Foster Garvey

Bond Compliance: Important Reminders During COVID-19 Outbreak

Legal Alert
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During the COVID-19 outbreak, municipal bond issuers are heavily engaged in many pressing matters as required to respond to the public health crisis, as well as the major economic and financial impacts resulting from the outbreak. We hope this Legal Alert may be helpful in calling attention to certain events resulting from the financial impacts of the COVID-19 outbreak that could affect an issuer's outstanding municipal bonds. If any of these events occur, you may wish to consult with your bond attorney about actions that may be required or appropriate in response to the event.

School District Draws Upon the School Bond Guarantee Program for Debt Service Payments on Voter-Approved Unlimited Tax General Obligation Bonds.

If a school district, in consultation with its County Treasurer as *ex officio* Treasurer of the district, determines that property tax collections expected to be received prior to June 1, 2020, may be insufficient to make debt service payments due on its outstanding voter-approved unlimited tax general obligation bonds due on June 1, 2020, and that it may be necessary to call upon the State's guarantee under the School Bond Guarantee Program, the district is required by WAC 210-02-115 to provide written notice to the State Treasurer of that determination at least seven business days prior to that debt service payment date. For example, if a debt service payment is due on Monday, June 1, 2020 (recognizing that Monday, May 25, 2020 is Memorial Day and not a business day), the school district must notify the State Treasurer by Wednesday, May 20, 2020.

Additionally, school districts should analyze their Debt Service Fund and General Fund balances (and tax collection projects) for the remainder of calendar year 2020 to anticipate a potential decline in overall tax collections. Many County Treasurers are concerned that the COVID-19 outbreak will increase tax payment

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delinquencies.

Filing of Event Notice With the MSRB on Its EMMA System for a Draw Upon the School Bond Guarantee Program.

If a school district is required to draw upon the State's School Bond Guarantee Program in order to make a debt service payment on its publicly offered outstanding voter-approved unlimited tax general obligation bonds on June 1, 2020, the district will be required to provide to the MSRB on its EMMA system timely notice (not in excess of 10 business days after the occurrence of that event) of an "unscheduled draw on credit enhancements reflecting financial difficulties" in accordance with the district's undertaking to provide continuing disclosure with respect to those outstanding bonds.

Reporting of General Economic and Financial Effects of the COVID-19 Outbreak.

S&P Global Ratings recently assigned a "negative outlook" to the entire U.S. public finance sector. However, that action by S&P does not, in and of itself, require any particular bond issuer to file a material event notice with the MSRB on its EMMA system with respect to the issuer's outstanding publicly offered bonds. That event is not a "rating change" of which an issuer is required to provide notice under a continuing disclosure undertaking. Many issuers are voluntarily posting statements on EMMA regarding the financial and other effects of the COVID-19 outbreak on the issuer. If particular investors or rating agencies request information from an issuer about these effects, and the information requested is not publicly available, then it would be advisable for the issuer to post the information on its website, and potentially on EMMA, in order to avoid "selective disclosure" of material information to particular investors and not others. However, if the impact of the pandemic were to result, for example, in a principal and interest payment delinquency, a material non-payment related default, an unscheduled draw on debt service reserves or credit enhancements reflecting financial difficulties, or an actual rating change with respect to outstanding publicly offered bonds, the issuer then would be required to provide timely notice of such an event (not in excess of 10 business days after the occurrence of that event) to the MSRB on its EMMA system.

Draws on Debt Service Reserves for Revenue Bonds; Revenue Bond Coverage Requirements.

If an issuer of revenue bonds finds that it is necessary to draw on a debt service reserve fund in order to make debt service payments on the bonds when due because revenue received by the issuer are insufficient for that purpose, the issuer will be required to provide timely notice (not in excess of 10 business days after the draw) to the MSRB on its EMMA system of an "unscheduled draw on debt service reserves reflecting financial difficulties" in accordance with the issuer's undertaking to provide continuing disclosure with respect to the related outstanding publicly offered bonds.

Also, a resolution or ordinance authorizing the issuance of revenue bonds typically includes a covenant by the issuer to impose and collect rates and charges sufficient to produce net revenue (after payment of operating and maintenance expenses) at least equal to a specified ratio to annual debt service on the issuer's outstanding revenue bonds, such as 1.25 times annual debt service, referred to as the "coverage requirement" or sometimes as a "rate covenant." If revenues decline because of the economic and financial impacts of the COVID-19 outbreak, an issuer of affected revenue bonds should monitor whether the decline would result in a failure to satisfy the coverage requirement for the applicable fiscal period, and whether that failure would constitute a "material non-payment related default" timely notice (not exceeding 10 business days after the occurrence of the event) of which would be required to be provided to the MSRB on its EMMA system.

Monitoring Tax Collections to Avoid Debt Service Payment Delinquencies.

Any bond issuer, particularly an issuer that is heavily, if not exclusively, dependent upon revenues derived from regular property taxes, sales taxes and hotel/motel excise taxes (lodging taxes) for making debt service payments on outstanding general obligation bonds, should carefully monitor its tax collections to anticipate tax revenue declines and tax payment delinquencies in order to avoid potential principal and interest payment delinquencies on outstanding bonds. Cities, towns, counties, public hospital districts, fire protection districts and public facilities districts may be especially affected. It may be possible for such an issuer to use proceeds from an interfund loan or a cashflow borrowing to avoid bond payment delinquencies. The occurrence of a "principal and interest payment delinquency" with respect to outstanding publicly offered bonds would require the issuer to provide timely notice of the occurrence of that event (not in excess of 10 business days after the occurrence) to the MSRB on its EMMA system.

Financial Reporting Requirements for Privately-Placed Bonds.

It has been common recently for local governments to sell bonds to banks and other financial institutions in private placements. The bond authorizing resolutions or ordinances, bond purchase agreements, continuing covenant agreements or similar agreements for those privately placed bonds ("bond agreements") may contain financial reporting requirements that could come into play as a result of the economic and financial impacts of the COVID-19 outbreak on the issuer. Thus, an issuer of privately placed bonds should review any financial reporting requirements contained in the bond agreements to determine what its obligations may be under those provisions so that any "technical" default that could arise from a failure to comply with those requirements may be avoided.

Changes in the Terms of Privately Placed Bonds.

Because of the economic and financial impacts of the COVID-19 outbreak, the issuer of a bond privately placed with a bank or other financial institution could be forced to consider asking the bond owner to accept changes in the payment terms of the bond, such as deferring required principal payments. An issuer in that situation should consult with its bond attorney to determine whether any such changes could result in a "reissuance" of the bond for federal tax purposes—*i.e.*, the deemed issuance of a new, revised bond to refund and retire the original bond. Such a "reissuance" would occur if the issuer and the bond owner were to mutually agree to make a "significant modification" (within the meaning of Treas. Reg. §1.1001-3) in the terms of the original bond in a manner that was not already provided for in the terms of the original bond.

The "reissuance" of a bond is not in and of itself prohibited, but it would have certain federal tax consequences with respect to both the original bond and the new, revised bond. In that situation, the issuer should consult with its bond attorney about the steps that would have to be taken to preserve the tax exemption for interest on both the original bond and the new, revised bond (if otherwise eligible for tax exemption). For example, the deemed issuance of the new, revised bond would require filing a Form 8038-G Information Return for that bond, and the deemed retirement date of the original bond would be the final rebate calculation date for an original bond that was subject to the arbitrage rebate requirement.

Delays in Spending Bond Proceeds on Capital Projects Resulting From the Effects of the COVID-19 Outbreak.

An issuer of tax-exempt bonds to finance a capital project certifies in its federal tax certificate for the bonds that it "reasonably expects" on the issue date of the bonds that at least 85 percent of the sale proceeds of the bonds will be spent for the capital project within three years after the issue date of the bonds. Because of the effects of the COVID-19 outbreak, an issuer may experience significant delays in actually spending proceeds of the bonds on the capital project. It is not a mandatory requirement that at least 85 percent of sale proceeds of the bonds actually be spent within three years after the issue date, but the issuer must have reasonably expected on the issue date that it would do so. An issuer's expectations in this regard are "reasonable" if a prudent person in the same circumstances as the issuer would have had the same expectations, based on all the objective facts and circumstances.

Aside from this "reasonable expectations" requirement, another basic requirement for any issuer of tax-exempt obligations for a capital project is that the issuer must exercise "due diligence" to spend the bond proceeds and to complete the bond-financed project. Delays in spending proceeds of bonds issued before the COVID-19 outbreak and completing the financed project resulting from the direct and indirect effects of the COVID-19 outbreak—which were not reasonably expected when the bonds were issued and are not within the issuer's control—would not be treated as a failure by the issuer either to have had such "reasonable expectations" or to exercise such "due diligence."

Restrictions on Tax-Exempt Borrowing for Current Operating Expenses.

An issuer that wishes to borrow money on a tax-exempt basis to pay current operating expenses (referred to in IRS regulations as "working capital expenditures") (a "cashflow borrowing") would have to comply with complex IRS regulations that restrict the amount and maturity of tax-exempt obligations, such as tax anticipation notes ("TANs"), issued for that purpose. TANs typically would be used to finance a temporary maximum cumulative cashflow deficit occurring within six months after the TANs are issued. Under Washington law, short-term obligations issued in anticipation of the receipt of taxes, such as TANs, must be retired from tax revenues not later than the date six months after the end of the fiscal year in which the TANs were originally issued.

In general, under IRS regulations applicable to an ordinary cashflow borrowing: (i) the TANs must mature not later than 13 months after their issue date; (ii) proceeds of TANs are treated as spent only to the extent that the current operating expenses financed by the TANs exceed other cash, investments and other amounts that are held by and available to the issuer to pay the same type of operating expenses being financed by the TANs, if those other available amounts may be used *without* legislative or judicial action and *without* a legislative, judicial or contractual requirement that those amounts be reimbursed; and (iii) in determining what are "available amounts" for this purpose, an issuer's "reasonable working capital reserve" in an amount that does not exceed five percent of the issuer's actual working capital expenditures in the prior fiscal year is treated as unavailable.

Other more complex IRS regulations provide a "safe harbor" for longer-term bonds issued to finance persistent cashflow deficits of an issuer that is "experiencing financial distress" or to finance "extraordinary" working capital expenditures, either of which could result from the COVID-19 outbreak. To use this safe harbor for longer-term bonds, the issuer must (i) identify the first year after the issue date of the bonds in which it expects to have available amounts (as described above) for working capital expenditures (the "first testing year"); (ii) monitor for available amounts as of the first day of that first testing year, which cannot be more than five years after the issue date of the bonds, and for each subsequent year; and (iii) within 90 days after each testing date, apply the available amounts to either redeem the outstanding bonds or invest the available amounts in other tax-exempt governmental bonds. This monitoring/ investment requirement continues for as long as any bonds using this safe harbor remain outstanding.

In light of the potential administrative burden of compliance with the foregoing IRS regulations applicable to tax-exempt working capital financings, an issuer may wish to consider the advisability of issuing taxable bonds for this purpose, particularly in a low interest rate environment, in order to achieve greater financing flexibility and reduce administrative burden during the COVID-19 outbreak.