

# Tax-Exempt Lending to Governments and Nonprofits; Bank Loans and Direct Purchases of Municipal Securities



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## CHAPTER 1

# Introduction<sup>1</sup>

Commercial banks and other financial institutions (“lender” or “lenders”) have historically provided financing to both governmental entities and nonprofits on a tax-exempt basis through loans and direct purchases of municipal securities. The purchase of municipal securities by a lender is generally referred to as a direct purchase or direct placement. Since bank loans to governmental entities and nonprofit borrowers are generally private transactions not subject to the same reporting requirements applicable to municipal securities, there is less historical and empirical data to track the volume. However, loan reporting provided by large banks to the Federal Reserve reflecting the amount of bank loans to municipalities is significant. Direct purchases and bank holdings of municipal securities are tracked and, prior to the Tax Reform Act of 1986, lenders held almost 40% of outstanding municipal issues of tax-exempt debt. After the Tax Reform Act of 1986 and prior to the 2008 financial crisis, lenders shifted much of their participation in the tax-exempt market through products that provided credit enhancement and liquidity. After the 2008 financial crisis, due to multiple factors, the tax-exempt market once again experienced an increase in bank loans and direct purchases of municipal securities by lenders.

The purpose of this booklet is to provide a roadmap for lenders who are considering lending on a tax-exempt basis and for governmental entities and nonprofit organizations considering incurring tax-exempt debt through a bank loan or a direct placement. Each incurrence or issuance of tax-exempt debt should be reviewed by a qualified bond counsel such as the Orrick Public Finance Group listed on the inside back cover of this booklet.

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<sup>1</sup> Matthew R. Marlin, “Did Tax Reform Kill Segmentation in the Municipal Bond Market,” 54 *Public Administration Review* 387 (Jul. – Aug, 1994); “The Securities Law of Public Finance, Third Edition,” Fippinger, Robert, “The Securities Law of Public Finance, Third Edition, Vol. 2”, Practising Law Institute, 2011; Ivanov, Ivan and Zimmermann, Tom, “The ‘Privatization’ of Municipal Debt,” Hutchins Center Working Paper #45, Sept. 2018; National Association of Bond Lawyers, “Direct Purchase Of State Or Local Obligations By Commercial Banks And Other Financial Institutions,” July 2017.

## CHAPTER 2

# Governmental Lending

Lending to governmental entities can take many forms, but at the outset of each incurrence of tax-exempt debt, the fundamental question must be asked of whether the governmental entity has the power and authority under state law to enter into the debt and agree to the specific terms proposed by the lender. The answer to this question will dictate the form of the tax-exempt debt, the terms, the collateral that can be provided to the lender, and ensure that the lender and governmental entity are entering into valid debt.

When referring to governmental entities, this booklet discusses statutorily created governments or political subdivisions and instrumentalities thereof. These may include (1) cities, townships, villages or towns, (2) counties, (3) school districts, (4) economic development corporations, (5) hospital districts and other healthcare authorities, (6) tax reinvestment zones, (7) port authorities, (8) airport authorities, (9) municipal utility and special purpose districts, (10) public improvement districts, (11) river or water authorities, (12) drainage districts, (13) sports authorities, (14) regional transportation authorities, (15) emergency service districts, (16) community college districts, (17) local and regional transportation authorities, (18) housing authorities, or (19) any other statutorily created political subdivision. Generally, to directly issue any tax-exempt debt, a governmental entity must have the sovereign power (1) to tax, (2) of eminent domain, and (3) of police power.<sup>2</sup>

### DILLON'S RULE

Most state laws follow the Dillon's Rule to some extent in determining the authority of governmental entities. Dillon's Rule is derived from two court decisions issued by Justice John F. Dillon of the Supreme Court of Iowa from 1896 to 1879. In the opinion of *City of Clinton v. Cedar Rapids and the Missouri River Rail Road Company*<sup>3</sup>, Justice Dillon set forth the following test that has

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<sup>2</sup> *Commissioner of Estate of Alexander v. Shamburg*, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd 144 F.2d 998 (2d Cir. 1944), cert denied, 323 U.S. 792 (1945).

<sup>3</sup> 24 Iowa 455 (Iowa. 1868).

been applied to municipal powers in most states—a municipal corporation (and political subdivision) can exercise only the following powers:

1. those granted in express words (from the state);
2. those necessarily implied or necessarily incident to the powers expressly granted;
3. those absolutely essential to the declared objects and purposes of the corporation—not simply convenient, but indispensable; and
4. any fair doubt as to the existence of a power is resolved by the courts against the corporation.<sup>4</sup>

Dillon's Rule was later affirmed by the United States Supreme Court in *Hunter v. City of Pittsburgh*.<sup>5</sup> This is a narrow interpretation of a governmental entity's authority. Applying Dillon's Rule requires that each governmental entity be examined individually to see what powers and authority were granted to them and, for the purposes of this booklet, the forms of debt they may incur.

## **CONSTITUTIONAL AND STATUTORY AUTHORITY**

First, governmental entities must look to their statutes and state constitutions to see if they may issue debt. The power to borrow money may not be implied from any other powers granted to the governmental entity. The ability to issue debt may also be conditioned on certain actions by the governmental entity or by the approval of voters in an election. In a limited number of states, the debt may also need approval by the state's attorney general or other governmental agency.

Second, the governmental entity must determine what form of debt it can incur or issue. The statutory authority will generally dictate the form of the debt, which may include a bond, a loan, a purchase agreement, a credit agreement, an installment sale contract, a reimbursement agreement, a note, a certificate, a warrant, a lease purchase agreement, or some combination of the foregoing. If only a particular form of debt is allowed, then the governmental entities will need to issue their debt in conformity with such specific authority.

Third, statutory authority may also limit additional aspects of debt such as the maximum term, the net effective interest rate, the interest rate or adjustment,

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<sup>4</sup> *Hunter v. City of Pittsburgh*, 207 U.S. 161, (1907).

<sup>5</sup> *Id.*

the default rate, or other specific provisions. Generally, if a provision would require a tax increase or revenue increase outside of the payment schedule, then such provision may be invalid or subject to annual appropriation. This concept usually applies to debt with balloon maturities.

Lenders can generally purchase tax-exempt debt in any of these forms but should be mindful of the items set forth in "Chapter 7: Loan vs. Security."

## **COLLATERAL AND PURPOSE**

The examination of the statutory authority for the incurrence of debt does not end with a determination of the form of such debt, as the applicable statute will also generally include what purpose the debt can be issued and what collateral may secure that debt. These items will vary widely between governmental entities, and the purpose of the debt will often track the purpose of the governmental entity. For example, school districts are generally authorized to issue debt only for educational facilities. For collateral, the statutes may authorize a general obligation pledge, a revenue pledge, a limited tax pledge, an unlimited tax pledged, or other revenue or tax stream for that governmental entity. It is rare for governmental entities to be able to pledge real property as collateral, which means lenders may not be able to use traditional loan-to-value tests in their credit analysis. Lease purchase financing is an efficient method of acquiring equipment and other personal property and is typically structured to be paid from available revenues of the governmental entity, and such entity may cease to appropriate funds and discontinue the lease purchase agreement at any time. Typically, the security for the lender under a lease purchase financing is the equipment or other personal property being financed. In some states, a properly structured lease purchase agreement is not considered debt since the obligation of the governmental entity does not extend for more than one fiscal year without an annual renewal through appropriation.

## **LIMITATIONS ON TERMS AND REMEDIES**

Many traditional provisions and covenants in loan agreements with private entities are not applicable or are prohibited in loan agreements with governmental entities or in documents for municipal securities. For example, in *Faitoute Iron & Steel Co. v. City of Asbury Park*, the Supreme Court noted the importance in considering the legal limitations and the practical limitations to



enforcing remedies against governmental entities.<sup>6</sup> A governmental entity's assets cannot merely be taken to satisfy debt, and remedies cannot be enforced that prevent a governmental entity from providing essential governmental services. If a governmental entity is unable to pay its debts, lenders may be competing with more compelling governmental obligations that would prevent them from enforcing their remedies. The following are some of the most frequently encountered limitations.

**Indemnification.** Governmental entities may or may not be authorized to provide indemnification. If a lender requests an indemnity provision, they are often limited "to the extent permitted by law." If agreed to, indemnification could also be deemed subject to appropriation by the governmental entity and not secured by any other collateral or pledge.

**Sovereign Immunity.** In general, the doctrine of sovereign immunity and governmental immunity protects a state and its political subdivisions from being sued absent their consent. First, it provides immunity from suit, a jurisdictional issue that prevents a plaintiff from bringing suit against a sovereign unless immunity from suit is waived. Second, it provides immunity from liability, which is an affirmative defense that prevents the recovery of damages against the sovereign or governmental entity even when immunity from suit is waived. These two layers operate independently, and a sovereign or governmental entity may have the ability to waive one, both, and neither. A lender can mitigate and minimize the risks associated with sovereign immunity by (a) seeking a clear written contractual waiver of sovereign immunity when the authority exists, (b) limiting the tax-exempt debt to express statutorily authorized purposes and structures, and (c) exercising its right to seek a writ of mandamus against any defaulting governmental entity. Note though that the laws regarding sovereign immunity may vary from state to state.

**Breakage Fees.** Like indemnification, breakage, or other fees (such as increased costs or those related to variable rate index prepayments) are costs outside of the regularly scheduled payments of principal and interest. Such fees may be determined to be unenforceable against a governmental entity or subject to appropriation.

**Waiver of Jury Trial and Choice of Law.** Standard provisions for lenders include a waiver of jury trial and a choice of law to govern the debt that is favorable to

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<sup>6</sup> 316 U.S. 502 (1942).

the lender. A lender should carefully consider if such provisions are enforceable against a governmental entity. Some states allow for a waiver of jury trial, but it's rare that governmental entities can agree to be governed by another state's laws.

**Acceleration.** Generally, acceleration cannot be obtained on governmental debt secured by taxes or revenues. Acceleration is not allowed because (a) the governmental entity may not have sufficient funds on hand to pay the debt, and (b) there is no ability to accelerate the receipt of revenues or the payment of taxes, which is the underlying security for the debt. A lender's only remedy for default is to force the governmental entity to raise taxes or revenues, within any applicable statutory or constitutional limits, sufficient to pay debt service as it comes due through a writ of mandamus. A lender may accelerate in the rare instance where the lender received real estate or personal property collateral to foreclose upon.

**Mandamus.** A writ of mandamus is the proper remedy by which payment of a lawfully incurred debt can be enforced against a governmental entity. Payment of a lawfully incurred debt is a ministerial duty for which a writ of mandamus may be issued. Through a mandamus action, the governmental entity can be directed to levy and to collect sufficient taxes, or to raise rates and fees with respect to its revenues, to satisfy outstanding judgments against the entity when there are not sufficient funds on hand. No writs will be issued that would require the governmental entity to go beyond its statutory limitation or that would deny it the means of paying its current expenses. The major limitation of a writ is that judgments are only rendered for the amounts currently due, and thus additional writs may have to be sought for each installment of principal or interest on the debt to satisfy any default.

**Bankruptcy.** Unlike corporations, governmental entities cannot file bankruptcy unless they are specifically authorized to do so. Lenders should consider whether a governmental entity can file bankruptcy and how their security would be treated in a municipal bankruptcy.

**Banking Relationship and the Right-of-setoff.** Lenders often require borrowers to maintain their banking relationship with such lenders. Lenders will also request a corresponding setoff provision that allows them to set off late fees and payments directly from a borrower's account. When dealing with governmental entities, a banking relationship with the right of setoff may be

considered an additional pledge that is not statutorily authorized. In addition, a governmental entity may be required to offer its banking relationship for public bid. If a lender does have lawful access to the accounts of a governmental entity, any right of setoff will likely be limited to amounts that have already come due and not future payments.

***Invalid Loans.*** If a governmental entity lacks the authority to enter into the debt or if it is determined that the lender has collateral or remedies that are invalid under state law, it will have material consequences for the lender. The lender may be limited in its ability to collect on the debt, or, in the worst-case scenario, it could be determined that the governmental entity is not required to pay back the debt. Lenders should clearly understand what remedies are available in the event of default. Lenders should also always obtain opinions that the debt is a valid, binding obligation of the governmental entity from a qualified bond counsel.

## CHAPTER 3

# Advantages and Disadvantages of Direct Placement and a Public Offering

Often a direct placement of tax-exempt debt can take a similar form to what is offered in the public municipal bond market. However, there are some important differences to consider when comparing the public municipal bond market versus a direct placement.

### **AMORTIZATION**

Lenders traditionally offer shorter maturity dates than those obtainable in the public market. Lenders can offer longer amortization on such debt, but that often results in a balloon payment for borrowers at the maturity of the debt. Longer maturities offered by lenders may also be coupled with a “put option” by the lender which gives the lender the option to make the debt due and payable upon or after the put date. Public offerings commonly offer bonds with maturities ranging from 20 to 30 years, and in some instances up to 40 years, from the date of issuance.

### **INTEREST RATE**

Publicly offered bonds commonly have long-term fixed interest rates. Lenders may offer fixed interest rates for shorter periods, and some lenders prefer variable rate options and other interest rate adjustment provisions.

### **COVENANTS**

Financial covenants and other covenants in a public offering may be less restrictive than in a direct placement. Covenants are dependent upon the underwriter selling and the investors purchasing the publicly offered bonds.

Covenants are usually set at the first issuance of debt by a borrower in a public offering and become increasingly harder to amend with each issuance once they are set. Amendment of covenants in a public offering require consent of bondholders that can often be tedious or impossible to obtain. Lenders have their own independent underwriting standards and generally have more restrictive covenants. In a direct placement, a borrower negotiates each covenant directly with the lender, and it is much easier to obtain a waiver of a covenant or an amendment to a covenant from the lender in the future. It should be noted that inconsistent covenants between an outstanding public debt and direct placement can be problematic. Consequently, lenders often strive to conform to existing issuer covenants.

## **COLLATERAL**

Unless bond insurance or a letter of credit is required due to the underlying rating of the borrower, public offerings usually do not require the collateral pledged to have any certain value compared to the amount of the debt. Real estate collateral is usually not required in public offerings, or, in the case of many municipal entities, is prohibited by law.

## **CLOSING COSTS**

Public offerings usually have higher closing costs (bond counsel, financial advisor, underwriter, underwriter's counsel, borrower's counsel, issuer, issuer's counsel, rating agencies, trustee, trustee's counsel, etc.) than direct placements which are generally limited to the fees of issuer, issuer/bond counsel, borrower's counsel, and bank's counsel.

## **CONTINUING DISCLOSURE**

A public offering will require the borrower to agree to the continuing disclosure requirements under U.S. Securities and Exchange Commission Rule 15c2-12 (the "Rule"). The Rule requires annual disclosure on the Electronic Municipal Market Access ("EMMA"), a service of the Municipal Securities Rulemaking Board that usually includes the borrower's audit and certain other information in the final offering document. This information is publicly posted to EMMA for anyone to view. In addition, the borrower must file a notice to EMMA if any of the enumerated "material events" occur such as rating changes, defaults, etc.

This requirement puts the borrower more “in the public eye” and is not required in a direct placement where the borrower provides reporting information directly to the lender.

## **RATINGS**

Lenders are required to conduct their own independent underwriting process and, therefore, do not require ratings for direct placements. This eliminates any fees for such ratings and the ongoing rating requirements and fees. Although not always required, ratings are often an integral part of the public offering process and will require the ongoing review of the rating agencies and payment of annual fees until the debt is paid.

## **PREPAYMENT**

The prepayment terms on publicly offered bonds are set by the public market. Traditionally, publicly offered bonds are only prepayable after a set number of years. If a shorter prepayment is available, such prepayment typically requires a prepayment penalty. Lenders may offer shorter prepayment terms on private placement debt, and if variable rate debt is issued, then such debt can be prepaid almost at any time.

## **DRAWDOWN STRUCTURING**

Publicly offered municipal securities are fully funded at closing; therefore, the borrower pays interest on the full amount of the debt from the date of issuance. During construction, borrowers often use capitalized interest to support the debt service associated with the unfinished project. Lenders may offer drawdown loans that are funded incrementally to coincide with construction, which allows borrowers to avoid paying interest prior to the funds being expended for the construction of a project.

## CHAPTER 4

# Nonprofit Lending

Bank loans and direct purchases with 501(c)(3) corporations can be more similar to traditional commercial bank loans as compared with direct purchases with debt of governmental entities. Even though most tax-exempt debt issued to benefit a nonprofit corporation is issued as “qualified 501(c)(3) bonds” pursuant to Section 145 of the Internal Revenue Code, there is usually no requirement that the lending instrument be a bond. Many lenders request that tax-exempt debt transactions be documented as a loan. This chapter will explore lending to nonprofit organizations generally. The Orrick Public Finance Group has other materials on this subject—including booklets on “Nonprofit Corporations: Borrowing with Tax-Exempt Bonds,” “Public Charter Schools: Borrowing with Tax-Exempt Bonds,” “Multifamily Rental Housing: Financing with Tax-Exempt Bonds,” and “Student Housing: Comparing Options for Tax Exempt Financing,” all of which are available at <https://www.orrick.com/Generic-Articles/Public-Finance-Green-Book-Series>.

### CONDUIT ISSUERS

501(c)(3) corporations cannot directly issue their own “qualified 501(c)(3) bonds” and must rely on a conduit issuer to issue such debt on their behalf. A conduit issuer is a state or local government (or instrumentality thereof) that issues tax-exempt debt and loans the proceeds to the borrower who takes responsibility for repaying the debt. The conduit issuer is only obligated to make payments on the debt to the extent it receives funds for that purpose from the nonprofit borrower or other obligated party. The primary actions of the conduit issuer in a tax-exempt transaction are:

1. Approving a borrower’s application for tax-exempt financing.
2. Approving the transactions (including TEFRA approval mentioned in “Charter 6: Special Tax Issues”).
3. Reviewing any documents to which it is a party.

4. Filing IRS Form 8038.
5. Securing issuer identification (as that term is used in the Regulations) of any swaps or other hedges related to the tax-exempt financing.

It is standard for the borrower to completely indemnify the conduit issuer for essentially all liability arising out of the transaction, except as a result of the conduit issuer's gross negligence or willful misconduct, and to permit the conduit issuer to select and engage counsel at the expense of the borrower in the event of any proceeding giving rise to indemnification. Similarly, borrowers usually covenant to pay all fees and expenses arising out of a conduit transaction, including both ordinary expenses and extraordinary expenses. Additional information from Orrick Public Finance Group on "Conduit Financing With Tax-Exempt Bonds" can be found at: <https://www.orrick.com/en/Insights/2017/09/Conduit-Financing-With-Tax-Exempt-Bonds>.

## **FORM OF FINANCING DOCUMENTS**

The form of the financing documents (unless restricted by the conduit issuer's authorizing statute) may come in the form of a tri-party loan agreement with a promissory note for a loan structure, a trust indenture and a related loan agreement for a bond issue, or some combination of the two. All forms are generally acceptable, but most lenders prefer that the financing be structured as a loan. All structures must provide that the lender makes the loan to the conduit issuer, and in turn, the conduit issuer makes a loan to the 501(c)(3) organization. The loan from the lender to the conduit issuer is secured by the loan payments made from the 501(c)(3) organization. The conduit issuer assigns its rights under the loan to the lender. Any remaining collateral such as real property or revenues may be pledged directly to the lender or to a trustee for the benefit of the lender or bondholders. If additional security is pledged to the conduit issuer, the conduit issuer will also assign its rights to such collateral.

If the form of the financing is a bond purchased by the lender, the bond and corresponding documents may be structured to all the bond to be treated as a loan as approved to a security for the lender's purpose as further described in "Chapter 7: Loan vs. Security" herein.



## REAL ESTATE COLLATERAL

As previously mentioned, most lenders have some loan-to-value requirement when making a loan. In tax-exempt financing, this is usually met by securing the financing with real estate collateral. There are several issues outlined below that arise with real estate collateral.

**Title Policy.** Lenders will require a title policy insured by a national title insurance company. A title company should be engaged early in the transaction to identify any possible liens, restrictions, or easements on the property. Most lenders have a list of title endorsements they will require on the final policy. If the tax-exempt financing is a drawdown construction loan, the title company may also be needed post-closing to complete drawdown endorsements for each construction draw.

**Survey.** A survey, in proper American Land Title Association (commonly known as "ALTA") form or other similar state-specific form, is important for lenders as they may receive both the survey endorsement on the title policy and they can separately review for any easement encroachments or other restrictions affecting the property. The survey endorsement provides coverage in the event that the land identified on the survey described in the endorsement is not the same land as described in the policy. Specifically, it covers "any discrepancies, conflicts, or shortages in area or boundary lines, or any encroachments or protrusions, or any overlapping of improvements." For construction financings, a survey is often also required after the completion of construction to review the same issues.

**Appraisal.** The lender will typically engage an appraiser to review the current "As-Is" value of the real estate collateral. In a construction financing, the lender will also need the "As-Built" or "As-Complete" value of the real estate collateral. This will allow the lender to make its loan-to-value determination and see if additional borrower equity or other types of financings, such as subordinate financings, are needed to finance the project. The lender will also have parameters on the methodology used by the appraiser to calculate the appraised value.

**Environmental Reports.** An environmental report is an investigation on the real estate collateral to discover if there are any dangerous contaminants. Such reports must be conducted within 180 days of closing and must allow

for the lender to rely upon such report. Lenders require environmental reports to protect themselves from environmental contamination and its associated liability that may have significant adverse effect on the value of real estate collateral.

**Insurance.** Lenders will require the borrower maintain certain types and levels of insurance, which can include commercial liability, property, and workers' compensation insurance. Generally, lenders require that a borrower maintain property insurance equivalent to the balance of the outstanding debt on the real estate collateral. Lenders will also request to be named as "mortgagee" or "loss lender payee" on these policies.

**Flood Insurance.** In 1973, Congress enacted the Flood Disaster Protection Act of 1973 ("FDPA").<sup>7</sup> Section 102(b) of the FDPA amended the National Flood Insurance Act ("NFIA")<sup>8</sup> to require the issuance of regulations to lenders that prevented them from making, increasing, extending, or renewing any loan secured by improved real estate located, or to be located, in a special flood hazard area ("SFHA"). Due to this change, lenders now require a determination of whether or not the real estate collateral is in an SFHA, and they will require flood insurance if the real estate collateral is, in fact, located therein.

**Restrictive Covenants.** Restrictive covenants on any portion of real estate collateral could negatively affect the lender's ability to liquidate the property in the event of a foreclosure. Any restrictive covenants should be removed to the extent possible or otherwise factored into the value of the property. This issue often arises when a property only has a single use such as a school.

**Access and Parking.** In limited situations, lenders may agree to take a portion of a piece of property. One example would be if a lender was financing the construction of an individual building on a college campus. The borrower may be unwilling to pledge the whole campus, so the lender will only take a lien on the single building. Real estate diligence should be done in these situations to determine if the lender would have parking and access to the building in the event of a foreclosure. Access easements and parking agreements may be needed to protect the lender in the event of a foreclosure.

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<sup>7</sup> 5 Pub. Law No. 93-234, 87 Stat. 975. (December 31, 1973). Codified, as amended to 42 U.S.C. §4128.

<sup>8</sup> Pub. Law No. 90-448, 82 Stat. 572 (August 1, 1968). Codified, as amended, at 42 U.S.C. §4001.

**Abundance of Caution.** "Abundance of caution" means that the property is not being taken to meet any loan-to-value requirement, but, rather, it is additional collateral for the financing or is not viewed as a primary source of repayment. Typically, when real estate collateral is secured as an abundance of caution, a title policy and other real estate diligence is not required.

## **CONSTRUCTION FINANCING**

Financing for construction projects is very common in direct placements. Each lender will have its own requirements for construction diligence and procedures to draw down construction proceeds. Typically, lenders will require (a) review of all architect, engineer, and construction contracts, (b) collateral assignment of all architect, engineer, and construction contracts to the lender, (c) review of the plans and specifications, (d) collateral assignment of the plans and specifications to the lender, (e) building permits, (f) evidence of zoning and utilities, (g) builder's risk insurance naming the lender, and (h) a payment and performance bond. The assignments allow the lender to proceed with construction in the event of default. Both the insurance and the payment and performance bond further protect the lender in case of damage during construction or default or bankruptcy of the contractor.

Tax-Exempt construction loans can be fully funded into a construction account or advanced as needed by the borrower. If the funds are not fully advanced at closing, the title company will need to be involved in the draws to issue drawdown endorsements on the title policy. During the draw process, lenders can require that each requested advance be supported by invoices and lien waivers from the contractor and subcontractors requesting payment. Additionally, lenders may require that these items and the construction site be reviewed by a construction consultant. The final advance for a construction project typically requires the borrower to provide the lender with full waivers from contractors, a certificate of occupancy, and an updated survey.

## CHAPTER 5

# Special Issues

There are many special issues that arise in tax-exempt financing. The following are a few that are prevalent in direct placements.

### ESTABLISHMENT CLAUSE

Questions on separation of church and state usually arise in the context of tax-exempt debt for a nonprofit organization that benefits a religious organization. The religious organization is generally financing capital assets such as a school or health care facility. The ability to finance these capital assets require compliance with the Establishment of Religion Clause (the “Establishment Clause”) of the First Amendment of the United States Constitution and the relevant state’s laws, regulations, and policies regarding separation of church and state (“State Religious Aid Restrictions”). Some State Religious Aid Restrictions based on state constitutional or statutory provisions are more stringent than the requirements of the Establishment Clause in restricting governmental aid to religious organizations.

The First Amendment to the U.S. Constitution provides that “Congress shall make no law respecting an establishment of religion.”<sup>9</sup> Since the First Amendment also forbids Congress from making any law “prohibiting the free exercise” of religion,<sup>10</sup> federal and state courts have over time crafted a policy towards religious matters, including financing, that champions neutrality as the course least likely to stray into the abuses of sectarianism that gave rise to the Amendment.<sup>11</sup>

Although a thorough analysis on the state and federal level must be done for tax-exempt debt’s compliance with the Establishment Clause, some consistent themes have emerged. The Supreme Court of the United State has ultimately

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<sup>9</sup> U.S. Const. amend. I.

<sup>10</sup> *Id.*

<sup>11</sup> The historical background of the First Amendment’s religion clauses is explained in *Everson v. Board of Educ.*, 330 U.S. 1, 8-15 (1947).

pursued six major courses of inquiry in its evaluation of the constitutionality of public aid, including tax-exempt debt, to sectarian schools:

1. Is the aid equally available to sectarian and nonsectarian private schools?
2. Is the aid in the form of a direct cash subsidy or an indirect financial benefit?
3. Does the aid flow from the government directly to the school or indirectly through private citizens?
4. Are the activities furthered by the aid essentially subjective or objective in nature?
5. To what degree does the aid program involve the government in the affairs of a religious institution?
6. Is the benefitted institution pervasively sectarian?

Generally, tax-exempt debt can be used for education, health care, or other 501(c)(3) purposes, but no tax-exempt debt can be used for projects used primarily for sectarian instruction, places of religious worship, facilities for divinity schools or classes. Equity or a separate taxable financing can be allocated or used to finance any facilities that would otherwise violate or potentially violate the Establishment Clause.

## **PREPAYMENT PENALTIES**

As previously noted, lenders typically do not offer a fixed long-term interest rate, but if they do, this often comes with a prepayment or “make whole” provision. These provisions can be broken down to (a) a fixed percentage of the outstanding balance or (b) a formula that allows the lender to maintain the initial rate of return or yield that was the basis for offering such rate. While on shorter financings this is not necessarily a major concern for a borrower, it becomes a more important consideration on a longer-term placement of debt. If a variable rate is offered, prepayment is available more frequently based on when the index is reset, which can vary from daily, monthly, quarterly, and so on. Some variable rate breakage fees can also be required if the borrower desires to prepay between reset dates.

## **INTEREST RATE SWAP INTEGRATION**

If an interest rate swap is used in connection with variable rate tax-exempt financing, the interest rate swap could carry a breakage fee if terminated before the life of the interest rate swap, depending upon where interest rates are at the time of termination. Borrowers often request that the breakage fee on the interest rate swap be refunded on a tax-exempt basis. In order to refund the breakage fee on a tax-exempt basis, it must qualify as a qualified hedge within the meaning of Treasury Regulations §1.148-4(h)(2) and §1.148-4(h)(5) (iv). Identifying the interest rate swap as a qualified hedge must be done within three days of entering into the interest rate swap. If the interest rate swap is not properly integrated, then the breakage fee cannot be refinanced on a tax-exempt basis. Additional information from the Orrick Public Finance Group on “Interest Rate Swaps: Application to Tax-Exempt Financing” can be found at <https://media.orrick.com/Media%20Library/public/files/4/430-pdf.pdf>.

## **CHANGE IN CORPORATE TAX RATE**

Lenders may request a “Change in Corporate Tax Rate” provision that allows for the lender to adjust the interest rate in the event of a change in the lender’s federal corporate tax rate. If the corporate tax rate is decreased, the lender will need a higher rate of interest to maintain the initial rate of return or yield that was the basis for offering such rate. Although unused for many years, Change in Corporate Tax Rate was triggered in 2018 after the passage of the Tax Cuts and Jobs Act that lowered the federal corporate tax rate for lenders and triggered an increase to the interest rates of many borrowers. For those lenders that waived the tax gross-up, an analysis of whether such waiver caused a reissuance for federal tax law purposes had to be done for each tax-exempt debt issuance effected.

## **TAX GROSS-UP**

For any tax-exempt rate offered, the lender will generally require a taxable adjustment if the financing is deemed taxable by the Internal Revenue Service. After the event of taxability, the financing will bear interest at a new taxable rate. The taxable rate may vary from a preset rate to a predetermined formula. For a governmental entity, it should be determined if such increased rate is legally binding and if such additional interest is subject to appropriation by the governmental entity.

## **INDEMNIFICATION**

It is standard in lending transactions for the borrower to indemnify the lender for all liability arising out of the transaction except as a result of the lender's gross negligence or willful misconduct, and to permit the lender to select and engage counsel at the expense of the borrower in the event of any proceeding giving rise to indemnification. Similarly, borrowers usually covenant to pay all fees and expenses arising out of the transaction (including in an event of default). For governmental entities, it should be determined if state law permits indemnification by the borrower.

## **INCREASED COSTS**

"Increased costs," "yield maintenance," or "change-in-law" provisions allow for the lender to charge additional fees or increase the interest rate if the lender determines that any change in applicable laws, rules, or regulations regarding capital adequacy, or any change in the application of the law, rules, or regulations increases the capital required to be maintained with respect to the financing and therefore reduces the rate of return or yield by the lender.

## **DEFAULT RATE**

Lenders often include a default interest rate, which is designed to incentivize a borrower to cure any default and to compensate the lender for its exposure during a default. For both governmental entities and nonprofit organizations, it should be carefully considered whether the default rate might exceed the maximum rate of interest permitted by law and if a limitation should be put in place to adjust the default rate below the maximum rate permitted by law.

## **LIBOR**

The London Interbank Offered Rate is an interest-rate average calculated from estimates submitted by the leading panel banks in London. Each lender estimates what it would be charged were it to borrow from other panel banks. The resulting rate is usually abbreviated to "Libor" or "LIBOR." LIBOR was an extremely common index offered to borrowers in direct placements. On March 5, 2021, the Financial Conduct Authority announced that the publication of 1-week and 2-month U.S. dollar LIBOR will cease after December 31, 2021, and the publication of all other U.S. dollar LIBOR settings will cease or be deemed

unrepresentative after June 30, 2023. For new financings, borrowers and lenders must decide whether to use LIBOR as the index for the financing and what fallback index provisions to use for when LIBOR is no longer available. This includes determining whether a hardwired approach (fallback language is built into the financing agreement, and the financing automatically converts to a new reference rate following a trigger event) or amendment approach (following a trigger event, the bank group enables a streamlined amendment to replace LIBOR) should be used.

One of the most daunting challenges for the LIBOR transition is its impact on outstanding financings and interest rate swaps. The unavailability of LIBOR may create a tax reissuance on tax-exempt financing or breakage fees on interest rate swaps. Existing financings should be reviewed and discussed with bond counsel before amendments are made to the financing.

### **MOST-FAVORED NATIONS**

A most-favored nations clause in the documents allows for the lender to benefit from any different or additional covenants, defaults, rights, or remedies that a borrower might provide to a future lender or in a public offering. Any of these additional provisions would apply to the debt that contains the most-favored nations clause.

### **WAIVER OF JURY TRIAL AND ARBITRATION**

Lenders may request a waiver of jury trial or arbitration in place of a trial. Governmental entities may or may not have the right to grant such waiver or engage in arbitration. Review of the existing state law should be done to determine the enforceability of these provisions.



## CHAPTER 6

# Special Tax Issues

This chapter describes the basic federal tax rules applicable to tax-exempt debt. Sections 103 and 141 through 150 of the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), along with the related Treasury Regulations (the “Regulations”) set forth the federal tax law applicable to tax-exempt financing. The Internal Revenue Code provides for two categories of tax-exempt debt that may be issued by or on behalf of state and local governments: (a) “governmental bonds” that finance facilities owned by the governmental entity and are used by the general public or by the governmental entity itself, and (b) “private activity bonds” that finance facilities or loans used for governmental purposes but provide significant benefit to private businesses. Most tax-exempt debt issued for the benefit of a nonprofit organization is issued as “qualified 501(c)(3) bonds” pursuant to Section 145 of the Internal Revenue Code.

There are five eligible categories of expenditures for the proceeds of tax-exempt debt: (a) capital expenditures, (b) refinancing prior debt, (c) reimbursing prior capital expenditures, (d) working capital, and (e) financing costs, such as the costs of issuing the tax-exempt debt, capitalized interest, and reserves. A single issuance of tax-exempt debt may combine more than one or even all of these purposes.

### USE OF PROCEEDS

The proceeds of tax-exempt debt may only be used for certain purposes as set forth below:

**Capital Expenditures.** The most common use of any debt is the acquisition or construction of a capital project—land, buildings, equipment, and/or related infrastructure. The primary limitation on the types of projects that can be financed with tax-exempt debt is that they must be owned by the Borrower. Such projects may not be used (a) in a manner that constitutes an unrelated

trade or business under Section 513(a) of the Internal Revenue Code (which generally means that it be used in a manner consistent with the nonprofit purpose of the borrower) or (b) in the trade or business of another person or entity (other than another 501(c)(3) organization or governmental entity) (a "non-exempt entity"). The unrelated trade or business is limited to 5% in qualified 501(c)(3) bonds and is limited to 10% for governmental bonds.

**Refinancing.** Refinancing outstanding taxable or tax-exempt debt is a very common use of tax-exempt debt. The primary limitation is that the proceeds of the prior debt were used for capital projects that would have qualified for original financing with tax-exempt debt as described above. Tax-exempt debt being used to refinance (or "refund") prior outstanding tax-exempt debts is further limited to prohibit an "advance refunding." An advance refunding occurs when the issuance of the tax-exempt refunding debt is more than 90 days before repayment of the tax-exempt debt to be refunded. Refundings of tax-exempt debt within 90 days of repayment of the tax-exempt refunded debt is allowed (these are called current refundings). Prior to the enactment of the 2017 Tax Cuts and Jobs Act, advance refundings were allowed and may be reauthorized in the future. An analysis of any debt being refunded must be completed by bond counsel.

**Reimbursement of Prior Capital Expenditures.** The Internal Revenue Code generally prohibits reimbursement of expenditures made prior to the issuance of tax-exempt debt. However, there are some exceptions:

1. If the prior expenditures were made with the proceeds of a loan or other type of borrowing which is still outstanding, then that prior debt may be refinanced, as described above.
2. Certain preliminary "soft costs" such as architectural, engineering, surveying, soil testing and similar costs paid prior to commencement of acquisition, construction, or rehabilitation of a project may be reimbursed in an amount up to 20% of the aggregate issue price of the tax-exempt debt issued to finance the project. Land acquisition, site preparation, and similar costs are not included in such "soft costs."
3. Any other capital expenditures (including costs of issuance) paid before the tax-exempt debt is issued may be reimbursed if they are paid after, or not more than 60 days before, the borrower expresses "official intent" to reimburse such expenditures by resolution, declaration, or other

action that meets the requirements of applicable Regulation. Certain limitations apply, namely that the reimbursement can only be made no later than 18 months after the later of (a) the date the cost is paid or (b) the date the project is placed in service (but in no event, more than three years after the cost is paid). One of the first steps in any consideration of a tax-exempt financing for a capital project should be the adoption of an official intent reimbursement resolution. Properly drafted, it can be simple and nonbinding. There is no cost or liability if the borrower adopts an official intent reimbursement resolution and never issues any tax-exempt debt.

**Working Capital.** Even though the use of tax-exempt debt to finance operating expenses (or “working capital”) is not specifically prohibited, the Internal Revenue Code makes such financings impractical. This holds true, except in some cases for an amount not exceeding 5% of the tax-exempt debt proceeds (net of reserves), if used as working capital in connection with the project being financed with the balance of the bond issue.

**Costs of Issuance.** Costs of issuance may be financed with proceeds of tax-exempt debt. Payment of costs of issuance for tax-exempt debt for nonprofit organizations is subject to certain limitations as set forth below under Requirements for “Qualified 501(c)(3) Bonds.”

**Capitalized Interest.** Interest payable on the tax-exempt debt during the longer of (a) three years from the date of closing or (b) the period in which the project is to be constructed and for up to one year after completion of construction may be included (i.e., capitalized) in the tax-exempt debt issue.

**Reserves.** If a debt service reserve fund is requested, it may be funded with the tax-exempt debt proceeds equal to the lesser of 10% of the tax-exempt debt, 125% of average annual debt service on the tax-exempt debt, or (in the typical case) maximum annual debt service. Other reserves, such as operating reserves, may also be funded with tax-exempt debt proceeds but usually only within the limitations on working capital as set forth in the section above.

**SWAP Breakage Fees.** As previously stated, if an interest rate swap is used in connection with variable rate tax-exempt financing, the interest rate swap could carry a breakage fee if terminated before the life of the interest rate swap, depending upon where interest rates are at the time of termination. In order

to refund the breakage fee on a tax-exempt basis, it must qualify as qualified hedge within the meaning of Treasury Regulations §1.148 4(h)(2) and §1.148 4(h)(5)(iv).

## **QUALIFIED TAX-EXEMPT OBLIGATIONS (“BANK QUALIFIED”)**

Governmental tax-exempt debt and tax-exempt debt issued to provide financing for a 501(c)(3) organization may be eligible for “qualified tax-exempt obligation” status (also referred to as “bank qualified” status).<sup>12</sup> This status is based on the eligibility of the governmental (or conduit governmental) issuer of the tax-exempt debt. The governmental issuer (a) must reasonably expect to issue no more than \$10 million of tax-exempt obligations (excluding private activity bonds, other than “qualified 501(c)(3) bonds”) during the current calendar year and (b) must specifically designate the tax-exempt debt as qualified tax-exempt obligations. This status permits lenders to deduct a certain portion of their interest expense that is related to ownership of tax-exempt debt.

## **120% TEST**

The Internal Revenue Code prohibits tax-exempt debt that “overburdens” the tax-exempt debt market, such as issuing more debt, issuing debt earlier (as provided below), and allowing tax-exempt debt to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the tax-exempt debt. This analysis mostly depends on whether the primary purpose of the transaction is a bona fide purpose and whether the tax-exempt debt would have been issued if interest on the debt was not tax-exempt. Tax-exempt debt with a weighted average maturity of more than 120% of the average reasonably expected economic life of the financed assets and tax-exempt debt that does not qualify for any expenditure-related temporary periods may indicate overburdening.

The Internal Revenue Code generally prohibits tax-exempt debt from being issued too far in advance of the time the proceeds are expected to be used to construct or acquire the assets to be financed. However, under certain circumstances, borrowers may be interested in issuing tax-exempt debt at the earliest opportunity, particularly when interest rates are expected to rise. In general, interest on the tax-exempt debt will not be tax-exempt unless the

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<sup>12</sup> Section 265(b) of the Internal Revenue Code.

borrower reasonably expects to spend at least 85% of the net sale proceeds (generally the proceeds from the sale of the tax-exempt debt, less any proceeds used to fund a debt service reserve fund) within three years of the issue date and does not invest more than 50% of the tax-exempt debt proceeds in investments with a guaranteed yield for four or more years.

## **ARBITRAGE AND REBATE RULES**

With respect to arbitrage yield restrictions, the Internal Revenue Code generally prohibits the issuance of tax-exempt debt if the issuer reasonably expects to use the proceeds of such tax-exempt debt, directly or indirectly, either (a) to acquire securities or obligations with a yield materially higher than the yield on such tax-exempt debt or (b) to replace funds used to acquire such higher-yielding securities or obligations. Thus, the Internal Revenue Code restricts the rate of return on investments made with tax-exempt debt proceeds to a yield that is not materially higher than the “arbitrage yield” on the borrower’s tax-exempt debt. Generally, the arbitrage yield is the discount rate when used to calculate the present value of all principal and interest payments on the tax-exempt debt that produces an amount equal to the issue price of the of tax-exempt debt with certain adjustments. However, exceptions to yield restriction apply to some of the tax-exempt debt proceeds during certain periods of time (referred to as “temporary periods”) and for the portion of the of tax-exempt debt proceeds held in a “reasonably required reserve or replacement fund” during the life of the tax-exempt debt issue.

Because of the technical requirements and complexities involved in rebate calculations, a borrower should consider engaging an expert to provide rebate (and penalty) calculation services for its debt financings. BLX, a subsidiary of Orrick, Herrington and Sutcliffe LLP, offers full rebate compliance services on a cost-effective basis. For further information regarding BLX, contact a member of the Orrick Public Finance Group listed on the inside back cover of this booklet.

## **REQUIREMENTS FOR “QUALIFIED 501(C)(3) BONDS”**

“Qualified 501(c)(3) Bonds” have certain unique issues that do not apply to governmental bonds. Below is an overview of some of those issues:

**“Qualified 501(c)(3) Financing” under the Internal Revenue Code.** As previously stated, most tax-exempt debt issued to benefit nonprofit organizations is

issued as “qualified 501(c)(3) bonds,” a category of private activity bonds issued pursuant to Section 145 of the Internal Revenue Code that are available to organizations exempt from federal income taxation pursuant to Section 501(c)(3) of the Internal Revenue Code (“501(c)(3) organizations”). Generally, tax-exempt debt qualifies as a “qualified 501(c)(3) bond” if the 501(c)(3) organization owns the financed facility and uses it to conduct its exempt activities.

**Ownership.** The ownership requirement of the Internal Revenue Code mandates that all property financed with the proceeds of a borrower’s “qualified 501(c)(3) bonds” must be owned by the borrower, another 501(c)(3) organization, or a state or local governmental entity.<sup>13</sup> Certain alternate structures can provide some flexibility while meeting this ownership requirement, including long-term ground leases and the financing of tenant improvements. An ownership analysis should also be done when a borrower is considering any joint ventures, making sure that any new entities with ownership interests still meet the applicable ownership and 501(c)(3) bond requirements.

*Ground Leases and Tenant Improvements.* A borrower could enter into a long-term ground lease of land owned by a non-exempt entity and use the proceeds of tax-exempt debt to construct its facility on this land so long as the term of the ground lease is long enough to cause the tax-exempt debt-financed facility to be owned by the borrower for federal tax purposes. Generally, this requires the term of the ground lease to be substantially longer than the reasonably expected economic life of the financed project. Another common structure involves the lease of an existing structure and the use of tax-exempt debt proceeds solely to finance certain “tenant improvements” required for the borrower’s educational activities. Similar to the ground lease, the term of the lease cannot end prior to the end of the expected economic life of the financed improvements.

**95% Requirement.** In addition to the requirement that all property financed with proceeds of the tax-exempt debt must be owned by the borrower, at least 95% of the net proceeds of the tax-exempt debt must be used to finance qualified project costs. Use by the borrower for activities that constitute an unrelated trade or business use is counted as part of the 5% non-qualified use (including use of proceeds to pay costs of issuance up to the 2% limit). Nevertheless, the project or portions of it may be used by non-exempt entities in their trade or business if (a) the portion of the project so used can be allocable to monies

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<sup>13</sup> Section 145(a) of the Internal Revenue Code.

spent on the project from sources other than proceeds of tax-exempt debt (such as accumulated funds, donations, or proceeds of taxable debt), (b) as stated above, the portion of the project so used represents less than 5% of proceeds of the tax-exempt debt (net of reserves), with any proceeds (up to the 2% cap) used to pay costs of issuance counted against this 5% amount, or (c) the use by a non-exempt entity is pursuant to an operating or management contract that meets the requirements of a qualified management contract.

**Costs of Issuance.** Costs incurred in connection with issuing the tax-exempt debt, such as fees of bond counsel, lender's counsel and other lawyers, consultants, and the like, may be financed with the tax-exempt debt issue, subject to a cap of 2% of the sale proceeds of the tax-exempt debt. This 2% counts against the 5% otherwise permitted for nonqualified costs. While this 2% cap may be sufficient to cover costs for a large tax-exempt issuance, for smaller issuances, additional sources of financing like taxable debt or a cash contribution from the borrower may be required (in excess of the 2% cap).

**\$150 Million Limitation.** In some circumstances, a 501(c)(3) organization cannot benefit from more than \$150 million of outstanding "qualified 501(c)(3) bonds" that are not "qualified hospital bonds" (95% or more of the net proceeds used for a hospital). Because most tax-exempt debt does not meet the requirements of qualified hospital bonds, this \$150 million limitation must be taken into account. This limitation was repealed for capital project tax-exempt debt issued after August 5, 1997, as long as at least 95% of the net proceeds of such tax-exempt debt is used to finance capital expenditures incurred after that date. In other words, the \$150 million limitation may apply to tax-exempt debt that is issued to finance borrowers if the tax-exempt debt also finances working capital expenditures, including otherwise permissible post-construction funded interest on the tax-exempt debt, exceeding 5% of the net proceeds of the tax-exempt debt. Organizations under common management and control are treated as one entity under this limitation; thus, large borrower networks and management organizations must monitor their working capital expenditures financed with "qualified 501(c)(3) bond" proceeds to ensure compliance with this exception to the \$150 million limitation.

**Public Hearing and Governmental Approval.** "Qualified 501(c)(3) bonds" must be approved by the governmental issuer of the tax-exempt debt. Additional approval is also required if the governmental issuer does not have jurisdiction over the site(s) where the bond financed property will be located. This approval

must occur after a public hearing held in the jurisdiction providing the approval and before the tax-exempt debt is issued. The public hearing is often referred to as the “TEFRA Hearing” based on the name of the tax legislation mandating it.<sup>14</sup> Public notice of such hearing must be published at least seven days prior to the date of the TEFRA Hearing using one of several permitted methods. Publication in a newspaper of general circulation in the approving jurisdiction is currently the most common method used, but notice can now be posted on the governmental entity’s primary public website as an alternative to newspaper publication. A public hearing may be held no more than 100 miles from the project’s location. Once the public hearing has occurred, the borrower must seek approval of the issuance of the tax-exempt debt from the corresponding governmental entity. Approval can take several forms but typically consists of approval by the applicable elected official of the governmental entity or its elected legislative body.

If the tax-exempt debt will finance multiple projects, then the notice and approval must specify the maximum stated principal amount of tax-exempt debt to be issued to finance each of the separate projects. The maximum stated principal amount of tax-exempt debt used to finance a project may be determined on any reasonable basis and may take into account contingencies, such as cost overruns or failures to receive construction approvals, without regard to whether the occurrence of any such contingency is reasonably expected at the time of the notice. Supplemental public approval can be received after tax-exempt debt is issued but before the proceeds are used for a non-approved use. There is no maximum time period between a public hearing and valid public approval, but there is a one-year (three years for plans of finance) maximum time limit from approval to issuance.

***Contracts With Private Managers, Operators, and Other Service Providers.***

The existence of management or service contract may be determined to constitute private business use of a tax-exempt financed facility. The Internal Revenue Service has provided a safe harbor, and satisfying the safe harbor requirements means these contracts will not cause private business use of the financed project.

***Qualified Management Contracts Rules – Safe Harbor Requirements.*** Key components of the safe harbor for qualified management contracts are set forth below:

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<sup>14</sup> Tax Equity and Fiscal Responsibility Act.



1. *Reasonable Fee.* The fee paid to the service provider must be reasonable.
2. *No Net Profits or Net Losses.* Compensation to the service provider cannot be based, even in part, on the net profits or net losses of the financed project.
3. *Term Limitation.* The term of the services contract may not be longer than 30 years or, if shorter, 80% of the remaining useful life of the project.
4. *Control.* The project owner must exercise control over the project, including approval of the annual operating budget, capital expenditures, disposition of property, the rates charged for the use of the project, and the general nature and type of use of the project.
5. *Risk of Loss.* The service provider cannot be responsible for replacing the project if there is a catastrophic loss; however, it can obtain adequate insurance as long as this cost is reimbursed by the borrower.
6. *Service Provider Tax Position.* The contract must state that the service provider will not claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the financed project.<sup>15</sup>
7. *Limitation on Rights.* Finally, the service provider must not have a role or relationship with the borrower that as a practical matter would limit the borrower's rights to take action under the contract.
8. *Excluded Incidental Services.* Contracts for ancillary or incidental services (routine repair and maintenance contracts, for example) are not considered to be service contracts and therefore do not cause the service provider to be a private business user even if the term of the contract is longer than 30 years.
9. *Management Organizations and Management Contracts.* Management Organizations are created to manage an association of borrowers and typically qualify as a 501(c) (3) organization. Management Organizations have significant control over the activities and funding of the individual borrowers; thus, management contracts between borrowers and Management Organizations often are not qualified management contracts because the contract cannot satisfy the "Limitation of Rights"

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<sup>15</sup> IRS Revenue Procedure 2017-13, 2017-16 I.R.B. 787.

requirement set forth above. In this circumstance, it is important that the Management Organization's status as a 501(c)(3) organization be confirmed before the borrower's tax-exempt debt is issued and while they remain outstanding.

## **FUNDRAISING**

The Internal Revenue Code generally prohibits tax-exempt debt where there are two sources of funds for the same assets. This often arises when a borrower is fundraising for a specific project, but the fundraising dollars (or capital campaign pledges) will not be received until a later time. If the borrower desires to issue tax-exempt debt to cover the full cost of the project, the tax-exempt debt will need to be structured to account for any fundraising dollars already received and any fundraising dollars to be received in the future. Fundraising dollars already received should be applied before any proceeds of tax-exempt debt, and fundraising dollars received in the future should be used to pay down the debt upon receipt (or pay for other project costs). Careful structuring of the tax-exempt debt to avoid an overissuance based on the expected fundraising should be done by bond counsel.

## **LIQUIDITY COVENANTS**

Many lending transactions include liquidity covenants. For tax-exempt debt, if a lender wants to require a liquidity covenant, it must meet one of following requirements:

1. The borrower or a substantial beneficiary may grant rights in the funds that are superior to the rights of the lender, or
2. The amount does not exceed the reasonable needs for which it is maintained, the required level is tested no more frequently than every six months, and the amount may be spent without any substantial restriction other than a requirement to replenish by the next testing date.

## **TAX REISSUANCE**

It is very common in direct lending to amend transaction documents for an array of different reasons. In a tax-exempt transaction, amendments should always be analyzed to determine if they will cause a tax reissuance. Some common causes of tax reissuance include a change to the interest rate that is greater than 25 basis points or re-amortization of the existing payments. If a reissuance occurs, a new TEFRA notice may be required if the weighted average maturity of the new (reissued) tax-exempt debt exceeds the remaining weighted average maturity of the original issue. A tax reissuance can also have implications for the Bank Qualified status of the tax-exempt debt. If a tax reissuance occurs, lenders will also want to receive a new tax opinion based on the reissued tax-exempt debt.

## **POSSESSORY RIGHTS**

The Internal Revenue Service has taken the position, in some situations, that private business use of a tax-exempt financed facility may arise without any possessory rights to the use of such facility by such private business. Naming rights to an athletic facility is an example of these non-possessory rights that may result in private business use. Any analysis of possessory rights is a fact-specific analysis that should be completed by Bond Counsel.

## **CHANGE OF USE OR DISPOSITION OF TAX-EXEMPT FINANCED FACILITIES**

If the borrower takes a deliberate action that changes the use of tax-exempt financed property or disposes of it while the tax-exempt debt is outstanding, and the change in use or disposition causes the tax-exempt debt to fail to comply with applicable federal tax law, it must take one of the remedial actions permitted by the Internal Revenue Code in order to preserve the tax-exempt status of interest on its tax-exempt debt. If a change in use or disposition of tax-exempt financed property occurs or is being considered, the borrower should contact bond counsel immediately to discuss the remedial actions available to it.

## CHAPTER 7

# Loan vs. Security

One of the most important issues for lenders to consider for banking regulatory and accounting purposes when entering into a direct placement is whether the tax-exempt debt issued as a “security” may be treated as a “loan.” If tax-exempt debt is characterized as a security, this could have material consequences for the lender and the security would be governed by federal securities law and the Municipal Securities Rulemaking Board (the “MSRB”).

### STATE LAW

As previously mentioned, State statutes may require that tax-exempt debt be issued as a bond, be offered public bidding, or a number of other restrictions that point to the tax-exempt debt as a security for state-law purposes. This does not preclude lenders from classifying the tax-exempt debt as a “loan” for federal securities law, banking law, and accounting purposes. This is just one factor when reviewing the total facts and circumstances of the transaction.

### BANKING LAW

The Office of the Comptroller of Currency (the “OCC”) has stated that, for banking law purposes, a debt obligation may be a loan, a security, or an investment security. For example, the OCC has recognized in Interpretive Letter No. 182 that an industrial development bond, which is a security for purposes of the securities laws, may be evidence of a loan for national bank purposes.<sup>16</sup> *The Comptroller’s Handbook for National Bank Examiners* § 411.1 (the “Handbook”) has set forth guidance under which national banks may purchase direct purchase securities and record and report these products as loans. Handbook § 411.1 provides that lending statutes will apply when a national bank chooses to acquire a direct purchase security and record and report this acquisition as a loan portfolio item. The OCC has stated that when

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<sup>16</sup> OCC Interpretive Letter No. 182 (March 10, 1981), [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶185,263.

a bank has acquired a direct purchase security as a loan, the validity of this assertion should be tested as follows:

1. Is the management of the purchasing bank capable of doing the required credit analysis?
2. Is the management in fact doing the analysis, initially, and on an ongoing basis?
3. Did management base its purchase decision on this analysis?
4. Are the purchased assets consistent with the bank's credit policies regarding quality, type, diversification, and borrower location?

If the answer to any of the above questions is no, then the direct purchase security may not be regarded as a loan. Additionally, the following requirements are used by the bank pursuant to its internal lending guidelines in supporting the validity of the bank in acquiring the tax-exempt debt as a loan:

1. The bank will ensure that the loan complies with the lending limit restrictions of 12 U.S.C. § 84 and 12 C.F.R. Part 32.
2. The bank will apply the standards of Banking Circular 181 (Rev.).
3. The bank will review the loan to determine if reserves are necessary and, if necessary, will reserve for losses.
4. The bank's loan will be made in accordance with the bank's loan policies and procedures.
5. The bank is capable of doing the required credit analysis and will perform an initial credit analysis and ongoing analyses.
6. The treatment of the transaction described above as a loan also is fully consistent with the reporting requirements set forth in the instruction book for the Consolidated Reports of Condition and Income.

For accounting purposes, the lender should also comply with the Statement of Financial Accounting Standards No. 115 promulgated by the Financial Accounting Standards Board ("FASB") on held-to-maturity securities and with FASB Accounting Standards Codification No. 320 providing a three-part test of "transferability," "divisibility," and "function" in determining whether the debt instrument should be classified as a "security" for purposes of GAAP. This further bolsters the argument that the lender intends to hold such tax-exempt debt for its own purposes to maturity and has correspondingly accounted for the tax-exempt debt this way in its audit.

## SECURITIES LAW

Under *Reves v. Ernst & Young, Inc.*,<sup>17</sup> a note is presumed to be a security unless it bears a strong resemblance, determined by examining four specified factors, to one of a judicially crafted list of categories of instruments that are not securities.<sup>18</sup> The types of non-security notes identified in *Reves* include notes delivered in a consumer financing transaction, notes secured by a mortgage on a home, short-term notes secured by a lien on a small business or its assets, short-term notes evidenced by accounts receivable, notes evidencing "character" loans to bank customers, notes formalizing open account debts incurred in the ordinary course of business, and notes evidencing loans from commercial banks for ordinary operations. Tax-exempt debt typically does not fit into any one of the categories discussed in *Reves* and therefore is deemed to be a security unless it bears a "strong family resemblance" to the non-security notes identified in the opinion. The family resemblance test is broken down into four factors (a) motivation of the seller and buyer (or issuer and lender), (b) the plan of distribution, (c) reasonable expectations of the investing public, and (d) an alternative regulatory scheme which reduces the risk of the instrument. As set forth under "Loan Classification" below, lenders and their counsel have developed ways to use the family resemblance test to classify tax-exempt debt as a loan under *Reves*.

With a rise in direct placements after the financial crisis, the MSRB and the Financial Industry Regulatory Authority ("FINRA") issued joint regulations providing guidance to remind parties of their obligations in connection with a direct placement and on the use of bank loans in the municipal securities market based on the *Reves* case.<sup>19</sup> FINRA found that documentation often described the tax-exempt debt as "bonds" or contained language consistent with bond offerings, such as: (a) references to "purchasers" or "sellers," (b) the debt instruments were to be sold in separate denominations, (c) the purchasers made representations regarding their knowledge and experience in investments and willingness to take on risk, and (d) the debt instruments could have been resold.<sup>20</sup> FINRA believed that these factors run contrary to the *Reves* tests. The MSRB and FINRA aptly pointed out that failure to properly classify the tax-exempt debt as a loan could make parties subject to FINRA and MSRB Rules.

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<sup>17</sup> 494 U.S. 56 (1990).

<sup>18</sup> 494 U.S. 57 (1990).

<sup>19</sup> Fin. Indus. Reg. Auth. Regulatory Notice 16-10, Direct Purchases and Bank Loans as Alternatives to Public Financing in the Municipal Securities Market (2016) and MSRB Regulatory Notice 2016-12, Direct Purchases and Bank Loans as Alternatives to Public Financing in the Municipal Securities Market (2016).

<sup>20</sup> Fin. Indus. Reg. Auth. Regulatory Notice 16-10 and MSRB Regulatory Notice 2016-12.

## LOAN CLASSIFICATION

In order to rebut the presumption under *Reves* and ensure that direct placements of tax-exempt debt are classified as loans, the tax-exempt debt should be generally structured as follows:

1. The lender should choose a structure which resembles a commercial loan whenever possible. If a bond is used, lenders should request that it be issued in a term bond registered in the name of the lender. Any tax-exempt debt issued under a multimodal indenture should be subject to a specific "bank mode" that is distinct from other modes under the indenture while the lender is holding such debt.
2. The lender should express its intent to hold the tax-exempt debt in its own loan portfolio until maturity, both in writing and through its banking practices. If the transfer of the tax-exempt debt is allowed, it should be restricted to transfer to other lenders within the definition of Section 3(a)(2) of the Securities Act of 1933.
3. The lender should engage in its own credit analysis of the financial condition of the borrower and the value of the collateral being pledged. Lenders do not rely on or request ratings for the tax-exempt debt.
4. No official statement, private placement memorandum, or other offering document should be prepared by the borrower in connection with the tax-exempt debt.
5. The tax-exempt debt should not be held in book-entry form or registered with The Depository Trust Company.
6. The tax-exempt debt should be a single term instrument.
7. The tax-exempt debt should be limited in its transferability to entities other than affiliates of the lender, financial institutions, or accredited investors or qualified institutional buyers.
8. The tax-exempt debt should not be assigned a CUSIP number.
9. The borrower should not be obligated to make any ongoing disclosures in accordance with Rule 15c2-12 of the Securities and Exchange Commission.

## MUNICIPAL ADVISOR RULE

In tax-exempt debt transactions, lenders will also want to avoid any classification as a "Municipal Advisor" under Section 15B of the Securities and Exchange Act of 1934 and the corresponding MSRB rules governing Municipal Advisors. The term municipal advisor means a person (who is not a municipal entity or an employee of a municipal entity) that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or undertakes a solicitation of a municipal entity or an obligated person. Lenders typically fall under the bank exclusion in 17 CFR § 240.15Ba1-1(d)(3)(iii) (B), which excludes any bank as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), to the extent the bank provides advice on any extension of credit by a bank to a municipal entity or obligated person, including the issuance of a letter of credit, the making of a direct loan, or the purchase of a municipal security by the bank for its own account. The Securities and Exchange Commission stated that banks providing municipal entities or obligated persons with the terms under which they would make direct purchases of municipal securities are not considered to be engaging in municipal advisory activities but are, instead, acting as principals in purchase transactions.

Generally, the lender will want any borrower and any conduit issuer to acknowledge and agree that: (a) the transactions contemplated are arm's-length commercial transactions between the parties; (b) in connection with such transaction, the lender and any affiliates are acting solely as a principal and not as an advisor, including, without limitation, a "Municipal Advisor" as such term is defined in Section 15B of the Securities and Exchange Act of 1934, as amended, and the related final rules (the "Municipal Advisor Rules"), agent or a fiduciary of borrower or conduit issuer; (c) the lender and any affiliates are relying on one or more exemptions in the Municipal Advisor Rules; (d) the lender and any affiliates have not provided any advice or assumed any advisory or fiduciary responsibility in favor of borrower or conduit issuer with respect to the transactions contemplated hereby and the discussions, undertakings, and procedures leading thereto (whether or not lender, or any affiliate of the lender, has provided other services or advised, or is currently providing other services or advising borrower or conduit issuer on other matters); (e) the lender and its affiliates have financial and other interests that differ from those of



the borrower or the conduit issuer; and (f) the borrower or conduit issuer has consulted with its own financial, legal, accounting, tax, and other advisors, as applicable, to the extent it deemed appropriate.

## **CONCLUSION**

As set forth in this chapter and through this booklet, there are many issues affecting the structure of tax-exempt debt. A qualified bond counsel, such as the Orrick Public Finance Group, should be utilized by lenders and borrowers to assist in the structuring and documentation of direct placements, as well as to give the appropriate opinions on these matters.

# About the Authors

**Todd Brewer** has over 30 years of public finance experience in all areas of tax exempt transactions, serving as bond counsel, bank counsel, underwriter's counsel, trustee's counsel, letter of credit providers counsel and borrowers counsel in transactions for traditional governmental entities, nonprofit organizations and private entities. Todd devotes a significant portion of his practice to the representation of banks and other financial institutions in connection with direct purchases of tax-exempt bonds, tax-exempt loans, and the issuance of letters of credit and other liquidity facilities in connection with tax-exempt obligations. He also serves as Vice Chair of Orrick's Texas Public Finance practice.

**Hoang Vu** serves as bond counsel, disclosure counsel, underwriters' counsel, issuer's counsel, borrower's counsel and bank's counsel in connection with a broad range of taxable and tax-exempt transactions. Such transactions include governmental issuers and not-for-profit organizations (higher education, private schools, charter schools, health care and other entities). Hoang has particular experience in representing banks and other financial institutions on financings for nonprofit entities, direct purchase and private placements of governmental debt, and letter of credit and liquidity facilities for variable rate obligations and commercial paper programs. Hoang also serves as the Chair of the Diversity, Equity and Inclusion committee for Orrick's Houston office.

**Amanda Stephens** represents borrower, banks, funds and other financial institutions in connection with structuring financing products for nonprofits across the county. Amanda also works with a first-of-its-kind nonprofit social impact fund that leverages private loans to the public market. In her practice, she serves as bond counsel, disclosure counsel, underwriters' counsel, issuer's counsel, banks counsel and lender's counsel in connection with a broad range of taxable and tax-exempt transactions including education, nonprofit corporations and healthcare. Amanda currently serves as the Vice President of the Texas Chapter of Women in Public Finance and Vice Chair of the National Association of Bond Lawyers' Education and Member Services Committee.

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