Government Disclosures to Bondholders Face Greater Scrutiny

Kevin A. White

Government issuers of municipal bonds are facing greater scrutiny in the press, from rating agencies, from investors, and from rulemaking bodies like the Securities and Exchange Commission (SEC). The message from major bond investors is that the quality and breadth of issuer disclosures to bondholders is deficient, both in terms of disclosure at the time of the offering, and post-issuance continuing disclosure. The SEC echoed that view in a July 2012 Report on the Municipal Securities Market, which contained strong recommendations for broader direct SEC authority over municipal securities disclosure practices.

In recent years the SEC has targeted weak municipal securities disclosure through enforcement actions, and by exerting pressure on municipal market underwriters to strengthen their due diligence before taking bonds to market. Although the SEC tends to focus on the most egregious cases, it would be prudent for most municipal bond issuers to devote more resources to their disclosure policies and procedures. Rating agencies and bond investors view detailed, ongoing disclosure favorably, which can lead to better pricing for a local government’s bonds and, by extension, lower costs of funding capital projects. If the progress toward better disclosure in the municipal bond market is perceived by Congress or the SEC as being too slow, a day may soon arrive when municipal bond issuers become subject to stricter rules similar to those that apply in the private sector securities market.

Background on Municipal Securities Regulation

Issuers of municipal bonds have never been subject to the rigorous disclosure requirements imposed on corporate securities issuers by the Securities Act of 1933 (the 1933 Act). However, disclosures in connection with offering and selling an issuer’s bonds are subject to

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the antifraud provisions of the securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934 (the 1934 Act) and Section 17(a) of the 1933 Act. The SEC’s efforts to influence disclosure in the municipal bond market have mainly come in the form of enforcement actions following high profile defaults or scandals. In recent years the SEC has targeted issuers that have failed to adequately disclose the extent and effects of their underfunded pension liabilities in the course of offering their bonds to investors.

Because of the 1975 “Tower Amendment” to the 1934 Act, the SEC and the Municipal Securities Rulemaking Board (MSRB) are barred from direct prior regulation or approval of the form or

Chairman’s Message

Greetings to Section members from a new Chairman and a new Board of Governors. At each year’s Annual Meeting in Virginia Beach, the Section elects new Board members and officers effective July 1. Along with me, Bonnie France was elected as the Vice Chairman and Annie Kim as the Secretary. Leo Rogers will continue to serve on the Board as the Immediate Past Chairman.

The past year was an exceptionally productive year for the Local Government Law Section. Most importantly, we established the Virginia State Bar Local Government Fellowship as a way to nurture young attorneys with an interest in working in local government law. The Fellowship provided $4,500 to an outstanding first- or second-year law student who has committed to working full time (10 weeks, 40 hours/week) at a Virginia local government attorney’s office during the summer. In May 2013, the Board awarded the first fellowship to Mike Kaestner, who spent the summer working with Steve Micas in the office of the Prince George County Attorney. It sounds like Mike had an interesting summer learning a variety of local government topics. We’re hoping to share more of his experiences with you in an upcoming issue. Meanwhile, as local government attorneys begin thinking about hiring law clerks for summer 2014, keep this Fellowship in mind and encourage prospective interns/clerks to apply. We’ll continue to advertise the Fellowship – especially in the Spring – but meanwhile you can obtain information about it at http://www.vsb.org/site/sections/localgovernment-news/vsb-local-government-fellowship.

The Section also co-sponsored not one, but two panels at the Annual Meeting. One program, co-sponsored with the Real Property Section, discussed the recent eminent domain constitutional amendment. The other program, co-sponsored with the Construction Law Section, focused on the decision by the U.S. District Court for the Western District of Virginia in Carnell Construction Corporation v. Danville Redevelopment and Housing Authority et al. I was unable to attend the Annual Meeting because I had a high-school graduation to attend, but I heard praise for both panels.

I’m hoping the coming year can be as successful as the last one. We start out the year well, with several excellent articles focused specifically on local government law issues: Kevin White, with Kaufman & Canoles, has written on government disclosure to bondholders, and Jesse Bausch and Dan Siegel of Sands Anderson present an article on the basics of infrastructure finance in Virginia. We are also publishing the Annual Report from our Immediate Past Chair, Leo Rogers.

Erin Ward
Chairman
content of municipal bond disclosures. But since 1990, when the SEC adopted Rule 15c2-12 under the 1934 Act, the SEC has required the underwriters in most bond offerings to obtain written agreements from the issuer to make continuing public disclosures that are updated during the life of the bonds. Such disclosures must include annual financial information, audited financial statements and timely disclosure of certain listed material events. The SEC has thereby been able to achieve, indirectly, a degree of the regulation it cannot directly impose.

Rule 15c2-12 and EMMA
The SEC’s indirect regulatory efforts have been strengthened in recent years, including by certain amendments to Rule 15c2-12 that took effect in 2010. The 2010 amendments curtailed certain exemptions from the Rule, added to the scope of events that must be disclosed, and shortened the required period for disclosure of such events to a period “not in excess of ten business days after the occurrence of the event.” The occurrences required to be disclosed include, among others, payment delinquencies, material defaults, adverse tax opinions, material modifications to the rights of security holders, bond defeasances, credit rating changes, and the appointment of a successor bond trustee.

In the last few years the MSRB has established the Electronic Municipal Market Access system (EMMA) as the single required public depository of continuing disclosure filings by municipal bond issuers. All event notices and other post-issuance disclosures required by Rule 15c2-12 must be posted to EMMA, as should any voluntary disclosure that the issuer decides to release. It is expected that EMMA’s functionality will be enhanced and expanded in the future, and that it will be the repository for an expanded set of disclosures as regulations are strengthened.

It is clear that the SEC will not overlook an issuer’s failure to make continuing disclosure filings through proper channels such as EMMA. For example, in a recent settlement order with the City of Harrisburg, Pennsylvania, the SEC stated that, because of the city’s failure to release annual financial information and event notices in an acceptable fashion, investors had no choice but to rely on such information as the mayor’s “State of the City Address,” published on the city’s website, which substantially downplayed the city’s deteriorating financial condition.

The Increasing Importance of Due Diligence
Effective August 2, 2012, the MSRB adopted significant amendments to its interpretive guidance on Rule G-17, which governs the fair dealing obligations of municipal bond underwriters. As a result, underwriters now must provide to the governmental issuer in each new transaction written disclosures regarding the underwriter’s role, including that the underwriter is not acting as the issuer’s fiduciary and that the underwriter’s arrangement with the issuer is an “arm’s length transaction.” Some underwriters have developed lengthy documents to convey these points. Their length and complexity have sometimes been a burden to local government lawyers, but because they clearly designate the governmental issuer as having the chief responsibility for its own financing decisions and disclosures, they merit a close review and should be discussed with bond counsel, disclosure counsel and the issuer’s financial advisor.

The MSRB’s strengthened Rule G-17 guidance has led underwriters to increase their emphasis on pre-issuance due diligence. Document request lists and due diligence conference calls should now be expected in most transactions. Underwriters have especially focused their inquiries on whether the issuer has made timely continuing disclosure filings over the five years preceding the new issuance of bonds. In some cases, issuers have been asked to disclose in their Official Statements even simple technical failures like missing deadlines. If such past failures are severe and persistent, an underwriter may not be able to recommend the bonds, based on the likelihood of the issuer having Rule 15c2-12 compliance problems in the future. An underwriter may also face direct scrutiny from the SEC
and the Financial Industry Regulatory Authority (FINRA) for consistently failing to make these inquiries.

It is important to fully cooperate with underwriters and their counsel in the due diligence process. In competitive transactions, bond counsel or disclosure counsel should also make diligent inquiries in advance of bidding to properly prepare the preliminary disclosure documents (including the Preliminary Official Statement and the Notice of Sale). Issuers’ financial advisers should also permit (and, indeed, require) ample time in both negotiated and competitive transactions for due diligence to be completed. Allowing for such time should also be a key objective of a municipal bond issuer’s disclosure policies and procedures. After all, the Official Statement is the issuer’s document and the issuer is the most likely party to suffer legal and financial consequences if disclosure is incomplete or misleading.

SEC Recommendations for Stricter Regulation
The SEC released a “Report on the Municipal Securities Market” on July 31, 2012. The Report was the result of a series of public “field hearings” and other meetings and conference calls held throughout the United States by Commissioner Elisse Walter and SEC staff. Using such hearings and meetings, together with a variety of academic and statistical sources, the SEC produced a very detailed overview of the current state of the municipal bond industry and its participants. The Report also contained proposals for the SEC to be given significantly greater authority for direct regulation of municipal bond disclosure. Publication of the Report and its proposals was unanimously approved by the SEC’s five commissioners, which included three Democrats and two Republicans.

The SEC Report reflects a strong impression by market participants, particularly bond investors, that the quality and extensiveness of municipal bond disclosure is uneven and, in many cases, deficient. Participants in the field hearings raised particular concerns about the slow nature of the Consolidated Annual Financial Report (CAFR) process, the fact that many issuers do not adhere to Government Accounting Standards Board (GASB) standards in their financial reporting, a lack of in-depth disclosure on pension and other post-employment benefits (OPEB) funding obligations, a lack of clear disclosure on the use of interest rate swaps, and failures to disclose conflicts of interest among members of financing teams.

The Report’s recommendations on disclosure rules include proposals for broader legislative authority, as well as actions that could be taken by the SEC pursuant to its already-existing powers. The most aggressive recommendations are for Congress to grant the SEC the power to: (i) directly require that municipal issuers prepare and disseminate official statements and disclosure (instead of requiring underwriters to impose these requirements by contract); (ii) impose specific rules about the frequency and minimum requirements of disclosure (such as uniform standards for financial statements); and (iii) reorganize the statutory exemptions applying to municipal bond transactions to impose higher standards on conduit borrowers, such as manufacturing companies or 501(c)(3) organizations that issue debt through governmental authorities. The scope of any such disclosure rules would likely be tiered according to the relative size and market experience of municipal bond issuers. All of these measures would bring SEC regulation of municipal bond issuers closer to the level of scrutiny that the SEC currently exercises over public company issuers.

Another recommendation is for Congress and the SEC to provide improved safe harbors with respect to forward-looking statements in issuer disclosure, similar to what exists for corporate securities disclosure, to encourage the disclosure of projections deemed useful by bond investors. Current law imposes a duty to update projections unless specifically-tailored cautionary language is used, giving the issuer a limited safe harbor under the “beseaks caution” doctrine. Many issuers do not engage counsel when filing their financial statements in continuing disclosure reports, and may not be aware of the “bespeaks caution” doctrine.
Without stronger safe harbors, issuers might either avoid projections altogether or fail to publish clear qualifications and disclaimers when projections are used.

Short of congressional action, the SEC could make regulatory changes by amending Rule 15c2-12 to require underwriters to impose stricter disclosure requirements in the continuing disclosure agreements executed by municipal bond issuers. One of the Report’s recommendations is to further expand the list of “event notice” requirements in Rule 15c2-12, such as by including a requirement to report any issuance of new debt (including direct purchases of issuers’ bonds by commercial banks). Another recommendation is to require the MSRB to make further enhancements to EMMA functionality to include clearer and more timely trading and pricing information.

Voluntary Disclosure
Except pursuant to Rule 15c2-12 and the anti-fraud rules, federal securities laws generally do not require municipal bond issuers to provide ongoing information about themselves after selling a tranche of bonds. But with the advent of EMMA and the increasing market pressure and incentives described in this article, many issuers have undertaken to provide extra disclosure on a voluntary basis. Industry organizations such as the Government Finance Officers’ Association (GFOA) and the National Association of Bond Lawyers (NABL) have developed uniform suggested standards for primary offering disclosure and post-issuance voluntary disclosure. One example of such an industry initiative was described in NABL’s white paper entitled “Considerations In Preparing Disclosure In Official Statements Regarding an Issuer’s Pension Funding Obligations.” The paper was developed with input from a diversity of market participants following the SEC’s 2010 enforcement action against the State of New Jersey for failing to adequately disclose the extent of its unfunded pension liabilities.

If a municipal bond issuer undertakes to provide ongoing voluntary disclosure, it should implement procedures to assure that the disclosed information is properly reviewed before disclosure is made and that the included voluntary disclosure, when taken together with any required continuing disclosure, is not materially inaccurate or misleading. An issuer should also consider some or all of the following practices, among others: (1) appointing an investor-relations specialist; (2) maintaining records of all contacts with market makers, securities analysts and investors; (3) establishing a chain of appropriate officials and advisors that must review and approve information before it is released; (4) ensuring that content on the issuer’s website does not conflict with its formal disclosure materials; and (5) including disclaimers that limit responsibility for projections and information coming from third party sources.

Despite the presence of industry voluntary disclosure initiatives, which have improved and harmonized disclosure practices over the years, progress has been slow and uneven. In an October 2012 speech, SEC Commissioner Walter opined that voluntary disclosure programs are not consistently effective because they are likely to be among the first items on the “chopping block” in localities that need to find budget savings. In the view of Commissioner Walter and some market participants, voluntary initiatives are ineffective because they are unlikely to be vigorously or consistently followed by issuers. This does not mean they should be ignored by issuers, but such statements underscore the impression that greater regulation is on the horizon.

What Should Be Said, and Why?
SEC and MSRB rules and interpretations provide guidance on what types of information should be disclosed, with the emphasis being on what constitutes “material” information. The definition of materiality is well developed in securities law. Information is viewed as material if reasonable investors would consider the information to be important to their investment decision-making process such that they might have viewed the information as “significantly altering the total mix of
information available.” In the municipal bond market, information is viewed as material if investors would need to know it to fully evaluate and price the risks associated with the debt obligation.

Knowing this doctrine is helpful, but in practice the line of materiality is not always clear, and can shift with the fickleness of public opinion and ever-changing news headlines. In an era of significant fiscal uncertainty, what risks should be disclosed and how can an issuer keep its disclosure up to date? How much should local government issuers discuss the general economic risks caused by the failure of state governments to properly maintain transportation infrastructure, federal government budget problems and “sequestration,” or state legislatures’ perennial cuts to services that are traditionally delivered, or are required to be delivered, by local governments? In sum, to what extent (legally and practically) can local government finance officers be held responsible for the effects of uncertainty and political instability?

In an environment demanding better results with fewer resources, it can be easy to downplay risks in order to gain short-term benefits, particularly because the SEC can only scrutinize disclosure on a retrospective basis and tends to focus on the most egregious cases. It may also be tempting for advisors to short-cut the process to gain favor with overstressed issuer personnel. Perhaps for this reason, the Securities Industry and Financial Markets Association (SIFMA) recently issued a paper recommending that underwriters insist on disclosing in the Official Statement when an issuer insists on designating the firm that will serve as underwriter’s counsel for a bond issue. The implication is that SIFMA has observed less objectivity from underwriters’ counsel who have been, in effect, hired by the issuer and imposed upon the underwriter rather than allowing the underwriter to select its own counsel.

The risk of insufficient municipal bond disclosure is ultimately in the hands of the issuer. Although the public officials responsible for managing the disclosure process can and should enlist the assistance of outside counsel, it is improper to rely on outside advisors for uncovering information that is in the issuer’s control and is ultimately the issuer’s responsibility to disclose. In its March 2013 settlement order with the State of Illinois over the state’s insufficient disclosure of pension obligations, the SEC stated that Illinois should not have relied on prior “carryover” disclosures or “page-turn reviews” during group conference calls with attorneys and investment bankers. Instead, the state should have had stronger controls, policies and procedures to ensure that information was freshly assembled and evaluated as to its materiality.

Conclusion

Strong, timely disclosure practices and procedures are cited as beneficial factors by the credit rating agencies. Analysts assert that thorough disclosure can help issuers lower their borrowing costs and gain better access to credit markets. This may be more true today than it has ever been, and it will likely be true as long as America’s infrastructure financing model is based upon the purchase of government debt instruments by private investors.

It is clear that market demand and stronger legal and regulatory pressure are increasingly coalescing to require more rigorous municipal bond market disclosure practices. Local governments that intend to keep using municipal bonds as an important source of capital funding should focus immediately on improving their institutional policies to ensure better disclosure practices. Without such focus, issuers run the risk of being targeted for inquiries or enforcement actions by the SEC. A day may soon come when municipal bond issuers are subjected to the same level of scrutiny that the SEC currently exercises over private sector issuers. In the meantime, a sharper focus on good disclosure may provide tangible benefits to your jurisdiction.
Economic growth in any locality is always dependent to some extent on the quality of infrastructure in the locality. Businesses need good locations with good roads, water and sewer service and a solid internet backbone. They also need quality lifestyle – that means good schools, parks, libraries, diverse housing and other community benefits such as arts and recreational activities – to attract quality workers.

Unfortunately, while infrastructure needs for local governments continue to grow:

- the financial burden is increasingly being shifted to local governments as sources of funding at the state and federal levels shrink, especially relating to roads, and

- at the same time active local citizen groups are more frequently organizing to (1) oppose any sort of tax or revenue increase or (2) demanding improved facilities and services from their local governments.

Local governments often find themselves in a crunch where none of their constituents are particularly satisfied. If there isn’t investment in infrastructure, growth is stymied and, in turn, tax and other revenues stagnate or decline. Additionally, deferring long-term infrastructure projects due to short-term budget concerns can end up costing more overall than if they’d been done earlier.

Good financial planning and legal expertise are more critical than ever to maximize the infrastructure localities can finance on increasingly strained budgets.

### Evaluating Needs and Capacity

The first step in financing infrastructure needs is evaluating and prioritizing the locality’s needs. The locality’s capital improvements plan is the obvious starting point.

Active involvement of citizens in public meetings on essential infrastructure needs can provide education on the benefits of infrastructure investment and political support required to pay for it.

The next step is to evaluate the locality’s financial capacity. Many localities actively utilize their financing professionals in this analysis. Having a financial advisor as part of the locality’s team is generally advised.

The financial advisor will work with bond counsel and locality staff to evaluate questions such as “what’s the locality’s debt load relative to other similar localities? What is the prudent ratio of debt service to expenses? What’s the mix of short term to long term debt? Under state law, for cities and towns there is a hard debt cap of 10% of the assessed value of real estate in the locality. But many localities have even more restrictive financial policies. These are some of the questions that financial professionals along with locality staff can evaluate for the governing body.

For instance, one of the most important factors is how much unassigned fund balance the locality has available. If they have a lot of cash on hand, borrowing for smaller projects may not be needed. Yet localities can also unduly constrain themselves if they pay cash for everything.

National rating agencies look very favorably upon a healthy unassigned fund balance – it indicates that the locality has the foresight and flexibility to deal with a wide range of unforeseen problems – natural disasters, local emergencies, economic downturns, development opportunities among others – without threatening the financial stability of the locality.

Ultimately the locality’s staff and financial professionals will weigh in on the right mix of debt, debt service capacity and available cash and how the impact of the debt should be layered over time as outstanding debt is paid off, but it’s important for anyone dealing with local taxpayers to understand why “no taxes/no debt” may not
be the best solution for the long-term financial stability of a locality and its taxpayers.

Once the locality has identified projects and determined the most practical financing candidates, the next step is to determine your funding source. Fortunately there are a wide variety of options available to Virginia localities to finance infrastructure projects.

**Traditional Options for Financing**

Localities can avail themselves of a number of outlets to issue and sell their obligations to finance necessary projects. There is no single solution that works for every locality or every project. It’s important for localities to use the expertise of financial professionals, the bond counsel and financial advisor along with locality staff to evaluate the constantly changing financial marketplace to determine the appropriate option for financing. Some of the more traditional options are set out below:

- **Bank financing** – the locality, usually through its financial advisor, sends out a request for proposals to a variety of local, regional and national banks based on a requested principal amount and maturity, purpose and structure. The winner is generally selected based on the lowest cost of funds given the most flexibility as determined in consultation with the locality’s financial advisor and bond counsel. If the locality is able to take advantage of “bank qualified” financing, which limits annual tax exempt issues to $10 million per locality, then this option may be more attractive than others. This option can be done fairly quickly, but in the current financial climate, banks usually do not offer fixed rate loans longer than 10 or 15 years without requiring some sort of call by the bank or a rate reset.

- **Public markets** – The locality selects an underwriter, either on a negotiated basis or through competitive bidding, again, with assistance from its financial professionals and prepares a detailed offering document that describes the proposed financing, purpose and describes the County and its financial condition. The underwriter prepares the offering for sale of bonds on the public markets and agrees to purchase the bonds based on its sale. This approach is more time consuming and expensive than a bank financing since the locality will need to help prepare the offering document and work with rating agencies to get a rating on the locality’s debt. The benefit is that the locality has control over the structure, the flexibility of terms and can finance longer term, at fixed rates, up to 30 to 40 year debt. Once a locality is rated by the national rating agencies this option becomes easier to utilize in future financings. This is an often used approach when the locality has a single large project or a number of long term projects that can be combined to create an issue with a sizeable principal amount.

- **State level borrowing entities** – There are a number of entities created by the General Assembly which have financing programs for localities. The primary ones are the Virginia Public School Authority (which provides financing for public school facilities) and the Virginia Resources Authority (which primarily finances water and sewer improvements, but can also finance a wide variety of other projects).

Both VPSA and VRA offer pooled financings at least twice a year. These pool financings allow localities to obtain long term financing (VPSA and VRA issue long-term bonds in the public market and use those proceeds to make loans to pool participants) with the additional high credit ratings of these state entities and reduce borrowing costs by spreading them across multiple borrowers. The downside is that the schedule and structure of these pool borrowings may not be as flexible as the locality needs to meet its goals or to allow for refunding benefits in the future.
VRA also administers revolving loan funds for water and sewer financings which provide below-market rates for qualifying (usually relatively small) projects.

- Federal assistance – There are a number of federal programs which can assist in financing specific projects. The Rural Utilities Service provides grants and below-market rate loans for smaller localities, generally for water and sewer projects, usually for terms of up to 40 years. The federal Department of Housing and Urban Development also provides financing assistance for housing projects, usually in connection with the locality’s housing authority. These federal programs usually offer attractive long term fixed rates and grant assistance; however the scope of those projects is usually quite limited and the approval process can take a long time.

Once the locality has identified some likely sources for financing, then it’s time for bond counsel, the financial advisor and the local government’s attorney to help determine what form the locality’s financing obligation will take. There are a number of common financing avenues for localities in Virginia.

**Forms of Borrowings**

Set out below are several basic options for financing capital projects in Virginia.

**General Obligation Bonds**

General obligations bonds are the most straightforward way for localities to issue debt. They are obligations of a locality supported by a pledge of the full faith and credit of the locality to pay them. “Full faith and credit” refers to the general taxing power of the locality, meaning the locality agrees to raise taxes to make payments on the bond if necessary. General obligation bonds are governed by Article VII Section 10 of the Virginia Constitution and the provisions of the Public Finance Act (§ 15.2-2600 et seq. of the Code of Virginia of 1950, as amended). Under the constitution, any locality may issue a general obligation bond if the issue is put to referendum and approved by the voters of the locality.

Cities and towns may also issue general obligations bonds up to the 10% of aggregate assessed value as discussed earlier without referendum, after public hearing and approval by their council.

Counties, however, do not have the ability that cities and town have to issue general obligation bonds with only governing body approval, unless they elect (after a referendum) to be treated as a city for debt issuance purposes. The only exception is that county general obligation bonds may be issued for certain obligations sold to state agencies, such as VPSA and the Literary Fund, without a referendum.

**Revenue Bonds**

Revenue bonds are bonds issued by localities (cities and towns and counties) that are supported by a pledge of the revenues and receipts of some revenue generating undertaking. These revenue bonds can be issued without referendum by localities. Water and sewer revenue bonds are the most common, but solid waste system revenue bonds and parking revenues and are often issued as well. Any undertaking by a locality that generates non-tax revenue can be financed with revenue bonds; the practical issue is the bank’s, rating agency’s, or other lender’s evaluation of that particular revenue stream and its creditworthiness.

**EDA Lease Financings**

Lease financings are increasingly common for counties because of the referendum requirement for most county general obligation debt (but cities/towns occasionally use them as well). In an EDA lease financing, pursuant to Va. Code § 15.2-1800 et seq., the locality leases one or more of its properties to its local IDA/EDA. The EDA leases the property back to the locality and issues its bond to a lender (or underwriter) with the rental payments by the locality under the financing lease being equal to the debt service on the EDA’s bond.

The financing lease specifically provides that the lease
is subject to appropriation by the locality and is not supported by the full faith and credit of the locality. The EDA bond provides that it is solely payable from payments made by the locality under the financing lease, which, again, is subject to appropriation.

Since there is no pledge of the locality’s full faith and credit (or of any specified revenues), the financing lease is not debt for any constitutional purposes. The security for a lender is the ground lease – this is assigned to the benefit of the lender, so if the locality fails to pay, the lender can take over the pledged real estate for the term of the ground lease (usually the term of the financing lease plus 5-10 years) and of course, the creditworthiness of the locality.

**Equipment Lease Financings**

In recent years, many localities have turned to direct lease financings with lenders to fund for a variety of equipment purchases. No referendum is required for this financing. The most common currently are for E-911 system equipment and for equipment related to energy performance contracts. Here the locality undertakes a financing lease directly with a lender. The equipment lease is subject to appropriation by the locality, but the lender does have a security interest in the equipment. There is no EDA bond, just a lease of equipment directly with the locality. It is difficult for localities to do leases of real estate directly with lenders due to a variety of legal requirements, but most of these do not apply to equipment leases. This option allows localities to finance a variety of equipment for up to usually around 10-15 years.

**Other Financing Vehicles**

There are a variety of other options available to localities to finance specific infrastructure projects. Community development authorities (CDAs) have become popular in the last decade as an option to allow localities to assist private landowners in the financing of public infrastructure related to private development. Under the CDA statute (Va. Code § 15.2-5152 et seq.), a CDA may be created by the petition of landowners in a specified area to assist in financing various public infrastructure (water, sewer, roads, parks, etc.). The obligations of the CDA typically are ultimately paid by special assessments agreed to by the landowners and their successors. Therefore the burden for payment of the CDA obligations used to finance public improvements falls on the landowners themselves. There are a number of CDA financed projects over the last few years that have had difficulties due to the economic downturn and it’s important for localities to have their financial professionals involved with these financings to avoid adverse effects on the locality in the future. Localities may also establish service districts (Va. Code § 15.2-2400 et seq.) for similar projects/services, but service districts are not quite as flexible as CDAs and need the involvement of an EDA or the locality to issue bonds; however, service districts do give the locality more control over the projects financed than CDAs since the governing body of the locality serves as the governing body of the district.

**Use of Proceeds and Federal Tax Issues**

While a full discussion of the federal tax laws governing tax-exempt issues is outside the scope of this article, there are a few basic provisions to be aware of. The first is private use. The Internal Revenue Code restricts the use of proceeds of tax-exempt issues to uses by local governments. That mean generally that a locality may not loan bond proceeds to a private entity or use proceeds to finance a facility that is to be used primarily by a private entity. If the IRS determines that a bond issue meets the private use tests, the issue may be consider taxable retroactively to the date it was issued. Specific application of these regulations should be discussed with bond counsel, but generally it is important to be aware of any private entities that may benefit in a special way from a tax-exempt bond issue (other than the benefit that the general public may receive).

The other tax issue to be aware of is arbitrage. The Internal Revenue Code generally restricts the investment of tax-exempt bond proceeds to the yield on that bond issue. The concern is that local governments might
issue bonds at lower tax-exempt rates and then just put the money in investments that earn at a rate higher than the rate on the bonds. The tax exemption provisions were established to facilitate local financing of capital projects; the IRS has established strong regulations to prevent localities from using tax exemption as a way to earn profits. Again, the specific application of these rules will need to be discussed with bond counsel, but generally the locality needs to be aware that they will at best break even on investments (and in the current market, not even that).
Below are five important practice points to keep in mind for those representing localities in finance transactions:

1. **Public hearing.** Is a public hearing required? What are the notice requirements? Most bond issues under the Public Finance Act require a public hearing that has been advertised in a local newspaper (such notice describing the nature of the projects to be financed and the expected maximum principal amount) once a week for two successive weeks with the last notice not less than six or more than 21 days before the date of the public hearing (Va. Code § 15.2-2606). The notable exceptions which require no public hearing are refunding bonds (Va. Code § 15.2-2643), county bonds approved by a referendum (Va. Code § 15.2-2606(B)), and short-term revenue or tax anticipation financings (Va. Code §§ 15.2-2629 and -2630). Also, most lease financings do not require a public hearing, but depending on the structure and, in the case of cities and towns, the governing charter, something more may be required.

2. **Approval Requirements.** What is required to approve the financing? Generally under the Public Finance Act, only a majority is required. Obviously a quorum at the meeting following the public hearing is needed, but additionally some charters require more than a majority approval for borrowings and leases. Also, for a lease financing the approval of the local economic/industrial development authority will likely be needed.

3. **File it!** Under § 15.2-2627 of the Public Finance Act, the only time to challenge a resolution or ordinance authorizing a bond issue is within 30 days of the filing of such adopted resolution/ordinance with the circuit court. After 30 days if no challenge is filed, the authorization and any bond or other financing documents related to it are conclusively presumed to be valid. You can save yourself an incredible amount of headache by filing the adopted resolution/ordinance as soon as possible.

4. **Real estate?** In a lease financing, lenders will often want to see the deeds into the locality, plus a basic title search, any liens, financing statements, etc. Title insurance is overkill even with the most conservative lenders since the locality can typically use eminent domain if needed. But an opinion or other letter from the locality counsel may be requested. Some lenders also have environmental questionnaires as well, but these are usually no more burdensome than something akin to a Phase I environmental. Please note that any environmental indemnity (or any other indemnity for that matter) is generally not enforceable under the Virginia constitution because they constitute an unqualified promise to pay. Locality counsel will typically be asked to handle recording of lease documents, so make sure bond counsel/bank counsel provide clear direction on how they would like documents to be recorded.

5. **Opinions.** In a straightforward general obligation issue, locality counsel will often be asked to provide a simple certificate as to the adoption and validity of the resolution rather than a full blown opinion. In more complex transactions, locality counsel will usually be asked to opine as to the resolution/ordinance and as to the authorization, execution and validity of any major financing documents. Often they will also be asked to opine as to noncontravention (no other agreements or rulings which the financing would violate) and no litigation related to the issue or that may materially affect the locality’s financial ability to perform. If there is bond counsel, you will not be asked to opine as to the validity and enforceability of the bond itself – that will be covered in the bond counsel opinion. The opinion of locality counsel is usually limited to Virginia law. Specific provisions of federal law – securities law and/or the Internal Revenue Code – are almost never addressed by locality counsel. If a lender requests an opinion regarding such issues, please contact your bond counsel to discuss whether or not they are appropriate.
Membership:
As of June 17, 2013, the Local Government Section had 637 members.

Budget:
The budget for fiscal year 2012-13 was $9,680. The budget for fiscal year 2013-14 is $9,616.

Annual Meeting CLE Programs:
The Local Government Section sponsored two continuing legal education programs at the VSB Conference in Virginia Beach. The Friday morning session was co-sponsored with the Real Property Law Section and was entitled, “Eminent Domain Constitutional Amendment – Cheers and Jeers.” The afternoon session was co-sponsored with the Construction Law Section and was entitled, “Carnell Construction Corporation v. Danville Redevelopment and Housing Authority, et al; Lessons from the Front Lines on Administering and Litigating Public Construction Contracts.” An informal lunch was promoted by the Section and was well attended by members.

Journal on Local Government Law:
The Section electronically published all four quarterly issues of the Journal in a timely manner. The Journal remains a law review quality publication on current legal issues facing practitioners of local government law. The Journal had articles on the topic of eminent domain, constitutional law, legislation, real property rights, financing and bonds, transportation, the appellate process, storm water management, construction contracts, working with FEMA, zoning litigation, limiting damages in construction cases, and how to enter the practice of local government law.

Significant Issues:
The Section started electronically sending the Journal to its members last year. The savings from printing and mailing costs helped to fund a fellowship program for law students with an interest in working in local government law. A standing subcommittee has developed criteria for the program. After an application process, the fellowship was awarded to Michael F. Kastener, who will be working this summer for Steven L. Micas, Esquire, in the Prince George County Attorney’s Office.

The Section has been using its webpage to keep members informed about activities of the Section and happenings in local government law.

Officers and Members:
The Officers for 2012-2013 were: Leo P. Rogers, Chair; Erin Ward, Vice Chair; and Bonnie France, Secretary. Roderick R. Ingram was immediate past chair. King George County Attorney, Eric Gregory served as a new Section member.

At the Sections annual meeting on June 14, 2013, the Section elected the following officers: Erin Ward, Chair; Bonnie France, Vice Chair and Annie Kim, Secretary. The Section members also voted to approve Bonnie France and Annie Kim to serve a second term.
**Virginia State Bar’s Local Government Fellowship**: The Board of Governors is pleased to announce that Michael Kaestner has been selected to be the 2013 inaugural recipient of the Virginia State Bar’s Local Government Fellowship. The VSB Local Government Fellowship was created in 2012 to attract promising future attorneys to the practice of local government law by providing a monetary award to an outstanding 1L or 2L Virginia law student working as a summer intern in a local government attorney’s office in the Commonwealth. Mr. Kaestner is a second-year student at the William & Mary School of Law and is interning this summer at the Prince George County Attorney’s Office. Prior to law school, Mr. Kaestner worked for several years as a manager of legislation and policy at the Virginia Economic Development Partnership in Richmond, Virginia. More information about the VSB Local Government Fellowship is available at http://www.vsb.org/site/sections/localgovernment-news/vsb-local-government-fellowship.

**Bibliography & Back Issues Notice**: A bibliography of all articles published in the *Journal of Local Government Law* may be accessed at the Section’s website: http://www.vsb.org/site/sections/localgovernment/view/Publications/. Local Government Section members have website access to back issues at the same site. The username is lgmember and the password is Kdqp38fm (reset August 8, 2012).

**Notice to Members**: The Board voted at its January meeting of the 2011-2012 fiscal year to deliver the *Journal* to members by electronic distribution only beginning with the 2012-2013 fiscal year. If you become aware that as a member of the Local Government Section you are not receiving *Journal* via email, please contact the *Journal* Editor, Susan W. Custer, at susan.custer5@gmail.com.
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2013-2014 Board of Governors

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