

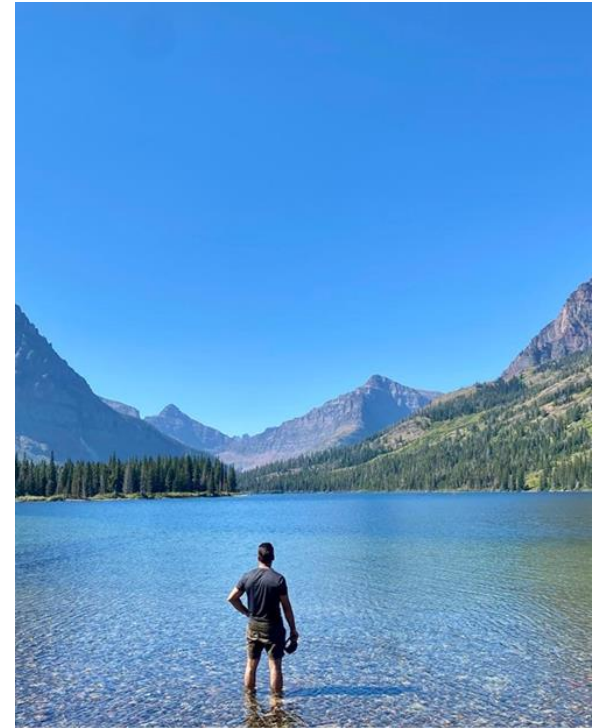
# Municipal Bond Compliance

New England States GFOA  
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# Topics Covered

1. Tax Compliance Obligations of Municipal Bonds
2. Best Practices to Achieve Tax Compliance
3. Securities Compliance Obligations of Municipal Bonds
4. Best Practices to Achieve Securities Compliance

# Standard Disclaimer

We cannot provide specific legal advice. We are providing general information only, and the information contained herein should not be relied upon without first consulting a licensed attorney.



# Cheaper With Tax-Exempt Bonds



- Tax-exempt bonds provide more favorable interest rates than other financing options
- Result of statutory law exempting interest on bonds issued by governmental units, nonprofits, and certain private entities
- Municipalities, school districts, utility districts, and other government entities often use tax-exempt bonds to finance infrastructure projects

# Tax Compliance Is Always An Issue



- Tax code limits the use of tax-exempt bonds to prevent abuses
- Compliance requirements apply to all tax-exempt borrowings

# Municipal Challenges



- Post-issuance tax compliance presents unique challenges to municipal officials
- Bonds can remain outstanding on facilities for many years
- These facilities must be monitored the entire time



# Possible Outcomes

## Bad

- Bond is no longer compliant with the Code
- Bond becomes taxable
- Bondholders sue issuer
- Issuer may have to pay difference between tax-exempt and taxable rate
- Other possible IRS sanctions

## Good

- No tax code violations
- Bond remains tax-exempt
- Even if violations occur, if they are identified quickly enough, it is possible to remediate the violations and the bond



# Private Use Restrictions



- IRS Code places a 10% cap on “private business use” of bond-financed assets
- Private business use is preferential use by a non-governmental entity who is not the issuer of the bonds

# Two Tests

## Private Use

- The “use test” prohibits a private user from using more than 10% of the bond proceeds in its trade or business

## Private Payments

- The “payments test” provides that no more than 10% of the debt service on the bonds may be derived from direct or indirect payments related to private use of the bonds

# Unrelated Use

- Use or payments which are “unrelated” to the bond-financed asset are capped at 5%
- Unrelated use is determined on a fact-specific basis which analyzes the purpose for which the bonds were intended and the nature of the allegedly unrelated use
- Unrelated use will also count towards the 10% maximum private business use limit

# Hypotheticals #1

- School builds new auditorium using tax exempt bonds
- School leases space at the auditorium to the following:
  1. A local business to show off an advertising banner during School basketball games;
  2. A private, youth basketball league to host a tournament over a weekend;
  3. New England States GFOA to host its annual conference;
  4. The Internal Revenue Service to teach classes to new IRS agents on the weekend.

Which of these are private business use? Are any unrelated use?

# Short-Term Exceptions



- There are three limited, short-term exceptions to private business use, each of which requires a number of requirements be met
- 50-day, 100-day, and 200-day exceptions

# 200-Day Exception

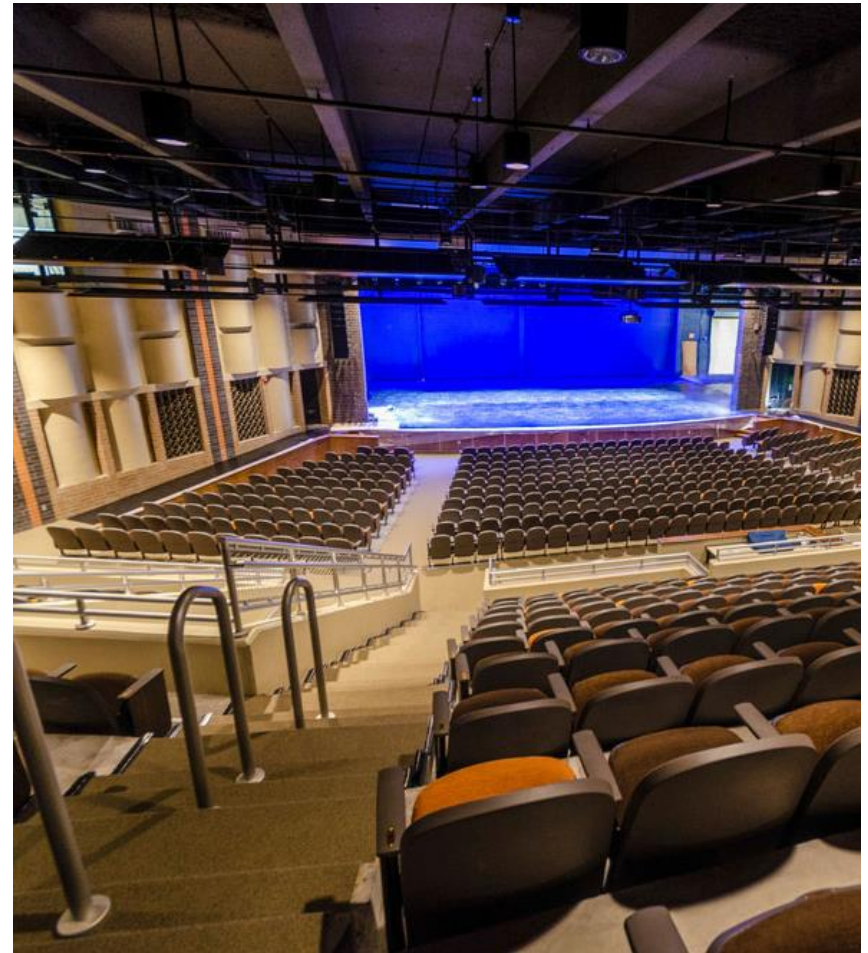


- Use of a bond-financed facility by an entity in its trade or business for less than 200 days, including all options for renewal, will not result in private business use, if:
  1. Other members of the public have the same type of access to the bond-financed facility; and
  2. Generally applicable rates must apply to potential users
  3. Different rates may apply to different types of users, but all rates must be reasonable and customary



# 100-Day Exception

- Use of a bond-financed facility by a private user for not longer than 100 days, including all options for renewal may also qualify for exemption from private business use, if:
  1. The property is not financed principally to provide it for use by that nongovernmental person





# 50-Day Exception

- Use of a bond-financed facility by a private user for not longer than 50 days, including all options for renewal, may be exempt from private business use so long as:
  1. the agreement for use was negotiated at arm's-length; and
  2. the compensation for the use is fair-market value



# Other Fun Stuff

## Naming Rights

- Special analysis for the sale of “naming rights” for bond-financed facilities
- No official or authoritative guidance from the IRS on this topic however, so much remains speculative

## Management Contracts

- What happens when the issuer hires a private entity to manage (includes many types of service contracts) their bond-financed facility ?
- A number of safe harbors must be satisfied in order to avoid potentially triggering a compliance violation

# Post-Issuance Tax Compliance

- Have a policy. Basically, a pre-requisite to issue a bond
- Designate and train a municipal official for compliance
- Good record retention
- Ongoing monitoring of bond-financed assets

# Practice Pointers for Practitioners

1. Is the user of the bond-financed facility a person or entity who is not the Issuer?
2. Is the private user providing either direct or indirect payments to the Issuer for such use?
3. Is the private user's use of the bond-financed facility inconsistent with the facility's purpose?
4. Is the private user's use of the bond-financed facility for a term of more than 100 or 50 days?

# Achieving Good Outcomes



- Ounce of prevention...
- Municipal officials are the first line of defense
- Any flag is a red flag
- Even if violations exist, remediation may be possible

# Securities Compliance



- Issuers who sell bonds on the public market are subject to SEC rules
- In 2014, the SEC stepped up enforcement actions against issuers in response to widespread noncompliance
- More active SEC enforcement action is here to stay

# SEC Cases Against Bond Issuers

- Ramapo, NY in 2016: SEC charged Ramapo, NY with securities fraud for fraudulently hiding the financial strain caused by a \$60 million baseball stadium. The town manager was charged with altering records of the town's operating fund to show positive cash flow when there was a deficit.
- Port Authority of New York in 2017: SEC charged the Port Authority of New York with failing to disclose internal legal memos about the Port Authority's power to legally issue \$2.3 billion in bonds.
- West Clark Community Schools in 2013: SEC charged West Clark Community Schools with falsely claiming in an official statement that it was fully compliant with annual disclosures.
- State of Rhode Island in 2016: SEC charged Rhode Island Economic Development Corporation with defrauding investors for failing to fully inform investors about a funding shortfall of the company.



# Relevant Securities/Anti-fraud Laws

- Material Misstatements: Section 17(A)(2) of the Securities And Exchange Act makes it unlawful “in the offer or sale of any securities...directly or indirectly...to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading”
- Negligence Can Still Be Fraud: Negligence is sufficient to establish a violation of Section 17(a)(2)
- Continuing Disclosures: Rule 15c2-12 requires an issuer to annually submit certain financial information

# What is Material?

- No definition of “material” in any SEC statute or rule
- No bright-line test
- Determinations are made based on the facts and circumstances of a particular issuer and situation
- Is there a...
  - Substantial likelihood that a reasonable investor would consider the information important in deciding whether or not to invest?
  - Substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of the information made available?



# Material Misstatements



- Violating Rule 10b-5 requires intention – an individual must have acted with the intent to deceive, manipulate, or defraud investors
- It is important to note that the defendant does not have to intend to steal from an investor
- The defendant must only possess the intent to omit a material fact in the offering materials
- Town of Ramapo, New York Case
  - Town supervisor and town attorney fraudulently hid the financial strain caused by a \$60 million baseball stadium as well as the town's declining sales and property tax revenues
  - They altered records of the town's operating fund to falsely depict positive balances during a six-year period when the town actually had a \$14 million deficit.
  - These false operating fund balances were included in the official statements of at least 16 municipal bond offerings

# Negligence

- Negligence = best characterized by the failure to conduct proper due diligence
- New York Port Authority Case:
  - The Port Authority offered and sold \$2.3 billion in bonds to investors despite internal concerns that the projects were outside its mandate and were not legal
  - One Port Authority memo noted, “[t]here is no clear path to legislative authority to undertake such projects”
  - Another memo explicitly identified “the risk of a successful challenge by the bondholders and investors” in connection with the funding of the roadway projects
  - The Port Authority, however, omitted any mention of these risks in its offering documents



# Continuing Disclosure

- Rule 15c2-12 prohibits municipal financial advisors from purchasing or selling bonds unless the issuer has agreed to provide continuing disclosure regarding its financial condition, operating data, and the bond itself
- The issuer's agreement to provide continuing disclosure is documented in the continuing disclosure agreements which accompany each public sale of a bond
- The SEC has interpreted this obligation to require that any final official statement prepared in connection with an offering of municipal bonds contain a description of any instances in the previous five years in which the issuer failed to comply, in all material respects, with any previous commitment to provide such continuing disclosure
- West Clark Community Schools Case



# Hypotheticals #2

Town issues bonds on the public market for the first time in 30 years. Excise taxes have declined by more than 50% over the last five years but represent only 2% of the Town's annual budget:

1. Are the declining excise taxes material and should the Town disclose them?
2. What are the possible repercussions if the Town Tax Collector does not think it matters and fails to bring it to the attention of the Town Manager/Municipal Financial Advisor?
3. What are the possible repercussions if the Town Manager says, "I do not think we need to disclose that fact, excise taxes are only a small part of our budget."

# Risks of Securities Noncompliance



- Barred from Participating in the Market: Subsequent disclosure problems identified by the SEC could result in a bar to participating in the municipal bond markets and/or substantial fines and penalties
- Personal Liability: Individual securities fraud liability for individuals responsible for material misstatements or material omissions
- Ratings and Interest Rates: Rating agencies and underwriters may lower issuers' creditworthiness



# Achieving Good Outcomes

- Adopt a Disclosure Policy
- Identify key disclosure obligations and tasks
- Designate a Disclosure Officer, allocate key tasks to individuals and working groups
- Team / collaborative approach is key



# THANK YOU!

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