PUBLIC FINANCE BANK LENDING AND DIRECT PURCHASES

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Introduction

- Purchases of obligations of state and local governmental entities and nonprofit corporations
- Tax-exempt and taxable
- Special issues for lenders

Governmental Entities

State Law Authority to Borrow

- Cities, counties, school districts, hospital districts, many others
- The Dillon Rule – (1) powers expressly granted by the state; (2) powers necessarily and fairly implied from the grant of power; and (3) powers crucial to the existence of local government
- Home Rule – authority for local governments to pass laws to govern themselves
- Types of Obligations – general obligations (GO bonds; tax notes; etc.), revenue obligations, lease-purchase obligations

Federal Tax Law Requirements

- Must be an obligation under section 103 of the Internal Revenue Code
- Must be an obligation of a state or political subdivision (i.e. have sovereign powers or act "on behalf of")
- Must not be a private activity bond (i.e. no private business use and no private payment/security)
- Must not be an arbitrage bond; must be in registered form; must not be federally guaranteed
- Weighted average life of obligations cannot exceed 120% of weighted average economic life of financed assets
- Arbitrage/rebate rules: can earn arbitrage during temporary period; any arbitrage earnings must be rebated to federal government unless a rebate exception is met
- Must file an IRS 8038-G

Federal Securities Law

- Exempt from registration requirements
- Subject to anti-fraud provisions (statements to investors usually through an offering document)
- Continuing disclosure (Rule 15c2-12)

Special Issues for Bank Lending

- Limitations on state law for types of debt and collateral
- Limitations on "standard" loan provisions: default rate, event of taxability, indemnification, arbitration, yield protection
- Limitations on remedies
- Third-party paying agent: presentation and surrender of bond for payment
- Rate locks
- Typically the issuer will have a financial advisor and bond counsel

Non-Profit Entities

Non-Profit Entities

- Private schools, universities, colleges, hospitals, museums, many others
- Not limited in powers as compared to governmental entities
- Requires a conduit issuer (state or local government unit)
- Conduit issuers are created by states, cities and counties

Federal Tax Law Requirements

- Must be a qualified 501c3 financing; project must be a capital project and owned by the nonprofit
- At least 95% of proceeds must be used by non-private business users in furtherance of the nonprofit's charitable purpose; 5% of private use includes 2% cap on costs of issuance (excess paid by cash or financed with taxable debt)
- Any management contract covering any portion of the project must be a qualified contract (reasonable compensation may be fixed or variable; no percentage of compensation may be based on net profits and management party cannot bear the burden of any net losses)
- Tax Equity and Fiscal Responsibility Act (TEFRA) requirements: publication of notice of hearing; public hearing; governmental approval
- Weighted average life of obligations cannot exceed 120% of weighted average economic life of financed assets

Federal Tax Law Requirements (cont'd)

- Arbitrage/rebate rules: can earn arbitrage during temporary period; any arbitrage earnings must be rebated to federal government unless a rebate exception is met
- Replacement proceeds: capital campaign proceeds may be treated as bond proceeds if specific to financed project.
- Liquidity covenants: must be reasonable and tested not more frequently than semiannually
- Reimbursement: must establish intent by adopting a reimbursement resolution; exceptions include de minimis and preliminary costs

Establishment Clause

- Cannot finance facilities primarily used for sectarian instruction, places of religious worship or divinity schools
- Can allocate equity or finance using taxable debt

Special Issues for Bank Lending

- Pledge of cash and/or investments
- Real estate collateral: usual issues involving diligence, survey, title insurance
- Liquidity covenants: must be reasonable and tested not more frequently than semiannually

General Bank Issues

Government vs. Nonprofit Differences

- Governmental deals usually involve a financial advisor and are fixed rate deals
- Governmental entities usually cannot enter into loan documents
- Governmental entities usually cannot pledge real estate or cash
- Governmental deals usually don’t include provisions such as indemnification, increased costs, acceleration, default rate, taxability gross-up, change in corporate tax rate, financial covenants, extensive events of default

Loan vs. Security

- Obligation usually held in loan portfolio
- Structuring issues such as no offering document, single term bond, single interest rate, no DTC book-entry (i.e. physical delivery), no CUSIPs, bank acts as its own paying agent, no ratings (bank performs its own credit analysis)

Public Bond vs. Bank Deal

- Public Bond Advantages:
  - lower rates
  - longer maturity
  - less covenants
- Bank Deal Advantages:
  - lower closing costs
  - less deal parties (no offering document)
  - faster timing
  - flexibility in structures such as variable rates, advancing for construction
  - more flexibility in future amendments
  - more privacy/no continuing disclosure

Bank Qualified (Qualified Tax-Exempt Obligation)

- For a Bank Qualified (BQ) deal, the bank can deduct up to 80% of its interest cost.

  Taxable Rate > Non BQ Tax-Exempt Rate > BQ Tax-Exempt Rate

- Borrower/Issuer and any conduit issuer must not issue more than $10 million of tax-exempt debt in a calendar year

Recent Issues

- LIBOR Transition
- Disclosure of bank deals: Rule 15c2-12 amendments

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