

# **BEYOND THE CLOSING A Guide to Post-Issuance Compliance**

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Activities relating to a bond issue do not end at closing. This presentation will focus on ongoing compliance issues relating to outstanding indebtedness.

## **Closing Process**

- Purpose is to properly document the validity (and tax-exempt status) of the financing and to evidence compliance with applicable laws and regulatory requirements.
- The Closing Transcript (your roadmap to ongoing compliance).



Focus on three major topics:

- Federal Tax Law Compliance;
- Securities Law Compliance; and
- General Document Compliance.



## **Federal Tax Law Compliance**

Two key compliance issues:

- Private Activity
- Arbitrage



## **Private Activity**

The federal tax laws divide State and local government obligations into two categories – governmental purpose bonds and private activity bonds (“PABs”).



Interest on most PABs is not tax-exempt.

- Exceptions for certain types of users (501(c)(3) organizations).
- Exception for certain types of facilities (airports, solid waste disposal, multi-family housing, others).
- Exception for certain loan programs (single family housing, student loans).



PAB test is a two-part test.

- Private Use Test.
- Private Security or Payments Test.
- Special Rule for Private Loans.



Private Business Use Test is met if on more than 10% of proceeds of an issue is used in a private trade or business.



10% limit is sometimes reduced to 5% if private use is unrelated to government use.



## **What is Private Business Use:**

- Ownership of financed property by a private business user.
- Leasing of financed property by a private business user.
- Management Contracts can create private business use.



- Research Agreements – Contract to conduct research using bond financed property, based on facts and circumstances.
- Output Contracts - “take or pay” or reserved capacity contracts for output of utility property.
- Other arrangements that convey special legal entitlements for beneficial use of financed property similar to the rights conveyed in the arrangements mentioned above.



For property not available for use by the general public, private use may result solely on the basis of a special economic benefit to a private user, even if there is not a special legal entitlement.



What is Not Private Business Use:

Use as a member of the general public is not private business use.



Certain short-term arrangements are not private business use.

- 50-day (month to month) exception for leases.
- Incidental use (telephones, vending machines, advertising displays) that does not exceed 2.5% of the financed facility.



## **More About Management Contracts**

- Revenue Procedure 97-13 “safe harbor.”
- General Principle – is the City acquiring the management service, or going into business with the private manager?
- No sharing of “net profits.”



- Revenue Procedure 97-13 creates a “menu” of permissible arrangements, generally based upon compensation arrangements and length of term.
  - Shorter terms – more variable the compensation (percentage of gross revenues or expenses (not both), capitation fee, per unit fee).
  - Longer terms – fixed fees.
- Renewal option/terminations without penalties, or “evergreen contracts,” are generally permissible.



### **Measurement of Private Business Use**

- Compute private business use for the year, then average the years over the lifetime of the issue.
- Special rules for overlapping use, time of day use, etc.
- Some special rules have been created to measure use under naming rights agreements or similar arrangements.



## **Arbitrage**

- Rules relating to investment of bond proceeds pending expenditure.

## **Two Concepts**

- Yield Restriction; and
- Arbitrage Rebate.

## **Yield Restriction**

- Project Funds – generally 3 year temporary period (invest at unrestricted yield)
  - Contract to spend at least 5% of proceeds within 6 months;
  - Proceed with due diligence until completion; and
  - spend 85% of bond proceeds within 3 years
- Reserve Funds – Size limited to least of (1) 10% of bond proceeds, (2) 125% of AADS and (3) MADS.



## **Arbitrage Rebate**

- General Rule – Rebate to federal government investment earnings on bond proceeds above yield on bonds.
  - Generally paid every 5 years.
  - Final payment when bonds fully retired.



## **Rebate Exceptions**

- 2 years construction exception.
- 18 month expenditure exception.
- 6 month expenditure exception.
- Small issuer exception.



**EVERY ISSUER OF TAX-  
EXEMPT BONDS SHOULD  
KNOW**



Question 1.

Does the Issuer know how and when all the bond proceeds, including investment earnings, were invested and expended and does it have records to prove it?



What are the basic records that should be retained?

- *Basic records* relating to the bond transaction (including the trust indenture, loan agreements and bond counsel opinion);
- Documentation evidencing *expenditure* of bond proceeds;
- Documentation evidencing *use of bond-financed property* by public and private sources (i.e., copies of management contracts and research agreements);



- Documentation evidencing *all sources of payment or security* for the bonds; and
- Documentation pertaining to any *investment of bond proceeds* (including the purchase and sale of securities, SLGs subscriptions, yield calculations for each class of investments, actual investment income received the investment of proceeds, guaranteed investment contracts and rebate calculations).



How long should records be maintained?

As long as bonds are outstanding, plus three (3) years.



Question 2.

Is there any private use of the bond financed property? If so, does the Issuer have a program in place to track the private use and assure it stays within the permitted limits?



Question 3.

Did the Issuer meet an expenditure exception to arbitrage rebate and can it document it?



- Did the Issuer meet “small issuer” exception?
- Bond proceeds and the earnings on those proceeds must be spent within the required periods.
- Subject to certain “de minimis” exceptions.



#### Question 4.

Even if the Issuer met an expenditure exception to rebate for most of the bond proceeds, are other funds still subject to rebate?



- Reserve Funds.
- “Other” Funds.



Question 5.

If the Issuer did not meet a rebate exception, is it tracking rebate liability and is it making required rebate payments to the U.S. Treasury?



- Rebate paid every 5 years (may pay sooner).
- May want to reserve for a payment.
- Negative earnings can offset positive earnings.
- Utilization of rebate analysts.



Question 6.

Even if all rebate liability has been addressed, does the Issuer have yield restriction issues that should be addressed?



- Bond proceeds “yield restricted” after first 3 years.
- How do you yield restrict – yield reduction payments.
  - Very similar to computing rebate.
  - Yield restriction applies even if there is no rebatable arbitrage.
  - Yield restriction applies even if the Issuer meets \$5,000,000 exception.



## **SECURITIES LAW COMPLIANCE**



## **SEC Rule 15c2-12 Continuing Disclosure**

### Applicability

- Issue must exceed \$1,000,000;
- Does not apply to offering with \$100,000 denominations and
  - Sold to no more than 35 sophisticated investors; or
  - Maturity of 9 months or less; or
  - Subject to optional tender at least every 9 months (variable rate bonds);
- Other limited exceptions (typically not applicable).



### Condition to underwriter underwriting the bonds

- Contractual “undertaking” by issuer or obligated person.
- Undertaking must:
  - Identify person or persons for whom financial information and notice of material events will be provided;
  - Type of financial information and operating data to be provided;



- Accounting principles pursuant to which financial statements will be prepared and whether or not they will be audited; and
- The date by which the annual financial information will be provided and to whom it will be provided.



### Annual Disclosure of Financial Information

- File with Nationally Recognized Securities Information Repositories (NRMSIRs) and State Information Depository (SID), if any (currently no SID).
- File financial statements annually by date specified (file unaudited statements if audit not complete).



- File audited financial statement when and if available.
- Operating data (determined by Official Statement disclosure).
  - General obligation bonds and COPs (debt and tax information).
  - Revenue bonds (also include System operating information).



### Material Events Disclosure

- Eleven specified events:
  - Principal and interest payment delinquencies;
  - Non-payment related defaults;
  - Unscheduled draws on any 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 bonds;
- Modifications to the rights of the beneficial owners of the bonds;
- Bond calls, other than calls for mandatory sinking fund redemption;
- Defeasances;
- Release, substitution or sale of any property securing repayment of the bonds; and
- Rating changes.



- File with NRMSIRs or Municipal Securities Rulemaking Board (MSRB).
- Notices must be sent “if material” and “in a timely manner.”



### Other Requirements

- “Undertaking” must also include agreement to timely notify each NRMSIR or the MSRB and the appropriate SID, if any, of any failure to provide required annual financial information on or before date specified in the agreement.
- Official Statements must disclose any failure to comply in any material respects with any previous continuing disclosure undertaking within the previous 5 years.



### Electronic Filings

- Texas Municipal Advisory Council (MAC) at [www.disclosureusa.org](http://www.disclosureusa.org).
- Use of Digital Assurance Corporation (DAC).
- Future SEC-sponsored central repository.



### Other Ongoing Disclosure Requirements

- Duty to speak truthfully to the market.
- Voluntary disclosure.
- Ongoing disclosure obligations for variable rate issues.



### **General Document Compliance**

- Typically required by financing documents or credit/liquidity facility documents.



- Typical annual filing requirements (with LGC or Trustee):
  - Annual/quarterly filing of financial statements and annual budget.
  - Evidence of compliance with rate covenant (revenue bonds).
  - Insurance certificate filings.



- Conditions precedent to taking certain actions:
  - Redemption or defeasance of bonds.
  - Incurrence of additional debt.
  - Disposition of assets or other security.
  - Amendment of documents.
- UCC continuation statements and other UCC filings.
- Special bond insurer covenants.



## Best Practices

- Familiarize yourself with closing transcripts and keep them handy.
- Develop compliance checklists.
- Keep good records.
- Be aware of “red flags.”
- Prepare and provide for adequate transition of information when necessary.
- Rely on consultants for assistance (bond counsel, underwriters, financial advisors, rebate analysts, trustees).



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