PUBLIC FINANCE AND BORROWING

By:
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INTRODUCTION

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 cannot easily be paid for on a cash basis.

It will quickly become apparent that this memorandum deals primarily with public finance of public projects. Towns do have authority to assist in financing privately-owned projects, but 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. This memorandum is not intended to provide specific legal advice, and should only be relied upon after consultation with an attorney.

I. TYPES OF FINANCING

The number of ways in which towns can finance projects is enormous, but many of them apply to only a relatively few situations. The most widely used financing mechanisms can be broken down into a small number of categories.

A. General Obligation Bond. A general obligation bond is an obligation that promises the full faith and credit of the issuing governmental unit to payment of principal and interest. All assets and resources of the town, including the unlimited power to tax, will be used to fulfill the town’s agreement to pay back the bond. The security for this type of bond is the pledge of those resources and taxing powers.

B. Revenue Bond. A revenue bond pledges to pay the bond owner principal and interest only from certain defined revenues, often those generated by the facility financed by the bond proceeds. No general obligation pledge is involved. Normally "net" revenues (that is "gross" revenues less operating and maintenance expenses) are pledged, but a gross revenue pledge is permitted in some cases.

A revenue bond is typically used for self-supporting utilities, such as health care facilities, electric utilities, recreational facilities, and municipal liquor stores, although 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 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.

1 Minnesota Statutes, Chapter 475 sets out the general rules for municipal borrowing in Minnesota.
Revenue bonds typically carry higher interest rates than general obligations because of the higher risk of nonpayment.

C. General Obligation Revenue Bonds. In some instances, general obligation revenue bonds are issued, permitting a town to pledge both the revenues of the facility and, as a backup if these are insufficient to make the bond payments, the town's full faith and credit. This 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. These types of bonds are widely used for sewer, water, and storm sewer utilities.

D. Certificate of Indebtedness. A certificate of indebtedness is little more than a general obligation bond subject to certain special rules. Unlike many other kinds of general obligation borrowing, no election is required prior to its issuance, although if the amount of the certificate exceeds 0.25% of the town’s market value, a reverse referendum can be triggered by petition of the voters. The term of a certificate is limited to no more than five years.

E. Lease Purchase Agreements. Towns may enter into lease purchase agreements to acquire real or personal property. The lease payments are applied 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 nonappropriation must not expose the town to any type of 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. 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. The statutes are less than clear about their history and validity, and attorney general opinions that have struggled with them reflect this lack of clarity. Making matters more confusing, many of the statutes pertaining to public financing have evolved over the years, but at separate times and not necessarily in conjunction with each other. Ultimately, while it is impossible to be absolutely certain as to the legal status of warrants, two points merit special attention.

First, warrants should not be used as a way to borrow funds from a financial institution for the purpose of paying someone else to whom a town owes money. By

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2 Certificates of indebtedness are described in Minnesota Statutes, Section 366.095.
3 Lease purchase agreements are authorized by Minnesota Statutes, Section 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.
definition, warrants cannot be issued with a specific maturity date. Instead, to the extent that they may be permissible at all, they are to be issued to a town’s vendors and suppliers when those people submit a bill to the town for which there is not sufficient 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 at most a way to defer making payments.

Second, even without these restrictions, warrants should not be viewed as a less complicated way for towns to borrow money. Any town financing should be accomplished 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 in board minutes, accompanied by a loan agreement or a note signed by the board chair and clerk, will usually not be adequate if questions are raised about the transaction.

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. There are a number of exceptions to this rule, the most common of which include:

♦ refunding bonds;
♦ improvement bonds where special assessments pay at least 20% of the cost of the project financed;
♦ revenue bonds, including sewer, water, and wastewater bonds where revenues are expected 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.

In addition, a number of other financing tools, such as lease-purchase agreements, are outside the election requirement. As a result, voter approval is fairly uncommon. When it is

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5 This position is outlined in the Attorney General’s opinion dated April 27, 1962.
6 Towns do have the authority to use certificates of indebtedness for “any purpose otherwise authorized by law.” Thus, the legislature has left open other options for towns that have short-term borrowing needs.
7 Minnesota Statutes, Section 475.58
8 Special assessment projects and financings are discussed in more detail in an earlier MAT memorandum, “Special Assessments: Procedures and Financing.”
required, however, the specific steps for obtaining it are quite detailed. In particular, state
law mandates that the ballot question contain fairly detailed information about the financial
effect of approval of bond ballot questions, including a statement that a “yes” vote will raise
taxes.9 Because of the importance of precisely following the statutory mandates, if an
election is to be held to authorize the issuance of bonds, legal counsel should be sought.

A question that sometimes arises is whether an advisory election can be held if borrowing is
to be conducted under a statute that does not otherwise require an election. The short
answer is no; it is an unlawful expenditure of public funds to hold an election under these
circumstances10, 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, the borrowing can be done at a substantially lower interest rate than
would be the case if the tax exemption was not available. Nevertheless, in order to take
advantage of this, certain rules must be followed.

A. General Matters. As a general rule, 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:

◆ Will the project be dedicated to a private use?

◆ 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.11

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 in the assessments often is. Beyond
that, considerations include arbitrage calculations (limiting a town's earnings on the
proceeds of tax-exempt debt), bank qualification (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), and a host of other factors.

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9 Minnesota Statutes, Section 275.60.
10 This principle is outlined in an Attorney General’s opinion dated May 18, 1961.
11 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.
B. **Reimbursement Resolutions.** A frequent problem that 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 proceeds of tax-exempt bonds. Federal law permits such a strategy, but only if the town has complied with certain 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 declaration may be made up to 60 days after the expenditure is made. 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 percent of the proceeds of the issue; and
- "Preliminary expenditures" in an amount up to 20 percent of the issue price of the bonds. Preliminary expenditures include architectural, engineering, survey, soil testing, costs of bond issuance, and similar costs that are incurred prior to 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.

The declaration may be made in any reasonable form by the town board or any person authorized by the board to make a declaration on behalf of the town. It must contain these two items:

- A description of the project for which the original expenditure will be made; and
- The maximum principal amount of bonds expected to be issued for the project.

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 are: *road capital improvement program; parks and recreation fund; and recreational facility improvement program.* Deviations between the declaration and the actual expenditure are allowed as long as the actual project is reasonably related in function to the described project. For example, *hospital equipment* is a reasonable deviation from *hospital building*, but *town hall renovation* is not a reasonable deviation from *road improvements.*

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12 These rules are set forth in Treasury Regulations, Section 1.150-2
13 A sample form is attached.
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 in fact none should be made, if the town knows that all project costs will be paid after proceeds of the bonds are in hand.

C. **Arbitrage.** In its simplified form, arbitrage is nothing more than the concept of borrowing money at one interest rate and then reinvesting it at a higher rate. While this may appear to be sound fiscal policy, federal regulations greatly restrict the ability of municipalities to do this.\(^\text{14}\)

Arbitrage regulations are among the most complex involved in debt issuance and are the subject of a number of 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 may fare 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. Any questions relating to arbitrage should be addressed to competent legal or financial advisors.

D. **Bank Qualification.** Federal law prevents banks from taking advantage of tax exempt interest treatment unless the bonds on which the interest is paid are designated as “bank qualified.”\(^\text{15}\) 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), the designation should be made in the awarding resolution.

**IV. DEBT LIMITS**

Towns may not incur debt in excess of two percent of the market value of taxable property in the town.\(^\text{16}\) Nevertheless, almost all debt obligations for which some other source of revenue is pledged as security are excluded from the definition of “net debt.” For example, improvement bonds, utility revenue bonds, lease purchase agreements of less than $1,000,000, and a number of other different types of obligations may be issued without regard to the statutory debt limit.\(^\text{17}\) 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 largely a theoretical concern. The more important

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\(^\text{14}\) The relevant statute is 26 United States Code, Section 148.

\(^\text{15}\) 26 United States Code, Section 265(b)(3).

\(^\text{16}\) Minnesota Statutes, 475.53, subdivision 1.

\(^\text{17}\) Minnesota Statutes 475.51, subdivision 4.
practical consideration is the point at which a town will be unable to borrow money because of a potential lender’s concern about the extent of a town’s debt burden.

V. PUBLIC SALE REQUIREMENT

Unless an exception applies, bonds must be sold to the highest bidder, and only after published notice.18 Again, this is a rule subject to numerous exceptions, including:

♦ Whenever a law or charter provision permits negotiated (noncompetitive) 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 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 must be paid on municipal bonds, except for a few limitations implicitly established by arbitrage and other federal tax laws. 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 should be expected.

VII. DISCLOSURE

A. Initial Disclosure. Federal law requires that certain information be made available to potential purchasers of a municipality’s debt obligations.19 Large issues, which

18 Minnesota Statutes, Section 475.60.
are often sold 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.

A preliminary official statement is circulated by the financial adviser to prospective underwriters. A final official statement showing actual interest rates and yield is completed after the sale.

The official statement should be reviewed carefully by an appropriate town officer prior to 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 appropriate investigation of the facts, and is otherwise a sophisticated investor.

B. Continuing Disclosure. In addition to the disclosure that must be made prior to sale, a Securities and Exchange Commission rule also requires issuers to 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 bonds outstanding.²⁰ A professional financial adviser can assist the town in complying with this rule.

VIII. STEPS IN THE BORROWING PROCESS

A. Planning. Depending on the size and complexity of the project, town staff and officers will either independently or with appropriate consultants determine the amount of money that will need to be borrowed, how long the term of the obligations will be, 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

²⁰ Securities Exchange Act rule 15c2-12(b)(5)
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 offering of the bonds. These terms
are often expressed 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 issuing the bonds.

C. Official Statement. After the anticipated terms of the bonds have been determined,
and assuming the bonds are to be publicly sold, an official statement will be
prepared and circulated. If the obligations are being privately placed with a bank or
other financial institution, an official statement is usually unnecessary.

D. Sale. On the date of the bond sale date, underwriters submit their offers to acquire
the bonds. The town financial advisor, or the town clerk or treasurer if no financial
advisor is being used, reviews the bids and prepares a recommendation for the town
board. (When bonds are being publicly sold on a competitive basis, there is virtually
no situation in which the town would award sale to any person other than the best
bidder.) Following presentation of the bids on the day of the sale, the board adopts a
bond resolution that establishes the details of the bonds, levies any required taxes
and makes any necessary pledges, promises to abide by all of the federal rules and
regulations about tax exemption, and otherwise sets out the details of the transaction.
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 an acceptable
interest rate cannot be obtained.

If the bonds are being sold on a negotiated basis, the procedure is much the same,
except that there is only one “bid” to be considered.

E. Closing. After sale of the bonds has been approved, a closing must be arranged 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. Depending on
whether the bonds are being privately placed or publicly sold, certain arrangements
need to be made as to delivery of the bonds by the town and transfer to the town 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 payments on the bonds are appropriately made and that any
continuing disclosure requirements are met.
IX. OTHER CONSIDERATIONS

In evaluating a potential bond issue, other factors play an important role. To some extent, the relevance of these factors depends on the nature of the underlying project, but a number hold true in any situation.

First, 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.

Second, 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 one person or a small group, it may be worth more thoroughly considering the risk to the town and 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 bonds can be sold on a tax-exempt basis).

Third, 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.

Fourth, is the town prepared to take on the responsibilities that go along with being a bond issuer? While they sound more onerous 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 one is used), and ensuring that revenues are collected in a timely fashion.

Fifth, 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. 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 a number that specialize in advising municipalities) can help structure the issue, obtain the most favorable terms, and manage ongoing reporting and payment matters.

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21 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.
FORM 1

RESOLUTION NO. ______

DECLARING THE OFFICIAL INTENT OF THE
TOWN OF _____, MINNESOTA
TO REIMBURSE CERTAIN EXPENDITURES FROM THE PROCEEDS OF 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 issuance of tax-exempt bonds;

NOW, THEREFORE, BE IT RESOLVED BY THE TOWN BOARD OF THE TOWN OF _____, AS FOLLOWS:

1. The Town 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.

2. 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.

3. 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 _____, Minnesota this _________ day of ________________, 200____.

Attest: ____________________________

Chair

_______________________________

Clerk
**EXHIBIT A**

**TO OFFICIAL INTENT RESOLUTION**

**ADOPTED _________________________, 200_____**

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<th>Description of Project</th>
<th>Maximum Principal Amount of Debt for Project</th>
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