will establish and collect charges with respect to the project or the program loans sufficient to meet expenses and debt service, perhaps with coverage
- Restriction on sale or disposal—a covenant not to sell or lease the project or to sell program loans, except as specifically authorized in the financing documents
- Limitation on operating expenses and other costs—a covenant not to incur operating expenses and other costs in excess of the reasonable and necessary amount of such expenses
- Insurance covenant—a covenant to maintain insurance against various events, such as fire, casualty, flood, earthquake, theft, liability or, in the case of a lending program, mortgage default
- Reconstruction; application of insurance proceeds—a covenant to repair or reconstruct the project with the proceeds of insurance, or if it does not make economic sense to repair or reconstruct the project, insurance proceeds would be applied to the redemption of the bonds
- Payment of taxes and charges—a covenant to pay and discharge all taxes and fees imposed in connection with the project or the program except taxes and fees which are contested by proper legal proceedings
- Tax covenant—a covenant that the issuer will not take any action or consent to any party taking any action that will cause interest on the bonds to be subject to federal income taxation or to cause the bonds to be arbitrage bonds
- Maintenance of the project—a covenant by the issuer to use its best efforts to acquire, construct, and maintain the project with due diligence and in a sound and economic manner
- Additional bonds—a covenant not to issue any bonds whose security is equal to or superior to that of the existing issue unless certain additional bonds tests (often including historical or projected coverage ratios) are satisfied
- Maintenance of books and records—a covenant to maintain financial records relating to project or program revenues and costs in accordance with generally accepted accounting principles
- Noncompetition—a covenant not to operate, and perhaps (to the extent permitted by law) not to permit the operation of, competing enterprises

COVERAGE

The extent to which revenues in addition to the amount necessary to pay operating expenses and debt service are required to be collected by a rate covenant or by the conditions to the issuance of additional parity bonds.

For example, the bond resolution pursuant to which water revenue bonds are issued may require the issuer to maintain fees and charges for the sale of water at levels sufficient to enable it to collect in each year the amount necessary to pay all of its water system operating expenses, debt service on the bonds, plus an amount equal to 25 percent of debt service on the bonds. The additional 25 percent is referred to as coverage.

CREDIT ENHANCEMENT PROVIDER; CREDIT ENHANCEMENT

See **Chapter 1 – Overview of a Debt Financing—Roles and Responsibilities of Principal Participants – Credit Enhancement Provider.**

CREDIT RATING/CREDIT RATING AGENCY

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Credit Rating Agencies.**

CROSSOVER REFUNDING

See **Refunding.**

CURRENT REFUNDING

See **Refunding.**

CUSIP

The acronym for Committee on Uniform Security Identification Procedures, which was established under the auspices of the American Bankers Association to develop a uniform method of identifying municipal, United States government, and corporate securities.

A separate CUSIP number is assigned for each maturity of each issue and is printed on each bond.

DATE OF ISSUANCE/ORIGINAL ISSUANCE DATE

The date of issuance is the same as the closing date. However, the original issuance date, as used on the standard registered bond form, is the same as the dated date.

DATED DATE

The first date from which interest is deemed to accrue on a bond.

The dated date is typically printed on the front of the bond and can be before or as of the closing date, but not after the closing date. For fixed rate bonds, the dated date is generally the first day of the calendar month in which the bonds are sold. For variable rate bonds, the dated date is generally the closing date.

DEBT LIMIT

A statutory or constitutional limit on the amount of debt that an issuer may incur or that it may have outstanding at any one time.

The constitutional debt limit for California cities and counties is found in the California Constitution at Article XVI, Section 18, and for the State of California is found at Article XVI, Section 1. See **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**. California statutes also provide debt limits for a number of different entities. See generally, **Chapter 6, Types of Financing Obligations**.

DEBT SERVICE

The total of interest, principal, and mandatory sinking fund payments.

DEBT SERVICE ACCOUNT (BOND ACCOUNT OR PRINCIPAL, INTEREST, AND REDEMPTION ACCOUNTS)

The account or accounts into which the issuer makes periodic deposits to assure the timely availability of sufficient monies for the payment of debt service on an issue.

DEBT SERVICE RESERVE ACCOUNT

See **Reserve Account (Bond Reserve Account or Debt Service Reserve Account)**.

DEDICATED POOL

See **Pooling of Debt Issues**.

DEEMED FINAL

Under SEC Rule 15c2-12, prior to bidding for, offering, or selling bonds, an underwriter must obtain and review an Official Statement (usually a Preliminary Official Statement) deemed final as of its date by the issuer.

DEFAULT/EVENT OF DEFAULT

Failure to make prompt payment on a bond or otherwise comply with other covenants in the financing agreements.

Indentures and bond resolutions commonly provide for some short period of time—a cure period—to correct a failure to comply with a covenant before a simple default becomes an event of default that allows acceleration and certain other remedies to be pursued. In conduit financings, a default may also occur if the nongovernmental borrower becomes the subject of bankruptcy proceedings.

DEFEASANCE

The termination of the rights and interests (including the pledge of revenues but not including the right to payment) of the bondholders under the indenture or bond resolution upon final payment or provision for payment of all debt service on the bonds, all in the specific manner required by the indenture or bond resolution.

In an advance refunding, the defeasance of the bonds being refunded is generally accomplished by placing in an escrow sufficient high quality investments to provide for payment of debt service on the bonds to redemption or maturity.

DELIVERY DATE

See **Closing Date (Delivery Date)**.

DEMAND BOND (PUT BOND OR TENDER OPTION BOND)

A bond that the holder has the right to sell back to the issuer, a nongovernmental borrower, or another party at specified times and for a specified price (usually par).

Variable rate bonds generally have a demand feature. The demand feature gives the holder investment flexibility and protection against fluctuating market interest rates and other risks. The interest rate rises or falls in step with market rates, and the holder has the option to keep the bond or to demand the purchase of the bond in accordance with the holder's investment needs.

Demand bonds are sometimes referred to as put bonds or tender option bonds because the holder can “put,” or has an option to tender, the bond back to the issuer.

Put bonds that are tendered are customarily remarketed. If not, they may be purchased using monies available for that purpose, including advances under a line of credit or draws under a letter of credit.

DENOMINATION

The face amount of a bond—generally its original principal amount. Usually the denominations are \$5,000 or any integral multiple of \$5,000. In some short-term or variable rate financings, denominations may be multiples of \$100,000 or in multiples of \$5,000 in excess of \$100,000.

For compound interest bonds, denominations may be expressed in terms of either the original principal amount (in which case they may be odd dollar amounts, such as \$127.55) or compounded maturity or conversion amount (in which case they will commonly be multiples of \$5,000).

DISCLOSURE

Providing to investors (usually in the form of an Official Statement) all material facts relating to an issue.

DISCLOSURE COUNSEL

See **Chapter 1, Overview of a Debt Financing Roles and Responsibilities of Principal Participants – Underwriter’s Counsel and Disclosure Counsel – Disclosure Counsel.**

DISCOUNT

The amount, if any, by which the principal amount or par value of a bond exceeds its sale price. See also **Underwriter's Gross Spread (Underwriter's Discount).**

Original issue discount (OID) is the amount by which the principal amount or par value of a bond exceeds the offering price to the public at the time it is originally sold, or if sold in a private placement, the price to its first purchaser.

If the original issue discount is greater than approximately two percent or three percent, the bonds are sometimes referred to as deep discount bonds. The original issue discount is generally treated as tax-exempt income to the investor if held to maturity and interest on the bond is otherwise tax-exempt to the investor. When the investor sells the bond before maturity, any profit realized on such sale is determined (for federal income tax purposes) with respect to the investor's adjusted basis in the security. The adjusted basis is determined by adding to the investor's original cost the portion of the original issue discount allocable to the period that the investor held the bond.

The total amount of original issue discount and its allocation over time are determined in accordance with the provisions of the Internal Revenue Code and the rules and regulations of the Internal Revenue Service. To the extent the sale price of bonds exceeds their original cost plus allocable OID, such excess may be treated as taxable gain. Conversely, if the sale price is less

than the original price plus allocable OID, the difference may be treated as a loss for federal income tax purposes.

DISSEMINATION AGENT

An agent appointed pursuant to a continuing disclosure agreement for the purpose of filing annual reports and event notices with NRMSIRs and state information depositories. See, generally, **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

DUE DILIGENCE

The inquiry made to reveal or confirm facts about the issuer, the issue, and the security for the issue that would be material to a prudent investor in making a decision to purchase the issue.

Due diligence inquiries are made by underwriters and lawyers to determine, for example, whether the issue follows the purpose and scope outlined by the enabling legislation, statutes, and resolutions of the issuer and whether all material facts have been accurately disclosed in the Official Statement. Courts have generally concluded that participants who demonstrate that they have conducted reasonable investigations resulting in a reasonable belief in the accuracy and sufficiency of the disclosure document have satisfied their responsibilities under the disclosure laws relating to municipal bonds.

ECONOMIC USEFUL LIFE

The period over which an asset may reasonably be expected to yield economic benefit to its owner.

Because economic factors can render property useless for its intended purpose long before the property deteriorates physically, the economic useful life of an asset is often different from its physical life. The maturity of an issue of bonds generally may not exceed 120 percent of the weighted average useful life of financed facilities if interest on the bonds is to be tax-exempt. In determining the economic useful life for this purpose, a safe harbor is available by reference to periods prescribed by the Internal Revenue Service under its Asset Depreciation Range (ADR) system.

ENTERPRISE

A defined revenue producing set of facilities that are operationally integrated and which have a common service purpose.

An enterprise may consist of all of the facilities of a special district, such as a municipal water district, or may consist of only a portion of the assets of a general purpose governmental entity, such as the water system of a city.

With respect to certain types of revenue bonds, the specification of the extent of the enterprise is important, because it is the revenues of the enterprise that provide the security for the bonds.

ESCROW AGENT

With respect to an advance refunding, the commercial bank or trust company retained to hold the investments purchased with the proceeds of the refunding and, customarily, to use the amounts received as payments on such investments to pay debt service on the refunded bonds.

EVENT NOTICE

A notice delivered to the NRMSIRs and any state information depository in connection with a listed event. See generally, **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

EXEMPT FACILITIES

As defined in the Internal Revenue Code, airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas, local district heating or cooling facilities, and qualified hazardous waste facilities.

Qualified private activity bonds may be issued for exempt facilities.

FAILED AUCTION

An auction that occurs in which, due to a lack of demand for the auction rate securities (ARS) on the auction date, insufficient clearing bids were received. In the event of a failed auction, existing holders maintain their positions (or some pro rata portion) in the ARS at the maximum rate until a subsequent successful auction. Failed auctions are rare and, to the extent they do occur, are usually associated with downgrades in the credit ratings of the issuer or the insurer.

FEASIBILITY CONSULTANT

The person or firm retained, customarily by the issuer, to express an opinion (generally printed as an appendix to the Official Statement) on the economic feasibility of a facility, enterprise, or lending program to be undertaken with the proceeds of an issue.

Feasibility consultants are retained for a wide variety of different types of financings, ranging from large single projects such as a hydroelectric power plant to lending programs such as a multideveloper single-family mortgage revenue program. The objective of a feasibility report is to provide an assessment of one or more aspects of the economic feasibility of the purpose of a

financing. The views of the feasibility consultant are taken into account by the credit rating agencies and investors in the process of marketing the bonds.

FINANCIAL ADVISOR

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Financial Advisor.**

FINANCING LEASE

The document by which the issuer leases to another public entity (the obligor) the project to be acquired or constructed with the proceeds of the issue and by which the obligor agrees to make periodic lease payments to the issuer, generally for the period of time the issue is outstanding.

An installment purchase contract or installment sale agreement is a similar instrument by which the issuer sells, rather than leases, the project to the obligor, which agrees to purchase the project by making periodic payments (installments). Whether lease payments or installments, such payments are designed to be sufficient to pay debt service on the issue. The choice whether to structure a financing utilizing the municipal lease, installment purchase contract, or loan agreement often depends upon state law requirements such as constitutional debt limits and the authorization to lease property.

FISCAL AGENT

A commercial bank or trust company designated by an issuer under the indenture or bond resolution to act as a fiduciary and as the custodian of monies relating to an issue.

The fiscal agent's duties typically are limited to receiving monies from the issuer that are to be held in funds and accounts created under the indenture or bond resolution and, when acting as paying agent, paying out principal and interest to bondholders. See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Trustee/Fiscal Agent/Paying Agent/Registrar/Authenticating Agent.**

FIXED RATE

An interest rate that is set at the time a bond is issued and that does not vary during the term of the bond.

Compare to **Variable Rate.**

FLOATING RATE

See **Variable Rate.**

FLOW OF FUNDS

The provisions of an indenture or bond resolution pursuant to which pledged revenues are periodically allocated in a specified priority to accounts, if any, for operating expenses, debt service, the bond reserve account, redemption of bonds prior to maturity, other reserves, surplus, etc.

FORECLOSURE

A lawsuit by which the issuer of assessments or Mello-Roos bonds enforces the payment obligation against a defaulting landowner by suing to have the property sold to repay the debt. Issuers in these land-secured financings promise in the bond documents to prosecute foreclosure actions against defaulting landowners.

FORECLOSURE AND WORKOUT

The incidence of defaults and other payment problems on Mello-Roos and assessment bonds has risen markedly over the past several years, due largely to the fluctuation of the real estate market in California. Because issuers have a duty under the bond documents to enforce the special tax or assessment payment obligations, they have often been compelled to file foreclosure actions against defaulting landowners. In many cases the payment problems have also led to workout efforts by issuers, sometimes with the assistance of the original financing team, and other times with a new team brought in for this purpose.

Some issuers have shown flexibility in forgiving interest and penalties, which can be helpful in resolving a payment problem. Also, there is a procedure that allows the issuer to seek permission from bondholders to sell foreclosed property for less than the amount owing on the special tax lien, but this procedure is cumbersome and may involve a principal loss to the bondholders. There is also recently enacted legislation in California that would permit landowners to tender Mello-Roos bonds in lieu of payment, which means that if the bonds could be purchased for a discount on the open market, the special tax lien can be extinguished for less money than if it were paid in cash.

Finally, the increasing number of defaults in Mello-Roos and assessment financings over the past several years has shown that those financings can be severely affected by a downturn in the real estate market. To avoid future problems, more scrutiny may be appropriate at the outset. Some of the questions that might be posed include:

- Is the financing wise from a public policy perspective?
- If a real estate developer is involved in the financing, does the developer have a good track record?

- Have the appraisals supporting the financing been prepared by competent and experienced professionals?
- Is the real estate market likely to support the financing long-term?

GOOD FAITH DEPOSIT

A deposit made by an underwriter with the issuer of a new issue as assurance that the underwriter will proceed with the closing of the purchase of the issue if the issuer meets all of the conditions of the bond purchase contract.

The good faith deposit is commonly one percent of the par value of the issue, and generally is provided in the form of a certified or cashier's check. In the case of a competitive sale, each bidder submits a good faith check with its bid, the check is returned to the bidder if its bid is not accepted, and the deposit of the successful bidder is retained by the issuer until the issue is delivered and paid for at the closing. In a negotiated sale, the underwriter delivers the good faith deposit at the time the bond purchase contract is entered into and the deposit is held by the issuer until the closing. In the event the winning bidder or underwriter fails to take delivery of and pay for the new issue for reasons other than those permitted under the notice of sale or the bond purchase contract, the good faith deposit may be retained by the issuer as liquidated damages.

GOVERNMENTAL BONDS

Bonds that are issued by a public agency and not private activity bonds.

GROSS PROCEEDS

See **Proceeds/Sale Proceeds/Investment Proceeds/Gross Proceeds/Net Proceeds**.

GROSS REVENUES

See **Revenues/Gross Revenues/Net Revenues**.

GUARANTEED INVESTMENT CONTRACT.

See **Investment Agreement**.

HEDGE BONDS

Bonds issued substantially in advance of when monies will be needed for the purpose being financed, in order to hedge against subsequent interest rate increases.

The Internal Revenue Code contains specific limitations on tax-exempt hedge bonds (as defined therein).

INDENTURE/BOND RESOLUTION (GENERAL, SUPPLEMENTAL, AND SERIES)

An agreement executed by an issuer and a trustee (or fiscal agent) that pledges certain revenues and other property as security for the repayment of the issue, sets forth the terms of the bonds, and contains the responsibilities and duties of the trustee and the rights of the bondholders.

The responsibilities and duties of the trustee may include, among others, the following:

- Regulating the disbursement of proceeds of the issue for the intended purpose
- Funding transfers to assure that bondholders receive timely and complete payment
- Protecting the assets of the trust if a default occurs, and
- Exercising a specified standard of care in the administration of those trusts

The rights of bondholders are set forth in indenture provisions relating to the timing of interest and principal payments, interest rate setting mechanisms (in the case of variable rate bonds), redemption provisions, events of default, remedies, and the mailing of notices of various events. The indenture typically also contains the text to be printed on the bond.

A bond resolution differs from an indenture in that the issuer unilaterally adopts the resolution, which is then accepted as an agreement by the trustee or fiscal agent in a separate document. The provisions of a resolution used in this manner do not differ substantially from those of an indenture.

The term bond resolution is often also used to mean a resolution that authorizes the issuance of bonds, and may or may not also authorize the execution of an indenture.

General and series indentures are used when several issues of parity bonds are to be issued. The general indenture customarily specifies the matters that will be common to all series of bonds, and the series indenture is a supplemental indenture that specifies the terms of the particular series and any other features that are unique to that series.

A supplemental indenture is an indenture that amends or supplements a prior indenture, whether that prior indenture stands by itself, is a general indenture, or a series indenture. See also **Chapter 1, Overview of a Debt Financing – Basic Legal Documents**.

INDUCEMENT RESOLUTION

A very preliminary resolution of the governing body of an issuer confirming its then current intent to issue qualified private activity bonds for a specified project.

An inducement resolution is not legally binding on the issuer, but serves to mark the time under federal tax rules after which costs expended on the project qualify for financing with tax-exempt bonds.

INFORMATION REPORTING REQUIREMENT

The requirement to report to the Internal Revenue Service certain information about a new issue if interest on the issue is to be tax-exempt. These reports must be filed on IRS Form 8038, 8038G, or 8038GC and must be submitted no later than the fifteenth day of the second month following the close of the calendar quarter in which the bonds are issued.

INSTALLMENT PURCHASE CONTRACT

See **Financing Lease**.

INSTALLMENT SALE AGREEMENT

See **Financing Lease**.

INTERCEPT PROGRAM

An intercept program is a program by which the bond documents permit the bond trustee to intercept revenues from a third party that would otherwise flow to the issuer in order to pay debt service on the bonds. The most common such program in California relates to motor vehicle license fee revenues, which are normally collected by the state and distributed to cities and counties pursuant to a formula. Under Government Code Section 37351.5 (for cities) and Section 25350.55 (for counties), cities and counties can elect to have certain lease obligations (such as COPs or lease revenue bonds) secured by a pledge of motor vehicle license fee revenues. If the issuer then fails to make a lease payment when due, the trustee can notify the State Controller and obtain funds directly from the issuer's account within the State Motor Vehicle License Fee Fund to make the lease payment.

INTEREST/INTEREST RATE

A charge paid to the bondholder by the issuer for the use or borrowing of money. The interest rate is the interest charge expressed as a percentage of principal (which generally corresponds roughly to the amount borrowed) accruing over a specified period (generally a year) so long as the debt remains unpaid.

Interest may be paid or may compound at intervals different from the period used to express the interest rate. For example, interest on current interest fixed rate bonds generally is expressed as an annual rate, but is paid semiannually, with each semiannual payment being one-half of the amount that would accrue over an entire year. Interest on compound interest fixed rate bonds

generally is compounded semiannually and paid at maturity. Interest on variable rate bonds accrues at a rate which changes from time to time (perhaps as often as daily), but each such rate is nevertheless generally expressed as a percentage per year.

The amount of interest that has accrued over a period shorter than the payment or compounding interval may be determined by one of several different rules. For example, if interest accrues “on the basis of a 360-day year of 12 30-day months,” the amount of interest that has accrued since the last payment or compounding date is calculated assuming that $1/12^{\text{th}}$ of one year's interest accrues for each complete calendar month and $1/360^{\text{th}}$ of one year's interest accrues for each additional day. On the other hand, if interest is calculated on the basis of a year of 365 days and the actual number of days elapsed, the amount of interest accrued since the last payment or compounding date is calculated assuming that $1/365^{\text{th}}$ of one year's interest accrues each day.

Generally, interest on fixed rate bonds is calculated on the basis of a 360-day year and interest on variable rate bonds is calculated on the basis of a 365-day year.

INVESTMENT AGREEMENT

An agreement, typically purchased by the trustee for an issue from a financial institution, in which the financial institution agrees to guarantee a certain investment return on monies—often proceeds of the issue—invested under the agreement.

The return provided by the investment agreement may be fixed at a stated interest rate for each fund or account held by the trustee, or may float at a level related to the yield on the bonds (if the bonds bear interest at a variable rate) or some other index. Monies that may be invested include a fund for the construction or acquisition of the project or the program loans to be financed, a reserve account, and a fund in which monies to pay debt service on the issue are accumulated. An investment agreement is usually provided by a highly rated financial institution, in most instances a commercial bank or insurance company, because the credit rating on the bonds may be based in part on the credit rating (or the rating of the claims-paying ability) of the institution providing the investment agreement.

Investment agreements are sometimes used as a convenient means of managing the investment of monies that are subject to arbitrage yield restriction or rebate.

INVESTMENT OF PROCEEDS

The investment of proceeds and other monies relating to an issue is typically governed by state law and by the indenture or bond resolution.

Either document may prescribe both the types of investments that may be purchased (e.g. U.S. Treasury obligations, bank certificates of deposit, or corporate obligations with a specified rating) and the maximum maturity of investments of certain funds (e.g. short-term investments for monies to be used to make the next debt service payment or longer term investments for

reserves). The arbitrage rules under federal tax law may regulate the yield at which proceeds may be invested and may require rebate of certain investment earnings.

INVESTMENT PROCEEDS

See **Proceeds**.

INVESTORS/INSTITUTIONAL INVESTORS/RETAIL INVESTORS

Investors are persons or firms who purchase bonds. They are in effect loaning their money (the amount of their investment) to the issuer of the bonds in exchange for the issuer's obligation to repay them with interest. Investors are often thought of in two broad classes: institutional and retail.

An institutional investor is a mutual fund, insurance company, bank, or other financial institution that buys bonds, usually in very large blocks (sometimes in the tens of millions of dollars). Institutional investors have professional staffs whose purpose is to analyze credit risk, monitor investments, and manage the investor's assets.

A retail investor is an individual who purchases bonds, usually in small blocks—as small as \$5,000. Retail investors vary from the quite unsophisticated investor with a small amount of savings (often colloquially referred to as the “widows and orphans”) to so called “high net worth” individuals who may have significant holdings and experience in the bond market.

See, generally, **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Investors**.

ISSUE

One or more bonds initially delivered by an issuer in a substantially simultaneous transaction and which are generally designated in a manner that distinguishes them from bonds of other issues.

Bonds of a single issue may vary in maturity, interest rate, redemption, and other provisions. Under a revolving credit agreement or line of credit, obligations recorded or delivered representing the obligation to repay draws under the credit facility are commonly aggregated into a single issue.

For federal income tax purposes, the meaning of the term issue may depend upon the context in which it is used and may differ from definitions used under state law or in bond documents. For example, bonds of different issuers sold at substantially the same time, payable from substantially the same source of funds, and sold pursuant to a common financing plan may be a single issue for certain federal tax purposes.

ISSUER

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Issuer.**

LEGAL INVESTMENT MEMORANDUM OR SURVEY

An informational document setting forth the probable eligibility of the bonds for investment by certain potential investors in the specific jurisdictions covered by the survey (usually all 50 states, the District of Columbia, and Puerto Rico).

A legal investment memorandum is used by underwriters in the marketing of bonds, especially to institutional investors. The investors included in the memorandum are commonly savings banks, trust funds, and insurance companies. The legal investment memorandum is usually prepared by counsel to the underwriters, who reviews the current investment laws of the jurisdictions and summarizes the results of such review in the memorandum. The legal investment survey is usually circulated to appropriate dealers and investors with the Preliminary Official Statement and the preliminary Blue Sky Survey.

LENDER LOAN AGREEMENT

A loan agreement under which the nongovernmental borrower is a lending institution that agrees to relend the proceeds for purposes and under terms designed to achieve the public purpose for the issue.

LESSEE/LESSOR

See the sections in **Chapter 6, Types of Financing Obligations on Public Lease Revenue Bonds and Financing Leases and Certificates of Participation.**

LETTER OF CREDIT

An arrangement with a bank that provides additional security that money will be available to pay debt service on an issue.

Customarily, a letter of credit is issued by a commercial bank directly to the trustee and is irrevocable until a specified date. The letter of credit entitles the trustee, if certain conditions are met, to draw upon the letter of credit by submitting to the bank a written request for payment (a draft) and other carefully specified documents and certificates. If the documents submitted for the draw meet the requirements specified in the letter of credit, the bank must pay as provided in the letter of credit.

Letters of credit are also used as liquidity facilities in connection with obligations such as commercial paper or demand bonds. The trustee may draw upon the letter of credit if

commercial paper has matured and not been rolled over by issuing new commercial paper, or if demand bond owners put them to the issuer, and the remarketing agent is unable to find new purchasers. See also **Line of Credit**.

A draw on a letter of credit results in an obligation by the account party on the letter of credit to reimburse the bank for the amount of the draw, plus interest if reimbursement is not immediate. The account party may be either the issuer or, in the case of a conduit financing, the nongovernmental borrower.

A letter of credit may be either a “direct pay letter of credit” or a “standby letter of credit.” A direct pay letter of credit entitles the trustee to draw on the letter of credit for all debt service payments. Monies that would otherwise be available to pay debt service are then used to reimburse the bank. Because payments of principal and interest are made from monies of the bank rather than of the issuer, receipts by the owners of bonds are not subject to being reclaimed from the owners of bonds under the federal Bankruptcy Code.

In the case of a standby letter of credit, the trustee only draws on the letter of credit in the event monies available to pay debt service are insufficient. In this type of financing, to assure that payments to owners of bonds are not subject to being reclaimed in a bankruptcy, monies for debt service are typically required to be on deposit several months in advance of the date on which payments are made to the owners of bonds. These monies are then “seasoned” for the period required to extinguish any potential claim to them in a bankruptcy.

See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Credit Enhancement Provider**.

LINE OF CREDIT

A line of credit is a contract between the issuer and a bank that provides a source of borrowed monies to the issuer in the event that monies available to pay debt service (e.g. on commercial paper) or to purchase a demand bond are insufficient for that purpose.

If a draw on a line of credit is necessary, the issuer notifies the bank and executes a note for the amount of the loan.

The bank extending the line of credit may refuse to make the loan if the issuer is involved in a bankruptcy proceeding and for certain other events, whereas a letter of credit is usually designed to be available even under these circumstances.

See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Credit Enhancement Provider**.

LIQUIDITY

The ease with which an investment may be converted to cash, either by selling it in the secondary market or by demanding its repurchase pursuant to a put or other prearranged agreement with the issuer or another party.

LIQUIDITY FACILITY

See **Letter of Credit** and **Line of Credit**.

LISTED EVENT

An event which, if material, is required to be reported to the NRMSIRs and any state information depository pursuant to an undertaking to provide continuing disclosure pursuant to SEC Rule 15c2-12. See generally **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

LOAN AGREEMENT

An agreement under which the proceeds of a conduit financing are loaned to the nongovernmental borrower and the borrower agrees to pay to the issuer or the trustee the amounts necessary to pay debt service on the issue.

A loan agreement usually includes a set of covenants, financial tests, and restrictive provisions governing the borrower and the project financed. See **Chapter 1, Overview of a Debt Financing – Basic Legal Documents**.

LOWER FLOATER

See **Variable Rate**.

MANAGEMENT FEE

See **Underwriter's Gross Spread (Underwriter's Discount)** and **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser**.

MANAGING UNDERWRITER

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser**.

MARKET AGENT

In an auction rate securities (ARS) transaction, an investment bank retained for the purpose of adjusting the applicable percentage used in determining the maximum auction rate, the percentage used in determining the all-hold rate, and the percentage used in determining the interest rate in the event of a payment default. Generally, the market agent and the broker/dealer will be the same party for each series of ARS issued. A market agent may or may not be required on a transaction depending on the document structure. If an ARS program does not require a market agent, the broker/dealer assumes these responsibilities. There is no fee for this service.

MATERIAL/MATERIAL FACTS

Facts that a reasonably prudent investor would want to know in making an investment decision. See also **Disclosure, Official Statement** and **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

MATURE

With respect to principal, to become due and payable pursuant to a bond's original terms (not by acceleration). See also **Maturity**.

MATURITY

With respect to a single bond, the date upon which the principal of the bond is stated to be due. With respect to an issue, all of the bonds of an issue that are due on a single date.

For example, the bonds listed in the first line of the example under the definition of **Serial Bonds** in this appendix have a maturity in the year 1988, whereas the entire issue has serial maturities in the years 1988 through 2000 and a term bond maturity in the year 2011. See also **Term**.

MAXIMUM AUCTION RATE

On any auction date of an auction rate security, the interest rate per annum specified in the bond indenture or trust agreement, or the maximum rate, if any, established under the laws of the state for obligations of public agencies, if less than the rate specified in the indenture or trust agreement.

MELLO-ROOS BONDS

Created under the Mello-Roos Community Facilities District Act of 1982. See **Chapter 6, Types of Financing Obligations – Mello-Roos Bonds**.

MULTI-MODAL BONDS

Bonds that can be converted to different interest rate modes at the option of the issuer—or in the case of conduit bonds, the borrower. Typically, multi-modal bond documents permit bonds to be remarketed in daily, weekly, or monthly interest rate modes as variable rate tender option bonds and in term or fixed rate modes as well. Sometimes, “commercial paper mode” or “flexible rate mode” is included to allow the bonds to be broken up into pieces that have different interest rate periods.

MUNICIPAL SECURITIES RULEMAKING BOARD (MSRB)

An independent, self-regulatory organization established by Congress in 1975 having general rulemaking authority over municipal securities market participants (generally, brokers and dealers).

The MSRB is required by federal law to propose and adopt rules in the areas of professional qualification standards, rules of fair practice, record keeping, the scope and frequency of compliance examinations, the form and content of municipal bond quotations, and sales to related portfolios during the underwriting period.

The 15 MSRB members include 5 from each of 3 categories—securities firms’ representatives, bank dealer representatives, and public members. All market participants subject to MSRB jurisdiction are required to register with the SEC. Its jurisdiction does not extend to issuers of municipal securities. In recognition of the existing regulatory structure in place for banks and securities firms, the MSRB does not have inspection or enforcement authority.

NATIONAL ASSOCIATION OF SECURITY DEALERS (NASD)

A self-regulatory organization established as a “registered securities association” pursuant to the Securities Exchange Act of 1934 for the purpose of preventing fraudulent and manipulative acts and practices, promoting just and equitable principles of trade among over-the-counter brokers and dealers, and promoting rules of fair practice and self-discipline in the securities industry.

All securities firms (other than those dealing solely in government and federal agency securities) must be NASD members. The SEC holds certain residual powers over the activities of NASD. The NASD has very limited rulemaking authority with respect to municipal securities and is primarily responsible for enforcing members' compliance with Municipal Securities Rulemaking Board rules.

NEGOTIATED SALE

A sale of bonds, the terms and price of which are negotiated by the issuer through an exclusive agreement with a previously selected underwriter and/or underwriting syndicate.

Unlike a competitive sale, the underwriter is customarily active in all aspects of structuring the negotiated deal. Selection of the underwriter can be based on many different considerations including, but not limited to, expertise with a particular type of issue, market expertise, reputation, guaranties of maintaining a maximum gross spread, as well as prior relationships with the issuer.

In addition to negotiating the terms and covenants of the issue, the issuer and the underwriter also negotiate pricing of the issue. One advantage of a negotiated sale is that the issue can be brought to market at the most advantageous time giving special consideration to a volatile interest rate environment for the particular issue. Negotiated sales are often used for complex financings that may require targeting to specialized investors due to the financing structure or the nature of the security for the bonds.

The underwriter's gross spread is generally larger on a negotiated sale than on a competitive sale, because it includes compensation for additional services, including analytical services, due diligence, structuring, and making markets in these securities after the issue has been completed (secondary market transactions).

NET DIRECT DEBT

With respect to any given issuer the amount of all outstanding debt of such issuer (direct debt), less the sum of any amounts accumulated in sinking funds for such debt and the amount of such debt that is self-supporting.

NET INTEREST COST (NIC)

A measure of the interest cost of an issue derived by adding together all interest payments for the term of the issue and dividing that sum by the sum for all bonds of the amount of each bond multiplied by the number of years it is outstanding.

If the bonds are to be issued at a discount, the amount of the discount is added to the interest total as if it had been paid by the issuer. If the bonds are to be issued at a premium, that amount is subtracted from the interest total. The formula is as follows:

$$\text{NIC} = \frac{\text{Total Interest Payments} + \text{Discount (or - Premium)}}{\text{Bond Year Dollars}}$$

The denominator, bond year dollars, measures the amount of bonds outstanding over the time they are outstanding. Bond years equal the number of bonds outstanding (in \$1,000 denominations) multiplied by the number of years they are outstanding. One bond year is one

\$1,000 bond outstanding for one year. Bond year dollars are the number of bond years multiplied by \$1,000 for each bond.

NIC is distinguished from the True Interest Cost (TIC) measure in that the NIC does not take into account the time value of money.

Consider the following example of the NIC calculation. The NIC is computed for a \$3 million offering with 3 serial bond maturities and a fixed interest rate of 5 percent for each maturity.

Example 1

Years to Maturity	Par Value	Interest Rate	Interest Payments Per Maturity	Bond Year Dollars
1	\$1,000,000	5%	\$ 50,000	\$1,000,000
2	1,000,000	5%	100,000	2,000,000
3	<u>1,000,000</u>	5%	<u>150,000</u>	<u>3,000,000</u>
Total	<u>\$3,000,000</u>		<u>\$300,000</u>	<u>\$6,000,000</u>

The total interest payments come to \$300,000, paid out as follows:

- \$50,000 is paid out for the first maturity, which is due in a year
- \$50,000 per year is paid out for two years on the second maturity, and
- \$50,000 per year for three years on the third maturity

The bonds were issued at par so there is no addition or deduction from the total interest payments for a discount or premium. Bond year dollars equal \$6,000,000. The NIC equals 5 percent.

$$\text{NIC} = \frac{\text{Total Interest Payments}}{\text{Bond Year Dollars}} = \frac{\$300,000}{\$6,000,000} = .05 \text{ or } 5.0\%$$

Because the interest rate was the same for all three issues and there was no discount, the NIC was equal to the interest rate. A more complicated example will help make the calculation clearer. An issuer chooses to sell \$10 million of bonds in five separate maturities. The serial maturities and the interest rates follow. There are no discounts or premiums.

Example 2

Years to Maturity	Par Value	Interest Rate
1	\$1,000,000	5.0%
2	2,000,000	5.1%
3	2,000,000	5.2%
4	2,000,000	5.25%
5	3,000,000	5.3%

The total interest payments and bond year dollars follow, in order of maturity.

	Interest Payments per Maturity	Bond Year Dollars
	\$ 50,000	\$ 1,000,000
	204,000	4,000,000
	312,000	6,000,000
	420,000	8,000,000
	<u>795,000</u>	<u>15,000,000</u>
Total	\$1,781,000	\$ 34,000,000

$$\text{NIC} = \frac{\text{Total Interest Payments}}{\text{Bond Year Dollars}} = \frac{\$1,781,000}{\$34,000,000} = .05238 \text{ or } 5.238\%$$

Had the issue been sold at a discount, the NIC would be higher. For example, if the issue had sold at an average price of 97 percent, the issuer would have had \$300,000 less in proceeds. To compute the NIC, the \$300,000 would be added to total interest payments. The NIC rises to 6.12 percent.

$$\text{NIC} = \frac{\$1,781,000 + \$300,000}{\$34,000,000} = \frac{\$2,081,000}{\$34,000,000} = .06121 \text{ or } 6.121\%$$

Note that in these examples, the NIC was a function only of the total amount of interest and did not take into account the consideration of when the interest payments would be made. In other words, all \$1,781,000 of interest could have been paid in the first year and the NIC would have still equaled 5.238 percent.

The NIC is sometimes used to compare bids at a competitive sale. See also **True Interest Cost (TIC)**.

NET OVERALL DEBT

With respect to any given issuer, the amount of such issuer's net direct debt plus the issuer's share of the overlapping net direct debt of other public entities.

NET REVENUES

See **Revenues/Gross Revenues/Net Revenues**.

NO-LITIGATION CERTIFICATE

A certificate signed on behalf of the issuer and dated as of and delivered at the closing to the effect that no litigation is pending that would adversely affect the financing.

If litigation is pending, it is customarily described in the no-litigation certificate and, presuming that the bonds are to be issued in spite of such litigation, the issuer and the purchasers of the bonds must be able to conclude that the litigation does not present a material risk to the investors. One method of reaching that conclusion is to obtain, if available, an opinion of counsel to the effect that there is “no merit” to the adverse claims presented in the litigation.

NONGOVERNMENTAL BORROWER

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Nongovernmental Borrower**.

NOTICE OF SALE

The document that issuers use to solicit bids from prospective underwriters for a competitive sale of bonds.

The notice will commonly be published in a financial industry journal, usually *The Bond Buyer* or *The Wall Street Journal* (and, if required by law, a local newspaper of general circulation) and will list the details concerning an issue. This may include:

- The date, time and place of the sale
- The amount of the issue, maturity schedule, and redemption provisions
- Legal authority for the sale
- The manner in which the bid is to be delivered
- The type of security (general obligation, pledge of revenues, etc.)
- Limitations on interest rates and interest payment dates

- Denominations and registration provisions (registered, book entry, etc.)
- Names of bond counsel and any other attorneys delivering opinions, credit enhancement facilities, and other details

The notice of sale, the winning bid and the issuer's acceptance of the winning bid together constitute an agreement for the purchase and sale of the issue in a competitive sale. See also **Chapter 1, Overview of a Debt Financing – Basic Legal Documents**.

NRMSIR

Nationally Recognized Municipal Securities Information Repository—NRMSIRs are the repositories for all annual reports and event notices filed under SEC Rule 15c2-12. NRMSIRs are required to be approved by the MSRB. A list of all the currently approved NRMSIRs is contained in **Appendix B – Resources and Contacts**. See **Chapter 10, Continuing Disclosure and Investor Relations Programs**. See also **State Information Depository (SID)**.

OBLIGATED PERSON

Any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part, of the obligations on the municipal securities (other than providers of credit enhancement). See generally **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

OFFICIAL STATEMENT/PRELIMINARY OFFICIAL STATEMENT

A document containing information about the bonds being offered, the issuer, and the sources of repayment of the bonds.

Federal securities laws generally require that if an Official Statement is used to market an issue, it must fully disclose all facts that would be of interest (i.e. material) to a potential buyer of bonds of the issue. For example, for a general obligation issue, the most important information may concern the financial health of the issuer, its tax base, and the economic health of the jurisdiction. For a water revenue issue, the most important information may be the financial health and physical condition of the water system enterprise, water supply, and the economic health of the service area. For a conduit financing, the most important information may concern the financial health of the nongovernmental borrower. The materiality of such information may also depend upon whether or not credit enhancement is utilized. See also **Deemed Final**.

Under MSRB rules, a final Official Statement—which is printed only after the final terms of the bonds are available—must (if available) be delivered by the broker or dealer to purchasers of bonds no later than the settlement date of the transaction. An Official Statement may also be called an Offering Circular, Offering Memorandum, or bond prospectus. See also **Chapter 1**,

Overview of a Debt Financing – Basic Legal Documents and Chapter 10, Continuing Disclosure and Investor Relations Programs.

A Preliminary Official Statement is the version of an Official Statement or Offering Circular used by the issuer or underwriters to inform the marketplace of the terms of the bonds being issued prior to receipt of bids at a competitive sale or prior to the determination of interest rates and purchase price in a negotiated sale.

The Preliminary Official Statement is often referred to as the “red herring” because of the sentence, printed in red on the cover page, to the effect that the information contained in the Official Statement is subject to change and that there are conditions to the taking of orders by underwriters. Generally, however, few substantial changes are made between the Preliminary and final versions of the Official Statement.

ORGANIC ACT

The statute under which a particular governmental entity is organized.

Generally, this term is used to describe an act that specifies the manner of organization and the powers of a single agency, authority, or district named in the act, rather than the type of statute under which, for example, any city or county could cause to be created an agency of the type described in the statute. Compare, for example, the statute under which the California Housing Finance Agency is organized (Health and Safety Code Sections 50900 et seq.) with the statute under which a city or county may create a housing authority (Health and Safety Code Sections 34200 et seq.).

ORIGINAL ISSUANCE DATE

See **Date of Issuance/Original Issuance Date**.

ORIGINAL ISSUE DISCOUNT

See **Discount**.

OUTSTANDING

In general, as used with respect to the principal of an issue, the amount remaining unpaid.

However, the terms of indentures and bond resolutions often provide that bonds, which are not yet paid but are the subject of a defeasance or an advance refunding, are treated as no longer being outstanding.

OVERLAPPING DEBT

With respect to any given issuer, debt of other public entities the jurisdictions of which overlap the jurisdiction of such issuer.

The issuer may partially overlap another public entity (e.g. a special district may contain parts of several counties), may be wholly within another public entity (e.g. a city is entirely within a county), or may wholly encompass another public entity (e.g. a county normally contains a number of cities).

The term may be used with respect to both general obligation debt payable from ad valorem taxes (in which case it is generally apportioned on the basis of relative assessed value), or may be used with respect to special assessment, special tax, or other revenue based debt, in which case other methods of apportionment may be used, such as relative amounts of benefit or service delivered.

PAR/PAR VALUE

Par or par value refers to the principal amount of a bond.

A bond may be purchased at par—meaning the price of the bond is equal to its principal amount, below par—meaning the price is below its principal amount, or above par—meaning the price is above its principal amount. See also **Discount** and **Premium**.

PARITY

Having equal security with other obligations.

For example, two issues of revenue bonds are said to be on parity with each other if the revenues, projects, program loans, and other assets securing the first issue also secure the second issue, and vice versa.

Issues may be on parity with each other with respect to one level of security but not with another level of security. For example, one issue may be the subject of bond insurance, while another is not, in which case they would be on parity with respect to the basic revenues, but not with respect to the insurance.

PAYING AGENT

The institution—usually a commercial bank or trust company—appointed in the indenture or bond resolution to act as the agent of the issuer to pay principal and interest from monies provided by or on behalf of the issuer. See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Trustee/Fiscal Agent/Paying Agent/Registrar/Authenticating Agent**.

PLACEMENT AGENT

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser.**

PLEDGE

To grant a security interest in or lien on an asset to provide security for the repayment of bonds or the performance of some other obligation.

A pledge may cover an existing asset (such as a reserve account) or a stream of revenues to be received in the future (such as the income of a defined enterprise).

POINT/BASIS POINT

Point is a shorthand reference to 1 percent.

Because municipal dollar prices are quoted relative to \$1,000, a point is worth \$10 regardless of the actual denomination of a bond. Thus, a bond discounted 2.5 points, or \$25, is quoted at 97.5 percent of its value, or \$975 per \$1,000.

Basis point is a shorthand reference to one one-hundredth of one percent (.01 percent). The term is generally used to describe interest rates rather than prices. For example, if an interest rate increases from 8.25 percent to 8.5 percent, the difference is referred to as a 25 basis point increase.

POOLING OF DEBT ISSUES

This term encompasses two different concepts, pooled financings (including both blind pools and dedicated pools), and composite issues.

The users of the proceeds of pooled financings may be public or private entities. Generally, the issuer (or the trustee on behalf of the issuer) holds the proceeds of the issue until they are loaned to users. The issue is typically secured by the proceeds until expended, a reserve fund, and the loan agreements with the users. Because repayment of the bonds depends on the repayment of each loan, the creditworthiness (and, therefore, the rating of the issue) is based on the credit of the weakest user or borrower. Generally, the default of one borrower has no effect on the obligations of any other borrower—that is, no borrower is required to make up any payment not made by another borrower. To strengthen the credit of the issue that would otherwise be determined by the weakest credit, pooled financings commonly require either that each loan be insured or guaranteed or that the issue be secured by bond insurance or a letter of credit. As a result, the rating of the issue is based on the insurance company or bank rather than on the individual borrowers.

Local agencies may pool issues under the Marks-Roos Local Bond Pooling Act of 1985 (Government Code Sections 6584 et seq.).

Blind Pool Issue

An issue the proceeds of which are used to make or finance loans to, or projects for, entities that are not identified at the time the bonds are issued.

If some but not all of the users are identified, the pool is partially blind.

Dedicated Pool

An issue the proceeds of which are to be used to finance loans to, or projects for, entities that are identified and committed to the financing at the time the bonds are issued.

See **Chapter 6, Types of Financing Obligations – Marks-Roos Bonds** for a further discussion of pooled financings.

PRELIMINARY OFFICIAL STATEMENT

See **Official Statement/Preliminary Official Statement**.

PREMIUM

The amount by which the price of a bond exceeds its principal amount or par value.

A redemption premium is the premium an issuer is required (by the terms of a bond) to pay to redeem (call) the bond prior to its stated maturity.

See also **Discount**.

PRICING/REPRICING

The determination (or redetermination) by the underwriters in a negotiated sale of the interest rates and reoffering prices at which an issue will be offered to investors.

Generally, the underwriters will have mailed a Preliminary Official Statement to potential investors and to other underwriters approximately one to two weeks prior to the pricing date. On the pricing date the underwriters will price the issue at the lowest marketable interest cost to the issuer. The price must be agreeable to the issuer. The underwriters then offer the bonds to investors on the agreed terms and if an appropriate number of orders are received, the issuer and the underwriters enter into a bond purchase contract on those terms. If not enough or too many orders are received on the original terms, the issue may be repriced to be more attractive to investors or to give a better rate to the issuer, as the case may be.

PRINCIPAL

With respect to a loan, the amount loaned and to be repaid, i.e. the amount for the use of which interest is charged. Similarly, with respect to a bond, principal is the amount on which interest accrues and which is to be paid to the bondholder on the maturity date (not including simple interest or compounded interest).

The principal of a bond is sometimes referred to as its face amount since the amount to be paid at maturity is printed on the front (the face) of the bond. See also **Original Issue Discount** and **Par/Par Value**.

PRIVATE ACTIVITY BONDS

In general, bonds of which 10 percent or more of the proceeds are used in the trade or business of nongovernmental persons and 10 percent or more of the debt service is secured by or derived from property used in the trade or business of nongovernmental persons, or 5 percent or more of the proceeds are loaned to nongovernmental persons.

For this purpose, nongovernmental persons are treated as users of facilities that they lease and of facilities the output of which they agree to purchase. Nongovernmental persons may be treated as users of facilities by reason of long-term management contracts. The U.S. government is treated as a nongovernmental person.

Interest on private activity bonds is tax-exempt only if they are qualified private activity bonds.

With the exception of qualified 501(c)(3) bonds and certain bonds for government owned seaports or airports, qualified private activity bonds must be exempt from that requirement under an exception for refunding bonds. See **Chapter 3, General Federal Tax Requirements**.

PRIVATE PLACEMENT

The offer and sale of an issue by the issuer directly to one or more investors, rather than through an underwriter.

Often, the terms of the issue are negotiated directly between the issuer and the investor. Sometimes, an investment banker will act as placement agent, bringing the parties together and acting as an intermediary in the negotiations. Instead of an Official Statement, an Offering Circular, Offering Memorandum, or Private Placement Memorandum may be prepared.

PRIVATE PLACEMENT MEMORANDUM

A memorandum that takes the place of an Official Statement in a private placement and contains a description of the bonds, the financing structure, and the issuer.

It is normally prepared in very small quantities for very limited distribution. It is not normally as extensive as with public offerings because the investor generally does its own investigation of the credit risk of the issue.

PROCEEDS/SALE PROCEEDS/INVESTMENT PROCEEDS/GROSS PROCEEDS/NET PROCEEDS

Proceeds are comprised of sale proceeds and investment proceeds. Sale proceeds are the amount paid by the ultimate purchasers (not including an underwriter) of a new issue, excluding any accrued interest.

The term gross proceeds refers to all of the monies relating to an issue, which are subject to arbitrage limitations and rebate under the Tax Code. Gross proceeds include sale proceeds, investment proceeds, and any other monies pledged to pay debt service and expected to be used to pay debt service, including monies in a sinking fund and monies in a reserve account.

The term net proceeds refers to all proceeds less any investment proceeds earned after completion of the financed project.

See **Chapter 3, General Federal Tax Requirements.**

PROJECT FINANCING

An issue for the purpose of financing all or a portion of the costs of acquiring, constructing, and/or renovating a specified project for a public or private entity.

Generally, the term is used in situations in which the issue is to be repaid with revenues relating to the project financed, although other revenues and guarantees may also secure the issue. See also **Conduit Financing.**

PUBLIC OFFERING

The sale of bonds (generally through an underwriter) to the general public (or a limited section of the general public).

The offer is usually disclosed by an Official Statement in which the terms of the financing and its structure are set forth, allowing the investor to make an informed decision about the merits of the proposed securities. The issuer may market a proposed public offering either via competitive sale or negotiated sale.

In addition to public offerings, bonds are also sold in limited public offerings and private placements.

PUBLIC SALE

See **Competitive Sale**.

PUT BOND

See **Demand Bond (Put Bond or Tender Option Bond)**.

QUALIFIED PRIVATE ACTIVITY BONDS

See **Chapter 3, General Federal Tax Requirements**.

QUALIFIED 501(c)(3) BONDS

Private activity bonds issued for certain nonprofit organizations (including hospitals and universities) described in Section 501(c)(3) of the Internal Revenue Code. See **Chapter 3, General Federal Tax Requirements**.

See also the sections in **Chapter 6, Types of Financing Obligations on Conduit Revenue Bonds: General, Conduit Revenue Bonds: Hospital and Health Care Facilities; Certificates of Participation, and Conduit Revenue Bonds: Educational Facility Bonds**.

RATING

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Credit Rating Agencies**.

REBATE REQUIREMENT

To pay to the U.S. government (or in the case of certain qualified single-family mortgage revenue bonds, to mortgagors) amounts earned from the investment of gross proceeds at a yield in excess of the yield on the issue.

Generally, the amount of this rebate requirement should be computed at least annually, and at least 90 percent of the cumulative rebate amount must be paid to the federal government every 5 years. Certain exceptions are provided—and no rebate of arbitrage need be paid—for example, if all proceeds (other than certain debt service accounts and reserve accounts) are spent within six months or, with certain limitations, eighteen months or even two years, after the date of

issuance, or the amounts are earned with respect to monies in debt service funds that generate gross investment receipts of not more than \$100,000 during the year.

See **Chapter 3, General Federal Tax Requirements.**

REDEMPTION

The payment of principal of a bond, whether at maturity, or—under certain circumstances described in the bond—prior to maturity. Redemption of a bond by the issuer prior to maturity is sometimes referred to as calling the bond. Redemption prior to maturity may be optional, mandatory, or extraordinary (sometimes also called special).

Optional redemption provisions give the issuer the option to redeem the bonds prior to maturity from any available funds of the issuer on certain specified dates at specified prices. A redemption price may consist of the principal amount plus a premium expressed as a percentage of the principal amount. Since a purchaser of a bond has made an investment decision based in part on the date the principal is to be repaid, the purchaser generally wants to know under what circumstances the bond may be redeemed prior to its maturity. There is often a minimum period of time during which the issuer may not optionally redeem the bond, giving the owner what is referred to as call protection.

After the call protection period, an issuer may be required to pay the owner a premium to redeem a bond prior to its maturity. The premium percentage generally decreases the longer the issuer waits to optionally redeem the bond. For example, the issuer might be required to pay 103 percent of the principal amount of the bond (100 percent of principal plus a premium of 3 percent) to optionally redeem the bond in the eleventh year after its issuance, 102 percent in the twelfth year, 101 percent in the thirteenth year, and 100 percent in the fourteenth year, and each year thereafter until maturity.

Mandatory redemption provisions require the issuer to redeem all or a portion of an issue at certain times, or upon the occurrence or nonoccurrence of certain events. Generally, the issuer is not required to pay a premium for mandatory redemption and the risk of a mandatory redemption is taken into account by an investor when purchasing the bond. For example, single-family mortgage revenue bonds are generally subject to mandatory redemption from proceeds not used to acquire mortgage loans and from prepayments of mortgage loans.

Another example is mandatory sinking fund redemption, which requires the issuer to regularly redeem a portion of a term bond of an issue prior to its stated maturity in accordance with a schedule in the indenture or bond resolution. Mandatory sinking fund redemption results in the periodic retirement of the principal of term bonds in a manner similar to the periodic retirement of principal by the payment of serial bonds at maturity. For example, an issue might consist of \$5,000,000 of term bonds maturing in 2011. Mandatory sinking fund redemption provisions for such bonds might require the issuer to redeem \$1,000,000 of the term bonds in each of the years

2007 through 2011. In each of those years the issuer (or the trustee or fiscal agent) would choose \$1,000,000 of the term bonds at random for repurchase.

Extraordinary redemption provisions allow the issuer to repurchase bonds prior to their maturity upon the occurrence of certain unforeseen and extraordinary circumstances, such as destruction of the facilities that were intended to generate revenues to pay the bonds. Extraordinary redemption is sometimes allowed to be made at the option of the issuer upon the occurrence of the extraordinary event, or may be required to be made upon such occurrence as an extraordinary mandatory redemption. For example, the issuer may be permitted to rebuild the facilities with insurance proceeds or use the insurance proceeds to redeem bonds.

REFUNDING

An issue of new bonds (the refunding bonds) to pay debt service on a prior issue (the refunded bonds).

Generally, the purpose of a refunding is either to reduce the debt service on the financing or to remove or replace a restrictive covenant imposed by the terms of the refunded bonds (for example, an excessive coverage ratio).

The proceeds of the refunding bonds are either deposited in escrow to pay the refunded bonds when subsequently due (see **Advance Refunding**) or applied immediately to the payment of the refunded bonds (see **Current Refunding**).

For accounting purposes, refunded bonds are not considered part of the issuer's outstanding debt because the refunded bonds are to be paid from the proceeds of the refunding bonds and not from the revenues originally pledged. Refunded bonds may continue to hold a lien on the revenues originally pledged, however, unless the indenture or bond resolution provides for defeasance of the refunded bonds prior to maturity or redemption.

Advance Refunding

A refunding in which the refunding bonds are issued more than 90 days prior to (in advance of) the date upon which the refunded bonds will be repaid. Compare to **Current Refunding**.

Typically, the proceeds of the refunding bonds are placed in escrow and invested in obligations of the federal government (although other investments such as federal agency obligations may be used). See also **SLGS**. Payments received on the investments held in escrow are then applied to make payments on the refunded bonds as they become due (including by redemption) or, in some cases, are applied to pay interest on the refunding bonds until also applied to pay principal of the refunded bonds.

Refunded bonds are considered “prerefunded” when the proceeds of the refunding bonds are placed in escrow and invested until a date upon which the refunded bonds may be redeemed.

The escrow (including earnings thereon) is applied to the payment of interest, principal maturing prior to the redemption date, and the redemption price of the refunded bonds.

Refunded bonds are considered “escrowed to maturity” when the proceeds of the refunding bonds are placed in escrow, invested, and applied to payments on the refunded bonds when due, without redemption prior to maturity.

Generally, in an advance refunding, the revenues originally pledged to the payment of the refunded bonds become pledged to the payment of the refunding bonds on the date the refunding bonds are issued. Payment of the refunded bonds is then secured by the escrow. See **Crossover Refunding**.

Crossover Refunding

A refunding in which the revenues originally pledged to secure the refunded bonds continue to be applied to pay the refunded bonds until the refunded bonds mature or are redeemed.

On the date the refunded bonds are paid in full, the pledged revenues “cross over” and are thereafter pledged to pay the refunding bonds.

During the period when both the refunded and the refunding bonds are outstanding, the escrow containing the proceeds of the refunding bonds pays interest on the refunding bonds. Then on the crossover date, the escrow pays the principal of the refunded bonds.

Current Refunding

A refunding in which refunding bonds are issued not more than 90 days before the date upon which the refunded bonds will be paid.

Generally, the proceeds of the refunding bonds are applied immediately to pay the refunded bonds. Thereafter, the revenues originally pledged to the payment of the refunded bonds are pledged to the payment of the refunding bonds.

REGISTERED BOND

A bond for which the name and address of the legal owner is required to be listed on the bond registration books of the trustee or a registrar.

Generally, interest payments on a registered bond are made by check or wire sent to the registered owner. The registered owner may not be the beneficial owner of the bond, but rather a nominee for the beneficial owner. If the registered owner is a broker/dealer acting as nominee for a client, the bond is referred to as being held in “street name.” Registered bonds are often held in the name of a securities depository or in the name of a nominee for a securities

depository, such as Depository Trust Company, which then keeps a record of the broker/dealers whose clients are the beneficial owners of the bonds. Compare to **Coupon Bond**.

REGISTRAR

The agent of the issuer appointed to maintain a list of the names and addresses of all registered owners of the bonds and to record transfers and exchanges of the bonds.

See also **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Trustee/Fiscal Agent/Paying Agent/Registrar/ Authenticating Agent**.

REIMBURSEMENT RESOLUTION

See **Chapter 3, General Federal Tax Requirements**.

REMARKET

To buy and resell to the public previously issued bonds that have been or are required to be purchased from the original or subsequent holders of the bonds by the issuer or another party upon the occurrence of certain events specified in the legal documents.

With respect to variable rate bonds, remarketings commonly occur in connection with:

- A tender of the bonds at the option of the holder
- The conversion from one interest rate mode (e.g. weekly variation) to another interest rate mode (e.g. quarterly variation)
- The conversion of the variable rate bonds to fixed rate bonds, or
- The termination or other alteration of the letter of credit, standby purchase agreement, or other credit enhancement facility or liquidity facility

With respect to an issue the proceeds of which were escrowed upon closing, a remarketing would occur upon satisfaction of the requirements for breaking the escrow and disbursing the proceeds for the purposes for which the bonds were issued.

In a remarketing, bonds tendered by their holders (perhaps mandatorily) for purchase are sold to new purchasers. A remarketing is usually conducted on behalf of the issuer by an investment bank or commercial bank acting as remarketing agent pursuant to a remarketing agreement entered into at the time of the original issuance of the bonds. Frequently, the remarketing agent is the same firm that acted as the managing underwriter for the original issue.

In many instances, including a conversion to fixed rate or the breaking of escrow, a remarketing will resemble a new issue in many respects, including the preparation and distribution of a new

Official Statement, often called a Reoffering Circular. Unlike a new issue, however, the proceeds of remarketing do not go to the issuer. Rather, remarketing proceeds are used to pay the purchase price of the tendered bonds to the previous owners or to reimburse the credit facility provider for draws made on the credit facility for such purchase.

REMARKETING AGENT

The investment bank or commercial bank retained to remarket bonds that have been tendered for purchase by the issuer or another party pursuant to an option to sell (a put) that accompanies the bond.

See also **Remarket, Demand Bond (Put Bond or Tender Option Bond), and Variable Rate.**

REOFFERING

Literally, offering again.

This term is used in two contexts. First, it is used to describe the offering of bonds by the underwriter to the public. For example, the initial offering price to the public is often referred to in shorthand as the reoffering price. Second, the term reoffering is used to describe a form of remarketing in which an issuer exercises the right to require bondholders to mandatorily tender their bonds for reoffering to the public, customarily in the context of a conversion from a variable rate to a fixed rate.

REQUEST FOR PROPOSAL

See **Chapter 1, Overview of a Debt Financing – Using a Request for Proposal to Select Financing Team Members.**

REPRICING

See **Pricing/Repricing.**

RESERVE ACCOUNT (BOND RESERVE ACCOUNT OR DEBT SERVICE RESERVE ACCOUNT)

An account from which monies may be drawn to pay debt service on an issue if pledged revenues and other amounts available to satisfy debt service are temporarily insufficient.

A reserve account may be funded to its agreed requirement with bond proceeds, or it may be only partly funded at the time of issuance and expected to reach its full requirement over time through the accumulation of pledged revenues or other available monies. If a bond reserve account is used in whole or part to pay debt service, the issuer usually is required to replenish the reserve account from revenues available after payment of debt service.

A typical reserve requirement for an enterprise revenue bond would be an amount equal to maximum annual debt service on the issue, but not more than 10 percent of the original principal amount of the issue.

The size of the reserve account and the investment of the monies held therein are subject to restrictions contained in the federal tax law for tax-exempt bonds. Investment earnings on bond reserve account monies may also be subject to yield restriction and rebate.

Sometimes, reserve account requirements are satisfied by the provision of a surety policy instead of a deposit of cash. See **Surety**.

REVENUES/GROSS REVENUES/NET REVENUES

The income produced by a given source.

In the context of revenue bonds, revenues typically means the income and receipts generated from the operation of the project or loan program being financed, or from the enterprise of which the project or loan program is a part, or from other nontax sources—for example, water charges in the case of water revenue bonds, lease payments in the case of lease revenue bonds, or loan repayments in the case of mortgage revenue bonds or a conduit financing. Such revenues would normally be pledged to the payment of the revenue bonds.

Gross revenues refers to the total receipts derived from the operation of the project, program, or enterprise. Net revenues refers to the amount available after subtracting certain costs and expenses, most commonly for operation and maintenance, from gross revenues.

REVERSE VALIDATION ACTION

This term is sometimes used to describe the exclusive procedure under the California law for an interested person to challenge the legality of a bond financing. The validation statutes provide that if the issuer does not file a validation action concerning the financing, then any interested person may file an action within 60 days from when the financing is approved—a so-called reverse validation action. Once an interested person files a reverse validation action, the case proceeds in a manner similar to a validation action by the issuer.

SEC REGISTRATION

The filing of information with the SEC in accordance with the Securities Act of 1933 as a prerequisite to selling or marketing securities.

Most bonds issued by or on behalf of state or local governmental entities are exempt from such registration requirements.

SEC RULE 15c2-12

A rule promulgated by the SEC under the Securities Exchange Act of 1934 concerning disclosure and continuing disclosure requirements for municipal securities. The full text of SEC Rule 15c2-12 is contained in **Appendix D – Legal References – Federal Laws of General Application to Public Finance**. See also **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

SECONDARY MARKET

The market in which bonds are purchased from bondholders who have held such bonds for investment purposes, as opposed to being purchased directly from the issuer or from the issuer through an underwriter.

SECURITY

The features of a debt instrument designed to reduce the risk of nonpayment or late payment, including the sources of monies for timely payment.

For example, a pledge of revenues that restricts the use of the revenues solely to payment of operating expenses of an enterprise and debt service on bonds issued to finance that enterprise provides security for the repayment of those bonds. Similarly, credit enhancement also provides additional security.

SELF-INSURANCE RESERVE FINANCING

A financing in which the proceeds of the issue are deposited in an insurance reserve fund that is used to pay liability claims against participating entities as such claims arise.

The fund is invested and, depending upon the investment earnings and the claims paid, may require additional deposits from participating entities.

Typically, an entity separate from the participating entities, such as a joint powers authority, is the issuer of the bonds and is responsible for the administration of the insurance reserve fund, including the investment of the fund and the payment of claims (although a separate entity may administer these functions through a contractual arrangement with the issuer). Insurance is provided to participating entities (which may be cities, counties, and other public entities) that pay premiums for the coverage. The premiums paid by the participating entities constitute the revenue source for the repayment of the issue.

SELLING GROUP

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser**.

SERIAL BONDS

Bonds of an issue, which are payable as to principal in amounts due at successive regular intervals, generally annual or semiannual and usually in the early years of the term of the issue. An issue may consist of both serial bonds and term bonds.

For example, an issue in the total principal amount of \$4,000,000 might consist of serial bonds maturing in the years 1988 through 2000 and \$2,595,000 of term bonds maturing in 2011 (but subject to mandatory sinking fund redemption in the years 2001 through 2010) as follows:

Year	Serial Maturities	Term Bond Mandatory Sinking Fund Payments
1988	70,000	
1989	75,000	
1990	80,000	
1991	85,000	
1992	95,000	
1993	100,000	
1994	105,000	
1995	110,000	
1996	120,000	
1997	130,000	
1998	135,000	
1999	145,000	
2000	155,000	
2001		165,000
2002		180,000
2003		190,000
2004		200,000
2005		215,000
2006		230,000
2007		245,000
2008		265,000
2009		280,000
2010		300,000
		325,000*

* Payment at maturity

SINKING FUND PAYMENTS OR INSTALLMENTS

Payments made by an issuer (often into a sinking fund) to provide for the redemption or payment at maturity of term bonds. Also called mandatory sinking account payments or sinking fund installments.

Generally, sinking fund payments are mandatory in a specified amount for each payment period to provide for the periodic redemption of term bonds prior to their final maturity. See the example under the **Serial Bonds** definition. The individual term bonds to be redeemed each year are customarily selected at random by the trustee.

SLGS

An acronym (pronounced “slugs”) for a type of U.S. Treasury obligation, the complete name of which is United States Treasury Securities - State and Local Government Series.

SLGS are an investment vehicle made available by the U.S. Bureau of Public Debt for investment of gross proceeds. The Bureau of Public Debt offers three types of SLGS, which are commonly referred to as Demand Deposit SLGS, Time Deposit SLGS, and Zero SLGS. Generally, Time Deposit SLGS are acquired in connection with an advance refunding. The SLGS are held in escrow, and principal and interest received on the SLGS are used to pay debt service on the prior issue. Because the issuer can specify the rate (subject to the maximum rate specified in a weekly schedule) earned on the SLGS, the issuer may design the escrow investment to meet any yield restrictions while maximizing its permitted investment return. Demand Deposit SLGS are intended for the investment of monies subject to the rebate requirements. Earnings on Demand Deposit SLGS are not subject to the rebate requirement. The interest rate on the Demand Deposit SLGS is determined weekly, effective each Monday and is calculated based upon a formula which takes into account the Federal Funds Rate which is published by the Federal Reserve Board and an estimated average marginal tax rate of owners of short-term municipal securities and an administrative fee. The estimated marginal tax rate and the administrative fee may be changed periodically by the Bureau of Public Debt. Zero SLGS bear interest at 0 percent, have flexible purchase and redemption terms, and are designed to be used to average down investment yields on open market securities for yield restriction purposes.

SPECIAL TAX COUNSEL

A law firm retained by the issuer to render the opinion that interest on an issue is tax-exempt under circumstances where the firm retained as bond counsel either does not have the expertise or is otherwise unable to render that opinion.

SPREAD

See **Underwriter's Gross Spread (Underwriter's Discount)** and **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser.**

STANDBY PURCHASE AGREEMENT

An agreement between an issuer and a financial institution, usually a bank, whereby the bank agrees to purchase bonds in the event the bondholders tender them to the issuer and they are not remarketed to new purchasers.

See also **Demand Bond (Put Bond or Tender Option Bond)** and compare to **Letter of Credit** and **Line of Credit**.

STATE INFORMATION DEPOSITORY (SID)

An information depository for a particular state approved by the MSRB in accordance with SEC Rule 15c2-12. Currently, there is no state information depository for California. See generally, **Disclosure** and **Continuing Disclosure**.

SURETY

In the public finance context, a surety policy is a form of insurance provided by a bond insurer to satisfy a reserve fund requirement for a bond issue. Under this arrangement, instead of depositing cash in a reserve fund, the issuer buys a surety policy by paying a one-time premium equal to some percentage of the face amount of the policy. If the reserve fund is needed to make a debt service payment, the trustee notifies the surety provider and the provider makes the payment, up to the face amount of the policy. The issuer then has an obligation to reimburse the provider for the payment, plus interest.

SYNDICATE

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser**.

TAKEDOWN

See **Underwriter's Gross Spread (Underwriter's Discount)** and **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser**.

TAX ALLOCATION (TAX INCREMENT)

See **Chapter 6, Types of Financing Obligations – Tax Allocation and Other Redevelopment Bonds**.

TAX CODE

The Internal Revenue Code of 1986, as amended. See also **Treasury Regulations**.

TEFRA NOTICE, HEARING, AND APPROVAL

See **Chapter 3, General Federal Tax Requirements**. The published notice, public hearing, and approval by elected officials required by Section 147(f) of the Internal Revenue Code for qualified private activity bonds; originally enacted in the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982.

TEMPORARY PERIODS

See **Chapter 3, General Federal Tax Requirements**. The periods during which the federal tax rules relating to arbitrage yield restriction permit certain gross proceeds of an issue to be invested at a yield that is materially higher than the yield on the issue.

The most important of these is the temporary period generally available for the investment of monies in construction funds or loan acquisition funds after the date the governmental obligations are issued. In addition, a 13-month temporary period is provided for monies in certain debt service funds—generally including funds used primarily to achieve a proper matching of revenues and debt service within each year.

10B-5 STANDARD

10b-5 standard refers to the formulation of the anti-fraud rule in securities law contained in SEC Rule 10b-5. See **Appendix D – Legal References – Federal Laws of General Application to Public Finance**. The language of the 10b-5 standard is often contained in legal opinions or closing certificates. It is generally required that an issuer and/or a nongovernmental borrower certify that the descriptions of their financial condition and operations contained in an Official Statement meet the 10b-5 standard as a part of the closing documentation, as well as in connection with the execution of a bond purchase agreement. See generally **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

TENDER OFFER

The process by which a potential purchaser of bonds (which may be the issuer of the bonds) solicits from the holders of such bonds offers to sell those bonds to the purchaser upon the terms specified in the solicitation.

This technique borrows its name from the corporate securities arena, where shares in a company may be acquired by the purchase of common stock on the open market pursuant to a tender offer. In the context of public finance, a tender offer may be a refinancing method in which an issuer

distributes, by publication or otherwise, to the owners of its bonds an offer either to purchase a specific aggregate amount of such bonds at a specific price if such bonds are tendered by a specified date, or to utilize a stated amount of money to purchase the bonds by accepting tenders of the bonds in order of price until the stated amount is exhausted. Bonds purchased by an issuer pursuant to a tender offer are usually deemed retired and no longer outstanding under the indenture or bond resolution.

While an issuer may utilize the tender offer technique to reduce its outstanding debt by use of excess cash on hand, it is more commonly used as an alternative to an advance refunding. In such a case, a new issue might be issued subsequent to or concurrently with the tender offer to provide the monies with which to purchase tendered bonds.

TENDER OPTION BOND

See **Demand Bond (Put Bond or Tender Option Bond)**.

TERM

With respect to a single bond, the period of time until the maturity date of the bond and with respect to an issue, the period until the maturity date of the last bond of the issue to mature.

TERM BONDS

Originally, the maturity due at the end of the term of an issue; now, more commonly, a maturity that is subject to redemption over a specified period from sinking fund payments.

See also **Redemption** and **Sinking Fund Payments or Installments**.

TRANCHE

A colloquial term used to refer to a portion of financing for a project or program. Sometimes used to describe a series of bonds (i.e. “The Series 2005 bonds represent the first *tranche* of financing for the airport expansion project.”) Derived from the French, the term originally meant a series of bonds issued for sale in a foreign country.

TREASURY REGULATIONS

The federal income tax regulations adopted by the U.S. Department of Treasury. Treasury Regulations are designed to provide additional detail and interpretation of the Tax Code.

TRUE INTEREST COST (TIC)

A measure of the interest cost of an issue that accounts for the time value of money.

The obligation to pay a dollar today is not the same as the obligation to pay a dollar 10 years from now. Presumably, one could take a much smaller sum, invest it today and let the interest on that investment accumulate and compound until one had a dollar on the date 10 years from now. The smaller sum is called the present value of having that dollar 10 years from now, and the interest rate necessary to accumulate and compound that smaller sum up to that dollar 10 years from now is called the discount rate. If one knows the future value (the dollar 10 years from now) and the discount rate, the process of calculating the present value is called discounting the future value to the present. With these general concepts in mind, the TIC of an issue can be more fully defined and compared to the NIC for the same issue. The TIC is sometimes also called the internal rate of return or the net effective interest rate.

The TIC for an issue is the annual discount rate which, when used to discount all debt service payments on the issue to the date of initial delivery of the issue, using a compounding interval equal to the interest payment periods for the issue, results in the aggregate present value of such debt service payments being equal to the original purchase price (including accrued interest) of the issue. For the purpose of calculating the TIC, sinking fund payments for any term bonds are considered principal payments. Because there is no algebraic formula for the direct computation of the TIC, it must be determined either by successive approximation on a computer or calculator or by using present value tables.

Consider the following example: An issuer chooses to sell \$10,000,000 of bonds in 5 separate maturities (1 year through 5 years) at par values of \$1,000,000, \$2,000,000, \$2,000,000, \$2,000,000, and \$3,000,000, respectively, and at interest rates of 5.0, 5.1, 5.2, 5.25, and 5.30 percent, respectively. The price paid for the issue is par, i.e. \$10,000,000. See Example 2 under the definition of **Net Interest Cost** (NIC)—the NIC in that example is 5.238 percent. The TIC as demonstrated by the chart below is 5.236 percent.

Time of Payment (Months)	Interest Paid	Principal Paid	Present Value Payments Discounted by 5.235 percent
6	\$ 260,000		\$ 253,370
12	260,000	\$1,000,000	1,196,530
18	235,000		217,470
24	235,000	2,000,000	2,015,500
30	184,000		161,700
36	184,000	2,000,000	1,870,300
42	132,000		110,150
48	132,000	2,000,000	1,733,800
54	79,500		63,000
60	<u>79,500</u>	<u>3,000,000</u>	<u>2,378,180</u>
Total	\$1,781,000	\$10,000,000	\$10,000,000

The TIC is the rate that will discount all future payments so that the sum of their present values equals the price. Note that the sum of the present value of all the cash flows equals \$10,000,000 when discounted at 5.236 percent. Interest is assumed to be compounded semiannually.

If the price paid for the issue had been 97 percent of par, the TIC would have differed even more from the NIC. The price would have equaled \$9,700,000. The TIC that would discount the present values to \$9,700,000 is 6.24 percent, whereas the NIC for the same issue would be 6.12 percent. See **Net Interest Cost**. The TIC is often used to compare bids at a competitive sale. See also **Yield**.

TRUSTEE

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Trustee/Fiscal Agent/Paying Agent/Registrar/Authenticating Agent**.

UNDERWRITE

To agree to purchase bonds, generally upon initial issuance, in a guaranteed amount, for a guaranteed price, and with the intention to resell the bonds to investors.

In a best efforts underwriting, the underwriter agrees only to use its best efforts to resell bonds to be purchased from the issuer and only agrees to purchase those bonds if the underwriter can resell them.

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/Placement Agent/Purchaser**. See also **Competitive Sale** and **Negotiated Sale**.

UNDERWRITER

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter/ Placement Agent/Purchaser**.

UNDERWRITER'S COUNSEL

See **Chapter 1, Overview of a Debt Financing – Roles and Responsibilities of Principal Participants – Underwriter's Counsel**.

UNDERWRITER'S GROSS SPREAD (UNDERWRITER'S DISCOUNT)

The difference between the purchase price paid to the issuer for a new issue and the sum of the prices at which the bonds are initially offered to the investing public by the underwriter.

To the extent that the initial offering prices are subsequently lowered by the underwriter, the full amount of the spread may not be realized by the underwriter. The spread is usually expressed in points or fractions thereof. The spread generally consists of:

- **Management Fee.** A fee paid to the managing underwriter for handling the affairs of the syndicate, including, in the case of a negotiated sale, structuring the issue and negotiating with the issuer.
- **Expenses.** Any advertising and printing costs to the underwriter, underwriter's counsel's fees and expenses, computer expenses, travel expenses, MSRB fees, CDIAAC fees, and other similar expenses.
- **Takedown.** Normally the largest component of the spread, similar to a commission, the takedown represents the income derived by the selling broker or dealer from the sale of the bonds. If bonds are sold by a member of a syndicate, the seller is entitled to the full takedown (also called the total takedown). If bonds are sold by a dealer, which 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.
- **Risk.** This is the amount of compensation for risks incurred by the underwriter in underwriting the bond issue, relating to the difficulty of marketing the issue, bond market conditions, and the amount of bonds remaining to be resold after the execution of the bond purchase agreement. There is rarely a risk component in the underwriting spread.

In the case of a syndicated offering, a portion of any residual is generally paid to each underwriter within the syndicate on a pro rata basis according to the number of bonds each dealer has committed to sell without regard to the actual sales by each member.

VALIDATION

Sometimes refers to the process of undertaking a validation action. Validation may also refer to the validating acts passed each year by the California Legislature to validate certain types of actions taken by local agencies—including bond financings. These acts, however, do not protect a bond financing from challenge on the grounds of unconstitutionality under the California Constitution.

VALIDATION ACTION

A special procedure under California law that allows an issuer to have the legality of a bond financing approved, including any issue regarding constitutionality of the bond issue. The issuer files a lawsuit naming “all interested persons” as defendants. Notice of the lawsuit is given by publication in the newspaper and by posting public notices. If no interested person comes forward and challenges the financing, the issuer may ask the court for a judgment declaring that the financing is valid. This process takes approximately 45 days. Once the court issues a validation judgment, and the 30-day appeal period expires, the financing cannot later be challenged in court. However, if an interested person does step forward in a timely manner to challenge the financing, the process can take much longer.

VARIABLE RATE

An interest rate that periodically changes based upon an index or a pricing procedure.

For example, the interest rate may be a specified percentage of the weekly U.S. Treasury bill auction rate or of the Federal Home Loan Bank borrowing rate, or may be the rate established by the remarketing agent as the rate necessary to remarket the bonds at par. The variable rate may change on a daily, weekly, monthly, or other periodic basis.

Variable rate bonds generally have a demand feature (see also **Demand Bond (Put Bond or Tender Option Bond)**) allowing the owner to demand that the issuer or another party repurchase the bond upon a specified number of days' notice or at certain times which reflect the intervals at which the rate varies. For example, a variable rate bond bearing interest at a rate, which is set each week, customarily has a demand feature allowing the bondholder to put the bond on one week's notice. Investors treat such a bond as having a term of one week. Because interest charged on money borrowed for a short term is normally less than interest on money borrowed for a long term, variable rates are normally lower than long-term fixed rates.

A variable rate is often called a floating rate. Since variable rates are lower than long-term fixed rates, variable rate bonds are also referred to as lower floaters.

VOLUME CAP

See **Chapter 3, General Federal Tax Requirements**. Under federal tax law, the limit on the aggregate amount of certain tax-exempt qualified private activity bonds that may be issued during any calendar year.

See also **Appendix A – Working With State Agencies – California Debt Limit Allocation Committee**.

WINNING BID RATE

The lowest rate specified in the bids submitted by potential holders for an auction rate security, which if selected by the auction agent as the auction rate, will result in the sale of all of the securities subject to the bid orders.

WORKOUT

The process of trying to resolve a default or other payment problem in a bond financing. A workout may involve assembling a workout team of professionals to assist in the process. Workouts often involve negotiations with the bondholders (such as seeking approval to restructure the debt) and with the persons who are obligated to provide funds for repayment of the bonds (such as defaulting landowners in an assessment district).

YIELD

See **Chapter 3, General Federal Tax Requirements**. As used in the Tax Code, the discount rate that makes the present value of all payments with respect to an investment equal to its purchase price or, in the case of bonds, equal to the initial offering price at which a substantial amount of the governmental obligations is sold to the public.

If proceeds are used to make loans to nongovernmental persons (as is often the case with qualified private activity bonds), the underwriter's gross spread, costs of issuance, and costs of originating, carrying, or selling the conduit obligations may be recovered under the conduit obligations without increasing the yield on those conduit obligations.

Additionally, premiums for bond insurance and other credit enhancement fees may be treated as additional interest, thereby increasing the yield of the issue.

YIELD CURVE

Yield curve means the curve obtained by plotting the yield of investment or debt instruments (on the x-axis) against time (on the y-axis). The typical yield curve is upward sloping, so that the shorter the maturity of the instrument, the lower the yield of that instrument. However, this is not always true, and sometimes yield curves flatten out or even become inverted. The yield curve varies over time in response to general economic conditions and the yield curve may be differently sloped for different types of instruments depending on credit quality, tax-exempt status, and other factors.

YIELD RESTRICTION

See **Arbitrage Yield Restriction**.

YIELD VERIFICATION CONSULTANT

The firm retained by the issuer to verify the calculations leading to the conclusion that the yield on investments acquired with the proceeds of an issue does not exceed the amount permitted under the federal arbitrage rules.

For example, a yield verification consultant is often retained to verify that the yield on the escrow purchased with the proceeds of an advance refunding does not exceed the yield on the refunding bonds.

Similarly, such a firm is also often retained to verify that the effective rate of interest on mortgages acquired with the proceeds of a single-family mortgage revenue bond does not exceed the yield on the bonds by more than 1-1/8 percentage points.

ZERO COUPON BONDS

See **Compound Interest Bond**.

Appendix D

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STATE CONSTITUTIONAL PROVISIONS

The following are selected State Constitutional Sections of particular interest in connection with public finance transactions.

ARTICLE II. VOTING, INITIATIVE AND REFERENDUM, AND RECALL

Section 8. Initiative

- (a) The initiative is the power of the electors to propose statutes and amendments to the Constitution and to adopt or reject them.
- (b) An initiative measure may be proposed by presenting to the Secretary of State a petition that sets forth the text of the proposed statute or amendment to the Constitution and is certified to have been signed by electors equal in number to 5 percent in the case of a statute, and 8 percent in the case of an amendment to the Constitution, of the votes for all candidates for Governor at the last gubernatorial election.
- (c) The Secretary of State shall then submit the measure at the next general election held at least 131 days after it qualifies or at any special statewide election held prior to that general election. The Governor may call a special statewide election for the measure.
- (d) An initiative measure embracing more than one subject may not be submitted to the electors or have any effect.

Section 9. Referendum

- (a) The referendum is the power of the electors to approve or reject statutes or parts of statutes except urgency statutes, statutes calling elections, and statutes providing for tax levies or appropriations for usual current expenses of the State.
- (b) A referendum measure may be proposed by presenting to the Secretary of State, within 90 days after the enactment date of the statute, a petition certified to have been signed by electors equal in number to 5 percent of the votes for all candidates for Governor at the last gubernatorial election, asking that the statute or part of it be submitted to the electors. In the case of a statute enacted by a bill passed by the Legislature on or before the date the Legislature adjourns for a joint recess to reconvene in the second calendar year of the biennium of the legislative session, and in the possession of the Governor after that date, the petition may not be presented on or after January 1 next following the enactment date unless a copy of the petition is submitted to the Attorney General pursuant to subdivision (d) of Section 10 of Article II before January 1.
- (c) The Secretary of State shall then submit the measure at the next general election held at least 31 days after it qualifies or at a special statewide election held prior to that general election. The Governor may call a special statewide election for the measure.

Section 10. Initiative and Referendum; Majority Vote; Effective Date; Conflicting Measures; Amendments and Repeals; Submission of Petition to Attorney General; Submission to Electors

- (a) An initiative statute or referendum approved by a majority of votes thereon takes effect the day after the election unless the measure provides otherwise. If a referendum petition is filed against a part of a statute the remainder shall not be delayed from going into effect.
- (b) If provisions of 2 or more measures approved at the same election conflict, those of the measure receiving the highest affirmative vote shall prevail.
- (c) The Legislature may amend or repeal referendum statutes. It may amend or repeal an initiative statute by another statute that becomes effective only when approved by the electors unless the initiative statute permits amendment or repeal without their approval.
- (d) Prior to circulation of an initiative or referendum petition for signatures, a copy shall be submitted to the Attorney General who shall prepare a title and summary of the measure as provided by law.
- (e) The Legislature shall provide the manner in which petitions shall be circulated, presented, and certified, and measures submitted to the electors.

Section 11. Initiative and Referendum—Powers of Cities and Counties

- (a) Initiative and referendum powers may be exercised by the electors of each city or county under procedures that the Legislature shall provide. Except as provided in subdivisions (b) and (c), this section does not affect a city having a charter.
- (b) A city or county initiative measure shall not include or exclude any part of the city or county from the application or effect of its provisions based upon approval or disapproval of the initiative measure, or based upon the casting of a specified percentage of votes in favor of the measure, by the electors of the city or county or any part thereof.
- (c) A city or county initiative measure shall not contain alternative or cumulative provisions wherein one or more of those provisions would become law depending upon the casting of a specified percentage of votes for or against the measure.

ARTICLE XI. LOCAL GOVERNMENT

Section 5. City Charters; Provisions

- (a) It shall be competent in any city charter to provide that the city governed thereunder may make and enforce all ordinances and regulations in respect to municipal affairs, subject only to restrictions and limitations provided in their several charters and in respect to other matters they shall be subject to general laws. City charters adopted pursuant to this Constitution shall supersede any existing charter, and with respect to municipal affairs shall supersede all laws inconsistent therewith.
- (b) It shall be competent in all city charters to provide, in addition to those provisions allowable by this Constitution, and by the laws of the State for: (1) the constitution, regulation, and government of the city police force (2) subgovernment in all or part of a city (3) conduct of city elections and (4) plenary authority is hereby granted, subject only to the restrictions of this article, to provide therein or by amendment thereto, the manner in which, the method by which, the times at which, and the terms for which the several municipal officers and employees whose compensation is paid by the city shall be elected or appointed, and for their removal, and for their compensation, and for the number of deputies, clerks and other employees that each shall have, and for the compensation, method of appointment, qualifications, tenure of office and removal of such deputies, clerks and other employees.

ARTICLE XIII A. TAX LIMITATION

Section 1. Ad Valorem Tax on Real Property; Maximum Amount; Application

- (a) The maximum amount of any ad valorem tax on real property shall not exceed One percent of the full cash value of such property. The one percent tax to be collected by the counties and apportioned according to law to the districts within the counties.
- (b) The limitation provided for in subdivision (a) shall not apply to ad valorem taxes or special assessments to pay the interest and redemption charges on
 - (1) any indebtedness approved by the voters prior to July 1, 1978.
 - (2) Bonded indebtedness for the acquisition or improvement of real property approved on or after July 1, 1978, by two-thirds of the votes cast by the voters voting on the proposition.
 - (3) Bonded indebtedness incurred by a school district, community college district, or county office of education for the construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities, approved by 55 percent of the voters of the district or county, as appropriate, voting on the proposition on or after the effective date of the measure adding this paragraph. This paragraph shall apply only if the proposition approved by the voters and resulting in the bonded indebtedness includes all of the following accountability requirements:
 - (A) A requirement that the proceeds from the sale of the bonds be used only for the purposes specified in Article XIII A, Section 1(b) (3), and not for any other purpose, including teacher and administrator salaries and other school operating expenses.
 - (B) A list of the specific school facilities projects to be funded and certification that the school district board, community college board, or county office of education has evaluated safety, class size reduction, and information technology needs in developing that list.
 - (C) A requirement that the school district board, community college board, or county office of education conduct an annual, independent performance audit to ensure that the funds have been expended only on the specific projects listed.
 - (D) A requirement that the school district board, community college board, or county office of education conduct an annual, independent financial

audit of the proceeds from the sale of the bonds until all of those proceeds have been expended for the school facilities projects.

- (c) Notwithstanding any other provisions of law or of this Constitution, school districts, community college districts, and county offices of education may levy a 55 percent vote ad valorem tax pursuant to subdivision (b).

Section 2. Full Cash Value; Reassessment; Newly Constructed Property; Seismic Safety; Value and Location of Replacement Dwelling; Full Cash Value Base; Change in Ownership; Family Transfers

- (a) The full cash value means the county assessor's valuation of real property as shown on the 1975-76 tax bill under "full cash value" or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment. All real property not already assessed up to the 1975-76 full cash value may be reassessed to reflect that valuation. For purposes of this section, "newly constructed" does not include real property that is reconstructed after a disaster, as declared by the Governor, where the fair market value of the real property, as reconstructed, is comparable to its fair market value prior to the disaster. Also, the term "newly constructed" shall not include the portion of reconstruction or improvement to a structure, constructed of unreinforced masonry bearing wall construction, necessary to comply with any local ordinance relating to seismic safety during the first 15 years following that reconstruction or improvement.

However, the Legislature may provide that under appropriate circumstances and pursuant to definitions and procedures established by the Legislature, any person over the age of 55 years who resides in property which is eligible for the homeowner's exemption under subdivision (k) of Section 3 of Article XIII and any implementing legislation may transfer the base year value of the property entitled to exemption, with the adjustments authorized by subdivision (b), to any replacement dwelling of equal or lesser value located within the same county and purchased or newly constructed by that person as his or her principal residence within two years of the sale of the original property. For purposes of this section, "any person over the age of 55 years" includes a married couple one member of which is over the age of 55 years. For purposes of this section, "replacement dwelling" means a building, structure, or other shelter constituting a place of abode, whether real property or personal property, and any land on which it may be situated. For purposes of this section, a two-dwelling unit shall be considered as two separate single-family dwellings. This paragraph shall apply to any replacement dwelling which was purchased or newly constructed on or after November 5, 1986.

In addition, the Legislature may authorize each county board of supervisors, after consultation with the local affected agencies within the county's boundaries, to adopt an ordinance making the provisions of this subdivision relating to transfer of base year value

also applicable to situations in which the replacement dwellings are located in that county and the original properties are located in another county within this State. For purposes of this paragraph, “local affected agency” means any city, special district, school district, or community college district which receives an annual property tax revenue allocation. This paragraph shall apply to any replacement dwelling which was purchased or newly constructed on or after the date the county adopted the provisions of this subdivision relating to transfer of base year value, but shall not apply to any replacement dwelling which was purchased or newly constructed before November 9, 1988.

The Legislature may extend the provisions of this subdivision relating to the transfer of base year values from original properties to replacement dwellings of homeowners over the age of 55 years to severely disabled homeowners, but only with respect to those replacement dwellings purchased or newly constructed on or after the effective date of this paragraph.

- (b) The full cash value base may reflect from year to year the inflationary rate not to exceed 2 percent for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction, or may be reduced to reflect substantial damage, destruction or other factors causing a decline in value.
- (c) For purposes of subdivision (a), the Legislature may provide that the term “newly constructed” shall not include any of the following:
 - (1) The construction or addition of any active solar energy system.
 - (2) The construction or installation of any fire sprinkler system, other fire extinguishing system, fire detection system, or fire-related egress improvement, as defined by the Legislature, which is constructed or installed after the effective date of this paragraph.
 - (3) The construction, installation, or modification on or after the effective date of this paragraph of any portion or structural component of a single or multiple family dwelling that is eligible for the homeowner's exemption if the construction, installation, or modification is for the purpose of making the dwelling more accessible to severely disabled person.
 - (4) The construction or installation of seismic retrofitting improvements or improvements utilizing earthquake hazard mitigation technologies, that are constructed or installed in existing buildings after the effective date of this paragraph. The Legislature shall define eligible improvements. This exclusion does not apply to seismic safety reconstruction or improvements which qualify for exclusion pursuant to the last sentence of the first paragraph of subdivision (a).

- (5) The construction, installation, removal, or modification on or after the effective date of this paragraph of any portion or structural component of an existing building or structure if the construction, installation, removal, or modification is for the purpose of making the building more accessible to, or more usable by, a disabled person.
- (d) For purposes of this section, the term “change in ownership” does not include the acquisition of real property as a replacement for comparable property if the person acquiring the real property has been displaced from the property replaced by eminent domain proceedings, by acquisition by a public entity, or governmental action that has resulted in a judgment of inverse condemnation. The real property acquired shall be deemed comparable to the property replaced if it is similar in size, utility, and function, or if it conforms to state regulations defined by the Legislature governing the relocation of persons displaced by governmental actions. The provisions of this subdivision shall be applied to any property acquired after March 1, 1975, but shall affect only those assessments of that property that occur after the provisions of this subdivision take effect.
- (e) (1) Notwithstanding any other provision of this section, the Legislature shall provide that the base year value of property which is substantially damaged or destroyed by a disaster, as declared by the Governor, may be transferred to comparable property within the same county that is acquired or newly constructed as a replacement for the substantially damaged or destroyed property.
- (2) Except as provided in paragraph (3), this subdivision shall apply to any comparable replacement property acquired or newly constructed on or after July 1, 1985, and to the determination of base year values for the 1985-86 fiscal year and fiscal years thereafter.
- (3) In addition to the transfer of base year value of property within the same county that is permitted by paragraph (1), the Legislature may authorize each county board of supervisors to adopt, after consultation with affected local agencies within the county, an ordinance allowing the transfer of the base year value of property that is located within another county in the State and is substantially damaged or destroyed by a disaster, as declared by the Governor, to comparable replacement property of equal or lesser value that is located within the adopting county and is acquired or newly constructed within three years of the substantial damage or destruction of the original property as a replacement for that property. The scope and amount of the benefit provided to a property owner by the transfer of base year value of property pursuant to this paragraph shall not exceed the scope and amount of the benefit provided to a property owner by the transfer of base year value of property pursuant to subdivision (a). For purposes of this paragraph, “affected local agency” means any city, special district, school district, or community college district that receives an annual allocation of ad valorem

property tax revenues. This paragraph shall apply to any comparable replacement property that is acquired or newly constructed as a replacement for property substantially damaged or destroyed by a disaster, as declared by the Governor, occurring on or after October 20, 1991, and to the determination of base year values for the 1991-92 fiscal year and fiscal years thereafter.

- (f) For the purposes of subdivision (e):
 - (1) Property is substantially damaged or destroyed if it sustains physical damage amounting to more than 50 percent of its value immediately before the disaster. Damage includes a diminution in the value of property as a result of restricted access caused by the disaster.
 - (2) Replacement property is comparable to the property substantially damaged or destroyed if it is similar in size, utility, and function to the property which it replaces, and if the fair market value of the acquired property is comparable to the fair market value of the replaced property prior to the disaster.
- (g) For purposes of subdivision (a), the terms “purchased” and “change in ownership” shall not include the purchase or transfer of real property between spouses since March 1, 1975, including, but not limited to, all of the following:
 - (1) Transfers to a trustee for the beneficial use of a spouse, or the surviving spouse of a deceased transferor, or by a trustee of such a trust to the spouse of the trustor.
 - (2) Transfers to a spouse which take effect upon the death of a spouse.
 - (3) Transfers to a spouse or former spouse in connection with a property settlement agreement or decree of dissolution of a marriage or legal separation.
 - (4) The creation, transfer, or termination, solely between spouses, of any co-owner's interest.
 - (5) The distribution of a legal entity's property to a spouse or former spouse in exchange for the interest of the spouse in the legal entity in connection with a property settlement agreement or a decree of dissolution of a marriage or legal separation.
- (h) (1) For purposes of subdivision (a), the terms “purchased” and “change in ownership” shall not include the purchase or transfer of the principal residence of the transferor in the case of a purchase or transfer between parents and their children, as defined by the Legislature, and the purchase or transfer of the first \$1,000,000 of the full cash value of all other real property between parents and their children,

as defined by the Legislature. This subdivision shall apply to both voluntary transfers and transfers resulting from a court order or judicial decree.

- (2) (A) Subject to subparagraph (B), commencing with purchases or transfers that occur on or after the date upon which the measure adding this paragraph becomes effective, the exclusion established by paragraph (1) also applies to a purchase or transfer of real property between grandparents and their grandchild or grandchildren, as defined by the Legislature, that otherwise qualifies under paragraph (1), if all of the parents of that grandchild or those grandchildren, who qualify as the children of the grandparents, are deceased as of the date of the purchase or transfer.
 - (B) A purchase or transfer of a principal residence shall not be excluded pursuant to subparagraph (A) if the transferee grandchild or grandchildren also received a principal residence, or interest therein, through another purchase or transfer that was excludable pursuant to paragraph (1). The full cash value of any real property, other than a principal residence, that was transferred to the grandchild or grandchildren pursuant to a purchase or transfer that was excludable pursuant to paragraph (1), and the full cash value of a principal residence that fails to qualify for exclusion as a result of the preceding sentence, shall be included in applying, for purposes of subparagraph (A), the one million dollar (\$1,000,000) full cash value limit specified in paragraph (1).
- (i) (1) Notwithstanding any other provision of this section, the Legislature shall provide with respect to a qualified contaminated property, as defined in paragraph (2), that either, but not both, of the following shall apply:
 - (A) (i) Subject to the limitation of clause (ii), the base year value of the qualified contaminated property, as adjusted as authorized by subdivision (b), may be transferred to a replacement property that is acquired or newly constructed as a replacement for the qualified contaminated property, if the replacement real property has a fair market value that is equal to or less than the fair market value of the qualified contaminated property if that property were not contaminated and, except as otherwise provided by this clause, is located within the same county. The base year value of the qualified contaminated property may be transferred to a replacement real property located within another county if the board of supervisors of that other county has, after consultation with the affected local agencies within that county, adopted a resolution authorizing an intercounty transfer of base year value as so described.

- (ii) This subparagraph applies only to replacement property that is acquired or newly constructed within five years after ownership in the qualified contaminated property is sold or otherwise transferred.
 - (B) In the case in which the remediation of the environmental problems on the qualified contaminated property requires the destruction of, or results in substantial damage to, a structure located on that property, the term “new construction” does not include the repair of a substantially damaged structure, or the construction of a structure replacing a destroyed structure on the qualified contaminated property, performed after the remediation of the environmental problems on that property, provided that the repaired or replacement structure is similar in size, utility, and function to the original structure.
- (2) For purposes of this subdivision, “qualified contaminated property” means residential or nonresidential real property that is all of the following:
- (A) In the case of residential real property, rendered uninhabitable, and in the case of nonresidential real property, rendered unusable, as the result of either environmental problems, in the nature of and including, but not limited to, the presence of toxic or hazardous materials, or the remediation of those environmental problems, except where the existence of the environmental problems was known to the owner, or to a related individual or entity as described in paragraph (3), at the time the real property was acquired or constructed. For purposes of this subparagraph, residential real property is “uninhabitable” if that property, as a result of health hazards caused by or associated with the environmental problems, is unfit for human habitation, and nonresidential real property is “unusable” if that property, as a result of health hazards caused by or associated with the environmental problems, is unhealthy and unsuitable for occupancy.
 - (B) Located on a site that has been designated as a toxic or environmental hazard or as an environmental cleanup site by an agency of the State of California or the federal government.
 - (C) Real property that contains a structure or structures thereon prior to the completion of environmental cleanup activities, and that structure or structures are substantially damaged or destroyed as a result of those environmental cleanup activities.
 - (D) Stipulated by the lead governmental agency, with respect to the environmental problems or environmental cleanup of the real property, not

to have been rendered uninhabitable or unusable, as applicable, as described in subparagraph (A), by any act or omission in which an owner of that real property participated or acquiesced.

(3) It shall be rebuttably presumed that an owner of the real property participated or acquiesced in any act or omission that rendered the real property uninhabitable or unusable, as applicable, if that owner is related to any individual or entity that committed that act or omission in any of the following ways:

- (A) Is a spouse, parent, child, grandparent, grandchild, or sibling of that individual.
- (B) Is a corporate parent, subsidiary, or affiliate of that entity.
- (C) Is an owner of, or has control of, that entity.
- (D) Is owned or controlled by that entity.

If this presumption is not overcome, the owner shall not receive the relief provided for in subparagraph (A) or (B) of paragraph (1). The presumption may be overcome by presentation of satisfactory evidence to the assessor, who shall not be bound by the findings of the lead governmental agency in determining whether the presumption has been overcome.

(4) This subdivision applies only to replacement property that is acquired or constructed on or after January 1, 1995, and to property repairs performed on or after that date.

(j) Unless specifically provided otherwise, amendments to this section adopted prior to November 1, 1988, shall be effective for changes in ownership that occur, and new construction that is completed, after the effective date of the amendment. Unless specifically provided otherwise, amendments to this section adopted after November 1, 1988, shall be effective for changes in ownership that occur, and new construction that is completed, on or after the effective date of the amendment.

Section 3. Changes in State Taxes Enactments to Increase Revenues; Imposition

From and after the effective date of this article, any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed.

Section 4. Special Taxes; Imposition

Cities, Counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district, except ad valorem taxes on real property or a transaction tax or sales tax on the sale of real property within such City, County or special district.

Section 5. Effective Date of Article

This article shall take effect for the tax year beginning on July 1 following the passage of this Amendment, except Section 3 which shall become effective upon the passage of this article.

Section 6. Severability

If any section, part, clause, or phrase hereof is for any reason held to be invalid or unconstitutional, the remaining sections shall not be affected but will remain in full force and effect.

ARTICLE XIII B. GOVERNMENT SPENDING LIMITATION

Section 1. Total Annual Appropriations; Amount Not to Exceed Limit of Prior Year; Adjustments

The total annual appropriations subject to limitation of the State and of each local government shall not exceed the appropriations limit of the entity of government for the prior year adjusted for the change in the cost of living and the change in population, except as otherwise provided in this article.

Section 1.5. Annual Calculation of Appropriations Limit

The annual calculation of the appropriations limit under this article for each entity of local government shall be reviewed as part of an annual financial audit.

Section 2. Revenues in Excess of Limitation

- (a) (1) Fifty percent of all revenues received by the State in a fiscal year and in the fiscal year immediately following it in excess of the amount which may be appropriated by the State in compliance with this article during that fiscal year and the fiscal year immediately following it shall be transferred and allocated, from a fund established for that purpose, pursuant to Section 8.5 of Article XVI.
- (2) Fifty percent of all revenues received by the State in a fiscal year and in the fiscal year immediately following it in excess of the amount which may be appropriated by the State in compliance with this article during that fiscal year and the fiscal

year immediately following it shall be returned by a revision of tax rates or fee schedules within the next two subsequent fiscal years.

- (b) All revenues received by an entity of government, other than the State, in a fiscal year and in the fiscal year immediately following it in excess of the amount which may be appropriated by the entity in compliance with this article during that fiscal year and the fiscal year immediately following it shall be returned by a revision of tax rates or fee schedules within the next two subsequent fiscal years.

Section 3. Adjustment of Appropriation Limits; Transfer of Financial Responsibility; Emergency

The appropriations limit for any fiscal year pursuant to Sec. 1 shall be adjusted as follows:

- (a) In the event that the financial responsibility of providing services is transferred, in whole or in part, whether by annexation, incorporation or otherwise, from one entity of government to another, then for the year in which such transfer becomes effective the appropriations limit of the transferee entity shall be increased by such reasonable amount as the said entities shall mutually agree and the appropriations limit of the transferor entity shall be decreased by the same amount.
- (b) In the event that the financial responsibility of providing services is transferred, in whole or in part, from an entity of government to a private entity, or the financial source for the provision of services is transferred, in whole or in part, from other revenues of an entity of government, to regulatory licenses, user charges or user fees, then for the year of such transfer the appropriations limit of such entity of government shall be decreased accordingly.
- (c)
 - (1) In the event an emergency is declared by the legislative body of an entity of government, the appropriations limit of the affected entity of government may be exceeded provided that the appropriations limits in the following three years are reduced accordingly to prevent an aggregate increase in appropriations resulting from the emergency.
 - (2) In the event an emergency is declared by the Governor, appropriations approved by a two-thirds vote of the legislative body of an affected entity of government to an emergency account for expenditures relating to that emergency shall not constitute appropriations subject to limitation. As used in this paragraph, “emergency” means the existence, as declared by the Governor, of conditions of disaster or of extreme peril to the safety of persons and property within the State, or parts thereof, caused by such conditions as attack or probable or imminent attack by an enemy of the United States, fire, flood, drought, storm, civil disorder, earthquake, or volcanic eruption.

Section 4. Establishment or Change in Appropriation Limit for New or Existing Entities by Electors

The appropriations limit imposed on any new or existing entity of government by this Article may be established or changed by the electors of such entity, subject to and in conformity with constitutional and statutory voting requirements. The duration of any such change shall be as determined by said electors, but shall in no event exceed four years from the most recent vote of said electors creating or continuing such change.

Section 5. Establishment of Funds by Each Entity of Government; Contributions; Withdrawals

Each entity of government may establish such contingency, emergency, unemployment, reserve, retirement, sinking fund, trust, or similar funds as it shall deem reasonable and proper. Contributions to any such fund, to the extent that such contributions are derived from the proceeds of taxes, shall for purposes of this Article constitute appropriations subject to limitation in the year of contribution. Neither withdrawals from any such fund, nor expenditures of (or authorizations to expend) such withdrawals, nor transfers between or among such funds, shall for purposes of this Article constitute appropriations subject to limitation.

Section 5.5. Prudent State Reserve

Prudent State Reserve. The Legislature shall establish a prudent state reserve fund in such amount as it shall deem reasonable and necessary. Contributions to, and withdrawals from, the fund shall be subject to the provisions of Section 5 of this Article.

Section 6. New Programs or Services Mandated by Legislature or State Agencies; Subvention

- (a) Whenever the Legislature or any state agency mandates a new program or higher level of service on any local government, the State shall provide a subvention of funds to reimburse that local government for the costs of the program or increased level of service, except that the Legislature may, but need not, provide a subvention of funds for the following mandates:
 - (1) Legislative mandates requested by the local agency affected.
 - (2) Legislation defining a new crime or changing an existing definition of a crime.
 - (3) Legislative mandates enacted prior to January 1, 1975, or executive orders or regulations initially implementing legislation enacted prior to January 1, 1975.
- (b) (1) Except as provided in paragraph (2), for the 2005-06 fiscal year and every subsequent fiscal year, for a mandate for which the costs of a local government claimant have been determined in a preceding fiscal year to be payable by the

State pursuant to law, the Legislature shall either appropriate, in the annual Budget Act, the full payable amount that has not been previously paid, or suspend the operation of the mandate for the fiscal year for which the annual Budget Act is applicable in a manner prescribed by law.

- (2) Payable claims for costs incurred prior to the 2004-05 fiscal year that have not been paid prior to the 2005-06 fiscal year may be paid over a term of years, as prescribed by law.
 - (3) Ad valorem property tax revenues shall not be used to reimburse a local government for the costs of a new program or higher level of service.
 - (4) This subdivision applies to a mandate only as it affects a city, county, city and county, or special district.
 - (5) This subdivision shall not apply to a requirement to provide or recognize any procedural or substantive protection, right, benefit, or employment status of any local government employee or retiree, or of any local government employee organization, that arises from, affects, or directly relates to future, current, or past local government employment and that constitutes a mandate subject to this section.
- (c) A mandated new program or higher level of service includes a transfer by the Legislature from the State to cities, counties, cities and counties, or special districts of complete or partial financial responsibility for a required program for which the State previously had complete or partial financial responsibility.

Section 7. No Impairment of Obligation to Meet Bonded Indebtedness

Nothing in this Article shall be construed to impair the ability of the State or of any local government to meet its obligations with respect to existing or future bonded indebtedness.

Section 8. Definitions

As used in this article and except as otherwise expressly provided herein:

- (a) “Appropriations subject to limitation” of the State means any authorization to expend during a fiscal year the proceeds of taxes levied by or for the State, exclusive of state subventions for the use and operation of local government (other than subventions made pursuant to Section 6) and further exclusive of refunds of taxes, benefit payments from retirement, unemployment insurance, and disability insurance funds.
- (b) “Appropriations subject to limitation” of an entity of local government means any authorization to expend during a fiscal year the proceeds of taxes levied by or for that

entity and the proceeds of state subventions to that entity (other than subventions made pursuant to Section 6) exclusive of refunds of taxes.

- (c) “Proceeds of taxes” shall include, but not be restricted to, all tax revenues and the proceeds to an entity of government, from (1) regulatory licenses, user charges, and user fees to the extent that those proceeds exceed the costs reasonably borne by that entity in providing the regulation, product, or service, and (2) the investment of tax revenues. With respect to any local government, “proceeds of taxes” shall include subventions received from the State, other than pursuant to Section 6, and, with respect to the State, proceeds of taxes shall exclude such subventions.
- (d) “Local government” means any city, county, city and county, school district, special district, authority, or other political subdivision of or within the State.
- (e)
 - (1) “Change in the cost of living” for the State, a school district, or a community college district means the percentage change in California per capita personal income from the preceding year.
 - (2) “Change in the cost of living” for an entity of local government, other than a school district or a community college district, shall be either (A) the percentage change in California per capita personal income from the preceding year, or (B) the percentage change in the local assessment roll from the preceding year for the jurisdiction due to the addition of local nonresidential new construction. Each entity of local government shall select its change in the cost of living pursuant to this paragraph annually by a recorded vote of the entity's governing body.
- (f) “Change in population” of any entity of government, other than the State, a school district, or a community college district, shall be determined by a method prescribed by the Legislature.

“Change in population” of a school district or a community college district shall be the percentage change in the average daily attendance of the school district or community college district from the preceding fiscal year, as determined by a method prescribed by the Legislature.

“Change in population” of the State shall be determined by adding (1) the percentage change in the State's population multiplied by the percentage of the State's budget in the prior fiscal year that is expended for other than educational purposes for kindergarten and grades one to 12, inclusive, and the community colleges, and (2) the percentage change in the total statewide average daily attendance in kindergarten and grades one to 12, inclusive, and the community colleges, multiplied by the percentage of the State's budget in the prior fiscal year that is expended for educational purposes for kindergarten and grades one to 12, inclusive, and the community colleges.

Any determination of population pursuant to this subdivision, other than that measured by average daily attendance, shall be revised, as necessary, to reflect the periodic census conducted by the United States Department of Commerce, or successor department.

- (g) “Debt service” means appropriations required to pay the cost of interest and redemption charges, including the funding of any reserve or sinking fund required in connection therewith, on indebtedness existing or legally authorized as of January 1, 1979, or on bonded indebtedness thereafter approved according to law by a vote of the electors of the issuing entity voting in an election for that purpose.
- (h) The “appropriations limit” of each entity of government for each fiscal year is that amount which total annual appropriations subject to limitation may not exceed under Sections 1 and 3. However, the “appropriations limit” of each entity of government for fiscal year 1978-79 is the total of the appropriations subject to limitation of the entity for that fiscal year. For fiscal year 1978-79, state subventions to local governments, exclusive of federal grants, are deemed to have been derived from the proceeds of state taxes.
- (i) Except as otherwise provided in Section 5, “appropriations subject to limitation” do not include local agency loan funds or indebtedness funds, investment (or authorizations to invest) funds of the State, or of an entity of local government in accounts at banks or savings and loan associations or in liquid securities.

Section 9. Appropriations Subject to Limitations; Exclusions

“Appropriations subject to limitation” for each entity of government do not include:

- (a) Appropriations for debt service.
- (b) Appropriations required to comply with mandates of the courts or the federal government which, without discretion, require an expenditure for additional services or which unavoidably make the provision of existing services more costly.
- (c) Appropriations of any special district which existed on January 1, 1978, and which did not as of the 1977-78 fiscal year levy an ad valorem tax on property in excess of 12 1/2 cents per \$100 of assessed value; or the appropriations of any special district then existing or thereafter created by a vote of the people, which is totally funded by other than the proceeds of taxes.
- (d) Appropriations for all qualified capital outlay projects, as defined by the Legislature.
- (e) Appropriations of revenue which are derived from any of the following:

- (1) That portion of the taxes imposed on motor vehicle fuels for use in motor vehicles upon public streets and highways at a rate of more than nine cents (\$0.09) per gallon.
- (2) Sales and use taxes collected on that increment of the tax specified in paragraph (1).
- (3) That portion of the weight fee imposed on commercial vehicles which exceeds the weight fee imposed on those vehicles on January 1, 1990.

Section 10. Effective Date

This Article shall be effective commencing with the first day of the fiscal year following its adoption.

Section 10.5. Appropriations Limit for Fiscal Years Beginning on or after July 7, 1990

For fiscal years beginning on or after July 1, 1990, the appropriations limit of each entity of government shall be the appropriations limit for the 1986-87 fiscal year adjusted for the changes made from that fiscal year pursuant to this article, as amended by the measure adding this section, adjusted for the changes required by Section 3.

Section 11. Adjustment of Appropriations Limit; Judgment of Court; Severability

If any appropriation category shall be added to or removed from appropriations subject to limitation, pursuant to final judgment of any court of competent jurisdiction and any appeal therefrom, the appropriations limit shall be adjusted accordingly. If any section, part, clause or phrase in this Article is for any reason held invalid or unconstitutional, the remaining portions of this Article shall not be affected but shall remain in full force and effect.

Section 12. Appropriations Subject to Limitations; Exclusion of Cigarette and Tobacco Revenue

“Appropriations subject to limitation” of each entity of government shall not include appropriations of revenue from the Cigarette and Tobacco Products Surtax Fund created by the Tobacco Tax and Health Protection Act of 1988. No adjustment in the appropriations limit of any entity of government shall be required pursuant to Section 3 as a result of revenue being deposited in or appropriated from the Cigarette and Tobacco Products Surtax Fund created by the Tobacco Tax and Health Protection Act of 1988.

AMALGAMATED EDITION OF PROPOSITION 218 AND SB 919

The following section is a combination of the provisions of Proposition 218, an initiative constitutional amendment approved by California voters on November 5, 1996, which added Articles XIIC and XIID to the California Constitution, and Senate Bill 919, the “Omnibus Proposition 218 Implementation Act,” which was adopted by the California Legislature as an urgency measure and signed by the Governor on July 1, 1997. Typographical conventions are as follows:

- Language contained only in Proposition 218 is in ‘normal’ text
- Language contained only in SB 919 is in ‘*italic*’ text
- Language contained in both measures is in underlined text

Article XIII C. Right to Vote on Taxes Act

Section 1. Definitions

As used in this article:

- “(General tax)” means any tax imposed for general governmental purposes.
- “(Local government)” means any county, city, city and county, including a charter city or county, any special district, or any other local or regional governmental entity.
- “(Special district)” means an agency of the state, formed pursuant to general law or a special act, for the local performance of governmental or proprietary functions with limited geographic boundaries including, but not limited to, school districts and redevelopment agencies.
- “(Special tax)” means any tax imposed for specific purposes, including a tax imposed for specific purposes, which is placed into a general fund.

Section 2. General and Special Taxes; Local Government Powers; Powers of Special Purpose Districts or Agencies

Notwithstanding any other provision of this Constitution:

- All taxes imposed by any local government shall be deemed to be either general taxes or special taxes. Special purpose districts or agencies, including school districts, shall have no power to levy general taxes.
- No local government may impose, extend, or increase any general tax unless and until that tax is submitted to the electorate and approved by a majority vote. A general tax shall

not be deemed to have been increased if it is imposed at a rate not higher than the maximum rate so approved. The election required by this subdivision shall be consolidated with a regularly scheduled general election for members of the governing body of the local government, except in cases of emergency declared by a unanimous vote of the governing body.

- (c) Any general tax imposed, extended, or increased, without voter approval, by any local government on or after January 1, 1995, and prior to the effective date of this article, shall continue to be imposed only if approved by a majority vote of the voters voting in an election on the issue of the imposition, which election shall be held within two years of the effective date of this article and in compliance with subdivision (b).
- (d) No local government may impose, extend, or increase any special tax unless and until that tax is submitted to the electorate and approved by a two-thirds vote. A special tax shall not be deemed to have been increased if it is imposed at a rate not higher than the maximum rate so approved.

[Ed. Note: The following provisions of SB 919 (Chapter 38, Statutes of 1997) add new sections dealing with variable formulas for taxes, assessments, fees and charges which must be voter approved under Proposition 218.]

Article 4.3 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53739. Rates or Amounts; Voter-Approved Ordinances or Resolutions; Adjustments

- (a) *An ordinance or resolution presented for voter approval pursuant to this article or to Article XIIC or XIID of the California Constitution may state a range of rates or amounts. If the ordinance or resolution is approved by the requisite number of votes at an election held for that purpose, the governing board of the adopting local government may thereafter impose the tax, assessment, or property-related fee or charge at any rate or amount that is less than or equal to the maximum amount authorized by the voter-approved ordinance or resolution.*
- (b) (1) *Except as provided in paragraph (2), an ordinance or resolution presented for voter approval pursuant to Article XIIC or XIID of the California Constitution may provide that the tax, assessment, or property-related fee or charge rates or amounts stated in that ordinance or resolution may be adjusted for inflation pursuant to a clearly identified formula stated in that ordinance or resolution. If an ordinance or resolution described in the preceding sentence is approved by the requisite number of votes at an election held for that purpose, the governing board of the adopting local government may thereafter impose the tax, assessment, or property-related fee or charge at any rate or amount that is less than or equal to the inflation-adjusted maximum amount authorized by the voter-approved ordinance or resolution.*

- (2) *Notwithstanding the authority established in paragraph (1), if the amount or rate of a tax, assessment, or property-related fee or charge is determined by using a percentage calculation, the ordinance imposing the tax, assessment, or property-related fee or charge may not provide that the percentage will be adjusted for inflation.*

[Ed. Note: The following provisions of SB 919 (Chapter 38, Statutes of 1997) are amendments to the general provisions for all-mailed ballot elections contained in the Elections Code.]

Chapter 1 of Division 4 of the Elections Code

Section 4000. Conduct of Local, Special or Consolidated Elections; Authority; Conditions

A local, special, or consolidated election may be conducted wholly by mail provided that all of the following conditions apply:

- (a) *The governing body of the local agency authorizes the use of mailed ballots for the election.*
- (b) *The election is held on an established mailed ballot election date pursuant to Section 1500.*
- (c) *The election is one of the following:*

* * * * *

- (9) *Any election or assessment ballot proceeding required or authorized by Article XIII C or XIII D of the California Constitution. However, when an assessment ballot proceeding is conducted by mail pursuant to this section, the following rules shall apply:*
- (A) *The proceeding shall be denominated an “assessment ballot proceeding” rather than an election.*
- (B) *Ballots shall be denominated “assessment ballots.”*

Article XIII C. Right to Vote on Taxes Act

Section 3. Power of Initiatives

Notwithstanding any other provision of this Constitution, including, but not limited to, Sections 8 and 9 of Article II, the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment, fee or charge. The power of initiative to affect local taxes, assessments, fees and charges shall be applicable to all local governments and neither

the Legislature nor any local government charter shall impose a signature requirement higher than that applicable to statewide statutory initiatives.

Chapter 10.5 of Division 6 of Title 1 of the Government Code

Section 5854. Municipal Securities; Owners' Risks and Contractual Rights; Effect of Adoption of Proposition 218

Section 3 of Article XIIC of the California Constitution, as adopted at the November 5, 1996, general election, shall not be construed to mean that any owner or beneficial owner of a municipal security, purchased before or after that date, assumes the risk of, or in any way consents to, any action by initiative measure that constitutes an impairment of contractual rights protected by Section 10 of Article I of the United States Constitution.

Article XIII D. Assessment and Property Related Fee Reform

Section 1. Application of Articles

Notwithstanding any other provision of law, the provisions of this article shall apply to all assessments, fees and charges, whether imposed pursuant to state statute or local government charter authority. Nothing in this article or Article XIII C shall be construed to:

- (a) Provide any new authority to any agency to impose a tax, assessment, fee, or charge.
- (b) Affect existing laws relating to the imposition of fees or charges as a condition of property development.
- (c) Affect existing laws relating to the imposition of timber yield taxes.

Section 2. Definitions

and

Article 4.6 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code

As used in this article

and

Section 53750. Definitions

For purposes of Article XIIC and Article XIID of the California Constitution and this article:

- (a) “Agency” means any local government as defined in subdivision (b) of Section 1 of Article XIII C of the California Constitution.
- (b) “Assessment” means any levy or charge upon real property by an agency [that is based upon] for a special benefit conferred upon the real property by a public improvement or service, that is imposed to pay the capital cost of the public improvement, the maintenance and operation expenses of the public improvement, or the cost of the service being provided. “Assessment” includes, but is not limited to, “special assessment,” “benefit assessment,” “maintenance assessment” and “special assessment tax.”
- (c) “Capital cost” means the cost of acquisition, installation, construction, reconstruction, or replacement of a permanent public improvement by an agency.
- (d)(c) “District” means an area determined by an agency to contain all parcels which will receive a special benefit from a proposed public improvement or property-related service.
- (d) *“Drainage system” means any system of public improvements that is intended to provide for erosion control, landslide abatement, or for other types of water drainage.*
- (e) *“Extended,” when applied to an existing tax or fee or charge, means a decision by an agency to extend the stated effective period for the tax or fee or charge, including, but not limited to, amendment or removal of a sunset provision or expiration date.*
- (e) “Fee” or “charge” means any levy other than an ad valorem tax, a special tax, or an assessment, imposed by an agency upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service.
- (f) *“Flood control” means any system of public improvements that is intended to protect property from overflow by water.*
- (g) *“Identified parcel” means a parcel of real property that an agency has identified as having a special benefit conferred upon it and upon which a proposed assessment is to be imposed, or a parcel of real property upon which a proposed property-related fee or charge is proposed to be imposed.*
- (h) (1) *“Increased,” when applied to a tax, assessment, or property-related fee or charge, means a decision by an agency that does either of the following:*
- (A) *Increases any applicable rate used to calculate the tax, assessment, fee or charge.*
- (B) *Revises the methodology by which the tax, assessment, fee or charge is calculated, if that revision results in an increased amount being levied on any person or parcel.*

- (2) *A tax, fee, or charge is not deemed to be “increased” by an agency action that does either or both of the following:*
- (A) *Adjusts the amount of a tax or fee or charge in accordance with a schedule of adjustments, including a clearly defined formula for inflation adjustment that was adopted by the agency prior to November 6, 1996.*
 - (B) *Implements or collects a previously approved tax, or fee or charge, so long as the rate is not increased beyond the level previously approved by the agency, and the methodology previously approved by the agency is not revised so as to result in an increase in the amount being levied on any person or parcel.*
- (3) *A tax, assessment, fee or charge is not deemed to be “increased” in the case in which the actual payments from a person or property are higher than would have resulted when the agency approved the tax, assessment, or fee or charge, if those higher payments are attributable to events other than an increased rate or revised methodology, such as a change in the density, intensity, or nature of the use of land.*
- (f) “Maintenance and operation expenses” means the cost of rent, repair, replacement, rehabilitation, fuel, power, electrical current, care, and supervision necessary to properly operate and maintain a permanent public improvement.
- (i) “Notice by mail” means any notice required by Article XIIC or XIID of the California Constitution that is accomplished through a mailing, postage prepaid, deposited in the United States Postal Service and is deemed given when so deposited. Notice by mail may be included in any other mailing to the record owner that otherwise complies with Article XIIC or XIID of the California Constitution and this article, including, but not limited to, the mailing of a bill for the collection of an assessment or a property-related fee or charge.
- (g) “Property ownership” shall be deemed to include tenancies of real property where tenants are directly liable to pay the assessment, fee, or charge in question.
- (h) “Property-related service” means a public service having a direct relationship to property ownership.
- (j) “Record owner” means the owner of a parcel whose name and address appears on the last equalized secured property tax assessment roll, or in the case of any public entity, the State of California, or the United States, means the representative of that public entity at the address of that entity known to the agency.

- (k) *“Registered professional engineer” means an engineer registered pursuant to the Professional Engineers Act (Chapter 7 (commencing with Section 6700) of Division 3 of the Business and Professions Code).*
- (i) *“Special benefit” means a particular and distinct benefit over and above general benefits conferred on real property located in the district or to the public at large. General enhancement of property value does not constitute “special benefit.”*
- (l) *“Vector control” means any system of public improvements or services that is intended to provide for the surveillance, prevention, and abatement and control of vectors as defined in subdivision (k) of Section 2002 of the Health and Safety Code and a pest as defined in Section 5006 of the Food and Agriculture Code.*
- (m) *“Water” means any system of public improvements intended to provide for the production, storage, supply, treatment, or distribution of water.*

Article XIII D. Assessment and Property Related Fee Reform

Section 3. Limitations on Property Taxes, Assessments, Fees and Charges; Electric and Gas Service Fees

- (a) No tax, assessment, fee, or charge shall be assessed by any agency upon any parcel of property or upon any person as an incident of property ownership except:
 - (1) The ad valorem property tax imposed pursuant to Article XIII and Article XIII A.
 - (2) Any special tax receiving a two-thirds vote pursuant to Section 4 of Article XIII A.
 - (3) Assessments as provided by this article.
 - (4) Fees or charges for property related services as provided by this article.
- (b) For purposes of this article, fees for the provision of electrical or gas service shall not be deemed charges or fees imposed as an incident of property ownership.

Article XIII D. Assessment and Property Related Fee Reform

Section 4. Proposed Assessments; Procedures and Requirements

and

Article 4.6 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code Section 53753. Notice, Protest and Hearing Requirements

- (a) An agency which proposes to levy an assessment shall identify all parcels which will have a special benefit conferred upon them and upon which an assessment will be imposed. The proportionate special benefit derived by each identified parcel shall be determined in relationship to the entirety of the capital cost of a public improvement, the maintenance and operation expenses of a public improvement, or the cost of the property related service being provided. No assessment shall be imposed on any parcel which exceeds the reasonable cost of the proportional special benefit conferred on that parcel. Only special benefits are assessable, and an agency shall separate the general benefits from the special benefits conferred on a parcel. Parcels within a district that are owned or used by any agency, the State of California or the United States shall not be exempt from assessment unless the agency can demonstrate by clear and convincing evidence that those publicly owned parcels in fact receive no special benefit.
- (b) All assessments shall be supported by a detailed engineer's report prepared by a registered professional engineer certified by the State of California.
- (a) *The notice, protest, and hearing requirements imposed by this section supersede any statutory provisions applicable to the levy of a new or increased assessment that is in existence on the effective date of this section, whether or not that provision is in conflict with this article. Any agency that complies with the notice, protest, and hearing requirements of this section shall not be required to comply with any other statutory notice, protest, and hearing requirements that would otherwise be applicable to the levy of a new or increased assessment, with the exception of Division 4.5 (commencing with Section 3100) of the Streets and Highways Code. If the requirements of that division apply to the levy of a new or increased assessment, the levying agency shall comply with the notice, protest, and hearing requirements imposed by this section as well as with the requirements of that division.*
- (c) (b) *Prior to levying a new or increased assessment, or an existing assessment that is subject to the procedures and approval process set forth in Section 4 of Article XIID of the California Constitution, an agency shall give notice by mail to the record owner of each identified parcel. The amount of the proposed assessment for each identified parcel shall be calculated and the record owner of each parcel shall be given written notice by mail of the proposed assessment, the total amount thereof chargeable to the entire district, the amount chargeable to the owner's particular parcel, the duration of the payments, the*

reason for the assessment and the basis upon which the amount of the proposed assessment was calculated, together with [and] the date, time, and location of a public hearing on the proposed assessment. Each notice shall also include, in a conspicuous place thereon, a summary of the procedures applicable to the completion, return, and tabulation of the ballots required pursuant to subdivision (d) (c), including a disclosure statement that the existence of a majority protest, as defined in subdivision (e), will result in the assessment not being imposed. The assessment shall not be imposed if the ballots submitted in opposition to the assessment exceed the ballots submitted in favor of the assessment, with ballots weighted according to the proportional financial obligation of the affected property. An agency shall give notice by mail at least 45 days prior to the date of the public hearing upon the proposed assessment.

- (d) (c) Each notice mailed to owners of identified parcels within the district pursuant to subdivision (c) [given pursuant to subdivision (b)] shall contain a [an assessment] ballot which includes the agency's address for receipt of the ballot [form] once completed by any owner receiving the notice whereby the owner may [and a place where the person returning the assessment ballot may] indicate his or her name, reasonable identification of the parcel, and his or her support or opposition to the proposed assessment. Each assessment ballot shall be in a form that conceals its contents once it is sealed by the person submitting the assessment ballot. Each assessment ballot shall be signed and either mailed or otherwise delivered to the address indicated on the assessment ballot. Regardless of the method of delivery, all assessment ballots shall be received at the address indicated, or the site of the public testimony, in order to be included in the tabulation of a majority protest pursuant to subdivision (e). Assessment ballots shall remain sealed until the tabulation of ballots pursuant to subdivision (e) commences, provided that an assessment ballot may be submitted, or changed, or withdrawn by the person who submitted the ballot prior to the conclusion of the public testimony on the proposed assessment at the hearing required pursuant to subdivision (d). An agency may provide an envelope for the return of the assessment ballot, provided that if the return envelope is opened by the agency prior to the tabulation of ballots pursuant to subdivision (e), the enclosed assessment ballot shall remain sealed as provided in this section.

[Ed. Note: The following subsection is an amalgamation of Art. XIIIID, §4(e) and Sections 53375(d) and (e).]

- (e) (d) The agency shall conduct a public hearing upon the proposed assessment not less than 45 days after mailing the notice of the proposed assessment to record owners of each identified parcel. *At the time, date, and place stated in the notice mailed pursuant to subdivision (b), the agency shall conduct a public hearing upon the proposed assessment. At the public hearing, the agency shall consider all protests against the proposed assessment and tabulate the ballots. At the public hearing, any interested person shall be permitted to present written or oral testimony. The public hearing may be continued from time to time.*

(e)(1) *At the conclusion of the public hearing conducted pursuant to subdivision (d), an impartial person designated by the agency who does not have a vested interest in the outcome of the proposed assessment shall tabulate the assessment ballots submitted, and not withdrawn, in support of or opposition to the proposed assessment. In a city, the impartial person may include, but is not limited to, the clerk of the agency. The impartial person may use technological methods of tabulating the assessment ballots, including, but not limited to, punchcard or optically readable (bar-coded) assessment ballots. During and after the tabulation, the assessment ballots shall be treated as disclosable public records, as defined in Section 6252, and equally available for inspection by the proponents and the opponents of the proposed assessment.*

In the event that more than one of the record owners of an identified parcel submits an assessment ballot, the amount of the proposed assessment to be imposed upon the identified parcel shall be allocated to each ballot submitted in proportion to the respective record ownership interests or, if the ownership interests are not shown on the record, as established to the satisfaction of the agency by documentation provided by those record owners. The agency shall not impose an assessment if there is a majority protest.

(e)(2) A majority protest exists if, upon the conclusion of the hearing, assessment ballots submitted, and not withdrawn, in opposition to the proposed assessment exceed the assessment ballots submitted, and not withdrawn, in [its] favor of the assessment. In tabulating the ballots, the ballots shall be weighted according to the proportional financial obligation of the affected property. *[weighting those assessment ballots by the amount of the proposed assessment to be imposed upon the identified parcel for which each assessment ballot was submitted.]*

(e)(3) *If there is a majority protest against the imposition of a new assessment, or the extension of an existing assessment, or an increase in an existing assessment, the agency shall not impose, extend, or increase the assessment.*

(e)(4) *The majority protest proceedings described in this subdivision shall not constitute an election or voting for purposes of Article II of the California Constitution or of the California Elections Code.*

(f) In any legal action contesting the validity of any assessment, the burden shall be on the agency to demonstrate that the property or properties in question receive a special benefit over and above the benefits conferred on the public at large and that the amount of any contested assessment is proportional to, and no greater than, the benefits conferred on the property or properties in question.

(g) Because only special benefits are assessable, electors residing within the district who do not own property within the district shall not be deemed under this Constitution to have been deprived of the right to vote for any assessment. If a court determines that the

Constitution of the United States or other federal law requires otherwise, the assessment shall not be imposed unless approved by a two-thirds vote of the electorate in the district in addition to being approved by the property owners as required by subdivision (e).

**Article 4.6 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code
Section 53753.5. Exempt Assessments; Application of Notice, Protest, and Hearing Requirements; Subsequent Increases**

- (a) *If an agency has complied with the notice, protest, and hearing requirements of Section 53753, or if an agency is not required to comply with those requirements because the assessment is exempt from the procedures and approval process set forth in Section 4 of Article XIID of the California Constitution, then those requirements shall not apply in subsequent fiscal years unless the assessment methodology is changed to increase the assessment, or the amount of that assessment is proposed to exceed an assessment formula or range of assessments adopted by an agency in accordance with Article XIID of the California Constitution or Section 53753.*

[Ed. Note: The following provisions of SB 919 (Chapter 38, Statutes of 1997) are amendments to the Ralph M. Brown Act, commonly known as the Sunshine Law.]

Chapter 9 of Part 1 of Division 2 of Title 5 of the Government Code

Section 54954.6. New or Increased Taxes or Assessments; Public Meetings and Public Hearings; Joint Notice Requirements

- (a) (1) *Before adopting any new or increased general tax or any new or increased assessment, the legislative body of a local agency shall conduct at least one public meeting at which local officials shall allow public testimony regarding the proposed new or increased general tax or new or increased assessment in addition to the noticed public hearing at which the legislative body proposes to enact or increase the general tax or assessment.*

For purposes of this section, the term “new or increased assessment” does not include any of the following:

- (A) *A fee that does not exceed the reasonable cost of providing the services, facilities, or regulatory activity for which the fee is charged.*
- (B) *A service charge, rate, or charge, unless a special district's principal act requires the service charge, rate, or charge to conform to the requirements of this section.*
- (C) *An ongoing annual assessment if it is imposed at the same or lower amount as any previous year.*

- (D) *An assessment that does not exceed an assessment formula or range of assessments previously specified in the notice given to the public pursuant to subparagraph (G) of paragraph (2) of subdivision (c) and that was previously adopted by the agency or approved by the voters in the area where the assessment is imposed.*
 - (E) *Standby or immediate availability charges.*
- (2) *The legislative body shall provide at least 45 days public notice of the public hearing at which the legislative body proposes to enact or increase the general tax or assessment. The legislative body shall provide notice for the public meeting at the same time and in the same document as the notice for the public hearing, but the meeting shall occur prior to the hearing.*
- (b) (1) *The joint notice of both the public meeting and the public hearing required by subdivision (a) with respect to a proposal for a new or increased general tax shall be accomplished by placing a display advertisement of at least one-eighth page in a newspaper of general circulation for three weeks pursuant to Section 6063 and by a first-class mailing to those interested parties who have filed a written request with the local agency for mailed notice of public meetings or hearings on new or increased general taxes. The public meeting pursuant to subdivision (a) shall take place no earlier than 10 days after the first publication of the joint notice pursuant to this subdivision. The public hearing shall take place no earlier than seven days after the public meeting pursuant to this subdivision. Notwithstanding paragraph (2) of subdivision (a), the joint notice need not include notice of the public meeting after the meeting has taken place. The public hearing pursuant to subdivision (a) shall take place no earlier than 45 days after the first publication of the joint notice pursuant to this subdivision. Any written request for mailed notices shall be effective for one year from the date on which it is filed unless a renewal request is filed. Renewal requests for mailed notices shall be filed on or before April 1 of each year. The legislative body may establish a reasonable annual charge for sending notices based on the estimated cost of providing the service.*
- (2) *The notice required by paragraph (1) of this subdivision shall include, but not be limited to, the following:*
 - (A) *The amount or rate of the tax. If the tax is proposed to be increased from any previous year, the joint notice shall separately state both the existing tax rate and the proposed tax rate increase.*
 - (B) *The activity to be taxed.*
 - (C) *The estimated amount of revenue to be raised by the tax annually.*

- (D) *The method and frequency for collecting the tax.*
 - (E) *The dates, times, and locations of the public meeting and hearing described in subdivision (a).*
 - (F) *The phone number and address of an individual, office, or organization that interested persons may contact to receive additional information about the tax.*
- (c) (1) *The joint notice of both the public meeting and the public hearing required by subdivision (a) with respect to a proposal for a new or increased assessment on real property shall be accomplished through a mailing, postage prepaid, in the United States mail and shall be deemed given when so deposited. The public meeting pursuant to subdivision (a) shall take place no earlier than 10 days after the joint mailing pursuant to this subdivision. The public hearing shall take place no earlier than seven days after the public meeting pursuant to this subdivision. The envelope or the cover of the mailing shall include the name of the local agency and the return address of the sender. This mailed notice shall be in at least 10-point type and shall be given to all property owners proposed to be subject to the new or increased assessment by a mailing by name to those persons whose names and addresses appear on the last equalized county assessment roll or the State Board of Equalization assessment roll, as the case may be.*
- (2) *The joint notice required by paragraph (1) of this subdivision shall include, but not be limited to, the following:*
- (A) *The estimated amount of the assessment per parcel. If the assessment is proposed to be increased from any previous year, the joint notice shall separately state both the amount of the existing assessment and the proposed assessment increase.*
 - (B) *A general description of the purpose or improvements that the assessment will fund.*
 - (C) *The address to which property owners may mail a protest against the assessment.*
 - (D) *The phone number and address of an individual, office, or organization that interested persons may contact to receive additional information about the assessment.*
 - (E) *A statement that a majority protest will cause the assessment to be abandoned if the assessment act used to levy the assessment so provides.*

Notice shall also state the percentage of protests required to trigger an election, if applicable.

- (F) The dates, times, and locations of the public meeting and hearing described in subdivision (a).*
- (G) A proposed assessment formula or range as described in subparagraph (D) of paragraph (1) of subdivision (a) if applicable and that is noticed pursuant to this section.*
- (3) Notwithstanding paragraph (1), in the case of an assessment that is proposed exclusively for operation and maintenance expenses imposed throughout the entire local agency, or exclusively for operation and maintenance assessments proposed to be levied on 50,000 parcels or more, notice may be provided pursuant to this subdivision or pursuant to paragraph (1) of subdivision (b) and shall include the estimated amount of the assessment of various types, amounts, or uses of property and the information required by subparagraphs (B) to (G), inclusive, of paragraph (2) of subdivision (c).*
- (4) Notwithstanding paragraph (1), in the case of an assessment proposed to be levied pursuant to Part 2 (commencing with Section 22500) of Division 2 of the Streets and Highways Code by a regional park district, regional park and open-space district, or regional open-space district formed pursuant to Article 3 (commencing with Section 5500) of Chapter 3 of Division 5 of, or pursuant to Division 26 (commencing with Section 35100) of, the Public Resources Code, notice may be provided pursuant to paragraph (1) of subdivision (b).*
- (d) The notice requirements imposed by this section shall be construed as additional to, and not to supersede, existing provisions of law, and shall be applied concurrently with the existing provisions so as to not delay or prolong the governmental decisionmaking process.*
- (e) This section shall not apply to any new or increased general tax or any new or increased assessment that requires an election of either of the following:*
 - (1) The property owners subject to the assessment.*
 - (2) The voters within the local agency imposing the tax or assessment.*
- (f) Nothing in this section shall prohibit a local agency from holding a consolidated meeting or hearing at which the legislative body discusses multiple tax or assessment proposals.*
- (g) The local agency may recover the reasonable costs of public meetings, public hearings, and notice required by this section from the proceeds of the tax or assessment. The costs*

recovered for these purposes, whether recovered pursuant to this subdivision or any other provision of law, shall not exceed the reasonable costs of the public meetings, public hearings, and notice.

- (h) *Any new or increased assessment that is subject to the notice and hearing provisions of Article XIIC or XIID of the California Constitution is not subject to the notice and hearing requirements of this section.*

[Ed. Note: The following provisions of SB 919 (Chapter 38, Statutes of 1997) are amendments to the Refunding Act of 1984 for 1915 Act Improvement Bonds.]

Chapter 2 of Division 11.5 of the Streets and Highways Code

Section 9525. Conditions for Approval and Confirmation of Report; Finding of Satisfaction; Reassessments Pursuant to this Section; Procedural Requirements

- (a) *If the legislative body finds that all of the following conditions are satisfied, it may approve and confirm the report prepared pursuant to Section 9523 and proceed to authorize, issue, and sell refunding bonds pursuant to Chapter 3 (commencing with Section 9600):*
- (1) *That each estimated annual installment of principal and interest on the reassessment, as set forth pursuant to subdivision (d) of Section 9523, is less than the corresponding annual installment of principal and interest on the portion of the original assessment being superseded and supplanted, as set forth in subdivision (c) of Section 9523, by the same percentage for all subdivisions of land within the district. Any amount added to the annual installments on the reassessment due to a delinquency in payment on the original assessment need not be considered in this calculation.*
 - (2) *That the number of years to maturity of all refunding bonds is not more than the number of years to the last maturity of the bonds being refunded.*
 - (3) *That the principal amount of the reassessment on each subdivision of land within the district is less than the unpaid principal amount of the portion of the original assessment being superseded and supplanted by the same percentage for each subdivision of land within the district. Any amount added to a reassessment because of a delinquency in payment on the original assessment need not be considered in this calculation.*
- (b) *Any reassessment that is approved and confirmed pursuant to this section shall not be deemed to be an assessment within the meaning of, and may be ordered without compliance with the procedural requirements of, Article XIID of the California Constitution.*

[Ed. Note: The following is an amalgamation of Article XIII D, §5 and Government Code §53753.5(b).]

Article XIII D. Assessment and Property Related Fee Reform

Section 5. Effective Date of Article; Assessment Exempted from Procedures and Requirements of Section 4

and

Article 4.6 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code Section 53753.5

Pursuant to subdivision (a) of Section 10 of Article II, the provisions of this article shall become effective the day after the election unless otherwise provided. Beginning July 1, 1997, all existing, new, or increased assessments shall comply with this article. Notwithstanding the foregoing [subdivision (a) of Govt. Code §53753.5], the following assessments existing on the effective date of this article [Article XIII D of the California Constitution] shall be exempt from the procedures and approval process set forth in Section 4 [of that Article]:

- (a)(1) Any assessment imposed exclusively to finance the capital costs or maintenance and operation expenses for sidewalks, streets, sewers, water, flood control, drainage systems or vector control. Subsequent increases in such assessments shall be subject to the procedures and approval process set forth in Section 4.
- (b)(2) Any assessment imposed pursuant to a petition signed by the persons owning all of the parcels subject to the assessment at the time the assessment is initially imposed. Subsequent increases in such assessments shall be subject to the procedures and approval process set forth in Section 4.
- (c)(3) Any assessment the proceeds of which are exclusively used to repay bonded indebtedness of which the failure to pay would violate the Contract Impairment Clause of the Constitution of the United States.
- (d)(4) Any assessment which previously received majority voter approval from the voters voting in an election on the issue of the assessment. Subsequent increases in those assessments shall be subject to the procedures and approval process set forth in Section 4.
- (b)(4) *Any subsequent increases in an assessment listed in paragraph (1[a]), (2[b]), or (4[d]) shall be subject to the procedures and approval process set forth in Section 4 of Article XIII D of the California Constitution.*
- (c) *For purposes of this section, the following words and phrases shall have the following meanings:*

- (1) *“Assessments existing on the effective date of Article XIID of the California Constitution” means assessments levied by the legislative body of the agency on or before November 6, 1996.*
- (2) *“Procedures and approval process set forth in Section 4 of Article XIID” means all of the requirements set forth in Section 4 of Article XIID of the California Constitution, including, but not limited to, the requirement to separate general and special benefits and the requirement to assess parcels that are owned or used by an agency, the State of California, or the United States of America.*

Article XIII D. Assessment and Property Related Fee Reform

Section 6. New or Existing Increased Fees and Charges; Procedures and Requirements; Voter Approval

- (a) Procedures for New or Increased Fees and Charges. An agency shall follow the procedures pursuant to this section in imposing or increasing any fee or charge as defined pursuant to this article, including, but not limited to, the following:
 - (1) The parcels upon which a fee or charge is proposed for imposition shall be identified. The amount of the fee or charge proposed to be imposed upon each parcel shall be calculated. The agency shall provide written notice by mail of the proposed fee or charge to the record owner of each identified parcel upon which the fee or charge is proposed for imposition, the amount of the fee or charge proposed to be imposed upon each, the basis upon which the amount of the proposed fee or charge was calculated, the reason for the fee or charge, together with the date, time, and location of a public hearing on the proposed fee or charge.
 - (2) The agency shall conduct a public hearing upon the proposed fee or charge not less than 45 days after mailing the notice of the proposed fee or charge to the record owners of each identified parcel upon which the fee or charge is proposed for imposition. At the public hearing, the agency shall consider all protests against the proposed fee or charge. If written protests against the proposed fee or charge are presented by a majority of owners of the identified parcels, the agency shall not impose the fee or charge.
- (b) Requirements for Existing, New or Increased Fees and Charges. A fee or charge shall not be extended, imposed, or increased by any agency unless it meets all of the following requirements:
 - (1) Revenues derived from the fee or charge shall not exceed the funds required to provide the property related service.

- (2) Revenues derived from the fee or charge shall not be used for any purpose other than that for which the fee or charge was imposed.
 - (3) The amount of a fee or charge imposed upon any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel.
 - (4) No fee or charge may be imposed for a service unless that service is actually used by, or immediately available to, the owner of the property in question. Fees or charges based on potential or future use of a service are not permitted. Standby charges, whether characterized as charges or assessments, shall be classified as assessments and shall not be imposed without compliance with Section 4.
 - (5) No fee or charge may be imposed for general governmental services including, but not limited to, police, fire, ambulance or library services, where the service is available to the public at large in substantially the same manner as it is to property owners. Reliance by an agency on any parcel map, including, but not limited to, an assessor's parcel map, may be considered a significant factor in determining whether a fee or charge is imposed as an incident of property ownership for purposes of this article. In any legal action contesting the validity of a fee or charge, the burden shall be on the agency to demonstrate compliance with this article.
- (c) Voter Approval for New or Increased Fees and Charges. Except for fees or charges for sewer, water, and refuse collection services, no property related fee or charge shall be imposed or increased unless and until that fee or charge is submitted and approved by a majority vote of the property owners of the property subject to the fee or charge or, at the option of the agency, by a two-thirds vote of the electorate residing in the affected area. The election shall be conducted not less than 45 days after the public hearing. An agency may adopt procedures similar to those for increases in assessments in the conduct of elections under this subdivision.
- (d) Beginning July 1, 1997, all fees or charges shall comply with this section.

ARTICLE XVI. PUBLIC FINANCE

Section 6. Public Credit or Funds; Loan or Gift; Public Ownership of Corporate Stock; Veterans Aid; Transfer of Funds

The Legislature shall have no power to give or to lend, or to authorize the giving or lending, of the credit of the State, or of any county, city and county, city, township or other political corporation or subdivision of the State now existing, or that may be hereafter established, in aid of or to any person, association, or corporation, whether municipal or otherwise, or to pledge the credit thereof, in any manner whatever, for the payment of the liabilities of any individual,

association, municipal or other corporation whatever; nor shall it have power to make any gift or authorize the making of any gift, of any public money or thing of value to any individual, municipal or other corporation whatever; provided, that nothing in this section shall prevent the Legislature granting aid pursuant to Section 3 of Article XVI; and it shall not have power to authorize the State, or any political subdivision thereof, to subscribe for stock, or to become a stockholder in any corporation whatever; provided, further, that irrigation districts for the purpose of acquiring the control of any entire international water system necessary for its use and purposes, a part of which is situated in the United States, and a part thereof in a foreign country, may in the manner authorized by law, acquire the stock of any foreign corporation which is the owner of, or which holds the title to the part of such system situated in a foreign country; provided, further, that irrigation districts for the purpose of acquiring water and water rights and other property necessary for their uses and purposes, may acquire and hold the stock of corporations, domestic or foreign, owning waters, water rights, canals, waterworks, franchises or concessions subject to the same obligations and liabilities as are imposed by law upon all other stockholders in such corporation; and

Provided, further, that this section shall not prohibit any county, city and county, city, township, or other political corporation or subdivision of the State from joining with other such agencies in providing for the payment of workers' compensation, unemployment compensation, tort liability, or public liability losses incurred by such agencies, by entry into an insurance pooling arrangement under a joint exercise of powers agreement, or by membership in such publicly-owned nonprofit corporation or other public agency as may be authorized by the Legislature; and

Provided, further, that nothing contained in this Constitution shall prohibit the use of state money or credit, in aiding veterans who served in the military or naval service of the United States during the time of war, in the acquisition of, or payments for, (1) farms or homes, or in projects of land settlement or in the development of such farms or homes or land settlement projects for the benefit of such veterans, or (2) any business, land or any interest therein, buildings, supplies, equipment, machinery, or tools, to be used by the veteran in pursuing a gainful occupation; and

Provided, further, that nothing contained in this Constitution shall prohibit the State, or any county, city and county, city, township, or other political corporation or subdivision of the State from providing aid or assistance to persons, if found to be in the public interest, for the purpose of clearing debris, natural materials, and wreckage from privately owned lands and waters deposited thereon or therein during a period of a major disaster or emergency, in either case declared by the President. In such case, the public entity shall be indemnified by the recipient from the award of any claim against the public entity arising from the rendering of such aid or assistance. Such aid or assistance must be eligible for federal reimbursement for the cost thereof.

And provided, still further, that notwithstanding the restrictions contained in this Constitution, the treasurer of any city, county, or city and county shall have power and the duty to make such temporary transfers from the funds in custody as may be necessary to provide funds for meeting the obligations incurred for maintenance purposes by any city, county, city and county, district,

or other political subdivision whose funds are in custody and are paid out solely through the treasurer's office. Such temporary transfer of funds to any political subdivision shall be made only upon resolution adopted by the governing body of the city, county, or city and county directing the treasurer of such city, county, or city and county to make such temporary transfer. Such temporary transfer of funds to any political subdivision shall not exceed 85 percent of the anticipated revenues accruing to such political subdivision, shall not be made prior to the first day of the fiscal year nor after the last Monday in April of the current fiscal year, and shall be replaced from the revenues accruing to such political subdivision before any other obligation of such political subdivision is met from such revenue.

Section 16. Property in Redevelopment Project

All property in a redevelopment project established under the Community Redevelopment Law as now existing or hereafter amended, except publicly owned property not subject to taxation by reason of that ownership, shall be taxed in proportion to its value as provided in Section 1 of this article, and those taxes (the word "taxes" as used herein includes, but is not limited to, all levies on an ad valorem basis upon land or real property) shall be levied and collected as other taxes are levied and collected by the respective taxing agencies.

The Legislature may provide that any redevelopment plan may contain a provision that the taxes, if any, so levied upon the taxable property in a redevelopment project each year by or for the benefit of the State of California, any city, county, city and county, district, or other public corporation (hereinafter sometimes called "taxing agencies") after the effective date of the ordinance approving the redevelopment plan, shall be divided as follows:

- (a) That portion of the taxes which would be produced by the rate upon which the tax is levied each year by or for each of those taxing agencies upon the total sum of the assessed value of the taxable property in the redevelopment project as shown upon the assessment roll used in connection with the taxation of that property by the taxing agency, last equalized prior to the effective date of the ordinance, shall be allocated to, and when collected shall be paid into, the funds of the respective taxing agencies as taxes by or for those taxing agencies on all other property are paid (for the purpose of allocating taxes levied by or for any taxing agency or agencies which did not include the territory in a redevelopment project on the effective date of the ordinance but to which that territory has been annexed or otherwise included after the ordinance's effective date, the assessment roll of the county last equalized on the effective date of that ordinance shall be used in determining the assessed valuation of the taxable property in the project on that effective date); and
- (b) Except as provided in subdivision (c), that portion of the levied taxes each year in excess of that amount shall be allocated to and when collected shall be paid into a special fund of the redevelopment agency to pay the principal of and interest on loans, moneys advanced to, or indebtedness (whether funded, refunded, assumed or otherwise) incurred

by the redevelopment agency to finance or refinance, in whole or in part, the redevelopment project. Unless and until the total assessed valuation of the taxable property in a redevelopment project exceeds the total assessed value of the taxable property in the project as shown by the last equalized assessment roll referred to in subdivision (a), all of the taxes levied and collected upon the taxable property in the redevelopment project shall be paid into the funds of the respective taxing agencies. When the loans, advances, and indebtedness, if any, and interest thereon, have been paid, then all moneys thereafter received from taxes upon the taxable property in the redevelopment project shall be paid into the funds of the respective taxing agencies as taxes on all other property are paid.

- (c) That portion of the taxes identified in subdivision (b) which are attributable to a tax rate levied by a taxing agency for the purpose of producing revenues in an amount sufficient to make annual repayments of the principal of, and the interest on, any bonded indebtedness for the acquisition or improvement of real property shall be allocated to, and when collected shall be paid into, the fund of that taxing agency. This paragraph shall only apply to taxes levied to repay bonded indebtedness approved by the voters of the taxing agency on or after January 1, 1989.

The Legislature may also provide that in any redevelopment plan or in the proceedings for the advance of moneys, or making of loans, or the incurring of any indebtedness (whether funded, refunded, assumed, or otherwise) by the redevelopment agency to finance or refinance, in whole or in part, the redevelopment project, the portion of taxes identified in subdivision (b), exclusive of that portion identified in subdivision (c), may be irrevocably pledged for the payment of the principal of and interest on those loans, advances, or indebtedness.

It is intended by this section to empower any redevelopment agency, city, county, or city and county under any law authorized by this section to exercise the provisions hereof separately or in combination with powers granted by the same or any other law relative to redevelopment agencies. This section shall not affect any other law or laws relating to the same or a similar subject but is intended to authorize an alternative method of procedure governing the subject to which it refers.

The Legislature shall enact those laws as may be necessary to enforce the provisions of this section.

Section 18. Debt Limit; County, Municipal and School; Majority Vote for Repair or Replacing of School Buildings; Election to Exceed Limit

- (a) No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof, voting at an election to be held for that purpose, except that

with respect to any such public entity which is authorized to incur indebtedness for public school purposes, any proposition for the incurrence of indebtedness in the form of general obligation bonds for the purpose of repairing, reconstructing or replacing public school buildings determined, in the manner prescribed by law, to be structurally unsafe for school use, shall be adopted upon the approval of a majority of the voters of the public entity voting on the proposition at such election; nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and to provide for a sinking fund for the payment of the principal thereof, on or before maturity, which shall not exceed forty years from the time of contracting the indebtedness.

- (b) Notwithstanding subdivision (a), on or after the effective date of the measure adding this subdivision, in the case of any school district, community college district, or county office of education, any proposition for the incurrence of indebtedness in the form of general obligation bonds for the construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities, shall be adopted upon the approval of 55 percent of the voters of the district or county, as appropriate, voting on the proposition at an election. This subdivision shall apply only to a proposition for the incurrence of indebtedness in the form of general obligation bonds for the purposes specified in this subdivision if the proposition meets all of the accountability requirements of paragraph (3) of subdivision (b) of Section 1 of Article XIII A.
- (c) When two or more propositions for incurring any indebtedness or liability are submitted at the same election, the votes cast for and against each proposition shall be counted separately, and when two-thirds or a majority or 55 percent of the voters, as the case may be, voting on any one of those propositions, vote in favor thereof, the proposition shall be deemed adopted.

Section 19. Special Assessments; Improvements; Property for Public Use; Charter Cities or Counties

All proceedings undertaken by any chartered city, or by any chartered county or by any chartered city and county for the construction of any public improvement, or the acquisition of any property for public use, or both, where the cost thereof is to be paid in whole or in part by special assessment or other special assessment taxes upon property, whether the special assessment will be specific or a special assessment tax upon property wholly or partially according to the assessed value of such property, shall be undertaken only in accordance with the provisions of law governing: (a) limitations of costs of such proceedings or assessments for such proceedings, or both, in relation to the value of any property assessed therefor; (b) determination of a basis for the valuation of any such property; (c) payment of the cost in excess of such limitations; (d) avoidance of such limitations; (e) postponement or abandonment, or both, of such proceedings in whole or in part upon majority protest, and particularly in accordance with such provisions as

contained in Sections 10, 11 and 13a of the Special Assessment Investigation, Limitation and Majority Protest Act of 1931 or any amendments, codification, reenactment or restatement thereof.

Notwithstanding any provisions for debt limitation or majority protest as in this section provided, if, after the giving of such reasonable notice by publication and posting and the holding of such public hearing as the legislative body of any such chartered county, chartered city or chartered city and county shall have prescribed, such legislative body by no less than a four-fifths vote of all members thereof, finds and determines that the public convenience and necessity require such improvements or acquisitions, such debt limitation and majority protest provisions shall not apply.

Nothing contained in this section shall require the legislative body of any such city, county, or city and county to prepare or to cause to be prepared, hear, notice for hearing or report the hearing of any report as to any such proposed construction or acquisition or both.

ARTICLE XXXIV. PUBLIC HOUSING PROJECT LAW

Section 1. Approval of Electors; Definitions

No low rent housing project shall hereafter be developed, constructed, or acquired in any manner by any state public body until, a majority of the qualified electors of the city, town or county, as the case may be, in which it is proposed to develop, construct, or acquire the same, voting upon such issue, approve such project by voting in favor thereof at an election to be held for that purpose, or at any general or special election.

For the purposes of this Article the term “low rent housing project” shall mean any development composed of urban or rural dwellings, apartments or other living accommodations for persons of low income, financed in whole or in part by the Federal Government or a state public body or to which the Federal Government or a state public body extends assistance by supplying all or part of the labor, by guaranteeing the payment of liens, or otherwise. For the purposes of this Article only there shall be excluded from the term “low rent housing project” any such project where there shall be in existence on the effective date hereof, a contract for financial assistance between any state public body and the Federal Government in respect to such project.

For the purposes of this Article only “persons of low income” shall mean persons or families who lack the amount of income which is necessary (as determined by the state public body developing, constructing, or acquiring the housing project) to enable them, without financial assistance, to live in decent, safe and sanitary dwellings, without overcrowding.

For the purposes of this Article the term “state public body” shall mean this State, or any city, city and county, county, district, authority, agency, or any other subdivision or public body of this State.

For the purposes of this Article the term “Federal Government” shall mean the United States of America, or any agency or instrumentality, corporate or otherwise, of the United States of America.

Section 2. Self-Executing Provisions

The provisions of this Article shall be self-executing but legislation not in conflict herewith may be enacted to facilitate its operation.

Section 3. Severability of Provisions

If any portion, section or clause of this article, or the application thereof to any person or circumstance, shall for any reason be declared unconstitutional or held invalid, the remainder of this Article, or the application of such portion, section or clause to other persons or circumstances, shall not be affected thereby.

Section 4. Conflicting Provisions Superseded

The provisions of this Article shall supersede all provisions of this Constitution and laws enacted thereunder in conflict therewith.

STATE STATUTES OF GENERAL APPLICATION

The following are selected California statutes of general application to public finance transactions. This is not a comprehensive listing of such statutes, but rather is a compilation of the generally applicable provisions which are probably of most interest to a wide audience. The reader should keep in mind that there are literally hundreds of other statutes and regulations in the public finance field that may have a bearing on any particular situation. This listing is not intended to serve as a checklist for ensuring compliance with legal requirements for a transaction.

CONFLICTS OF INTEREST

Contracts – General

Article 4 of Chapter 1 of Division 4 of Title 1 of the Government Code

Section 1090. Conflicts of Interest Contracts, Sales and Purchases

Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. Nor shall state, county, district, judicial district, and city officers or employees be purchasers at any sale or vendors at any purchase made by them in their official capacity.

As used in this article, “district” means any agency of the state formed pursuant to general law or special act, for the local performance of governmental or proprietary functions within limited boundaries.

Section 1090.1. Acceptance of Commission for Placement of Insurance

No officer or employee of the State nor any Member of the Legislature shall accept any commission for the placement of insurance on behalf of the State.

Section 1091. Remote Interest of Officer or Member

- (a) An officer shall not be deemed to be interested in a contract entered into by a body or board of which the officer is a member within the meaning of this article if the officer has only a remote interest in the contract and if the fact of that interest is disclosed to the body of the board of which the officer is a member and noted in its official records, and thereafter the body or board authorizes, approves, or ratifies the contract in good faith by a vote of its membership sufficient for the purpose without counting the vote or votes of the officer or member with the remote interest.
- (b) As used in this article, “remote interest” means any of the following:

- (1) That of an officer or employee of a nonprofit entity exempt from taxation pursuant to Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. Sec. 501(c)(3)) or a nonprofit corporation, except as provided in paragraph (8) of subdivision (a) of Section 1091.5.
- (2) That of an employee or agent of the contracting party, if the contracting party has 10 or more other employees and if the officer was an employee or agent of that contracting party for at least three years prior to the officer initially accepting his or her office and the officer owns less than 3 percent of the shares of stock of the contracting party; and the employee or agent is not an officer or director of the contracting party and did not directly participate in formulating the bid of the contracting party. For purposes of this paragraph, time of employment with the contracting party by the officer shall be counted in computing the three-year period specified in this paragraph even though the contracting party has been converted from one form of business organization to a different form of business organization within three years of the initial taking of office by the officer. Time of employment in that case shall be counted only if, after the transfer or change in organization, the real or ultimate ownership of the contracting party is the same or substantially similar to that which existed before the transfer or change in organization. For purposes of this paragraph, stockholders, bondholders, partners, or other persons holding an interest in the contracting party are regarded as having the “real or ultimate ownership” of the contracting party.
- (3) That of an employee or agent of the contracting party, if all of the following conditions are met:
 - (A) The agency of which the person is an officer is a local public agency located in a county with a population of less than 4,000,000.
 - (B) The contract is competitively bid and is not for personal services.
 - (C) The employee or agent is not in a primary management capacity with the contracting party, is not an officer or director of the contracting party, and holds no ownership interest in the contracting party.
 - (D) The contracting party has 10 or more other employees.
 - (E) The employee or agent did not directly participate in formulating the bid of the contracting party.
 - (F) The contracting party is the lowest responsible bidder.
- (4) That of a parent in the earnings of his or her minor child for personal services.

- (5) That of a landlord or tenant of the contracting party.
- (6) That of an attorney of the contracting party or that of an owner, officer, employee, or agent of a firm which renders, or has rendered, service to the contracting party in the capacity of stockbroker, insurance agent, insurance broker, real estate agent, or real estate broker, if these individuals have not received and will not receive remuneration, consideration, or a commission as a result of the contract and if these individuals have an ownership interest of 10 percent or more in the law practice or firm, stock brokerage firm, insurance firm, or real estate firm.
- (7) That of a member of a nonprofit corporation formed under the Food and Agricultural Code or a nonprofit corporation formed under the Corporations Code for the sole purpose of engaging in the merchandising of agricultural products or the supplying of water.
- (8) That of a supplier of goods or services when those goods or services have been supplied to the contracting party by the officer for at least five years prior to his or her election or appointment to office.
- (9) That of a person subject to the provisions of Section 1090 in any contract or agreement entered into pursuant to the provisions of the California Land Conservation Act of 1965.
- (10) Except as provided in subdivision (b) of Section 1091.5, that of a director of or a person having an ownership interest of 10 percent or more in a bank, bank holding company, or savings and loan association with which a party to the contract has a relationship of borrower or depositor, debtor or creditor.
- (11) That of an engineer, geologist, or architect employed by a consulting engineering or architectural firm. This paragraph applies only to an employee of a consulting firm who does not serve in a primary management capacity, and does not apply to an officer or director of a consulting firm.
- (12) That of an elected officer otherwise subject to Section 1090, in any housing assistance payment contract entered into pursuant to Section 8 of the United States Housing Act of 1937 (42 U.S.C. Sec. 1437f) as amended, provided that the housing assistance payment contract was in existence before Section 1090 became applicable to the officer and will be renewed or extended only as to the existing tenant, or, in a jurisdiction in which the rental vacancy rate is less than 5 percent, as to new tenants in a unit previously under a Section 8 contract. This section applies to any person who became a public official on or after November 1, 1986.
- (13) That of a person receiving salary, per diem, or reimbursement for expenses from a government entity.

- (14) That of a person owning less than 3 percent of the shares of a contracting party that is a for-profit corporation, provided that the ownership of the shares derived from the person's employment with that corporation.
- (c) This section is not applicable to any officer interested in a contract who influences or attempts to influence another member of the body or board of which he or she is a member to enter into the contract.
- (d) The willful failure of an officer to disclose the fact of his or her interest in a contract pursuant to this section is punishable as provided in Section 1097. That violation does not void the contract unless the contracting party had knowledge of the fact of the remote interest of the officer at the time the contract was executed.

Section 1091.1. Interest in Contracts; Subdivided Land

The prohibition against an interest in contracts provided by this article or any other provision of law shall not be deemed to prohibit any public officer or member of any public board or commission from subdividing lands owned by him or in which he has an interest and which subdivision of lands is effected under the provisions of Division 2 (commencing with Section 66410) of Title 7 of the Government Code or any local ordinance concerning subdivisions; provided, that (a) said officer or member of such board or commission shall first fully disclose the nature of his interest in any such lands to the legislative body having jurisdiction over the subdivision thereof, and (b) said officer or member of such board or commission shall not cast his vote upon any matter or contract concerning said subdivision in any manner whatever.

Section 1091.2. Private Industry Council Contracts or Grants

Section 1090 shall not apply to any contract or grant made by local workforce investment boards created pursuant to the federal Workforce Investment Act of 1998 except where both of the following conditions are met:

- (a) The contract or grant directly relates to services to be provided by any member of a local workforce investment board or the entity the member represents or financially benefits the member or the entity he or she represents.
- (b) The member fails to recuse himself or herself from making, participating in making, or in any way attempting to use his or her official position to influence a decision on the grant or grants.

Section 1091.5. Interests not Constituting an Interest in a Contract

- (a) An officer or employee shall not be deemed to be interested in a contract if his or her interest is any of the following:

- (1) The ownership of less than 3 percent of the shares of a corporation for profit, provided the total annual income to him or her from dividends, including the value of stock dividends, from the corporation does not exceed 5 percent of his or her total annual income, and any other payments made to him or her by the corporation do not exceed 5 percent of his or her total annual income.
- (2) That of an officer in being reimbursed for his or her actual and necessary expenses incurred in the performance of official duty.
- (3) That of a recipient of public services generally provided by the public body or board of which he or she is a member, on the same terms and conditions as if he or she were not a member of the board.
- (4) That of a landlord or tenant of the contracting party if such contracting party is the federal government or any federal department or agency, this state or an adjoining state, any department or agency of this state or an adjoining state, any county or city of this state or an adjoining state, or any public corporation or special, judicial, or other public district of this state or an adjoining state unless the subject matter of such contract is the property in which such officer or employee has such interest as landlord or tenant in which event his or her interest shall be deemed a remote interest within the meaning of, and subject to, the provisions of Section 1091.
- (5) That of a tenant in a public housing authority created pursuant to Part 2 (commencing with Section 34200) of Division 24 of the Health and Safety Code in which he or she serves as a member of the board of commissioners of the authority or of a community development commission created pursuant to Part 1.7 (commencing with Section 34100) of Division 24 of the Health and Safety Code.
- (6) That of a spouse of an officer or employee of a public agency in his or her spouse's employment or officeholding if his or her spouse's employment or officeholding has existed for at least one year prior to his or her election or appointment.
- (7) That of a nonsalaried member of a nonprofit corporation, provided that such interest is disclosed to the body or board at the time of the first consideration of the contract, and provided further that such interest is noted in its official records.
- (8) That of a noncompensated officer of a nonprofit, tax-exempt corporation, which, as one of its primary purposes, supports the functions of the body or board or to which the body or board has a legal obligation to give particular consideration, and provided further that such interest is noted in its official records.

For purposes of this paragraph an officer is “noncompensated” even though he or she receives reimbursement from the nonprofit, tax-exempt corporation for necessary travel and other actual expenses incurred in performing duties of his or her office.

- (9) That of a person receiving salary, per diem, or reimbursement for expenses from a government entity, unless the contract directly involves the department of the government entity that employs the officer or employee, provided that the interest is disclosed to the body or board at the time of consideration of the contract, and provided further that the interest is noted in its official record.
- (10) That of an attorney of the contracting party or that of an owner, officer, employee, or agent of a firm which renders, or has rendered, service to the contracting party in the capacity of stockbroker, insurance agent, insurance broker, real estate agent, or real estate broker, if these individuals have not received and will not receive remuneration, consideration, or a commission as a result of the contract and if these individuals have an ownership interest of less than 10 percent in the law practice or firm, stock brokerage firm, insurance firm, or real estate firm.
- (11) Except as provided in subdivision (b), that of an officer or employee of or a person having less than a 10 percent ownership interest in a bank, bank holding company, or savings and loan association with which a party to the contract has a relationship of borrower or depositor, debtor, or creditor.
- (12) That of (A) a bona fide nonprofit, tax-exempt corporation having among its primary purposes the conservation, preservation, or restoration of park and natural lands or historical resources for public benefit, which corporation enters into an agreement with a public agency to provide services related to park and natural lands or historical resources and which services are found by the public agency, prior to entering into the agreement or as part of the agreement, to be necessary to the public interest to plan for, acquire, protect, conserve, improve, or restore park and natural lands or historical resources for public purposes and (B) any officer, director, or employee acting pursuant to the agreement on behalf of the nonprofit corporation. For purposes of this paragraph, “agreement” includes contracts and grants, and “park,” “natural lands,” and “historical resources” shall have the meanings set forth in subdivisions (d), (g), and (i) of Section 5902 of the Public Resources Code. Services to be provided to the public agency may include those studies and related services, acquisitions of property and property interests, and any activities related to those studies and acquisitions necessary for the conservation, preservation, improvement, or restoration of park and natural lands or historical resources.

- (b) An officer or employee shall not be deemed to be interested in a contract made pursuant to competitive bidding under a procedure established by law if his or her sole interest is that of an officer, director, or employee of a bank or savings and loan association with which a party to the contract has the relationship of borrower or depositor, debtor or creditor.

Section 1092. Avoidance of Contracts

Every contract made in violation of any of the provisions of Section 1090 may be avoided at the instance of any party except the officer interested therein. No such contract may be avoided because of the interest of an officer therein unless such contract is made in the official capacity of such officer, or by a board or body of which he is a member.

Section 1092.5. Lease, Purchase or Encumbrance of Real Property; Avoidance

Notwithstanding Section 1092, no lease or purchase of, or encumbrance on, real property may be avoided, under the terms of Section 1092, in derogation of the interest of a good faith lessee, purchaser, or encumbrancer where the lessee, purchaser, or encumbrancer paid value and acquired the interest without actual knowledge of a violation of any of the provisions of Section 1090.

Section 1093. Warrants and Other Evidences of Indebtedness, Private Use or Benefit

The State Treasurer and Controller, county and city officers, and their deputies and clerks shall not purchase or sell, or in any manner receive for their own or any other person's use or benefit any State, county or city warrants, scrip, orders, demands, claims, or other evidences of indebtedness against the State, or any county or city thereof. This section does not apply to evidences of indebtedness issued to or held by such an officer, deputy or clerk for services rendered by them, nor to evidences of the funded indebtedness of the State, county, or city.

Section 1094. Accounts; Certificate as Prerequisite to Allowance

Every officer whose duty it is to audit and allow the accounts of other state, county, or city officers shall, before allowing such accounts, require each of such officers to make and file with him an affidavit or certificate under penalty of perjury that he has not violated any of the provisions of this article, and any individual who wilfully [sic] makes and subscribes such certificate to an account which he knows to be false as to any material matter shall be guilty of a felony and upon conviction thereof shall be subject to the penalties prescribed for perjury by the Penal Code of this State.

Section 1095. Warrants and Other Evidences of Indebtedness; Restrictions on Payments

Officers charged with the disbursement of public moneys shall not pay any warrant or other evidence of indebtedness against the State, county, or city when it has been purchased, sold, received, or transferred contrary to any of the provisions of this article.

Section 1096. Accounts; Suspension of Settlement or Payment; Prosecutions

Upon the officer charged with the disbursement of public moneys being informed by affidavit that any officer, whose account is about to be settled, audited, or paid by him, has violated any of the provisions of this article, the disbursing officer shall suspend such settlement or payment, and cause the district attorney to prosecute the officer for such violation. If judgment is rendered for the defendant upon such prosecution, the disbursing officer may proceed to settle, audit, or pay the account as if no affidavit had been filed.

Section 1097. Penalty for Violations

Every officer or person prohibited by the laws of this state from making or being interested in contracts, or from becoming a vendor or purchaser at sales, or from purchasing script, or other evidences of indebtedness, including any member of the governing board of a school district, who willfully violates any of the provisions of such laws, is punishable by a fine of not more than one thousand dollars (\$1,000), or by imprisonment in the state prison, and is forever disqualified from holding any office in this state.

Section 1098. Confidential Information; Use or Disclosure for Pecuniary Gain; Misdemeanor; Application

- (a) Any current public officer or employee who willfully and knowingly discloses for pecuniary gain, to any other person, confidential information acquired by him or her in the course of his or her official duties, or uses any such information for the purpose of pecuniary gain, is guilty of a misdemeanor.
- (b) As used in this section:
 - (1) “Confidential information” means information to which all of the following apply:
 - (A) At the time of the use or disclosure of the information, the information is not a public record subject to disclosure under the Public Records Act.
 - (B) At the time of the use or disclosure of the information, the disclosure is prohibited by (i) a statute, regulation, or rule which applies to the agency in which the officer or employee serves; (ii) the statement of incompatible activities adopted pursuant to Section 19990 by the agency in which the officer or employee serves; or (iii) a provision in a document similar to a statement of incompatible activities if the agency in which the officer or employee serves is a local agency.
 - (C) The use or disclosure of the information will have, or could reasonably be expected to have, a material financial effect on any investment or interest in real property which the officer or employee, or any person who

provides pecuniary gain to the officer or employee in return for the information, has at the time of the use or disclosure of the information or acquires within 90 days following the use or disclosure of the information.

- (2) For purposes of paragraph (1):
 - (A) “Interest in real property” has the definition prescribed by Section 82033.
 - (B) “Investment” has the definition prescribed by Section 82034.
 - (C) “Material financial effect” has the definition prescribed by Sections 18702 and 18702.2 of Title 2 of the California Administrative Code, as those sections read on September 1, 1987.
- (3) “Pecuniary gain” does not include salary or other similar compensation from the officer's or the employee's agency.
- (c) This section shall not apply to any disclosure made to any law enforcement agency, nor to any disclosure made pursuant to Sections 10542 and 10543.
- (d) This section is not intended to supersede, amend, or add to subdivision (b) of Section 8920 regarding prohibited conduct of Members of the Legislature.

Sales of Public Securities

Article 4.5 of Chapter 1 of Division 4 of title 1 of the Government Code

Section 1100. Public Securities

As used in this article, “public securities” means any issue of bonds, notes, warrants, or other evidences of indebtedness and the interest coupons, if any, attached thereto, issued by any public body.

Section 1101. Public Body

As used in this article, “public body” means any county, city and county, city, municipal corporation, political subdivision, school district, or any other public district or public corporation, any public authority, or any agency of any thereof.

Section 1102. Interest of Public Officer or Employee in Contract for Sale of Public Securities

Notwithstanding any provision of law to the contrary, a member of the legislative body of any public body or any officer or employee thereof shall not be deemed interested in a contract for the sale of any public securities issued by such public body; provided, that such public securities are sold at public sale to the highest bidder after notice inviting bids has been published as

required by the law under which said bonds are issued, or for one time in a newspaper of general circulation not less than five (5) days prior to the date of such sale.

BIDDING AND UNDERWRITING PROVISIONS

Underwriter/Financial Advisor/Bond Counsel Limitations

Article 12 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53590. Definitions

The following terms shall have the following meanings for purposes of this article:

- (a) “Bond counsel” means any attorney or firm of attorneys that represents the issuer of a new issue of bonds with respect to the issuance of the bonds and that renders a written legal opinion to, or as counsel for, the issuer with respect to the validity of the bonds.
- (b) “Bond” means any bonds, notes, or other evidences of indebtedness issued by any local agency or certificates of participation in any lease, sale, or other obligations of any local agency. “New issue of bonds” means the original issuance of bonds, including refunding bonds, by the issuer to one or more purchasers until, in the case of underwriters, the end of the underwriting period. In the case of bonds with a tender or put option feature, or commercial paper, “new issue of bonds” means only the original issuance and not any remarketing, rollover, or reissuance.
- (c) A “financial advisory relationship” exists when an investment firm, or other person or firm in the business of providing financial advisory or financial consulting services to issuers with respect to municipal securities, renders, or enters into an agreement to render, financial advisory or financial consultant services to, or on behalf of, an issuer with respect to a new issue or issues of bonds, including advice with respect to the structure, timing, terms, and other similar matters concerning the issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of those services. However, a financial advisory relationship does not exist when, in the course of acting as an underwriter, an investment firm renders advice to an issuer, including advice with respect to the structure, timing, terms, and other similar matters concerning a new issue of bonds or when, for any new issuer of bonds, an investment firm advises and assists an issuer with respect to obtaining consent from holders of previously issued bonds in connection with, among other things, amendments of covenants or defaults.
- (d) “Investment firm” means any bank, investment bank, partnership, corporation, association, or other firm engaged in the business of buying and selling bonds for its own account or for the account of others as part of its regular business.

- (e) “Local agency” means a public district, public corporation, authority, agency, board, commission, county, city and county, city, school district, or other local public entity.

Section 53591. New Issue of Bonds; Acquisition by Investments Firms Having Financial Advisory Relationships with Respect to Issue

No investment firm that has, or has had, a financial advisory relationship with respect to a new issue of bonds shall acquire as principal either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from the issuer all or any portion of the issue, or arrange for the acquisition or participation by a person controlling, controlled by, or under common control with the investment firm, unless the issue is to be sold by the issuer at competitive bid and the issuer has, prior to the bid, expressly consented in writing to the acquisition or participation. The limitations and requirements set forth in this section also apply to any investment firm controlling, controlled by, or under common control with the investment firm having a financial advisory relationship. The use of the term “indirectly” in this section does not preclude any investment firm which has a financial advisory relationship with respect to a new issue of bonds from purchasing any of those bonds from an underwriter, either for its own trading account or for the account of its customers, except to the extent that the purchase is made to contravene the purpose and intent of this section.

Section 53592. Evidence of Financial Advisory Relationships

Each financial advisory relationship shall be evidenced by a written document executed prior to, upon, or promptly after the inception of the financial advisory relationship, or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences. That written document shall set forth the basis of compensation for the financial advisory services to be rendered, which, except for bonds issued prior to January 1, 1988, to finance single-family or multifamily housing, shall be on a basis other than as a percentage of the amount of the bonds to be sold.

Section 53593. Bond Counsel Acting Also as Counsel to Underwriter or Initial Purchaser

No bond counsel with respect to a new issue of bonds shall also be counsel, with respect to that new issue of bonds, to the underwriter or other initial purchaser of the bonds. This section does not preclude the bond counsel from rendering one or more opinions to the underwriter or purchaser with respect to the bonds, the documents or laws pursuant to which the bonds are issued, the official statement, offering circular, or other disclosure document describing the bonds, or any related matter, if the opinion is rendered as bond counsel and not as counsel to the underwriter or purchaser.

Section 53594. Injunction of Violations

Injunctive relief shall be available, subject to judicial discretion, to prohibit or enjoin any violation of this article, but no violation shall affect the authority, validity, or enforceability of bonds.

Bids by Financial Advisors

Article 2.5 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53691. Financial Advisory Relationship; Written Agreement; Acquisition of Securities by Advisor; Disclosure; Application of Section

- (a) A financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders, or enters into an agreement to render, financial advisory or consultant services to, or on behalf of, an issuer, with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, and terms of an issue or issues, for a fee or other compensation, or in expectation of compensation for the rendering of the services. Notwithstanding the foregoing, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, and terms of a new issue of municipal securities.
- (b) Each financial advisory relationship shall be evidenced by a writing executed prior to, upon, or promptly after, the inception of the financial advisory relationship (or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences). The writing shall set forth the basis of compensation for the financial advisory services to be rendered, including provisions relating to the deposit of funds or the utilization of fiduciary or agency services offered by the broker, dealer, or municipal securities dealer, or by a person controlling, controlled by, or under common control with the broker, dealer, or municipal securities dealer in connection with the rendering of the financial advisory services.
- (c) No broker, dealer, or municipal securities dealer that has a financial advisory relationship with respect to a new issue of municipal securities shall acquire, as principal, either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from the issuer all or any portion of the issue, nor arrange for the acquisition or participation by a person controlling, controlled by, or under common control with the broker, dealer, or municipal securities dealer, unless one of the following applies:
 - (1) If the issue is to be sold by the issuer on a negotiated basis, all of the following conditions have occurred:
 - (A) The financial advisory relationship with respect to the issue has been terminated in writing and, at or after the termination, the issuer has expressly consented in writing to the acquisition or participation in the purchase of the securities on a negotiated basis.

- (B) The broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer, at or before the termination, that there may be a conflict of interest in changing from the capacity of financial adviser to purchaser of the securities with respect to which the financial advisory relationship exists, and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipt of that disclosure.
 - (C) The broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer, at or before the termination, the source and anticipated amount of all remuneration to the broker, dealer, or municipal securities dealer with respect to the issue in addition to the compensation referred to in subdivision (b), and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipt of that disclosure.
- (2) If the issue is to be sold by the issuer at competitive bid, the issuer has expressly consented in writing prior to the bid to that acquisition or participation.

The limitations and requirements set forth in this subdivision shall also apply to any broker, dealer, or municipal securities dealer controlling, controlled by, or under common control with the broker, dealer, or municipal securities dealer having a financial advisory relationship. The use of the term “indirectly” in this subdivision shall not preclude a broker, dealer, or municipal securities dealer who has a financial advisory relationship with respect to a new issue of municipal securities from purchasing those securities from an underwriter, either for its own trading account or for the account of customers, except to the extent that the purchase is made to contravene the purpose and intent of this section. Each broker, dealer, and municipal securities dealer subject to the provisions of this subdivision shall maintain a copy of the written disclosures, acknowledgments, and consents required by this section in a separate file.

- (d) If a broker, dealer, or municipal securities dealer acquires all or a portion of a new issue of municipal securities or participates in a syndicate or other account that acquires those securities in accordance with subdivision (c), the broker, dealer, or municipal securities dealer shall disclose the existence of the financial advisory relationship in writing to each customer who purchases those securities from that broker, dealer, or municipal securities dealer, at or before the completion of the transaction with the customer.

Notices and Procedures

Article 2.5 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53692. Notice of Intention to Sell Securities; Publication; Contents

In addition to any other requirement imposed by law, at least 15 days prior to the sale of any public securities that exceed one million dollars (\$1,000,000) but do not exceed ten million dollars (\$10,000,000) at a public sale and at least five days prior to the sale of any public securities that exceed ten million dollars (\$10,000,000) at a public sale, an issuer shall publish notice of the intention to sell the securities in a financial publication generally circulated throughout the state or reasonably expected to be disseminated among prospective bidders for the securities. The notice shall include the date, time, and place of the intended sale and the amount of the securities to be sold.

Chapter 11.5 of Division 1 of Title 2 of the Government Code

Section 8855. Creation; Composition; Term; Officers; Compensation; Powers and Duties

- (a) There is created the California Debt and Investment Advisory Commission, consisting of nine members...

* * * * *

- (k) The issuer of any proposed new debt issue of state or local government shall, no later than 30 days prior to the sale of any debt issue at public or private sale, give written notice of the proposed sale to the commission, by mail, postage prepaid. This subdivision shall also apply to any nonprofit public benefit corporation incorporated for the purpose of acquiring student loans. The notice shall include the proposed sale date, the name of the issuer, the type of debt issue, and the estimated principal amount of the debt. Failure to give this notice shall not affect the validity of the sale.

Fractionalization of Local Agency Obligations

Chapter 13 of Division 6 of Title 1 of the Government Code

Section 5950. Definitions

As used in this chapter:

- (a) “Accredited investor” has the meaning specified in Rule 501 of the Securities Act of 1933.
- (b) “In this state” has the meaning specified in Section 25008 of the Corporations Code.
- (c) “Issuer” has the meaning specified in Section 25010 of the Corporations Code.

- (d) “Issuer transaction” means any transaction directly or indirectly for the benefit of the issuer. A transaction is indirectly for the benefit of the issuer if any portion of the purchase price of any security constituting a fractional interest in a lease, installment sale, or other obligation of a local agency involved in the transaction will be received indirectly by the issuer. An offer or sale that involves both an issuer transaction and a transaction that is not an issuer transaction shall be treated as separate transactions.
- (e) “Knowingly” means that a person, with respect to an offer or sale of a security constituting a fractional interest in a lease, installment sale, or other obligation of a local agency, does any of the following:
 - (1) Has actual knowledge that the local agency has not consented to the offer or sale of such security.
 - (2) Acts in deliberate ignorance of whether or not the local agency has consented to the offer or sale of that security.
 - (3) Acts in reckless disregard of whether or not the local agency has consented to the offer or sale of that security.

Proof of specific intent to violate Section 5951 is not required.

- (f) “Local agency” means a city, county, city and county, school district, special district, public corporation, or other public entity of this state.
- (g) “Person” has the meaning specified in Section 25013 of the Corporations Code.
- (h) “Qualified institutional buyer” has the meaning specified in Rule 144A of the Securities Act of 1933.
- (i) “Sale,” “sell,” “offer,” and “offer to sell” have the respective meanings specified in Section 25017 of the Corporations Code.
- (j) “Security” has the meaning specified in Section 25019 of the Corporations Code.
- (k) “Securities Act of 1933” and “Investment Company Act of 1940” means the federal statutes of those names as amended before or after the effective date of this chapter.

Section 5951. Offer or Sale of Security Without Prior Consent of Local Agency; Prohibition; Exemptions

It is unlawful for any person to offer or sell in an issuer transaction in this state, or otherwise knowingly to offer or sell in this state, any security constituting a fractional interest in a lease, installment sale, or other obligation of a local agency without obtaining the prior written consent

of that local agency to that offer or sale. However, this section shall not apply to any of the following:

- (a) Any security that constitutes a fractional interest in a lease, installment sale, or other obligation of a local agency and that was first issued and sold prior to October 2, 1993.
- (b) Offers or sales of shares or interests in any registered unit investment trust or management company, each as defined in the Investment Company Act of 1940.
- (c) Any security that constitutes a fractional interest in a lease, installment sale, or other obligation of a local agency and that is registered under the Securities Act of 1933.
- (d) Offers or sales of any security described in this section subsequent to an offer or sale of that security in compliance with this section.
- (e) Offers or sales of participation interests between financial institutions.
- (f) Any security that constitutes a fractional interest in a lease, installment sale, or other obligation of a local agency and that is created concurrently with, and as an integral part of, a financing to which the local agency is a party.
- (g) Offers or sales of any security that constitutes a fractional interest in a lease, installment sale, or other obligation of a local agency made solely to one or more persons who are reasonably believed to be qualified institutional buyers or accredited investors.
- (h) Any security that was first issued and sold prior to the effective date of this section if that security is either described in subdivision (b), (c), or (f), or was issued and sold in a transaction described in subdivision (d), (e), or (g).

Section 5952. Evidence of Local Agency Consent

Any consent granted by a local agency under Section 5951 shall be conclusively evidenced by a resolution of the governing body of the local agency, or by a written instrument executed on behalf of the local agency by its treasurer, chief financial officer, or purchasing agent, or by any other officer of the local agency authorized by resolution of the governing body thereof to grant consents under Section 5951.

Section 5953. Local Agency Obligation to Review Proceedings Relating to Creation of Security or Offering or Placement Materials

No local agency that consents to an offer or sale of a security that constitutes a fractional interest in a lease, installment sale, or other obligation of the local agency shall be required to review any proceedings relating to the creation of the security or any of the offering or placement memoranda or any other marketing or descriptive materials relating to the security, and all memoranda or materials shall include a prominent statement on the face thereof substantially to

the effect that the consenting local agency (specified by name) has not reviewed any of the proceedings relating to the creation of the security or any of the offering or placement memoranda or other marketing materials relating thereto.

Section 5954. Punishment

Any person who violates this chapter shall upon conviction be fined not more than ten million dollars (\$10,000,000), or imprisoned in the state prison for five years, or be punished by both that fine and imprisonment.

Section 5955. Qualification of Offer or Sale of Security Under Securities Law; Necessity

The obtaining of local agency consent to an offer or sale of a security under Section 5951 shall not obviate the necessity of qualification of the offer or sale of such security under Division 1 (commencing with Section 25000) of Title 4 of the Corporations Code, unless the security or transaction is exempt from qualification under such law.

OVERRIDING BOND AUTHORIZATIONS

Maximum Interest Rate

Article 7 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53530. Definitions

As used in this article:

- (a) “Local agency” means county, city, city and county, public district, public entity or authority, or other public or municipal corporation, including redevelopment agencies, housing authorities, and industrial development authorities.
- (b) “Bonds” means bonds, warrants, notes or other evidences of indebtedness of a local agency or zone or improvement district thereof.

Section 53531. Maximum Interest Rate

Any provision of law specifying the maximum interest rate on bonds to the contrary notwithstanding, bonds may bear interest at a coupon rate or rates as determined by the legislative body in its discretion but not to exceed 12 percent per year payable as permitted by law, unless some higher rate is permitted by law.

Section 53531.1. Legislative Intent of §§53530 and 53531; Additional Authority to Specific Provisions; Bonds in Existence

- (a) The Legislature hereby finds and declares that, in enacting and amending Sections 53530 and 53531, the intent has been, and continues to be, to provide general authority to local

agencies to issue bonds bearing interest at the coupon rate specified in Section 53531, as amended from time to time. This general authority is intended to be in addition to, and not limited by, specific provisions authorizing bonds of particular local agencies. Due to the general application of Section 53531, it has been unnecessary to amend the numerous statutes which contain their own specific maximum interest rates. This section contains the intent of the Legislature in previously enacting and amending Sections 53530 and 53531 and does not affect Section 53532 or 53533. This section does not constitute a change in, but is declaratory of, the existing law in effect since 1969.

- (b) All bonds of any local agency issued prior to the effective date of this section, and bearing interest at coupon rates within the maximum rate specified in Section 53531, as in effect at the time of issuance, are legal, valid, and binding obligations of the local agency.
- (c) The authority provided to all local agencies in Section 53531 to issue bonds bearing interest at a coupon rate in accordance with that section is in addition to, and not limited by, any power or limitation made applicable to local agencies by any other law enacted before or on or after the effective date of this section, unless the other law specifically provides otherwise.

Section 53532. Application of Interest Rate; Bonds Sold at Discount

The provisions of Section 53531 shall apply only to coupon rates and shall not affect the power of a local agency to sell bonds at a discount below par if permitted by law. Any provision of law permitting bonds to be sold at a discount but specifying a maximum interest yield on bonds sold at a discount to the contrary notwithstanding, the bonds may be sold at a price yielding to the purchaser an effective interest rate of not to exceed 12 percent per year, payable as permitted by law, according to standard tables of bond values.

Section 53533. Exemptions; Obligations Payable to or Guaranteed by the Federal Government

Notwithstanding Section 53531 or any other provision of law establishing limitations on the rate of interest of any indebtedness or obligation of a city, county, or city and county the rate of interest on any indebtedness or obligation thereof which is payable to the federal government or any agency or instrumentality thereof or any indebtedness or obligation guaranteed by the federal government or any instrumentality thereof may be at a rate higher than the limitations established in any other law if such rate is the rate established by the federal government or any instrumentality thereof. Any such indebtedness or obligation shall be in such form and denomination, have such maturity, and be subject to such conditions as may be prescribed by the federal government or agency or instrumentality thereof.

Section 53534. Interest Rate Swap Agreements; Forward Payment Conversion Agreements

Any provision of law to the contrary notwithstanding, a city, county, or city and county may enter into contracts commonly known as “interest rate swap agreements” or “forward payment conversion agreements” with any person providing for the exchange of payments between the person and the city, county, or city and county, including, without limitation, contracts providing for the exchange of fixed interest payments for floating payments or floating interest payments for fixed payments, or a combination thereof. The contracts may be made upon the terms and conditions established by the legislative body of the city, county, or city and county. The authority conferred by this section includes the authority to enter into any and all contracts incident to the exercise of the authority conferred by this section including, without limitation, contracts to obtain credit enhancement devices and contracts for the performance of professional services. However, these contracts may be made only if all securities or bonds included in the contracts are rated in one of the three highest rating categories by two nationally recognized rating agencies selected by the legislative body of the city, county, or city and county, and if there has been receipt, from any rating agency rating the bonds, of written evidence that the contract will not adversely affect the rating.

Issuance of Authorized but Unissued Bonds

Article 8 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53540. Definitions

As used in this article:

- (a) “Local agency” means county, city, city and county, public district, public entity or authority or other public or municipal corporation.
- (b) “Legislative body” means the legislative body, as defined in Section 53000, of the local agency.
- (c) The term “bonds” includes bonds, warrants, notes, or other evidences of indebtedness of a local agency, zone or improvement district except those which under Section 18 of Article XI or other provision of the Constitution of the State of California are required to be authorized at an election.

Section 53541. Issuance Without Vote of Electors; Conditions; Interest Rate; Cancellation of Unissued Bonds

Any provision of law requiring an election to the contrary notwithstanding, the legislative body without a vote of the electors may issue bonds of the local agency, zone or improvement district if all the following occur:

- (a) The principal amount of such bonds does not exceed the then unissued balance of the principal amount of bonds of the same type authorized at an election heretofore held in the local agency, or in such zone or improvement district.
- (b) The bonds are issued for the same purpose as that for which the unissued bonds were authorized.
- (c) The bonds are issued in accordance with the laws governing the issuance of bonds of the local agency, except for the requirement of a bond election.

Bonds issued pursuant to this section may bear interest at a rate or rates not to exceed 12 percent per year. When bonds are issued pursuant to this section, unissued bonds as referred to in subdivisions (a) and (b) in a principal amount at least equal to the principal amount of bonds issued pursuant to this section, shall be canceled by order of the legislative body and shall not be issued.

Refunding Bonds – General Obligation

Article 4.5 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53506. Issuance or Refunding; Local Agencies Alternative Method

- (a) This article is full authority for the issuance of bonds or refunding bonds by any city, county, city and county, school district, community college district, or special district, secured by the levy of ad valorem taxes, authorized in accordance with the Constitution and, in the case of a chartered city, county, or city and county, with the charter thereof, or in the case of a special district, with the district's principal act.
- (b) This article is intended to provide a complete additional and alternative method for doing the things authorized by this article. The powers conferred by this article are supplemental and additional to the powers conferred by any other laws, and the limitations imposed by this article do not affect the powers conferred by any other law.

Section 53506.5. Article Provisions Controlling

This article shall be liberally construed to promote its objectives. If inconsistent with any other law, this article shall be controlling.

Section 53507. Definitions

As used in this article, the following terms shall have the meanings assigned to them in this section.

- (a) “Bonds” means bonds, notes, warrants, or other evidence of indebtedness payable, both principal and interest, from the proceeds of ad valorem taxes that may be levied without limitation as to rate or amount upon property subject to taxation by the legislative body.
- (b) “Issuer” means a city, county, city and county, school district, community college district, or special district, secured by the levy of ad valorem taxes, authorized to issue bonds pursuant to this article.
- (c) “Legislative body” means the governing body of the issuer.

Section 53507.5. Legislative body; Resolution; Issuance Statement

- (a) The legislative body may, by resolution, provide for the issuance of bonds pursuant to this article.
- (b) The resolution shall state that the bonds are being issued pursuant to this article.

Section 53508. Resolution; Contents

The resolution authorizing any bonds or any issue of bonds may provide for any of the following:

- (a) The form of the bonds to be issued as serial bonds, or sinking fund bonds, with serial or term maturities, or any combination thereof.
- (b) The number of series in which the bonds are to be issued.
- (c) The form of the bonds as coupon, registered, or book entry.
- (d) The interest on the bonds, either fixed or variable, and the interest rate or rates, payable at the times and in the manner specified therein, and whether all or part of any series of the bonds shall be issued as zero coupon or capital appreciation bonds; provided, however, that under no conditions may the annual interest rate, whether fixed or variable, exceed the maximum rate permitted by Section 53531 or 53532.
- (e) The time, medium, and place or places of payment.
- (f) The time or times of maturity of the bonds, not exceeding 40 years from their respective dates.
- (g) The date or dates to be borne by the bonds of each series.
- (h) The denomination of the bonds.
- (i) The registration and conversion privileges of the bonds.

- (j) The manner in which the bonds are to be executed.
- (k) The terms of redemption, with or without premium.
- (l) Other terms and conditions of the bonds and of their execution, issuance, and sale deemed necessary and appropriate by the legislative body.

Section 53508.3. Mandatory Tender for Purchase or Redemption; Bond Terms

- (a) No bond shall be subject to mandatory tender for purchase or redemption prior to its fixed maturity date unless it contains a recital to that effect.
- (b) Any bond protected by its terms or by the terms of this section from mandatory tender for purchase or redemption prior to its fixed maturity date or for a specified period of time after issuance, may specify terms upon which the issuer may sell or transfer its right to require the bond to be tendered for purchase or redemption prior to its fixed maturity date.

Section 53508.5. Bond Amortization; Restrictions; Exception

- (a) Annual payments of the principal and interest on an issue of bonds shall be structured to amortize the bonds in a manner whereby the maximum annual debt service payment on the bonds does not exceed the minimum annual debt service payment on the bonds by more than 10 percent. Notwithstanding the provisions of this subdivision, a deviation in annual debt service in excess of 10 percent is allowable if the excess deviation is the result of an accelerated repayment of principal on the bonds.
- (b) The restrictions set forth in subdivision (a) shall not apply if, as a result of the issuance of the particular bond issue, the overall outstanding general obligation bond debt of the issuer will be amortized in a more level manner.

Section 53508.7. Public Sale; Price Determinations; Sale Procedures

- (a) The bonds shall be sold at a public or private sale and at a price at, above, or below par, as the legislative body determines.
- (b) Any bonds sold at a discount below the par value of the bonds shall be sold in compliance with the provisions of Section 53532.
- (c) The private sale of bonds is limited to the sale of school districts' and community college districts' bonds pursuant to Sections 15140 or 15146 of the Education Code.

Section 53509. Refunding Bonds; Issuance Limitations

- (a) Any bond issued under the authority of this article may be refunded pursuant to this or any other applicable law. Any bond may be refunded pursuant to this article regardless of

whether the bond or the legislation under which its issuance was authorized explicitly provides that the bond may be refunded.

- (b) Refunding bonds shall not be issued if the total net interest cost to maturity on the refunding bonds plus the principal amount of the refunding bonds exceeds the total net interest cost to maturity on the bonds to be refunded plus the principal amount of the bonds to be refunded. Subject to that limitation, the principal amount of the refunding bonds may be more than, less than, or the same as the principal amount of the bonds to be refunded.

Section 53509.3. Contract Authority Unaffected

Nothing in this article shall limit the authority of the legislative body to enter into any contract in connection with the issuance of the bonds which it is permitted by Section 5922 to enter into.

Refunding Bonds – Local Agencies

Article 9 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53550. Definitions

The following terms shall have the following meanings:

- (a) “Local agency” means public district, public corporation, authority, agency, board, commission, county, city and county, city, school district, or other public entity.
- (b) “Bonds” means bonds, warrants, notes or other evidence of indebtedness of a local agency or any improvement district or zone thereof payable, both principal and interest, from the proceeds of ad valorem taxes or ad valorem assessments which may be levied without limitation as to rate or amount upon property in the local agency or any improvement district or zone thereof subject to taxation or assessment, or any outstanding indebtedness payable to the State Board of Equalization as repayment of the local agency's share of refunds made as a result of the California Court of Appeal decision in *Aerospace Corporation v. State Board of Equalization*, 218 Cal. App. 3d 1300, which indebtedness is hereby imposed on all the local agencies that are required to participate in the refund obligations arising from this decision and that are declared and determined to have been imposed by law.
- (c) “Legislative body” means the board of directors or other governing body of the local agency, unless the context otherwise requires.
- (d) “Principal act” means the law under which bonds to be refunded were issued.

- (e) “Costs of issuing the refunding bonds” means those of the following costs and expenses designated by the legislative body in the resolution providing for the issuance of the bonds:
 - (1) All expenses incident to the calling, retiring or paying of the bonds to be refunded and to the issuance of refunding bonds, including the charges of any escrow agent or trustee in connection with the issuance of the refunding bonds or in connection with the redemption or retirement of the bonds to be refunded.
 - (2) Either of the following:
 - (A) Interest upon the refunding bonds from the date of sale thereof to the date of payment of the bonds to be refunded out of the proceeds of the sale of the refunding bonds, or to the date upon which the bonds to be refunded will be paid pursuant to call or agreement with the holders of the bonds.
 - (B) Interest upon the bonds to be refunded from the date of sale of the refunding bonds to the date of payment of the bonds to be refunded or to the date upon which the bonds to be refunded will be paid pursuant to call or agreement with the holders of the bonds.
 - (3) Any premium necessary in the calling or retiring of the bonds to be refunded.
- (f) “Designated costs of issuing the refunding bonds” means whichever of the items specified in subdivision (e) that are designated by the legislative body in the resolution providing for the issuance of refunding bonds.
- (g) “Federal securities” means those securities described in Sections 1360 and 1360.1 of the Financial Code.

Section 53551. Issuance of Refunding Bonds; Amount

The legislative body of any local agency may issue negotiable coupon bonds, to be denominated refunding bonds, for the purpose of refunding any of the indebtedness of the local agency evidenced by bonds, whether due or not due, or which has or may hereafter become payable at the option of such local agency or by consent of the bondholders, or by any lawful means, whether such indebtedness, evidenced by bonds be now existing or may hereafter be created, and there shall not be moneys in a special fund in the treasury of such local agency irrevocably pledged to the payment or redemption of all such bonds; but the amount of such refunding bonds to be issued under the provisions of this article shall first be determined by such legislative body by resolution entered upon the minutes of such legislative body.

Section 53552. Issuance Without Election; Limitations on Issuance

Whenever the legislative body of a local agency determines that prudent management of the fiscal affairs of the local agency requires that it issue refunding bonds under the provisions of this article, it may do so without submitting the question of the issuance of the refunding bonds to a vote of the qualified electors of the local agency, unless the legislative body determines to submit the question to a vote, in which case the election shall be held in accordance with the principal act pursuant to which the bonds to be refunded were issued. Refunding bonds shall not be issued if the total net interest cost to maturity on the refunding bonds plus the principal amount of the refunding bonds exceeds the total net interest cost to maturity on the bonds to be refunded plus the principal amount of the bonds to be refunded, provided that this limitation shall not apply to bonds issued to refund indebtedness imposed by subdivision (b) of Section 53550 as a result of the court decision in *Aerospace Corporation v. State Board of Equalization*, 218 Cal. App. 3d 1300. Subject to this limitation, the principal amount of the refunding bonds may be more than, less than, or the same as the principal amount of the bonds to be refunded.

Section 53553. Resolution of Issuance; Adoption

When the legislative body determines to issue refunding bonds pursuant to this article, it shall adopt a resolution providing for the issuance of such bonds. Such resolution shall:

- (a) Describe the bonds being refunded; and the date on which it is anticipated that the exchange, purchase or call and redemption necessary to effect the refunding shall occur;
- (b) Fix the date of such refunding bonds;
- (c) Designate the denomination or denominations thereof;
- (d) Fix the rate or rates of interest to be borne by such refunding bonds, which rate or rates shall not exceed 8 percent per annum, payable semiannually, except that interest for the first year from date of issuance may be payable at the end of said year;
- (e) Fix the maturity dates of such refunding bonds, which shall not exceed 40 years from the date of such refunding bonds, or the latest maturity date of the bonds being refunded, whichever occurs earlier;
- (f) Designate the place or places of payment of both principal and interest;
- (g) Prescribe the form of such refunding bonds; and
- (h) State the designated costs of issuing the refunding bonds.

Section 53554. Form and Contents of Bonds; Interest Coupons

Such refunding bonds shall:

- (a) Be negotiable in form;
- (b) Recite that they are bonds of the local agency issuing the bonds;
- (c) Recite that they are issued pursuant to the provisions of this article;
- (d) Be executed in the name of the local agency; and
- (e) Be signed by the president or chairman of the legislative body of the local agency, and executed, countersigned or attested by such officer or officers of the local agency as are required to execute, countersign or attest bonds issued pursuant to the principal act, as the case may be.

The interest coupons shall be signed in the same manner as interest coupons attached to bonds issued by the local agency pursuant to the principal act. The provisions of the Uniform Facsimile Signatures of Public Officials Act (Chapter 6, (commencing with Section 5500), Division 6, Title 1) apply to refunding bonds issued pursuant to this article.

Section 53555. Exchange for Bonds to be Refunded

Refunding bonds issued pursuant to this article may be exchanged for the bonds to be refunded on such basis as the legislative body determines is for the benefit of the local agency but in no case on the basis that the principal amount of refunding bonds exceeds the principal amount of the bonds to be refunded plus the costs of issuing the refunding bonds. As an alternative to exchanging the refunding bonds for the bonds to be refunded, the legislative body may sell the refunding bonds at public or private sale for not less than their par value. The proceeds of any sale of refunding bonds for cash shall be placed in the treasury of the local agency to the credit of a fund to be established for the purpose of refunding the bonds to be refunded, which fund shall be designated the “funding fund,” and such proceeds shall be applied only as permitted by this article.

Section 53556. Costs of Issuing Refunding Bonds; Payment; Inclusion in Total Net Interest Cost

The designated costs of issuing the refunding bonds may be paid by the purchaser of the refunding bonds or may be paid from any other legally available source, including the general fund of the local agency, other available revenues of the local agency under the control of the legislative body, the proceeds of sale of the refunding bonds, the interest or other gain derived from the investment of any of the proceeds of sale of the refunding bonds, any other moneys in escrow or in trust or any combination thereof as the legislative body may determine; provided, however, that any amounts paid by the local agency other than from the proceeds of sale of the refunding bonds or from interest or other gains derived from the investment of such proceeds

shall be added to the total net interest cost to maturity on the refunding bonds in determining whether the test of the second sentence of Section 53552 has been met.

Section 53557. Proceeds of Sale of Refunding Bonds; Deposit; Investment

Any proceeds of sale of any refunding bonds may be deposited in escrow or trust with any bank or trust company within or without the state, or both within and without the state, and shall be secured in accordance with the laws applicable to funds of the local agency and may (along with any other moneys available for that purpose similarly deposited) be invested or reinvested in federal securities.

Section 53558. Proceeds and Investments; Required Amounts; Certification

Such proceeds and investments in escrow or trust shall be in an amount at the time of issuance of such refunding bonds which is certified by a certified public accountant licensed to practice in this state to be sufficient to meet the requirements of subdivision (a) or paragraph (b) of this section.

- (a) Such proceeds and investments, together with any interest or other gain to be derived from any such investment, shall be in an amount at least sufficient to pay (i) the principal of and interest and redemption premiums, if any, on the refunded bonds as they become due or at designated dates prior to maturity (in connection with which the legislative body has exercised or has obligated itself to exercise a redemption privilege on behalf of the local agency) and (ii) the designated costs of issuance of the refunding bonds, or
- (b) Such proceeds and investments, together with any interest or other gain to be derived from any such investment, shall be in an amount at least sufficient to pay (i) the principal of and interest and redemption premiums, if any, on the refunding bonds prior to the maturity of the bonds to be refunded or prior to a designated date or dates before the maturity of the bonds to be refunded (in connection with which the legislative body has exercised or has obligated itself to exercise a redemption privilege on behalf of the local agency), (ii) the principal of and any redemption premiums due on such refunded bonds at maturity or at said designated date or dates and (iii) the designated costs of issuance of the refunding bonds.

Section 53559. Payment of Principal and Interest; Pledge of Revenue

Following the issuance of any refunding bonds pursuant to this article, the legislative body of the local agency shall provide for the payment of principal and interest thereon in the same manner and at the same times as it provides for payment of principal and interest on bonds issued pursuant to its principal act and which constitute general obligations of such local agency. The legislative body may provide in the resolution of issuance of such refunding bonds for the pledge of revenues of any revenue-producing facility of the local agency as additional security for the

refunding bonds to the same extent that such revenues were pledged as additional security for the bonds to be refunded.

Section 53560. Indebtedness of Local Agency

Upon the issuance, sale and delivery or exchange of refunding bonds pursuant to this article:

- (a) If only the refunding bonds remain outstanding, such refunding bonds shall constitute indebtedness of the local agency issuing such bonds and shall be included in any computation of general obligation indebtedness of such local agency for purposes of any debt limitation applicable to bonds of such local agency under the principal act or for any other lawful purpose;
- (b) If both the refunding bonds and the bonds to be refunded remain outstanding for any period of time following the date of the issuance, sale and delivery of the refunding bonds, then until the date on which the bonds to be refunded are no longer outstanding;
 - (i) If the local agency has met the test of subdivision (a) of Section 53558 the refunding bonds shall constitute indebtedness of the local agency issuing such bonds and shall be included in any computation of general obligation indebtedness of such local agency for purposes of any debt limitation applicable to bonds of such local agency under the principal act or for any other lawful purpose, but the bonds to be refunded shall no longer be considered outstanding in any computation of the general obligation indebtedness of such local agency;
 - (ii) If the local agency has met the test of subdivision (b) Section 53558 then such refunding bonds shall, until the date on which the refunding bonds are no longer outstanding, constitute a special obligation of the local agency issuing such bonds and shall not be included in any computation of general obligation indebtedness of such local agency for any purpose, and the bonds to be refunded shall be considered outstanding in any computation of the general obligation bonded indebtedness of such local agency; but from and after the date on which the refunded bonds are no longer outstanding the refunding bonds shall constitute indebtedness of the local agency issuing such bonds and shall be included in any computation of general obligation indebtedness.

Section 53561. Public Purpose; Limitation on Tax Levy or Use of Other Funds for Payment of Bonds

It is hereby declared that it is a public purpose for a local agency to issue refunding bonds for the purposes set forth in this article and to invest and reinvest the proceeds thereof, and any other funds legally available therefor, for the purposes set forth herein; provided, however, that it is the intent of this article, and this article shall be so construed, that in no single fiscal year shall a tax be levied or shall funds of a local agency other than those expressly permitted herein be used to

pay the principal of and interest and redemption premium, if any, on both the refunding bonds and on the bonds to be refunded.

Section 53562. Powers Conferred by Article

The powers conferred by this article are in addition and supplemental to, and not in substitution for, and the limitations imposed by this article shall not affect the powers conferred by, any other law.

Section 53569. Sale of Refunding Bonds; Advertisement for Bids; Notice; Publication; Exceptions; Acceptance or Rejection of Bids; Private Sale

Before selling any refunding bonds subject to the provisions of this article, any local agency shall advertise such bonds for sale at public sale and shall invite sealed bids therefor by publication of a notice once at least 10 days before the date of such public sale in a newspaper of general circulation circulated within the boundaries of each local agency to be aided by the public project to be financed by the issuance of such bonds; provided that, if an issue of bonds is less than five hundred thousand dollars (\$500,000), a local agency is not required to advertise such bonds for public sale or to accept bids thereon pursuant to this section. If one or more satisfactory bids are received pursuant to such notice, such bonds shall be awarded to the highest responsible bidder. If no bids are received or if the local agency determines that the bids received are not satisfactory as to price or responsibility of the bidders, the local agency may reject all bids received, if any, and either readvertise or sell such bonds at private sale.

Refunding Bonds – Revenue

Article 10 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53570. Local Agency; Revenue Bonds Defined

The following terms shall have the following meanings:

- (a) “Local agency” means public district, public corporation, authority, agency, board, commission, county, city and county, city, school district, any other public entity, or any improvement district or zone thereof.
- (b) “Revenue bonds” means any of the following:
 - (1) Bonds, warrants, notes, or other evidence of indebtedness of a local agency payable from funds other than the proceeds of ad valorem taxes or the proceeds of assessments levied without limitation as to rate or amount by the local agency upon property in the local agency.
 - (2) Bonds, notes, interim certificates, debentures, or other obligations of a redevelopment agency, including, but not limited to, obligations payable in whole

or in part from taxes allocated to, and paid into, a special fund of the agency pursuant to Article 6 (commencing with Section 33670) of Chapter 6 of Part 1 of Division 24 of the Health and Safety Code.

Section 53571. Public Purpose; Relationship to Refunded Bonds; Laws Authorizing Issuance; Interest

It is hereby declared that it is a public purpose for a local agency to issue bonds for the purpose of refunding any revenue bonds of the local agency or any revenue bonds of a member of the local agency pursuant to Article 11 (commencing with Section 53580), whether due or not due, or that have or that may hereafter become payable at the option of the local agency, by consent of the bondholders, or by any lawful means.

Any refunding bonds may be outstanding at the same time as the revenue bonds for which the refunding bonds are issued, subject to any contractual limitations created in the proceedings for the issuance of the revenue bonds, and may be on a parity with, or subordinate to, the revenue bonds.

The refunding bonds may be issued pursuant to Article 11 (commencing with Section 53580) or under any applicable revenue bond law, including, but not limited to, the Revenue Bond Law of 1941 (Chapter 6 (commencing with Section 54300)), the Parking Law of 1949 (Part 2 commencing with Section 32500) of Division 18 of the Streets and Highways Code), the Parking District Law of 1951 (Part 4 (commencing with Section 35100) of Division 18 of the Streets and Highways Code), the joint exercise of powers provisions contained in Article 1 (commencing with Section 6500) and Article 2 (commencing with Section 6540) of Chapter 5 of Division 7 of Title 1, and the Community Redevelopment Law (Part 1 (commencing with Section 33000) of Division 24 of the Health and Safety Code), and shall be deemed issued for a valid public purpose and a proper bond purpose under Article 11 (commencing with Section 53580) or the applicable revenue bond law, and interest upon the refunding bonds or the bonds to be refunded from the date thereof to the date of payment of the bonds to be refunded or the date upon which the bonds to be refunded will be paid pursuant to call or agreement with the holders of the bonds may be paid from the proceeds of the refunding bonds or the investment of the proceeds.

Section 53572. Declaration of Proceeds as Revenue Producing Public Facility or to be Held in Trust

In connection with the issuance of bonds under any law permitting the issuance of refunding bonds, a local agency may declare the proceeds of such refunding bonds to be a revenue producing public facility, including an enterprise under the Revenue Bond Law of 1941, or may declare such proceeds to be part of such revenue producing public facility or enterprise or may otherwise declare such proceeds to be held, in whole or in part, and for such time as the local agency may deem advisable, in trust for the protection of holders of the bonds or of the refunding bonds.

Refunding Bonds – General Provisions

Article 11 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53580. Definitions

The following terms shall have the following meanings:

- (a) The term “local agency” means public district, public corporation, authority, agency, board, commission, county, city and county, city, school district, or other public entity or any improvement district or zone thereof.
- (b) The term “bonds” as used in this article means: bonds as defined in Section 53550, or revenue bonds as defined in Section 53570.
- (c) The term “refunding bonds” means bonds issued to refund bonds.
- (d) The term “federal securities” as used in this article means those securities defined in subdivision (g) of Section 53550 and in subdivision (a) of Section 53651.

Section 53581. Application of Article

Notwithstanding the provisions of any other law, the provisions of this article shall apply to all refunding bonds of any local agency, regardless of the authority for their issuance.

Section 53582. Deposit of Moneys; Obligations and Federal Securities; Amount

The proceedings of any local agency authorizing the issuance of bonds shall not require the deposit of any more moneys, obligations, and federal securities as are sufficient, taking into account both the principal amount of the moneys, obligations, and securities and the interest to become due thereon, to implement the refunding of those bonds. Federal securities and the interest thereon shall be used to satisfy any requirement of cash, money, specie, or lawful money in any proceeding conducted by a local agency before September 19, 1975.

Section 53583. Issuance of Bonds by Local Agencies; Proceedings Authorizing Issuance; Public or Private Sales

- (a) Any local agency may issue bonds pursuant to this article or any revenue bond law under which the local agency is otherwise authorized to issue bonds for the purpose of refunding any revenue bonds of the local agency or, if the local agency is a joint powers authority, any revenue bonds of a member local agency, upon authorization by resolution of that member of the joint powers authority.
- (b) The proceedings of any local agency authorizing the issuance of any refunding bonds may provide all of the following for those bonds:

- (1) The form of the bonds to be issued as serial bonds, term bonds, or installment bonds, or any combination thereof.
 - (2) The date or dates to be borne by the bonds.
 - (3) The time or times of maturity of the bonds.
 - (4) The interest, fixed or variable, to be borne by the bonds.
 - (5) The time or times that the bonds shall be payable.
 - (6) The denominations, form, and the registration privileges of the bonds.
 - (7) The manner of execution of the bonds.
 - (8) The place or places the bonds are payable.
 - (9) The terms of redemption.
 - (10) Any other terms and conditions determined necessary by the local agency.
- (c) (1) The refunding bonds may be sold at public or private sale or on a negotiated sale basis and at the prices, above or below par, as the local agency determines.
- (2) (A) If the local agency determines to sell the bonds at public sale, the local agency shall advertise the bonds for sale and invite sealed bids on the bonds by publication of a notice once at least 10 days before the date of the public sale in a newspaper of general circulation circulated within the boundaries of each local agency to be aided by the project to be financed by the issuance of the bonds. If one or more satisfactory bids are received pursuant to the notice, the bonds shall be awarded to the highest responsible bidder. If no bids are received or if the local agency determines that the bids received are not satisfactory as to price or responsibility of the bidders, the local agency may reject all bids received, if any, and either readvertise or sell the bonds at private sale or on a negotiated sale basis.
 - (B) If the local agency determines to sell the bonds at private sale or on a negotiated sale basis, the local agency shall send a written statement, within two weeks after the bonds are sold, to the California Debt Advisory Commission explaining the reasons why the local agency determined to sell the bonds at private sale or on a negotiated sale basis instead of at public sale.

Section 53584. Application of Proceeds of Refunding Bonds

The proceeds of refunding bonds may be applied to the purchase, retirement at maturity, or redemption of the bonds to be refunded either at their earliest redemption date or dates, any subsequent redemption date or dates, upon their purchase or retirement maturity, or paid to a third person to assume the local agency's obligation to make the payments, and may, pending that application, be placed in escrow and invested or reinvested in any obligations or securities, and any interest or other increment earned or realized on any such investment may be applied to the payment of the bonds to be refunded or to the payment of interest on the refunding bonds, as provided in the proceedings of the local agency authorizing the issuance of the refunding bonds.

Section 53585. Insurance or Credit Enhancement

A local agency that issues refunding bonds may obtain insurance or other credit enhancement of the refunding bonds or of the escrow referred to in Section 53584 and may enter into any credit reimbursement agreement or other agreement with any person or entity. The agreement shall contain the terms of the credit reimbursement, interest rate, security, and any other terms the local agency deems necessary or appropriate.

Section 53587. Determination of Amount of Refunding Bonds to Be Issued

In determining the amount of refunding bonds to be issued, the local agency may include all costs of issuing the refunding bonds and of refunding the bonds to be refunded, including the amount of any premium required to be paid to redeem any of the bonds to be refunded, any capitalized interest or bond reserve funds which the local agency determines to be reasonably required, and the cost of any insurance or other credit enhancement authorized by Section 53585.

Section 53588. Issuance, Transfer and Interest Income; Exemption From Taxation

The issuance, transfer, and interest income earned on any bonds issued by a local agency under this article is exempt from taxation of every kind by any state or local entity. The local agency shall not be required to pay any taxes on, or with respect to, the income earned on the investment of proceeds of the bonds placed in escrow or otherwise.

Section 53589. Supplemental and Additional Nature of Powers Provided by this Article

This article provides a complete, additional, and alternative method for doing the things authorized by this article and shall be regarded as supplemental and additional to the powers conferred by any other laws. The issuance of bonds and the entering into any credit reimbursement or other agreement under this article does not need to comply with the requirements of any other law applicable to the local agency or the issuance of bonds or the incurring of indebtedness, except that bonds which were subject to investigations, reports, and approval or certification by the Treasurer pursuant to the District Securities Investigation Law of 1965, Chapter 2.5 (commencing with Section 58750) of Division 2 of Title 6, and the Districts Securities Law, Chapter 1 (commencing with Section 20000) of Division 10 of the Water Code

prior to the adoption of this article shall continue to be subject to the investigations, reports, and approval or certification.

Section 53589.5. Actions to Determine Validity of Issuance and Connected Proceedings

An action may be brought pursuant to Chapter 9 (commencing with Section 860) of Title 10 of Part 2 of the Code of Civil Procedure to determine the validity of any issuance or proposed issuance of refunding bonds under this article, and the legality and validity of all proceedings previously taken or proposed to be taken in a resolution or ordinance adopted by the local agency for the authorization, issuance, sale, and delivery of the bonds, for entering into any credit reimbursement or other agreement in connection therewith, for the use of the proceeds of the bonds, and for the payment of the principal of, and interest on, the bonds.

Taxable Bonds

Chapter 11 of Division 6 of Title 1 of the Government Code

Section 5900. Legislative Findings and Declarations

The Legislature finds and declares all of the following:

- (a) The ability of the state and local governments to issue bonds is essential to their ability to finance public improvements and other projects and programs which serve important public purposes and have major social and economic consequences to the people of California.
- (b) The exemption of interest on these bonds from federal income taxation has been a major feature of this financing, reducing interest costs to the state and local government issuers and enhancing the marketability of the bonds.
- (c) Proposed federal tax legislation would substantially curtail the purposes for, and conditions under which, bonds may be issued with interest exempt from federal income taxation, with the result that in order to provide financing for those purposes or under those conditions state and local governments will in some instances be required, or elect, to issue bonds which bear interest not exempt from federal income taxation. These bonds often have different terms and structural features and are sold and traded in a different market than bonds the interest on which is exempt from federal income taxation.
- (d) The state and local governments have the power to issue bonds bearing interest subject to federal income taxation, but the state and local governments may lack clear authority to structure this financing for the applicable market or otherwise to achieve the lowest effective borrowing cost or terms most suitable to the state or local government issuer, the project, or the financing program.

Section 5901. Legislative Intent

It is the intent of the Legislature that state and local governments be provided with the powers and flexibility necessary and appropriate for them to access the market for bonds which bear interest subject to federal income taxation.

Section 5902. Definitions

As used in this chapter, the following words and terms shall have the following meanings, unless the context otherwise indicates or requires another or different meaning or intent:

- (a) “Bonds” means bonds, notes, warrants, bond anticipation notes, commercial paper, or other evidences of indebtedness, or lease, installment purchase, or other agreements or certificates of participation therein.
- (b) “Legislative body” means the governing body or board of the state or local government.
- (c) “State or local government” means the state, any department, agency, board, commission, or authority of the state, or any city, city and county, county, public district, public corporation, authority, agency, board, commission, or other public entity.

Section 5903. Issuance of Bonds Subject to Federal Tax; Structuring of Public Financing Agreements; Authority of State and Local Governments

If, prior to issuing any bonds, the legislative body determines that the interest payable on the bonds to be issued by the state or local government will be subject to federal income taxation under the law in existence on the date of issuance or pending on the date of issuance with an effective date preceding the date of issuance, then notwithstanding any other provision of law, the ordinance, resolution, indenture, agreement, or other instrument providing for the issuance of the bonds may provide for any of the following:

- (a) The bonds shall be in such denominations, in such form, either bearer or registered, and payable at such place or places, either within or without the United States, at such time or times, in lawful money of the United States of America, with such terms of redemption, and at such interest rate or rates, either fixed or variable, including methods of determining such rate or rates if variable, as the legislative body shall determine.
- (b) The bonds shall be sold at public or private sale, in such manner and place or places, either within or without the United States, and at such price or prices, above or below par, as the legislative body shall determine.
- (c) In connection with, or incidental to, the sale and issuance of the bonds, the state or local government may offer, sell, and issue warrants for additional bonds, as well as issue additional bonds pursuant to these warrants on terms consistent with this chapter, and may enter into any contracts which the legislative body determines to be necessary or

appropriate to place the obligation of the state or local government, as represented by the bonds and the contract or contracts, in whole or in part on the interest rate, cash flow, or other basis desired by the legislative body, including, without limitation, contracts commonly known as interest rate swap agreements, forward payment conversion agreements, futures, or contracts providing for payments based on levels of or changes in interest rates, or contracts to exchange cash flows or a series of payments, or contracts, including, without limitation, options, puts or calls to hedge payment, rate, spread, or similar exposure. These contracts or arrangements may also be entered into by state or local governments in connection with, or incidental to, entering into any agreement which secures bonds, including bonds issued by private entities. These contracts and arrangements shall be made upon the terms and conditions established by the legislative body, after giving due consideration for the credit worthiness of the counterparties, where applicable, including any rating by a nationally recognized rating agency or any other criteria as may be appropriate. In addition, these contracts and arrangements may be made only if the bonds are rated in one of the three highest rating categories by two nationally recognized rating agencies, and if there has been receipt, from any rating agency rating the bonds, of written evidence that the contract or agreement will not adversely affect the rating.

- (d) In connection with, or incidental to, the sale and issuance of the bonds, or entering into any of the contracts or arrangements referred to in subdivision (c), the state or local government may enter into such credit enhancement or liquidity agreements, with such payment, interest rate, security, default, remedy, and other terms and conditions as the legislative body shall determine.
- (e) Proceeds of the bonds and any moneys set aside or pledged to secure payment of the bonds, or any of the contracts entered into pursuant to subdivision (c), may be invested in securities or obligations described in the ordinance, resolution, indenture, agreement, or other instrument providing for the issuance of the bonds and may be pledged to and used to service any of the contracts or agreements entered into pursuant to this section.

Section 5903.5. Bonds with Interest Exempt from Federal Tax; Law on Date of Issuance Applicable

Section 5903 shall apply to any bonds the interest on which will not be subject to federal income taxation under the law in existence on the date of issuance or pending on the date of issuance with an effective date preceding the date of issuance, notwithstanding any other provision of law, if the bonds are issued by the same state or local government for the same project or purpose and within 45 days of the date of issuance of bonds described in Section 5903.

Section 5904. Authority of State or Local Governments to Register or Qualify Bonds for Offer and Sale

The state or a local government may take any actions, and enter into any agreements, necessary or appropriate to register or qualify the bonds described in Section 5903 for offer and sale under the federal or any state's or nation's securities laws and to comply with those laws.

Section 5906. Exemption of Bonds from Usury Provisions

Any bonds issued by a state or local government pursuant to this chapter, or otherwise, and the purchasers or holders thereof, shall be exempt from the usury provisions of Section 1 of Article XV of the California Constitution. Any loan, lease, installment sale, investment, forbearance of money, or other agreement between a user of the proceeds of or other moneys pledged to bonds and the issuer of the bonds, or entered into by or on behalf of the issuer of the bonds which provides for the use of the proceeds of the bonds or other moneys pledged to or securing the bonds, and the issuer of the bonds or any person acting on its behalf in connection with the foregoing shall be exempt from the usury provisions of Section 1 of Article XV of the California Constitution. This section creates and authorizes exempted classes of transactions and persons pursuant to Section 1 of Article XV of the California Constitution.

Section 5907. Exemption of Bonds Previously Approved

This chapter shall not affect bonds approved by the voters of the state or local government issuer prior to the effective date of this chapter, to the extent that this chapter is inconsistent with the measure authorizing those bonds.

Section 5908. Authority to Contract

The authority conferred by this chapter includes the authority to enter into any and all contracts incident to the exercise of the authority conferred by this chapter, including, without limitation, contracts for the performance of professional services.

Section 5909. Inconsistent Provisions

To the extent that the provisions of this chapter are inconsistent with any other provision of general law or special act or any part thereof, now or hereafter enacted, the provisions of this chapter shall be controlling.

INVESTMENT OF FUNDS – FINANCIAL CONTRACTS

Local Agency Investment Provisions

Article 1 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53601. Local Agencies; Authorized Investments; Shares of Beneficial Interest

This section shall apply to a local agency that is a city, a district, or other local agency that does not pool money in deposits or investments with other local agencies, other than local agencies that have the same governing body. However, Section 53635 shall apply to all local agencies that pool money in deposits or investments with other local agencies that have separate governing bodies. The legislative body of a local agency having money in a sinking fund or money in its treasury not required for the immediate needs of the local agency may invest any portion of the money that it deems wise or expedient in those investments set forth below. A local agency purchasing or obtaining any securities prescribed in this section, in a negotiable, bearer, registered, or nonregistered format, shall require delivery of the securities to the local agency, including those purchased for the agency by financial advisers, consultants, or managers using the agency's funds, by book entry, physical delivery, or by third-party custodial agreement. The transfer of securities to the counterparty bank's customer book entry account may be used for book entry delivery. For purposes of this section, "counterparty" means the other party to the transaction. A counterparty bank's trust department or separate safekeeping department may be used for the physical delivery of the security if the security is held in the name of the local agency. Where this section specifies a percentage limitation for a particular category of investment, that percentage is applicable only at the date of purchase. Where this section does not specify a limitation on the term or remaining maturity at the time of the investment, no investment shall be made in any security, other than a security underlying a repurchase or reverse repurchase agreement or securities lending agreement authorized by this section, that at the time of the investment has a term remaining to maturity in excess of five years, unless the legislative body has granted express authority to make that investment either specifically or as a part of an investment program approved by the legislative body no less than three months prior to the investment:

- (a) Bonds issued by the local agency, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency or by a department, board, agency, or authority of the local agency.
- (b) United States Treasury notes, bonds, bills, or certificates of indebtedness, or those for which the faith and credit of the United States are pledged for the payment of principal and interest.
- (c) Registered state warrants or treasury notes or bonds of this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or authority of the state.

- (d) Bonds, notes, warrants, or other evidences of indebtedness of any local agency within this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency, or by a department, board, agency, or authority of the local agency.
- (e) Federal agency or United States government-sponsored enterprise obligations, participations, or other instruments, including those issued by or fully guaranteed as to principal and interest by federal agencies or United States government-sponsored enterprises.
- (f) Bankers acceptances otherwise known as bills of exchange or time drafts that are drawn on and accepted by a commercial bank. Purchases of bankers acceptances may not exceed 180 days' maturity or 40 percent of the agency's money that may be invested pursuant to this section. However, no more than 30 percent of the agency's money may be invested in the bankers acceptances of any one commercial bank pursuant to this section. This subdivision does not preclude a municipal utility district from investing any money in its treasury in any manner authorized by the Municipal Utility District Act (Division 6 (commencing with Section 11501) of the Public Utilities Code).
- (g) Commercial paper of “prime” quality of the highest ranking or of the highest letter and number rating as provided for by a nationally recognized statistical-rating organization (NRSRO). The entity that issues the commercial paper shall meet all of the following conditions in either paragraph (1) or paragraph (2):
 - (1) The entity meets the following criteria:
 - (A) Is organized and operating in the United States as a general corporation.
 - (B) Has total assets in excess of five hundred million dollars (\$500,000,000).
 - (C) Has debt other than commercial paper, if any, that is rated “A” or higher by a nationally recognized statistical-rating organization (NRSRO).
 - (2) The entity meets the following criteria:
 - (A) Is organized within the United States as a special purpose corporation, trust, or limited liability company.
 - (B) Has programwide credit enhancements including, but not limited to, overcollateralization, letters of credit, or surety bond.
 - (C) Has commercial paper that is rated “A-1” or higher, or the equivalent, by a nationally recognized statistical-rating organization (NRSRO).

Eligible commercial paper shall have a maximum maturity of 270 days or less. Local agencies, other than counties or a city and county, may invest no more than 25 percent of their money in eligible commercial paper. Local agencies, other than counties or a city and county, may purchase no more than 10 percent of the outstanding commercial paper of any single issuer. Counties or a city and county may invest in commercial paper pursuant to the concentration limits in subdivision (a) of Section 53635.

- (h) Negotiable certificates of deposit issued by a nationally or state-chartered bank, a savings association or a federal association (as defined by Section 5102 of the Financial Code), a state or federal credit union, or by a state-licensed branch of a foreign bank. Purchases of negotiable certificates of deposit may not exceed 30 percent of the agency's money which may be invested pursuant to this section. For purposes of this section, negotiable certificates of deposit do not come within Article 2 (commencing with Section 53630), except that the amount so invested shall be subject to the limitations of Section 53638. The legislative body of a local agency and the treasurer or other official of the local agency having legal custody of the money are prohibited from investing local agency funds, or funds in the custody of the local agency, in negotiable certificates of deposit issued by a state or federal credit union if a member of the legislative body of the local agency, or any person with investment decisionmaking authority in the administrative office manager's office, budget office, auditor-controller's office, or treasurer's office of the local agency also serves on the board of directors, or any committee appointed by the board of directors, or the credit committee or the supervisory committee of the state or federal credit union issuing the negotiable certificates of deposit.
- (i)
 - (1) Investments in repurchase agreements or reverse repurchase agreements or securities lending agreements of any securities authorized by this section, as long as the agreements are subject to this subdivision, including the delivery requirements specified in this section.
 - (2) Investments in repurchase agreements may be made, on any investment authorized in this section, when the term of the agreement does not exceed one year. The market value of securities that underlay a repurchase agreement shall be valued at 102 percent or greater of the funds borrowed against those securities and the value shall be adjusted no less than quarterly. Since the market value of the underlying securities is subject to daily market fluctuations, the investments in repurchase agreements shall be in compliance if the value of the underlying securities is brought back up to 102 percent no later than the next business day.
 - (3) Reverse repurchase agreements or securities lending agreements may be utilized only when all of the following conditions are met:

- (A) The security to be sold on reverse repurchase agreement or securities lending agreement has been owned and fully paid for by the local agency for a minimum of 30 days prior to sale.
 - (B) The total of all reverse repurchase agreements and securities lending agreements on investments owned by the local agency does not exceed 20 percent of the base value of the portfolio.
 - (C) The agreement does not exceed a term of 92 days, unless the agreement includes a written codicil guaranteeing a minimum earning or spread for the entire period between the sale of a security using a reverse repurchase agreement or securities lending agreement and the final maturity date of the same security.
 - (D) Funds obtained or funds within the pool of an equivalent amount to that obtained from selling a security to a counterparty by way of a reverse repurchase agreement or securities lending agreement shall not be used to purchase another security with a maturity longer than 92 days from the initial settlement date of the reverse repurchase agreement or securities lending agreement, unless the reverse repurchase agreement or securities lending agreement includes a written codicil guaranteeing a minimum earning or spread for the entire period between the sale of a security using a reverse repurchase agreement or securities lending agreement and the final maturity date of the same security.
- (4) (A) Investments in reverse repurchase agreements, securities lending agreements, or similar investments in which the local agency sells securities prior to purchase with a simultaneous agreement to repurchase the security may only be made upon prior approval of the governing body of the local agency and shall only be made with primary dealers of the Federal Reserve Bank of New York or with a nationally or state-chartered bank that has or has had a significant banking relationship with a local agency.
- (B) For purposes of this chapter, "significant banking relationship" means any of the following activities of a bank:
- (i) Involvement in the creation, sale, purchase, or retirement of a local agency's bonds, warrants, notes, or other evidence of indebtedness.
 - (ii) Financing of a local agency's activities.
 - (ii) Acceptance of a local agency's securities or funds as deposits.

- (5) (A) "Repurchase agreement" means a purchase of securities by the local agency pursuant to an agreement by which the counterparty seller will repurchase the securities on or before a specified date and for a specified amount and the counterparty will deliver the underlying securities to the local agency by book entry, physical delivery, or by third-party custodial agreement. The transfer of underlying securities to the counterparty bank's customer book-entry account may be used for book-entry delivery.
- (B) Securities," for purpose of repurchase under this subdivision, means securities of the same issuer, description, issue date, and maturity.
- (C) "Reverse repurchase agreement" means a sale of securities by the local agency pursuant to an agreement by which the local agency will repurchase the securities on or before a specified date and includes other comparable agreements.
- (D) "Securities lending agreement" means an agreement under which a local agency agrees to transfer securities to a borrower who, in turn, agrees to provide collateral to the local agency. During the term of the agreement, both the securities and the collateral are held by a third party. At the conclusion of the agreement, the securities are transferred back to the local agency in return for the collateral.
- (E) For purposes of this section, the base value of the local agency's pool portfolio shall be that dollar amount obtained by totaling all cash balances placed in the pool by all pool participants, excluding any amounts obtained through selling securities by way of reverse repurchase agreements, securities lending agreements, or other similar borrowing methods.
- (F) For purposes of this section, the spread is the difference between the cost of funds obtained using the reverse repurchase agreement and the earnings obtained on the reinvestment of the funds.
- (j) Medium-term notes, defined as all corporate and depository institution debt securities with a maximum remaining maturity of five years or less, issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States. Notes eligible for investment under this subdivision shall be rated "A" or better by a nationally recognized rating service. Purchases of medium-term notes shall not include other instruments authorized by this section and may not exceed 30 percent of the agency's money that may be invested pursuant to this section.
- (k) (1) Shares of beneficial interest issued by diversified management companies that invest in the securities and obligations as authorized by subdivisions (a) to (j), inclusive, or subdivisions (m) or (n) and that comply with the investment

restrictions of this article and Article 2 (commencing with Section 53630). However, notwithstanding these restrictions, a counterparty to a reverse repurchase agreement or securities lending agreement is not required to be a primary dealer of the Federal Reserve Bank of New York if the company's board of directors finds that the counterparty presents a minimal risk of default, and the value of the securities underlying a repurchase agreement or securities lending agreement may be 100 percent of the sales price if the securities are marked to market daily.

- (2) Shares of beneficial interest issued by diversified management companies that are money market funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.).
- (3) If investment is in shares issued pursuant to paragraph (1), the company shall have met either of the following criteria:
 - (A) Attained the highest ranking or the highest letter and numerical rating provided by not less than two nationally recognized statistical rating organizations.
 - (B) Retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience investing in the securities and obligations authorized by subdivisions (a) to (j), inclusive, or subdivisions (m) or (n) and with assets under management in excess of five hundred million dollars (\$500,000,000).
- (4) If investment is in shares issued pursuant to paragraph (2), the company shall have met either of the following criteria:
 - (A) Attained the highest ranking or the highest letter and numerical rating provided by not less than two nationally recognized statistical rating organizations.
 - (B) Retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience managing money market mutual funds with assets under management in excess of five hundred million dollars (\$500,000,000).
- (5) The purchase price of shares of beneficial interest purchased pursuant to this subdivision shall not include any commission that the companies may charge and shall not exceed 20 percent of the agency's money that may be invested pursuant to this section. However, no more than 10 percent of the agency's funds may be

invested in shares of beneficial interest of any one mutual fund pursuant to paragraph (1).

- (l) Moneys held by a trustee or fiscal agent and pledged to the payment or security of bonds or other indebtedness, or obligations under a lease, installment sale, or other agreement of a local agency, or certificates of participation in those bonds, indebtedness, or lease installment sale, or other agreements, may be invested in accordance with the statutory provisions governing the issuance of those bonds, indebtedness, or lease installment sale, or other agreement, or to the extent not inconsistent therewith or if there are no specific statutory provisions, in accordance with the ordinance, resolution, indenture, or agreement of the local agency providing for the issuance.
- (m) Notes, bonds, or other obligations that are at all times secured by a valid first priority security interest in securities of the types listed by Section 53651 as eligible securities for the purpose of securing local agency deposits having a market value at least equal to that required by Section 53652 for the purpose of securing local agency deposits. The securities serving as collateral shall be placed by delivery or book entry into the custody of a trust company or the trust department of a bank that is not affiliated with the issuer of the secured obligation, and the security interest shall be perfected in accordance with the requirements of the Uniform Commercial Code or federal regulations applicable to the types of securities in which the security interest is granted.
- (n) Any mortgage pass-through security, collateralized mortgage obligation, mortgage-backed or other pay-through bond, equipment lease-backed certificate, consumer receivable pass-through certificate, or consumer receivable-backed bond of a maximum of five years' maturity. Securities eligible for investment under this subdivision shall be issued by an issuer having an "A" or higher rating for the issuer's debt as provided by a nationally recognized rating service and rated in a rating category of "AA" or its equivalent or better by a nationally recognized rating service. Purchase of securities authorized by this subdivision may not exceed 20 percent of the agency's surplus money that may be invested pursuant to this section.
- (o) Shares of beneficial interest issued by a joint powers authority organized pursuant to Section 6509.7 that invests in the securities and obligations authorized in subdivisions (a) to (n), inclusive. Each share shall represent an equal proportional interest in the underlying pool of securities owned by the joint powers authority. To be eligible under this section, the joint powers authority issuing the shares shall have retained an investment adviser that meets all of the following criteria:
 - (1) The adviser is registered or exempt from registration with the Securities and Exchange Commission.
 - (2) The adviser has not less than five years of experience investing in the securities and obligations authorized in subdivisions (a) to (n), inclusive.

- (3) The adviser has assets under management in excess of five hundred million dollars (\$500,000,000).

Section 53601.1. Investment in Financial Futures or Financial Option Contracts

The authority of a local agency to invest funds pursuant to Section 53601 includes, in addition thereto, authority to invest in financial futures or financial option contracts in any of the investment categories enumerated in that section.

Section 53601.2. Corporation

As used in this article, “corporation” includes a limited liability company.

Section 53601.5. Investments; Qualified Purchase Agent

The purchase by a local agency of any investment authorized pursuant to Section 53601 or 53601.1, not purchased directly from the issuer, shall be purchased either from an institution licensed by the state as a broker-dealer, as defined in Section 25004 of the Corporations Code, or from a member of a federally regulated securities exchange, from a national or state-chartered bank, from a savings association or federal association (as defined by Section 5102 of the Financial Code) or from a brokerage firm designated as a primary government dealer by the Federal Reserve bank.

Section 53601.6. Prohibited Investments

- (a) A local agency shall not invest any funds pursuant to this article or pursuant to Article 2 (commencing with Section 53630) in inverse floaters, range notes, or mortgage-derived, interest-only strips.
- (b) A local agency shall not invest any funds pursuant to this article or pursuant to Article 2 (commencing with Section 53630) in any security that could result in zero interest accrual if held to maturity. However, a local agency may hold prohibited instruments until their maturity dates. The limitation in this subdivision shall not apply to local agency investments in shares of beneficial interest issued by diversified management companies registered under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.) that are authorized for investment pursuant to subdivision (k) of Section 53601.

Section 53601.7. Criteria for Investment of Funds by Local Agency; Definitions

Notwithstanding the investment parameters of Sections 53601 and 53635, a local agency that is a county or a city and county may invest any portion of the funds that it deems wise or expedient, using the following criteria:

- (a) No investment shall be made in any security, other than a security underlying a repurchase or reverse repurchase agreement or a securities lending agreement, that, at the time of purchase, has a term remaining to maturity in excess of 397 days, and that would

cause the dollar-weighted average maturity of the funds in the investment pool to exceed 90 days.

- (b) All corporate and depository institution investments shall meet or exceed the following credit rating criteria at time of purchase:
 - (1) Short-term debt shall be rated at least “A-1” by Standard & Poor's Corporation, “P-1” by Moody's Investors Service, Inc., or “F-1” by Fitch Ratings. If the issuer of short-term debt has also issued long-term debt, this long-term debt rating shall be rated at least “A,” without regard to +/- or 1, 2, 3 modifiers, by Standard & Poor's Corporation, Moody's Investors Service, Inc., or Fitch Ratings.
 - (2) Long-term debt shall be rated at least “A,” without regard to +/- or 1, 2, 3 modifiers, by Standard & Poor's Corporation, Moody's Investors Service, Inc., or Fitch Ratings.
- (c) No more than 5 percent of the total assets of the investments held by a local agency may be invested in the securities of any one issuer, except the obligations of the United States government, United States government agencies, and United States government-sponsored enterprises. No more than 10 percent may be invested in any one mutual fund.
- (d) Where this section specifies a percentage limitation for a particular category of investment, that percentage is applicable only at the date of purchase. A later increase or decrease in a percentage resulting from a change in values or assets shall not constitute a violation of that restriction. If subsequent to purchase, securities are downgraded below the minimum acceptable rating level, the securities shall be reviewed for possible sale within a reasonable amount of time after the downgrade.
- (e) Within the limitations set forth in this section, a local agency electing to invest its funds pursuant to this section may invest in the following securities:
 - (1) Direct obligations of the United States Treasury or any other obligation guaranteed as to principal and interest by the United States government.
 - (2) Bonds, notes, debentures, or any other obligations of, or securities issued by, any federal government agency, instrumentality, or government-sponsored enterprise.
 - (3) Registered state warrants or treasury notes or bonds of this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or other entity of the state.
 - (4) Bonds, notes, warrants, or other indebtedness of the local agency, or any local agency within this state, including bonds payable solely out of the revenues from

a revenue-producing property owned, controlled, or operated by the local agency, or by a department, board, agency, or authority of the local agency.

- (5) Bankers acceptance, otherwise known as bills of exchange or time drafts drawn on and accepted by a commercial bank, primarily used to finance international trade. Purchases of bankers acceptances may not exceed 180 days to maturity.
- (6) Short-term unsecured promissory notes issued by corporations for maturities of 270 days or less. Eligible commercial paper is further limited to the following:
 - (A) Issuing corporations that are organized and operating within the United States, having total assets in excess of five hundred million dollars (\$500,000,000).
 - (B) Maturities for eligible commercial paper that may not exceed 270 days and may not represent more than 10 percent of the outstanding paper of an issuing corporation.
- (7) A certificate representing a deposit of funds at a commercial bank for a specified period of time and for a specified return at maturity. Eligible certificates of deposit shall be issued by a nationally or state-chartered bank or a state or federal association, as defined in Section 5102 of the Financial Code, or by a state-licensed branch of a foreign bank. For purposes of this subdivision, certificates of deposits shall not come within Article 2 (commencing with Section 53630), except that the amount so invested shall be subject to the limitations of Section 53638. The legislative body of a local agency and the treasurer or other official of the local agency having legal custody of the money may not invest local agency funds, or funds in the custody of the local agency, in negotiable certificates of deposit issued by a state or federal credit union if a member of the legislative body of the local agency, or any person with investment decisionmaking authority in the administrative office, manager's office, budget office, auditor-controller's office, or treasurer's office of the local agency also serves on the board of directors, or any committee appointed by the board of directors, other credit committee or the supervisory committee of the state or federal credit union issuing the negotiable certificate of deposit.
- (8) Repurchase agreements, reverse repurchase agreements, or securities lending agreements of any securities authorized by this section, if the agreements meet the requirements of this paragraph and the delivery requirements specified in Section 53601. Investments in repurchase agreements may be made, on any investment authorized by this section, when the term of the agreement does not exceed one year. The market value of the securities that underlay a repurchase agreement shall be valued at 102 percent or greater of the funds borrowed against those securities, and the value shall be adjusted no less than quarterly. Because the

market value of the underlying securities is subject to daily market fluctuations, the investments in repurchase agreements shall be in compliance with this section if the value of the underlying securities is brought back to 102 percent no later than the next business day. Reverse repurchase agreements may be utilized only when all of the following criteria are met:

- (A) The security being sold on reverse repurchase agreement or securities lending agreement has been owned and fully paid for by the local agency for a minimum of 30 days prior to the sale.
 - (B) The total of all reverse repurchase agreements on investments owned by the local agency not purchased or committed to purchase does not exceed 20 percent of the market value of the portfolio.
 - (C) The agreement does not exceed a term of 92 days, unless the agreement includes a written codicil guaranteeing a minimum earning or spread for the entire period between the sale of a security using a reverse repurchase agreement and the final maturity date of the same security.
 - (D) Funds obtained or funds within the pool of an equivalent amount to that obtained from selling a security to a counterparty by way of a reverse repurchase agreement or securities lending agreement, may not be used to purchase another security with a maturity longer than 92 days from the initial settlement date of the reverse repurchase agreement or securities lending agreement, unless the agreement includes a written codicil guaranteeing a minimum earning or spread for the entire period between the sale of a security using a reverse repurchase agreement or securities lending agreement and the final maturity date of the same security.
 - (E) Investments in reverse repurchase agreements or similar investments in which the local agency sells securities prior to purchase with a simultaneous agreement to repurchase the security, shall only be made with prior approval of the governing body of the local agency and shall only be made with primary dealers of the Federal Reserve Bank of New York or with a nationally or state-chartered bank that has or has had a significant banking relationship with a local agency. "Securities," for purposes of this paragraph, means securities of the same issuer, description, issue date, and maturity.
- (9) All debt securities issued by a corporation or depository institution with a remaining maturity of not more than 397 days, including securities specified as "medium-term notes," as well as other debt instruments originally issued with maturities longer than 397 days, but which, at time of purchase, have a final maturity of 397 days or less. Eligible medium-term notes shall be issued by

corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States.

- (10) (A) Shares of beneficial interest issued by diversified management companies that invest in the securities and obligations described in this subdivision and that comply with the investment restrictions of this section. However, notwithstanding these restrictions, a counterparty to a reverse repurchase agreement shall not be required to be a primary dealer of the Federal Reserve Bank of New York if the company's board of directors finds that the counterparty presents a minimal risk of default. The value of the securities underlying a repurchase agreement may be 100 percent of the sales price if the securities are marked to market daily.
- (B) Shares of beneficial interest issued by diversified management companies that are money market funds registered with the Securities and Exchange Commission under the federal Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.).
- (C) All shares of beneficial interest described in this paragraph shall have met either of the following criteria:
 - (i) Attained the highest ranking or the highest letter and numerical rating provided by not less than two nationally recognized statistical rating organizations.
 - (ii) Retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission and who has not less than five years' experience investing in money market instruments and with assets under management in excess of five hundred million dollars (\$500,000,000).
- (11) Any mortgage passthrough security, collateralized mortgage obligation, mortgage-backed or other paythrough bond, equipment lease-backed certificate, consumer receivable passthrough certificate, or consumer receivable-backed bond. Securities eligible for investment under this paragraph shall be issued by an issuer having an "A" or higher rating from the issuer's debt as provided by a nationally recognized rating service and rated in a rating category of "AA" or its equivalent or better by a nationally recognized rating.
- (12) Contracts issued by insurance companies that provide the policyholder with the right to receive a fixed or variable rate of interest and the full return of principal at the maturity date.

- (13) Any investments that would qualify under SEC Rule 2a-7 of the Investment Company Act of 1940 guidelines. These investments shall also meet the limitations detailed in this section.
- (f) For purposes of this section, all of the following definitions shall apply:
- (1) “Repurchase agreement” means a purchase of securities pursuant to an agreement by which the counterparty seller will repurchase the securities on or before a specified date and for a specified amount and the counterparty will deliver the underlying securities to the local agency by book entry, physical delivery, or by third-party custodial agreement.
 - (2) “Significant banking relationship” means any of the following activities of a bank:
 - (A) Involvement in the creation, sale, purchase, or retirement of a local agency's bonds, warrants, notes, or other evidence of indebtedness.
 - (B) Financing of a local agency's securities or funds as deposits.
 - (C) Acceptance of a local agency's securities or funds as deposits.
 - (3) “Reverse repurchase agreement” means a sale of securities by the local agency pursuant to an agreement by which the local agency will repurchase the securities on or before a specified date and includes other comparable agreements.
 - (4) “Securities lending agreement” means an agreement with a local agency that agrees to transfer securities to a borrower who, in turn agrees to provide collateral to the local agency. During the term of the agreement, both the securities and the collateral are held by a third party. At the conclusion of the agreement, the securities are transferred back to the local agency in return for the collateral.
 - (5) “Local agency” means a county or city and county.
- (g) For purposes of this section, the base value of the local agency's pool portfolio shall be that dollar amount obtained by totaling all cash balances placed in the pool by all pool participants, excluding any amounts obtained through selling securities by way of reverse repurchase agreements, or other similar borrowing methods.
- (h) For purposes of this section, the spread is the difference between the cost of funds obtained using the reverse repurchase agreement and the earnings obtained on the reinvestment of the funds.

- (i) This section shall remain in effect only until January 1, 2007, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2007, deletes or extends that date.

Section 53602. Investment in Legal Investments for Savings Banks; Securities of Public Districts

The legislative body shall invest only in notes, bonds, bills, certificates of indebtedness, warrants, or registered warrants which are legal investments for savings banks in the State, provided, that the board of supervisors of a county may, by a four-fifths vote thereof, invest in notes, warrants or other evidences of indebtedness of public districts wholly or partly within the county, whether or not such notes, warrants, or other evidences of indebtedness are legal investments for savings banks.

Section 53603. Direct Purchase of Securities

The legislative body may make the investment by direct purchase of any issue of eligible securities at their original sale or after they have been issued.

Section 53604. Sale or Exchange of Securities; Reinvestment of Proceeds

The legislative body may sell, or exchange for other eligible securities, and reinvest the proceeds of, the securities purchased.

Section 53605. Sale of Securities; Application of Proceeds to Original Purposes

From time to time, the legislative body shall sell the securities so that the proceeds may be applied to the purposes for which the original purchase money was placed in the sinking fund or the treasury of the local agency.

Section 53606. Cancellation of Bonds Issued by Purchaser; Resale

The bonds purchased, which were issued by the purchaser, may be canceled either in satisfaction or sinking fund obligations or otherwise. When canceled, they are no longer outstanding, unless in its discretion, the legislative body holds them uncanceled. While held uncanceled, the bonds may be resold.

Section 53608. Deposit of Securities; Receipt; Delegation of Authority

The legislative body of a local agency may deposit for safekeeping with a federal or state association (as defined by Section 5102 of the Financial Code), a trust company or a state or national bank located within this state or with the Federal Reserve Bank of San Francisco or any branch thereof within this state, or with any Federal Reserve bank or with any state or national bank located in any city designated as a reserve city by the Board of Governors of the Federal Reserve System, the bonds, notes, bills, debentures, obligations, certificates of indebtedness, warrants, or other evidences of indebtedness in which the money of the local agency is invested pursuant to this article or pursuant to other legislative authority. The local agency shall take

from such financial institution a receipt for securities so deposited. The authority of the legislative body to deposit for safekeeping may be delegated by the legislative body to the treasurer of the local agency; the treasurer shall not be responsible for securities delivered to and received for by a financial institution until they are withdrawn from the financial institution by the treasurer.

Section 53609. Eligible Securities for Investment of Funds Held by Local Agency Pursuant to Deferred Compensation Plans

Notwithstanding the provisions of this chapter or any other provisions of this code, funds held by a local agency pursuant to a written agreement between the agency and employees of the agency to defer a portion of the compensation otherwise receivable by the agency's employees and pursuant to a plan for such deferral as adopted by the governing body of the agency, may be invested in the types of investments set forth in Sections 53601 and 53602 of this code, and may additionally be invested in corporate stocks, bonds, and securities, mutual funds, savings and loan accounts, credit union accounts, life insurance policies, annuities, mortgages, deeds of trust, or other security interests in real or personal property. Nothing herein shall be construed to permit any type of investment prohibited by the Constitution. Deferred compensation funds are public pension or retirement funds for the purposes of Section 17 of Article XVI of the Constitution.

Article 2 of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code

Section 53635. Local Agency Investments; Commercial Paper; Concentration Limits

- (a) This section shall apply to a local agency that is a county, a city and a county, or other local agency that pools money in deposits or investments with other local agencies, including local agencies that have the same governing body. However, Section 53601 shall apply to all local agencies that pool money in deposits or investments exclusively with local agencies that have the same governing body. This section shall be interpreted in a manner that recognizes the distinct characteristics of investment pools and the distinct administrative burdens on managing and investing funds on a pooled basis pursuant to Article 6 (commencing with Section 27130) of Chapter 5 of Division 2 of Title 3. A local agency that is a county, a city and county, or other local agency that pools money in deposits or investments with other agencies may invest in commercial paper pursuant to subdivision (g) of Section 53601, except that the local agency shall be subject to the following concentration limits:
 - (1) No more than 40 percent of the local agency's money may be invested in eligible commercial paper.
 - (2) No more than 10 percent of the local agency's money that may be invested pursuant to this section may be invested in the outstanding commercial paper of any single issuer.

- (3) No more than 10 percent of the outstanding commercial paper of any single issuer may be purchased by the local agency.
- (b) Notwithstanding Section 53601, the City of Los Angeles shall be subject to the concentration limits of this section for counties and for cities and counties with regard to the investment of money in eligible commercial paper.

Section 53635.2. Deposit of Money Belonging To or in Custody of Local Agency

As far as possible, all money belonging to, or in the custody of, a local agency, including money paid to the treasurer or other official to pay the principal, interest, or penalties of bonds, shall be deposited for safekeeping in state or national banks, savings associations, federal associations, credit unions, or federally insured industrial loan companies in this state selected by the treasurer or other official having legal custody of the money; or may be invested in the investments set forth in Section 53601. To be eligible to receive local agency money, a bank, savings association, federal association, or federally insured industrial loan company shall have received an overall rating of not less than “satisfactory” in its most recent evaluation by the appropriate federal financial supervisory agency of its record of meeting the credit needs of California's communities, including low- and moderate-income neighborhoods, pursuant to Section 2906 of Title 12 of the United States Code. Sections 53601.5 and 53601.6 shall apply to all investments that are acquired pursuant to this section.

Section 53635.7. Agency Consideration When Borrowing Funds in Excess of \$100,000

In making any decision that involves borrowing in the amount of one hundred thousand dollars (\$100,000) or more, the legislative body of the local agency shall discuss, consider, and deliberate each decision as a separate item of business on the agenda of its meeting as prescribed in Chapter 9 (commencing with Section 54950). As used in this section, “borrowing” does not include bank overdrafts or security lending.

Investment of Bond Proceeds

Chapter 12 of Division 6 of Title 1 of the Government Code

Section 5922. Bonds and Investments; Contracts to Place on Interest Rate, Currency, Cash-Flow, or Other Basis; Foreign Currency; Proceeds

Notwithstanding any other provision of law, all of the following apply:

- (a) In connection with, or incidental to, the issuance or carrying of bonds, or acquisition or carrying of any investment or program of investment, any state or local government may enter into any contracts which the state or local government determines to be necessary or appropriate to place the obligation or investment of the state or local government, as represented by the bonds, investment or program of investment and the contract or contracts, in whole or in part, on the interest rate, currency, cash-flow, or other basis

desired by the state or local government, including, without limitation, contracts commonly known as interest rate swap agreements, currency swap agreements, forward payment conversion agreements, futures, or contracts providing for payments based on levels of, or changes in, interest rates, currency exchange rates, stock or other indices, or contracts to exchange cash flows or a series of payments, or contracts, including, without limitation, interest rate floors or caps, options, puts or calls to hedge payment, currency, rate, spread, or similar exposure. These contracts or arrangements may also be entered into by state or local governments in connection with, or incidental to, entering into or maintaining any agreement which secures bonds, including bonds issued by private entities. These contracts and arrangements shall be entered into with the parties, selected by the means, and contain the payment, security, default, remedy, and other terms and conditions, determined by the state or local government, after giving due consideration for the creditworthiness of the counterparties, where applicable, including any rating by a nationally recognized rating agency or any other criteria as may be appropriate.

No local government shall enter into any of the contracts or arrangements pursuant to this subdivision, unless its governing body first determines that the contract or arrangement or program of contracts is designed to reduce the amount or duration of payment, currency, rate, spread, or similar risk or result in a lower cost of borrowing when used in combination with the issuance of bonds or enhance the relationship between risk and return with respect to the investment or program of investment in connection with, or incident to, the contract or arrangement which is to be entered into.

- (b) Bonds issued by a state or local government may be payable in accordance with their terms, in whole or in part, in currency other than lawful money of the United States of America, provided that the state or local government enter into a currency swap or similar agreement for payments in lawful money of the United States of America, which covers the entire amount of the debt service payment obligation of the state or local government with respect to the bonds payable in other currency, and provided further that if the term of that agreement is less than the term of the bonds, the state or local government shall covenant to enter into additional agreements as may be necessary to cover the entire amount of the debt service payment obligation. An issuer shall include in its written notice to the California Debt Advisory Commission pursuant to subdivision (g) of Section 8855 a statement of its intent to issue bonds payable in a currency other than lawful money of the United States of America.
- (c) In connection with, or incidental to, the issuance or carrying of bonds, or entering into any of the contracts or arrangements referred to in subdivision (a), the state or local government may enter into credit enhancement or liquidity agreements, with payment, interest rate, currency, security, default, remedy, and other terms and conditions as the state or local government determines.

- (d) Proceeds of bonds and any moneys set aside and pledged to secure payment of the bonds or any of the contracts entered into pursuant to this section, may be invested in securities or obligations described in the ordinance, resolution, indenture, agreement, or other instrument providing for the issuance of the bonds or the contract and may be pledged to and used to service any of the contracts or agreements entered into pursuant to this section.

Financial Contracts – Swaps and Forwards

Chapter 12 of Division 6 of title 1 of the Government Code

Section 5920. Legislative Findings and Declarations

The Legislature finds and declares that the incurring or carrying of obligations and making and managing of investments by state and local governments involves a variety of interest rates, payment, and other risks, that a number of financial instruments are available to offset, hedge, or reduce, and improve net costs, and that many state agencies and local governments lack express statutory authority to take advantage of those instruments.

Section 5921. Definitions

As used in this chapter, the following definitions apply, unless the context otherwise indicates or requires another or different meaning or intent:

- (a) “Bonds” mean bonds, notes, bond anticipation notes, commercial paper, or other evidences of indebtedness, or reimbursement warrants or refunding warrants, or lease, installment purchase, or other agreements or certificates of participation therein.
- (b) “State or local government” means the state, any department, agency, board, commission, or authority of the state, or any city, city and county, county, public district, public corporation, authority, agency, board, commission, or other public entity.

Section 5922. Bonds and Investment; Contracts to Place on Interest Rate, Currency, Cash-Flow, or Other Basis; Foreign Currency; Proceeds

Notwithstanding any other provision of law, all of the following apply:

- (a) In connection with, or incidental to, the issuance or carrying of bonds, or acquisition or carrying of any investment or program of investment, any state or local government may enter into any contracts which the state or local government determines to be necessary or appropriate to place the obligation or investment of the state or local government, as represented by the bonds, investment or program of investment and the contract or contracts, in whole or in part, on the interest rate, currency, cash-flow, or other basis desired by the state or local government, including, without limitation, contracts commonly known as interest rate swap agreements, currency swap agreements, forward

payment conversion agreements, futures, or contracts providing for payments based on levels of, or changes in, interest rates, currency exchange rates, stock or other indices, or contracts to exchange cash flows or a series of payments, or contracts, including, without limitation, interest rate floors or caps, options, puts or calls to hedge payment, currency, rate, spread, or similar exposure. These contracts or arrangements may also be entered into by state or local governments in connection with, or incidental to, entering into or maintaining any agreement which secures bonds, including bonds issued by private entities. These contracts and arrangements shall be entered into with the parties, selected by the means, and contain the payment, security, default, remedy, and other terms and conditions, determined by the state or local government, after giving due consideration for the creditworthiness of the counterparties, where applicable, including any rating by a nationally recognized rating agency or any other criteria as may be appropriate.

No local government shall enter into any of the contracts or arrangements pursuant to this subdivision, unless its governing body first determines that the contract or arrangement or program of contracts is designed to reduce the amount or duration of payment, currency, rate, spread, or similar risk or result in a lower cost of borrowing when used in combination with the issuance of bonds or enhance the relationship between risk and return with respect to the investment or program of investment in connection with, or incidental to, the contract or arrangement which is to be entered into.

- (b) Bonds issued by a state or local government may be payable in accordance with their terms, in whole or in part, in currency other than lawful money of the United States of America, provided that the state or local government enter into a currency swap or similar agreement for payments in lawful money of the United States of America, which covers the entire amount of the debt service payment obligation of the state or local government with respect to the bonds payable in other currency, and provided further that if the term of that agreement is less than the term of the bonds, the state or local government shall covenant to enter into additional agreements as may be necessary to cover the entire amount of the debt service payment obligation. An issuer shall include in its written notice to the California Debt Advisory Commission pursuant to subdivision (g) of Section 8855 a statement of its intent to issue bonds payable in a currency other than lawful money of the United States of America.
- (c) In connection with, or incidental to, the issuance or carrying of bonds, or entering into any of the contracts or arrangements referred to in subdivision (a), the state or local government may enter into credit enhancement or liquidity agreements, with payment, interest rate, currency, security, default, remedy, and other terms and conditions as the state or local government determines.
- (d) Proceeds of bonds and any moneys set aside and pledged to secure payment of the bonds or any of the contracts entered into pursuant to this section, may be invested in securities or obligations described in the ordinance, resolution, indenture, agreement, or other

instrument providing for the issuance of the bonds or the contract and may be pledged to and used to service any of the contracts or agreements entered into pursuant to this section.

Section 5923. Construction of Chapter

- (a) To the extent that this chapter is inconsistent with any other general statute or special act or parts thereof, now or hereafter enacted, this chapter is controlling.
- (b) This chapter shall be liberally construed to effect its purpose.

PLEDGE OF REVENUES

Chapter 5.5 of Division 6 of Title 1 of the Government Code

Section 5450. Definitions

- (a) “Bonds” means any bonds, notes, bond anticipation notes, commercial paper, or other evidences of indebtedness, or lease, installment purchase, or other agreements, or certificates of participation therein, that are not issued pursuant to statutory authority containing a provision governing the perfection and priority of pledges of collateral unless the provision provides that this chapter shall govern.
- (b) “Collateral” means any revenues, moneys, accounts receivable, contractual rights to payment, and other rights to payment of whatever kind, subject to the pledge provided for or created in a pledge document.
- (c) “Pledge document” means the resolution, ordinance, indenture, trust agreement, loan agreement, lease, installment sale agreement, reimbursement or similar agreement with any provider of credit enhancement for bonds, pledge agreement, or similar agreement in which the pledge is provided for or created.
- (d) “Pledge” means, and as used in any pledge document shall be deemed to create, a grant of a lien on and a security interest in and pledge of the collateral referred to in a pledge document.
- (e) “Public body” means the state or any city, county, city and county, district, other political subdivision of the state, public authority, or other public corporation which is authorized to issue bonds. “Public body” shall not include any private person, partnership, corporation, or other private entity, including any nonprofit private entity.
- (f) “Security interest” means a prior claim on any revenues, moneys, accounts receivable, contractual rights to payment, or other rights to payment, which are pledged in a pledge document, unless otherwise provided in the pledge document.

Section 5451. Pledge of Collateral by Public Body; Validity

- (a) A pledge of collateral by any public body to secure, directly or indirectly, the payment of the principal or redemption price of, or interest on, any bonds, or any reimbursement or similar agreement with any provider of credit enhancement for bonds, which is issued by or entered into by a public body, shall be valid and binding in accordance with the terms of the pledge document from the time the pledge is made for the benefit of pledgees and successors thereto.
- (b) The collateral shall immediately be subject to the pledge, and the pledge shall constitute a lien and security interest which shall immediately attach to the collateral and be effective, binding, and enforceable against the pledgor, its successors, purchasers of the collateral, creditors, and all others asserting the rights therein, to the extent set forth, and in accordance with, the pledge document irrespective of whether those parties have notice of the pledge and without the need for any physical delivery, recordation, filing, or further act.

Section 5452. Construction of Chapter

Nothing in this chapter shall be construed to authorize new or increased authority to issue bonds.

STATE STATUTORY REFERENCES FOR TYPES OF FINANCING INSTRUMENTS

The following tables present statutory references for the specific sections of **Chapter 6, Types of Financing Obligations** in the *Primer*. The tables are represented in the order the sections appear in that chapter.

Table D-1-1
Statutes Authorizing Assessments, Assessment Districts,
and the Issuance of Assessment Bonds

Name of Statute	Code Reference	Procedure For Assessments And Districts	Authorizes Assessment Bonds	Type of Bonds Authorized
Improvement Act of 1911	Streets & Highways Code §§ 5000 et seq.	1911 Act	Yes	1911 or 1915 Act
Municipal Improvement Act of 1913	Streets & Highways Code §§ 10000 et seq.	1913 Act	No	
Improvement Bond Act of 1915	Streets & Highways Code §§ 8500 et seq.		Yes	1915 Act
Park Playground Act of 1909	Government Code §§ 38000 et seq.	1911 or 1913 Act	No	
Street Opening Act of 1903	Streets & Highways Code §§ 4000 et seq.	1911 or 1913 Act	Yes	1911 or 1915 Act
Pedestrian Mall Law of 1960	Streets & Highways Code §§ 11000 et seq.	1911 or 1913 Act	Yes	1911 or 1915 Act
Street Lighting Act of 1915	Streets & Highways Code §§ 18000 et seq.	Self Contained ¹	No	
Street Lighting Act of 1931	Streets & Highways Code §§ 18300 et seq.	Self Contained ¹	No	
Municipal Lighting Maintenance District Act of 1927	Streets & Highways Code §§ 18600 et seq.	Self Contained ¹	No	

Table D-1-1
Statutes Authorizing Assessments, Assessment Districts,
and the Issuance of Assessment Bonds (continued)

Name of Statute	Code Reference	Procedure For Assessments And Districts	Authorizes Assessment Bonds	Type of Bonds Authorized
Highway Lighting District Act	Streets & Highways Code §§ 19000 et seq.	Self Contained ¹	No	
Tree Planting Act of 1931	Streets & Highways Code §§ 22000 et seq.	Self Contained ¹	No	
Landscaping & Lighting Act of 1972	Streets & Highways Code §§ 22500 et seq.	Self Contained ¹	Yes	1915 Act
Vehicle Parking District Law of 1943	Streets & Highways Code §§ 31500 et seq.	1911 or 1913 Act	Yes	1911 or 1915 Act
Parking District Law of 1951	Streets & Highways Code §§ 35100 et seq.	Self Contained ¹	Yes	Self Contained ²

¹ The statute authorizes the levy of assessments and does not incorporate the procedures of the 1911 or 1913 Acts to establish the district, but contains specific procedures to establish the district within it.

² The statute authorizes the issuance of bonds but not under the 1911 or 1915 Acts.

Table D-1-2
Entities Authorized to Levy Assessments under the 1911 Act or the 1913 Act
and to Issue Bonds under the 1911 Act or the 1915 Act

Entity	Statutory Authority	Bond Act
California Water Districts	Water Code § 36455.1	1911 or 1915 Act
Cities	Streets & Highways Code §§ 5005; 10003	1911 or 1915 Act
City Maintenance Districts	Streets & Highways Code § 5820	1911 Act
Community Rehabilitation Districts	Government Code § 53382	1911 or 1915 Act
Community Service Districts	Government Code §§ 61710; 61712	Self Contained ¹
Community Service District Improvement Districts	Government Code § 61712	Self Contained ¹
Counties	Streets & Highways Code §§ 5005; 10003	1911 or 1915 Act
County Drainage Districts	Water Code § 56100	1911 or 1915 Act
County Maintenance District	Streets & Highways Code § 5830	1911 Act
County Sanitation Districts	Health & Safety Code § 4771	1911 or 1915 Act
County Water Districts and their improvement districts	Water Code §§ 31501-31503	1911 or 1915 Act
County Waterworks Districts	Water Code § 55386	1911 Act
Drainage Districts	Water Code § 56100	1911 or 1915 Act
Water Conservation Districts	Water Code § 74507	Self Contained ¹
Geologic Hazard Abatement Districts	Public Resources Code § 26587	1911 or 1915 Act

Table D-1-2
Entities Authorized to Levy Assessments under the 1911 Act or the 1913 Act
and to Issue Bonds under the 1911 Act or the 1915 Act (continued)

Entity	Statutory Authority	Bond Act
Integrated Financing Districts	Government Code § 53175	Most (see Government Code § 53179)
Irrigation Districts	Water Code § 23600	Self Contained ¹
Irrigation District Distribution Districts	Water Code § 23530	Self Contained ¹
Irrigation District Improvement Districts	Water Code § 23910	Self Contained ¹
Joint Municipal Sewage Disposal Districts	Public Utilities Code §§ 12921; 13010	1911 Act
Levee Districts	Water Code § 70230	1911 Act
Local Hospital Districts	Health & Safety Code §§ 32240; 32243	Self Contained ¹
Mosquito Abatement or Vector Control Districts	Health & Safety Code § 2291.4	¹
Municipal Utility Districts	Public Utilities Code §§ 12921; 13010	1911 or 1915 Act
Municipal Water Districts and their improvement districts	Water Code § 71820	1911 or 1915 Act
Pest Abatement Districts	Health & Safety Code §§ 2823; 2872	¹
Project Areas of Redevelopment Agencies	Health & Safety Code § 33800	1911 or 1915 Act ²
Reclamation Districts	Water Code §§ 39060; 50001; Government Code § 38901	

Table D-1-2
Entities Authorized to Levy Assessments under the 1911 Act or the 1913 Act
and to Issue Bonds under the 1911 Act or the 1915 Act (continued)

Entity	Statutory Authority	Bond Act
Resource Conservation Districts	Public Resources Code § 9964	1911 or 1915 Act
Sanitary Districts	Health & Safety Code §§ 6540; 6541	1911 or 1915 Act
Water Districts	Water Code §§ 36455; 36455.1; 71820	1911 or 1915 Act
Zones of County Water Agencies	Water Code §§ 55385-55408	1911 Act

¹ Although the entity may levy assessments, both the procedure to establish the district and the provisions for the bonds are contained in the statute. Neither 1911 Act nor 1915 Act bonds are authorized.

² Bonds may be issued to pay obligations of the agency incurred before July 1, 1978.

**Table D-2-1
Special Districts Authorized to Issue General Obligation Bonds**

Entity	Code Reference
Airport Districts	Public Utilities Code §§ 22701 et seq.
Bridge and Highway Districts	Streets & Highways Code §§ 27220 et seq.
California Water Districts	Water Code §§ 35950 et seq.
Community Facilities Districts (not to be confused with Mello-Roos Districts, Government Code §§ 53345 et seq.)	Health & Safety Code §§ 4614.13 et seq.
Community Services Districts ¹ and their improvement districts	Government Code §§ 61650 et seq.
County Drainage Districts	Water Code §§ 56070 et seq.
County Sanitation Districts and their improvement districts	Health & Safety Code §§ 4780 et seq.
County Service Areas and their improvement service areas	Government Code §§ 25211.1 et seq.
County Water Agencies ¹	See Water Code-Appendix
County Water Authorities ¹	Water Code-Appendix §§ 45-7 et seq.
County Water Districts and their improvement districts	Water Code §§ 31370 et seq.
County Waterworks Districts	Water Code §§ 55520 et seq.
Fire Protection Districts and service zones thereof	Health & Safety Code §§ 13925 et seq.
Garbage and Refuse Disposal Districts	Public Resources Code §§ 49160 et seq.
Harbor Districts ¹	Harbors & Navigation Code §§ 6090 et seq.

Table D-2-1
Special Districts Authorized to Issue General Obligation Bonds (continued)

Entity	Code Reference
Harbor Improvement Districts	Harbors & Navigation Code §§ 5880 et seq.
Irrigation Districts and their improvement districts	Water Code §§ 24950 et seq.
Joint Highway Districts and their funding districts	Streets & Highways Code §§ 25370 et seq.
Library Districts	Education Code §§ 19520 et seq.
Library Districts and Museums in unincorporated towns and villages	Education Code §§ 19720 et seq.
Local Hospital Districts	Health & Safety Code §§ 32300 et seq.
Memorial Districts	Military & Veterans Code §§ 1210 et seq.
Municipal Park Improvement Districts	Public Resources Code §§ 5350 et seq.
Municipal Utility Districts	Public Utilities Code §§ 13201 et seq.
Municipal Water Districts and their improvement districts	Water Code §§ 71852 et seq.
Port Districts ¹	Harbors & Navigation Code §§ 6330 et seq.
Public Utility Districts and zones thereof	Public Utilities Code §§ 17001 et seq.
Recreation and Park Districts and zones thereof	Public Resources Code §§ 5790 et seq.
Regional Park, Park and Open-Space, and Open-Space Districts ¹	Public Resources Code §§ 5568 et seq.
Resort Improvement Districts and their improvement areas	Public Resources Code §§ 13100 et seq.
River Port Districts	Harbors & Navigation Code § 6930

Table D-2-1
Special Districts Authorized to Issue General Obligation Bonds (continued)

Entity	Code Reference
Sanitary Districts	Health & Safety Code § 6640 et seq.
School Facilities Improvement Districts	Education Code §§ 15300 et seq.
Separation of Grade Districts	Streets & Highways Code §§ 8205 et seq.
Small Craft Harbor Districts	Harbors & Navigation Code §§ 7210 et seq.
Storm Water Districts ¹	Water Code-Appendix §§ 13-26a et seq.
Transit Districts ¹	Public Utilities Code Division 10 (§§ 24501-103700)
Unified School Districts and Union High School Library Districts	Education Code §§ 18510 et seq.
Water Conservation Districts and their improvement districts	Water Code §§ 74790 et seq.
Water Replenishment Districts	Water Code §§ 60270 et seq.

¹ Many specific agencies, authorities, and districts are governed by special statutory authority, which is not specifically mentioned in **Table D-3-1**.

**Table D-3-1
Other Revenue Bond Laws**

Issuer	Statutory Authority	Projects Which May Be Financed	Process for Approval
Cities, counties, and any municipal or public corporations and districts	Health and Safety Code §§ 4950 et seq.	Sewage collection and treatment facilities and water recycling facilities	Election if 15 percent of voters or owners petition majority vote
Counties	Government Code §§ 26301 et seq.	Public beaches, public small boat harbors, public golf courses, and skiing areas	No election required
California Water District	Water Code §§ 36300 et seq.	Acquisition or construction of irrigation and water supply works and sewage, waste, and stormwater facilities	Resolution of board of directors; irrigation works also require an election (see Water Code § 35150)
County Sanitation Districts	Health and Safety Code §§ 4780-4803; 4805	Sewage collection, treatment, and disposal works and refuse transfer or disposal facilities	Revenue Bond Law of 1941
County Water Districts	Water Code § 31030	Waterworks, reservoirs, dams, facilities for the collection, treatment, and disposal of sewage, waste, and storm waters, and fire protection facilities	Revenue Bond Law of 1941
	Water Code §§ 31480 et seq.	Same as above	Procedures applicable to irrigation districts

**Table D-3-1
Other Revenue Bond Laws (continued)**

Issuer	Statutory Authority	Projects Which May Be Financed	Process for Approval
County Waterworks Districts	Water Code §§ 55520 et seq.	Waterwork facilities for irrigation, domestic, industrial, or fire protection purposes	Election, majority vote
	Water Code § 55610	Production, transmission, and distribution of water for public or private purposes	Revenue Bond Law of 1941
Irrigation Districts	Water Code §§ 24950 et seq.	Irrigation, drainage, and power development and distribution works	Election, majority vote
	Water Code §§ 25400 et seq.	Same as above—restrictive provisions apply to electrical works	Revenue Bond Law of 1941
Municipal Utility Districts	Public Utilities Code § 12851	Electrical, water, and sewage works, communications services and electricity conservation programs	Revenue Bond Law of 1941
	Public Utilities Code § 13071 et seq.	Transmission and distribution of electric energy – restrictions apply (see Public Utilities § 13091)	Subject to referendum petition. Aggregate amount of bonds outstanding may not exceed \$10,000,000

**Table D-3-1
Other Revenue Bond Laws (continued)**

Issuer	Statutory Authority	Projects Which May Be Financed	Process for Approval
Public Utility Districts	Public Utilities Code §§ 17001-17009	Public Utility works (see Public Utilities Code § 16461)	Resolution of board of directors
	Public Utilities Code § 16575	Waterworks to carry out objects and purposes of district	Resolution of board of directors
Local Hospital Districts	Health and Safety Code §§ 32315-32316	Hospitals	Revenue Bond Law of 1941, except no election; resolution must be approved by 4/5 th of board and is subject to referendum
Housing Authorities	Health and Safety Code §§ 34350 et seq.	Low income housing	Resolution of board of commissioners

Table D-4-1
Statutory Authorization for Public Lease Revenue Bonds

Issuer	Statutory Authorization
Nonprofit corporation	Non-Profit Public Benefit Corporation Law (Corporations Code §§ 5110 et seq.); Public Leaseback Act (Government Code §§ 54240 et seq.)
Joint powers authority	Joint Exercise of Powers Act (Government Code §§ 6500 et seq.)
Redevelopment agency	Community Redevelopment Law (Health and Safety Code §§ 33000 et seq.)
Parking authority	Parking Law of 1949 (Streets & Highways Code §§ 32500 et seq.)
Public Works Board	State Building Construction Act of 1955 (Government Code §§ 15800 et seq.)

Table D-5-1
Selected Statutory Authorizations to Lease Property

Public Agency	Statutory Authorization
City	Government Code §§ 37350-37351.5
County	Government Code §§ 23004, 25351-25351.6
Irrigation Districts	Water Code §§ 22425, 24252
Redevelopment Agencies	Health & Safety Code §§ 33391, 33430-33442
School Districts	Education Code §§ 17000-17009.5, 17385 et seq.

Table D-6-1
Statutory Authorization for Transit and Transportation
Sales Tax Revenue Bonds

Issuer	Authority To Impose Tax¹	Authority To Secure Bonds Solely With Tax	Authority To Issue Bonds Under Revenue Bond Law Of 1941	Other Authority To Issue Revenue Bonds
Counties in Nine-County San Francisco Bay Area	§ 131102 ²	§ 131109	–	–
Fresno County Transportation Authority	§142250	§ 142264	–	§§ 142264 et seq.
Los Angeles County Transportation Commission	§§ 130350 et seq.	§§ 130533 and 130538	–	§§ 130500 et seq.
Marin County Transit District	§§ 70223.1	–	§§ 70265 and 70266	–
County Regional Justice Facility Agency	Government Code § 26299.041	–	–	Government Code § 26299.060 et seq.
Orange County Regional Justice Facilities Commission	Government Code § 26298.2	Government Code § 26298.12	–	Government Code § 26298.32
Orange County Transit District	§ 40330 ²	§ 40336	§§ 40265-40266, 40336	–
Orange County Transportation Commission	§ 130410 ²	§ 130420	–	§§ 130420 et seq.

Table D-6-1
Statutory Authorization for Transit and Transportation
Sales Tax Revenue Bonds (continued)

Issuer	Authority To Impose Tax¹	Authority To Secure Bonds Solely With Tax	Authority To Issue Bonds Under Revenue Bond Law Of 1941	Other Authority To Issue Revenue Bonds
Riverside County Transportation Commission	§ 240103	–	–	§ 240308 et seq.
Sacramento Regional Transit District	§ 102350	–	§§ 102530 and 102531	–
San Bernardino County Transportation Commission	§ 190103 ³	§ 190309	–	§ 190308 et seq.
San Diego County Regional Transportation Commission	§ 132301 ^{2,3}	§ 132310	–	§§ 132310 et seq.
San Francisco Bay Area Rapid Transit District	§ 29140 ³	§ 29140	§ 29143	§§ 29240 et seq.
San Joaquin County Regional Justice Facility Financing Agency	Government Code § 26292.1 ³	Government Code § 26292.8	–	Government Code § 26292.7
San Mateo County Transit District	§§ 103350 ³ et seq.	§ 103356	§§ 103530 and 103531	–
Santa Clara County Transit District	§ 100250	§§ 100256 and 100450	§§ 100450 and 100451	–

Table D-6-1
Statutory Authorization for Transit and Transportation
Sales Tax Revenue Bonds (continued)

Issuer	Authority To Impose Tax¹	Authority To Secure Bonds Solely With Tax	Authority To Issue Bonds Under Revenue Bond Law Of 1941	Other Authority To Issue Revenue Bonds
Santa Cruz Metropolitan Transit District	§§ 98290 ³ et seq.	§ 98296	§§ 98380 and 98381	–
Shasta County Regional Library Facilities and Services Commission	Government Code § 26172.2 ³	–	–	Government Code Chapter 6 (commencing with § 29900) of Division 3 of Title 3
Tuolumne County Traffic Authority	§ 150201 ^{2,3}	§ 150209	–	§§ 150209 et seq.
Yolo County Transportation District	§ 60042 ³ and 60100	§ 60151	–	§ 60150 et seq.

¹ All references are to the Public Utilities Code unless otherwise noted.

² Statute permits transactions and use tax to be imposed at a greater rate, up to 1 percent.

³ Statute requires that 75 percent of the transactions and use tax is to be allocated to the San Francisco Bay Area Rapid Transit District, with the remaining 25 percent to be allocated among specified public transit entities by the Metropolitan Transportation Commission.

**Table D-6-2
Certain Limitations on Sales Tax Revenue Bonds**

Issuer	Code Sections Governing Uses of Transactions And Use Tax¹	Public Sale Required²	Maximum Interest Rate³	Maximum Maturity	Maximum Redemption Premium⁴
Counties	Government Code §§ 55800-55821	No	None	31 years	None
Local Transportation Authorities	§§ 180200-180207	No	None	20 years (termination of the tax)	None
Counties in Nine-County San Francisco Bay Area	§§ 131101-131122	No	None	None (termination of the tax)	None
Fresno County Transportation Authority	§§ 142254-142261	No	None	None (termination of the tax)	None
Los Angeles County Transportation Commission	§ 130354	No	None	50 years	None
Marin County Transit District	None ⁵	Yes	None	50 years	5 percent
County Regional Justice Facility Agency	Government Code §§ 26299.032, 26299.046, and 26299.062	No	None	None (termination of the tax)	None

**Table D-6-2
Certain Limitations on Sales Tax Revenue Bonds (continued)**

Issuer	Code Sections Governing Uses of Transactions And Use Tax¹	Public Sale Required²	Maximum Interest Rate³	Maximum Maturity	Maximum Redemption Premium⁴
Orange County Regional Justice Facilities Commission	Government Code § 26298.18	No	None	31 years	None
Orange County Transit District	§ 40332	Yes	None	50 years	5 percent
Orange County Transportation Commission	§ 130405	No ⁶	None	31 years	None
Riverside County Transportation Commission	§ 240305	No	None	None (termination of the tax)	None
Sacramento Regional Transit District	§ 102351	Yes	7 percent	50 years	None
San Bernardino County Transportation Commission	§ 190305	No	None	None (termination of the tax)	None
San Diego County Regional Transportation Commission	§§ 132305- 132306	No ⁵	None	None	None

**Table D-6-2
Certain Limitations on Sales Tax Revenue Bonds (continued)**

Issuer	Code Sections Governing Uses of Transactions And Use Tax¹	Public Sale Required²	Maximum Interest Rate³	Maximum Maturity	Maximum Redemption Premium⁴
San Francisco Bay Area Rapid Transit District	§ 29142	Yes ⁷	8 percent ⁷	50 years	6 percent
San Joaquin County Regional Justice Facility Financing Agency	Government Code § 26291.7 and § 26292.2	No	None	None	None
San Mateo County Transit District	None ⁸	Yes	7 percent	50 years	None
Santa Clara County Transportation Authority	None	Yes	7 percent	50 years	None
Santa Cruz Metropolitan Transit District	None	Yes	None	50 years	5 percent
Shasta County Regional Library Facilities and Services Commission	Government Code § 26172.2(c)	No	8 percent	20 years	None

Table D-6-2
Certain Limitations on Sales Tax Revenue Bonds (continued)

Issuer	Code Sections Governing Uses of Transactions And Use Tax¹	Public Sale Required²	Maximum Interest Rate³	Maximum Maturity	Maximum Redemption Premium⁴
Tuolumne County Traffic Authority	§§ 150202- 150205	No ⁵	None	None	None
Yolo County Transportation District	§ 60105	No	None	None (termination of the tax)	None

¹ All references are to the Public Utilities Code unless otherwise noted.

² Those issuers, which have a public sale requirement, may sell the bonds privately, but only after publicly inviting sealed bids and, if no satisfactory bids are received, then the issuer may sell the bonds at private sale.

³ If there is none noted, then the maximum interest rate is the maximum allowable by law—12 percent. See Government Code § 53531.

⁴ The premiums below are in addition to par value and accrued interest.

⁵ Statutes governing the issuance of bonds for the district begin at § 70225 et seq.

⁶ Discount limited to 5 percent.

⁷ Required under issuance and sale of general obligation bonds.

⁸ Statutes governing the issuance of bonds for the district begin at § 103500 et seq.

Table D-7-1
Authorization for Single-Family Bond Programs

Issuer	Authorization For Home Mortgage Financing Program	Authorization For Issuance Of Mortgage Revenue Bonds
Cities, counties, and joint powers authorities consisting of cities and counties	Health and Safety Code §§ 52000 et seq.	Health and Safety Code §§ 52030 et seq.
Redevelopment agencies	Health and Safety Code §§ 33750 et seq.	Health and Safety Code §§ 33775 et seq.
Housing authorities	Health and Safety Code § 34312.4	Health and Safety Code §§ 34350 et seq.

Table D-8-1
Legal Authority to Issue
Economic Development Conduit Revenue Bonds

Issuer	Legal Authority
Local industrial development authorities (IDAs)	Government Code §§ 91500 et seq.
Joint powers authorities (JPAs)	Government Code § 6547.7
Charter cities	California Constitution, Article XI, § 5, and charter and ordinance of particular city in question
California Pollution Control Financing Authority	Health and Safety Code §§ 44500 et seq.
California Infrastructure and Economic Development Bank	Government Code §§ 63021 et seq.

Table D-9-1
Statutory Authorization for
Multifamily Housing Revenue Bonds

Issuer	Code Sections
Cities, counties, and joint powers authorities ¹	Health and Safety Code §§ 52075-52099
Housing authorities	Health and Safety Code § 34312.3
Redevelopment agencies	Health and Safety Code §§ 33750-33769 ²

¹ These sections are made applicable to joint powers authorities pursuant to Section 6547.7 of the Government Code.

² See also Health and Safety Code Section 33413 with respect to multi-family housing units developed to replace units removed from the housing market because of a redevelopment project.

FEDERAL LAWS OF GENERAL APPLICATION TO PUBLIC FINANCE

The following are excerpts of certain federal statutes and regulations of general application to public finance transactions. This is by no means a complete compilation and is merely included for convenience of reference with respect to the laws discussed in the *Primer*. These are excerpted versions for illustrative purposes only.

FEDERAL SECURITIES LAWS

Securities Act of 1933

Section 3. Exempted Securities

- (a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

* * * * *

- (2) 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, . . . or any certificate of deposit for any of the foregoing; or any security issued or guaranteed by any bank; . . . or any security which is an industrial development bond (as defined in Section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code . . .

General Rules and Regulation Promulgated under the Securities Act of 1933

Section 17. Fraudulent Interstate Transactions

- (a) Use of Interstate Commerce for Purpose of Fraud or Deceit

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS §78c note]) by the use of any means or instruments of transportation or communication in interstate commerce or by the 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 the 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.

* * * * *

(c) Exemptions of Section 3 Not Applicable to this Section

The exemptions provided in section 3 shall not apply to the provisions of this section.

Rule 131. Definition of Security Issued Under Governmental Obligations

- (a) Any 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(a)(1) of the Act, issued by the lessee or obligor under the lease, sale or loan arrangement.
- (b) An obligation shall not be deemed a separate “security” as defined in paragraph (a) of this section if,
 - (1) the obligation is payable from the general revenues of a governmental unit, specified in section 3(a)(2) of the Act, having other resources which may be used for the payment of the obligation, or
 - (2) the obligation relates to a public project or facility owned and operated by or on behalf of and under the control of a governmental unit specified in such section, or
 - (3) the obligation relates to a facility which is leased to and under the control of an industrial or commercial enterprise but is a part of a public project which, as a whole, is owned by and under the general control of a governmental unit specified in such section, or an instrumentality thereof.
- (c) This rule shall apply to transactions of the character described in paragraph (a) only with respect to bonds, notes, debentures or other evidences of indebtedness sold after December 31, 1968.

Securities Exchange Act of 1934

Section 10. Regulation of the Use of Manipulative and Deceptive Devices

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

* * * * *

- (b) To 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, any manipulative or deceptive device or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) 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.

General Rules and Regulations Promulgated Under the Securities Exchange Act of 1934

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

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

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 15c2-12. Municipal Securities Disclosure

Preliminary Note: For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Securities Exchange Act Release No. 33741; FR-42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommending municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

- (a) General. As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a

“Participating Underwriter” when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of \$1,000,000 or more (an “Offering”) unless the Participating Underwriter complies with the requirements of this section or is exempted from the provisions of this section.

(b) Requirements.

- (1) Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date, except for the omission of no more than the following information: The offering price(s), interest rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriter(s).
- (2) Except in competitively bid offerings, from the time the Participating Underwriter has reached an understanding with an issuer of municipal securities that it will become a Participating Underwriter in an Offering until a final official statement is available, the Participating Underwriter shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the most recent preliminary official statement, if any.
- (3) The Participating Underwriter shall contract with an issuer of municipal securities or its designated agent to receive, within seven business days after any final agreement to purchase, offer, or sell the municipal securities in an Offering and in sufficient time to accompany any confirmation that requests payment from any customer, copies of a final official statement in sufficient quantity to comply with paragraph (b)(4) of this rule and the rules of the Municipal Securities Rulemaking Board.
- (4) From the time the final official statement becomes available until the earlier of –
 - (i) Ninety days from the end of the underwriting period or
 - (ii) The time when the official statement is available to any person from a nationally recognized municipal securities information repository, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

- (5) (i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined 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, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent:
- (A) To each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;
 - (B) If not submitted as part of the annual financial information, then when and if available, to each nationally recognized municipal securities information repository and to the appropriate state information depository, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;
 - (C) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of any of the following events with respect to the securities being offered in the Offering, if material:
 - (1) Principal and interest payment delinquencies;
 - (2) Non-payment related defaults;
 - (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
 - (4) Unscheduled draws on credit enhancements reflecting financial difficulties;

- (5) Substitution of credit or liquidity providers, or their failure to perform;
 - (6) Adverse tax opinions or events affecting the tax-exempt status of the security;
 - (7) Modifications to rights of security holders;
 - (8) Bond calls;
 - (9) Defeasances;
 - (10) Release, substitution, or sale of property securing repayment of the securities;
 - (11) Rating changes; and
- (D) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide required annual financial information, on or before the date specified in the written agreement or contract.
- (ii) The written agreement or contract for the benefit of holders of such securities also shall identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:
- (A) Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information;
 - (B) Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and
 - (C) Specify the date on which the annual financial information for the preceding fiscal year will be provided, and to whom it will be provided.
- (iii) Such written agreement or contract for the benefit of holders of such securities also may provide that the continuing obligation to provide annual financial information and notices of events may be terminated with respect

to any obligated person, if and when such obligated person no longer remains an obligated person with respect to such municipal securities.

- (c) Recommendations. As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of any event disclosed pursuant to paragraph (b)(5)(i)(C), paragraph (b)(5)(i)(D), and paragraph (d)(2)(ii)(B) of this section with respect to that security.
- (d) Exemptions.
 - (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of \$100,000 or more, if such securities:
 - (i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:
 - (A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and
 - (B) Is not purchasing for more than one account or with a view to distributing the securities; or
 - (ii) Have a maturity of nine months or less; or
 - (iii) At the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.
 - (2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the Participating Underwriters:
 - (i) No obligated person will be an obligated person with respect to more than \$10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt from this section pursuant to paragraph (d)(1) of this section.
 - (ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or

obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide:

- (A) Upon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and
 - (B) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and
- (iii) The final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.
- (3) The provisions of paragraph (b)(5) of this section, other than paragraph (b)(5)(i)(C) of this section, shall not apply to an Offering of municipal securities, if such municipal securities have a stated maturity of 18 months or less.
- (4) The provisions of paragraph (c) of this section shall not apply to municipal securities:
- (i) Sold in an Offering to which paragraph (b)(5) of this section did not apply, other than Offerings exempt under paragraph (d)(2)(ii) of this section; or
 - (ii) Sold in an Offering exempt from this section under paragraph (d)(1) of this section.
- (e) Exemptive Authority. The Commission, upon written request, or upon its own motion, may exempt any broker, dealer, or municipal securities dealer, whether acting in the capacity of a Participating Underwriter or otherwise, that is a participant in a transaction or class of transactions from any requirement of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.
- (f) Definitions. For the purposes of this rule—

- (1) The term “authorized denominations of \$100,000 or more” means municipal securities with a principal amount of \$100,000 or more and with restrictions that prevent the sale or transfer of such securities in principal amounts of less than \$100,000 other than through a primary offering except that, for municipal securities with an original issue discount of 10 percent or more, the term means municipal securities with a minimum purchase price of \$100,000 or more and with restrictions that prevent the sale or transfer of such securities, in principal amounts that are less than the original principal amount at the time of the primary offering, other than through a primary offering.
- (2) The term “end of the underwriting period” means the later of such time as
 - (i) the issuer of municipal securities delivers the securities to the Participating Underwriters or
 - (ii) the Participating Underwriter does not retain, directly or as a member of an underwriting syndicate, an unsold balance of the securities for sale to the public.
- (3) The term “final official statement” means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and 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, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.
- (4) The term “issuer of municipal securities” means the governmental issuer specified in section 3(a)(29) of the Act and the issuer of any separate security, including a separate security as defined in rule 3b-5(a) under the Act.
- (5) The term “potential customer” means

- (i) Any person contacted by the Participating Underwriter concerning the purchase of municipal securities that are intended to be offered or have been sold in an offering,
 - (ii) Any person who has expressed an interest to the Participating Underwriter in possibly purchasing such municipal securities, and
 - (iii) Any person who has a customer account with the Participating Underwriter.
- (6) The term “preliminary official statement” means an official statement prepared by or for an issuer of municipal securities for dissemination to potential customers prior to the availability of the final official statement.
- (7) The term “primary offering” means an offering of municipal securities directly or indirectly by or behalf of an issuer of such securities, including any remarketing of municipal securities.
 - (i) That is accompanied by a change in the authorized denomination of such securities from \$100,000 or more to less than \$100,000, or
 - (ii) That is accompanied by a change in the period during which such securities may be tendered to an issuer of such securities or its designated agent for redemption or purchase from a period of nine months or less to a period of more than nine months.
- (8) The term “underwriter” means any person who has purchased from an issuer of municipal securities with a view to, or offers or sells for an issuer of municipal securities in connection with, the offering of any municipal security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking except, that such term shall not include a person whose interest is limited to a commission, concession, or allowance from an underwriter, broker, dealer, or municipal securities dealer not in excess of the usual and customary distributors' or sellers' commission, concession, or allowance.
- (9) The term “annual financial information” means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously

provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

- (10) The term “obligated person” means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

- (g) Transitional Provision. If on July 28, 1989, a Participating Underwriter was contractually committed to act as underwriter in an Offering of municipal securities originally issued before July 29, 1989, the requirements of paragraphs (b)(3) and (b)(4) shall not apply to the Participating Underwriter in connection with such an Offering. Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; except that paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996. Paragraph (c) shall become effective on January 1, 1996. Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

Appendix E

SUMMARY OF FINANCING OBLIGATIONS

INSTRUMENT	ISSUER	SECURITY	LEGAL AUTHORITY	ADMINISTRATIVE PROCEEDINGS	RESTRICTIONS
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Direct Bonds

Assessment Bonds	Multiple entities (see Appendix D – Legal References – Table D-1-2 for listing)	Assessments on property/fees	Improvement Bond Acts of 1911 and 1915 (see Appendix D – Legal References – Table D-1-1 for list of statutes) State Constitution - Proposition 218.	State Constitution - Proposition 218 and Special Assessment, Investigation, Limitation and Majority Protest Act of 1931 for detailed requirements	Projects must distinguish between and identify parcels being assessed and specific benefits received
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Typical Projects: Works of a "local nature". Improvements authorized by the Bond Acts of 1911 and 1915.

Project Examples: Streets, roads, parks, sewer, lighting, water, drains, transportation, water, gas, and electric power.

Local Agency General Obligation Bonds	Multiple entities (see Appendix D – Legal References – Table D-2-1 for listing of special districts authorized to issue general obligation bonds)	Ad valorem tax	Article XVI, Section 18 and Article XIII A Section 1(b) of the California Constitution. Cities, Counties, School districts and Special districts each have specific requirements.	Article XVI, Section 18 and Article XIII A Section 1(b) of the California Constitution. Cities (Government Code Section 43600), Counties (Government Code Section 29900), School Districts (Education Code Section 15100) and special districts (see Appendix D – Legal References – Table D-2-1 for listings) each have specific requirements.	Two-thirds majority approval of voters in specified area (with some exceptions)
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Typical Projects: Projects are classified by City, County, School District and Special District.

Project Examples: Schools, parks, highways bridges, airports. (See tables in Local Agency General Obligation Bonds section for a comprehensive description of projects financed categorized (by county, city and school district).

Mello-Roos Bonds	Community Facilities District (CFD)	Parcel taxes	Mello-Roos Facilities Act of 1982	See Mello-Roos section in Chapter 6, Types of Financing Obligations for the establishment of a CFD and approval process.	Two-thirds majority voter approval of landowners in district. Must be sold using competitive bid unless negotiated bid cost is proven lower
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Typical Projects: Purchase or rehabilitation of real or other tangible property with a useful life of at least five years. Services associated with the CFD.

Project Examples: Local parks, recreation, open-space, schools, libraries, childcare centers, water/power/gas facilities. Services such as police, fire, recreation, and park maintenance.

INSTRUMENT	ISSUER	SECURITY	LEGAL AUTHORITY	ADMINISTRATIVE PROCEEDINGS	RESTRICTIONS
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Direct Bonds

Pension Obligation Bonds	Local Agencies	General Fund	Structured as refunding bonds issued pursuant to the Local Agency Refunding Law (Government Code Section 53580) Article XVI, Section 18. Qualify for exception of "obligations imposed by law." No two-thirds majority needed.	Resolution of issuance, validation procedures	Must be bond issuance refunding. Cannot exceed Unfunded Accrued Actuarial Pension Liability (UAAL).
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Typical Projects: Refunding of UAAL.

Project Examples: Restricted to UAAL.

Sales Tax Bonds	Special sales tax districts	Sales and use tax revenues	Revenue Bond Act of 1941. See Appendix D - Legal References - Table D-6-1 for listing of statutory authorizations.	Revenue Bond Act of 1941	California Constitution, Article XVI Sec. 18 for issuing, Community Redevelopment Act of 1993 (AB 1290) for restrictions
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Typical Projects: Transportation infrastructure.

Project Examples: Highway improvement, expansion, and maintenance. Public transit systems.

Tax Allocation/ Redevelopment Bonds	Redevelopment Agencies, Chartered Cities	Mostly tax increment but may include tax allocations, transient occupancy taxes, revenues or income from projects, contributions from state or federal government	California Constitution Article XVI Sec. 16, Health and Safety Code Sections 33640, 33204	California Constitution Article XVI Sec. 16, Health and Safety Code Sections 33640,33204	Community Redevelopment Act of 1993 (AB 1290) for a complete listing of restrictions
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Typical Projects: Activities that reduce or eliminate blight within a project area not expected to be improved by private or government action.

Project Examples: Buildings, housing, freeway interchange, sewer systems.

Public Enterprise Revenue Bonds	Cities, Counties, Joint Powers Authorities	Revenue from the enterprise	Revenue Bond Act of 1941. See Appendix D - Legal References - Table D-3-1 for listing of statutory authorizations.	Revenue Bond Act of 1941. See Appendix D - Legal References - Table D-3-1 for specific codes relating to issuance requirements.	
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Typical Projects: Revenue producing enterprises. See **Public Enterprise Revenue Bond** section in **Chapter 6, Types of Financing Obligations** for examples.

Project Examples: Public buildings, stadiums, electric utilities, water and sewer treatment, airports, police stations, libraries, low income housing, police and fire vehicles, computers.

INSTRUMENT	ISSUER	SECURITY	LEGAL AUTHORITY	ADMINISTRATIVE PROCEEDINGS	RESTRICTIONS
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Direct Bonds

Public Lease Revenue Bonds	Joint Powers Authorities, Nonprofits, Redevelopment Agencies, Parking Authorities, Public Works Departments	Lease payments	Instruments structured as leases, not classified as debt for purposes of debt limit and voter approval. See Appendix D - Legal References - Table D-4-1 for codes addressing authorization for specific issuers.	See Appendix D - Legal References - Table D-4-1 for codes addressing approval procedures for specific issuers	Maturity cannot be longer than useful life of project. A legally enforceable lease must be created.
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Typical Projects: Capital improvements to be leased by a public agency.

Project Examples: Stadiums, parking facilities, convention centers, school buildings, airports, entire water or sewer systems.

Conduit Bonds

Conduit Revenue Bonds - Economic Development	CEDFA, CPCFA, Joint Powers Authorities, Industrial Development Agencies	Revenue derived from project	Various. See Appendix D - Legal References - Table D-8-1 for specific issuers.	Various. See Appendix D - Legal References - Table D-8-1 for specific issuers.	CDLAC volume cap, CIDFAC approval, CPCFA approval
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Typical Projects: Small manufacturing facilities, pollution control facilities, specific narrowly defined projects.

Project Examples: Manufacturing, assembly fabrication, renovation, or processing plants for goods or agriculture. Hazardous waste disposal and processing facilities, waste collection/treatment facilities.

Conduit Revenue Bonds - Educational Facility	CEFA, Joint Powers Authorities, Charter Cities	Payments from educational facility	California Educational Facilities Act - Education Code Section 94100	California Educational Facilities Act - Education Code Section 94100	No facilities for religious worship
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Typical Projects: Educational facilities.

Project Examples: Dormitories, administration buildings, dining halls, student unions, school libraries, research facilities, student loan programs.

Conduit Revenue Bonds - Hospital and Health Care	CHFFA, County Health Care Districts, Charter Cities, Joint Powers Authorities	Payments from health care facility	California Health Care Facilities Financing Authority Act – Government Code Section 15430	California Health Care Facilities Financing Authority Act – Government Code Section 15430	TEFRA hearing required
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Typical Projects: Construction, renovation, expansion of health care facilities.

Project Examples: Acute care hospitals, psychiatric care hospitals, skilled nursing facilities, community clinics, outpatient hospitals.

INSTRUMENT	ISSUER	SECURITY	LEGAL AUTHORITY	ADMINISTRATIVE PROCEEDINGS	RESTRICTIONS
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Conduit Bonds

Conduit Revenue Bonds - Multifamily Housing	Cities, Counties, Joint Powers Authorities, Housing Authorities, Redevelopment Agencies (Described in Appendix D - Legal References - Table D-9-1)	Revenue derived from project or lending program	See code sections described in Appendix D - Legal References - Table D-9-1	See code sections described in Appendix D - Legal References - Table D-9-1	CDLAC volume cap. Various rent and income limitations.
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Typical Projects: Financing and/or refinancing construction, renovation, rental housing developments for private developers.

Project Examples: Multifamily projects, including apartment buildings.

Marks-Roos Bonds	Joint Powers Authorities	General Fund or revenue derived from participating local agency	Marks-Roos Local Bond Pooling Act of 1985-Government Code Section 6584. See Marks-Roos Bonds section in Chapter 6, Types of Financing Obligations for complete discussion.	Marks-Roos Local Bond Pooling Act of 1985; Government Code Section 6584. See Marks-Roos Bonds section in Chapter 6, Types of Financing Obligations for complete discussion.	
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Typical Projects: Assisting local agencies with financing needs. Capital improvement bonds, bond pooling, and working capital or insurance programs.

Project Examples: Public buildings, stadiums, electric utilities, water and sewer treatment, airports, police stations, libraries, low income housing, mass transit, telecommunications.

Single Family Mortgage Revenue Bonds	Cities, Counties, Joint Powers Authorities, Housing Authorities	Revenue from project	Authorized through California Health and Safety Code. See Appendix D - Legal References - Table D-7-1 for specific issuers.	Authorized through California Health and Safety Code. For codes related to issuance procedure, see Appendix D - Legal References - Table D-7-1 .	CDLAC volume cap, various rent and income limitations
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Typical Projects: Below market loan programs for low to moderate-income families, acquisition, rehabilitation, and improvement of single-family homes.

Project Examples: Purchase mortgage loans originated by one or more lenders participating in the program.

Leases

Certificates of Participation / Financial Leases	Joint Powers Authority, Nonprofit Corporation, Leasing Company, Bank or Other Lessor	Rent	Instruments structured as lease, not classified as debt for purposes of debt limit and voter approval. See Appendix D – Legal References – Table D-5-1 for codes addressing authorization for specific issuers.	See Appendix D – Legal References – Table D-5-1 for codes addressing approval procedures for specific issuers	May be used for land and depreciable property
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Typical Projects: Public buildings. Only land and depreciable property that a public agency has statutory authorization to lease.

Project Examples: Educational facilities; irrigation, water, sewer, police, and fire facilities; transportation equipment.

INSTRUMENT	ISSUER	SECURITY	LEGAL AUTHORITY	ADMINISTRATIVE PROCEEDINGS	RESTRICTIONS
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Short Term Debt/Other

Commercial Paper	State, Local Agencies	General Fund	Issuer must have statutory authority to issue notes in an unlimited principal amount and sell in negotiated sale	Governing body adopts resolution authorizing the issuance	Denominations of \$25 million
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Typical Projects: Provide short-term working capital.

Project Examples: Operating expenses or capital project start-up costs.

Tax and Revenue Anticipation Notes (TRANS)	Public Agencies	General Fund	General and individual entity authorizations detailed in Government Code Sections 53820-53859.08	General and individual entity authorizations detailed in Government Code Sections 53820-53859.08	15-month maturity, 85 percent of estimated uncollected taxes, income, revenue, or other sources needed to repay notes
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Typical Projects: Fund cash flow deficits in a fiscal year.

Project Examples: Provide funds to cover operating expenses (salaries, miscellaneous expenses) for school districts.

Teeter Plan	Counties	Delinquent property taxes, fines, and penalties	California Revenue and Tax Code Sections 4701-4717	Teeter Plan Bond Law of 1994. Government Code Sections 54773–54783.
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Types of Projects: County financing of local agency's delinquent property taxes, fines, and penalties.

Project Examples: County acts as "bank" to local agencies and loans on delinquent property taxes and penalties.