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The *McDonnell* Case and Its Impact on Federal Corruption Law

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The Stakes

The conviction of former Governor Robert McDonnell and his wife on September 24, 2014, for alleged honest services fraud and Hobbs Act extortion, sent shock waves through the ranks of Virginia state and local officials. From the outset, the Government conceded that Governor McDonnell and his wife had not violated state laws but nevertheless claimed they had violated federal corruption statutes by performing official acts in exchange for various loans and gifts from Virginia businessman, Jonnie Williams.

In particular, the Government alleged that Governor McDonnell performed five "official acts" which became the focus of the trial and subsequent appeal. The indictment described them as follows:

(1) arranging meetings for [Williams] with Virginia government officials, who were subordinates of the Governor, to discuss and promote Anatabloc [a nutritional supplement developed by a Williams' company];

(2) hosting and . . . attending events at the Governor's mansion designed to . . . promote Star Scientific's products. . .;

(3) contacting other government officials. . . as part of an effort to encourage Virginia state research universities to initiate studies of anatabine;

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Chairman's Message

I hope the holiday season is as joyous and beautiful throughout the Commonwealth as it is in the Great Southwest. Our Fall *Journal* includes two impressive articles on Private Activity Bonds and the Supreme Court's decision in the *McDonnell* case.

I had been County Attorney for about two weeks when a company approached our IDA about issuing seven million Dollars in private activity bonds. Needless to say, I wondered what I had gotten into and felt a little over my head. I was just getting a grasp on the whole IDA concept at the time. I worked my way through it. My biggest break was discovering that the bond attorneys do most of the work. But I wanted to understand it in and out, being new.

I am not sure I ever achieved the level of understanding I wanted. What I did learn is that this is an excellent economic development tool for localities. When Kevin White suggested an article on private activity bonds and volunteered to bring the article to fruition, I had a post traumatic flash back and wished that then I had had the benefit of a concise description of how these bonds work.

Last summer I went to Virginia Beach and learned two things. The Chesapeake is still cold in June and Bob McDonnell is going to walk. The showcase seminar on the *McDonnell* case was enlightening. The Supreme Court's ruling was not a surprise to anyone who attended. I believe this case is of particular importance to local government attorneys, in that high-profile cases often set the bar for local government officials' unofficial conduct.

After McDonnell was indicted, our office received calls from our local officials about everything they received, even door prizes at Rotary dinners. Those have dropped off since the Supreme Court's decision. In the meantime, the COIA has changed at least three times and our office has bombarded our local officials with ever changing forms. This does not go over well with persons who volunteer their time for appointed positions on boards that already get more blame than glory in the local press. I have been telling them there are even more changes coming. I think this article dissects the Court's decision, so we can anticipate the direction of the next wave of changes to COIA.

Beyond this issue of the *Journal*, I wanted to take this opportunity to discuss due process in the enactment of local ordinances. When we enact our ordinances here, we run the ads in the local paper and post the ordinance at the Courthouse. Posting in Tazewell County means our Court Clerk and me with stick pins in the wall beside the deed room. Our newspaper is a weekly, so we very carefully count our days to be sure we meet the publication deadlines. Sure, we post on our webpage too. But it is not exactly Facebook.

After posting an ordinance earlier this year, I was walking out of the courthouse and passed about twenty or more residents. Some sat. Some stood. Some paced. All were staring at their phones, those so suddenly ubiquitous phones. I am confident none read the ordinance I posted. I suspect the same is true of the newspaper ads.

Is it really due process to post these ordinances and advertise in places we know the public does not actually see? Is it time to move forward with other media? After all, we live in a world where people register to vote at the DMV because we do not expect them to find the courthouse, but we expect them to read local ordinances there. We also live in a world where our phones beep if school is called off for snow or if our football team scores. But if our neighborhood is being rezoned we have to find a newspaper.

I believe we, as local government attorneys, need to start thinking about how ordinances are going to be enacted ten years from now. There are profound consequences for the democratic process when proposed changes to law are advertised by antiquated means. How many times has your governing body enacted an ordinance without a peep by the public, only to fill the meeting room with angry voters after it becomes law?

We need to consider changes for the twenty-first century. Should the statute require comments to be accepted electronically in addition to being voiced in a public hearing? Should the code require ordinances be advertised by texting to residents of the locality on their phones? What social media should be required to be used to advertise changes to the laws by which we live? I respectfully submit that the local government attorney's bar should look at this issue.

That concludes my soapbox stand for this issue. I hope this issue of the *Journal* is helpful to you and that you all have a happy holiday season.

Eric Young
Chairman

(4) . . . allowing Williams to invite individuals important to Star Scientific's business to exclusive events at the Governor's mansion; and

(5) recommending that senior government officials in the [Governor's Office] meet with Star Scientific executives to discuss ways that the company's products could lower healthcare costs.

McDonnell v. United States, 136 S. Ct. 2355, 2365–66 (2016) (internal quotation marks omitted).

Three things were most concerning to elected officials. First, the definition of "official acts" urged by the Government, and adopted by the trial court, included routine political activities such as attending ceremonial events and setting up meetings with constituents. "The Government concludes that the term 'official act' [] encompasses nearly any activity by a public official . . . includ[ing] arranging a meeting, contacting another public official, or hosting an event—without more—concerning any subject." *Id.* at 2367. Second, the Government's theory did not require that those "official acts" be performed or even explicitly identified, it was enough if the official agreed to perform "unspecified future action." *United States v. McDonnell*, 64 F. Supp. 3d 783, 793–94 (E.D. Va. 2014), *rev'd*, 136 S. Ct. 2355. In the Government's view, even the first "steps to exercise influence or achieve an end" would be sufficient. *McDonnell,* 136 S. Ct. at 2366. Third, the jury was instructed that it could infer a corrupt agreement from circumstantial evidence, such as the temporal relationship between any gifts or loans to the McDonnells, on the one hand, and any actions taken to benefit Williams on the other. *McDonnell*, 64 F. Supp. 3d at 793–94.

The case spawned an impressive group of amicus briefs, nearly all on the side of Governor McDonnell and his wife. Six former attorneys general of Virginia—Democrat and Republican—signed a brief saying that none of them "would have concluded that any of these actions—all involving access or speech—constitute 'official actions' within the meaning of the federal statutes used by prosecutors here." Amicus Brief of Former Va. Attorneys General in Support of Petitioner at 7. Attorneys general from other states concurred: "Dangling the threat of criminal liability over every lunch with a lobbyist and every meeting with an interest group would impede the proper functioning of state and local governments." Amici Curiae Brief of 77 Former State Attorneys General (Non-Va.) Supporting Petitioner Robert F. McDonnell at 18. A brief filed by former federal officials, including two former attorneys general, one former solicitor general, and lawyers who served as White House counsel or counsel to the President during every administration dating back to Ronald Reagan, predicted that the defendants' convictions, if allowed to stand, would "cripple the ability of elected officials to fulfill their roll in our representative democracy by understanding and serving the needs of their constituents." Brief of Former Fed. Officials as Amici Curiae in Support of Petitioner at 7.

The Fourth Circuit heard the case on May 12, 2015, and a three-judge panel unanimously upheld the conviction.[1] *United States v. McDonnell*, 792 F.3d 478, 520 (4th Cir. 2015), *rev'd,* 136 S. Ct. 2355. Rehearing was denied and Governor McDonnell applied for an emergency application to stay the mandate prior to reporting to prison. For the first time since the passage of the Bail Reform Act of 1984, the Supreme Court granted such a stay pending appeal. Ultimately, the court granted certiorari and the case was argued on August 27, 2016.

Oral Argument

At oral argument, the justices expressed concerns with the Government's broad interpretation of "official action." They pressed attorneys for both parties, searching for a test—"I am looking for the line," as Justice Breyer phrased it—that would put officials on notice about what is allowed and what is not. Transcript of Oral Argument at 38.

Chief Justice Roberts was clearly swayed by the amicus briefs. He referenced one such brief less than a minute into the Government's argument:

> [T]here's an extraordinary document in this case, and that's the amicus brief filed by former White House counsel to President Obama, former White House counsel to President George W. Bush, former White House counsel to President Clinton, former White House counsel to George H. W. Bush, former White House counsel to President Reagan. And they say, quoting their brief, that 'if this decision is upheld it will cripple the ability of elected officials to fulfill their role in our representative democracy.'
>
> Now, I think it's extraordinary that those people agree on anything. . . But—but to agree on something as sensitive as this and to be willing to put their names on something that says this—this cannot be prosecuted conduct. I think is extraordinary.

Id. at 28–29.

Justice Breyer was the most animated justice during questioning. At one point, the Government argued that it would "send a terrible message to citizens" if the defendants' definition of official action was adopted. *Id.* at 39. Breyer's response was telling: "And I'm not—you say it sends a terrible message. I'm not in the business of sending messages in a case like this. I'm in the business of trying to figure out the structure of the government." *Id.* at 47.

That structure, in Justice Breyer's view, required a precise and workable definition for what constituted an official act. Counsel for Governor McDonnell suggested that it must include either an exercise of actual government power or, at the very least, trying to influence such an exercise. *Id.* at 14 ("But I think the line has to be . . . you're actually either

[1] Maureen McDonnell's case was severed from Governor McDonnell's case at the Fourth Circuit Court of Appeals due to scheduling issues. After the three-judge panel upheld Governor McDonnell's conviction, the court requested separate briefing regarding the arguments unique to Maureen McDonnell. Prior to the Fourth Circuit decision on her case, certiorari was granted by the Supreme Court on Governor McDonnell's case and Mrs. McDonnell's case was stayed pending the outcome of that appeal.

making a decision . . . or you're urging someone else to do so."). Justice Breyer pushed back on even that test:

> But wait. The word 'influence' is too broad, because every day of the week politicians write on behalf of constituents letters to different parts of the government, saying, will you please look at the case of Mrs. So-and-so who was evicted last week? And that's so common, you can't pick that up.

Id. at 15.

The Justices tossed around various hypotheticals including fishing trips, lunches, and expensive bottles of wine—"the lunch with the Chateau Lafite wine. . . that's worth, like a thousand dollars, or 500, anyway." *Id.* at 34. They were troubled by the Government's position that the only limit on whether a public official's acts constituted "official action" was whether the jury could infer a corrupt *quid pro quo* from the circumstances. Justice Kennedy prompted a chuckle when he said: "You're going to tell the senators, the official with the lunches, that, don't worry. The jury has to be convinced beyond a reasonable doubt, and that's tough." *Id.* at 37.

The clear takeaway from oral argument was that the justices worried about the vagueness of the Government's approach ("political figures will not know what they're supposed to do and what they're not supposed to do, and that's a vagueness problem," *id.* at 32) as well as the potential for unbridled prosecutorial discretion. Accordingly, the Court's opinion would draw some fairly bright lines around the definition of "official action," providing guidance to public officials and limitations for prosecutors.

Framing the Issues

The Court looked at two main issues. The first was whether the district court properly instructed the jury about what constituted "official action." *McDonnell*, 136 S. Ct. at 2367. At the Government's request, for example, the trial court told the jury that official action "encompasses 'acts that a public official customarily performs,' including acts 'in furtherance of longer-term goals' or 'in a series of steps to exercise influence or achieve an end.'" *Id.* at 2366.

Defense counsel had requested limiting instructions which would have informed the jury that "merely arranging a meeting, attending an event, hosting a reception, or making a speech are not, standing alone, 'official acts,' even if they are settled practices of the official, because they 'are not decisions on matters pending before the government.'" *Id.* This limiting instruction was denied. *Id.* Defense counsel also asked for an instruction explaining that an official act must influence, or at least intend to influence, a specific official decision the government actually makes, such as awarding a contract, hiring a government employee, issuing a license, passing a law, or implementing a regulation. *Id.* That instruction was rejected as well. *Id.* The first issue then, was whether the instructions as a whole were overly broad, thereby including within their ambit "virtually all of a public servant's activities. . . no matter how minor or innocuous" and allowing a public official to be convicted on the theory that he agreed to perform some "future unspecified action." *Id*. at 2367.

The second issue was a sufficiency challenge. Defense counsel argued both that the five acts specified in the indictment could not constitute "official acts" as a matter of law and that, even if they could, the evidence at trial did not support any attempt to influence an official decision or action. *Id.* at 2375.

Official Action

The Court[2] began its analysis by reciting the definition of "official action" set forth in the federal bribery statute:

> Any decision or action on any question, matter, cause, suit, proceeding or controversy, which may at any time be pending, or which may by law be brought before any public official, in such official's official capacity, or in such official's place of trust or profit.

18 U.S.C. §201(a)(3). The Court analyzed three separate aspects of the statute, each limiting the scope of an official act in a significant way.

Official Action Requires a "Formal Exercise of Governmental Power"

First, the Court focused on the type of action that the statute proscribed, i.e., it must be on a "question, matter, cause, suit, proceeding or controversy." The last four words in the list—cause, suit, proceeding or controversy—"connote a formal exercise of governmental power, such as a lawsuit, hearing, or administrative determination." *McDonnell,* 136 S. Ct. at 2368. Applying the interpretive maxim that "a word is known by the company it keeps," *id.*, the Court held that the first two words in that list—a "question" or "matter"—must also refer to a formal exercise of governmental power that is similar in nature to the other categories, *id.* at 2369. Thus, a typical meeting, call, or ceremonial event did not qualify, without more, as a "question," or "matter" because it did not constitute a formal exercise of governmental power. *Id.*

Official Action Must Be Focused and Concrete

The second limitation on official action sprung from the statutory language that required the question or matter to be "pending" or "may by law be brought before" a public official. *Id.* That language suggested something focused and concrete—the kind of thing that, in the words of the Court, "can be put on an agenda, tracked for progress, and then checked off as complete." *Id.*

At trial, the district court accepted the Government's argument that the matter "pending" was "Virginia business and economic development," or, as it was put to the jury—Bob's for jobs. *Id.* This did not pass muster under the "focused and concrete" test. "Economic development is not naturally described as a matter 'pending' before a public official. . . any more than 'justice' is pending. . . before a judge. . ." *Id.* at 2370.

On appeal, the Fourth Circuit had suggested three alternative matters "pending" that did pass the Supreme Court's focused and concrete test: (1) Whether researchers at any of Virginia's state universities would initiate a study of Anatabloc; (2) Whether the state-funded Tobacco Indemnification and Community Revitalization Commission would allocate grant money for the study of anatabine; and (3) Whether the health insurance plan for state employees would include Anatabloc. *Id.*

But that did not end the analysis. The question still remained whether Governor McDonnell made any decision or took any action "on" those three matters. *Id.*

Official Action Requires More Than Merely Setting Up a Meeting, Hosting an Event or Calling Another Official

The third limitation arose from the meaning of making a decision or taking action "on" a matter. Citing *United States v. Sun Diamond Growers of Cal*., 526 U.S. 398 (1999), the Court rejected an expansive definition that would include merely setting up a meeting, hosting an event, or calling another official regarding a matter. *McDonnell*, 136 S. Ct. at 2370. Even if an event, meeting, or speech is related to a pending question or matter, something

[2] The opinion was unanimous, authored by Chief Justice Roberts.

more is required for official action. The statutory definition requires action "*on*" a question or matter [rather] than just preliminary activities that are a routine part of a public official's duties. *Id.* (emphasis in original).

For example, "setting up a meeting, hosting an event, or calling an official . . . merely to talk about a research study or gather information" about a research study "does not qualify as a decision or action *on* the pending question of whether to initiate the study." *Id.* at 2371. Additionally, "expressing support" for the research study at a meeting or event "does not qualify as a decision or action" on the study. *Id.* Particularly under the facts of this case, where no public officials testified that Governor McDonnell pressured them to take any action on behalf of Jonnie Williams, those routine duties of office holders could not qualify as official action.

On the other hand, an actual decision or action on a qualifying step in setting up a research study, such as narrowing down the list of potential applicants, may qualify as a decision "on" the matter. *Id.* at 2370. Moreover, if a public official uses his position to pressure another public official to take concrete action or provides advice that will form the basis for an official act by another public official, those activities can also qualify as a decision or action "on" a matter. *Id.* And finally, a public official is not required to actually make the decision or take the action "on" a matter if he agrees to do so. *Id.* at 2370–71. Such an agreement can be proven by circumstantial evidence. *Id.* at 2371.

In sum, an official act does not occur unless (1) a public official makes a decision or takes action "on" a matter before him or (2) uses his office to exert pressure on another official to perform an official act or (3) advises another official, knowing that his advice will form the basis for an official act.

Sufficiency Challenge

Having found that the district court did not properly instruct the jury, the Supreme Court turned to the sufficiency issue. It noted that no subordinates of Governor McDonnell testified that he asked them to do anything other than attend meetings; there was no pressure to take further action for Williams. *Id.* at 2374. "If that testimony reflects what Governor McDonnell agreed to do at the time he accepted the loans and gifts from Williams, then he did not agree to make a decision or take an action on any of the three questions or matters described by the Fourth Circuit." *Id.* But, ultimately, the Supreme Court expressed "no view" on the question of whether the evidence was sufficient under its newly articulated parameters for "official action." *Id.* at 2375. Instead, it remanded the case to the Fourth Circuit with instructions to determine whether there was "sufficient evidence for a jury to convict Governor McDonnell of committing or agreeing to commit an 'official act.'" *Id.* If the appellate court decided that sufficient evidence existed, the case could be set for a new trial. *Id.*

After remand to the Fourth Circuit, and after prosecutors spent three months reviewing the evidence in light of the Supreme Court's opinion, the U.S. Attorney moved to dismiss the case with prejudice. Unopposed Motion to Remand for Dismissal at 1, *United States v. McDonnell*, 792 F. 3d 478 (2015) (No. 15-4019). On September 23, 2016, that motion was granted. Order at 1, *United States v. McDonnell*, No. 3:14cr12-JRS (E.D. Va. Sept. 23, 2016).

Federal Corruption Statutes in a Post-*McDonnell* World

The *McDonnell* case was notable both for what it changed and for what it left unchanged. While the unanimous Court reframed the definition of "official action" for *quid pro quo* corruption cases, it left a number of unanswered questions concerning the "quid" and "pro" parts of the equation.

Quid: "In for a penny, in for a pound"

At oral argument, the Government was adamant that the size of the "quid" did not matter. Any gift or favor, including a simple lunch or fishing trip, was sufficient to support a *quid pro quo* deal. In the words of Justice Breyer: "The [G]overnment has argued continuously that in for a penny, in for a pound. Okay? So, we don't have the limitation on the quid side." Transcript of Oral Argument at 31.

For example, the Assistant Solicitor General was not willing to concede even a *de minimis* exception for an afternoon of trout fishing:

> Justice Breyer: What's the lower limit, in the Government's opinion, on the quid? What? Tell me right now. What—if you're going to say $10,000, okay, I feel quite differently about this. If you will say an afternoon of trout fishing or et cetera., then I feel quite differently about this. . . .
>
> Mr. Dreeben: It's not the Government's—
>
> Justice Breyer: What is the Government's position—what—you tell me if I'm wrong, in for a penny, in for a pound. You tell me right now it is not the Government's position that the trout fishing afternoon is sufficient to be a—a quid. If you say that, I'll feel differently about the case.
>
> (Laughter)
>
> Mr. Dreeben: It's tempting, Justice Breyer, but I'm not going to—
>
> Justice Breyer: Exactly.
>
> Mr. Dreeben: —exempt from the corruption laws—
>
> Justice Breyer: Okay.
>
> Mr. Dreeben: —certain types of quids.

Id. at 45–46.

It is certainly true that a larger quid may provide increased ammunition at trial to convince a jury that a corrupt agreement existed. But, as the Court noted in its opinion, "the Government's legal interpretation is not confined to cases involving extravagant gifts or large sums of money, and we cannot construe a criminal statute on the assumption that the Government will 'use it responsibly.'" *McDonnell*, 136 S. Ct. at 2372–73 (quoting *United States v. Stevens*, 559 U.S. 460, 480 (2010)).

It is also important to note that campaign contributions are treated the same as gifts or favors received by a public official while in office.

> Justice Alito: [A]nd I know that this case doesn't involve campaign contributions. But certainly, a campaign contribution can be the quid, can it not?
>
> Mr. Dreeben: Certainly.

Transcript of Oral Argument at 40.

As noted by the Court in its opinion, the Government viewed "nearly anything a public official accepts—from a campaign contribution to a lunch—[] as a quid …" *McDonnell*, 136 S. Ct. at 2372. Nothing about the *McDonnell* case changed that.

Pro: The Agreement Need Not Be Explicit

Similarly, the *McDonnell* opinion did little to change the law regarding the "pro". The Court noted that, to prove corruption, the prosecutors did not have to prove that the public official actually made a decision or took action, "it is enough that the official agreed to do so." *Id.* at 2371 (quoting *Evans v. United States*, 504 U.S. 255, 268 (1992)). The agreement does not need to be explicit and the public official does not need to specify the means she will use to perform the bargain. *Id.* Even if the public official has no intention of actually performing the official act, if she agrees to do so the "pro" has been satisfied:

> It is up to the jury, under the facts of the case, to determine whether the public official agreed to perform an 'official act' at the time of the alleged *quid pro quo*. The jury may consider a broad range of pertinent evidence, including the nature of the transaction, to answer that question.

Id. at 2371.

As Justice Kennedy noted at oral argument, "you can imply an agreement over time. You can imply a contract over time. And if the lunch takes place first and there's--there's no precondition on the lunch, but after the lunch there is a wink-wink, nod-nod, and the contract takes place, it's clear in the standard of criminal law that there is a conspiracy there." Transcript of Oral Argument at 35.

All of this means, with regard to the corrupt agreement aspect of the *quid pro quo*, that standard conspiracy principles apply. The agreement need not be explicit (and in most cases, will not be), the means need not be specified, and the agreed upon action need not be carried out. It is, for public officials, an element of the crime with few safeguards other than the requirement that a jury believe beyond a reasonable doubt that an agreement existed. As Justice Kennedy noted during oral argument in the *McDonnell* case, that limitation provides little solace.

Quo: "Official Action" Has Real Limitations

In light of the virtually limitless reach of the "quid" and the guilt-by-implication possibilities for the "pro" element of the equation, as discussed above, the Court recognized the need to limit the "quo" so that public officials would not "be subject to prosecution, without fair notice, for the most prosaic interactions." *McDonnell*, 136 S. Ct. at 2373. By its limitations on the reach of official action, the Court's "more constrained interpretation" was designed to avoid a "vagueness shoal." *Id.*

Accordingly, the Court placed the three limitations on official action discussed above. First, the action must involve the formal exercise of governmental power. *Id.* at 2372. Second, the matter or question before the public official must be focused and concrete rather than a broad policy objective like economic development. *Id.* And third, the government official must make a decision or take an action (or agree to do so) on the identified matter or question rather than merely setting up meetings, attending ceremonial events, or performing other common constituent services. *Id.*

But even as the Court provided its limitations on the definition of official action, it still left a lot of gray on the margins. For example, public officials need not actually carry out the acts; it is enough if the official agrees to do them at some point in the future. Moreover, the official does not have to perform the official action himself, it is enough if he pressures someone else to do so. And all of this can be proven by circumstantial and indirect evidence, like any other conspiracy.

So, while the *McDonnell* opinion placed important restrictions on the Government's unbounded definition of "official action," it still left some areas of federal corruption law murky. Anyone who accepts a campaign contribution, enjoys a fine glass of wine at a constituent's expense, or relaxes on a trout fishing trip should take note.

Conduit Issues of Qualified Private Activity Bonds: "What's The Deal?"

Kevin A. White

As a local government attorney, you are probably familiar with tax-exempt bonds issued by your locality to finance such governmental facilities as public schools, utilities, and courthouses. You may be less familiar with qualified private activity bonds issued by your local economic development authority or housing authority. Such bonds may be issued on behalf of private entities such as non-profit hospitals or retirement communities, private schools and colleges, affordable housing developers, and small manufacturing companies. You may be called upon by members of those authorities, or your elected board of supervisors or council, to advise on whether your locality can or should serve as a conduit issuer of qualified private activity bonds.

Local governments and their related political subdivisions have the authority to issue tax-exempt bonds. Under Section 103 of the Internal Revenue Code of 1986, as amended (the "IRC"), a taxpayer's gross income does not include interest on any state or local bond which is not (i) a private activity bond, other than a "qualified bond," (ii) an arbitrage bond, or (iii) a bond that is not in registered form. This article does not discuss "arbitrage bonds" or "registered form," but focuses only on qualified private activity bonds. Because the borrower's bond counsel will be focused on technical questions related to use and expenditure of bond proceeds, this article does not cover all of those details. Instead, this article is designed to help you understand the threshold considerations for determining whether your local authority may and should entertain requests for issuing qualified private activity bonds.

A private activity bond is defined in IRC Section 141 as a bond which meets certain tests relating to private (non-governmental) use, private security or private payment. For example, a bond issued by a local government to finance construction of a for-profit business's corporate headquarters would not, in and of itself,[1] qualify as a tax-exempt bond under federal tax laws. (It would be a non-qualified private activity bond.) However, there are certain types of private activity bonds which may be tax-exempt if they are "qualified bonds." IRC Section 141(e) lists several categories of "qualified bonds," the most commonly used of which include: (i) exempt facility bonds for residential rental housing (usually paired with low-income housing tax credits), airports, port facilities, or other specific categories; (ii) bonds for small manufacturing facilities having a limited amount of capital expenditures over a 6-year test period; and (iii) qualified 501(c)(3) bonds issued to finance facilities of 501(c)(3) organizations such as hospitals, retirement communities, museums, private colleges, real estate foundations associated with public universities, or private elementary and secondary schools.

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"Why Does My Government Need to be Involved?"

One question that may arise when private entities ask your government to serve as a conduit issuer of bonds is: why does my government need to be involved? Certainly private colleges, hospitals, or museums could obtain conventional loans from banks, or maybe even issue and sell corporate bonds of their

[1] There may be ways to finance the infrastructure around such a facility with tax-exempt bonds, but those approaches are beyond the scope of this article.

own. However, it has proven more efficient for these businesses, most of which advance some public policy goal by private means, to access the tax-exempt bond market for their financing. This is because purchasers of tax-exempt bonds pay a premium, either through a higher purchase price or lower interest rates (or both), for the benefit of holding bonds which will pay them tax-free interest. A borrower in a qualified private activity bond structure thereby enjoys a lower cost of capital for its projects. Your locality is asked to be involved because accessing the tax-exempt bond market requires a bond issuer that is a public body or political subdivision.

In Virginia, political subdivisions such as economic development authorities or redevelopment and housing authorities have broad powers to be "conduit issuers" of qualified private activity bonds. For example, when an industrial or economic development authority (hereinafter referred to as an "EDA") serves as a conduit issuer of bonds for a non-profit hospital, the bonds are technically issued by the authority, but all payment obligations on the bonds are undertaken by the hospital. The authority (and the local government with which it is associated) bear no liability. In return for simply approving the bond issue and serving as a pass-through entity in the transaction, federal tax law allows a governmental authority to charge the borrower an annual administrative fee of up to 0.125% of the outstanding principal amount of the bonds. All legal fees and other closing costs of the bond issue must also be paid by the borrower, including but not limited to the fees and costs of the EDA's counsel.

Even though a conduit issuer of qualified private activity bonds has limited liability and is entitled to full indemnification by the conduit borrower, since 1982 federal tax law has required that, to be tax-exempt, a qualified private activity bond must be approved by the applicable elected body of the issuer's government unit after there has been a properly noticed public hearing. These public hearing and elected body approval requirements are known as the "TEFRA" requirements, given that they were introduced into the IRC by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The TEFRA hearing and approval requirements apply to qualified private activity bond issuances that finance new projects, but do not apply to any refinancing in which the average maturity of the bonds is not extended. Under Virginia law, an issuing authority such as an EDA must hold the TEFRA hearing, and the elected body (e.g., the city council or the county board of supervisors) must provide its approval within 60 days after such hearing has been held at the authority level.

"Who is Benefiting from This?"

The rationale for the continued existence of qualified private activity bonds is that Congress has determined that the private entities borrowing under qualified private activity bond structures are serving public purposes that should be subsidized by means of the tax-exemption. The abbreviated list of qualified private activity bond purposes given above (e.g., for affordable rental housing, small manufacturing companies, healthcare, and education) reflects the distinct public policy preferences of current law in this area.[2]

In a similar way, Virginia's Industrial Development and Revenue Bond Act, at Title 15.2, Chapter 49 of the Virginia Code of 1950, as amended (the "Virginia Code"), describes a broad array of public purposes that an EDA may promote through bond issuances. Authorities can issue bonds to finance the following types of projects, for the public purposes described below (and if such purposes align with federal tax-exempt bond authority, interest on the bonds may be exempt from federal income taxation):

> (i) Properties to promote industry and develop trade by "inducing manufacturing, industrial, governmental, nonprofit and commercial enterprises and institutions of higher education to locate in or remain in the Commonwealth and further the use of

[2] By comparison, prior to the 1986 amendments and recodification of the federal tax code, the categories of allowable subsidized private activities were significantly broader.

its agricultural products and natural resources," thereby benefiting inhabitants of the Commonwealth, "either through the increase of their commerce, or through the promotion of their safety, health, welfare, convenience or prosperity";

(ii) Pollution control facilities, to "protect and promote the health of the inhabitants of the Commonwealth and the conservation, protection and improvement of its natural resources";

(iii) Medical facilities and facilities for the residence or care of the aged, to "protect and promote the health and welfare of the inhabitants of the Commonwealth";

(iv) Facilities for use by organizations (other than institutions organized and operated exclusively for religious purposes) which are described in § 501(c)(3) of the IRC, to "protect or promote the safety, health, welfare, convenience, and prosperity of the inhabitants of the Commonwealth";

(v)Facilities for private, accredited and nonprofit institutions of collegiate education in the Commonwealth whose primary purpose is to provide collegiate or graduate education and not to provide religious training or theological education, to "protect and promote the health and welfare of the inhabitants of the Commonwealth";

(vi) Facilities for museums and historical education, demonstration and interpretation, for use by nonprofit organizations "to promote tourism and economic development in the Commonwealth, to promote the knowledge of and appreciation by the citizens of the Commonwealth of the historical and cultural development and heritage of the Commonwealth and the United States and to promote thereby their health, welfare, convenience and prosperity";

(vii) Facilities devoted to the staging of equine events and activities (other than racing) for use by governmental or nonprofit, nonreligious organizations, to "promote the equine industry and equine-related activities (other than racing) which are integral to the Commonwealth's economy and heritage and to promote thereby the safety, health, welfare, convenience, and prosperity of the inhabitants of the Commonwealth"; and

(viii) In localities where housing authorities have not been established, facilities used primarily for single or multi-family residences to "promote safe and affordable housing in the Commonwealth and to benefit thereby the safety, health, welfare and prosperity of the inhabitants of the Commonwealth."

If a borrower approaches an EDA to serve as a conduit issuer for a project within any of these broad categories, the authority should feel comfortable agreeing to participate. Occasionally, a public commenter will question the policy basis for such involvement. For example, they may ask why a local government authority is issuing millions of dollars of bonds for a private school, when the locality's own public schools are under budgetary stress. The answer to that question is two-fold: (1) that the local government is not, in fact, incurring any obligation on behalf of the borrower, but is merely serving as a conduit to the tax-exempt bond market, and (2) that the public benefit to the private school is coming from the federal government through subsidies inherent in the qualified private activity bond legislation, and not through any local subsidy.

"So, Now You Want My Allocation?"

One of the more confusing twists on the qualified private activity bond structure is bank-qualified (BQ) bonds for 501(c)(3)s. Although many banks seem to have a strong demand for BQ bonds, not all qualified 501(c)(3) bonds or governmental bonds purchased by banks are required to be "bank-qualified" (hence, the descriptor is somewhat misleading). Banks may purchase bonds that are not bank-qualified ("non-BQ" or "NBQ" bonds). BQ bonds, however, provide a double benefit for the bank holder which, in turn, benefits the conduit borrower.

As with any tax-exempt bond, the interest on a BQ bond is exempt from income taxation. But BQ bonds, unlike most tax-exempt bonds, can be partially included by banks in their cost of carry deduction. IRC Section 265 states that when a bank purchases and holds a tax-exempt bond in connection with a bond-financed loan, the bank cannot deduct its cost of carry of such bond (in contrast to its ability to deduct cost of carry for loans that are not in the form of tax-exempt bonds). However, Section 265(b)(3) of the Code contains an exception to that loss of cost of carry rule, allowing banks to deduct 80% of the carrying cost of a "qualified tax-exempt obligation," or BQ bond. BQ bonds purchased directly by a bank provide a very competitive low interest rate alternative for governmental or 501(c)(3) borrowers because, in a competitive market for loans, banks pass along to the borrower a healthy portion of this double tax benefit.

BQ bonds were created to incentivize bank lending to small governmental or 501(c)(3) borrowers. They may only be issued by "qualified small issuers," which are defined in IRC Section 265(b)(3) as issuers which, when aggregated with the jurisdiction on behalf of which they issue bonds, together with all other similar issuers in the jurisdiction, do not expect to issue more than $10,000,000 in total principal amount of tax-exempt bonds for the benefit of government or 501(c)(3) borrowers in the applicable <u>calendar</u> year of the BQ bond issue.[3] Qualified small issuers in Virginia therefore tend to be in rural areas.

If a borrower contacts an EDA with a request to issue BQ bonds, the EDA should communicate with the local government's finance director to determine whether the local government has issued, or intends to issue, any tax-exempt bonds during the calendar year. The EDA and the finance director should also examine whether the EDA or any other authorities of the locality have issued, or plan to issue, any bonds on behalf of other 501(c)(3)s during the calendar year.[4] All governmental and qualified 501(c)(3) bond issuance (whether it is BQ or NBQ) counts against the $10,000,000 limit. Because of this aggregation of bonds issued in a calendar year, it is unusual for an EDA established in a city or a suburban county (which are frequent issuers of bonds) to qualify as a small issuer. Conduit borrowers located in those localities may consequently request a BQ small issuer from another jurisdiction to intervene and serve as the conduit issuer.

The last paragraph of Virginia Code Section 15.2-4905 permits an EDA to issue bonds for projects located outside the EDA's local jurisdiction so long as the governing body of the jurisdiction where the financed facility is located concurs with the EDA's participation in the transaction. With new projects, the jurisdiction where the project is located will also need to conduct a TEFRA hearing and grant TEFRA elected body approval even if its EDA is not the issuer of the bond. Some bond counsel require assurance that the EDA issuing a BQ bond has a "nexus" with the project being financed, such as geographical proximity, or residents that travel to or from the other jurisdiction for work or services. These extra-jurisdictional approvals and related questions should be addressed by the borrower's bond counsel, and are not the direct responsibility of the EDA or its attorneys.

Conclusion

Serving as a conduit issuer of qualified private activity bonds through your EDA or similar authority, and charging an annual administrative fee of up to 0.125%, is a good way to obtain an extra revenue source for local services. An EDA may be able, if permitted by the local board of supervisors or council, to use those revenues to establish economic development

[3] In contrast to "volume cap" (a subject for another day), the $10 million is not an allocation as such, but is a limitation that establishes small issuer status.

[4] Note that the BQ measurement period is the "calendar" year, not the fiscal year, of the locality.

incentives or loan programs to develop local business. A housing authority may be able to use those revenues to advance its mission of improving housing in the jurisdiction.

As a local government attorney, you may be faced with questions from board members or the public about the jurisdiction's role in qualified private activity bond transactions. Although the state and local laws and regulations applying to qualified private activity bonds are complex, in sum the responsibility and liability of the local authority are limited. So long as a borrower does not propose a BQ bond that conflicts with the locality's own borrowing plans in a calendar year, EDAs and their counsel should usually be comfortable with being involved in a qualified private activity bond issue.

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