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PUBLIC FINANCE AND BORROWING

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Towns have historically borrowed very little, particularly when compared with other units of government. Increasingly, however, they are faced with large capital acquisitions, infrastructure projects, and similar costs that towns cannot simply pay for on a cash basis.

Although towns do have authority to assist in financing privately-owned projects, this type of activity, while it shares many characteristics with purely public finance, also has its own set of rules and, for the most part, is outside the scope of the following discussion. Whenever the town is looking to publicly finance or borrow for a project, the town should always consult their town attorney and financial advisor.

I. Types of Financing

The number of ways in which towns can finance projects is enormous, but many of them apply to only a few situations. One can separate the most widely used financing mechanisms into smaller categories.

A. General Obligation Bond[1]

A general obligation bond promises the full faith and credit of the issuing governmental unit for payment of principal and interest. A pledge of full faith and credit is a promise to use all assets and resources of the town, including the unlimited power to tax, to fulfill the town's agreement to pay back the bond. Because this type of bond promises all the town's resources toward repayment, it is the most secure type of bond for banks to purchase, thus providing the town a lower interest rate. Towns should use these bonds only for smaller projects because of the risks of tying up all the town's resources toward repayment of the bond.

B. Revenue Bond

Revenue bonds pledge to pay the bond owner a principal amount and interest, only from certain defined revenues. Often, these bonds generate revenue by the facility financed by the bond proceeds. No general obligation pledge is involved. Minnesota Statute Chapter 475 does not explicitly define these types of bonds. In some cases, however, the law may permit any bond that usually promises "net" revenues (that is, "gross" revenues less operating and maintenance expenses) or a gross revenue pledge; these are revenue bonds.

Typically, municipalities will use a revenue bond for self-supporting utilities, such as health care facilities, electric utilities, recreational facilities, and municipal liquor stores. However, there may be cases in which, for example, special assessment revenues, or water or sewer revenues, are pledged without a concurrent general obligation pledge.

The issuing town gives the owner additional assurances in the bond documents that it will operate the facility efficiently and impose the necessary charges for the use of the facility to

[1] Minnesota Statutes, Chapter 475 sets out the general rules for municipal borrowing in Minnesota.

ensure prompt and full payment of the bond. The town also gives the holder rights to enforce those assurances, or "covenants," as they are known. Revenue bonds typically carry higher interest rates than general obligations because of the higher risk of nonpayment.

C. General Obligation Revenue Bonds

A general obligation revenue bond promises a revenue stream as the primary means of repayment, and the town's full faith and credit if the revenue stream is insufficient to make the bond payments. This arrangement often results in more favorable interest rates than can be obtained for a pure revenue bond because the bond investor looks primarily to the general obligation pledge in analyzing the underlying credit. The most common types of usage for these bonds are for sewer, water, and storm sewer utilities.

D. Certificate of Indebtedness[2]

A certificate of indebtedness is little more than a general obligation bond subject to specific special rules. Unlike many other kinds of general obligation borrowing, there is not an election requirement before its issuance. However, if the amount of the certificate exceeds 0.25% of the town's market value, a reverse referendum can be triggered by a petition of the voters. The term of a certificate is limited to no more than ten years.

E. Lease-Purchase Agreements[3]

Towns may enter into lease-purchase agreements to acquire real or personal property. The lessor applies the lease payments to the purchase price and associated interest cost of acquiring the capital asset. The town has the right to acquire the property at the end of the lease term for a nominal sum and may typically prepay the lease at certain times during its term. Significantly, the town must retain the right to terminate the agreement at the end of any fiscal year during its term. This right to non-appropriate must not expose the town to any penalty (such as a cancellation charge or the loss of property owned outright by the town) that would make it impossible or overly burdensome for the town to cancel the contract. Generally, the town is the lessee, and either a bank or another governmental entity is the lessor.

F. Warrants[4]

For many years, warrants have been proposed as a form of short-term financing for towns struggling with cash flow issues; in other words, as a sort of tax anticipation note, or even more simply, an "I-owe-you." There is little clarity about their history and validity,[5] and to make matters worse, statutes on different types of public financing have not evolved in conjunction

[2] Certificates of indebtedness are described in Minn. Stat. § 366.095.
[3] Lease purchase agreements are authorized by Minn. Stat. § 465.71.
[4] Tim Strom of Duluth's Hanft Fride law firm prepared an excellent analysis of town finance, and warrants in particular, for MAT's 2000 legal seminar.
[5] Minnesota Attorney General Opinions considering warrants have struggled to find and explain a legal basis for the use of warrants as a form of municipal debt.

with each other. Ultimately, while it is impossible to be sure as to the legal status of warrants, two points merit special attention:

1. Towns should not use warrants to borrow funds from a financial institution to pay debts. By definition, warrants cannot be issued with a specific maturity date.[6] Instead, if they are allowed at all, they may be issued only to the town's creditors when there is not enough cash on hand to make immediate payment. As the town receives funds, it must then make payments on the warrants in the order the warrants are issued. In other words, warrants are not a way to borrow money but are a way to defer making payments.[7]

2. Towns should not view warrants as a less complicated way to borrow money. Towns should accomplish their financing through the adoption of appropriate resolutions and other certificates that appropriately describe the process and authority by which the town board is acting. A brief description of the warrant in the minutes of the board meeting, accompanied by a loan agreement or a note signed by the board chair and clerk, will usually not be adequate if someone raises questions about the transaction.

In general, because of the dubious legality of warrants, the nature of warrants being a payment deferment rather than a borrowing tool, and the availability of other tools like certificates of indebtedness and bonding, towns should avoid warrants and borrow only by clearly legal methods.

II. Elections

The default rule in Minnesota is that the issuance of bonds by a municipality must be approved by a majority of the people voting on the question.[8] There are 11 exceptions found in Minn. Stat. Ch. 475, and several others found elsewhere in Minnesota law, the most common of which include:

- refunding bonds;
- improvement bonds where special assessments pay at least 20% of the cost of the project financed;[9]
- revenue bonds, including sewer, water, and wastewater bonds where the town expects revenues to cover debt service;
- certificates of indebtedness (subject to the reverse referendum in some cases); and
- bonds issued under a specific statute that permits issuance without an election.

Additionally, several other financing tools, such as lease-purchase agreements, are outside the election requirement. As a result, voter approval is uncommon. When it is required, however, the

[6] Op.Atty.Gen., dated April 27, 1962.
[7] Towns may use certificates of indebtedness for "any purpose otherwise authorized by law" which provide an option for towns that have short-term borrowing needs.
[8] Minnesota Statutes, Section 475.58
[9] Special assessment projects and financings are discussed in more detail in MAT's information library document number **F4000**.

specific steps for obtaining it are quite detailed. In particular, state law mandates that the ballot question contain detailed information about the financial effect of approval of bond ballot questions, including a statement that a "yes" vote will raise taxes.[10] Because of the importance of precisely following the statutory mandates, if the town is going to hold an election to authorize the issuance of bonds, it should seek legal counsel.

A question that sometimes arises is whether the town can hold an advisory election if it is borrowing under a statute that does not require an election. The short answer is no; it is an unlawful expenditure of public funds to hold an election under these circumstances,[11] and the town board cannot delegate its decision-making authority to the public at large. Nothing prohibits an informal canvass of town residents, though, if the town board desires additional guidance as to whether to proceed.

III. Tax Issues

Perhaps most important to keep in mind is that much, if not most, of the borrowing that a town does can be done on a tax-exempt basis. If a lender does not have to pay taxes on the interest it receives, it can do the borrowing at a substantially lower interest rate than would be the case if the tax exemption was not available. Nevertheless, to take advantage of this, specific rules must be followed.

A. General Matters

Generally, a two-part test is used under federal law to determine whether debt can be issued on a tax-exempt basis to finance a project:

1. Will the project be dedicated to a private use?
2. Is the debt backed by a pledge of private security?

If the answer to **either** of these questions is **no**, then tax-exempt bonds can typically be used as a financing tool.[12]

These questions can nevertheless be deceptively simple. For instance, a public road designed to serve a new residential subdivision is usually considered a public use, while a road that serves only one industrial facility may not be. Similarly, a pledge of special assessments is not typically the use of private security, although an agreement by a developer to pay deficiencies

[10] Minn. Stat. § 275.60.
[11] *See* Op.Atty.Gen., dated May 18, 1961.
[12] Industrial revenue and 501(c)(3) bonds, and some other types of debt, are issued under different Internal Revenue Code provisions. They are beyond the scope of this memorandum.

in the assessments often is. Beyond that, considerations include arbitrage calculations,[13] bank qualification,[14] and a host of other factors.

B. Reimbursement Resolutions[15]

A frequent problem towns face when selling bonds for capital projects is the "reimbursement" dilemma. This situation occurs when the town pays for a project from funds on hand and later reimburses that expenditure from the proceeds of tax-exempt bonds. Federal law permits such a strategy, but only if the town has complied with federal regulations. Essentially, these regulations require the issuing town to make a written "declaration" of "official intent" to reimburse an original expenditure with bond proceeds. The town may declare its intent up to 60 days after making the expenditure.[16] Expenditures for a project made before this 60-day "look back" period may not be reimbursed with proceeds of tax-exempt bonds unless the expenditures were either:

- A "de minimis amount," which is the lesser of $100,000 or 5% of the proceeds of the issue;[17] and
- "Preliminary expenditures" in an amount up to 20% of the issue price of the bonds. Preliminary expenditures include architectural, engineering, survey, soil testing, costs of bond issuance, and similar costs incurred before the commencement of acquisition, construction, or rehabilitation of a project. Land acquisition, site preparation, and similar costs are not preliminary expenditures, and therefore must be included in the declaration.[18]

The town board or person authorized by the board may declare the town's intent in an appropriate form.[19] It must contain these two items: (1) the maximum principal amount of bonds expected to be issued for the project; and (2) a description of the project for which the original expenditure will be made.[20]

The project description is sufficient if it describes the nature of the expenditure or the nature of the fund from which the expenditure will be made. Examples include road capital improvement program, a parks and recreation fund, or recreational facility improvement programs.[21]

Deviations between the declaration and the actual expenditure are allowed if the actual project is reasonably related in function to the described project. For example, hospital equipment is a

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[13] Limiting a town's earnings on the proceeds of tax-exempt debt.
[14] Restricting the amount of debt a town can issue in one year if it intends to allow banks to collect interest on a tax-exempt basis.
[15] S*ee* 26 CFR § 1.150-2
[16] *Id.*, at (d)(1)
[17] *Id.* at (f)(1)
[18] *Id.* at (f)(2)
[19] A sample form is attached.
[20] 26 CFR § 1.150-2(e)(2)(i) & (ii).
[21] *Id.*

reasonable deviation from hospital building, but town hall renovation is not a reasonable deviation from road improvements.[22]

The issuer must have a reasonable expectation that it will actually incur the described expenditures and later reimburse them with bond proceeds. It is not reasonable to make blanket declarations (say, for all public improvements the town may construct), or in amounts that substantially exceed the amount expected to be necessary for the project. Also, a pattern of failing to reimburse actual expenditures covered by declarations will be evidence of unreasonableness. No declaration is needed, and the town should not make one if it knows that it will pay all project costs after the proceeds of the bonds are in hand.[23]

C. Arbitrage

In its simplified form, arbitrage is the concept of borrowing money at one interest rate and then reinvesting it at a higher rate. While this may appear to be a sound fiscal policy, federal regulations greatly restrict the ability of municipalities to do this.[24]

Arbitrage regulations are among the most complex involved in debt issuance and are the subject of several book-length explanations. For present purposes, it is sufficient to note that a town wishing to reinvest borrowed funds instead of immediately spending them for project costs will likely face arbitrage restrictions. Violation of the regulations can have serious impacts on the town's ability to borrow on a tax-exempt basis in the future, as well as on the tax-exempt status of its current outstanding debt. If the town has any questions relating to arbitrage, they should address them to both legal or financial specialists.

D. Bank Qualification

Federal law prevents banks from taking advantage of tax-exempt interest treatment unless the interest on the bonds paid is designated as "bank qualified."[25] Unless a town cannot make this designation (a case that usually only arises if the town will be issuing more than $10 million in bonds in any calendar year), it should make the designation in the awarding resolution.

IV. Debt Limits

Minn. Stat. § 475.53 establishes what is known as a "debt limit."[26] Towns may not incur debt in excess of 2% of the market value of taxable property in the town.[27] However, this statute is seldom an issue because the law excludes most debt obligations for which some other source of revenue

[22] *Id.* at (iii)
[23] *Id.*, at (e)(3)
[24] *See* 26 USC § 148.
[25] Also called "qualified tax-exempt obligations," *see* 26 USC § 265(b)(3).
[26] Minn. Stat. § 475.53.
[27] *Id.*, at subd. 1.

pledged as security from the definition of "net debt." For example, improvement bonds, utility revenue bonds, lease purchase agreements of less than $1,000,000, and several other types of obligations may be issued without regard to the statutory debt limit.[28] As a result, the primary obligations subject to the debt limit are general obligation bonds payable solely from ad valorem property taxes, which means that for most towns, this limit is mostly a theoretical concern. The more critical practical consideration is the point at which a lender will be unwilling to lend money to the town because of concerns about the town's debt.

V. PUBLIC SALE REQUIREMENT

Unless an exception applies, bonds must be sold to the highest bidder, and only after published notice.[29] Again, this is a rule subject to numerous exceptions, including:

- Whenever a law or charter provision permits negotiated (non-competitive) sale;
- Bonds sold by an issuer in amounts not exceeding $1,200,000 in any period of 12 consecutive months;
- Bonds sold to state or federal agencies;
- Taxable bonds;
- Installment sale contracts and lease-purchase agreements; and
- Bonds are issued with the advice and assistance of an independent financial adviser.

These exceptions apply to the great majority of bonds that are sold by towns.

VI. INTEREST RATES

For the most part, there is no minimum or maximum interest rate that the town must pay on municipal bonds, except for a few limitations implicitly established by arbitrage and other federal tax laws.[30] Given that most bonds are bought by banks or marketed through professional underwriters or with the assistance of financial advisors, the market provides a usually reliable check on unscrupulous lending. In those cases where a concern exists as to the fairness of proposed rates, bond counsel, municipal financial advisors, or the town attorney can offer some advice as to the appropriate interest that the town should expect.

[28] Minn. Stat. § 475.51, subd. 4.
[29] Minn. Stat. § 475.60.
[30] Minn. Stat. § 475.55, subd. 1a.

VII. DISCLOSURE

Federal law requires that certain information be made available to potential purchasers of a municipality's debt obligations.[31] Large issues, which the town or underwriter often sell to the general public or one or more financial institutions, may be accompanied by an "official statement" that sets out in great detail both the terms of the bonds in question and discloses pertinent information about the town. The official statement contains:

- The notice of sale;
- A description of the issue;
- Financial and other economic data on the town;
- The proposed form of the bond counsel's opinion; and
- Forms for use in submitting offers.[32]

The financial adviser circulates a preliminary official statement to prospective underwriters. The town must complete a final official statement showing actual interest rates and yield after the sale.

The official statement should be reviewed carefully by an appropriate town officer before circulation. Everything in the statement must be accurate, and the board chair and some other official, usually the town clerk, will be required to sign a certificate as to its accuracy and truthfulness.

On the other hand, bonds privately placed with a bank or other financial institution (often, though not always, issues of no more than several hundred thousand dollars) should be sold in conjunction with an investment letter. This letter is a representation by the purchaser that it understands the risks, has undertaken an appropriate investigation of the facts, and is otherwise a sophisticated investor.

In addition to the disclosure that the town must make before the sale, they must also make continuing disclosure reports on at least an annual basis if the amount of the bond issue exceeds $1 million or if the issuer has more than $10 million in outstanding bonds.[33] A professional financial adviser can assist the town in complying with this rule.

VIII. STEPS IN THE BORROWING PROCESS

Any town looking to borrow should consider the following basic steps. The town should ask their financial advisor and town attorney, for more specific guidance through the process.

[31] Securities Exchange Act rule 15c2-12(f)(3), *or* (17 CFR § 240.15c2-12(f)(3)).
[32] *Id.*
[33] *Id.* at (b)(5).

A. Planning

Depending on the size and complexity of the project, town staff and officers will determine or consult with the appropriate experts the amount of money that will need to be borrowed, the length of the obligations, whether a prepayment option is desirable, and other related issues. At the same time, a reimbursement resolution should be adopted by the town board if it anticipates borrowing money on a tax-exempt basis more than 60 days after it has begun to expend funds on the project. The town's banker, financial advisor, and attorney should be contacted and informed of the town's plans.

B. Set Sale Resolution

Once the town has identified the general outlines of the borrowing, the board should adopt a resolution determining to issue the bonds, setting the sale date, and approving the terms of the offering of the bonds. Issuers often express these terms in a notice of bond sale specifying, among other things, the details of the bonds, time for receipt of the bids or proposals, time of award and sale, and the minimum price that will be accepted. This resolution does **not** commit the town to issue the bonds.

C. Official Statement

After the anticipated terms of the bonds have been determined and assuming the town is publicly selling the bonds, an official statement will be prepared and circulated. If the town is privately placing obligations with a bank or other financial institution, an official statement is usually unnecessary.

D. Sale

On the date of the bond sale, underwriters submit their offers to acquire the bonds. The town financial advisor, or the town clerk or treasurer, if the town is not using a financial advisor, reviews the bids and prepares a recommendation for the town board. (When the town is publicly selling the bonds on a competitive basis, there is virtually no situation in which the town would award sale to any person other than the best bidder.) After the presentation of bids, that day, the board must adopt a bond resolution establishing the bond's details, levy required taxes, make necessary pledges, promise to follow the federal rules and regulations regarding tax exemption, and set out the transaction details. The board does have the right to reject all bids, something that usually only occurs if, for some reason, the bond market is such on the day of the sale that it cannot obtain an acceptable interest rate.

If the town is selling the bonds on a negotiated basis, the procedure is similar, except that there is only one "bid" to be considered.

E. Closing

After the sale of the bonds has been approved, the town must arrange a closing with the purchaser. In most cases, either the financial advisor or attorney will work with the town in filing the bond resolution with the county auditor, preparing final closing documents and certificates, and completing other related tasks. Whether the town privately places or publicly sells the bonds, it must make certain arrangements regarding the delivery of the bonds by the town and the transfer of the bond proceeds. After closing, IRS Form 8038 is prepared and filed with the Internal Revenue Service. The sale process is then complete, although the town will still need to ensure they appropriately make payments on the bonds and that they meet any continuing disclosure requirements.

IX. Other Considerations

In evaluating a potential bond issue, other factors play an essential role. The relevance of these factors depends on the nature of the underlying project, but several are true for all situations.

1. Under what terms is it politically feasible to issue bonds? Some towns dislike the idea of going into debt, while others are willing to consider it only in limited situations.
2. Why will the bonds be issued? If the project benefits all or a substantial number of the town's residents, a general obligation pledge might be appropriate. If the project primarily benefits an individual or small group, it may be worth more considering the increased risk to the town. The town may consider whether private forms of security, such as a letter of credit, can replace or supplement the town's general obligation (although this may affect whether the town can sell the bonds on a tax-exempt basis).
3. What is the best way to finance the project? In some cases, it may make more sense to impose necessary rates and charges on users. In other situations, a town may want to encourage local development by granting property tax abatements as a means of reducing a property owner's development costs. In still others, the state or federal government may offer grants or low-interest loans that will reduce the town's costs.
4. Is the town prepared to take on the responsibilities that go along with being a bond issuer? While they sound more demanding than they usually are, these responsibilities include operating a debt service fund within the town's general accounts, making payments to the bond purchasers (or a trustee if using one), and ensuring that it collects revenues in a timely fashion.
5. How much outside assistance does the town need in completing the transaction? Most banks do, or at least should, require a bond counsel opinion, and the town attorney may or may not be comfortable in that role.[34]A banker or other financial institution representative needs to be involved in negotiating their purchase of the bonds. Especially for large or complex transactions, a professional financial advisory firm (there are several that specialize in advising municipalities) can help structure the issue, obtain the most favorable terms, and manage ongoing reporting and payment matters

[34] At a minimum, the town attorney should be kept up-to-date on the process even if he or she is not acting as bond counsel.

APPENDIX A

A RESOLUTION TO REIMBURSE CERTAIN EXPENDITURES FROM THE PROCEED OF THE BONDS TO BE ISSUED BY THE TOWN

WHEREAS, the Internal Revenue Service has promulgated Treasury Regulations, Section 1.150-2, providing that proceeds of tax-exempt bonds used to reimburse prior expenditures will not be deemed spent unless certain requirements are met; and

WHEREAS, the Town of ______________________ (the "Town") expects to incur certain expenditures which may be financed temporarily from sources other than bonds, and reimbursed from the proceeds of the issuance of tax-exempt bonds;

NOW, THEREFORE, BE IT RESOLVED, by the town board of the town of ____________________, reasonably intends to make expenditures for the project described in Exhibit A (the "Project"), and reasonably intends to reimburse itself for such expenditures from the proceeds of debt to be issued by the Town in the maximum principal amount described in Exhibit A.

NOW, THEREFORE, BE IT FURTHER RESOLVED, the Town Board Chair is authorized to designate appropriate additions to Exhibit A in circumstances where time is of the essence, and any such designation shall be reported to the Town Board at the earliest practicable date and shall be filed with the official books and records of the Town as provided in Section 3.

NOW, THEREFORE, BE IT FURTHER RESOLVED, this resolution is intended to constitute a declaration of official intent for purposes of Treasury Regulations, Section 1.150-2, and any successor law, regulation, or ruling.

Approved by the Town Board of the Town of ____________________, ______________________ County, Minnesota this _____/_____/20__.

Attest: ____________________________________

Chair

____

Clerk

EXHIBIT A
TO OFFICIAL INTENT RESOLUTION ADOPTED _____/_____/20___.

Date of Declaration	Description of Project	Maximum Principal Amount of Debt for Project
_____/______/20____	INSERT SHORT DESCRIPTION OF PROJECT (e.g. “Public improvements designed to serve property asjacent to Main Streetin the Town of ________________, ________________ County, Minnesota.”)	$_________________