Promoting Prudence: Alternatives for Improving U.S. Local Government Borrowing Practices and Securities Law Compliance

Heather Grace White

B.A., University of California, Los Angeles
J.D., Harvard Law School

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Law School

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ABSTRACT

State and local governments play a critical role in American society and construct much of the infrastructure upon which we rely. They frequently finance this infrastructure by borrowing, often in the form of bonds that are sold to the public. This thesis focuses on state laws and federal securities laws governing this borrowing.

It first examines how states can provide local governments the flexibility to borrow while protecting current and future residents. There are good reasons that local governments incur debt, including spreading the cost of a capital project evenly over its life so that all who benefit from the project contribute to its cost. However, local politicians have incentives to borrow more (and for longer) than would be appropriate and local government officials do not always have the expertise to make wise decisions about debt. The consequences of borrowing too much or unwisely can be severe. As a result, it is important that laws governing local government debt are carefully considered.

The thesis evaluates a variety of approaches to some of the typical state law provisions governing local government borrowing and presents alternative ways to improve these laws. It then analyzes an example of a problematic borrowing method, “capital appreciation bonds,” long-term compound interest bonds on which neither interest nor principal is paid until at or near maturity. The thesis discusses the problems created by this form of financing, explores the reasons that California and Texas school districts nonetheless use these bonds, describes laws adopted in recent years to limit the use of these bonds in California and Texas, and proposes alternative ways to reduce the inappropriate use of these bonds while preserving the ability of school districts to meet student needs.

The thesis then turns to the “antifraud provisions” of U.S. securities laws and the increased emphasis in the past decade by the U.S. Securities and Exchange Commission (“SEC”) on internal practices of state and local governments that have led to inadequate disclosure and violations of the antifraud provisions. The thesis describes some of the actions that the SEC has taken, the effectiveness of those actions, and ways that going forward the SEC, states, and others can best promote state and local government policies and practices that lead to better compliance with federal securities laws. Inadequate disclosure can harm investors and ultimately be costly to the state or local government and its constituents. Addressing some of the practices identified by the SEC may also lead to better debt management in general.

Not enough attention has been paid to these topics in the past, and hopefully this thesis inspires conversation that leads to concrete action. Given the important role that state and local governments and their borrowing play in developing and maintaining infrastructure in the United States, it is essential that issues discussed in this thesis be addressed, perhaps even more so as the nation strives to recover from the COVID-19 pandemic.
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AUTHORSHIP DECLARATION: SOLE AUTHOR PUBLICATIONS

This thesis contains the following sole-authored work that has been published and/or prepared for publication.

Details of the work:

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Chapter 2

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CHAPTER 1
INTRODUCTION

State and local governments have long played a critical role in American society, providing services and facilities on which we rely. Decades ago, local governments built the Golden Gate Bridge, the Los Angeles Aqueduct, and the Brooklyn Bridge, all of which remain significant today.¹ State and local governments still construct and preserve much of the nation’s public infrastructure, and they borrow hundreds of billions of dollars annually to do so, usually in the form of long-term debt securities referred to as “municipal bonds.”² These bonds are typically sold to the public.

Municipal bonds play an important role in the everyday lives of Americans. As then-Director of the Enforcement Division of the U.S. Securities and Exchange Commission (the “SEC”) put it, “[M]unicipal bonds touch every aspect of our lives: if your children attend a

¹ The Golden Gate Bridge was built by a local authority formed by six counties. Special District Formed, GOLDEN GATE BRIDGE HIGHWAY & TRANSP. DIST., https://www.goldengate.org/bridge/history-research/bridge-construction/special-district-formed/ (last visited Mar. 14, 2021). Over 40 million vehicles cross the Golden Gate Bridge every year. Annual Vehicle Crossings and Toll Revenues, GOLDEN GATE BRIDGE HIGHWAY & TRANSP. DIST., https://www.goldengate.org/bridge/history-research/statistics-data/annual-vehicle-crossings-toll-revenues/ (last visited Mar. 14, 2021). The Los Angeles Aqueduct was built by the City of Los Angeles, and some credit it with the dramatic growth of the city (albeit at great cost to the Owens Valley, from which the water for the city was acquired). See ALBERTA M. SBRAGIA, DEBT WISH: ENTREPRENEURIAL CITIES, U.S. FEDERALISM, AND ECONOMIC DEVELOPMENT 71 (1996) (noting that areas that wished to receive water had to agree to be annexed to the city and citing an expansion of the city from 43 to 422 square miles between 1906 and 1930); LES STANDIFORD, WATER TO THE ANGELS: WILLIAM MULHOLLAND, HIS MONUMENTAL AQUEDUCT, AND THE RISE OF LOS ANGELES xviii (2015) (suggesting that the man responsible for the construction of the aqueduct had “made such a place as Los Angeles possible”). The cities of Brooklyn (then a separate city) and New York both contributed to the financing and construction of the Brooklyn Bridge. See Murphy v Kelly, 76 N.Y. 475, 480-87 (1879) (describing the cities’ involvement during the early stages of construction); City Pays Off Brooklyn Bridge of 1883; Interest Was Double Cost of Erecting It, N.Y. TIMES (Nov. 3, 1956) (noting that New York City had made its final debt service payment on bonds issued to construct the Brooklyn Bridge). In 2016, an average of over 100,000 vehicles crossed the Brooklyn Bridge each day. N.Y.C. DEPT. OF TRANSP., 2016 NEW YORK CITY BRIDGE TRAFFIC VOLUMES 61 (2018).
public school or a university; if you have been treated at a local hospital; if you have visited a library, park or sports facility; if your parents reside in an assisted living facility; if you took the subway, or drove on roads or bridges or through a tunnel today; even if you turned on your tap water this morning, you are likely seeing the tangible results and benefits of the municipal securities marketplace.”

Municipal bonds are governed by state laws, federal securities laws and, for those municipal bonds the interest earnings on which are exempt from federal taxation, federal tax laws and regulations. This thesis focuses on state laws and federal securities laws governing municipal bonds. In particular, it considers how states can provide local governments the flexibility to borrow while minimizing unwise transactions, and how the SEC, states, and others can best promote state and local government policies and practices that lead to better compliance with federal securities laws and perhaps also to better decisions about debt.

There are several compelling reasons local governments borrow to finance infrastructure. First, doing so allows a government to spread the burden of paying for a facility fairly over time (referred to as “intergenerational equity” or “interperiod equity”) rather than requiring current taxpayers or fee payers to pay the full cost of a facility that will be used for many years. In addition, because major capital projects arise intermittently, financing them from revenue streams that do not vary significantly from year to year would be difficult. A local government may issue bonds because it not have sufficient funds to construct an urgently needed facility or because its existing resources are required to meet other immediate needs. Local governments also borrow when the expected interest cost is less than the anticipated increase in construction or acquisition costs if the project is delayed until funds would otherwise be

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4 In 2011, 90.6% of state and local government securities were issued on a tax-exempt basis. SEC & EXCH. COMM’N, REPORT ON THE MUNICIPAL SECURITIES MARKET 11 (2012). See infra notes 21-22 and accompanying text for further discussion.

5 The reasons identified in this paragraph are discussed in greater detail in Section 3.1 of Chapter 2.


7 ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 6, at 9.

8 LEAGUE OF OR. CITIES, DEBT ISSUANCE MANUAL 1 (2007); also see CAL. DEBT & INV. ADVISORY COMM’N, CDIAC NO. 19.05, CALIFORNIA DEBT FINANCING GUIDE § i.2.2, i.2.2.2 (2019).
available. Furthermore, new facilities may attract new residents to a community, increasing a local government’s ability to service its debt.

At the same time, elected officials have incentives to borrow more (and for longer) than would be consistent with interperiod equity, and possibly than the local government can comfortably support, in order to obtain short-term benefits the cost of which will not be paid until far into the future. In addition, officials may not always have the expertise to make wise decisions about terms of debt, particularly when they are using more complex transaction structures.

The consequences of borrowing too much or unwisely can be severe. While government financial distress has causes other than imprudent borrowing, obligations to pay large amounts of debt certainly can contribute to financial problems. For example, the use of complex financial products such as auction rate bonds (on which interest rates were reset periodically at auction, or if the auction failed, were set at predetermined rates, which often were very high) and

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9 Cal. Debt and Inv. Advisory Comm’n, supra note 8, at § i.2.2.2; League of Or. Cities, Guide to Borrowing and Bond for Oregon Municipalities 6 (2018).
11 See, e.g., Robert S. Amdursky et al., Municipal Debt Finance Law: Theory and Practice § 4.1.1 (2nd ed., 2020-2 Cum. Sup.) (“[L]ocal officials, who will want to demonstrate constructive activity to constituents before the next election, have incentives to over-utilize debt, paying scant attention to long-term adverse effects.”); Richard Briffault, Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law, 34 Rutgers L.J. 907, 917-18 (2003) (“the ability to shift the costs forward may … induce elected officials to incur too much debt” because “they can get the credit for the new project immediately, while the blame for the additional taxes needed to pay off the debt will be borne by their successors.”); Stewart E. Sterk & Elizabeth S. Goldman, Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations, 1991 Wis. L. Rev. 1301, 1323-24 (1991) (“Debt limitations were meant to cure a perceived institutional defect of legislatures: the inability to account for the future costs of present decisions to incur debt.”). Incentives to borrow too much are discussed in greater detail in Section 3.3.1 of Chapter 2 and Section IV.B of Chapter 3.
12 See, e.g., Andrew Ang & Richard C. Green, Lowering Borrowing Costs for States and Municipalities through CommonMuni 8 (Hamilton Project, Discussion Paper 2011-01, 2011) (“Furthermore, when municipalities negotiate with investment banks and other financial intermediaries to issue debt, municipalities often have less expertise and relatively few resources to guide their decision making. This is detrimental not only to investors, but also to municipalities themselves.”); Gov’t Fin. Officers Assoc., Debt 101: Issuing Bonds and Your Continuing Obligations 2 (2020) (noting that many government finance officials have limited experience with issuing debt and that issuing debt is typically not their primary responsibility); Justin Marlowe, Governing Inst., Governing Guide to Financial Literacy: Connecting Money, Policy and Priorities 5 (2014), https://media.erepublic.com/document/GOV14_FinancialLiteracy_v.pdf (indicating that only 38% of government leaders surveyed considered themselves experts or very knowledgeable about public finance). Lack of expertise is discussed further in Section 3.3.2 of Chapter 2, Section IV.G of Chapter 3, and Section III.D of Chapter 4.
interest rates swaps (agreements to exchange periodic interest payments, for example with one party making payments at a fixed interest rate and the other at a variable rate) appear to have contributed to fiscal challenges that local governments confronted during and in the aftermath of the 2008 economic downturn.\footnote{13}

Local governments in financial distress may have to cut important services, may default on bonds, and in some states may file for bankruptcy protection.\footnote{14} When local government issuers experience financial distress, bondholders may not be paid the full amount they are owed, or payments to them may be delayed. Residents and property owners may experience reduced services or increased taxes and fees. Retired employees may lose their retirement benefits.

Even absent financial distress, imprudent borrowing can unnecessarily increase risks and costs borne by local governments. For example, one California school district issued $105 million of bonds in 2011 and will have to pay nearly $1 billion in debt service over the life of the bonds.\footnote{15} Furthermore, debt can come with burdensome financial and operating covenants, and failure to comply with covenants may result in a default.\footnote{16} These covenants may reduce the flexibility of governments to adapt to changing circumstances, particularly if they are not carefully considered.

Because of the potential impacts of poor decisions about borrowing, local government debt is regulated to varying degrees by state constitutions and statutes.\footnote{17}


\footnote{14} Some of the potential impacts of imprudent borrowing and financial distress are discussed in Section 3.3 of Chapter 2.


\footnote{17} ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, M-186, STATE LAWS GOVERNING LOCAL GOVERNMENT STRUCTURE AND ADMINISTRATION 10 (1993) (describing the prevalence of several types of
Municipal bonds are also subject to the “antifraud provisions” of federal securities laws and are regulated by the Securities and Exchange Commission and the (federal) Municipal Securities Rulemaking Board (“MSRB”). Very generally, the antifraud provisions, which also apply to corporate securities, prohibit fraud and the use of “any untrue statement of a material fact” or the omission of “a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading” to obtain money or property or in connection with the purchase or sale of securities. The SEC enforces the antifraud provisions and other federal securities laws. The MSRB has adopted rules that, among other things, are “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, … to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, … and the public interest ….”

In the past decade, the SEC has increased the level of enforcement activity in the municipal securities market and has acted against state and local governments that do not appear to have intentionally or recklessly deceived investors, but rather have internal practices that have unwittingly led to inaccurate or misleading disclosure. It also has required modifications to internal policies and practices as part of settlements with state and local governments. While the SEC’s purpose in addressing these practices is protecting investors, doing so may also benefit citizens and taxpayers. However, the SEC’s use of enforcement actions as a means of communicating with the municipal market is costly to state and local governments (particularly those against which the SEC has taken enforcement proceedings), and ultimately to taxpayers.

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restrictions, including debt limits, voter approval requirements, restrictions on the purposes for which debt can be used, maximum interest rates and maximum terms); Clayton P. Gillette, Fiscal Home Rule, 86 DENV. U. L. REV. 1241, 1255 (2009) (“Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects . . . .”); James E. Spiotto, The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress, MUN. FIN. J., at 1, 6-8 (Spring 2013) (discussing the limits states have placed on debt municipalities may issue and noting that all states except three have a limit on local government debt). A variety of state limits on borrowing and restrictions on terms of borrowing are addressed in Chapter 2.

18 Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5 promulgated pursuant to the Exchange Act are collectively referred to as the “antifraud provisions.”
19 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. The antifraud provisions and other federal securities laws applicable to municipal bonds are discussed in Section II.C of Chapter 4.
Given the importance of municipal bonds in meeting the country’s infrastructure needs and the potential negative impacts on communities and investors if local governments make poor borrowing decisions, it crucial that the laws and regulations governing local government bonds be examined closely and reformed where shortcomings are identified. It is also essential that the SEC, states, and others promote compliance by state and local governments with federal securities laws. The fact that federal and state governments subsidize state and local government borrowing adds to the significance of issues related to municipal bonds. The federal government reduces the cost to state and local governments of issuing debt by making interest earnings on most of such debt (referred to as “tax-exempt debt” or “tax-exempt bonds”) exempt from federal income tax. Tax-exempt debt typically bears interest at a lower rate than taxable debt of identical credit quality because lenders receive the benefit of tax exemption. Interest on most state and local government debt is also exempt from home state taxation.

This thesis first examines state laws governing local government borrowing in Chapters 2 and 3, then turns to federal securities laws and SEC enforcement in Chapter 4. Chapters 2 and 3 focus on how states can provide local governments the flexibility to borrow while minimizing unwise transactions, with Chapter 2 looking at state laws governing local government bonds more generally and Chapter 3 focusing on a particularly problematic type of borrowing, capital appreciation bonds, on which neither principal nor interest is paid until at or near maturity. Chapter 4 then turns to the SEC’s increased emphasis on internal policies and practices of state and local governments and ways the SEC, states, and others can best promote policies and practices that lead to better compliance with federal securities laws and ideally also to better decisions about debt.

Chapter 2, Beyond a “Bond-Aid” Approach: Building a Better Bond Law, provides an overview of local government bonds, identifies some of the typical provisions of state laws governing them, and provides examples of these provisions. The chapter evaluates various

21 In 2017, the loss of federal tax revenue resulting from the exemption from income of interest on public purpose tax-exempt bonds was $28.6 billion. GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL 30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 3 (2018).
22 See id., at 1 (explaining that investors are willing to receive a lower interest rate on tax-exempt bonds because their returns after taxes are the same as if they had received interest at a higher rate but had to pay taxes on the interest).
approaches to the types of laws discussed and suggests alternative ways to provide appropriate flexibility to local governments while protecting current and future residents. Because states have different priorities, values, and government structures, the chapter does not propose a single solution, but rather identifies key components of these laws and presents considerations, alternatives, and recommendations for each component. It also proposes alternative ways to improve bond laws in an effort to begin a conversation about this important topic.

Chapter 3, Getting Local Governments Where They Need to Go Without Taking Taxpayers for a Ride: “CABs,” Why They Are Used, and What Can Be Done to Prevent Their Misuse, focuses on an example of a problematic borrowing method, specifically “capital appreciation bonds” (also referred to as “CABs”), which are long-term compound interest bonds, on which neither principal nor interest is paid until at or near maturity. The chapter describes the problems created by the extensive use of this form of financing and explores the reasons California and Texas school districts issue hundreds of millions of dollars of CABs annually, including motivations created by state laws. Some of the reasons are more benign than others. The chapter describes state laws adopted in California and Texas in recent years that are intended to limit the use of these bonds and also suggests alternative ways to reduce the inappropriate use of these bonds while preserving the ability of school districts to meet student needs.

Chapter 4, A Little Help from Our Friends: Moving Beyond Enforcement to Improve State and Local Government Compliance with Federal Securities Laws, turns to the SEC’s enforcement of the antifraud provisions of federal securities laws. In recent years, the SEC has focused to a greater extent than it did historically on state and local government practices that have unwittingly led to inaccurate or misleading disclosure in municipal bond offerings. This chapter discusses several aspects of the internal practices of state and local governments that have been identified by the SEC as leading to inadequate disclosure, how the SEC has responded to these practices, and whether there are better ways for the SEC, states, and others to address them in the future. The chapter concludes that although recent SEC enforcement of securities laws has caused state and local government issuers to make positive changes, there is little to be gained by additional aggressive enforcement. Instead, interpretive guidance from the SEC and support and guidance from state governments and others could more effectively guide issuers towards improved disclosure, and towards better debt management in general.
Chapter 5, Conclusion, identifies some of the common threads and key conclusions reached in Chapters 2-4.
Local governments play a critical role in American society and construct much of the infrastructure upon which we rely, frequently financing this infrastructure by borrowing. Local government borrowing is likely to play a significant role in the building and improving of infrastructure as we look for ways to revive the economy and move beyond the COVID-19 pandemic. This article discusses some of the typical provisions of state laws governing this borrowing and suggests some ways these laws could be revised to provide appropriate flexibility to local governments while protecting current and future residents. Because states have varying priorities, values, and government structures, it does not propose a single solution, but rather identifies key components of these laws and presents considerations, alternatives, and recommendations for each component. It also proposes alternative ways to improve bond laws in an effort to begin a conversation about this important topic.
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1. Introduction

The COVID-19 pandemic has highlighted the important role that local governments play in our lives, thrusting county public health officials into the spotlight and causing us to turn to them and to other local officials to keep us safe. But local governments have long played a critical role in American society, providing services and facilities on which we rely, such as roads, bridges, schools, hospitals, fire and police protection, clean water, sewers, solid waste collection, electricity, airports, ports, and public transportation. Some local governments have transformed their regions with public transportation projects, bridges, stadiums, and other infrastructure projects. Local governments built the Golden Gate Bridge, the Los Angeles Aqueduct, and the Brooklyn Bridge.¹

State and local governments build and preserve much of the nation’s public infrastructure (considerably more than the federal government does).² They borrow hundreds of billions of dollars annually to do so, usually in the form of long-term debt securities referred to as

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¹ The Golden Gate Bridge was built by a local authority formed by six counties. Special District Formed, GOLDEN GATE BRIDGE HIGHWAY & TRANSP. DIST., https://www.goldengate.org/bridge/history-research/bridge-construction/special-district-formed/ (last visited Mar. 14, 2021). Over 40 million vehicles cross the Golden Gate Bridge every year. Annual Vehicle Crossings and Toll Revenues, GOLDEN GATE BRIDGE HIGHWAY & TRANSP. DIST., https://www.goldengate.org/bridge/history-research/statistics-data/annual-vehicle-crossings-toll-revenues/ (last visited Mar. 14, 2021). The Los Angeles Aqueduct was built by the City of Los Angeles, and some credit it with the dramatic growth of the city (albeit at great cost to the Owens Valley, from which the water for the city was acquired). See ALBERTA M. SBRAGIA, DEBT WISH: ENTREPRENEURIAL CITIES, U.S. FEDERALISM, AND ECONOMIC DEVELOPMENT 71 (1996) (noting that areas that wished to receive water had to agree to be annexed to the city and citing an expansion of the city from 43 to 422 square miles between 1906 and 1930); LES STANDIFORD, WATER TO THE ANGELS: WILLIAM MULHOLLAND, HIS MONUMENTAL AQUEDUCT, AND THE RISE OF LOS ANGELES xviii (2015) (suggesting that the man responsible for the construction of the aqueduct had “made such a place as Los Angeles possible”). The cities of Brooklyn (then a separate city) and New York both contributed to the financing and construction of the Brooklyn Bridge. See Murphy v Kelly, 76 N.Y. 475, 480-87 (1879) (describing the cities’ involvement during the early stages of construction); City Pays Off Brooklyn Bridge of 1883; Interest Was Double Cost of Erecting It, N.Y. TIMES (Nov. 3, 1956) (noting that New York City had made its final debt service payment on bonds issued to construct the Brooklyn Bridge). In 2016, an average of over 100,000 vehicles crossed the Brooklyn Bridge each day. N.Y.C. DEPT. OF TRANSP., 2016 NEW YORK CITY BRIDGE TRAFFIC VOLUMES 61 (2018).

“municipal bonds.” Local governments are likely to play a critical role in moving past COVID-19 and the economic crisis it has created, and municipal bonds will be an essential tool for doing so.

Most states have constitutional and/or statutory restrictions on the amount and terms of debt that local governments within their borders may issue. These restrictions are intended to serve a variety of purposes, including promoting fiscally sound decision-making, reducing the risk of default, preventing excessive burdens on taxpayers, and promoting interperiod equity (the concept that the burden of paying for a facility should be spread fairly over period during which the facility is used).

Because of the critical role that local government borrowing plays in the development of public infrastructure and likely will play in the recovery from the effects of the COVID-19 pandemic, and because of the volume of this borrowing, it is essential that the laws that govern local government borrowing (referred to herein as “bond laws”) are clear and coherent, and that they set reasonable parameters while also providing sufficient flexibility to allow local

3 See SEC. INDUS. & FIN. MKTS. ASS’N, 2021 CAPITAL MARKETS FACT BOOK 17 (2021) (indicating that state and local governments issued $484.5 billion in long-term bonds in 2020); Andrew J. Ceresney, Dir., Div. of Enforcement, Sec. & Exch. Comm’n, Keynote Address at the Securities Enforcement Forum: The Impact of SEC Enforcement on Public Finance (Oct. 13, 2016), available at https://www.sec.gov/news/speech/speech-ceresney-10132016.html (“[I]f your children attend a public school or a university; if you have been treated at a local hospital; if you have visited a library, park or sports facility; if your parents reside in an assisted living facility; if you took the subway, or drove on roads or bridges or through a tunnel today; even if you turned on your tap water this morning, you are likely seeing the tangible results and benefits of the municipal securities marketplace.”).

4 See, e.g., U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, M-186, STATE LAWS GOVERNING LOCAL GOVERNMENT STRUCTURE AND ADMINISTRATION 10 (1993) (describing the prevalence of several types of restrictions, including debt limits, voter approval requirements, restrictions on the purposes for which debt can be used, maximum interest rates and maximum terms); James E. Spiotto, The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress, MUN. FIN. J., at 1, 6-8 (Spring 2013) (discussing the limits states have placed on debt municipalities may issue and noting that all states except three have a limit on local government debt); Clayton P. Gillette, Fiscal Home Rule, 86 DENV. U. L. REV. 1241, 1255 (2009) (“Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects . . .”).

5 See, e.g., James A. Coniglio, Chapter 1: Borrowing Authority of State and Local Governments, in 1 GELFAND, STATE AND LOCAL GOVERNMENT DEBT FINANCING § 1.3, (2d. ed.) (database updated Nov. 2020) (“The traditional objective of constitutional debt limitations has been to prevent municipalities from improvidently contracting debts for other than ordinary current expenses of administration, and to restrict their borrowing capacity, and to prevent the creation of excessive debt, the carrying charges of which would fall on current revenues, and the principal on posterity.”); Gillette, supra note 4, at 1256 (discussing the reasons debt limitations were created, including protecting taxpayers and promoting interperiod equity); Spiotto, supra note 4, at 10 (identifying prevention of financial crises and defaults as a reason for the imposition of debt limits). The reasons states have laws concerning local government borrowing are discussed in greater detail in Section 3.3.
governments to borrow in the most efficient way possible even as market conditions change. Unfortunately, not all existing bond laws meet these standards. This article discusses a range of existing bond laws and proposes improvements. Because states have varying priorities, values, and government structures, because state constitutions contain a variety of restrictions on local government borrowing that may be difficult to change, and because the types of bonds vary somewhat from state to state, this article does not propose a single solution for all states or all bonds. Rather, it identifies key components of laws governing municipal bonds and presents considerations, alternatives and recommendations for each component. It is intended to start a thoughtful conversation about what modifications to bond laws would be desirable and achievable.

Following this introduction, Part 2 of this article provides a brief overview of municipal bonds and Part 3 briefly describes the laws governing them and highlights some of the problems with these laws.

Part 4 identifies and discusses the aims to be achieved by improved bond laws. One key objective of these laws should be providing appropriate flexibility for local governments to innovate, make decisions and adapt to changing circumstances while protecting citizens (including future citizens) from poor decisions made by local governments. A second critical objective is ensuring that citizens have the opportunity to be aware of and involved in local government borrowing decisions. These objectives are more likely to be achieved if different types of borrowing and different local governments are treated the same way unless there are clear reasons not to do so; legislation is not unduly complicated; and laws are flexible enough that local governments can adapt to changing market conditions.

Parts 5-7 each address different aspects of bond laws. Part 5 addresses restrictions on the ability to issue debt. Part 6 covers laws regulating bonds, including those relating to the use of proceeds, restrictions on terms of bonds such as maturity, amortization, and interest rate, and on the process of selling bonds. Part 7 focuses on the process for governing boards to approve bonds, information requirements, and opportunities for community involvement. Each section discusses some existing approaches to bond laws and alternatives.

While it might be ideal for a state to adopt one cohesive set of laws for the issuance of municipal bonds, this may not be a realistic political option. Therefore, Part 8 discusses ways to
improve state bond laws short of wholesale revision. These improvements can still provide great benefit to local governments that issue bonds and, more important, to their citizens.

2. An Introduction to Municipal Bonds

2.1. Overview

“Municipal bonds” generally refers to debt securities issued by state or local governments.6 However, this article focuses on securities issued by local governments and uses the term to refer to that debt.7 There are more than 90,000 local governments in the United States.8 Many local governments have overlapping territory. For example, a piece of property could be within a county, a city, a school district and one or more other special districts.9

6 See Glossary of Municipal Securities Terms: Municipal Bond, MUN. SEC. RULEMAKING BD., https://www.msrb.org/Glossary/Definition/MUNICIPAL-BOND.aspx (last visited Aug. 28, 2021) (defining “municipal bond” as “a debt security issued by or on behalf of a state or its political subdivision, or an agency or instrumentality of a state, its political subdivision, or a municipal corporation”).

7 While the term “bonds” typically refers only to debt securities sold to the public, for simplicity’s sake in this article it also refers to borrowing from financial institutions.

8 AM. COUNTS STAFF, FROM MUNICIPALITIES TO SPECIAL DISTRICTS, OFFICIAL COUNT OF EVERY TYPE OF LOCAL GOVERNMENT IN 2017 CENSUS OF GOVERNMENTS 2 (2019), available at https://www.census.gov/content/dam/Census/library/visualizations/2019/econ/from_municipalities_to_special_districts_america_counts_october_2019.pdf (defining governmental services, such as courts, jails, law enforcement, public health, welfare, hospitals, airports, streets and highways, parks, libraries and environmental protection within a particular area. Definitions: Local Purpose Governments, U.S. CENSUS BUREAU, https://www.census.gov/newsroom/cspan/govts/20120301_cspan_govts_def_3.pdf (last visited Mar. 15, 2021); U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 4, at 1. These are sometimes referred to as “general governments.” Special districts are created for a more limited purpose or purposes, such as fire protection, transportation, water supply or parks. Id. at 2-3; AM. COUNTS STAFF, supra note 5, at 2-5.

9 See, e.g., MONTEREY COUNTY TAX RATES FOR FISCAL YEAR 2020-21, available at https://www.co.monterey.ca.us/home/showpublisheddocument?id=98164 (identifying the cities, redevelopment agencies, school districts, community colleges, county service areas, water resources agency and other special districts within the county and showing the overlap between various local governments in the county); SAN JUAN UNIFIED SCH. DIST. (SACRAMENTO CNTY., CAL.), $30,000,000 GENERAL OBLIGATION BONDS, ELECTION OF 2012, SERIES 2020, $150,000,000 GENERAL OBLIGATION BONDS, ELECTION OF 2016, SERIES 2020 & $143,090,000 2020 GENERAL OBLIGATION REFUNDING BONDS (FEDERALLY TAXABLE) OFFICIAL STATEMENT 30 (Oct. 15, 2020), available at https://emma.msrb.org/P21409591-P11111346-P11521176.pdf (identifying the various debt issued by other local governments that have territory overlapping with all or part of the district, including a community college district, park district, county, cities and other special districts); THE CNTY. OF COOK, ILL. $101,820,000 GENERAL OBLIGATION REFUNDING BONDS, SERIES 2018 OFFICIAL STATEMENT 29 (Jan. 18, 2018), available at https://emma.msrb.org/ER1119813-ER875890-ER1276531.pdf (identifying debt of other local governments with territory overlapping that of the county, including a city, board of education, park district, community college system, water reclamation district and forest preserve district).
Local governments issue bonds primarily to finance capital projects and to refinance existing debt, though they are sometimes issued for other purposes. They typically (though not always) have a maturity of more than three years; many bonds have a significantly longer term, frequently up to thirty years and sometimes even longer.

Municipal bonds are issued in a face amount (also referred to as a “principal amount” or a “par amount”) that is payable upon maturity or earlier prepayment. Municipal bonds may bear interest at a rate that does not change (a “fixed rate bond”) or at a rate that changes periodically based on market conditions or a predetermined index (a “variable rate bond”). Interest is paid by the issuer of the bond to the purchaser, usually semiannually for fixed rate bonds.

Municipal bonds are sometimes (in my experience, usually) sold at a price lower or higher than their face amount (at a “discount” or “premium,” respectively). Thus, the amount received by the issuer from the sale may be lower or higher than the principal amount of the bonds sold, and the rate of return for the investor may be higher or lower than the interest rate on the bonds. Municipal bonds are typically sold to investors based on the “yield” of the bond, the annual rate of return taking into account not only the interest rate on the bond but also any

10 Grant A. Driessen, Cong. Research Serv., RL 30638, Tax-Exempt Bonds: A Description of State and Local Government Debt 1, 6 (2018). State and local governments also issue shorter term debt, typically referred to as “notes.” Glossary of Municipal Securities Terms: Note, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Glossary/Definition/NOTE.aspx (last visited Mar. 15, 2021). While short-term debt is not the focus of this article and is not addressed in the proposed framework for laws governing municipal bonds, some of the principles discussed also apply to short-term debt.


13 Glossary of Municipal Securities Terms: Interest Payment Date, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Glossary/Definition/INTEREST-PAYMENT-DATE.aspx (last visited Mar. 18, 2021). Sometimes interest is added to principal and itself bears interest until it is paid at or near maturity. Bonds that accrete interest in this matter are referred to as capital appreciation bonds and are discussed in detail in Heather G. White, Getting Local Governments Where They Need to Go Without Taxing Taxpayers for a Ride: “CABs,” Why They Are Used, and What Can Be Done to Prevent Their Misuse, 49 ST. MARY’S L.J. 363 (2018).

Discount or premium.\textsuperscript{16} Discounts and premiums can make bonds more attractive to investors.\textsuperscript{17} For example, some institutional investors prefer to buy long-term bonds that are priced at a premium.\textsuperscript{18}

Bonds are usually issued in a group (referred to as a series) with different maturities.\textsuperscript{19} Sometimes a single issuance consists of more than one series, particularly when the bonds being issued have different characteristics, such as being issued for different purposes or having different tax-exempt status.\textsuperscript{20}

Principal of each bond is typically paid at maturity or over a period of years leading up to maturity.\textsuperscript{21} However, because bonds are usually issued in a series with multiple maturities, principal payments are typically made over the life of a series of bonds, though the amount of such payments may vary from year to year.

\textbf{2.2. Payment Sources and Security for Municipal Bonds}

Principal and interest on municipal bonds may be payable from a single source or a combination of sources, such as property taxes, sales taxes or other taxes, the local government issuer’s general fund, or revenues from a particular project, such as a utility system or an airport.\textsuperscript{22} Bonds payable from property taxes and/or from all legally available funds of the issuer are referred to as “general obligation bonds.”\textsuperscript{23} Bonds payable from a particular revenue stream, such as a sales tax, hotel tax, or other tax, revenues generated by a particular project or

\begin{itemize}
\item \textsuperscript{16} \textit{Id.}, NEIL O’HARA, SEC. INDUS. & FIN. MKTS. ASS’N, THE FUNDAMENTALS OF MUNICIPAL BONDS 281 (6\textsuperscript{th} ed. 2012) (definition of “yield”).
\item \textsuperscript{17} O’HARA, supra note 16, at 82.
\item \textsuperscript{19} \textit{See ANDREW ANG & RICHARD C. GREEN, LOWERING BORROWING COSTS FOR STATES AND MUNICIPALITIES THROUGH COMMONMUNI 10} (Hamilton Project, Discussion Paper 2011-01, 2011) (“Since 1995, the average municipal bond series has contained thirteen separate bonds, with the top 5 percent of bond series comprising more than twenty-five separate bonds.”)
\item \textsuperscript{21} Payment of principal over a period of years leading up to maturity is referred to as “mandatory sinking fund redemption.” Payments are allocated to investors by lot. O’HARA, supra note 16, at 273.
\item \textsuperscript{22} This article provides only a general overview of the types of local government debt. For additional detail, see generally ROBERT S. AMDURSKY ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE §§ 1.3, 4.4-4.12, 4.14 (2\textsuperscript{nd} ed., 2020-2 Cum. Sup.); CAL. DEBT & INV. ADVISORY COMM’N, CDIAC NO. 19.05, CALIFORNIA DEBT FINANCING GUIDE ch. 3 (2019).
\item \textsuperscript{23} NAT’L ASS’N OF BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS i-ii (2014).
\end{itemize}
enterprise, or rent payments made on particular property, or from a combination of such sources, are called “revenue bonds.” Some revenue bonds, called “lease revenue bonds,” are paid from rent under a lease; in some circumstances that lease is from the local government issuer to another local government, and the rent is payable from all legally available funds of the renting local government. Some bonds are hybrid in nature, payable primarily from a stream of revenues or, if that stream is not sufficient, from property taxes.

Payment of principal and interest and on some municipal bonds is guaranteed by a bank or a bond insurer. Sometimes, issuers establish a reserve fund from which funds can be drawn to pay debt service if other funds are not available.

2.3. Federal and State Tax Exemption

The U.S. federal government and state governments subsidize most local government borrowing. The federal government reduces the cost to state and local governments of issuing debt by making interest earnings on most of such debt (referred to as “tax-exempt debt” or “tax-exempt bonds”) exempt from federal income tax. Tax-exempt debt typically bears interest at a lower rate than taxable debt of identical credit quality because lenders receive the benefit of tax exemption.

Interest on most state and local government debt is also exempt from home state

24 See AMDURSKY ET AL., supra note 22, at § 1.3.4 (describing a variety of revenue bonds). Some revenue bonds are payable solely from loan payments or lease payments made by a nongovernmental borrower in what is referred to as a “conduit financing.” CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 3.3.9. These financings are beyond the scope of this article. These financings allow nongovernmental entities to take advantage of the lower interest rates on tax-exempt bonds (see infra Section 2.3).

25 See CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 3.6.1 (describing financing leases and noting that sometimes the leased property is owned by the renting local government, which leases the property to the lessor and then subleases it back). Certificates of participation have a similar structure to lease revenue bonds. Id. at § 3.6.3. They are not addressed separately in this article.

26 AMDURSKY ET AL., supra note 22, at § 1.3.4.

27 SEC. & EXCH. COMM’N, supra note 13, at 10-11. For more information regarding bond insurance, letters of credit and other support, see CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 2.3.2.

28 CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 2.4.4.

29 In 2011, 90.6% of state and local government securities were issued on a tax-exempt basis. SEC. & EXCH. COMM’N, supra note 13, at 11. In 2017, the loss of federal tax revenue resulting from the exemption from income of interest on public purpose tax-exempt bonds was $28.6 billion. DRIESEN, supra note 10, at 3.

30 See DRIESEN, supra note 10, at 1 (explaining that investors are willing to receive a lower interest rate on tax-exempt bonds because their returns after taxes are the same as if they had received interest at a higher rate but had to pay taxes on the interest).
taxation.\textsuperscript{31} Tax-exempt bonds are subject to extensive requirements under the Internal Revenue Code of 1986 and related regulations.\textsuperscript{32}

2.4. Other Provisions

Sometimes, the local government issuing bonds may have the option to prepay them or may be obligated to do so (such prepayment is referred to “redemption”) upon the occurrence of specified events or on a predetermined schedule.\textsuperscript{33} While these provisions vary, issuers often have a right to elect to redeem bonds without paying a premium approximately ten years after the date the bonds were issued.\textsuperscript{34} Bondholders, particularly those holding variable rate bonds, may have the right to require the issuer to repurchase their bonds at certain times or under specified circumstances.\textsuperscript{35}

The terms of municipal bonds are contained in bond resolutions, indentures, trust agreements or other agreements, which generally also contain provisions regarding (among other things) the use of proceeds of the bonds, the security and source of payment for the bonds, terms of a reserve fund (if any), events of default, remedies, and covenants of the issuer.\textsuperscript{36}

Local governments sometimes enter into interest rate swaps (agreements to exchange periodic interest payments, for example with one party making payments at a fixed interest rate and the other at a variable rate) and other derivative arrangements in connection with their bonds.\textsuperscript{37} Local governments use these for a variety of reasons, including attempting to manage exposure to interest rate risk, better matching assets and liabilities, endeavoring to reduce net interest costs, generating cash, and locking in current interest rates.\textsuperscript{38} However, swaps entail risks to local governments, including the potential that the local government could have to make a


\textsuperscript{32} For a description of some key requirements, see generally CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at ch. 4. These regulations are not addressed in this article except where relevant to discussion of state bond laws.

\textsuperscript{33} See id. at § 2.3.1 (describing common redemption provisions).

\textsuperscript{34} Id. at § 2.3.1.3.

\textsuperscript{35} See id. at § 3.4.2.2 (describing variable rate bonds with a tender feature).

\textsuperscript{36} See id. at § 2.4 (describing a variety of provisions included in bond documents).

\textsuperscript{37} JUSTIN MARLOWE, WILLIAM C. RIVENBARK & A. JOHN VOGT, CAPITAL BUDGETING AND FINANCE 200 (2009); SEC. & EXCH. COMM’N, supra note 13, at 8.

\textsuperscript{38} CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 2.3.3; SEC. & EXCH. COMM’N, supra note 13, at 8.
substantial payment if the agreement is terminated (even if the termination is through no fault of
the local government), that the counterparty will not be able to meet its obligations, and that as
market conditions change the interest received will not align with the interest rate the issuer pays
on the hedged obligation. 39

2.5. Issuance and Sale of Bonds

Newly issued municipal bonds may be sold publicly or privately. Most municipal bonds
are sold publicly, but a growing portion are sold privately to financial institutions. 40 Public sales
are made through an investment bank acting as an underwriter in either a competitive or
negotiated sale. 41 In a competitive sale, the issuer solicits bids to purchase the bonds and sells
them to the underwriter that offers the lowest interest cost on the bonds. 42 In a negotiated sale,
the issuer selects an underwriter to purchase the bonds on negotiated terms. 43 Regardless of
which method of public sale is used, the underwriter then sells the bonds to investors. 44

Issuers prepare offering documents that are used by underwriters in selling newly issued
municipal bond and provide updates to certain information annually as long as the bonds are
outstanding. 45

Local governments issuing bonds engage lawyers to serve as bond counsel; the primary
role of these lawyers is to provide an expert opinion as to the validity and the tax-exempt status

39 CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 2.3.3.
40 See SEC. & EXCH. COMM’N, supra note 13, at 15-16 (noting that in 2011, 54.4% of municipal securities
issuances were sold in negotiated sales, 42.2% in competitive sales and 3.2% in private placements, and that
private placements had increased from $3 billion in 2010 to $15 billion in 2011); Benji Nguyen et al., Policy
Brief, Risky Business: Bank Loans to Local Governments, Stanford Institute for Economic Policy Research 1
(Aug. 2017) (noting that private bank loans to local governments in California increased from $49 billion to
$91 billion over a four year period).
41 SEC. & EXCH. COMM’N, supra note 13, at 15. For discussion of the reasons to use each method of sale, see
infra the text accompanying notes 280-282.
42 SEC. & EXCH. COMM’N, supra note 13, at 17; Jun Peng et al., Method of Sale in the Municipal Bond Market,
in THE HANDBOOK OF MUNICIPAL BONDS 51, 52 (Sylvan G. Feldstein & Frank J. Fabozzi eds., 2008).
43 SEC. & EXCH. COMM’N, supra note 13, at 16; Peng, supra note 42, at 52.
44 Id. at 15.
45 For a brief discussion of the legal requirements imposed on underwriters with respect to offering documents
and ongoing disclosure, see Heather G. White, A Little Help from Our Friends: Moving Beyond Enforcement
to Improve State and Local Government Compliance with Federal Securities Laws, 22 N.Y.U. J. LEGIS. &
of the bonds.\textsuperscript{46} Increasingly, issuers also engage lawyers as disclosure counsel to assist them in complying with their disclosure obligations under federal securities laws.\textsuperscript{47}

In addition, local governments often engage an external advisor (referred to as a “municipal advisor” or “financial advisor”) to assist in developing a financing plan, advising on the method of sale, and assessing alternative financing strategies, among other things.\textsuperscript{48} Municipal advisors have a fiduciary duty towards their local government clients.\textsuperscript{49}

3. State Regulation of Municipal Bonds

3.1. Local Government Borrowing

There are several good reasons that local governments borrow to finance infrastructure. First, major capital projects such as airport terminals or schools will last many years, and debt can be used to spread the cost of such a project over its useful life. Spreading the burden of paying for a facility fairly over time (referred to as “intergenerational equity” or “interperiod equity”) is one of the justifications for borrowing to finance capital projects rather than requiring current taxpayers or fee payers to pay the full cost of a facility that will be used for many years.\textsuperscript{50}

In addition, because major capital projects arise intermittently, it would be difficult to finance them from revenue streams that do not vary significantly from year to year.\textsuperscript{51} A local government may borrow because it not have sufficient funds to construct an urgently needed

\textsuperscript{46} SEC. \& EXCH. COMM’N, supra note 13, at 47.
\textsuperscript{47} Id. at 48.
\textsuperscript{48} See CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § i.4.1.1 (describing the types of services provided by municipal advisors); Governing Inst., Bond Issuance Guide for Small & Mid-sized Municipalities 13 (2017) (indicating that nationwide 85% of municipal bond transactions had used a municipal advisor so far in 2017); Diana Yang, Top Municipal Financing Team Participants: Calendar Year 2018, CAL. DEBT AND INV. ADVISORY COMM’N, DEBT LINE, Feb. 2019, at 3, 4-5 (indicating that municipal advisors were used on approximately 53% of reported municipal debt issuances in California in 2018, down from 61% the prior year).
\textsuperscript{50} ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, STATE CONSTITUTIONAL AND STATUTORY RESTRICTIONS ON LOCAL GOVERNMENT DEBT 9-10 (1961); CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § i.2.2; LEAGUE OF OR. CITIES, GUIDE TO BORROWING AND BOND FOR OREGON MUNICIPALITIES 6 (2018); MARLOWE, RIVENBARK & VOGT, supra note 37, at 133; RICHARD A. MUSGRAVE \& PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 693-94 (4th ed. 1984); M. David Gelfand, Seeking Local Government Financial Integrity Through Debt Ceilings, Tax Limitations, and Expenditure Limits: The New York City Fiscal Crisis, the Taxpayers ‘Revolt, and Beyond, 63 MINN. L. REV. 545, 550-51 (1979).
\textsuperscript{51} ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 9.
facility or because its existing resources are required to meet other immediate needs.\textsuperscript{52} Local governments also borrow when the cost of borrowing is less than the expected increase in construction or acquisition costs if the project is delayed until funds are available.\textsuperscript{53} New facilities may also attract new residents to the community, increasing its ability to pay debt service.\textsuperscript{54}

Furthermore, some local governments borrow because this is the only way that they can generate additional tax revenues to pay for a project.\textsuperscript{55} That is, they would not be allowed to impose or raise a tax or fee absent the borrowing. For example, property taxes in California are limited by a cap which can be exceeded for assessments to pay bonded debt approved by the voters.\textsuperscript{56}

However, there are also reasons that local governments may borrow too much or may borrow unwisely. Some of these reasons are discussed in Sections 3.3.1 and 3.3.2.

3.2. \textit{State Regulation}

Local governments are created by state law and have only the powers given to them by the state.\textsuperscript{57} Local governments only have the powers expressly conferred upon them by state constitution or statute or charter; powers fairly implied by the powers expressly granted; and powers essential to the declared objectives or purposes of the local government.\textsuperscript{58} This is referred to as “Dillon’s Rule.”\textsuperscript{59}
Borrowing by local governments is regulated by state constitutions and statutes. The extent to which states exercise control over local government borrowing varies. At one end of the spectrum is a requirement that a state agency approve all local government bond issuances, or a prohibition of all local government borrowing. North Carolina takes the former approach for virtually all local government debt. At the other end of the spectrum would be an unfettered ability to borrow on any terms the local government deems appropriate. I am not aware of any state at this end of the spectrum, though some are closer than others.

This article addresses four main categories of State bond laws: restrictions on the ability to issue debt; limitations on the use of proceeds of bonds; constraints on use of proceeds, terms of debt, and mechanics of selling debt; and requirements for information to be made available and opportunities for citizens to provide input. These categories of regulations are discussed in Parts 5-7.

Some state laws include provisions governing how different types of bonds are to be paid and secured and what remedies are available to bondholders and provisions intended to ensure that bonds are not invalidated after they are issued. State laws also address more general topics that are relevant to municipal bonds, such as the treatment of financially distressed municipalities and whether they can apply for bankruptcy, restrictions on the ability to raise taxes or other revenues, laws governing the duties of government officials, laws concerning the procedures for elections, and open meeting laws. While all of these laws are important, they are beyond the scope of this article.

3.3. Reasons for States to Regulate Local Government Borrowing

The consequences of borrowing too much or borrowing unwisely can be severe. Local governments in financial distress may have to cut important city services, may default on bonds

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62 See AMDURSKY ET AL., supra note 22, at §§ 2.7, 5.2.1, 5.4, 5.14 (2nd ed., 2020-2 Cum. Sup.) for a description of some of the methods that states use to ensure validity of bonds and discussion of some provisions relating to payment of bonds and security and remedies available to bondholders.
63 While Chapter 9 of the federal Bankruptcy Act governs municipal bankruptcy, it does so only if state law permits the affected municipality to file for bankruptcy protection. See AMDURSKY ET AL., supra note 22, at § 5.15.2.2 and NAT’L ASSOC. OF BOND LAWYERS, MUNICIPAL BANKRUPTCY: A GUIDE FOR PUBLIC FINANCE ATTORNEYS 40-43 (2011) for discussion of this limitation and some of the relevant state laws.
and may (in some states) file for bankruptcy protection. There were 55 defaults on municipal bonds rated by Moody’s Investors Service (one of the three main organizations that provides credit ratings on municipal bonds) between 2007 and 2019, including defaults by 24 general governments (such as counties, municipalities and townships).64 Financial distress and defaults harm not only bondholders, but also residents and potentially the state and other communities in the state. When issuers experience financial distress, bondholders may not be paid the full amount they are owed, or payments to them may be delayed. Residents and property owners may experience reduced services or increased taxes and fees.65 Retired employees may lose their retirement benefits.66 States may be under pressure to provide fiscal relief to the distressed city, and other cities in the state may have to pay higher interest rates on their bonds.67

While local government financial distress has causes other than imprudent borrowing, obligations to pay large amounts of debt service certainly can contribute to financial problems. For example, the use of auction rate securities (on which interest rates were reset periodically at auction, or if the auction failed, were set at predetermined rates, which often ranged between 12-15% and as high as 20%)68 and interest rates swaps appear to have contributed to fiscal

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65 For example, during its bankruptcy, the City of Vallejo made significant cuts to police and firefighting services, resulting in more violent crime and longer response times to fires and medical emergencies. THE PEW CHARITABLE TRUSTS, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS 14 (2013). Also see Christine Sgarlata Chung, Government Budgets as the Hunger Games: The Brutal Competition for State and Local Government Resources Given Municipal Securities Debt, Pension and OBEP Obligations, and Taxpayer Needs, REV. OF BANKING U FIN. LAW 663, 667 (2013) (describing some impacts of the Detroit’s fiscal distress on taxpayers and noting that they “face escalating expenses, crumbling infrastructure, and grossly inadequate services, despite their tax burden”). Note, however, that some local governments have strongly resisted doing either of these things. See Clayton P. Gillette, Fiscal Federalism, Political Will and Strategic Use of Municipal Bankruptcy, 79 U. CHI. L. REV. 283, 285 (2012) (describing “refusals of fiscally distressed municipalities to accept higher taxes or reduced services”).
67 ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 37-38; Gillette, supra note 65, at 288, 303-09 (2012); Parker, supra note 61, at 112 (quoting Massachusetts Representative Barney Frank).
challenges that local governments confronted during and in the aftermath of the 2008 economic downturn.\textsuperscript{69}

Even absent financial distress, borrowing may result in excessive costs for local governments and may reduce government flexibility to address changing circumstances. Payments on debt can divert funds from other important uses. Furthermore, in addition to the obligation to make the payments, debt can come with burdensome financial and operating covenants, and failure to comply with covenants may result in a default.\textsuperscript{70} Debt gives some power over policy decisions is given to lenders, rating agencies and others.\textsuperscript{71} For all of these reasons, state governments are justified in regulating local government borrowing.

Two primary reasons (in addition to the need under Dillon’s Rule to provide clear authorization for local governments to be allowed to borrow at all) that states regulate local government borrowing are discussed in the following subsections: incentives of local governments to borrow more than they should, or for longer than they should; and inexperience or lack of knowledge leading local government officials to make unwise decisions about borrowing.

3.3.1. Incentives to Borrow Too Much

Government officials may have incentives to borrow more (and for longer) than would be consistent with interperiod equity,\textsuperscript{72} and possibly than the local government can comfortably support, in order to obtain short-term benefits the cost of which will not be paid until far into the future.\textsuperscript{73} Furthermore, special interest groups that benefit from a particular borrowing may


\textsuperscript{70} See infra notes 180-181 & 259 and accompanying text for discussion of some covenants.


\textsuperscript{72} See text accompanying note 50 for discussion of interperiod equity.

\textsuperscript{73} See, e.g., AMDURSKY ET AL., \textit{supra} note 22, at § 4.1.1 (“[L]ocal officials, who will want to demonstrate constructive activity to constituents before the next election, have incentives to over-utilize debt, paying scant attention to long-term adverse effects.”); Richard Briffault, \textit{Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law}, 34 RUTGERS L.J. 907, 917-18 (2003) (“the ability to shift the costs
influence officials to undertake the transaction, resulting in more debt than is appropriate or debt the cost of which outweighs the benefits for the population as a whole.74

Voters may not prevent officials from borrowing too much. Elected officials may rely on support from interest groups to help them be elected or reelected, and these groups may not have the same interests as the broader community.75 Even if current constituents are concerned about the burden on future residents, that will be merely one of many factors that contribute to their decision whether to re-elect the local official.76 In addition, voters may not monitor local government finances adequately. Even assuming that residents generally prefer that their local government behave in a fiscally responsible manner, each individual resident has the incentive to rely on others to monitor, with the result being an underinvestment in monitoring, and those that do have a greater interest in monitoring may not represent the interests of the residents as a whole.77

Furthermore, voters may have similar incentives to government officials to benefit today even if doing so burdens future residents, or they may not fully appreciate the long-term impacts of borrowing.78

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74 See Sterk & Goldman, supra note 73, at 1365-66.
76 Amdursky et al., supra note 22, at § 4.1.1.
77 Gillette, supra note 75, at 955, 961-64. Gillette identifies expected duration of residency and different individual priorities within the range of services provided by local governments as two reasons that even if some residents monitor, they may not represent residents as a whole. Id. at 961-964.
78 Amdursky et al., supra note 22, at §§ 2.1, 4.1.1; Gelfand, supra note 50, at 599 (also noting that voters may reject desirable projects); Shoked, supra note 31, at 1267. If debt service were fully capitalized into real estate values and rents — that is, if property values fully reflected the cost of future debt service — then the interests of current and future residents would be more closely aligned. Clayton P. Gillette, Direct Democracy and Debt, 13 J. CONTEMP. LEGAL ISSUES 365, 392 (2004). Scholars have reached varying conclusions about the extent to which taxes are capitalized into home values, though it appears that some capitalization occurs. See id. at 392 (noting varying conclusions about the extent of capitalization but indicating that some level of capitalization occurs); William A. Fischel, The Homevoter Hypothesis: How Homes Values Influence Local Government Taxation, School Finance and Land Use Policies 47-51 (2005) (discussing various capitalization studies and concluding that anticipated taxes are fully capitalized). However, even if property taxes are fully capitalized in some circumstances, it seems unlikely that the possibility of higher taxes in the future to pay debt service, much less the possibility of higher rates, charges or fees of other kinds, would be.
3.3.2. Lack of Expertise

Local government officials are not always experienced or knowledgeable enough to make good decisions about borrowing. Only 38% of government leaders surveyed considered themselves experts or very knowledgeable about public finance.\(^79\) Local governments often have few resources dedicated to debt management, and frequently borrowing is outside the primary roles of even those officials responsible for issuing debt.\(^80\) Many local governments only issue bonds once every few years; staff and officials at these governments may be particularly likely to be unfamiliar with the bond issuance process. Smaller communities tend to have smaller financial staffs, and the differences in capacity are likely to impact management of the issuer’s debt, including the interest rates paid on that debt.\(^81\) Even large issuers don’t always understand the agreements they make.\(^82\)

Of course, there are also many local government officials who are extremely capable and knowledgeable about local government finance and borrowing. Some of the most knowledgeable, intelligent, dedicated people with whom I have had the pleasure to work have been local government officials involved in public finance. Some local government officials are recognized leaders in their field, training others at programs for the Government Finance Officers Association, the California Debt and Investment Advisory Commission, and others.\(^83\)


\(^80\) Gov’t Fin. Officers Assoc., Debt 101: Issuing Bonds and Your Continuing Obligations 2 (2020); Monique Moyer, Current Issues Facing Bond Issuers and Their Financial Advisors, Mun. Fin. J. 17, 18 (Summer 2003); see also Ang & Green, supra note 19, at 8 (“Furthermore, when municipalities negotiate with investment banks and other financial intermediaries to issue debt, municipalities often have less expertise and relatively few resources to guide their decision making. This is detrimental not only to investors, but also to municipalities themselves.”); Jack Casey, MCDC’s Appropriateness, Effect on Market Disclosure Debated, Bond Buyer (May 5, 2016, 10:20 AM), http://www.bondbuyer.com/news/washington-securities-law/mcdcs-appropriateness-effect-on-market-disclosure-debated-1102961-1.html (noting that officials at small issuers sometimes have multiple responsibilities and citing the example of a finance director for a small school district who also drives the school bus).


\(^83\) See, e.g., Debt Management: Overview of a Bond Issuance, Gov’t Fin. Officers Assoc., https://www.gfoa.org/events/overview-of-a-bond-issuance (last visited Mar. 26, 2021); Municipal Debt
3.4. How Problems Have Developed

Many state laws governing municipal bonds have developed piecemeal over the years, with new laws being added on top of existing legislation, rather than legislation being revised in its entirety. Furthermore, in most states bond laws are scattered throughout numerous statutes and codes. The requirements for different types of bonds and different types of issuers are not always the same (and this is not always intentional). This makes it more difficult (and hence more time consuming and potentially more costly) to determine which requirements apply to a particular transaction.

Additionally, state laws have not always kept up with changing circumstances. For example, debt limits are tied to property values in most states. This dates back to 1800s, when property taxes generated most local government revenues and property owners were regarded as a class deserving special protection. Today, more local government revenues come from sources other than property taxes, and several have suggested that to the extent debt limits should apply this is not an appropriate measure. Some laws do not reflect current market practices. For example, Montana law requires that a notice of competitive sale be published in a local

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Salsich, supra note 60, at §§ 12.1, 12.2; see also Cal. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 1.1.2 (noting that rather than amending existing statutes to reflect changes in the bond market, California added a series of statutes that apply to all local governments issuing bonds); Fredric A. Weber et al., A Case for Public Finance Reform in Texas, 23 HOU. L. REV. 1113, 1113-1116 (1986) (describing Texas borrowing law as developing “gradually by bits and pieces in response to immediate needs” and describing the tendency to establish new governments and to add new statutes rather than amending existing ones).

Salsich, supra note 60, at § 12.1; see also Cal. DEBT AND INV. ADVISORY COMM’N, supra note 22, at App. A (a list of bonding statutes that spans several pages).

Id. at § 12.2; see Harvey W. Rogers, Government Borrowings Work Group: Revision of State and Local Government Borrowing Laws Found in ORS Chapters 286, 287 and 288 HB 3263, in Biennial Report of the Or. Law Comm’n 2005-2007 § 2 (noting that prior to a revision of Oregon bond law in 2007, local governments were “occasionally left out because of drafting inconsistencies”).

See Salsich, supra note 60, at § 12.2 (noting that authorizing statutes must be reviewed carefully); Rogers, supra note 86, at § 2 (noting that “ambiguous or inconsistent” borrowing statutes create “significant and unnecessary cost” to local governments and that prior to the revisions in HB 3265, it had become increasingly difficult to determine how different statutory provisions relate to each other and what the statutes mean).


Gelfand, supra note 88, at § 11.1.

See infra Section 5.1.2.
newspaper and Hawaii law requires that a notice of a competitive sale be published in a financial newspaper published in New York, Chicago or San Francisco. As a practical matter, bidders are more likely to learn of a competitive sale through an online service today. Complying with or legally avoiding archaic requirements can be costly.

Complicated laws increase the likelihood of errors. For example, one New York bond lawyer has noted that in reviewing bond resolutions and procedures taken by New York local governments, his firm “often find[s] an error or other violation of New York State law that raises an issue of the validity of the bond resolution.”

4. Moving Towards a Better Bond Law

4.1. This is Not a New Idea

Parts 5-7 of this article discuss some existing bond law provisions and recommended improvements. This is not the first time that improved bond laws have been proposed. The National Municipal League proposed a model county and municipal bond law in 1953, a model municipal revenue bond law in 1958 and a revised model municipal bond law in 1962. Individual states have taken actions to improve their bond laws. For example, Texas consolidated (but did not revise) its bond laws in 1999. Oregon reformed its bond law in 2007 with the objectives of clarifying how provisions relate to each other; simplifying and modernizing language and definitions; eliminating inconsistencies and outdated or unnecessary requirements; making financing techniques available to all local governments unless there was a reason not to do so; granting the state Treasurer more authority to adopt rules affecting borrowings; and

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91 HAW. REV. STAT. ANN. §47-8 (LexisNexis 2020); MONT. CODE ANN. § 7-7-2252 (2019).
92 A. Joseph Scott, III, Esq., Ten Common Mistakes in the Preparation and Adoption of Bond Resolutions, TALK OF THE TOWNS 14, 14 (September/October 2008). Correcting these errors can delay a financing. Id.
93 See generally, NAT’L MUN. LEAGUE, A MODEL COUNTY AND MUNICIPAL BOND LAW (1953); NAT’L MUN. LEAGUE, MODEL MUNICIPAL REVENUE BOND LAW (1958); NAT’L MUN. LEAGUE, MODEL MUNICIPAL BOND LAW (1962).
94 See generally Tex. H.B. 3157 (Enrolled Version); also see Tex. Office of House Bill Analysis, Bill Analysis, H.B. 3157 (July 15, 1999) (“The Public Securities title is a nonsubstantive revision of Texas law. The sole purpose of the title is to compile the relevant law, arrange it in logical fashion, and rewrite it without altering its meaning or legal effect. If a particular source statute is ambiguous and the ambiguity cannot be resolved without a potential substantive effect, the ambiguity is preserved.”)
reforming older statutes to allow local governments to adapt to evolving market conditions.\textsuperscript{95} The revisions did not affect debt limits or other requirements that are in the state’s constitution.

In addition, others have criticized and proposed alternatives to some aspects of municipal bond law, particularly debt limits and voter approval requirements. Some of these criticisms and alternatives are discussed elsewhere in this article.

\textit{4.2. Starting a Conversation}

This article is intended to start a conversation about changes that could be made to move towards better bond laws. It does not present a single model bond law for all states, or for a particular state, nor does it describe in detail the complete bond laws of any particular state or the specific types of bonds that may be issued in any particular state. Rather, it is intended to provide decisionmakers with a basis for making informed decisions about the approach to municipal bonds that is most appropriate for local governments in their state. States vary in the types and structures of local governments and the powers given to them.\textsuperscript{96} Values and priorities are also likely to vary among states, so different states may prefer different solutions.

Furthermore, it does not address all aspects of bond laws. Instead, it focuses on areas that affect the ability of local governments to make decisions about how much debt to issue, in what form, with what terms, and how to sell that debt and the ability of the public to be aware of and to impact those decisions. Within this scope, the article provides a recommended policy option (or options) and the reasoning for the recommendations, as well as other alternatives and some examples of what states currently do. It addresses both constitutional and statutory provisions (recognizing that constitutional ones may be difficult to change).

\textsuperscript{95} Rogers, \textit{supra} note 86, at § 3. This bill “was warmly received by both Oregon House and Senate Revenue Committees, sailed through both chambers and was signed into law by the governor.” David R. Kenagy, \textit{The Oregon Law Commission at Ten: Finding Vision for the Future in the Functions of the Past}, 44 \textit{Willamette L. Rev.} 169, 190 n. 78 (2007). Although some policy changes were made by this bill, making policy changes was not its objective. Rogers, \textit{supra} note 86, at § 4.

\textsuperscript{96} See, e.g., U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, A-127, LOCAL GOVERNMENT AUTONOMY: NEEDS FOR STATE CONSTITUTIONAL, STATUTORY, AND JUDICIAL CLARIFICATION 7 (1993) (noting that local governments take a variety of forms and organizational structures); FRUG & BARRON, \textit{supra} note 57, at Part II (comparing the powers given to seven major cities in the United States).
4.3. Underlying Goals

Ideally, law governing local borrowing would achieve two principal goals: (1) providing local governments the freedom to innovate and make decisions in the interest of their citizens while protecting current and future citizens from poor decisions made by local governments, and (2) ensuring that information is available to the public and that the public has a meaningful opportunity to influence proposed local government borrowing.

4.3.1. Freedom and Protection

This article starts with the premise that there is value in allowing local governments to make their own decisions, in large part because local governments are more likely to represent the interests of their citizens than the state or federal government is. This is not to say that there

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97 Or, to put it another way, “striking a careful balance between flexibility in the exercise of authority on the one hand, and appropriate controls and safeguards on the other.” Elsie Addo Awadzi, Designing Legal Frameworks for Public Debt Management 5 (Int’l Monetary Fund Working Paper no. WP/15/147, 2015). Also see ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 2 (the purpose of bonds laws is “To empower local governments to make use of borrowing, prudently and in a responsible and locally responsive manner, as one means for financing their requirements.”).

98 Others have also noted the importance of transparency and responsiveness. See, e.g., Awadzi, supra note 97, at 4 (noting the importance of transparency and accountability, along with discipline); Gelfand, supra note 50, at 579, 586 (1979) (noting the importance of providing accurate information to stakeholders, including officials and voters, and of government being responsive to citizens).

99 Various commentators have taken this view. See, e.g., AMDURSKY ET AL., supra note 22, at § 1.1.3 (noting that local governments have been viewed as “the focal point of attempts to formulate communities of like-minded individuals” and “the only meaningful places in which political participation can occur and the objectives of democracy be realized” and that these perspectives suggest that local governments should differ from each other in the goods and services they provide); FRUG & BARRON, supra note 57, at 49-52 (highlighting the importance of local governments to democracy and innovation); Heather K. Gerken, A New Progressive Federalism, DEMOCRACY JOURNAL, https://democracyjournal.org/magazine/24/a-new-progressive-federalism/ (spring 2012) (noting that racial and political minorities can have more power at the local level than at the federal or state level); Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. POL. ECON. 416, 418 (1956) (suggesting that people will move to the community that best meets their set of preferences and that more communities and more variation between them will allow more people to more closely meet their preferences). Some have noted increased efforts of states to restrict power of local governments (in areas other than debt issuance) in recent years. See, e.g., Jessica Amoroso & Sarah Winston, COVID-19 Unmasks Issues Around Public Health Preemption, BILL OF HEALTH, PETRIE FLOM CENTER, HARVARD LAW SCHOOL, https://blog.petrieflom.law.harvard.edu/2020/12/21/covid-public-health-preemption/ (Dec. 21, 2020) (noting that state preemption is increasingly being used to prevent local governments from addressing public health issues, such as paid sick leave or prohibiting stay-at-home measures or mask requirements to prevent the spread of COVID-19); Erin Scharff, Preemption and Fiscal Authority, 45 FORDHAM URB. L.J. 1270, 1273-4, 1279-82 (2018) (describing more restrictive state laws constraining local and citing examples); Richard C. Schragger, The Attack on American Cities, 96 TEX. L. REV. 1163, 1169-1183 (2018) (citing examples).
should be no restrictions on local government action. For example, local governments should not be able to impose negative externalities on other communities or on future citizens (such as by violating interperiod equity), nor should they be able to act in ways that are fundamentally inconsistent with important values like protecting civil rights and promoting racial equality.

However, current and future citizens deserve and need protection from poor decisions made by local governments. As was discussed in Sections 3.3.1 and 3.3.2, local government officials may be predisposed to borrow more than they should and some officials may not be sufficiently knowledgeable to make prudent decisions about borrowing. This article suggests that while some restrictions on borrowing are appropriate, for the most part education and support is a better solution to lack of expertise than are detailed rules about the terms of financings. More straightforward bond laws may even help local government officials make better borrowing decisions, as is discussed in Section 4.3.3.

4.3.2. Ensuring Public Opportunity to Participate

The second primary objective of the framework is ensuring that information is available to the public and that the public has a meaningful opportunity to provide input on proposed local government borrowing. It is critical in a democratic society that residents are aware of and have the opportunity to understand the significant actions that are being taken by their government (including their local government) and that they have the opportunity to influence those actions, whether that is through public comment, contacting public officials, or voting on the matter.

4.3.3. Other Key Principles

In addition to the underlying goals identified above, the framework is guided by several principles. In particular, the importance of:

- Treating all local governments the same except where there is a reason not to do so.
- Treating all debt the same except where there is a reason not to do so.
- Focusing on the economics of the transaction rather than the structure.
- Providing flexibility for changing circumstances and market conditions.
- Avoiding overlapping, inconsistent and unduly complicated provisions whenever possible, and keep related provisions together whenever possible.
Each of these principles contributes to the underlying goals described above. Consistent treatment of different types of government and different types of debt encourage local governments to make decisions based on which type of financing structure best meets their needs rather than based on restrictions or approval requirements that apply to some types of debt but not others. Treating types of government and borrowings consistently also will promote transparency.\textsuperscript{100} Similarly, laws that focus on the economics of the transaction rather than its structure are less likely to distort borrowing decisions, and flexibility to adapt to changing circumstances and market conditions is more likely to allow local governments to structure their borrowing optimally and to avoid needing to satisfy obsolete requirements. Structuring borrowing law as simply as possible should make the law easier for both the governments and citizens to understand and follow and should help local governments avoid making costly mistakes.

4.4. Limitations of the Framework

Due to constraints of space, the framework doesn’t cover all possible types of borrowing or financing, nor does it specifically address interest rate swaps or other derivatives in any detail. Instead, it focuses on general obligation bonds and revenue bonds issued by local governments. Some of the same principles could be applied to other types of financing. The article uses the term “borrowing” to cover all transactions that result in a local government receiving money in exchange for an obligation to repay, but does not cover other obligations local governments may have, such as commitments to pay pension and other benefits to retirees in the future.

Furthermore, the article is focused on general purpose local governments and special districts, not on bonds issued for the benefit of private nonprofit or for-profit entities. Borrowings on behalf of private parties raise some of the same concerns, but many different ones.

Additionally, as noted in Section 4.2 above, this article focuses on topics related to the scope of decision-making authority of local governments and the involvement of community members in the decision-making process, rather than more technical (but also important) aspects of bonds such as how revenues to pay bonds are collected, how bonds are secured, remedies available to bondholders, and methods to ensure the validity of bonds issued. Those topics, and

\textsuperscript{100} See infra note 179 and accompanying text.
perhaps a proposed uniform act that could be adopted by multiple states covering some or all of them, could be the subject of a separate article or a project by an organization such as the National Association of Bond Lawyers.

State laws also address topics that are relevant to municipal bonds but have more general applicability, such as laws concerning treatment of financially distressed municipalities and whether they can apply for bankruptcy, restrictions on the ability to raise taxes or other revenues, laws governing the duties of government officials, laws concerning the procedures for elections, and open meeting laws. While these laws all are important, they are beyond the scope of this article.

5. Restrictions on the Ability to Issue Debt: Debt Limits and Voter Approval Requirements

5.1. Debt Limits

5.1.1. Existing Debt Limits

Most states impose limits on the amount of debt issued by their local governments.\textsuperscript{101} Some of these limits appear in state constitutions and others are statutory. The limits take a variety of forms, most commonly a fixed percentage of property values.\textsuperscript{102} The limits imposed on governments vary, sometimes even for different local governments within a state or for debt issued for different purposes. For example, the Hawaii Constitution limits outstanding debt of a local government to 15\% of the total assessed value of real property within the local government’s boundaries.\textsuperscript{103} The New York Constitution includes a range of limits based on a percentage of average full valuation, including, among others, 10\% for Nassau County and 7\%\textsuperscript{104}

\textsuperscript{101} Spiotto, supra note 4, at 6-8 (discussing the limits states have placed on debt municipalities may issue and noting that all states except three have a limit on local government debt); Gillette, supra note 4, at 1255 (“Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects . . . ”).

\textsuperscript{102} See supra note 88 and accompanying text.

for other counties; 10% for New York City, 9% for other cities with populations of 125,000 or more and 7% for smaller cities; 7% for towns and villages.\footnote{N.Y. Const. art. VIII, § 4.} Oregon limits outstanding general obligation bonds of counties to 2% of the market value of taxable property in the county, and of cities to 3% of the market value of the taxable property in the city (with exceptions for cities for some types of projects).\footnote{Or. Rev. Stat. §§ 287A.050, 287A.100 (2019).} California limits the outstanding general obligation bonds of elementary and high school districts to 1.25% of the assessed value of taxable property in the district, while the limit for non-home-rule cities is 3.75% and for counties is 1.25% or 3.75% depending on the purpose for which the bonds are being issued.\footnote{Cal. Debt & Inv. Advisory Comm’n, CDIAC No. 06-04, California Debt Issuance Primer 138 (2006). The limit for unified school districts (which include both elementary and high schools) is 2.5%. Id. The California State Board of Education sometimes waives the limits for school districts. Kevin Dayton, Cal. Policy Ctr., For the Kids: California Voters Must Become Wary of Borrowing Billions More from Wealthy Investors for Educational Construction 44 (2015).}

Exceptions to debt limits sometimes make them less meaningful. For example, local governments in New York are rarely constrained by debt limits because of exclusions and deductions.\footnote{See Douglas E. Goodfriend & Thomas E. Myers, Orrick, Bond Basics for School Districts in New York State 5 (2009), available at https://media.orrick.com/mediainlibrary/public/files/2/2163-pdf.pdf [hereinafter Goodfriend & Myers, Bond Basics for School Districts] (noting this with respect to school districts other than small city school districts); Douglas E. Goodfriend & Thomas E. Myers, Orrick, Bond Basics for Towns, Villages and Cities in New York State 5 (2009), https://media.orrick.com/mediainlibrary/public/files/2/2161-pdf.pdf [hereinafter Goodfriend & Myers, Bond Basics for Towns, Villages and Cities] (noting this with respect to towns, villages and cities); Thomas E. Myers & Douglas E. Goodfriend, Orrick, Bond Basics for Counties in New York State 5 (2009), https://media.orrick.com/mediainlibrary/public/files/2/2160-pdf.pdf [hereinafter Myers & Goodfriend, Bond Basics for Counties] (noting this with respect to counties); Thomas E. Myers & Douglas E. Goodfriend, Orrick, Bond Basics for Fire Districts in New York State 5 (2010), https://media.orrick.com/mediainlibrary/public/files/4/4257-pdf.pdf [hereinafter Myers & Goodfriend, Bond Basics for Fire Districts] (noting this with respect to fire districts).} Some state laws, such as the California and Oregon laws described in the preceding paragraph, expressly apply limits only to certain types of debt, and courts also have created exceptions to these limitations in most states.\footnote{See, e.g., Amdursky et al., supra note 22, at § 4.1.1 (“myriad devices have evolved, largely with judicial blessing, to remove borrowing schemes from what might, in common parlance, be considered debt.”); Gelfand, supra note 88, at § 11.12 (indicating that most courts have held that debt not backed by the government’s full faith and credit is exempt from debt ceilings and referendum requirements); Shoked, supra note 31, at 1253-54 (noting that financing structures that are equivalent to debt are not always subject to limits and that debt limits typically only apply to debt guaranteed by property taxes).} This is discussed in greater detail in Section 5.3.
5.1.2. Debt Limits in Their Current Form Do More Harm Than Good and Should Be Replaced or, Better Yet, Eliminated, Wherever Possible

Effective debt limits would promote interperiod equity and prevent local governments from borrowing more than they can afford. However, it is unlikely that debt limits in their current form achieve these goals, even if they are effective. Furthermore, debt limits may have negative impacts on some communities and prevent needed projects from proceeding, and they may be counter to the objective of providing the public with a meaningful opportunity to influence borrowing (at least if such borrowing exceeds the legal limits, since it would not be permitted regardless of public sentiment). If debt limits are effective, they raise some of the issues discussed below. The possibility that they may not be effective and may simply lead to more expensive debt and less transparency is discussed in Section 5.3. For these reasons, discussed in greater detail below, debt limits should be modified or, better yet, eliminated.

As was noted above, debt limits vary widely. Although some differences in limits may be explained by the different responsibilities or needs of local governments in different states, or of different types of local governments in the same state, the wide variety of limits “… suggests that, far from being linked to some conception of an optimal amount of debt, these provisions have been created in a haphazard manner in order to place some cap on borrowing, regardless of how that level correlates to ability to pay, to need, or to any other standard.” Compounding the problem, a single property may be within the boundaries of multiple overlapping local governments (for example, county, city, school district, special districts) with separate debt

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109 See, e.g., AMDURSKY ET AL., supra note 22, at § 2.1 (describing the purposes of restrictions as ensuring that bonds are issued only when the societal benefits outweigh the costs and describing interperiod equity as the purpose of debt limits); Gelfand, supra note 88, at § 11.2 (describing effective debt ceilings as protecting future taxpayers from “inordinate debt service on capital projects that may have produced few tangible benefits for them”); also see supra Section 3.3.

110 See ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 44 (suggesting that different types of local governments should have different limits because of differences in “scope of responsibilities and financial needs” and noting that municipal governments commonly borrow several times more than counties, school districts or townships).

111 Gelfand, supra note 88, at § 4.2. See also Gillette, supra note 4, at 1258 (2009) (noting that “the variety of limitations placed on municipalities belies [the] proposition” that “municipal debt limitations reflect[] some sophisticated analysis of the optimal debt level that a locality should incur” and describing various limits).
limitations, meaning that the amount of debt burdening that property is far higher than the debt limit for any individual local government within the boundaries of which it is located.\textsuperscript{112}

Furthermore, even if an optimal level of borrowing had been determined, it is not likely that level would be tied to real property values, particularly with respect to debt that is not payable exclusively from property taxes. When debt limits were initially enacted over a century ago, local revenues were derived almost entirely from property taxes.\textsuperscript{113} Today, though, property taxes comprise a minority of overall local government revenues (45.3\% of local own-source revenues and 28.3\% of total local government general revenues in 2008).\textsuperscript{114}

Property taxes tend to be a relatively stable revenue source because they are based on asset value rather than an annual stream of income or sales.\textsuperscript{115} In some states, property tax revenues can be adjusted when property values decline by increasing tax rates.\textsuperscript{116} For these reasons, if there are limits on borrowing, they should be a component of the limit. However, it would be sensible to also include other sources that would be available to pay debt service, including revenues from other taxes and fees. A limit based on appropriations or revenues (or revenues available to pay debt service) would be a better gauge of ability to pay.\textsuperscript{117} This would

\textsuperscript{112} See AMDURSKY ET AL., supra note 22, at § 4.13 (discussing this problem); also see supra note 9 and accompanying text.

\textsuperscript{113} Gelfand, supra note 88, at § 11.1.

\textsuperscript{114} Michael E. Bell, \textit{Real Property Tax, in The Oxford Handbook of State and Local Government Finance} 271, 271 (Robert D. Ebel & John E. Petersen, eds. 2012). Local own-source revenues are revenues generated by the local government itself (such as taxes and fees) rather than received from the federal or state government. General revenues are revenues that can be used for any purpose. A property tax that must be used to pay debt service on bonds or a grant that must be used for a specific purpose would not be general revenues. The extent to which local governments depend on property taxes varies. For example, on average, property taxes are responsible for 14\% of California city revenues, 22\% of California county revenues, and 65\% of non-enterprise special district (such as fire district or library district) revenues. Inst. for Local Gov’t, Understanding the Basics of Municipal Revenues in California: Cities, Counties and Special District (2016 Update), https://www.ca-ilg.org/sites/main/files/file-attachments/basics_of_municipal_revenue_2016.pdf, 4-6.

\textsuperscript{115} Bell, \textit{supra} note 114, at 274-75.

\textsuperscript{116} See Catherine Collins and Geoffrey Propheter, \textit{Tax Analysts Special Report: The Property Tax Base and The Great Recession} 1 (2013) (noting that some locales did this during the 2007-2009 recession). The ability to raise tax rates is limited in some states. For example, the California Constitution imposes a 1\% limit on property taxes with some exceptions, most significantly for voter-approved bonds. CAL. CONST. art. XIIIA, § 1.

\textsuperscript{117} See AMDURSKY ET AL., supra note 22, at § 4.2 (suggesting that limits based on revenues or appropriations might be better); Briffault, supra note 73, at 948 (noting that det limitations might be more defensible if they were tied to the revenue-generating capacity of governments); Gelfand, \textit{supra} note 50, at 587 (noting that limiting debt based on only a portion of the government’s income base is not effective and proposing including wealth if there is an income tax and sales volume if there is a sales tax).
not, however, address the issue of what the limit should be and as noted above, there does not seem to be consensus on what an appropriate limit is.

Debt limits tied to property values also may exacerbate existing economic disparities. Jurisdictions with relatively low property values per capita are more likely to be constrained by debt limits, both because the limits restrict them to a smaller amount per capita to meet infrastructure needs and because areas with lower property values may have greater needs than areas with higher property values.\textsuperscript{118}

Debt limits of the type discussed in this section do little to promote interperiod equity since they say nothing about how debt is amortized, the period for which debt is outstanding or the amount that can be borrowed for a particular project, all they restrict is the total amount borrowed. If set too low, debt limits could even be counter to interperiod equity because they would not allow for enough borrowing. That said, some studies do suggest that communities that are subject to debt limits borrow less than those not subject to such limits.\textsuperscript{119}

In addition, debt limits can block desirable as well as undesirable debt.\textsuperscript{120} Because of the important role that debt plays in providing important infrastructure, “[l]ow levels of debt and the resulting low levels of capital investment can be as harmful to a state or locality as excessive debt,” but debt limits that do not take need into account do nothing to address this.\textsuperscript{121} In addition,

\begin{footnotesize}
\begin{enumerate}
  \item See, e.g., AMDURSKY ET AL., supra note 22, at § 4.15 (noting there may be an inverse relationship between assessed valuation and need and debt limits may prevent the localities most in need of debt financing from borrowing); ORANGE CNTY. GRAND JURY, SCHOOL BONDS—THE UNTOLD STORY OF ASSESSED VALUES 11-12 (2014), https://www.ocgrandjury.org/pdfs/2013_2014_GJreport/BondsReport.pdf (providing an example of how borrowing capacity in a school district with lower assessed value per student compares to that in a district with higher assessed value per student); Eric J. Brunner & Kim Rueben, Financing New School Construction and Modernization: Evidence from California, 54 NAT’L TAX J. 527, 535-36 (2001) (school districts that have low assessed valuation per student are more likely to be constrained by debt limits that are based on property values); Darien Shanske, Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis, 43 U. MICH. J.L. REFORM 663, 703 n. 110 (2010) (noting that a limit on the tax rate required for debt service compared to assessed value has a disproportionate impact on areas with lower property values). The same may also be true of debt limits tied to local government revenues generally, and grants or other mechanisms to redistribute resources may be more effective at reducing disparities than relaxing restrictions on borrowing, though this topic is beyond the scope of this article.
  \item See infra note 177. Of course, it may be that regions where residents are less supportive of government borrowing are more likely to have debt limits. Others also have made this point. See D. Roderick Kiewiet & Kristin Szakaly, Constitutional Limitations on Borrowing: An Analysis of State Bonded Indebtedness, 12 J. L. ECON. & ORG. 62, 69 (1996) (noting that debt limits may “reflect the degree to which citizens of the state are averse to borrowing”).
  \item See Sterk & Goldman, supra note 73, at 1366 (“Mechanical limitations are doomed to failure,” in part because they can prevent borrowing even when it is desirable).
  \item Briffault, supra note 73, at 949.
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debt limits that cannot be modified by approval of voters in the affected area negatively affect the ability to respond to community desires because even if voters within a local government’s boundary want to borrow in excess of the limit, they cannot do so unless the state legislature and/or voters statewide act to allow them to do so.  

Some of these issues may have contributed to the creation of exceptions to debt limits described in Section 5.3. These exceptions have created significant additional problems. Because similar issues arise regarding exceptions to voter authorization requirements, both are discussed together in Section 5.3.

5.2. Voter Approval Requirements

5.2.1. Existing Voter Approval Requirements

Most states have voter approval requirements for some local government borrowing, most commonly majority approval, but in some states, supermajority approval (the size of the required supermajority varies). Sometimes, approval of debt is also an approval of an increased tax to pay the bonds, or approval occurs concurrently with the approval of the new tax. For example, California local governments must obtain the approval of two-thirds of their voters voting on the matter (with smaller percentages required for certain issuers in some circumstances) to issue general obligation bonds, which also authorizes the increase in property taxes to pay those bonds. Bonds payable from sales taxes also often require voter approval in California. Local governments in Oregon must obtain approval of a majority of their voters voting on the matter before issuing general obligation bonds. In some states, debt limits of the

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122 See Gelfand, supra note 50, at 91 (noting that voters in a locality that wanted to borrow in excess of a constitutional debt ceiling would need the support of voters throughout the state to amend the ceiling and allow them to do so).
123 Salsich, supra note 60, at §§ 12.23, 12.30; Gillette, supra note 78, at 370.
124 CAL. CONST. art. XIII A, § 1(b)(2), (3); art. XVI, § 18(a), (b).
125 CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 3.3.3. The sales taxes themselves also require voter approval (by either a majority or 2/3 of those voting on the matter, depending on the use of the tax proceeds). CAL. CONST. art. XIII C. See also CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 3.3.3.
126 OR. CONST. art. XI §§ 11(11)(d)(C)(ii), 11b(3)(b), 11L (these provisions allow property taxes to be set at levels sufficient to cover debt service with voter approval); OR. REV. STATS. §§ 287A.050, 287A.100 (2019).
type described in Section 5.1.1 above can be overridden with voter approval.\(^{127}\) In others, there is only a voter approval requirement, not a debt limit.\(^{128}\)

Sometimes, voters may be asked to approve debt only at certain elections. For example, in Oregon, general obligation bonds must be approved either at an election held in May or November, or at another election at which a majority of registered voters cast ballots.\(^{129}\) In California, school districts may obtain approval of general obligation bonds for which approval of only 55% of those voting on the matter (rather than two-thirds) is required only at “a primary or general election, a regularly scheduled local election at which all of the electors of the school district … are entitled to vote, or at a statewide special election.”\(^{130}\) Presumably these requirements are imposed because voter turnout is higher at some elections than others.\(^{131}\)

Instead of a voter approval requirement, some states provide a period in which voters can petition to have an election concerning particular debt (sometimes referred to as a “permissive referendum” or “backdoor referendum”) for some local government bonds. For example, with limited exceptions, bond resolutions adopted by towns and villages in New York are not immediately effective.\(^{132}\) Rather, the local government must publish a notice that the resolution has been adopted, and during a 30-day period after adoption, a petition may be filed signed by a specified number of voters requesting that the voters of the town or village be given an opportunity to vote on the bonds.\(^{133}\) If no petition is filed within 30 days, the resolution becomes

\(^{127}\) **AMDURSKY ET AL., supra** note 22, at § 4.2; **Salsich, supra** note 60, at § 12.25.
\(^{128}\) **Gelfand, supra** note 88, at § 11.7.
\(^{129}\) **OR. CONST. art. XI, §§ 11(8), 11k.** Since it is rare for a majority of voters to cast ballots, general obligation bond elections are usually held in May and November. **LEAGUE OF OR. CITIES, supra** note 50, at 8.
\(^{130}\) **CAL. EDUC. CODE § 15266(a)** (Deering 2021).
\(^{131}\) For example, one study covering the period from 2004-2006 found that voter turnout for local elections held concurrently with national elections had an average turnout rate of 76% during a presidential election year and 56% during congressional elections, while local elections held in off-years or not at the same time as national elections had an aggregate turnout rate of between 18-35% (the author suggests that the 35% reflects some states having statewide elections at the same time). J. **ERIC OLIVER, LOCAL ELECTIONS AND THE POLITICS OF SMALL-SCALE DEMOCRACY** 64-65 (2012).
\(^{132}\) **N.Y. LOCAL FIN. LAW §§ 35.00, 36.00** (McKinney 2021); **GOODFRIEND & MYERS, BOND BASICS FOR TOWNS, VILLAGES AND CITIES, supra** note 107, at 28. In contrast, cities and counties are often not subject to a permissive or mandatory referendum process (so no voter approval is required) and school districts and fire districts are often subject to a mandatory referendum process (so voter approval is always required). **Id. at** 30; **MYERS & GOODFRIEND, BOND BASICS FOR COUNTIES, supra** note 107, at 25; **GOODFRIEND & MYERS, BOND BASICS FOR SCHOOL DISTRICTS, supra** note 107, at 29; **MYERS & GOODFRIEND, BOND BASICS FOR FIRE DISTRICTS supra** note 107, at 23.
\(^{133}\) **N.Y. TOWN LAW §§ 90, 91** (McKinney 2021); **N.Y. VILLAGE LAW § 9-900, 9-902** (McKinney 2021).
effective and the bonds may be issued.\textsuperscript{134} Illinois, Oregon and Texas have similar procedures for some debt.\textsuperscript{135}

5.2.2. Voter Approval Requirements Should Be Carefully Considered and Potentially Limited

Voter approval requirements should ensure that local government officials are acting consistently with the desires of their constituents and that community members are informed (or at least have the opportunity to be informed) about proposed borrowing and major projects being financed. Ideally, they also would promote interperiod equity. While voter approval requirements are more successful in achieving these objectives than debt limits are in achieving theirs, they are imperfect tools.

5.2.2.1. Benefits of Voter Approval Requirements

Voter approval requirements provide greater flexibility than debt limits and improve the ability of the local government to respond to the preferences of the community.\textsuperscript{136} They likely also promote transparency. States that require bond elections typically require that information be provided to voters in a notice or the in the ballot measure itself.\textsuperscript{137} For example, California law requires that when any local government bond measure is presented to voters, a statement indicating the specific purposes of the bonds must be provided and that when a general obligation bond is proposed to voters, a statement must be sent to voters including an estimate of the average annual tax rate and the highest tax rate that will be required to pay the bonds, the final year in which the tax rate is expected to be collected, the year in which the tax rate is

\textsuperscript{134} N.Y. TOWN LAW § 91 (McKinney 2021); N.Y. VILLAGE LAW 9-902 (McKinney 2021).

\textsuperscript{135} See Kelly K. Kost & Anjali Vij, General Obligation and Revenue Bonds, in ILL. INST. FOR CONTINUING LEGAL EDUC., MUNICIPAL LAW FINANCING, TAX, AND MUNICIPAL PROPERTY §§ 2.20, 2.24 (2018) (describing the process that applies to some Illinois local government bonds); LEAGUE OF OR. CITIES, supra note 50, at 10, 13 (describing the process that applies to some Oregon full faith and credit bonds and revenue bonds); THOMAS M. POLLAN & DAVID MÉNDEZ, TEX. ASSOC. OF COUNTIES, 2017 PUBLIC FINANCE HANDBOOK FOR TEXAS COUNTIES 20-21 (2017) (describing the process that applies to county certificates of obligation).

\textsuperscript{136} See Gelfand, supra note 88, at § 11.7 (noting that voter approval requirements “emphasize[] the principles of fiscal flexibility and local political responsiveness”); Kirk J. Stark, The Right to Vote on Taxes, 96 NW. U. L. REV. 191, 194 (2001) (noting in the context of tax limits that while voter approval is “less reliable as a taxpayer protection device[,] … it is more respectful of majoritarian preferences and local autonomy.”) (the same would be true for voter approval as opposed to strict debt limits).

\textsuperscript{137} Salsich, supra note 60, at §§ 12.31, 12.32.
expected to be highest, and the estimated total principal and interest on the bonds.\textsuperscript{138} Oregon requires that ballot measures for general obligation bonds include the amount of bonds to be authorized and the purposes for which the proceeds are to be spent and a statement that property taxes may increase.\textsuperscript{139} This means that community members have at least some information about the proposed bonds and the project they are to finance. In addition, it may be that having bond measures on the ballot encourages more public discussion of the costs and benefits of the financing and the project being financed.

Furthermore, notwithstanding that voters may have incentives to borrow more or for a longer term than would be consistent with interperiod equity as was noted above, some studies suggest that voter approval requirements result in less debt that is subject to those requirements and possibly less debt overall (though there are conflicting conclusions about the impact on overall debt levels).\textsuperscript{140} While many bond measures are approved (for example, 73\% of school bond measures proposed in California from 2008 through 2020 passed),\textsuperscript{141} some are not. Furthermore, local government officials may be deterred from pursuing financings unless they have a reasonable expectation that they will be approved by voters, because presenting the measure to voters can be costly, both in terms of out-of-pocket costs and politically.\textsuperscript{142} The

\textsuperscript{138} \textsc{Cal. Elec. Code} § 9401 (Deering 2021); \textsc{Cal. Gov’t Code} § 53410 (Deering 2021).

\textsuperscript{139} \textsc{League of Or. Cities}, supra note 50, at 8. The estimated tax rates to pay debt service are not required to be included, but they often are. Id.

\textsuperscript{140} See \textsc{Amdursky et al.}, supra note 22, at § 4.15 (citing several studies suggesting that voter approval requirements reduce debt levels). One study of state borrowing found that referendum requirements appeared to reduce the level of guaranteed debt, but the study also found that the impact on nonguaranteed debt was not clear and that there were strong indications that in these states more debt was simply issued by local governments rather than the state. Kiewiet & Szakaly, supra note 119, at 84-86. This is not, of course, an option for local governments, but in some states they may be able to issue through state authorities or other local governments; this might have a similar effect. \textit{Also see infra} note 177 for description of other studies.

\textsuperscript{141} \textsc{School Bond Elections in California}, \textsc{Ballotpedia}, https://ballotpedia.org/School_bond_elections_in_California (last visited Mar. 26, 2021).

\textsuperscript{142} \textit{See infra} notes 158-162 and accompanying text. \textit{Also see} Kiewiet & Szakaly, supra note 119, at 68 (“public authorities probably do not put bond issues to voters unless the likelihood of voter approval is reasonably high”). Government officials also may avoid borrowing to finance projects if doing so is politically unpopular even absent a voter approval requirement, because presumably there is a political cost to doing so. However, they may be more inclined to approve a project and related borrowing when voter approval is not required because the borrowing may garner less attention than a ballot measure would and because they may hope that once community members are receiving the benefits of the facility, they will feel more positive about the borrowing to the extent they consider it at all. Occasionally when voters reject a bond measure, local government officials proceed to finance the project using a method of borrowing that does not require voter approval. \textit{See infra} note 176 for further discussion and examples.
resulting lower level of borrowing may serve to counterbalance the incentives to borrow more than is optimal (described above in Section 3.3.1).

5.2.2.2. Drawbacks of Voter Approval Requirements

Notwithstanding that voter approval requirements appear to be more beneficial than debt limits, they do raise some concerns.

5.2.2.2.1. Voter Approval Requirements May Lead to a Lower-than-Optimal Amount of Debt

There are reasons to believe that less than an optimal level of debt may be approved by voters, and some have expressed concerns about whether voter approval is an effective means for voters’ wishes to be met.

As was discussed in Section 3.3.1, current community members may have the same interest in deferring payment of debt to the future that elected officials do. But there are also reasons to believe that voters may not approve enough borrowing or may not approve the right borrowing.

Supermajority requirements give a minority the ability to block a financing desired by the majority.\(^{143}\) The size of the supermajority matters. For example, of the 857 ballot measures approved under a California law permitting the issuance of general obligation bonds for school facilities with approval of 55% of the voters, 488 would not have been approved had the alternative requirement for approval by 2/3 of voters applied (meaning that they were approved by more than 55% but fewer than 2/3 of voters voting on the matter).\(^{144}\)

In addition, it is not clear that voters are sufficiently informed enough to make good decisions about financing matters.\(^{145}\) Unless a measure receives significant media attention (and this is rare), voters generally have little information about the measures upon which they are

\(^{143}\) Schragger, supra note 71, at 870; see also Briffault, supra note 73, at 954 (noting that supermajority requirements thwart majority wishes); Editorial: State Must End Supremey Bad Supermajority for School Bonds, NEWS TRIB. (Apr. 28, 2018), https://www.thenewstribune.com/opinion/editorials/article210003224.html (describing defeat of a school district bond measure in Washington State that received 59% of the vote but not the 60% supermajority required to pass and advocating for the elimination of supermajority requirements as undemocratic).

\(^{144}\) Based on data in DAYTON, supra note 106, at 16.

\(^{145}\) See Briffault, supra note 73, at 953 (noting this concern).
Furthermore, one study determined that the descriptions and analysis of ballot initiatives included in voters’ handbooks prepared by states are written at the reading level of a third year college student. Presumably, many voters do not read at this level. While bond measures may be easier to understand than many ballot measures, voters may not always understand the matter on which they are voting. Certainly, it is unlikely that voters generally have the expertise, knowledge, or, often, incentive, to monitor a local government’s overall fiscal health and the impact of borrowing on that health. In addition, voters are not likely to be presented with the details of the financing structure and alternative methods of financing. Voters also are making decisions about bond measures without knowing whether other bond measures on the ballot will pass, or what bond measures may be on future ballots. As a result, an individual voter may approve either more or less debt than even that individual voter would desire.

Questions also have been raised about whether those who actually vote on ballot measures are representative of the electorate as a whole. Only a portion of voters typically participates in elections in the United States. Approximately two-thirds of people eligible to vote participated in the November 2020 presidential election, and this was the highest turnout since at

146 Richard Briffault, Distrust of Democracy, 63 Tex. L. Rev. 1347, 1355 (1985) (reviewing DAVID B. MAGLEBY, DIRECT LEGISLATION: VOTING ON BALLOT PROPOSITIONS IN THE UNITED STATES (1984)). See also Elizabeth Garrett & Mathew D. McCubbins, When Voters Make Laws: How Direct Democracy is Shaping American Cities, 13 Pub. Works Mgmt. & Pol’y 39, 40, 47, 55-57 (2008) (describing case studies that showed that the amount of information about bond measures varies significantly and discussing the low levels of voter knowledge about many some ballot measures); Craig M. Burnett, Elizabeth Garrett & Matthew D. McCubbins, The Dilemma of Direct Democracy, 9 Election L.J. 305, 317 (2010) (noting that a higher proportion of the information about ballot measures comes from political campaigns than is the case for political candidates and that not every ballot measure has a meaningful supporting and opposing campaign). Some states require certain information be provided to voters. See supra notes 137-139 and accompanying text.

147 DAVID B. MAGLEBY, DIRECT LEGISLATION: VOTING ON BALLOT PROPOSITIONS IN THE UNITED STATES 138 (1984). See also Garrett & McCubbins, supra note 146, at 55-56 (describing ballot pamphlets as “often dauntingly long and dense” and suggesting that while information may be in the pamphlet, “it is not provided in a format that makes voting cues accessible and salient to voters.”)


149 Garrett & McCubbins, supra note 146, at 45.

150 See Briffault, supra note 73, at 953 (noting this concern).
least 1980.\footnote{151} Turnout at elections that garner less attention, and in particular at local elections, is typically much lower.\footnote{152} Even among those who do vote in a particular election, some do not vote on ballot measures.\footnote{153} Those who vote on ballot measures may not represent the community as a whole. Studies suggest that more educated and older people are more likely to vote at all and that of those who vote, those with more education are more likely to vote on ballot measures.\footnote{154} Another study suggests that educated homeowners who are long-term residents may be more likely to vote in local elections than others are, and that any bias caused by low voter turnout is likely to lead to “policies that protect property values and suppress property taxes.”\footnote{155} At least for general obligation bonds that are payable from property taxes, the result may be that those who vote are more likely to oppose a bond measure, absent a clear connection between the project financed and higher property values.

Furthermore, local governments that need to obtain voter approval may seek it for a lower amount of bonds than the voters would approve. A study of school boards found that school boards typically propose a lower amount of borrowing than that for which they could obtain voter approval.\footnote{156} The authors of the study attribute this to the costs of the election and selling the bonds and because of uncertainty about voter preferences.\footnote{157} It is likely that other local governments behave in a similar manner to school boards. Furthermore, local governments may not put a bond measure on the ballot at all if it is not expected to pass, possibly by a substantial margin.\footnote{158}

\begin{footnotes}
\footnote{152} See supra note 131.
\footnote{153} The amount of “dropoff” (the percentage of people who vote in an election but not on a particular measure or candidate) varies, but can be substantial. See MAGLEBY, supra note 147, at 90-95 (reporting dropoff rates for a variety of measures in several elections, including a 13% dropoff rate for bonds in the 1976 California election and a 15% dropoff rate for bonds in the 1978 California election).
\footnote{154} MAGLEBY, supra note 147, at 80-82, 104-111. Other factors also correlate to turnout and proposition voting, including occupation, income, education, age, race, perceived social class and gender. Id.
\footnote{155} OLIVER, supra note 131, at 55-56.
\footnote{156} Ed Balsdon et al., Private Demands for Public Capital: Evidence from School Bond Referenda, 54 J. URB. ECON. 610, 612 (2003). But see Elizabeth Garrett & McCubbins, supra note 146, at 41 (suggesting that a local government can theoretically receive approval for a higher level of debt than would be the voter’s ideal preference because the voter is presented with a “take-it-or-leave-it” offer).
\footnote{157} Balsdon et al., supra note 156, at 612.
5.2.2.2.2. Voter Approval Requirements Increase Costs and May Cause Delays.

Even if local governments do not campaign in favor of a ballot measure (at least some states prohibit such campaigning), they incur financial costs in deciding whether to put a bond measure on the ballot and preparing the measure for the ballot. For example, local governments may hire lawyers and political consultants to assist with the ballot measure and election process and pay for a voter survey to determine whether to propose a ballot measure. They also will incur costs of running the election. In addition to these costs, and perhaps more significant, there is a political cost to proposing a bond measure. Elected officials “desire to remain in the good graces of the community and its voters and fear that frequent requests for property tax increases will jeopardize this.”

In addition, determining whether to put a measure on the ballot and preparing for the election takes time. One expert indicates that it can take six to nine months, or even longer, from

they appeared to have been less likely to do so in California at the November 2020 after a relatively high proportion of measures failed to pass at the March 2020 election).

159 See, e.g., CAL. EDUC. CODE § 7054 (Deering 2021) (prohibiting the use of “school district or community college district funds, services, supplies, or equipment … for the purpose of urging the support or defeat of any ballot measure …” with an exception for providing impartial factual information); CAL. GOV’T CODE § 54964 (Deering 2021) (prohibiting local government officials from spending public funds to support of oppose a ballot measure except to provide impartial information about relevant facts); 10 ILL. COMP. STAT. ANN. 5/9-25.1 (LexisNexis 2021) (prohibiting the expenditure of public funds to campaign for or against a candidate or ballot measure but permitting the use of public funds to provide factual information); TEX. ELEC. CODE § 255.003(a) (LexisNexis 2021) (prohibiting the spending of public funds for political advertising except for communications that merely describe factually the purpose of the measure).

160 See CAL. COALITION FOR ADEQUATE SCHOOL HOUSING, PROPOSITION 39 BEST PRACTICES HANDBOOK 27-30 (2003), available at http://www.cashnet.org/wp-content/uploads/2017/02/Prop-39-Handbook-2003-s.pdf (describing the role of bond counsel and political consultants and identifying voter surveys as a permitted use of public funds); Tex. Assoc. of Sch. Bds., Overview of a School District Bond Issuance (2020), available at https://www.tasb.org/services/legal-services/tasb-school-law-resource/business/documents/overview-of-school-district-bond-issuance.pdf (identifying retaining bond counsel and an election attorney as steps to take when determining whether to issue bonds and including publicity and communication as components of ordering the election); LEAGUE OF OR. CITIES, supra note 52, at 131 (noting the importance of hiring an outside expert to assess voter understanding of and support for the proposed measure); Balsdon et al., supra note 156, at 618 n. 14 (stating that school district funds can be used to conduct a survey of the community and provide guidance on how much should be requested and noting that this cost between $30,000-$40,000).

161 See CAL. DEBT & INV. ADVISORY COMM’N, supra note 106, at 138 (noting that if the election fails, the local government will usually have to pay the costs of the election out of its general fund); Election Costs and Billing, County of Marin, https://www.marincounty.org/depts/rv/election-info/election-costs-and-billing (last visited Mar. 26, 2021) (describing election costs charged by the county to cities, school districts and special districts).

162 Balsdon et al., supra note 156, at 618.
beginning election proceedings to issuing the bonds.\textsuperscript{163} This does not include the time to determine whether to pursue a bond election at all. In some states, bond measures may be presented at only certain elections.\textsuperscript{164} When projects are urgently needed or when construction costs are rising rapidly, these delays may create problems for local governments.

\textbf{5.2.3.\ Voter Approval Requirements Should be Carefully Evaluated}

Voter approval requirements, particularly those that require supermajority approval, should be carefully evaluated. However, it does appear that they contribute to providing information to community members and to protecting community members from local government officials who may be inclined to borrow more than community members would prefer. Requirements that specific information be provided to voters in an easily understandable format may make voter approval requirements more valuable.\textsuperscript{165}

It is less clear whether they help promote interperiod equity. In all likelihood, any impact they have on interperiod equity is fairly small. As was noted in Section 3.3.1, current community members may have the same interest in deferring payment of debt to the future that elected officials do. It is possible, however, that because of the factors discussed in Section 5.2.2.2.1, voter approval requirements result in less debt being incurred than the community would prefer. This may counterbalance tendencies to issue more debt than is appropriate. However, although voters generally approve the principal amount and use of debt (and may be given some other information, such as the expected impact on tax rates), this is an incomplete protection of interperiod equity because it does not prevent debt service from being disproportionately pushed to later years.

If voter approval requirements are used, they ideally would be consistent for different types of debt. This is not always the case. For example, under California law, different voter approval requirements apply depending on the purpose and payment source of the bonds and

\textsuperscript{163} See Greg Harrington, John Hartenstein, & Donald Field, Orrick, The XYZs of California School District Debt Financing 28 (2015), available at HTTPS://WWW.ORRICK.COM/EN/INSIGHTS/2007/03/The-XYZs-Of-California-School-District-Debt-Financing (indicating that it can take 6-9 months or more from initiation of bond proceedings to the issuance of the bonds); Pollan & Méndez, supra note 135, at 12 (indicating that it takes 5-12 months, or even longer, to issue general obligation bonds).

\textsuperscript{164} See supra notes 129-130 and accompanying text.

\textsuperscript{165} For examples of some current requirements, see supra note 137-138 and accompanying text.
other factors.\textsuperscript{166} In some states, supermajority requirements are imposed for general obligation bonds, but not revenue bonds.\textsuperscript{167} As is discussed in greater detail in the following section, some types of debt are typically not subject to voter approval requirements at all.

One alternative to voter approval requirements short of eliminating them entirely would be to ensure that there is appropriate notice of and ability to participate in board meetings at which bonds are approved, and a waiting period afterwards in which a specified number of voters could require that the measure be voted upon at the next election.\textsuperscript{168} This would shift the burden of convincing voters from the elected governing body to the objecting voters.\textsuperscript{169} As was described above, some states allow voters to petition to put certain types of debt on the ballot.\textsuperscript{170} There could be merit in broadening this approach to cover a wider range of debt. However, it would be important that the hurdles are set at the appropriate level; making it too easy for a handful of voters to compel an election defeats the purpose of using a permissive referendum process rather than a mandatory one, and making it too difficult or too expensive would have little difference from having no voter approval requirement.\textsuperscript{171}

5.3. Exceptions to Debt Limits and Voter Approval Have Distorted Borrowing Decisions

Courts and legislatures have created numerous exceptions to both debt limits and voter approval requirements, and the avoidance of these limits and requirements has “fundamentally shaped public finance.”\textsuperscript{172} General obligation bonds are typically subject to these restrictions, but they often do not apply to revenue bonds (though some voter approval requirements do apply to some revenue bonds).\textsuperscript{173} Avoiding debt limits is so common that guides to municipal finance have sections with titles like “Devices Employed to Avoid Debt Ceilings and Procedural

\textsuperscript{166} See supra notes 124-125 and accompanying text.
\textsuperscript{167} Salsich, supra note 60, at § 12.30.
\textsuperscript{168} The Advisory Commission on Intergovernmental Relations recommended permissive referendum requirements in 1961. See ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 72-73.
\textsuperscript{169} Id. at 73.
\textsuperscript{170} See supra notes 132-135 and accompanying text.
\textsuperscript{171} The challenges of obtaining signatures for initiatives (legislation proposed by voters) are discussed in MAGLEBY, supra note 147, at 61-70 (1984). Those gathering signatures for a permissive referendum likely would encounter similar issues.
\textsuperscript{172} AMDURSKY ET AL., supra note 22, at § 4.1; also see Briffault, supra note 73, at 925, citing WILLIAM D. VALENTE ET AL., CASES AND MATERIALS ON STATE AND LOCAL GOVERNMENT LAW 647 (William D. Valente ed., 5th ed. 2001) (noting that two-thirds of city and county debt is exempt from debt limits).
\textsuperscript{173} Gelfand, supra note 88, at § 11.14; Salsich, supra note 60, at§ 12.23; also see Gillette, supra note 4, at 1256-57 (describing some of the exceptions from debt limits).
Requirements”174 and “Common Strategies for Avoiding the Debt Limit.”175 Local governments sometimes simply issue a different form of debt than they might otherwise to avoid the limits and restrictions.176 It is not clear whether the end result is a lower amount of local government debt than there would be without the limits and approval requirements.177

What is clear is that the result is more expensive debt and less transparency. Interest rates on revenue bonds are generally higher than on general obligation bonds, and legal and administrative costs for revenue bonds are typically higher.178 The debt burdens borne by local governments are less visible, and government structures are more complicated and public authorities and agencies that are not necessarily run by elected officials play more significant roles.179

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174 See generally, Gelfand, supra note 88, at pt. IV.
175 See generally, CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 1.3.
176 See, e.g., Shama Gamkhar & Jerome Olson, Factors Affecting School District Choice of Bonds, 2002 NAT’L TAX ASS’N PROC. OF ANN. CONF. ON TAX’N, 396, 4397, 05 (concluding that school districts in Texas that are less likely to win a bond election are more likely to issue lease revenue bonds, which generally do not require voter approval); Gillette, supra note 78, at 375-378 (describing instances of local governments financing projects by methods that do not require voter approval after losing a bond election); Richard Williamson, Certificates of Obligation Fund Austin Courthouse After Voters Rejected Bonds, BOND BUYER (May 13, 2019), https://www.bondbuyer.com/news/certificates-of-obligation-deal-bypasses-voters-on-austin-courthouse (describing funding of courthouse with a different form of debt that does not require voter approval three-and-a-half years after voters rejected a general obligation bond measure for the same project).
177 See, e.g., ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 3 (noting that while debt limits may have restrained local government borrowing, the extent to which they are effective cannot be measured); AMDURSKY ET AL., supra note 22, at § 4.15 (citing several studies suggesting that voter approval requirements reduce debt levels); Briffault, supra note 73, at 925 (noting that while there may have been some impact on total debt levels, it does not seem significant); Paul G. Farnham, Re-examining Local Debt Limits: A Disaggregated Analysis, 51 S. ECON. J. 1186, 1195-96 (2001) (indicating that referenda requirements do not affect overall debt levels, but that debt limits do reduce the amount of both general obligation and overall borrowing); Kiewiet & Szakaly, supra note 119, at 78-82, 85-86, 92 (concluding that at the state level, referendum requirements and prohibitions on borrowing appeared to reduce the level of guaranteed debt, though limits based on revenues are less effective (but not totally ineffective), and that states do not appear to issue nonguaranteed government in lieu of guaranteed debt, but that there were strong indications that in these states more debt was simply issued by local governments and authorities rather than the state).
178 See, e.g., LEAGUE OF OR. CITIES, supra note 50, at 7 (noting that general obligation bonds “are regarded as very secure and are usually the least expensive way for a city to borrow money”); MARLOWE, RIVENBARK & VOGT, supra note 37, at 159 (“interest rates on GO bonds are usually lower than rates on other types of long-term debt used to finance capital projects”); Briffault, supra note 73, at 926 (noting higher interest rates and greater administrative and legal costs); Gelfand, supra note 50, at 560-61 (noting that interest rates on revenue bonds are typically higher than on general obligation bonds); Gillette, supra note 4, at 1257 (noting higher interest rates and additional costs to develop legal alternatives); Shoked, supra note 31 (noting that debt limits force local governments to pay higher interest rates and generate administrative expenses, among other things).
179 See, e.g., ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 3 (“Debt restrictions have tended to impair the public accountability and responsiveness of local governments in various ways, including the promotion of special districts and various kind of financing authorities, and the complication and obfuscation of financial arrangements.”); Briffault, supra note 73, at 926 (the avoidance of debt limits has
In addition, local governments may give up future budgeting flexibility and may be subject to more restrictive covenants when they issue revenue bonds rather than general obligation bonds. Revenue bond documents typically include requirements that the revenues from which the bonds are paid are tracked separately and can be used only for specified purposes in a specified order. The documents also typically include covenants that restrict future flexibility, such as restrictions on the ability to issue new bonds, insurance requirements, and covenants that rates be set at levels to cover debt service and maintain reserves (sometimes with additional cushion).

Furthermore, local government decisions about which projects to finance and construct may be distorted by differing approval requirements for different types of bonds. Projects that would typically be financed with general obligation bonds or other bonds requiring voter approval may be less likely to be undertaken, while those more typically financed with revenue bonds or other types of bonds that are not subject to the same restrictions may be more likely to proceed. Riskier projects that cannot be financed at reasonable interest rates without also including a pledge of taxing authority may be less likely to be undertaken, even when the projects are desired by the local community. New housing developments with new schools and other public facilities may be favored over rebuilding or building a new school in an existing community when it is easier to issue municipal bonds to finance facilities in new developments.

None of this is to say that revenue bonds shouldn’t be used or that they don’t serve important purposes. However, any debt limits or voter authorization requirements should “take

contributed to the “baroque structure of state and local government, and the major role played by un-elected public authorities and similar agencies”); Gamkhar & Olson, supra note 176, at 402 (noting that lease revenue bonds “can be concealed from voters since they are not legally required to be included as debt in the district’s budget or financial statements” notwithstanding that credit rating agencies and other bond market participants would consider them as debt); Gillette, supra note 4, at 1257 (“circumvention of debt limitations obfuscates the locality’s true debt position”).

180 See O’HARA, supra note 16, at 199-200 (describing typical provisions); ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 56-57 (noting that revenue bonds tend to come with earmarking arrangements that can narrow budgetary discretion).

181 See MARLOWE, RIVENBARK & VOGT, supra note 37, at 164-65 (describing typical provisions); O’HARA, supra note 16, at 201-202 (describing typical provisions).

182 Gillette, supra note 4, at 1258-59 (noting that these projects compete with “more traditional capital expenditures for a limited amount of permissible debt”).

183 Shanske, supra note 118, at 668 (2010). Shanske argues in this article that a particular type of bonds that is typically approved by the developer before homes in a new development are sold have contributed to urban sprawl.
cognizance of all forms of local borrowing and debt” and “should be designed to facilitate – rather than hamper – intelligent choice among suitable alternative forms of borrowing.”\textsuperscript{184} Different types of debt should be treated differently only if there is a sound basis for doing so. For example, there is a reasonable argument that short-term debt might be treated differently since it does not give rise to the same issues of interperiod equity,\textsuperscript{185} though other restrictions (such as the term and the amount that can be borrowed) would be appropriate to prevent misuse.\textsuperscript{186} Exceptions for emergencies or to meet legal mandates (such as to satisfy a tort judgment) also may be reasonable, at least if appropriately tailored.\textsuperscript{187} It also would be reasonable to treat debt for which the bondholders alone bear the risk of project failure differently than debt for which the community bears the risk, and one commentator suggests that this analysis may go a long way (albeit not the whole way) towards explaining exceptions from debt limits.\textsuperscript{188}

A fundamental question, then, is whether there is a good reason to subject general obligation bonds payable from property taxes to greater restrictions than other debt. For some types of facilities typically financed with revenue bonds, such as an airport paid for by airline rates and charges, a convention center paid for with hotel taxes from surrounding hotels, or an express lane financed by tolls, the answer likely is “yes” (at least if the local government is not obligated to pay any bonds from other sources should the relevant revenue sources prove inadequate). These are all facilities that a community member can truly elect whether or not to use (and that can be used by people other than members of the community). The answer for utilities such as water and wastewater systems is less clear, since even though residents may be able to cut back on their use of these utilities, it is unlikely that they can avoid using them entirely. For financing structures that use general fund revenues to finance a facility but are not treated as debt, such as some lease revenue bonds, the better answer in my view is that they should be treated the same as (or at least similarly to) general obligation bonds, even if bondholders take the risk that the local government will not appropriate funds to make the

\textsuperscript{184} \textit{Advisory Comm’n on Intergovernmental Relations}, supra note 50, at 4.
\textsuperscript{185} Some state courts “readily” reached this conclusion. Sterk & Goldman, supra note 73, at 1314.
\textsuperscript{186} See Gelfand, supra note 88, at § 11.9 (noting that overuse and abuse prompted states to impose limits on short-term debt).
\textsuperscript{187} See \textit{Amdursky et al.}, supra note 22, at § 4.4 for further discussion of these types of exceptions and how courts have created and interpreted them.
\textsuperscript{188} \textit{Amdursky et al.}, supra note 22, at § 4.1.1.
payment. General fund moneys that are used to pay the debt service to finance the facility could be used for other purposes (or taxes and fees could be reduced) if they were not used to pay debt service, and the local government likely will feel pressure to appropriate funds to repay the debt even if it is not legally obligated to do so because its ability to borrow in the future likely would be affected by a failure to pay.

Ideally, a broader range of debt would be treated more similarly for purposes of debt ceilings and voter approval rights. Treating debt similarly would lead to greater transparency (and hence public opportunity to participate) and to better financial decisions (because decisions about transaction structure would be based on the economics of the transaction rather than avoiding a debt ceiling or voter approval right). It is likely that fewer exceptions would also simplify the laws governing local government borrowing. That said, for the reasons discussed in Section 5.1.2, ideally debt ceilings would be eliminated; where they remain, exceptions likely will be needed and allowing a state agency to provide waivers of them in appropriate circumstance may be desirable. In contrast, it may be appropriate for some voter approval requirements to be retained in some form (perhaps providing for permissive referenda) and to apply to a broader range of debt.

6. Regulation of Use of Proceeds, Terms and Sale of Bonds

State laws restrict the purposes for which bonds can be issued, the terms of the bonds, and the mechanics for sale of the bonds. Each of these topics is addressed below. Some states also regulate other details of the bonds such as who can sign them and how they should be printed. These more administrative points are not addressed below. Suffice it to say that any provisions relating to purely administrative matters should be kept as flexible as possible to avoid unnecessary expense or requirements that are not consistent with standard practices in the bond market as it has evolved and continues to evolve. If states do regulate detailed terms of bonds or administrative points, legislatures may want to delegate to a state agency the power to create appropriate regulations since these will be easier to change over time than a statute or constitutional provision would be.
6.1. Restrictions on the Use of Bond Proceeds

Every state has restrictions on the purposes for which local governments can use their funds, including bond proceeds. Some have additional restrictions on the use of bond proceeds, as described below.

6.1.1. Public Purpose Requirements and Prohibitions on the Lending of Public Credit

Local governments generally may expend funds only for public purposes. Because proceeds of local government borrowing are public funds, these provisions apply to the use of bond proceeds. The intent of these provisions is to “restrict public funding to activities that serve the interests of the public at large.” Some public purpose restrictions are in state constitutions, and others have been created by courts. What has been considered a public purpose has evolved over time, and in virtually all states public purposes may include economic development programs that provide direct assistance to individual businesses. Courts tend to defer to legislative findings of public purpose, and public purpose requirements are “largely rhetorical” today. Nonetheless, requiring that public funds be used for public purposes (even if such purposes are defined very broadly), and retaining for courts the ability to decide in

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189 AMDURSKY ET AL., supra note 22, at § 3.1.
190 The use of local government bond proceeds is also restricted by the Establishment Clause of the U.S. Constitution; this is particularly relevant when bond proceeds are used to assist schools, hospitals and other organizations with religious affiliations. For a brief discussion, see id. at § 3.4. In addition, the Internal Revenue Code and U.S. Treasury Department regulations also impose restrictions on the use of proceeds of tax-exempt bonds. For a short description of some of the restrictions for tax-exempt bonds, see CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at §§ 4.4, 4.6.
191 Gelfand, supra note 88, at § 11.11; NAT’L ASSOC. OF BOND LAWYERS, SECTION 1: GENERAL LAW, FUNDAMENTALS OF MUNICIPAL BONDS LAW 2012 6 (2012); Briffault, supra note 73, at 910.
192 AMDURSKY ET AL., supra note 22, at § 3.1.
193 See id. at § 3.2 for discussion of both.
194 See, e.g., id. at § 3.5 (what constitutes a public purpose “changes to meet new developments and conditions of times” (quoting In re Limited Tax Gen. Obligation Bonds of the City of Edmonds, 256 P.3d 1242 (Wash. Ct. App. 2011)); Gelfand, supra note 88, at § 11.11 (“the concept has evolved through the case law to meet changing conditions”).
195 Gelfand, supra note 88, at § 11.11; Briffault, supra note 73, at 913.
196 AMDURSKY ET AL., supra note 22, at §§ 3.5.3, 3.5.4; Briffault, supra note 73, at 945-46.
197 Briffault, supra note 73, at 914.
controversial cases whether a purpose is public, serves the objective of protecting citizens from bad decisions by local government officials.\textsuperscript{198}

In addition, most states prohibit local governments from making gifts or loans of public credit to private parties and investing in private enterprises, presumably to restrict the ability of individuals or companies to benefit at the expense of the public.\textsuperscript{199} These provisions, like public purpose provisions, can limit the use of bond proceeds. Even if a gift of public credit serves a public purpose, it may be prohibited by these provisions. While there are often exceptions to these provisions,\textsuperscript{200} they do sometimes constrain local governments from undertaking activities that the community deems desirable. For example, in 2018, Oregon voters approved an constitutional amendment adding an exception to the state’s constitutional prohibition on the lending of public credit and investing in private enterprises that would allow local governments to invest with private developers in affordable housing projects.\textsuperscript{201} Supporters indicated that the amendment was needed because the constitutional prohibition constrained the ability of local governments to collaborate on much-needed affordable housing projects.\textsuperscript{202} However, like public purpose requirements, restrictions on lending of public credit (at least with appropriate exceptions) generally impose appropriate constraints on local governments and should be retained.

6.1.2. Other Restrictions

Bond proceeds may be used only for valid purposes of the local government.\textsuperscript{203} General obligation bond proceeds typically may be used only for “land acquisition, construction and

\textsuperscript{198} Additional statutory provisions may be valuable, too. See \textit{id.} at 947 (noting that statutory requirements for better record keeping and public disclosure of the public benefits of economic development might be more effective than judicial enforcement).

\textsuperscript{199} \textit{AMDURSKY ET AL., supra} note 22, at § 3.7; \textit{Gelfand, supra} note 88, at § 11.10. See, e.g., \textit{CAL. CONST. art. XVI, § 6; N.Y. CONST. art. VIII, § 1.}

\textsuperscript{200} \textit{Supra} note 199; \textit{see also CAL. DEBT AND INV. ADVISORY COMM’N, supra} note 22, at § 7.3 (describing broad court-created public purpose exceptions to California’s prohibition).


\textsuperscript{203} Salsich, \textit{supra} note 60, at § 12.38.
equipping of traditional public projects such as courthouses, hospitals, jails, libraries, schools, sewage treatment facilities, and streets and roads.” Some states allow general obligation bonds to be used for a broader range of purposes. The use of proceeds of other types of bonds also may be restricted by state law.

Where voter approval is required, the use of proceeds may be limited to the purposes approved by the voters or there may be additional steps that need to be taken for them to be applied to other purposes. Some have described the voter approval of a bond measure as creating a contract between the issuer and the voters; this contract would limit the use of bond proceeds to the purposes approved by the voters. The concept that proceeds cannot be used for purposes other than those approved by the voters sometimes also appears in statues. For example, California law provides that proceeds of local government general obligation bonds may be used only for the purposes for which the bond were issued. Should there be any proceeds remaining after the purpose is completed, it sometimes is required to be used to pay debt service on the bonds. Some states provide more flexibility. In Georgia, for example, if proceeds of bonds remain after the project approved by the voters is completed, or circumstances change such that the approved project would be obsolete or wasteful, unexpended bond proceeds must either be

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204 Id. at § 12.4.
205 For example, California cities can use general obligation bonds to finance loans to private landowners for seismic safety improvements, to finance redevelopment projects in blighted areas and to finance “other works, property, or structures necessary or convenient to carry out the objects, purposes, and powers of the city” and home rule cities have broader powers to borrow using general obligation bonds. CAL. GOV’T CODE §§ 43601, 43602 (Deering 2021); CAL. DEBT & INV. ADVISORY COMM’N, supra note 106, at 136. In Illinois, general obligation bonds can be used to finance wind generation turbine farms and redevelopment projects in blighted areas. Kelly K. Kost & Vij, supra note 135, at § 2.5.
206 See, e.g., CAL. DEBT & INV. ADVISORY COMM’N, supra note 106, at ch. 6 (identifying the types of projects that may be financed with each type of financing described).
207 See, e.g., id. at 13; Salsich, supra note 60, at § 12.23. The contract consists of the applicable law, the bond resolution, the ballot measure. Id. Related costs such as funding a reserve fund, capitalized interest and costs of issuance are typically also permissible uses as described in the following paragraph.
208 CAL. GOV’T CODE § 53410 (Deering 2021). Also see CAL. EDUC. CODE § 15146(g)-(j) (Deering 2021) (requiring virtually all proceeds of school district bonds to be deposited in the building fund and used for the purposes for which the bonds were issued, and allowing a portion to be used for capitalized interest, reserves and costs of issuance).
209 See, e.g., CAL. GOV’T CODE § 43628 (Deering 2021) (the proceeds of general obligation bonds issued by general law cities must be used for the purpose for which the bonds were issued or for capitalized interest; once such purpose is achieved, any excess must be used to pay debt service on the bonds until they are paid in full and then can be used for other purposes); N.Y. LOCAL FIN. LAW § 165.00(a) (McKinney 2021) (providing that bond proceeds may be applied only to the purpose for which the bonds were issued or to pay debt service on the bonds).
used for a substantially similar purpose or to repay the bonds or other bonds, as determined by a
two-thirds vote of the governing body of the local government.\textsuperscript{210}

In addition to the primary purpose of the issuance, bond proceeds are typically allowed to
be used to fund a reserve fund (available to pay debt service for a short period of time if the local
government does not pay), to pay costs of issuing the bonds (such as bond counsel and disclosure
counsel fees, printer costs, underwriter’s fees and municipal advisor fees), and sometimes to pay
interest on the bonds until shortly after a project is completed (sometimes referred to as
“capitalized interest.”)\textsuperscript{211} These purposes are consistent with the those permitted for tax-exempt
bonds under federal tax law.\textsuperscript{212} A state may want to have its own requirements rather than
relying on federal tax law requirements not only because the state may have different
perspectives on the purposes for which local governments should be allowed to borrow than the
federal government or even other states do, but also because not all bonds are subject to the
federal tax law requirements, federal tax law requirements can change without the approval of
any state, and because the focus of the federal tax restrictions is the circumstances under which
the federal government should subsidize borrowing, not when local governments should be able
to borrow.

Some states have additional restrictions on the use of proceeds, and these can be
problematic. For example, some California local governments may use premium received from
the sale of certain bonds only to pay interest on the bonds.\textsuperscript{213} These provisions likely are
intended to discourage issuers from borrowing more than the authorized amount of bonds by
selling them at a premium.\textsuperscript{214} However, the provisions can lead to undesirable outcomes when
market conditions are such that the best price on the bonds can be obtained if they are sold at a

\textsuperscript{210} JAMES P. MONACELL, GEORGIA PUBLIC FINANCE HANDBOOK § 3.2.5 (2018). \textit{See also} HAW. REV. STAT.
ANN. § 47-5 (LexisNexis 2020) (permitting application of county general obligation bonds proceeds to
purposes other than those for which the bonds were issued or to the repayment of the bonds, in either case with
the approval of 2/3 of the members of the county council).

\textsuperscript{211} Salsich, \textit{supra} note 60, at § 12.38.

\textsuperscript{212} CAL. DEBT AND INV. ADVISORY COMM’N, \textit{supra} note 22, at §§ 4.4.2-4.4.4 (describing permitted uses and
some limitations).

\textsuperscript{213} For example, California school districts generally are required to use any premium received from the sale of
general obligation bonds to pay debt service. CAL. EDUC. CODE § 15146(g) (Deering 2021). Similar
requirements apply to some bonds issued by various transit districts. \textit{E.g.,} CAL. PUB. UTIL. CODE §§ 40246,
50246, 70246, 96471, 98341, 101311 (Deering 2021). \textit{But see} notes 215-216 and accompanying text for
discussion of the use of premium to pay costs of issuance.

\textsuperscript{214} \textit{See supra} note 16-17 and infra 220-222 and accompanying text for further discussion of sale of bonds at a
premium.
premium. The bonds must be priced without premium notwithstanding the market conditions, or a small amount of interest must be capitalized rather than being used for the project, regardless of whether the issuer wishes to do so. Either option increases the cost of the bonds to the issuer.

Limits on the use of premium received by California school districts, combined with a limit (equal to 2% of the proceeds of the bonds) on the amount of school district general obligation bond proceeds that can be deposited into a costs of issuance account and be used to pay costs of issuance,\(^{215}\) have contributed to the practice many California school districts have used of issuing bonds at a premium and using the funds generated to pay costs of issuance without ever being “received” by the district, despite criticism of this practice.\(^{216}\) Any limit on the amount of bond proceeds that can be used to pay costs of issuance is likely to be particularly burdensome for smaller issuances because some costs do not vary proportionately with the size of the issuance.\(^{217}\)

Counting the premium towards the authorized amount as is discussed in Section 6.2.1 below would be a better solution to the problem of issuers generating excessive premium, as would restricting the amount of premium that can be generated as a percentage of the principal amount of the bonds using an amount that is high enough not to interfere with normal market practices but low enough to prevent issuers issuing bonds at unusually high premiums as a way

\(^{215}\) CAL. EDUC. CODE §§ 15146(h) (Deering 2021). Depending how one interprets the statute, this means that at best if costs of issuance are over 2% a portion of them must be paid from principal in the building fund, increasing the administrative burden because they are paid from two accounts rather than one, and at worst they cannot be paid from amounts received by the school district.

\(^{216}\) See Jason Chung, Selling at Premium: How School Districts Can Pay Costs of Issuance, FIELDMAN ROLAPP & ASSOCIATES SCH. FIN. NEWS (Oct. 2012) (on file with author) (describing the practice of paying costs of issuance from premium and noting criticism of it, but indicating that the practice is legal and generally accepted); Letter from Kamala D. Harris, Att’y Gen., State of Cal., to Wendy H. Wiles, Robert E. Anslow & Jeffrey A. Hoskinson, Bowie, Arneson, Wiles & Giannone, Poway Unified Sch. Dist. v. All Persons Interested, Sup. Ct. of Cal., Cty. of San Diego, Case No. 37-2010-00106255=CU-MC-CTI (Mar. 11, 2011) (expressing concern about the legality of using premium to pay costs of issuance); Rich Saskal, California Schools on Notice, BOND BUYER (Mar. 10, 2011), available at https://www.bondbuyer.com/news/california-schools-on-notice (describing this use of premium as a common practice, providing an example of the underwriter paying costs of issuance from premium, and describing the California attorney general’s response).

\(^{217}\) See Marc Joffe, Haas Institute for a Fair and Inclusive Society Research Brief, Doubly Bound: The Costs of Issuing Municipal Bonds 12 (2015), available at https://belonging.berkeley.edu/sites/default/files/haasinstituterefundamerica_doublybound_cost_of_issuingbonds_publish.pdf (noting that issuance costs are proportionately higher for smaller bond issuances and that there are certain costs associated with any bond issuance regardless of the amount issue); David Brodsly & Charles Turner, CDIAC Seminar: Session Five: Cost of Issuance 10 (Mar. 17, 2015), https://www.treasurer.ca.gov/cdiac/seminars/2015/20150317/day1/5.pdf (while financial advisor and bond counsel fees were lower for smaller issues, as a percentage of the principal amount issued they were higher).
to generate more bond proceeds while complying with limits on the principal amount that can be borrowed.

Limiting the use of bond proceeds to purposes for which the local government could spend its other funds ensures that the government is acting within its intended scope and is not encouraged to borrow simply because that is the only way it can spend for a particular purpose, thus protecting citizens from poor decisions made by local governments. Limiting the use of bond proceeds to capital projects and related costs (including costs of issuing the bonds and reserve funds securing the bonds) gives future citizens some protection from being disproportionally burdened by debt by limiting the use of debt to projects that are most clearly going to provide benefits over the term of the debt. While other uses likely would provide future benefits (for example, job training programs for the unemployed, supportive programs for the homeless, or higher quality education for children well might provide benefits for many years to come), these benefits are often more amorphous and uncertain. Limiting the use of proceeds of voter-approved bonds to the purposes that were authorized by the voters (or related or similar purposes) is essential to maintain the meaningfulness of a voter approval requirement. Other limits on the use of proceeds should be carefully considered before being imposed. As with the examples above, some have the effect of adding unnecessary complications or distorting the process of determining the terms or pricing of bonds, both of which are inconsistent with transparency and sound decision-making.

6.2. Restrictions on Terms of Bonds

6.2.1. Limits on Principal Amount

When voters or governing boards approve bonds, they usually approve a maximum principal amount to be issued. Sometimes state laws require that this information be included. For example, Texas law requires that the ballot proposition requesting approval of general obligation bonds include, among other things, “the total principal amount of the debt obligations to be authorized.”218 Governing board authorizing resolutions typically include the maximum

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218 TEX. ELEC. CODE § 52.072(f) (LexisNexis 2021); TEX. GOV’T CODE § 1251.052(a)(2) (LexisNexis 2021). Other states have similar requirements. See, e.g., CAL. EDUC. CODE § 15122 (Deering 2021) (amount of bonds must be included for school district bond measures); 65 ILL. COMP. STAT. ANN. 5/8-4-2 (LexisNexis 2021) (the form of question to the voters includes the amount of the bonds).
principal amount of bonds to be issued.\textsuperscript{219} The debt limits described in Section 5.1.1 also are framed in the context of the principal amount of debt outstanding.

However, municipal bonds are typically sold at a discount or a premium, which is reflected in the amount received by the issuer (the “proceeds”) from the sale.\textsuperscript{220} Limits tied to the amount actually borrowed rather than the principal amount of the bonds would promote transparency, because limits would be based on the economics of the transaction.\textsuperscript{221} In addition, limits tied to the amount borrowed rather than the principal amount would remove incentives issuers have to avoid original issue discount, which results in issuers receiving less than the principal amount of the bonds, or to maximize premium, which results in issuers receiving more than the principal amount of the bonds, and instead allow issuers to price the bonds with whatever premium or discount provided the lowest yield on the bonds.\textsuperscript{222} This would also eliminate any need for provisions restricting the use of premium such as those discussed above.\textsuperscript{223}

6.2.2. Limits on Interest Rate or Yield

Some states impose limits on the interest rate or interest cost on municipal bonds.\textsuperscript{224} For example, California generally imposes a maximum interest rate and maximum yield on

\textsuperscript{219} See, e.g., Jacquelynne Jennings, Schiff Hardin LLP, California Debt & Investment Advisory Commission Municipal Debt Essentials Day 2: Planning a Bond Sale Session Five: Bond Documents 9 (Feb. 13, 2019), available at https://www.treasurer.ca.gov/cdiac/seminars/2019/20190212/day2/5.pdf (describing the “maximum principal amount of bonds to be issued” as a key provision of the issuer’s resolution authorizing the bonds); GOODFRIEND & MYERS, BOND BASICS FOR TOWNS, VILLAGES AND CITIES, supra note 107, at 15 (identifying the principal amount of the bonds as an “essential component” of a bond resolution); GOODFRIEND & MYERS, BOND BASICS FOR SCHOOL DISTRICTS, supra note 107, at 13 (including the principal amount of the bonds as an “essential component” of a bond resolution).

\textsuperscript{220} See supra notes 15-16 and accompanying text for further discussion.

\textsuperscript{221} For example, under Texas law, any premium used to pay costs of the project financed is counted against the voter-authorized amount. TEX. GOV’T CODE § 1201.042(e) (LexisNexis 2021). I would go further and count any premium generated in, and exclude any original issue discount from, the calculation, regardless of how the premium is used.

\textsuperscript{222} Discounts and premiums can make bonds more attractive to investors. Supra notes 17-18 and accompanying text. Other restrictions on selling bonds at a discount or premium would also need to be eliminated. These restrictions are discussed at infra note 290 and accompanying text.

\textsuperscript{223} See supra note 213 and accompanying text.

\textsuperscript{224} In 1993, 24 did. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 4, at 10; also see Salsich, supra note 60, at § 12.4 (noting that most statutes authorizing county and municipal bonds include maximum interest rates).
municipal bonds of 12%. Local governments in Texas generally may not issue bonds with a net effective interest rate (taking into account original issue premium and discount and compounding of interest) in excess of 15%. Illinois uses a hybrid approach, allowing local governments to issue tax-exempt bonds bearing interest at a rate up to the greater of 9% or 125% of average municipal bond yields and taxable bonds bearing interest at a rate up to the greater of 13.5% or 200% of a recent benchmark rate for taxable bonds.

Other than perhaps as a negotiating point with lenders, these requirements do not serve any meaningful purpose. Maximum rates or yields do not ensure that local governments are paying a fair or appropriate interest rate on their bonds, but they sometimes may prevent local governments from borrowing when it would be desirable to do so. Average yields on general obligation bonds maturing in 20 years and having an average credit rating of Aa2 (Moody’s) and AA (S&P) have not approached 9% since 1987. An interest rate well below the maximum in California, Illinois or Texas would have been excessive during the last three decades, absent extraordinary circumstances.

However, particularly in high interest rate environments, maximum interest rates or yields expressed as a fixed percentage may restrict desirable transactions. For example, the California legislature amended its interest rate and yield caps in 1974, 1980 and 1981 from 7% to 8%, then 10% and 12% as interest rates rose, presumably to keep up with rising interest rates. (The caps were not subsequently reduced as interest rates declined.)

While they provide more flexibility, even limits tied to benchmark interest rates (for example published average interest rates on high quality bonds) may unduly restrict issuers with lower credit ratings (ratings of the creditworthiness of the issuer). Bonds with lower credit

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225 CAL. GOVT. CODE §§ 53531, 53532 (Deering 2021). (There are exceptions. For example, the limit is 8% for certain general obligation bonds issued by California school districts. CAL. EDUC. CODE § 15143 (Deering 2021), CAL. GOVT’ CODE § 53508.5 (Deering 2021)).


227 30 ILL. COMP. STAT. ANN. 305/2 (LexisNexis 2021).


230 While the Advisory Commission on Intergovernmental Relations recommended that states consider limits tied to the interest rates on high quality bonds in 1961, two council members dissented because “State
ratings bear interest at higher rates. Credit ratings are based on a variety of factors, such as the economy, debt, finances and management. A local government bond issuance may be desirable even if the government has a low credit rating or has to pay a higher interest rate on its bonds for other reasons, and restricting the ability of that government to do so without providing an alternative funding source may further exacerbate existing disparities (for example, if an economically disadvantaged area is not able to finance school facilities comparable to those provided in wealthier areas).

6.2.3. Regulation of Final Maturity and Amortization

Many states have limits on the final maturity of some or all local government bonds, and some also regulate the amortization schedule. Presumably the intent of these provisions is to prevent today’s decisionmakers from placing an excessive debt burden on future residents.

regulation of this nature might make it impossible for some local governments to borrow for outlays they urgently need.” ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 77.

See, e.g., Biles, supra note 71, at 1099 (“the differences in interest based upon the ratings often amount to millions of dollars for municipal treasuries”); John Yinger, Municipal Bond Ratings and Citizens’ Rights, 12 AM. L. AND ECON. REV. 1, 9-10 (2010) (discussing academic studies that demonstrate that higher credit ratings lead to lower interest costs); WM Financial Strategies, supra note 228, at table entitled Municipal Market Data Index 20th Year Maturity by Rating Grade (showing that interest rates on bonds with lower credit ratings have been higher than on bonds with higher credit ratings since 2008). Most municipal bonds are rated by one or more of the three rating agencies that dominate the market: Moody’s Investors Service, S&P Global Ratings and Fitch Ratings. O’HARA, supra note 16, at 175, 179. See id. at 189 (showing percentage of municipal debt not rated by Moody’s and S&P ranging from 7.5% in 2000 to 2.4% in 2009). Kroll Bond Rating Agency also rates some municipal bonds, and some bonds are not rated.


This may be particularly true if particular types of communities are disproportionately affected. For example, one study concluded that smaller communities pay higher interest rates than larger ones. See supra note 81. Another commentator suggests that credit rating formulae disadvantage cities with large Black and Hispanic populations. Yinger, supra note 231, at 28-29. Furthermore, to the extent that interest rate limits increase the importance of credit ratings to local governments, they may increase the risk that credit rating agencies have too much influence on local government decisions. See generally Biles, supra note 71 (arguing that local governments prioritize the requirements of credit rating agencies over the needs of their citizens).

Forty-one states had limits on maximum maturities in 1993. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 4, at 10. Also see Salsich, supra note 60, at § 12.4 (noting that many state laws include maximum terms for municipal bonds).
6.2.3.1. Forms of Limits on Maturity

Different states have different approaches to establishing final maturity dates, and the dates sometimes vary depending on the type of bonds or the type of project. Some states specify a period of years. For example, general obligation bonds issued by Hawaii counties must mature within 25 years and revenue bonds within 30. California local governments must mature within 40 years. The maximum term for many public enterprise revenue bonds in California is 40 years and for sales tax revenue bonds ranges from 20-50 years depending on the issuer and the authorizing law (with some instead limited by the term of the tax). New York municipalities and school districts generally may not issue bonds with a term longer than the “period of probable usefulness” of the project or projects being financed, and periods of probable usefulness for over 100 types of projects are included in the Local Finance Law, subject to constitutional caps. Oregon does not specify a maximum term for general obligation bonds and for some other types of local government borrowing, but instead requires that the weighted average life of the bonds be less than or equal to the weighted average life of the project financed with the bonds.

238 N.Y. Const. art. VIII, § 2; N.Y. Local Fin. Law § 11.00 (McKinney 2021). Projects range from more typical ones like water systems, sewer systems, and roads to unique and specific projects such as payments to certain former employees of the town of Southampton, Lynbrook and Oyster Bay and payments from the city of Elmira for past service costs due to the state. Id. Bonds generally cannot be issued for projects that are not included in the statute. Goodfriend & Myers, Bond Basics for Towns, Villages and Cities, supra note 107, at 21. The periods of probable usefulness and the items that are included are not always intuitive. For example, replacement vehicles are included but vehicles to expand a fleet are not; land has a useful life of 30 years; and cleaning of hazardous waste sites in some locations is included but not in others. Id. at 25-26.
239 Or. Const. art. XI, § 11L. Also see League of Or. Cities, supra note 50, at 10, 13 (noting that some financing agreements and revenue bonds are subject to these limitations). The weighted average life of bonds is the weighted period of time required to repay half of the principal of the bonds. It can be calculated by multiplying each principal payment by the number of years that principal is outstanding, then dividing that result by the total amount of principal of the bonds. For an example, see Glossary of Municipal Securities Terms: Average Life, MUN. SEC. RULEMAKING BD., http://www.msrb.org/glossary/definition/average-life.aspx (last visited Mar. 31, 2021).
6.2.3.2. Provisions Governing Amortization Schedule

Some states also have restrictions on how debt service is spread out over the life of the bonds. For example, general obligation bonds issued by Hawaii counties must mature in substantially equal installments and the first principal payment must be made within 5 years of issuance.\(^\text{240}\) In New York, local government bonds generally must be paid in annual installments beginning within two years after the bonds are issued, and no installment may be more than 50% higher than the smallest preceding installment unless the governing body of the local government provides for substantially level or declining debt service payments.\(^\text{241}\) Prior to 2010, California had a law that required substantially level debt service on many issuances of general obligation bonds, unless principal was paid faster or if the issuance of bonds resulted in more level debt service on all of the local government’s outstanding general obligation bonds.\(^\text{242}\) These restrictions do not always apply to revenue bonds.\(^\text{243}\)

6.2.3.3. Properly Drafted Restrictions on Maximum Term and Amortization Can Promote Interperiod Equity

“[I]t is axiomatic that bonds should be retired within the period of usefulness of the facilities which they have financed and that their retirement or amortization should begin at an adequate rate with a minimum of delay.”\(^\text{244}\) Limits on the period that bonds can be outstanding and provisions restricting the ability to backload debt service may each serve to effectively counterbalance the tendency of current officials to borrow more and for a longer term than would be consistent with interperiod equity. These provisions serve separate yet related functions.

Limits on maturity will best promote interperiod equity if they are tied to the useful life of the facilities financed rather than an arbitrary number of years. Although allowing local governments to determine the useful life of the project being financed, or of components of the project being financed, and tying final maturities to that is daunting, there are ways to make the


\(^{241}\) N.Y. Const. art. VIII, § 2. Because interest payments decline with the outstanding principal amount, principal payments go up from year to year if debt service (principal and interest) is the same in every year.

\(^{242}\) Former Cal. Gov’t Code § 253508.5 (1993 Cal ALS 841). The largest annual debt service payment could not exceed the smallest by more than 10%. Id.

\(^{243}\) For example, no such restriction applies to Hawaii revenue bonds.

\(^{244}\) Nat’l Mun. League, supra note 93, at xviii (1953).
process more manageable. It is important that the process be one with a result that is clear enough for bond counsel to be able to deliver an opinion as to the validity of the bonds. One alternative would be a statute or regulation detailing useful lives for various types of projects, along the line of New York’s periods of probable usefulness.\textsuperscript{245} Another option would be to incorporate the economic lives that are used as “safe harbors” for tax-exempt bonds.\textsuperscript{246} Since these are commonly used by local governments and bond counsel they should be comfortable working with these for another purpose, as well. If the state wished to allow local governments some flexibility to extend debt beyond the safe harbor useful life of the project financed, it could do so, either by generally providing for a longer period (for example, 120% of the specified period, like in the federal regulations) and/or by allowing local governments to amortize over a longer period in certain circumstances or with the approval of, or following consultation with, a state agency with relevant expertise.\textsuperscript{247} If a state were wary that the safe harbor useful lives could sometimes be too long, it could impose a shorter period (either a percentage of the useful life or an outside limit on maximum term). Laws governing maximum maturities and useful lives of projects should be the same regardless of the type of bond being issued.

Laws that promote front-loaded or fairly level debt service also play an important role in promoting interperiod equity. They should, however, provide some flexibility, for several reasons. First, future debt service will be paid in future dollars, which likely will be worth less than today’s dollars, and some cushion should be included to account for that. Second, while as a general rule it makes sense for bonds payable from an established tax or from rates paid for use of an existing facility to have fairly even payments over the term of the debt, this is not

\textsuperscript{245} See supra note 238 and accompanying text.

\textsuperscript{246} For interest on bonds to be excluded from income for federal income tax purposes, the average maturity of the bonds cannot exceed 120% of the average reasonably expected economic life of the assets financed with the proceeds of the bonds absent extenuating circumstances. 26 U.S.C.A. 147(b)(1) (West 2020); Treas. Reg. 1.148-1(c)(4)(B)(2); CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at §§ 4.4.1, 4.7.2.3. The safe harbors for various types of structures and equipment are in two revenue procedures released by the Internal Revenue Service, Rev. Proc. 62-21, 1962-2 C.B. 418 (1962) and Rev. Proc. 83-35, 1983-1 C.B. 745 (1983).

\textsuperscript{247} David Gamage and Darien Shanske have suggested that the California Debt and Investment Advisory Commission approve certain types of local debt that they believe are more likely to be problematic. See David Gamage & Darien Shanske, The Case for a State-Level Debt-Financing Authority, St. TAX NOTES, Jan. 21, 2013, at 188, 193. While their suggestion was not in the context of final maturity of bonds, state agency approval may be appropriate here because it would provide the opportunity for an agency with more expertise and without a vested interest in the outcome (unlike an underwriter) to provide guidance. While there is risk that a state agency could block financings for political reasons or otherwise unduly restrict the ability of local governments to borrow, in the context of borrowing for a term longer than the useful life of the project, the risks of involving such an agency seem minimal.
necessarily true for a new facility or a new stream of payments. A new facility that is being constructed will not generate revenues until it is completed, and perhaps will not reach its revenue-generating potential until some time after completion. Even in the absence of a new facility, it may take time for a new revenue stream from an existing facility or from a new tax to reach its full potential. Third, allowing local governments flexibility to structure new debt service around existing to provide a smoother structure can assist in avoiding large changes in fee levels and tax rates, which may create difficulties for taxpayers. 248

Fourth, and particularly salient in the midst of a global pandemic, local governments need the flexibility to deal with economic shocks and disasters. In a time of economic distress, local governments may need to structure debt service on new borrowing or refinancing so that a larger proportion of the debt service is payable in the future than might be ideal for interperiod equity in order to obtain critically needed funds in a timely manner and to provide economic relief to citizens. Safety valves could be built into amortization requirements to address this issue. For example, the local government might be permitted to deviate from the statutory restrictions in specified circumstances, such as a natural disaster or a recession, or if the governing body might be required to make findings with respect to economic distress. Exceptions of these kinds could be helpful, but risk being abused and also being too narrow to cover unanticipated circumstances.

While the legislature could amend the law to loosen level debt service requirements should the need to do so arise, it may not do so (or may not do so in a timely manner), or the looser requirements may remain in place after they are no longer desirable. For example, the California legislature eliminated a requirement of substantially level debt service on many general obligation bonds in 2009 to give local governments more flexibility during a time of financial crisis. 249 This change affected the way that local governments borrowed even after the crisis had passed. Prior to 2009, California school districts could issue bonds with a maturity of up to 25 years without having to provide for substantially level debt service; after the legislature acted in 2009, they could issue bonds with a maturity of up to 40 years without having to meet that requirement. In the years after the amendment passed, a significantly higher portion of the capital appreciation bonds (on which all or nearly all debt service is paid close to maturity)

248 See MUSGRAVE & MUSGRAVE, supra note 50, at 693 (noting that “taxpayers find it easier to live with a more or less stable tax rate”). Such flexibility should have reasonable limits.
issued by California school districts had maturities in excess of 25 years, increasing from 24% in 2009 to 80% in 2012 before declining to 58% by 2015 (still significantly higher than prior to the change).250

Perhaps a better alternative would be allowing a state agency to waive the statutory restrictions in appropriate circumstances,251 or allowing a local government to proceed with a financing with significantly higher debt service in later years if the government’s governing body makes findings of necessity and is given nonbinding guidance of a state agency or other entity with expertise.252

6.2.4. Restrictions on Other Provisions

States sometimes impose other restrictions on the provisions of bonds. For example, some California school district general obligation bonds must be subject to redemption at the option of the issuer beginning not later than 10 years after the date they were issued.253 Historically, some states required that bonds be issued in coupon form (meaning that whomever held a “coupon” for an interest payment would be paid the interest) rather than registered form (in which payments are made to the registered owner of the bond), but once the U.S. Congress amended the Internal Revenue Code to provide that tax-exempt bonds had to be in registered form, states modified their laws to allow for registered bonds.254

Most states “prescribe by bond statute bond terms that can be said to affect policy … but give local governing bodies a good deal of discretion in setting bond terms of an administrative nature.”255 In general, this provides appropriate flexibility to local governments to determine the terms of their bonds and adapt to changing market conditions that are not likely to create

250 See White, supra note 14, at 409 n. 225.
251 See supra note 247.
252 The nonprofit organization proposed in ANG & GREEN, supra note 19, to (among other things) establish best practices, provide independent advice to issuers and disseminate information could fulfill this role.
253 CAL. EDUC. CODE § 15144.2 (Deering 2021). This applies to capital appreciation bonds with maturities in excess of ten years. Id. While this right to redeem gives school districts greater flexibility to refinance at better interest rates or a preferable structure, it presumably comes at a cost in the form of higher yields, particularly when interest rates are high, since it creates the risk that investors will have to reinvest not only earning on but also principal of the CABs in lower yielding securities before the scheduled maturity date of the CABs. These requirements may become more costly should the market move away from 10-year par calls in the future.
254 CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at § 1.1.2; Bernard P. Friel, The Model Registered Public Obligations Act: A Brief History, 16 Urb. Law. 17, 19, 24-25 (1984); Salsich, supra note 60, at § 12.44.
255 Salsich, supra note 60, at § 12.35.
substantial risks to current or future citizens. Bond laws could either simply state that local government governing bodies and their delegees can determine terms of the bonds other than any specified by law, or could include a list of the types of terms that local governments may want to include in their bond documents along with flexibility to include other terms. For particular practices that cause concern, states may want to consider whether education of local government officials, requiring local governments to work with an experienced municipal advisor that has a fiduciary duty to the local government, mandating consultation with or approval by a state agency or other entity with expertise, or legislative prohibition are appropriate.

Bond laws typically authorize local government issuers to make agreements with lenders regarding the collection and use of revenues, creation of security interests, establishment of reserve fund and other matters. These covenants are important to bondholders, particularly those of revenue bonds, but they restrict the issuer’s flexibility. However, local governments may not always understand the terms to which they are agreeing. As a result, these covenants may prove harmful to current or future citizens. Because covenants vary significantly, legislating the types of covenants that are and are not appropriate is not a reasonable solution. Better options would be providing access to guidance from a state agency or other entity with expertise at a reasonable cost or at the very least making trainings and other materials available to local governments so they can better educate themselves. Requiring local governments to use a municipal advisor, which would have a fiduciary duty to the local government and have needed expertise, is another option.

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256 See, e.g., CAL. GOV’T CODE 53508 (Deering 2021) (listing several items that “may” be addressed in the resolution, including “other terms and conditions of the bonds and of their execution, issuance, and sale deemed necessary and appropriate ….”).

257 Some candidates would be auction rate securities or other types of transactions in which a local government bears a disproportionately high risk in exchange for a relatively small reward. Lori Raineri and Darien Shanske make this argument in Raineri & Shanske, supra note 68. Also see supra note 69 and accompanying text.

258 Raineri and Shanske urge the use of a state agency that would monitor local government borrowing for asymmetric risk. Id. at 83. For additional discussion of municipal advisors, see supra notes 48-49 and accompanying text. Also see supra notes 247 and 252.

259 Salsich, supra note 60, at § 12.45. Also see supra notes 180-181 and accompanying text for description of some other common covenants.

260 See, e.g., Nguyen et al., supra note 40, at 1 (noting that local governments may not fully comprehend loan risks); see also supra note 82 and accompanying text.
### 6.3. Refinancing

Most states allow local governments to issue bonds and to repay outstanding debt prior to maturity. This is referred to as “refunding,” the bonds being repaid are “refunded bonds,” and the bonds being issued to repay them are “refunding bonds.” The most common reason for refinancing is to take advantage of lower interest rates.

Sometimes, issuers refund outstanding bonds to eliminate or modify covenants that have become unduly burdensome or to restructure debt service. Due to the severe economic strain caused by the COVID-19 pandemic, some local governments have refinanced outstanding debt to provide short-term relief by deferring debt service.

In some states, refunding bonds must satisfy certain requirements, or refunding bonds that would otherwise require voter approval (such as general obligation bonds) do not need such approval if specific requirements are met. For example, in New York, refundings generally must result in present value savings and refunding bonds generally cannot mature later than the end of the period of probable usefulness of the project financed, computed from the same date as for the refunded bonds. California local governments may issue general obligation bonds to refund other general obligation bonds without obtaining a new voter approval only if the total amount of debt service through maturity is lower for the refunding bonds than for the refunded bonds and the refunding bonds mature no later than the refunded bonds. Other states are somewhat less restrictive. Oregon allows refunding bonds to be issued without voter approval as long as the maturity of the refunding bonds does not exceed any maturity limit imposed on the refunded bonds by the voters or by law by more than six months.

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261 Salsich, supra note 60, at § 12.50.
263 Id. at 236-237; O’HARA, supra note 16, at 83; LEAGUE OF OR. CITIES, supra note 50, at 17.
265 N.Y. LOCAL FIN. LAW §§ 90.00, 90.10 (McKinney 2021). See supra note 238 and accompanying text for discussion of periods of probable usefulness.
266 CAL. GOV’T CODE §§ 53552, 53553(e) (Deering 2021). Georgia similarly exempts refunding bonds from voter authorization requirements as long as the term is not extended, the interest rate is not increased, and debt service through maturity does not increase. GA. CONST. art. IX, § 5(III).
States generally limit the amount of refunding bonds to the amount necessary to repay the refunded bonds and pay costs of issuance. In addition, some states have other restrictions on the issuance of refunding bonds. For example, in Oregon, any refunding bonds that are issued more than a year in advance of the repayment of existing bonds must be approved by the State Treasurer’s office and are subject to additional requirements. Among other things, the State Treasurer’s regulations require that local governments use a municipal advisor for any such advance refundings.

Allowing local governments to refinance outstanding debt allows them to save money when they can refinance at lower interest rates and provides flexibility to adapt to changing circumstances by eliminating restrictive covenants in bond documents or restructuring debt service in challenging times. As long as the transaction does not increase the overall burden on taxpayers and as long as the term of the new bonds is not significantly longer than would have been legally allowed for the initial bonds and any level debt service requirements that applied to the refunded bonds also apply to the refunding bonds, present and future citizens are not likely to be harmed by a refinancing. Furthermore, because it takes several months to obtain voter approval, requiring such approval for refunded bonds would make it impossible for a local government to act quickly to take advantage of interest rate fluctuations, preventing some local governments from achieving debt service savings. That said, it may be sensible to require consultation with a state agency or other expert, state agency approval or use of a municipal advisor with a fiduciary duty to the local government issuer, or to require a local government governing body to make findings as to the benefits of the transaction in some circumstances, such as refinancings that do not result in debt service savings or that defer a significant portion of debt service.

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268 Salsich, supra note 60, at § 12.50. While California law does not expressly do so, the California Attorney General has interpreted the refunding statute to allow refunding general obligation bonds without voter approval only if proceeds for other purposes are not generated and noted that view is consistent with case law in other jurisdictions. Opinion of Edmund G. Brown Jr., Attorney General, No. 06-1102 8-9 (Jan. 9, 2009).

269 OR. REV. STATS. §§ 287A.001(1); 287A.365-287A.375 (2019). The additional requirements are likely because advance refundings are more costly than current ones because the proceeds of the refunding bonds must cover interest through the date the refunded bonds are to be paid.


271 See supra notes 163-164 and accompanying text.
6.4. Regulation of Sale of Bonds

6.4.1. Method of Sale

Some states restrict the method of sale for at least some bonds. For example, some states require some or all local governments to sell their general obligation bonds (but not revenue bonds) through a competitive process.\textsuperscript{272} General obligation bonds may be sold on a negotiated basis in other states.\textsuperscript{273} Some states also allow local governments to privately sell bonds to, and to borrow directly from, financial institutions, and this practice is becoming increasingly common.\textsuperscript{274} Most local government debt is sold in negotiated sales.\textsuperscript{275}

Some states impose additional requirements for bonds to be sold on a negotiated basis. For example, California local governments selling general obligation bonds on a negotiated basis must include a statement of the reasons for selecting a negotiated method of sale and an estimate of the costs of issuance in the governing body resolution that authorizes the bonds.\textsuperscript{276} For revenue bonds and refunding bonds, California local governments must disclose in a filing with the California Debt Investment Advisory Commission the reason for using a negotiated sale.\textsuperscript{277} In New York, some local governments must obtain the approval of the State Comptroller before selling some bonds privately or in a negotiated sale.\textsuperscript{278} In determining whether to approve the sale, the State Comptroller considers factors including the reasonableness of the underwriter’s fee, costs, bond yields, refunding savings, any derivatives (such as interest rate swaps) related to the transaction.\textsuperscript{279}

\textsuperscript{273} See, e.g., OR. REV. STATS. § 287A.300 (2019); CAL. GOV’T CODE § 53508.9 (Deering 2021).
\textsuperscript{274} See supra note 40.
\textsuperscript{275} Peng et al., supra note 42, at 62.
\textsuperscript{276} CAL. EDUC. CODE § 15146(b)(1) (Deering 2021); CAL. GOV’T CODE § 53508.9 (Deering 2021).
\textsuperscript{279} Id. at 4-5.
Each method of sale has advantages and disadvantages. Negotiated sales provide greater flexibility to adjust the transaction structure and timing as market conditions change and permit greater underwriter involvement in structuring the transaction and preparing the offering document.\textsuperscript{280} Competitive sales eliminate the risk of negotiating unfavorable terms with the underwriters (either because of corruption or lack of experience) because bonds are awarded to the lowest bidder in an open bidding process. Numerous studies suggest that local governments obtain lower yields and pay lower costs when they sell their bonds competitively, though others reach the opposite conclusion.\textsuperscript{281} Generally, negotiated sales are recommended for complex transactions, new issuers or complicated credits, while competitive sales are recommended for higher rated issuers with straight-forward security.\textsuperscript{282}

Presumably, restrictions on method of sale are intended to ensure that local governments get the lowest possible yields on their bonds and do not pay excessive compensation to underwriters. Ideally, rather than blanket restrictions on methods of sale, states will allow local governments to select the method of sale that best suits their needs. At the very least, states should allow local governments to sell revenue bonds and refunding bonds without using competitive bidding since these transactions tend to be more complex or more time-sensitive.\textsuperscript{283} Rather than prohibiting negotiated sales of general obligation bonds or borrowing from financial institutions, a state could require a local government’s governing body to make findings about the reasons a negotiated sale or private borrowing was being pursued, or could require use of a municipal advisor or consultation with or approval of a state agency or other expert before undertaking the transaction. Other options would include making available guidance from a state

\textsuperscript{280} Peng et al., supra note 42, at 56-57; also see CAL. DEBT & INV. ADVISORY COMM’N, supra note 106, at 10-12 (describing the roles played by an underwriter in a competitive and a negotiated sale).

\textsuperscript{281} See Peng et al., supra note 42, at 59-62 (describing some studies that indicate that competitive sales are most cost effective and others indicating that in some circumstances negotiated sales may result in better pricing); WM Financial Strategies, Studies Pertaining to Competitive and Negotiated Sales, (Nov. 2013), http://www.munibondadvisor.com/SaleStudies.htm (describing studies reaching various conclusions); Cestau, supra note 272 (concluding that prohibition of negotiated sales increase the yields on bonds maturing within 20 years and decrease the yields on bonds with longer maturities); Simonsen, supra note 81, at 714-15 (indicating that competitive sales lead to lower interest rates on bonds).


\textsuperscript{283} See Peng et al., supra note 42, at 63-64 (noting that revenue bonds tend to be riskier and investors may need more information about them, and that refunding bond sales are more time-sensitive).
agency or other entity with expertise at a reasonable cost or requiring local governments to use a municipal advisor for negotiated sales of general obligation bonds.

States also might want to encourage the use of a competitive process involving obtaining proposals from several underwriters to select underwriters for a negotiated sale, or even make available technical support to assist with such a process. Selecting underwriters for negotiated sales using a competitive process has significantly reduced the underwriting costs paid by issuers.

6.4.2. Mechanics of Sale

Some state laws include detailed provisions about the mechanics of competitive sales, in particular, such as when and where notice of sale must be published and what the notice must contain. Some of these provisions, such as requirements to publish in newspapers in particular cities, seem almost quaint today when competitive bidding takes place through electronic platforms. In all likelihood, some requirements that seem reasonable today will be obsolete in the future as technology and market practices evolve. Ideally, any specifics about notice, method of submission of bids and the like would be drafted in general terms (for example, requiring notices of sale to be published in a manner (including online) that is reasonably expected to reach prospective bidders) or delegated to a state agency that can more easily revise regulations to adapt to changing technology and market practices. The alternative is unnecessary expense and complication.

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284 The Government Finance Officials Association recommends using a competitive process to select underwriters for negotiated sales. Gov’t Fin. Officers Assoc., supra note 282. For descriptions of this process, see CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at §5.3; Peng et al., supra note 42, at 55-56.

285 Peng et al., supra note 42, at 55-56.

286 Salsich, supra note 60, at § 12.40.

287 See, e.g., CAL. PUB. UTILITIES CODE § 22784 (Deering 2021) (requiring that airport districts publish notice in a newspaper of general circulation in the county, or if there isn’t one, in a different county, before selling bonds); MONT. CODE ANN. § 7-7-2252 (2019) (requiring publication of notice of sale in a local newspaper and providing the option to also publish in a financial newspaper in New York or Chicago).

288 For example, one bidding platform indicates that it is used by the top 30 underwriters. IPREO, Competitive Bid Calculation System, https://www.newissuehome.i-deal.com/Destination/docs/BiDCOMP.pdf (last visited Mar. 31, 2021).

289 For example, California allows publication of a notice of sale in “a financial publication generally circulated throughout the state or reasonably expected to be disseminated among prospective bidders for the securities.” CAL. GOV’T CODE § 53692 (Deering 2021). This could be expanded to include online platforms.
Some states prohibit the sale of general obligation bonds at a discount or limit the amount of discount that is allowed. These laws presumably are intended to prevent local governments from selling bonds at a yield that is higher than (or substantially higher than) the authorized maximum interest rate. A better solution would be to authorize a maximum yield (or, better yet, to eliminate any maximum interest rate or yield imposed by state law), and to allow local governments to sell at a discount or premium to obtain the best price on their bonds.

7. The Approval Process, Information and Opportunities for Public Involvement

One of the key functions of bond laws is to ensure that governing bodies and the public have access to information about proposed bond issuances and existing debt, and that the public has a meaningful opportunity to influence proposed local government borrowing. Much of the information provided to the public and the public’s opportunity to provide input outside the voter approval process occurs on the context of governing body approval. All states require governing body approval (or that of a delegate of the governing body) of bond issuances, some require supermajority approval. Some states also require that issuers provide information to a central repository or otherwise make information about debt readily available to those interested. Governing body approval and information requirements are discussed in the following sections. As with voter approval requirements, if governing body approval and information requirements are imposed, they should be applied consistently so that decisions about financings are made on the basis of the needs of the community rather than the challenge of meeting the requirements.

7.1. Supermajority Approval

Some state laws require that a supermajority of a local government’s governing body approve certain bond issuances, with different definitions of supermajority in different cases.

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290 Salsich, supra note 60, at § 12.43. Also see N.Y. LOCAL FIN. LAW § 57.00(e) (McKinney 2021) (limiting the discount to no more than 5% except in specified circumstances).

291 See supra notes 15-17 and accompanying text. Also see Section 6.2.2.

292 Salsich, supra note 60, at § 12.2.

293 For example, New York local governments generally may issue bonds only if the transaction is approved by two-thirds of the membership of the governing body (or three-fifths if a referendum is being held). N.Y. LOCAL FIN. LAW § 33.00 (McKinney 2021). Two-thirds of council members of California non-home rule cities must approve an ordinance to put a general obligation bond measure on the ballot, and some California local transportation authority boards must approve the issuance of sales tax bonds by a two-thirds vote. CAL. DEBT & INV. ADVISORY COMM’N, supra note 106, at 139, 195.
Supermajority requirements may help protect against unwise borrowing by making it more difficult for “small but well-organized groups to put together the legislative coalition necessary to authorize new debt.”²⁹⁴ A supermajority requirement may also signal to the governing body that the decision to borrow is a particularly important one, and that in itself may have value. While at least one study has suggested that legislative supermajority approval requirements do not reduce the level of debt,²⁹⁵ it is possible that the requirements caused the debt to be more carefully considered.

7.2. Requirements for Information and Findings Before Issuance

Some states require that specific information be provided to governing body members or made publicly available before bonds are approved, or that governing bodies make specific findings in their resolutions authorizing bonds. For example, before authorizing the issuance of bonds, governing bodies of California local governments must obtain and disclose estimates of the expected yield on the bonds, the costs of issuance, the proceeds to be received and the total amount of debt service that will need to be paid to maturity.²⁹⁶ The purpose of this requirement, which was added in 2017, is to provide the public with a better understanding of the financial impact of the financing.²⁹⁷

At least in states that have laws requiring that meetings of local government governing bodies must be properly noticed and open to the public (“open meeting laws”),²⁹⁸ requirements to present information to the governing body and for the governing body to make findings can serve dual purposes of informing the governing board and informing the public. While it is safe to assume that few members of the public attend local government board meetings or review meeting agendas on local government web sites, there is value in having the information available to anyone who wants to see it, and interest groups and the press may bring attention to more controversial measures. Mandating wider publication of a notice with key information

²⁹⁴ Sterk & Goldman, supra note 73, at 1366.
²⁹⁵ Kiewiet & Szakaly, supra note 119, at 76. This study was of state legislatures, not local governments, but it is reasonable to think that the impact would be the same at the local level.
²⁹⁶ CAL. GOV’T CODE § 5852.1 (Deering 2021).
²⁹⁷ Cal. S. Rules Comm. Senate Floor Analysis, SB 450 (Cal. 2017) (quoting the bill’s author). Similarly, some local government governing bodies in California must make specific findings and include costs of issuance information in the authorizing governing body resolution in order to sell general obligation bonds at a negotiated sale. See supra note 276-277 and accompanying text.
²⁹⁸ Most states have such laws. 4 MCQUILLIN, supra note 57, at § 13.11.
about the financing in advance of the meeting might garner more public attention, but again it is likely that most people do not read the public notices published in their local newspaper. However, requirements should be as straightforward as possible and should be limited to information that is meaningful to members of the governing board and the public. Otherwise, the requirements may simply impose unnecessary costs and create another opportunity for error while providing little benefit.

7.3. *Opportunities for Public Discussion and Waiting Periods*

In addition to open meeting laws, some states provide specific opportunities for public discussion, or require a waiting period before bonds are issued to ensure that the public has the opportunity to provide input.299 For example, Illinois law requires that local governments hold at least one public hearing after giving public notice of the hearing before authorizing some types of bonds that do not require voter approval.300 For some bonds, California requires school districts to provide notice and present the resolution authorizing the bonds at two consecutive governing body meetings and it can be adopted only at the second one,301 in effect giving a longer period in which members of the public can comment on the proposed issuance. Requirements to give public notice and to give the public a period of time and the opportunity to provide input (whether that is in the context of a regular governing body meeting or otherwise) could promote public engagement and increase the likelihood that government officials hear varying viewpoints in the community before making a final decision to issue bonds, or at least before the bonds are issued. The Internal Revenue Code takes a similar approach, requiring that a public hearing after notice for some (but not all) tax-exempt bonds.302

7.4. *Additional Information Requirements and Other Accountability Measures*

Some states require reporting of bond issuance data to a state agency or otherwise require that the information be made accessible to the public. For example, every time a California local government issues bonds, it must provide information to the California Debt and Investment

300 30 ILL. COMP. STAT. ANN. 352 (LexisNexis 2021).
301 CAL. EDUC. CODE § 15146(b)(2) (Deering 2021). This only applies to capital appreciation bonds.
Advisory Commission ("CDIAC") about the issuance, including the principal amount of the bonds, premium and discount on the bonds, maturity schedule, purpose of the bonds, type of bonds, method of sale, identity of outside professionals and fees paid to them.\textsuperscript{303} Local governments in California also must annually file with CDIAC information about outstanding debt and debt issued and paid during the preceding year.\textsuperscript{304} CDIAC provides aggregate information about statewide debt issuances and also makes available information about individual issuances in excel on its web site.\textsuperscript{305} Other states also collect and publish information about local government borrowing.\textsuperscript{306} While information about publicly sold debt is available on the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access website, the information on that site is prepared for investors and does not include all of the information that might be of interest to, or provide information in the format that would be most usable by, citizens or to other local governments.\textsuperscript{307} States that do not collect and provide information should consider doing so and states that already collect information should evaluate whether it would be valuable to collect additional data. A state could form a working group that includes representatives of local governments, municipal advisors, and taxpayer organizations to evaluate what information would be useful and could be proved at a reasonable cost. States also could consider collaborating so that information from multiple states was available in a single database. While reporting requirements create additional work and cost for local governments, and compliance may not be perfect, this information is valuable not only to researchers and by the state, but also by citizens and by other local governments who may want to compare their issuance costs and bond yields to those of others.\textsuperscript{308}

\textsuperscript{303} CAL. GOV’T CODE § 8855(i), (j) (Deering 2021); CAL. CODE REGS. Tit. 4, § 6020 (Barclays 2021).
\textsuperscript{304} CAL. GOV’T CODE § 8855(k) (Deering 2021).
\textsuperscript{305} See generally https://www.treasurer.ca.gov/cdiac/debt.asp.
\textsuperscript{306} Numerous states collect and publish information about local government debt. The California Debt and Investment Advisory Commission found in 2007 that 17 states had some form of state and/or local government debt data on their web sites. Cal. Debt & Inv. Advisory Comm’n, State and Local Government Debt Data Resources (CDIAC No. 07-08) 1 (2007).
\textsuperscript{307} The site is emma.msrb.org. It generally includes disclosure information required to be provided for municipal bonds under federal securities laws. For example, official statements posted on the site do not typically include detailed information about fees charged by individual service providers involved in a transaction; this information may be useful to other local governments. In addition, because one has to look at official statements for separate transactions individually, it is not as easy to compare terms of issuances and issuers.
\textsuperscript{308} See Joffe, supra note 217, at 15-16 (noting that making costs of issuance more visible is the first step towards reducing them).
8. So, What Now?

This article has discussed some of the typical elements of bond laws and different ways that states have addressed them. It also has identified problems with some bond laws and proposed solutions. States have several options for improving bond laws and local government borrowing practices. These options range from a wholesale revision of the bond law to providing additional support and guidance to local governments. Several options are discussed below.

8.1. Changing the Law

8.1.1. Wholesale Revision or Even a New Model Bond Law

Ideally, states would consider revamping their bond laws entirely to ensure consistency and clarity while providing needed flexibility and updates. An organization like the National Association of Bond Lawyers or the National League of Cities could even undertake the drafting of model bond laws similar to what the National Municipal League did in the 1950s and 1960s or similar to the Uniform Commercial Code or other laws that have been adopted in numerous states, though these options may prove unduly challenging, particularly where constitutional provisions need to be amended or where there is a wide range in approaches among different states. Harmonizing a new set of model bond laws with existing laws that are spread throughout numerous statutes and codes, as is the case in many states, also may be challenging.

8.1.2. Incremental Change

As an alternative to a wholesale revision of bond laws, states could evaluate specific aspects of their bond laws and make changes to those provisions. Similarly, national organizations could prepare and promote uniform versions of laws to change particular aspects of municipal bond law. For example, when federal law was changed so that municipal bonds had to be in registered form in order to be tax exempt, representatives of several organizations worked together to develop a model law permitting local governments to issue bonds in registered form, and at least 20 states adopted the model law entirely or in part. It may be

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309 See supra note 93.
310 See supra note 85.
311 See supra note 254 and accompanying text.
simplest to make amendments to laws that relate to specific terms of bonds and mechanics of issuance and sale rather than to voter approval requirements or debt limits. Another alternative would be to delegate requirements regarding issuance and sale mechanics and terms of bonds to a state agency so that provisions can be changed more easily as circumstances warrant, and even to allow local governments to deviate from some or all those requirements either after approval by the state agency or after consultation with the agency or another expert.

8.1.3. Consolidation

In most states, bond laws are scattered throughout numerous statutes and codes.\textsuperscript{312} Even if no substantive changes to the laws are made, consolidating them in a single location would be valuable. Consolidation “would expose more fully the widespread existence of overlapping and contradictory provisions which have tended to hamper sound financial administration by local governments and to limit the ability of State legislatures to deal intelligently with this subject.”\textsuperscript{313} Consolidation would also make it easier for bond counsel and other professionals both within and outside local governments to understand what the laws are that apply to a particular issuance. Having statutes spread throughout multiple codes increases the risk of inadvertent noncompliance. It likely also increases the cost of compliance because of the time and effort involved in ensuring that all relevant provisions are considered or, where there is ambiguity, complying with provisions that may not be intended to apply to a particular transaction. Consolidation, or at least partial consolidation, is achievable. For example, Texas consolidated its bond laws in 1999.\textsuperscript{314}

8.1.4. Proceeding Carefully

Laws governing local government borrowing are complex, and they intersect with state laws regarding matters such as fiscal distress and municipal bankruptcy, the imposition of taxes and fees, open meeting laws and election laws. To avoid unintended consequences or disconnects with other bodies of law, amendments to bond laws should be made carefully. For example, when Texas consolidated its bond law in 1999, it involved public finance attorneys and

\textsuperscript{312} See supra note 85.
\textsuperscript{313} ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 50, at 85.
\textsuperscript{314} See supra note 94 and accompanying text.
the head of the public finance division of the office of the attorney general to review and provide comments on the proposed legislation and widely distributed drafts of the proposed law for comment. \textsuperscript{315} Oregon also involved numerous public finance professionals (lawyers and finance professionals, both from private practice and governments) in the drafting of its 2007 revised bond law. \textsuperscript{316} The Oregon bill also allowed Oregon local governments to use existing law for two years after the act became effective in order to “protect … local government borrowers against the possibility that the substantial revisions to existing law in this very large bill have adverse unintended consequences.” \textsuperscript{317} This gave the legislature time to address any problems of which it became aware during that two year period before any local government could be harmed.

In addition, additional research may be needed to inform discussion of some issues. For example, if permissive referenda are being considered, it would be valuable to know more about how the petition requirements and timing limitations affect the likelihood that citizens can actually require a measure to be on the ballot.

\textbf{8.2. Other Alternatives: Education and Guidance}

Even absent any revisions to the law, there are things states can do to improve the situation. For example, in its 2019 Debt Financing Guide, CDIAC includes a list of all of the general bond statutes. \textsuperscript{318} This list, together with the information provided in the guide, is very valuable. States also can (and do) provide training and educational resources to local governments through entities like CDIAC and the Oregon Municipal Debt Advisory Commission. \textsuperscript{319} States that don’t provide these resources should consider doing so or should consider supporting academic institutions and other organizations within the state that do.

States also could provide support to local governments in other ways, such as providing support services to local governments that could be accessed for a reasonable fee at the option of

\textsuperscript{315} Tex. Office of House Bill Analysis, Bill Analysis, H.B. 3157 (July 15, 1999).
\textsuperscript{316} Rogers, supra note 86, at § 1.
\textsuperscript{317} Id. at § 4.M.
\textsuperscript{318} See generally CAL. DEBT AND INV. ADVISORY COMM’N, supra note 22, at App. A.6.
the local government or collaborating with a nonprofit organization that would provide this assistance.\textsuperscript{320} States could take this a step farther and encourage or require use of these services for particularly complex or problematic transactions.

9. Conclusion

As we look for ways to revive the economy and to move beyond (or at least move forward despite) the COVID-19 pandemic, local government borrowing is likely to play a significant role. We need to do what we can now to make sure that borrowing is done in an effective and efficient way, and that local governments receive the guidance they need but are not constrained by outdated or unduly complicated mechanics. The first step to that is a robust dialogue about how state bond laws can be improved. The second step is determining whether in a particular state wholesale revision is realistic, or more circumspect objectives such as consolidation or revision of a particular aspect of bond laws are more achievable. It is time to start that conversation.

\textsuperscript{320} An organization was suggested in \textsc{ANG & GREEN}, \textit{supra} note 19. \textit{See supra} note 252 for a very brief description of the organization they proposed.
CHAPTER 3
GETTING LOCAL GOVERNMENTS WHERE THEY NEED TO GO WITHOUT TAKING TAXPAYERS FOR A RIDE: “CABS,” WHY THEY ARE USED, AND WHAT CAN BE DONE TO PREVENT THEIR MISUSE

[attached]
2018

Getting Local Governments Where They Need to Go Without Taking Taxpayers for a Ride: "CABs," Why They Are Used, and What Can Be Done to Prevent Their Misuse

Heather G. White
Nixon Peabody LLP

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ARTICLE

GETTING LOCAL GOVERNMENTS WHERE THEY NEED TO GO WITHOUT TAKING TAXPAYERS FOR A RIDE: “CABs,” WHY THEY ARE USED, AND WHAT CAN BE DONE TO PREVENT THEIR MISUSE

HEATHER G. WHITE*

The United States has tremendous infrastructure needs, and if those needs are to be met, local governments are likely to play a significant role in fulfilling them. Local governments spend hundreds of billions of dollars annually building infrastructure, and much of this is financed with debt in the form of bonds payable from real property taxes. Ideally, the cost of a capital project would be spread evenly over its life so all taxpayers who benefit from the project contribute to its cost. However, local political leaders have incentives to defer payment, requiring future taxpayers to pay more than their fair share. This article discusses an extreme example of this—the use of long-term compound interest bonds, on which neither principal nor interest is paid until at or near maturity.

The article describes the problems with the extensive use of this form of financing and explores the reasons California and Texas school districts issue hundreds of millions of dollars of these bonds annually, then considers alternative means of addressing those problems, including recent California and Texas legislation. It is critical that problems with the framework within which local governments issue debt, such as those that lead to the misuse of long-term compound interest bonds, be addressed.

* Ms. White is a practicing public finance lawyer affiliated with Nixon Peabody LLP and is a fellow in the Taxation Law and Policy Research Group at the University of Western Australia Law School. Thanks to Rick Krever, to my professional colleagues, and to participants at the Australasian Tax Teachers Association conference and the Monash University Taxation Law and Policy Research Group symposium for helpful comments. All errors are my own.
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I. INTRODUCTION

Every four years, the American Society of Civil Engineers releases its Infrastructure Report Card, which, like a school report card, assigns a letter grade to the condition of American infrastructure. The 2017 grade is a D+, and the Society indicates that nearly $4.6 trillion of infrastructure investment is needed over the next ten years. If pressing infrastructure needs are to be met, it is likely that local governments will play a major role in fulfilling them. Local governments construct much of the public infrastructure in the United States, and President Trump’s infrastructure plan is expected to require substantial spending by local governments.

Local governments frequently borrow to build facilities, many of which are intended to last for decades. Ideally, the cost of this infrastructure—and hence the payments on the debt issued to finance it—would be spread evenly over its life so that neither today’s nor tomorrow’s taxpayers (or users) pay more than their fair share. Yet, in recent years, in California, Texas, and elsewhere, there has been considerable—perhaps even excessive—reliance on long-term compound interest bonds (referred to as “capital appreciation bonds” or “CABs”), on which neither principal nor interest is paid until at or near maturity. This article explores this phenomenon, considers some of the factors that may cause local governments to resort to a financing structure that on its face seems unfair, and presents alternative means of addressing misuse of this financing tool, including recent California and Texas legislation.

This article focuses on the use, by California and Texas school districts, of debt that is payable from property taxes (referred to as “general obligation bonds”) and the reasons districts sometimes issue this debt in

2. Id. at 5, 8.
4. See GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016) (“[W]hen a municipal government issues bonds, the principal (or proceeds) is typically used to finance the construction of capital facilities”).
5. See infra note 9 and Part III for a discussion of the problems associated with CABs.
6. The term “general obligation bonds” refers to bonds supported by the issuer’s full faith and credit, power to levy ad valorem property taxes, or both. NAT’L ASSN OF BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS i–ii, 1–4
the form of CABs. California and Texas school districts administer public schools within their geographic areas and are controlled by locally elected governing boards. There are approximately 1,000 school districts in each of these states, each serving anywhere from a few students to hundreds of thousands of students.

In recent years, California and Texas have been among the states where CABs are used most, and in both states, school districts are the most frequent issuers of this type of debt, issuing hundreds of millions of dollars of these bonds. California legislation limiting the use of CABs (AB 182) took effect in January 2014. Texas legislation with the same purpose (HB 114) took effect in September 2015. The controversy surrounding
CABs that led to AB 182 and HB 114 focused on school districts. One of the transactions that received considerable attention was the 2011 issuance of $105 million CABs by the Poway Unified School District in California (Poway Transaction). No payments are required on these bonds until 2033, but nearly $1 billion will be due between 2033 and 2051. While this is an extreme example, it demonstrates the issue that exists to varying degrees with all CABs.

Problems with the framework within which local government debt is issued, including those that lead to the misuse of capital appreciation bonds, must be addressed because of the important role that local government debt plays in public construction in the United States and the nation’s looming infrastructure needs. Adding to the significance of these problems is the fact the United States federal government and state governments subsidize most local government borrowing.

12. See Ian Lovett, California Schools Finance Upgrades by Making the Next Generation Pay, N.Y. TIMES (Feb. 9, 2013), http://www.nytimes.com/2013/02/10/us/10schools.html?_r=0 [https://perma.cc/ENS6-9DEC] (quoting California Treasurer Bill Lockyer as analogizing the use of CABs as “the school district’s version of printing money”); Mark Lisheron, Texas Schools Pass Debt on to the Next Generation, WATCHDOG.ORG (Nov. 6, 2013), http://watchdog.org/114596/texas-schools-pass-debt-next-generation/ [https://perma.cc/5CPP-SAHL] (reporting the filing of bills by Texas representatives to modify the use of CABs due to their propensity to be abused); Dan Weikel, Risky Bonds Tie Schools to Huge Debt, L.A. TIMES (Nov. 29, 2012), http://articles.latimes.com/2012/nov/29/local/la-me-school-bond-20121129 [https://perma.cc/7HU5-3MJQ] (describing the dangers and concerns surrounding CABs).

13. Will Carless, Where Borrowing $105 Million Will Cost $1 Billion: Poway Schools, VOICE OF SAN DIEGO (Aug. 6, 2012), http://www.voicesandiego.org/topics/education/where-borrowing-105-million-will-cost-1-billion-poway-schools/ [https://perma.cc/3DAX-MU7J]; see also Randall Jensen, Calif. Capital Appreciation Bonds Have Unintended Consequences, THE BOND BUYER (Sept. 20, 2012) [hereinafter Jensen, Calif. Capital Appreciation Bonds Have Unintended Consequences], http://www.bondbuyer.com/issues/121_183/california-school-districts-capital-appreciation-bonds-consequences-1044196.html [https://perma.cc/Q5E8-C4KD] (stating the Poway Schools’ $105 million bond will “require nearly $1 billion in debt service at their 40-year maturity”); Lovett, supra note 12 (“And in the most expensive case yet, the Poway Unified School District borrowed $105 million to finish modernizing older school buildings, which local property owners will be paying off until four decades from now at an eventual cost of nearly $1 billion.”); Weikel, supra note 12 (“By the maturity date of 2051, however, the $105 million in Poway notes will cost district taxpayers almost $1 billion in principal and interest—more than $9 for every $1 borrowed.”).


15. GRANT A. DRIESSEN, SUMMARY TO CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT (2016) (“The federal
government reduces the cost to state and local governments of issuing debt by making interest earnings on most of such debt exempt from federal income tax.\textsuperscript{16} Tax-exempt debt typically bears interest at a lower rate than taxable debt of identical credit quality because lenders receive the benefit of tax exemption.\textsuperscript{17} Interest on most state and local government debt is also exempt from home state taxation.\textsuperscript{18}

Part II of this article provides general background information, including a brief introduction to local government bonds (also referred to as “municipal bonds”), the key legal limits that apply to these bonds (particularly to California and Texas school district general obligation bonds), and the differences between capital appreciation bonds and other local government bonds. Part III discusses the most significant problems associated with the use of long-term CABs, including concerns about interperiod equity, costs, and transparency. Some of the factors that appear to contribute to the use of CABs despite these problems are canvassed in Part IV. Part V outlines recent legislation adopted in California and Texas to limit the use of CABs and highlights similarities and differences in the approaches taken in these two states. Finally, Part VI sets out the potential means to prevent misuse of CABs. The lessons this article draws from the California and Texas school district experience with CABs can be applied to local governments generally.

\textsuperscript{16} Traditionally, the vast majority of state and local government securities are issued on a tax-exempt basis. U.S. SEC. & EXCH. COMM’N, REPORT ON THE MUNICIPAL SECURITIES MARKET 11 (2012). In 2015, the loss of federal tax revenue (also referred to as a “tax expenditure”)—resulting from the exemption from income of interest on public purpose tax-exempt bonds—was $29.4 billion. GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 3 (2016).

\textsuperscript{17} See GRANT A. DRIESSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016) (detailing the benefits of tax-exempt bonds).

II. INTRODUCTION TO MUNICIPAL BONDS

A. Overview

There are more than 90,000 local governments in the United States, including more than 12,500 school districts.\(^{19}\) State and local governments (including school districts) put in place $258.5 billion of new non-residential construction and improvements in 2016, including $41.3 billion for primary and secondary school facilities.\(^{20}\) Much of this construction is financed with state and local government debt.\(^{21}\) In 2015, state and local governments issued $403.6 billion of debt with maturities of at least thirteen months, and a total of approximately $3.7 trillion of state and local government debt was outstanding (including debt issued in prior years).\(^{22}\) Most of this is in the form of “bonds.”\(^{23}\) This term generally is used to refer to local government debt securities with a maturity of more than three years;\(^{24}\) most bonds have a significantly longer term, frequently up to thirty years and, sometimes, even longer.\(^{25}\)

Local governments, including California and Texas school districts, issue bonds primarily to finance capital projects (“new money bonds”) and


25. BOND, INVESTOPEDIA, http://www.investopedia.com/terms/b/bond.asp [https://perma.cc/L2H3-FHAT] (“Bond maturities can range from a day or less to more than 30 years.”).
to refinance previously issued bonds (“refunding bonds”). Principal and interest (“debt service”) on municipal bonds may be paid from a single source or a combination of sources, including property taxes, sales taxes or other taxes; the local government issuer’s general fund; or revenues from a particular project.

Most debt issued by school districts in California and Texas is in the form of general obligation bonds, several billion dollars of which are issued annually in each state. These bonds are the focus of this article. Principal and interest on California and Texas school district general obligation bonds are payable from ad valorem real property tax assessments that are levied solely for this purpose. Ad valorem property taxes are calculated as a percentage of property value. These taxes generally are collected shortly before debt service is due. Most, but not all, Texas school district general obligation bonds are also guaranteed under the Texas Permanent School Fund Bond Guarantee Program.
Bonds are usually issued in a group (referred to as a series) with different maturities. Sometimes a single issuance consists of more than one series, particularly when the bonds being issued have different characteristics, such as having been approved by voters at different elections, being issued for different purposes, or having different tax-exempt status.\footnote{33}

**B. Restrictions on Debt**

Most states have constitutional restrictions, statutory restrictions, or both on the amount and terms of debt that local governments within their borders may issue.\footnote{34} These restrictions are intended to serve a variety of purposes, including promoting fiscally sound decision-making, reducing the risk of default, preventing excessive burdens on taxpayers, and promoting interperiod equity (the concept that the burden of paying for a facility should be spread fairly over the period during which the facility is used).\footnote{35}

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\footnote{2016 REPORT, supra note 28, at 37, 47. The Texas Permanent School Fund was established to benefit Texas public schools. Bonds guaranteed by the fund receive the highest ratings from all three agencies that rate municipal bonds. TEX. EDUC. AGENCY, TEXAS PERMANENT SCHOOL FUND DISCLOSURE STATEMENT FOR BOND GUARANTEE PROGRAM 1, 17 (June 28, 2017) [hereinafter TEXAS PERMANENT SCHOOL FUND DISCLOSURE STATEMENT], http://tea.texas.gov/WorkArea/DownloadAsset.aspx?id=51539615528 [https://perma.cc/23BR-2G52] (click “I Agree”).


34. See U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, M-186, STATE LAWS GOVERNING LOCAL GOVERNMENT STRUCTURE AND ADMINISTRATION 10 (1993) (describing the prevalence of several types of restrictions); Paul G. Farnham, Re-examining Local Debt Limits: A Disaggregated Analysis, 51 S. ECON. J. 1186, 1187 (1985) (noting all but five states have restrictions on the use of debt by local governments); Clayton P. Gillette, Fiscal Home Rule, 86 DENV. U. L. REV. 1241, 1255–56 (2009) (“Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects . . . .”); James E. Spiotto, The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress, MUN. FIN. J., Spring 2013, at 1, 6–8 (discussing the limits states have placed on the debt municipalities may issue).

35. See U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, STATE CONSTITUTIONAL AND STATUTORY RESTRICTIONS ON LOCAL DEBT 37–39 (1961) (identifying reasons for restrictions, including potential negative impacts of excessive debt on the borrowing government, other local governments and the state); Gillette, supra note 34, at 255–56 (discussing the reasons debt limitations were created, including protecting taxpayers and promoting interperiod equity).}
Debt limits take different forms, such as requirements for voter approval—often supermajority approval—limits on the amount of total debt, and limits on the tax rate expected to be levied to service debt. In addition, states typically impose constraints on the structure and terms of debt and on the purposes for which bond proceeds—the amount received by the issuer, consisting of the principal amount of the bonds plus original issue premium or minus original issue discount—can be used. The restrictions that apply to California and Texas school district general obligation bonds are described below.

Voter Approval Requirements. Both California and Texas require voter approval of school district general obligation new money bonds. School districts in California may obtain voter approval under either of two authorization regimes. The California Constitution generally requires that general obligation bonds, issued by a local government, be approved by two-thirds of the residents in the local government’s territory voting on the matter (referred to in this article as the “California Two-Thirds Regime”). A provision was added to the California Constitution in late 2000 that allows school districts to issue general obligation bonds to finance school facilities with the approval of 55% of the residents of the district voting on the matter (referred to in this article as the “California 55% Regime”). Obtaining the approval of 55% of the voters is much easier than obtaining approval of 2/3 of the voters. As a result, virtually

36. See U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, supra note 35, at 27 (noting there are numerous types of restrictions on borrowing; and highlighting limits on the amount of debt, tax rates, and voter approval requirements); Farnham, supra note 34, at 1187 (identifying limits on the amount of debt and referendum requirements as the two major types of restrictions on debt).

37. See infra section II.D. (discussing original issue premium and original issue discount).

38. CAL. CONST. art. XVI, § 18; TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).

39. CAL. CONST. art. XVI, § 18.

40. Id. art. XVI, § 18(a).

41. Id. art. XVI, § 18(b). Community college districts and county offices of education can also obtain approval under the California 55% Regime, but other local governments cannot. Id.

42. While 79.4% of local educational bond measures presented to voters from 2001 through 2014 (including both California 55% Regime and California Two-Thirds Regime measures) passed; the success rate would have been only 36.9% if the California 55% Regime had not been available. KEVIN DAYTON, CAL. POLICY CTR., FOR THE KIDS: CALIFORNIA VOTERS MUST BECOME WARY OF BORROWING BILLIONS MORE FROM WEALTHY INVESTORS FOR EDUCATIONAL CONSTRUCTION 16 (2015).
all voter authorizations for school district bonds since 2001 have been obtained under the California 55% Regime. Distinctly, districts occasionally still use the California Two-Thirds Regime, however, because of the additional requirements imposed under the California 55% Regime.

To issue general obligation new money bonds, Texas school districts must obtain the approval of a majority of the residents of the district voting at an election held for that purpose. Once voter approval is obtained, bonds are often issued in multiple issuances over a period of several years.

Expected Tax Rate Limits. In addition to voter authorization requirements, both California and Texas restrict the issuance of school district bonds by imposing limits on the tax rates for debt service that are expected to result (referred to herein as “expected rate limits”); though the California limits do not apply as broadly as the ones in Texas, as discussed below.

California school districts may issue new money bonds approved under the California 55% Regime, only if the tax rate expected to be needed—to pay debt service on bonds approved at a single election—does not exceed $30 per $100,000 of assessed valuation for elementary school districts and high school districts, or $60 per $100,000 for unified school districts (which include both elementary and high schools) in any year through the maturity of the bonds. This restriction does not apply to bonds approved under the California Two-Thirds Regime. Further, since the expected rate limit applies to bonds approved at a single election only, school districts can go back to voters at a subsequent election and ask

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43. Only 110 of the 1,147 local educational bond measures presented to voters from 2001 through 2014 were under the California Two-Thirds Regime. Id.
44. These requirements include the expected rate limit described infra at notes 47–50 and accompanying text, and the formation of a citizens’ oversight committee, among others. CAL. EDUC. CODE §§ 15264–15288 (Deering 2013).
45. TEX. CONST. art. VII, § 3(c); TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).
47. CAL. EDUC. §§ 15268, 15270(a).
48. Id.
them to reauthorize the bonds, effectively doubling the limit. In fact, at least eleven school districts obtained reauthorization from voters in 2012, and at least another three did so in 2014.49 However, district officials may be reluctant to seek additional voter approval for a variety of reasons, including: because they do not believe they will obtain it; because they see a significant political cost to requesting the approval; or because they need to issue bonds quickly.50

The Texas limit, in contrast, applies to all general obligation bonds issued by a school district and cannot be modified by the voters in the district.51 Texas law requires that, before a school district issues general obligation new money bonds, it must demonstrate that it has “a projected ability to pay the principal of and interest on the proposed bonds and all previously issued bonds . . . from a tax at a rate not to exceed $0.50 per $100 of valuation” (adjusted to $0.45 per $100 for subsequent bond issuances in some circumstances as described in the following paragraph).52

Both California and Texas school districts must comply with expected rate limits at the time bonds are issued.53 Should a higher tax rate ultimately be necessary to pay debt service, the higher tax must be levied.54 Texas law allows expected rate limits to be calculated based on either historic assessed valuations or projections within specified


50. The election process takes time, and bonds may be approved under the California 55% Regime only at statewide election or at a regularly scheduled local election (typically in June and November). CAL. EDUC. § 15266(a) (Deering 2013).

51. TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).

52. Id. § 45.003. Districts may include state assistance that can legally be used for debt service.

Id.

53. CAL. EDUC. §§ 15268, 15270(a); TEX. EDUC. § 45.0031(a).

parameters.\textsuperscript{55} If a district uses projections and the tax rate necessary to pay debt service ultimately exceeds the expected rate limit, the limit is adjusted to $0.45 for subsequent issuances.\textsuperscript{56} California law provides no specific guidance on how to determine compliance and no penalty if actual rates are higher than the limit.\textsuperscript{57}

**California Limit on Debt as a Percentage of Assessed Valuation.** California school districts may not issue general obligation new money bonds if the total principal amount of general obligation bonds outstanding after the issuance would exceed 1.25% of the assessed value of taxable property of the district (2.50% for unified school districts).\textsuperscript{58} These caps can be—and in fact are—sometimes waived by the California State Board of Education.\textsuperscript{59} While requests for waivers of this limit are relatively infrequent, they are typically granted.\textsuperscript{60}

**Other Restrictions on Structure and Terms of Debt.** California and Texas also impose statutory restrictions on the structure and terms of school district general obligation new money bonds. For example, these bonds may be outstanding for no more than 40 years in either state, with shorter maximum terms for CABs as a result of the passage of AB 182 and HB 114.\textsuperscript{61} The maximum interest rate and maximum yield (taking into account original issue discount) for general obligation bonds issued by California school districts is 12% (8% for CABs as a result of AB 182).\textsuperscript{62} While in Texas, the maximum net effective interest rate (taking into account original issue premium, discount and compounding of interest) is 15%.\textsuperscript{63} Different restrictions apply to refunding bonds.\textsuperscript{64}

\textsuperscript{55} TEX. EDUC. §§ 45.0031(b)–(c) (West 2012). Most districts use historic assessed valuations. See infra note 201.

\textsuperscript{56} TEX. EDUC. § 45.0031(e) (West 2012).

\textsuperscript{57} CAL. EDUC. §§ 15268, 15270(a).

\textsuperscript{58} Id. §§ 15102, 15106, 15268, 15270(a).

\textsuperscript{59} DAYTON, infra note 42, at 44.

\textsuperscript{60} Of fifty-one requests made between 2000 and 2014, forty-eight were approved and three were withdrawn. Id. at 45. In contrast, the Board of Education has never granted a waiver of the expected rate limit. July 2016 Agenda Item #W-10 3, CAL. STATE BD. OF EDUC. (2015), http://www.cde.ca.gov/be/ag/ag/yr16/agenda201607.asp [https://perma.cc/78UT-SW35].

\textsuperscript{61} CAL. EDUC. § 15144 (Deering 2013); CAL. GOV’T §§ 53508(f), 53508.5 (Deering 2011 & Supp. 2017); TEX. EDUC. § 45.001(b) (West 2012); TEX. GOV’T CODE ANN. § 1201.0245(b)(1) (West Supp. 2017). See infra Section V for discussion of AB 182 and HB 114.

\textsuperscript{62} CAL. EDUC. § 15143 (Deering 2013); CAL. GOV’T §§ 53508(d), 53508.5, 53531, 53532 (Deering 2011 & Supp. 2017).

\textsuperscript{63} TEX. GOV’T § 1204.006 (West 2013); see also id. §§ 1204.003, 1204.004, 1204.005 (setting forth computations).
Bonds that are issued on a tax-exempt basis (that is, bonds the interest on which is excluded from income for federal income tax purposes) are also subject to extensive requirements under the Internal Revenue Code of 1986 and related regulations.65 These requirements are intended to ensure that proceeds of tax-exempt bonds are used for purposes and activities deemed appropriate by the U.S. Congress and to prevent local governments from issuing more tax-exempt bonds than they need, issuing the bonds too far in advance of the time proceeds are used, or allowing the bonds to remain unpaid for longer than is necessary.66

**Permitted Uses of Proceeds.** California and Texas school districts may use general obligation bond proceeds only for certain purposes.

School districts generally may use proceeds of bonds approved under the California Two-Thirds Regime to acquire, construct and improve school lots and facilities.67 Bonds issued under the California 55% Regime also may be used to finance furniture and equipment.68 California districts are further limited to financing projects that are described in the bond measure approved by the voters.69 In addition to paying direct project costs, districts may use bond proceeds to pay the costs of the bond issuance (including fees paid to financial advisors, underwriters, and lawyers) and capitalized interest (interest on the bonds prior to expected completion of the project or soon thereafter).70 California school districts may not use general obligation bond proceeds for operating expenses.71

Texas school districts generally may use proceeds of general obligation bonds to construct, acquire, improve and equip school sites and facilities, and to acquire school buses.72 Districts may also use proceeds to pay

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64. The most relevant of these restrictions in California and Texas are described in Sections V.A., V.B., and V.C., infra.

65. 26 U.S.C. §§ 103, 141–150 (2012); see also INTERNAL REVENUE SERV., OFFICE OF TAX EXEMPT BONDS, PUBLICATION 4079 TAX-EXEMPT GOVERNMENTAL BONDS (2016) (providing a summary of some of the United States Treasury regulations that apply to tax-exempt bonds).


67. CAL. CONST. art. XIII A, § 1(b)(2); CAL. EDUC. § 15100 (Deering 2013).

68. CAL. CONST. art. XIII A, § 1(b)(3); id. art. XVI, § 18(b); CAL. EDUC. §§ 15100, 15266(b) (Deering 2013).

69. CAL. CONST. art. XIII A, § 1(b)(3); id. art. XVI, § 18(b); CAL. EDUC. § 15122 (Deering 2013); CAL. GOV’T CODE § 53410 (Deering 2011).

70. CAL. EDUC. §§ 15146(b), (j) (Deering 2016).

71. CAL. CONST. art. XIII A, §§ 1(b)(2), 1(b)(3)(A); CAL. EDUC. §§ 15100, 15266(b).

72. TEX. EDUC. CODE ANN. § 45.001(a) (West 2012).
costs of issuance and capitalized interest.73 Proceeds may not be used to pay operating expenses.74 Texas districts, like those in California, are limited to financing projects that are within the scope approved by the voters.75

C. Repayment of Principal

Typically, principal of each bond is paid at maturity or over a period of years leading up to maturity.76 However, because bonds are usually issued in a series with multiple maturities, principal payments are typically made over the life of a series of bonds, though the amount of such payments may vary from year to year.77

D. Return on Investment

Municipal bonds provide return to investors in the form of interest, original issue discount, or both.78 The interest rate on the bonds may be

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73. TEX. GOV’T CODE ANN. §§ 1201.042(a), (d) (West Supp. 2017).
74. This prohibition has one limited exception that allows for the operation of the facility itself during construction and for one year after. Id. § 1201.042(a).
75. CAL. CONST. art. XIX A, § 1(b)(3); id. art. XVI, § 18(b); CAL. EDUC. § 15122 (Deering 2013); CAL. GOV’T CODE § 53410 (Deering 2011); TEX. EDUC. CODE ANN. § 52.072(e)(1)(B) (West Supp. 2016); TEX. GOV’T § 1201.042(e) (West Supp. 2017).
76. When principal is required to be paid over a period of years leading up to maturity, the principal payments are referred to as “mandatory sinking fund payments” and the bonds are referred to as being subject to “mandatory sinking fund redemption” in the amount of the payments. See TBRB, 2016 REPORT, supra note 28, at 126 (defining a term bond and how payments are made). Payments are allocated to investors by lot, meaning the bondholders do not know in advance which holders will be repaid early. See, e.g., MOJAVE UNIFIED SCH. DIST. $8,040,000 GENERAL OBLIGATION BONDS OF SCHOOL FACILITIES IMPROVEMENT DISTRICT NO. 1 OF THE MOJAVE UNIFIED SCHOOL DISTRICT (KERN COUNTY, CALIFORNIA) ELECTION OF 2014, SERIES 2015, at F-2 (2015) [hereinafter MOJAVE ISD 2015 OFFICIAL STATEMENT], http://emma.msrb.org/ER913004-ER713242-ER1114694.pdf [https://perma.cc/W6PY-TR86] (describing selection of bonds for redemption as “randomly” and “by lot”); SCHERTZ-CIBOLO-UNIVERSAL CITY INDEP. SCH. DIST., OFFICIAL STATEMENT DATED SEPTEMBER 18, 2014, at 4, 8 (2014), https://emma.msrb.org/EP831962-EP644201-EP1045821.pdf [https://perma.cc/AE26-L62A] (describing the selection of bonds for redemption “by lot”).
77. See Andrew Ang & Richard C. Green, Discussion Paper, Lowering Borrowing Costs for States and Municipalities Through CommonMuni, HAMILTON PROJECT, Feb. 2011, at 10 (“Since 1995, the average municipal bond series has contained thirteen separate bonds . . . .”).
78. Investors may also earn capital gains if they trade municipal bonds in the secondary market, but this does not directly affect local government issuers, and, therefore, is not a focus of this article. See What to Expect When Selling Municipal Bonds Before Maturity, MSRB, https://www.msrb.org/msrb1/EMMA/pdfs/Selling-Before-Maturity.pdf [https://perma.cc/WRG8-N312] (describing factors that can affect the price of bonds in the secondary market).
set at a fixed rate at the time they are issued: a rate that changes periodically based on market conditions or a predetermined index.\textsuperscript{79} Virtually all California school district general obligation bonds bear interest at a fixed rate, and only a very small percentage of Texas school district general obligation bonds do not. Some local government bonds are sold at a discount from their stated principal amount, meaning the investor pays less than the face amount of the bond.\textsuperscript{80} This discount is referred to as “original issue discount.”\textsuperscript{81} Original issue discount has the effect of increasing the yield on the bond (the return to the investor) above the nominal interest rate.\textsuperscript{82}

Most of the time, local governments issue bonds on which they pay interest periodically (usually semiannually) throughout the term of each bond.\textsuperscript{83} Bonds on which interest is required to be paid in this manner are referred to as “current interest bonds” or “CIBs.”\textsuperscript{84} Sometimes, local governments, instead, issue bonds of the type that are the focus of this paper—CABs—on which interest is added to principal (“compounded” or “accreted”) periodically rather than being paid.\textsuperscript{85} The compounded


\textsuperscript{80} CDIAC PRIMER, supra note 30, at C-18.


\textsuperscript{84} See ORANGE CTY. GRAND JURY, SCHOOL BONDS, supra note 83, at 7 (describing the CIB).

\textsuperscript{85} Local governments also issue “convertible capital appreciation bonds,” which are a hybrid of current interest bonds and capital appreciation bonds. Bond sales: Questions and Considerations for Districts, CAL. SCH. BD. ASS'N, https://www.csba.org/GovernanceAndPolicyResources/~/media/CSBA/Files/GovernanceResources/GovernanceBriefs/201212GBBondSales.pdf [https://perma.cc/KE6P-8GEJ]. Interest on these bonds compounds until a specified conversion date, then is paid periodically on the sum of the original principal amount plus the
interest itself then bears interest until it is paid, together with principal, at maturity. The sum of the principal plus the compounded interest to be paid at maturity is referred to as the “maturity amount” or “maturity value” of the CAB.

It is common for local governments to issue bonds with a small amount of original issue discount (typically—though not always—less than 3%). Local governments today rarely issue deeply discounted bonds, including “zero coupon bonds,” on which no interest is paid and all return on investment is in the form of original issue discount, though they did so more frequently in the early 1980s. Zero coupon bonds are the economic equivalent of CABs and have largely been replaced by CABs, primarily because of differences in their treatment in calculating compliance with debt limits.

California and Texas school districts often issue general obligation bonds at a premium, meaning the investor pays more than the face amount of the bond and the yield on the bond is lower than the nominal interest compounded through the conversion date. These raise the same concerns as CABs, though to a lesser degree, and are not addressed separately in this article. See Scott, supra note 49, at 22 (describing convertible CABs, and indicating they are a variation of CABs).


88. See CDIAC Primer, supra note 30, at C-18 (noting bonds with discounts in excess of two or three percent are “deep discount bonds”).

89. See Alan Walter Steiss, New Financing Instruments for State and Local Capital Facilities, PUB. BUDGETING & FIN., Fall 1988, at 24, 28 (indicating zero coupon municipal bonds were introduced in the late 1970s and became popular soon thereafter); Robert Metz, Market Place: Zero-Coupon Municipals, N.Y. TIMES (Mar. 31, 1982), http://www.nytimes.com/1982/03/31/business/market-place-zero-coupon-municipals.html [https://perma.cc/58NA-VPNK] (asserting the first major issue of zero coupon municipal bonds was in 1982).

90. See infra Section III.C.
interest rate. This results in additional proceeds—sometimes substantial additional proceeds (particularly in Texas)—from the financing.

A single issuance of bonds may include both current interest bonds and capital appreciation bonds, and also a combination of bonds issued at a discount, at face value, and at a premium.

III. THE TROUBLE WITH CABs

The use of CABs causes three significant problems. First, CABs allow local governments to benefit today’s taxpayers at the expense of tomorrow’s. This is inconsistent with the concept of interperiod equity. Second, CABs generally have higher yields than current interest bonds. Lastly, because compounded interest on CABs is not counted against state constitutional and statutory debt limits—that are based on the total amount of debt that can be issued or outstanding—the use of CABs encourages the perception that less debt is being incurred than is, in fact, the case.

A. CABs Are Incompatible with Interperiod Equity

In the context of local government debt issued to finance capital projects, “interperiod equity” or “intergenerational equity” is the concept that the burden of paying taxes to finance a facility should be spread fairly over the period during which taxpayers benefit from the facility.
Achieving interperiod equity is one of the justifications for financing capital projects by borrowing, rather than by requiring, current taxpayers to pay the full cost of a facility that will be used for many years. But interperiod equity also is violated if future taxpayers are required to pay a disproportionate share of the cost of a project.

Spreading the costs of facilities fairly over their lives encourages an optimal, or closer to optimal, level of investment in capital improvements. Requiring facilities to be paid for with current revenues is likely to result in too few capital improvements. Conversely, “the ability to shift the costs forward may . . . induce elected officials to incur too much debt,” because “they can get the credit for the new project immediately, while the blame for the additional taxes needed to pay off the debt will be borne by their successors.”

Because property taxes to pay debt service on general obligation bonds generally are not levied until near the time these amounts must be paid, any structure—under which the bulk of the debt service is not due until at or near maturity (a “back-loaded” structure)—disproportionately burdens

Debt Ceilings, Tax Limitations, and Expenditure Limits: The New York City Fiscal Crisis, the Taxpayers’ Revolt, and Beyond, 63 MINN. L. REV. 545, 550-51 (1979).

95. MUSGRAVE & MUSGRAVE, supra note 94, at 693–94; Maria Emilia Freire, Managing External Resources, in MUNICIPAL FINANCES: A HANDBOOK FOR LOCAL GOVERNMENTS 325, 327 (Catherine Farvacque-Virkovic & Mihaly Kopanyi, eds. 2014); Richard Briffault, Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law, 34 RUTGERS L.J. 907, 917 (2003); Gelfand, supra note 94, at 550–51; Lori Raineri & Darien Shanske, Municipal Finance and Asymmetric Risk, 4 BELMONT L. REV. 65, 69 (2017). Using debt to spread the cost of a project over its life is not a new idea. See JOHN A. FAIBIEL, MUNICIPAL ADMINISTRATION 330 (1910) (“At the present time the municipal debts are incurred for the erection of permanent works, so as to distribute the cost of construction over the period for which the works will be in existence.”).


97. See GRANT A. DRIESEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT 1 (2016) (noting paying for facilities when they are built “is likely to result in a less than optimal rate of public capital formation”); Raineri & Shanske, supra note 95, at 69 (arguing if capital projects are funded only with current revenue, large capital projects “could hardly ever be built”).

98. Briffault, supra note 95, at 917–18; see also ROBERT S. AMDURSKY ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE 207–08 (2nd ed. 2013) (observing local officials have incentives to over utilize debt); Gelfand, supra note 94, at 549–51 (providing historical context around the need for debt limitations and indicating that future taxpayers are the primary beneficiaries of debt ceilings); Stewart E. Sterk & Elizabeth S. Goldman, Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations, 1991 WIS. L. REV. 1301, 1322–24 (1991) (“As courts dealt with legislative attempts to evade constitutional restrictions, judicial opinions, too, reflected the view that constitutional limitations were necessary to retrain legislative tendencies to incur too much debt.”).
future taxpayers. Long-term capital appreciation bonds—on which no debt service (including interest on compounded interest) is paid until at or near maturity—take this to an extreme. In the case of the 2011 Poway Transaction, for example, taxpayers will pay nearly $1 billion between 2033 and 2051 on $105 million of debt ($126 million of proceeds including principal and original issue premium) for upgrades and modernization of schools; it is not hard to imagine that the facilities will again need to be modernized even before the first debt service payment is made.

Even if, as appears to be the case in some instances, school districts use CABs to try to maintain substantially level tax rates throughout the life of the debt, interperiod equity may be compromised. First, even if their tax rates are not higher because assessed valuations rise over time as projected, future taxpayers may pay a disproportionate share of the facilities financed with the CABs, particularly if assessed valuations were projected to rise more rapidly than inflation or if already outstanding debt that matures in the near-to-medium-term is also factored into the calculation. Second, future taxpayers bear the risk that property values will not increase as expected or (less likely) will decline. Should this occur, they will have to pay higher tax rates for debt service, and the district’s ability to issue additional debt may be constrained as long as the CABs remain outstanding.

If total debt service on school district general obligation bonds were fully capitalized into real estate values—that is, if property values accurately reflected the cost of future debt service—CABs would not disproportionately burden future property owners. Scholars have reached varying conclusions about the extent to which taxes are capitalized

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99. An increase in debt service over time that reflects expected inflation would be appropriate; otherwise future taxpayers would be paying less in real dollars than current taxpayers are. The concern is with structures in which a substantial portion of debt service is delayed.

100. POWAY UNIFIED SCH. DIST., 2011 OFFICIAL STATEMENT, supra note 14, at 1–2, 5, 13–14.

101. This is more likely to occur in states that do not impose strict limits on assessed valuation increases.

102. Requiring future taxpayers to bear the risk of assessed valuations growing more slowly than projected is particularly troubling because school district officials have incentives to make optimistic assumptions about future property value growth. See infra Section IV.E.

into home values, though it appears that some capitalization occurs.\textsuperscript{104} However, even if property taxes are fully capitalized in some circumstances, it is unlikely that the possibility of higher future taxes—because of a school district’s debt structure—would be. Information about a school district’s general obligation debt level and debt service structure is not typically provided to prospective purchasers by realtors or title companies, making it unlikely that this information would be known to a buyer.\textsuperscript{105}

Furthermore, even if a buyer had this information, he or she would also need information about current assessed valuations in the school district and would need to either obtain and evaluate existing projections of assessed valuation growth and the assumptions on which they were based,\textsuperscript{106} or develop his or her own projections in order to predict the impact of debt service on future tax rates. To obtain a complete picture, a prospective purchaser would have to gather and analyze information for every local government within the territory of which the property was located.\textsuperscript{107} The difficulties and uncertainties of determining the impact of CABs on future tax rates make it unlikely that they are fully capitalized.\textsuperscript{108}

\textsuperscript{104} See id. (noting some capitalization results in a limited ability to pass on tax increases to new buyers); see also WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOMES VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE AND LAND USE POLICIES 47–51 (2005) (discussing various capitalization studies and concluding that anticipated taxes are fully capitalized).

\textsuperscript{105} While information about a school district’s debt service structure is available from documents posted on the Municipal Securities Rulemaking Board’s (MSRB’s) Electronic Municipal Market Access website (emma.msrb.org), or by making a public records request to the district, it is not likely that many prospective purchasers do this.

\textsuperscript{106} See DAYTON, supra note 42, at 75 (noting assessed valuation projections may not be available at all). A new California law that requires school boards to obtain assessed valuation projections that take into consideration those of the county assessor, in advance of calling a bond election, (see infra note 308 and accompanying text) and the new requirements imposed by AB 182 and HB 114, with respect to CABs, may help to some extent (particularly the provisions of HB 114).

\textsuperscript{107} There could be several of these, including a county, a city, a community college district, and other special districts in addition to the school district.

\textsuperscript{108} Even William Fischel, who argues in favor of capitalization, notes that capitalization is 100% only for anticipated taxes. FISCHEL, supra 104, at 49–51. While Fischel was discussing anticipated changes in the law, the same concept would apply if potential purchasers could not determine the amount of the future taxes. See also DARIEN SHANSKE, PUBLIC TAX DOLLARS FOR PRIVATE SUBURBAN DEVELOPMENT: A FIRST REPORT ON A NATIONAL PHENOMENON, 26 VA. TAX REV. 709, 751–58 (2007) (arguing Mello-Roos assessments are not fully capitalized). Mello-Roos taxes, which are authorized under the Mello-Roos Community Facilities Act of 1982 (codified at California Government Code Sections 53311–53368.3), are more likely than a school district’s general obligation debt structure to be fully capitalized. Notices of Mello-Roos assessments that include information about the rate and
B. **CABs Cost More**

Yields often are higher on CABs—and zero-coupon bonds—than on current interest bonds, particularly in a low interest rate environment like that of recent years. There are three reasons for this. First, because CABs do not receive any payment on the bonds until at or near maturity, investors are more concerned about adverse changes in the condition of the issuer or changes in market conditions that would negatively affect the price at which the investor would be able to sell the CABs in the secondary market, and about the risk of default (though defaults of local government bonds, and particularly of general obligation bonds, are extremely rare). 109 Second, when interest rates are low, investors demand a higher rate because, in effect, the interest earned on CABs is automatically reinvested in the same bond (and cannot be invested in anything else). 110 Since investors expect interest rates to go up in the period during which the bonds are outstanding, they charge a premium for the foregone investment opportunities. Third, there generally are fewer buyers for CABs in the secondary market than there are for CIBs, which means that it may be harder to sell them. 111 Based on a review of data for the last business day

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109. Only ninety-five issuers defaulted on bonds rated by Moody's Investors Service (one of the three entities rating municipal bonds) between 1970 and 2014, and of these, only eight involved general obligation bonds (though four of these occurred in 2012 and 2013). *US Municipal Bond Defaults and Recoveries, 1970–2014, Moody's Investors Serv.,* 10 (July 24, 2015), https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_1006917 [https://perma.cc/7CAJ-SRCH]. This compares to a total of 15,400 ratings at the end of 2014, 8,600 of which were ratings on general obligation bonds. Id at 6.


of March and September from 1996 to 2015, in the vast majority of cases, AAA-rated CABs had higher yields than comparable CIBs, and in the most extreme case, 1.18% higher yields.112

In addition, the interest on CABs compounds over many years, which increases the overall cost, though not—absent the higher yields described in the preceding paragraph—the present value of the stream of debt service payments. Issuers generally pay approximately $2 to $3 of debt service for every $1 of principal on CIBs.113 In contrast, issuers reportedly pay between $3.50 and $23 for every $1 of principal on CABs.114 The ratio of proceeds to debt service would be lower for bonds issued at a premium. For the top one-hundred most expensive CABs outstanding in Texas as of August 31, 2016, districts paid between $2.85 to $10.87 of debt service for every $1 of proceeds, as compared to less than $2 for the typical CIB.115

C. CABs Conceal the Full Amount of Debt

As discussed in this section, interest that compounds on CABs is not counted against state constitutional and statutory debt limits even though, once it compounds, there is no substantive reason to distinguish the interest from the original principal. Failing to count compounding interest for debt limit purposes is likely to be contrary to the expectations of voters, gives the impression to the public (and to school board members

Matt Fabian of Municipal Market Advisors) (stating CABs (referred to as “zeros” in the article) lack broad investor demand).

112. The Municipal Market Monitor (TM 3), NonCall and Zero Yield Curves as of 09/30/2015 (2016) (on file with author). There were some instances in which yields on AAA-rated CABs were the same or slightly lower than the rate on AAA-rated CIBs with the same term (up to 0.06% and primarily for one, two, and three-year bonds). Id. The difference in interest rates for CABs and CIBs varies depending on the term of the bond and changes from day to day. In the very high interest rate environment of the early 1980s, interest rates on CABs and zero-coupon bonds were lower than those on comparable CIBs. See infra note 138 and accompanying text.


115. TBRB, 2016 REPORT, supra note 28, at 106–08.
and officials) that less debt is being incurred than actually is, and, in effect, allows issuers to circumvent these limits. This is particularly concerning in situations—such as that of California and Texas school district general obligation bonds—where voter approval of debt is required.\footnote{116}

Compounding interest on CABs is not counted against limits on the amount of debt that can be issued or outstanding, such as the amounts authorized by voters in Texas and California and the limit on debt as a percentage of assessed valuation in California.\footnote{117} This exclusion is such a fundamental component of the CAB that it is included in the definition of “Capital Appreciation Bonds” published by the MSRB—a self-regulatory organization created under federal securities laws to regulate the municipal bond market—which states that:

[B]ecause the investment return is considered to be in the form of compounded interest rather than accreted original issue discount [as it would be for a zero-coupon bond] . . . only the initial principal amount of a CAB would be counted against a municipal issuer's statutory debt limit.\footnote{118}

In Texas, ballot propositions and election orders are required to include the “principal amount” of the bonds,\footnote{119} and premium—used to pay costs of the project for which the bonds were issued—is also counted against the voter-authorized amount.\footnote{120} In California the “amount” of the bonds that must be included on the ballot is interpreted to mean the principal amount.\footnote{121}

However, there is a strong argument that once interest has been added to the original principal amount of the CABs, it should be treated as debt and counted against debt limits.\footnote{122} Clearly, from a commercial

\footnote{116. CAL. CONST. art. XVI, § 18; TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN. § 45.003(a) (West 2012).}

\footnote{117. See supra Section II.B. for discussion of these limits.}

\footnote{118. Glossary of Municipal Securities Terms: Capital Appreciation Bond, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Glossary/Definition/CAPITAL-APPRECIATION-BOND:_CAB_.aspx [https://perma.cc/KL84-R3F6]. In contrast, the full amount payable at maturity is counted for zero coupon bonds. Id.}

\footnote{119. TEX. ELEC. CODE ANN. §§ 3.009(b)(3), 52.072(c)(1)(A) (West Supp. 2016).}

\footnote{120. TEX. GOV'T CODE ANN. § 1201.042(c) (West Supp. 2016).}

\footnote{121. CAL. EDUC. CODE § 15122 (Deering 2013). In California, original issue premium cannot be used to pay project costs. CAL. EDUC. CODE § 15146 (Deering 2016).}

\footnote{122. In Texas, where premium—used to pay costs of the project for which the bonds were issued—is already counted against the debt limit (as described in Texas Government Code Section 45.003(a)).}
perspective, compound interest is treated as new debt as it accrues, in turn attracting its own interest;\textsuperscript{123} and, not surprisingly, under accrual basis accounting—which recognizes receipts and obligations when they are incurred—the interest on CABs is treated as a liability as it compounds.\textsuperscript{124} Most companies and government utilities in the U.S. use accrual accounting.\textsuperscript{125} Financial statements filed with the Securities and Exchange Commission (SEC) are presumed to be misleading or inaccurate if they are not prepared in accordance with generally accepted accounting principles,\textsuperscript{126} which require accrual accounting because it provides “a better basis for assessing the entity’s past and future performance than information solely about cash receipts and payments . . . .”\textsuperscript{127} Under the Internal Revenue Code, taxable income of large corporations is generally required to be determined on an accrual basis.\textsuperscript{128} Under standards promulgated by the Governmental Accounting Standards Board (GASB), government-wide financial statements—which show information about

\textsuperscript{123} See DAVID C. GARLOCK, ET AL., FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS 20 (6th ed. 2014) (“In effect, the lender is making one or more additional loans to the borrower by letting the accrued interest remain unpaid, and so charges interest on these additional loans.”).

\textsuperscript{124} See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 8, CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING ¶ OB17 (2010) [hereinafter FASB STATEMENT NO. 8] (describing accrual accounting as showing the effects of transactions on the economic condition of the entity at the time the effects occur, notwithstanding the timing of cash payments).

\textsuperscript{125} See GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 34, BASIC FINANCIAL STATEMENTS—AND MANAGEMENT’S DISCUSSION AND ANALYSIS—FOR STATE AND LOCAL GOVERNMENTS, at Preface (1999) [hereinafter GASB STATEMENT NO. 34] (explaining “most governmental utilities and private-sector companies” utilize accrual accounting, which reports all revenues and costs for current and long-term assets).

\textsuperscript{126} SEC, 17 C.F.R. § 210.4-01(a)(1) (2016).

\textsuperscript{127} FASB STATEMENT NO. 8, supra note 124, ¶ OB17; see also FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6, ELEMENTS OF FINANCIAL STATEMENTS ¶ 134 (1985) (describing accrual accounting and related concepts, and explaining that accrual accounting provides information that cannot be obtained by cash basis accounting); D. EDWARD MARTIN, ATTORNEY’S HANDBOOK OF ACCOUNTING, AUDITING AND FINANCIAL REPORTING §§ 2.04(3), 3.02(5) (4th ed. 2015) (stating the accrual basis of accounting “has been developed to provide the most accurate picture of an entity’s operations”).

the governmental entity as a whole—are prepared on an accrual basis.\(^\text{129}\) Further, treating the interest on capital appreciation bonds differently from the original issue discount on zero coupon bonds—even though they are functionally the same—values form over substance.

The California Debt and Investment Advisory Board (CDIAC) has indicated that California local governments should include the full accreted value of CABs as “debt outstanding” in annual debt transparency reports,\(^\text{130}\) suggesting they view compounded interest as debt.

The Texas Bond Review Board (TBRB) noted, in its local government annual reports for 2011, 2012, and 2013, that debt was understated because CABs were reported at their initial principal amount rather than their maturity value.\(^\text{131}\) This statement was dropped from the reports beginning in 2014, presumably because data on maturity values of CABs also were included in those reports.\(^\text{132}\) The disclaimer for the Texas Bond Review Board’s annual reports for 2013 read: “The California Debt and Investment Advisory Board (CDIAC) has stated that California local governments should include the full accreted value of capital appreciation bonds as “debt outstanding” in annual debt transparency reports, suggesting they view compounded interest as debt. The Texas Bond Review Board (TBRB) noted, in its local government annual reports for 2011, 2012, and 2013, that debt was understated because CABs were reported at their initial principal amount rather than their maturity value. This statement was dropped from the reports beginning in 2014, presumably because data on maturity values of CABs also were included in those reports.”

\(^{129}\) GASB STATEMENT NO. 34, supra note 125, ¶¶ 6(b)(1), 12(c), 16. Under GASB standards, local governments also prepare fund financial statements, which have a shorter-term focus and are intended to demonstrate compliance with budgets and legal and contractual requirements. Id. ¶ 6(b); see also GOVERNMENTAL ACCOUNTING STANDARDS BD., WHITE PAPER: WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS – AND SHOULD BE – DIFFERENT 7 (2013) (noting fund accounting focuses on control and accountability over public money and on whether there are sufficient resources in the short-term). GASB requires the use of a “modified accruals basis” in the fund financial statements for funds used to account for activities that are governmental in nature (like those related to general obligation bonds). Id. ¶ 79. Thus, interest on CABs is not reflected until it is due in this portion of the financial statements. See id. at Preface (using the example of taxes collected at the time they are needed to pay debt service as an example of the short-term focus of fund financial statements); see also CAL. DEPT. OF EDUC., SCH. FISCAL SERVS. DIV., CALIFORNIA SCHOOL ACCOUNTING MANUAL 101-3 (2016), http://www.cde.ca.gov/fg/ac/sa/documents/csem2016complete.pdf [https://perma.cc/F387-YNLY] (indicating un-matured interest on long-term debt is recorded when it is due under the modified accrual basis).


Comptroller’s “Texas Transparency” website—which provides information about state and local government finances—indicates that compounded interest on CABs is not included in the debt figures provided on the site, which suggests that readers, absent the disclaimer, might otherwise assume they were.

IV. REASONS LOCAL GOVERNMENTS ISSUE CABs

General obligation bonds are especially likely to be issued as CABs. Virtually all CABs issuances in California and Texas in 2015 were general obligation bonds. There are several possible reasons for this. In many cases, fees and charges can be raised without voter approval or with the approval of a lower percentage of voters than would be required to issue general obligation bonds. Perhaps the political cost of raising property taxes is higher than those of raising fees or charges, or possibly even other types of taxes (such as sales taxes) that support revenue bonds. Fees, charges, and other types of taxes generally are not subject to restrictions comparable to the expected rate limits; this may be another factor making it less likely that revenue bonds will be issued as CABs. Further, because general obligation bonds are payable from property taxes assessed specifically for that purpose, and not from other funds of the issuer, there is a disconnect between the funding of the issuer’s mission and the payment source for the bonds. That is, because payment of debt service does not directly affect a school district’s ability to educate students, officials may be less focused than they otherwise would be on the structure
and impact of those payments. In contrast, fees, charges, and other taxes often can be used to pay both operating and capital costs. In Texas, the requirement that the principal amount of general obligation refunding bonds must not exceed the principal amount of the refinanced bonds also encourages the issuance of general obligation bonds in the form of premium CABs.137

The following sections discuss several reasons why California and Texas school districts issue general obligation bonds in the form of CABs. More than one reason may contribute to an issuance.

A. In Some Instances, CABs Can Result in Lower Overall Debt Service

In some cases, school districts use capital appreciation bonds because doing so either alone or as part of a transaction that also includes current interest bonds, results in lower overall debt service.

While this generally is not the case today, in high interest rate environments—such as in the 1980s—the yield on CABs is lower than on CIBs because “[t]he investor accepts a somewhat lower rate of return to lock up a relatively high rate of interest for an extended period of years. Moreover, the investor has no worries about reinvesting coupon income, possibly at disadvantageous rates.”138

In some market conditions, using capital appreciation bonds in conjunction with current interest bonds allows issuers to achieve lower overall debt service (without violating expected rate limits, or while maintaining level tax rates or keeping tax rates below levels promised to voters).139 In circumstances where short-term interest rates are lower than long-term interest rates, issuing long-term CABs may allow the rest of

137. See infra Section IV.F. (explaining Texas’s requirements for refunding bonds).

138. See Metz, supra note 89 (demonstrating the bond maturity values for long term bonds); see also Petersen, supra note 83, at 20 (“Long-term original discount bonds attract investors whose objective is the accumulation of future wealth and who anticipate that their future reinvestment rates may be lower than present coupon rates.”); see also Scott H. Williamson, Tax-Exempt Zero Coupon Bond Pricing, 35 Nat’l Tax J. 497, 497 (1982) (“In order for rational investors to be willing to purchase ZCBs at lower yields than those on equivalent CCBs, there must be some features of ZCBs which are attractive. Often mentioned is the absence of coupon reinvestment rate risk. This usually implies the possibility that rates may fall.”); Michael Quint, Credit Markets: Rates Show Little Change, N.Y. TIMES (June 3, 1982), http://www.nytimes.com/1982/06/03/business/credit-markets-rates-show-little-change.html [https://perma.cc/N9RF-JHZ2] (noting the issuer will “automatically reinvest the interest payments at the stated rate”).

139. See infra Section IV.B. for a discussion of the use of CABs to avoid violating expected rate limits and Section 0 for discussion of the use of CABs to avoid near-term tax rate increases.
the bonds to be issued as shorter-term CIBs (rather than the alternative of issuing only longer-term CIBs) to take advantage of lower interest rates on shorter-term debt.\textsuperscript{140} More than 80\% of the issuances of general obligation CABs by California school districts in 2015 were part of a transaction that also included CIBs.\textsuperscript{141} However, absent concerns about keeping tax rates below a specified level, similar or even lower overall debt service often could be achieved by issuing only shorter-term current interest bonds—or even a combination of shorter-term and longer-term current interest bonds (but no capital appreciation bonds)—because interest would not be compounding and because, in most circumstances, rates on CABs are higher than on CIBs.\textsuperscript{142}

B. \textit{CABs Allow Districts to Provide Facilities While Avoiding Near-Term Tax Increases}

School districts and other issuers structure debt with payments concentrated at the end of the repayment schedule—long-term CABs are an extreme example—to provide facilities without increasing taxes for current property owners. Because taxes generally are not levied to pay principal and interest on general obligation bonds until near the time such debt service must be paid,\textsuperscript{143} interest that compounds over the life of a CAB is not reflected in tax rates until near maturity.

This use of CABs can be motivated by the political benefits of providing new facilities to current taxpayers without requiring them to pay the cost of the facilities, the desire to keep promises to voters about tax rates, or the inclination to maintain substantially level tax rates. Because these reasons all are ultimately efforts to avoid tax rate increases, albeit viewed from different perspectives, all three are addressed under this heading.

\textsuperscript{140}See \textit{CDIAC Webinar – Bond Math II Transcript} (Oct. 7, 2011), http://www.treasurer.ca.gov/cdiac/webinars/2011/20111007/transcript.pdf\ [https://perma.cc/5WYD-YG67] (explaining it is possible to structure the amount of bond allocated between CABs and CIBs in a way that lowers the overall cost for the entire bond issue).

\textsuperscript{141}This percentage calculation is drawn from data provided by the CDIAC. California Issuances 2015, supra note 9; see also \textit{CDIAC Webinar – Bond Math II Transcript}, supra note 140 (noting usually CABs are issued with CIBs); L.A. CIV. CIV. GRAND JURY REPORT, supra note 86, at 103, 111–12 (indicating that of the twelve CABs evaluated, only one was not issued in combination with CIBs).

\textsuperscript{142}See supra Section III.B. for discussion of interest rates on CABs.

\textsuperscript{143}\textit{CAL. EDUC. CODE} § 15250 (Deering 2013); \textit{TEX. TAX CODE ANN.} § 26.04 (West Supp. 2017).
Providing Facilities to Today’s Taxpayers at the Expense of Tomorrow’s. There is a significant incentive for locally elected officials to use debt to provide immediate benefits to constituents while ignoring potentially negative long-term issues that may eventually surface.\textsuperscript{144} Even if current constituents are concerned about the future burden, that concern will be merely one factor of many that contributes to their decision on whether to re-elect local officials.\textsuperscript{145}

Elected officials may be reluctant to propose bond measures that increase tax rates because of the political ramifications of doing so. This may be one reason that “they postpone maturity dates [on] the principal for a long period of time.”\textsuperscript{146} Issuing CABs, and, thus, postponing interest payments, simply takes this one step further. Moody’s Investors Service has indicated that one reason school districts use CABs is to respond to taxpayer requests “to build new schools and maintain low student-to-teacher ratios” without significantly increasing taxes.\textsuperscript{147}

The voters, school board members, and district officials who authorize and issue bonds today, and whose children benefit from the facilities financed with the proceeds of those bonds, likely will not pay the debt service on CABs that do not mature for many years. As stated by the then-treasurer of California, “The average tenure of a school superintendent is about three and a half years, so they aren’t going to be around in most instances to worry about paying that off. . . . Nor will the voters, probably, that enacted it in the first place.”\textsuperscript{148}

It appears that concern about keeping property tax rates low (at least in the near term) was one reason that, in 2009, the California legislature eliminated a requirement that general obligation new money bonds, issued by California local governments under the state’s Government Code, have

\begin{footnotesize}
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\item[144.] AMDURSKY, supra note 98, at 207–08 (“[L]ocal officials, who will want to demonstrate constructive activity to constituents before the next election, have incentives to overutilize debt, paying scant attention to long-term adverse effects.”).
\item[145.] Id. at 208.
\item[146.] JACKSON L. FLANIGAN ET AL., MANAGING SCHOOL INDEBTEDNESS: A COMPLETE GUIDE TO SCHOOL BONDING 83–84 (2d ed. 1995).
\end{enumerate}
\end{footnotesize}
substantially level debt service,\textsuperscript{149} which had the effect of making it easier for school districts to issue longer term CABs. The California Governor’s Office of Planning and Research indicated that the amendments would allow issuers to “use increasing property values to keep property taxes at their lowest possible rate through final maturity of the bonds.”\textsuperscript{150} Put another way, district officials would be able to defer debt service until a time further in the future when they projected that assessed valuations would be higher and the same property tax rate would generate more revenues than today.\textsuperscript{151}

**Keeping Promises to Voters.** School district officials use CABs to keep promises to voters about both tax rates and capital projects. When voters are asked to approve a school district bond measure in California, the bond measure must include the purposes for which the bonds are to be used.\textsuperscript{152} Texas law similarly requires that the document ordering the election and the ballot proposition describe the purposes of the bonds.\textsuperscript{153} California law also requires that voters be provided the “best estimate” of the tax rate for the bonds in the first year after bonds are expected to be issued, the year after the last bonds are expected to be issued, and the year in which the rate is estimated to be highest.\textsuperscript{154} While there is not a comparable requirement in Texas (where either the estimated tax rate or the maximum interest rate—but not both—must be included in the

\textsuperscript{149} See Assemb. B. 1388, 2009–2010 Leg., Reg. Sess. (Cal. 2010) (changing the law to eliminate the requirement that bonds “be structured to amortize so that the maximum annual debt service payment . . . does not exceed the minimum annual debt service payment by more than 10%”).

\textsuperscript{150} CAL. GOVERNOR’S OFFICE OF PLANNING AND RESEARCH, A.B. 1388 ENROLLED BILL REPORT 4 (2009).

\textsuperscript{151} See infra Section IV.E. for discussion of assumptions about future assessed valuation growth.

\textsuperscript{152} See CAL. CONST. art. XIXA, § 1(b)(3)(B) (mandating the proposition presented to the voters include “[a] list of the specific school facilities projects to be funded”); see also CAL. EDUC. CODE § 15122 (Deering 2013) (requiring “the purposes for which the proceeds of the sale of bonds are to be used” to be printed on the ballot box in a bonds election); CAL. GOV’T CODE §§ 53410(a), (b) (Deering 2011) (mandating any local bond measure subject to voter approval include a statement “indicating the specific purposes of the bond”).

\textsuperscript{153} TEX. ELEC. CODE ANN. §§ 3.009(b)(2), 52.072(c)(1)(B) (West Supp. 2016).

\textsuperscript{154} CAL. ELEC. CODE § 9401(a) (Deering 2016), amended by Assemb. B. No. 1194, 2017–2018 Leg., Reg. Sess. (Cal. 2017). The 2017 amendment to the California Election Code will require the statement to include the “best estimate of the average annual tax rate required to fund the proposed bond measure for the duration of its debt service” and to “identify the final fiscal year in which the tax is anticipated to be collected[,]” instead of providing the tax rate for the first year after the first bonds are expected to be issued and the first year after the last bonds are expected to be issued. Assemb. B. No. 1194, 2017–2018 Leg., Reg. Sess. (Cal. 2017).
election order), districts do, at least in some cases, make information about the expected tax rate impact of the bonds available on their web sites. In some instances (probably often), districts do not indicate that actual tax rates for debt service may be higher than expected.

Even where not legally required, districts make promises and provide information to voters about expected tax rates and planned capital projects. School districts opted to include language promising no increase in taxes on approximately 15% (13 out of 88) of the school district bond measures on local ballots in California in 2010. Furthermore, as was noted in the prior paragraph, some school districts present the projected tax impact of bond measures on their web sites and in information provided to the community. Some districts also provide information (with varying degrees of detail) on their web sites about the projects to be financed.

155. TEX. ELEC. § 3.009(b)(5) (West Supp. 2016).
156. See Alvin ISD Trustees Call for November Bond Election, ALVIN INDEP. SCH. DIST., https://www.alvinisd.net/site/default.aspx?PageType=3&ModuleInstanceID=29749&ViewID =7b977ed-8ec-4120-848f-a8b4987d588f&RenderLoc=0&FlexDataID=27512&PageID=23385 [https://perma.cc/UCY4-GAR4] (noting tax rates would increase by a maximum of $.083 per $100 of assessed valuation if a $245 million bond issue was passed by voters in November 2015); see also YISD Estimated Property Calculator, YSLETA INDEP. SCH. DIST., https://bisweb.yisd.net/YISDPROPERTYTaxCalculator/YISDPROPERTYTaxCalculator.aspx [https://perma.cc/C5DJ-44V9] (allowing anyone who visits the website to calculate the effect of the November 2015 bond measure on property taxes).
158. See Alvin ISD Trustees Call for November Bond Election, supra note 156; see also YISD Estimated Property Calculator, supra note 156 (providing a way to calculate the effect of the November 2015 bond measure on property taxes); Measure S, HERMOSA BEACH CITY SCH. DIST., http://hbcsd.org/District/23252 Untitled.html [https://perma.cc/GYP2-XBX5] (indicating the tax rate for a 2016 bond measure would be $29.50 per $100,000 of assessed value).
159. See Alvin ISD Trustees Call for November Bond Election, supra note 156 (describing projects to be financed with bond proceeds); see also Bond Site Maps, HERMOSA BEACH CITY SCH. DIST., http://hbcsd.org/District/23249 Untitled.html [https://perma.cc/8EQQ-TG88] (providing site maps for Hermosa Beach City School District and descriptions of projects at each site); Bond Projects by Campus, YSLETA INDEP. SCH. DIST., https://www.yisd.net/domain/2563 [https://perma.cc/ASJ3-LXPK] (identifying bond-funded school district projects by campus).
While property taxes must be raised if necessary to pay debt service on any bonds that are issued—and districts are not legally obligated to complete all the projects described—at least some district officials appear to view these types of statements as commitments that they endeavor to keep. For example, the official statement for CABs issued by the San Diego Unified School District in 2012 to refinance outstanding debt stated:

Due to lower assessed valuations of taxable property within the District than were projected at the time of issuance of the outstanding bonds, the District currently projects that the tax rate necessary to pay outstanding bonds . . . will exceed the tax rate [identified in the materials for the bond measure passed by the voters] unless actions are taken to restructure the outstanding bonds. The District is undertaking the plan of restructuring described below in order to reduce debt service in fiscal years 2011–12 and 2012–13 and establish a tax rate reserve, which will allow the District to continue to implement its capital improvement program through the issuance of additional authorized general obligation bonds within the tax rate identified . . . .

The desire to keep tax rates at or below promised levels appears to be one of the primary reasons for the controversial Poway Transaction. Napa Valley Unified School District also reportedly issued CABs for this reason.

District officials may feel greater pressure to keep promises to voters by issuing CABs when assessed values for real property have declined—or have not increased—as anticipated at the time a bond measure was passed. This situation is more likely to arise when districts base tax rate estimates


162. Shifflett, Pieczenik, & Bundy, infra note 148; see infra note 314 (noting Napa Valley Unified School District has since refinanced some of its CABs).
and planned projects on optimistic assumptions about assessed valuation growth.\textsuperscript{163}

**Maintaining Substantially Level Tax Rates.** Property owners “find it easier to live with a more or less stable tax rate.”\textsuperscript{164} Significant changes in property tax rates from year to year would make planning difficult, and likely would result in angry and frustrated taxpayers and possibly higher delinquency rates. Thus, school districts typically endeavor to impose a relatively level tax burden over time.\textsuperscript{165}

The use of CABs assists school districts in maintaining substantially level tax rates in two ways. First, in situations where school districts have outstanding general obligation bonds that have relatively high debt service payments in the near term, a district may issue CABs with maturity dates after all or most of the existing bonds have matured so that debt service payments on the new bonds (and hence collection of the related property taxes) begin after debt service on existing ones has declined significantly or ended. Second, school districts may assume that assessed valuations will have risen by the time that debt service payments need to be made years in the future, meaning that more revenues will be generated at the same tax rate.\textsuperscript{166}

**C. School Districts Use CABs to Continue to Issue Debt Without Violating Limits on Expected Tax Rates**

Both California and Texas law impose expected rate limits, which prohibit school districts from issuing general obligation new money bonds if the expected tax rate to pay debt service on all the district’s general obligation debt (in Texas), or on all the general obligation bonds approved under the California 55% Regime at a specific election (in California)

\textsuperscript{163} See infra Section IV.E. (discussing the assumptions about future assessed valuation growth).

\textsuperscript{164} MUSGRAVE & MUSGRAVE, supra note 94, at 693.


\textsuperscript{166} See infra Section IV.E. for discussion of assessed valuations and related assumptions.
These restrictions are a major reason California and Texas school districts issue CABs. As Fitch Ratings—one of the three entities providing credit ratings on municipal bonds—noted, “[B]y delaying repayment, CABs provide a financing vehicle when tax rate or debt level restrictions would prevent issuance of current interest bonds.” Fitch Ratings also indicated that tax rate limits or promised tax rates—combined with growing enrollments and stagnant or declining assessed valuations—or both, were among the primary reasons for increased CABs issuances in California and Texas. In a white paper generally critical of longer-term CABs, the Los Angeles County Treasurer and Tax Collector conceded that districts might need to use them to avoid violating the expected rate limit.

When debt service on a school district’s outstanding general obligation bonds—or, in California, general obligation bonds approved under the California 55% Regime at a particular election—is already at the expected rate limit, the district cannot legally issue current interest bonds because even a small amount of debt service before some of the outstanding bonds are repaid would cause the district to exceed the limit in any year. However, a district can issue CABs that mature after some or all of the existing debt matures and annual debt service declines.

School districts that cannot issue CIBs without violating the applicable expected rate limit have the option of issuing lease revenue bonds or certificates of participation (COPs), or not issuing debt at all; some do exercise these options. Lease revenue bonds and COPs are paid from

167. CAL. EDUC. CODE §§ 15268, 15270(a) (Deering 2013); TEX. EDUC. CODE ANN. § 45.0031(a) (West 2012); see also supra Section II.B., “Limits on Expected Tax Rates” (discussing the expected rate limits in Texas and California).
169. Id.; see also Aman Batheja, Swelling School Districts Find a Costly Way to Grow Within State Debt Limits, TEX. TRIB. (Aug. 29, 2014, 6:00 AM), https://www.texastribune.org/2014/08/29/fast-growing-school-districts-use-controversial-fi/ [https://perma.cc/JH79-5V2P] (“[I]n recent years, critics have raised concerns as some fast-growing school districts have used the bonds to sidestep the 50-cent test and sharply increase their overall debt.”).
171. The percentage of school district and community college district general obligation debt that had been authorized by voters, but had not been issued, grew dramatically during the economic downturn in California. CDIAC, VOTER APPROVED GENERAL OBLIGATION BONDS: AUTHORIZED BUT UNISSUED, supra note 46, at 2.
district general funds (primarily state aid), and are used as a means to avoid voter authorization requirements and other restrictions that apply to general obligation bonds. However, districts prefer to issue general obligation bonds rather than these alternatives for two reasons. First, unlike property taxes, other revenues generally cannot be increased to accommodate the debt service, and school districts prefer to use this finite resource to operate the district and educate students. In fact, districts sometimes obtain voter authorization to refinance lease revenue bonds and COPs with general obligation bonds. For example, Mojave Unified School District issued voter-approved bonds to repay COPs in 2015.

Second, interest rates on lease revenue bonds and COPs are typically higher because they are riskier to investors, generally have lower credit ratings than general obligation bonds, and, in Texas, because the Texas Permanent School Fund cannot guarantee these obligations.

School districts in California (unlike those in Texas) also can obtain another voter approval and issue bonds that otherwise cause debt service

172. See CAL. DEBT ADVISORY COMM’N, CDAC NO. 93-8, GUIDELINES FOR LEASES AND CERTIFICATES OF PARTICIPATION 50 (1993) [hereinafter CDAC GUIDELINES] (discussing the difficulties school districts have generating funds locally and noting that school districts receive the bulk of funding from the state); Shama Gamkhar & Jerome Olson, Factors Affecting School District Choice of Bonds, NAT’L. TAX ASS’N PROC. OF ANN. CONF. ON TAX’N, Fall 2002, at 396, 405 (stating Texas school district lease revenue “bonds can be repaid only with state aid (not taxes”). To use lease revenue bonds or certificates of participation, which are functionally the same, the third party acquires property or the school district leases property to a third party and the third party subleases the property back to the district at a rental rate that is sufficient to make payments on the lease revenue bonds or COPs issued by the third party. CDAC PRIMER, supra note 30, at 126, 185–86.

173. CDAC GUIDELINES, supra note 172, at 50; Craig L. Johnson & John Mikesell, Certificates of Participation and Capital Markets: Lessons from Brevard County and Richmond Unified School District, PUB. BUDGETING & FIN., Fall 1994, at 41, 42, 52; see also Gamkhar & Olson, supra note 172, at 405 (finding districts that are less likely to win a bond election are more likely to issue lease revenue bonds).

174. MOJAVE ISD 2015 OFFICIAL STATEMENT, supra note 76, at Cover, 2, 7.

175. CDAC GUIDELINES, supra note 172, at 16; Shama Gamkhar & Mona Koerner, Capital Financing of Schools: A Comparison of Lease Purchase Revenue Bonds and General Obligation Bonds, PUB. BUDGETING & FIN., Summer 2002, at 21, 24, 30–32; see Gamkhar & Olson, supra note 172, at 397; see also Beverly S. Bunch & Tina Smith, The Viability of Lease Purchases as a Means for Funding School Facilities, 27 J. OF EDUC. FIN. 1049, 1058–60 (2002). Bunch and Smith also found that issuance costs were higher, but noted that the savings from avoiding a bond election would partially offset these costs. Id. at 1058–59.

to exceed the expected rate limit,\textsuperscript{177} though they may be reluctant to or may not be able to do so in time to meet their funding needs.

When school districts perceive a need to issue bonds quickly, they may issue CABs if they would otherwise be legally prevented from issuing general obligation bonds at all. As was noted in Section IV.B., school district officials place importance on completing the capital projects that they have told voters they will undertake. If a project is already under way, and additional funds are needed to complete it, the pressure is likely even more intense. Further, many districts have pressing infrastructure needs that must be met to serve students in a safe, comfortable environment. For example, repairing or replacing leaking roofs was listed in dozens of California school district bond measures in 2014 as a use of bond proceeds.\textsuperscript{178} When California districts have issued bond anticipation notes (short-term interim debt) that are maturing, they have to either issue general obligation bonds to repay them (even if they must do so in the form of CABs) or repay them from the general fund (something they may not be able to do without compromising the education provided to students, if at all.)\textsuperscript{179} Districts also issue CABs to take advantage of state and federal assistance programs that are of limited duration or to take advantage of market conditions, such as low interest rates or low construction costs.\textsuperscript{180} For example, the Santa Ana Unified School District in California indicated it used CABs to take advantage of low construction costs, low interest rates, and state matching funds to issue federally subsidized Qualified School Construction Bonds (QSCBs) and Build America Bonds (BABs), and to build needed school facilities.\textsuperscript{181}
Poway Unified School District engaged in the interim funding transactions that it ultimately refinanced in the controversial Poway Transaction to access state matching funds, avoid cost increases, and complete projects as quickly as possible.\textsuperscript{182}

Expected rate limits appear to have a disproportionate impact on certain types of districts. Property-poor districts, which have low assessed valuation per student, are more likely to be constrained by debt limits that are based on property values.\textsuperscript{183} Taxes collected at the expected rate limit will raise a lower amount of money per student in a property-poor district than in a wealthier one.\textsuperscript{184} An unsuccessful bill to amend Texas’s expected rate limit in 2015 would have increased the cap only for sixty school districts designated as fast-growing, suggesting that the authors of the bill believe these districts are particularly affected by the limit.\textsuperscript{185}

Of course, the other side of limits on expected tax rates is that they impose at least some constraint on future tax rates, because a district would not legally be able to incur its debt in such a form that it expected debt service to exceed those limits in any year. Even though school districts have incentives to make optimistic assumptions about future valuation growth,\textsuperscript{186} districts are unlikely to make assumptions that have absolutely no basis.

D. School Districts May Issue CABs to Meet the Needs of a Rapidly Growing Population

Rapidly growing districts may be especially inclined to issue CABs. As Fitch Ratings expressed, "For rapidly growing areas, the primary appeal [of
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CABs] is that needed capital improvements can be funded immediately, but the repayment burden is shared with the larger future population.\textsuperscript{187}

Furthermore, because there is generally a lag between increases in property values and increases in assessed valuations,\textsuperscript{188} student numbers may grow before the larger overall population is reflected in higher assessed valuations. The Author’s/Sponsor’s Statement of Intent for HB 114 indicated that “[i]n recent years, Texas school districts and local government entities have increasingly turned to CABs because our growing populations are demanding new facilities and capital development that far outpace our local wealth and resources. Usually, immediate development is needed but there are limited other financing options. . . .”\textsuperscript{189} Of the top ten public school districts in Texas based on maturity amount of CABs outstanding as of August 31, 2015,\textsuperscript{190} seven had enrollment growth (expressed as a percentage) above that of the state as a whole over the ten-year period from state fiscal year 2005–2014 and six had enrollment growth far above that of the state as a whole for that same period.\textsuperscript{191} This suggests a correlation between rapid growth and the use of CABs.

\textsuperscript{187} Fitch Ratings Press Release, supra note 9.
\textsuperscript{188} Byron F. Lutz, The Connection Between House Price Appreciation and Property Tax Revenues 48 FIN. & ECON. DISCUSSION SERIES, Sept. 12, 2008, at 6–8, 12. The lag between increases in property values and assessed values likely is higher in California, where there are strict limits on increases in assessed values absent a sale of the property.
\textsuperscript{190} TBRB, 2015 REPORT, supra note 132, at 41.
It may be that rapidly growing districts are endeavoring to achieve interperiod equity through their use of CABs. Because, in many cases, they are building to accommodate a student population that they expect to continue to grow, they may be trying to protect today’s population from having to pay for more infrastructure than it needs or can use, while providing for the needs of a larger future population. These districts also may expect that their use of CABs will result in substantially level tax rates because they expect assessed valuations to grow with the population. Unfortunately, if growth does not occur as expected, it will be a small population in the future that bears the brunt of the decisions being made today.

The limits on expected tax rates discussed above are a significant force pushing rapidly growing districts to issue CABs rather than CIBs. As an official of a district in Texas that grew from 7,200 students in 1994 to 36,750 in 2014 put it, “Yes, [using CABs] costs more, but when you’re at [the expected rate limit] and another 1,200 children come in, we think ‘Where are we going to put them?’”192 They are not, however, the sole reason CABs are used. In the State of Texas, for example, of the forty fastest-growing districts, eleven are at the $0.50 rate cap and nine are even lower, within $0.05 of it.193 The other half of these districts presumably


192. Batheja, supra note 169 (quoting Ellen Skoviera, Assistant Superintendent for Business and Operations, Leander Independent School District); see Fitch Ratings Press Release, supra note 9 (discussing the benefits to growing districts that come with CABs, but also identifying potential risks); see also Lisheron, supra note 12 (noting CABs have been used to accommodate expected “exploding growth” in student numbers).

193. MOAK, CASEY & ASSOCS., FINDING BALANCE: A GUIDE TO ENROLLMENT, DEBT, & STATE FACILITIES SUPPORT, A REPORT BY THE FAST GROWTH SCHOOL COALITION TO THE 85TH
are using CABs for reasons other than to comply with the expected rate limit.

E. The Impact of Incorrect Assumptions About Growth in Assessed Valuations

When assessed valuations decline or do not increase as was projected at the time a bond measure was proposed, districts are more likely to issue CABs to maintain tax rates at desired levels or to comply with expected rate limits while completing promised projects. In California, statewide assessed valuations declined in fiscal year 2009–2010 for the first time since the State Board of Equalization began keeping records in 1933. This likely contributed to the significant increase in the aggregate principal amount of CABs issued by California school districts—both in absolute terms and as a percentage of all general obligation bonds issued—from 2007 to 2011. Furthermore, districts and their advisors have incentives to use, and sometimes do use, optimistic assumptions about assessed valuation growth when providing estimated tax rates in order to increase the likelihood that the bond measure will pass.

Equally, if not more troubling, district officials and their advisors have incentives to use aggressive assumptions about assessed valuation growth when evaluating whether taxes for debt service are expected to be within


195. While the aggregate principal amount of general obligation bonds issued by California school districts declined from approximately $6.6 billion in 2007 to $5.1 billion in 2011, the principal amount of these bonds issued as CABs increased from approximately $540 million in 2007 to $1.1 billion in 2011. CDJAC data includes 192 school district general obligation bond issuances (80 of which included CABs) in 2007 and 274 school district general obligation bond issuances (89 of which included CABs) in 2011. See Jensen, Calif. Capital Appreciation Bonds Have Unintended Consequences, supra note 13 (describing declining real estate values as a reason that some school districts issued CABs); see also Cal. Assemb., Bill Analysis (Sept. 5, 2013), Assemb. B. 182, 2013–14 Leg., Reg. Sess., at 3 (Cal. 2013) (noting CABs became more popular after home prices declined); Cal. S. Educ. Comm., Bill Analysis (June 24, 2013), Assemb. B. 182, 2013–14 Leg., Reg. Sess., at 3–4 (Cal. 2013) (attributing increased use of CABs to lower housing prices); L.A. Cty. CIV. GRAND JURY REPORT, supra note 86, at 127 (indicating all twelve of the school districts that issued CABs reviewed in the report had experienced slower assessed valuation growth or even assessed valuation decline).

the rates previously promised to voters and whether a bond issuance complies with the expected rate limit. Using aggressive assumptions allows districts to issue more bonds, and the fallout of higher tax rates will land on future, rather than current, officials and taxpayers.

California law (unlike Texas law) does not provide guidance on what assumptions are to be used in projecting assessed valuations for purposes of calculating compliance with the expected rate limit.197 The Orange County Grand Jury reviewed assumptions about estimated tax rates for three school districts in the county that issued CABs; it concluded that all three had assumed unreasonably high growth in assessed valuations, and that the taxpayers in these districts were likely to have to pay taxes in excess of the expected rate limit in the future.198

In Texas, if a district’s actual tax rate is higher than projected and exceeds the expected rate limit, that district is subject to a lower limit in the future.199 The impact of this penalty is not clear. On one hand, it may encourage districts to use conservative assumptions about assessed valuation growth or to use historic, rather than projected assessed valuation, in determining compliance.200 Most districts in Texas use the historic test.201 On the other hand, it may encourage some districts to use financing structures in which the bulk of the debt service is not due until at or near maturity—including, at the extreme, long-term CABs—to postpone the risk of exceeding the limit.

197. A 2010 bill in California would have imposed broad limits on the growth that could be assumed in projections for determining compliance with the expected rate limit, but it did not pass. Assemb. B. 2552, 2009–2010 Leg., Reg. Sess. (Cal. 2010). While it does not apply directly to calculating compliance with the expected rate limit, AB 2116 may impact the projections used by school districts for determining compliance. This bill is discussed supra note 196, and infra note 300 and accompanying text.
198. ORANGE Cnty. GRAND JURY, SCHOOL BONDS, supra note 83, at 4.
199. TEX. EDUC. CODE ANN. § 45.0031(e) (West 2013).
200. See ORANGE Cnty. GRAND JURY, SCHOOL BONDS, supra note 83, at 4 (claiming school districts would likely not exceed the mandated tax rate if they were conservative in their growth assumptions for assessed values).
201. For example, data from the TBRB indicates seventy-five school districts issued general obligation bonds in August 2015. TBRB Issuances FY 2007–2015, supra note 9. Official statements for sixty of the school districts indicated that the districts had not used projected property values to satisfy the test, three stated that they had and five were silent. See Texas, ELECTRONIC MUNICIPAL MARKET ACCESS https://emma.msrb.org/IssuerHomePage/State?state=TX [https://perma.cc/E8CJ-3ZP8] (providing information for Texas municipal securities issuers including issuers’ official statements). Official statements for the remaining seven were not available. Id.
F. Texas Par-to-Par Requirement for Refundings

Texas school districts may not issue general obligation refunding bonds without obtaining voter approval unless the principal amount of the refunding bonds is no greater than the principal amount of the bonds being refinanced.\(^\text{202}\) This means school districts need to generate original issue premium to pay costs of issuing the refunding bonds and to pay interest on the refinanced bonds through their maturity or redemption date.\(^\text{203}\) This amount can be significant, particularly for bonds that are refinanced far in advance of their redemption or maturity date.\(^\text{204}\) One way Texas school districts comply with this requirement is by issuing CABs that generate significant original issue premium.\(^\text{205}\)

G. School District Officials May Not Understand the Impact of CABs

It appears that in some instances, school district boards do not understand what capital appreciation bonds are, what their impact is, or even that they are being issued. Many school board members do not have the experience and background to understand the impact of CABs, at least not without explanation and guidance from district officials and outside financial advisors. While school board members frequently are committed, intelligent, and educated individuals who work hard for their school districts, the legal qualifications for serving are minimal.\(^\text{206}\)

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\(^\text{203}\) See LAWRENCE FIN. CONSULTING LLC, supra note 202, at 1 (describing how CABs are used by school districts to meet the par-to-par requirement for refunding).

\(^\text{204}\) See id. (noting the high interest expenses for advance refunded bonds).

\(^\text{205}\) See id. (claiming school districts must use CABs to cover issuance costs and interest amounts on advance refunded bonds); see also NORTON ROSE FULBRIGHT, WHAT HAPPENED IN AUSTIN: 10 NEW LAWS THAT MATTER 17–18 (2015), http://www.nortonrosefulbright.com/files/2015/07/22-what-happened-in-austin-ten-new-laws-that-matter-130804.pdf [https://perma.cc/B9WW-FBDD] (suggesting the par-to-par test partially explains why “Texas[] school districts are the largest issuer of capital appreciation bonds”).

\(^\text{206}\) In California, anyone who is at least eighteen years old, a citizen of California, a resident of the school district, a registered voter, and not disqualified under the California Constitution or state law from holding civil office, is eligible. CAL. EDUC. CODE § 35107(a) (Deering 2013). In Texas, anyone who is a U.S. citizen, at least eighteen years old, has not been determined by a final court judgment to be mentally incapacitated, has not been convicted of a felony, and has resided in Texas for twelve months and in the territory where the office is located for six months, is eligible. TEX. ELEC. CODE ANN. § 141.001(a) (West 2015).
Further, in many cases, school boards are presented with bond resolutions that authorize the issuance of both CIBs and CABs; they then delegate to their officers the decision of which type of bonds will be issued and the terms of the bonds (within specified parameters). These decisions typically are not made until closer to the time the bonds are sold and after the board has approved the transaction because market conditions affect the final structure.

Then California State Treasurer, Bill Lockyer, and California Superintendent of Public Instruction, Tom Torlakson, noted that school board members and the public have not always been fully informed about the costs and risks associated with CABs. Some school board members have stated that they could not recall approving CABs or were not aware of the impacts of issuing them.

The failure to count compounded interest against voter-authorized amounts and against the California limit on total debt as a percentage of assessed valuation exacerbates the problem by making the true level of debt created by these bonds less apparent.

Furthermore, school district officers and employees may not have sufficient experience to understand the full impact of CABs, at least

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209. Shifflett, Pieczenik, & Bundy, supra note 148; Lambert & Reese, supra note 165.

210. See supra Section III.C.
without guidance from outside financial advisors. Most cities and counties have few resources dedicated to debt management, and their external financial advisors frequently know more about bonds—and even about the issuer's own debt portfolio—than the issuers do; the same is likely true of school districts, particularly smaller ones. Even large issuers don't always understand the agreements they make. Smaller communities tend to have smaller financial staffs, and the differences in capacity are likely to impact management of the issuer's debt. An empirical study of municipal bond sales in Oregon concluded that small communities pay higher interest rates on their general obligation bonds than larger communities, all else being equal, and attributed this to them having more limited staffs with less expertise. Smaller school districts likely confront the same issues—particularly when evaluating a less common financing structure like CABs.

Recognizing their lack of in-house expertise, school districts and other local governments often engage an external financial advisor. Among other things, financial advisors assist issuers in developing a financing plan.

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211. See SAN MATEO Cnty. CIV. GRAND JURY, CAPITAL APPRECIATION BONDS: TICKING TIME BOMBS 7 (2013), http://www.sanmateocourt.org/documents/grand_jury/2012/bonds.pdf [https://perma.cc/G6D9-6AZT] (“A southern California school chief business officer lamented the lack of financial expertise that leaves many districts unqualified to navigate complex bond deals – or to do business with high-powered financial advisors:] ‘They’re swimming with the sharks . . . . These are principals and assistant superintendents of curriculum, and they’re being promoted to the role of a chief business officer.”).

212. Monique Moyer, Current Issues Facing Bond Issuers and Their Financial Advisors, MUN. FIN. J., Summer 2003, at 17, 18; see also U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT 9–11 (1965) [hereinafter U.S. ADVISORY COMM’N, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT] (examining the difficulty smaller communities have with bonds due to their lack of expertise); Ang & Green, supra note 77, at 8 (“Furthermore, when municipalities negotiate with investment banks and other financial intermediaries to issue debt, municipalities often have less expertise and relatively few resources to guide their decision[-]making. This is detrimental not only to investors, but also to municipalities themselves.”); Jayaraman Vijayakumar & Kenneth N. Daniels, The Role and Impact of Financial Advisors in the Market for Municipal Bonds, 30 J. FIN. SERVICES RES. 43, 44 (2006) (stating local communities often lack the sophistication and knowledge to navigate the debt issuance process and, therefore, utilize financial advisors to assist them).


215. Id. at 713–15.

216. Vijayakumar & Daniels, supra note 212, at 44.
structuring transactions, and negotiating with underwriters. In some cases, financial advisors receive fees that are either contingent on the closing of the bond financing, tied to the size of the issuance, or both (though California law prohibits compensation of financial advisors based on a percentage of the amount of bonds sold).

Municipal bonds are typically sold to the public through an investment bank acting as an underwriter. The underwriter’s compensation is a percentage of the total principal amount sold.

The MSRB, which regulates underwriters and other participants in the municipal securities market, notes that “compensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest, because it may cause the underwriter to recommend a transaction that it is unnecessary or to recommend that the size of the transaction be larger than is necessary.” The same analysis applies to financial advisors that are compensated in this manner.

While the vast majority of financial advisors and underwriters are honorable, experienced professionals, there may be instances in which financial advisors and underwriters encourage school districts to issue bonds—including CABs—when it is not in their best interest to do so, either because they are maximizing their compensation or because they are too focused on their clients’ short-term objectives. Concerns about the manipulation of local governments by financial advisors led to the passage of federal legislation in 2010 that required these advisors to register with the SEC, imposed fiduciary duties on them, and instructed the MSRB to

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217. A 2003 study found that using a financial advisor reduced underwriter compensation for negotiated general obligation bond offerings. Id. at 66.
218. CAL. GOV’T CODE § 53592 (Deering 2011).
219. Bonds are sold in either a competitive or negotiated sale. In a competitive sale, an issuer sells the bonds to the lowest bidding underwriter. In a negotiated sale, the issuer selects an underwriter to purchase the bonds on negotiated terms. In both cases, the underwriter then sells the bonds to investors. Typically, an underwriter in a negotiated sale plays a much more active role in the transaction than would an underwriter in a competitive sale. Negotiated sales are by far the most common sale method for California and Texas school district general obligation bonds, based on data provided by CDIAC. California Issuances 2015, supra note 9; Local Publications – Bond Issuance, TEX. BOND REV. BD., http://www.brb.state.tx.us/publications_local.aspx#BI [https://perma.cc/444R-FYDC].
regulate them.\textsuperscript{221} Similar concerns about underwriters have led to increased regulation of underwriters, including requirements that underwriters disclose conflicts of interest to issuers.\textsuperscript{222}

V. CALIFORNIA AND TEXAS LEGISLATION LIMITING THE USE OF CABs

A. Opposition to CABs

School districts in California and Texas have issued general obligation bonds in the form of CABs since at least the 1990s.\textsuperscript{223} Changes to California law that took effect in January 2010 eliminated the requirement that bonds issued under the relevant California Government Code provisions (including school district bonds with final maturity dates in excess of twenty-five years) generally had to have substantially level debt service.\textsuperscript{224} This had the effect of making it easier for school districts to issue CABs with final maturity dates later than twenty-five years after the date of issuance. The percentage of California school district general obligation bond issuances—consisting in whole or in part of CABs and with final maturities later than twenty-five years after the date of issuance—increased significantly beginning in 2010.\textsuperscript{225}

Capital appreciation bonds began receiving negative attention in both California and Texas in 2012 and 2013. Newspapers and web sites published articles with titles like: “Risky Bonds Tie Schools to Huge


\textsuperscript{222} See MUN. SEC. RULEMAKING BD., RULE G-17, supra note 220, at 2–3 (describing fair dealing and requiring that underwriters disclose conflicts of interest to issuers).


\textsuperscript{224} Assemb. B. 1388, 2009–2010 Leg., Reg. Sess. (Cal. 2009). There were exceptions under prior law, including for issuances that made amortization of overall general obligation bond debt more level. Id.

\textsuperscript{225} Of school district general obligation issuances that included CABs, the following percentages had final maturity dates in excess of twenty-five years: 21\% in 2007, 33\% in 2008, 24\% in 2009, 64\% in 2010, 72\% in 2011, 80\% in 2012, 69\% in 2013, 70\% in 2014, and 58\% in 2015; as a result of the passage of AB 182, final maturities in excess of twenty-five years in 2014 and 2015 would have to be CIBs, CABs issued to refinance outstanding bonds, or CABs qualifying for limited transition period exceptions. California Issuances 2002–2014 (2015) (unpublished data) (on file with author); California Issuances 2015, supra note 9.
Debt;”226 “California Schools Finance Upgrades by Making the Next Generation Pay;”227 and “Texas Schools Pass Debt on to the Next Generation.”228 The California State Treasurer and State Superintendent of Public Instruction issued a joint letter urging school districts not to issue any CABs until the state legislature and the Governor completed their consideration of reform proposals.229 Grand juries in three California counties investigated the use of CABs in their counties and issued scathing reports.230

A bill was unsuccessfully introduced in California in 2013 that declared the legislature’s intent to ban the use of CABs by school districts.231 In Texas, bills were unsuccessfully introduced in 2013, 2014 and early 2015, which would have prohibited or limited the use of CABs that are payable from property taxes.232

While those efforts did not succeed, California law was amended effective January 2014 to restrict the use of CABs by school districts and community college districts;233 and Texas law was modified effective September 2015 to constrain the use of CABs by all local governments.234

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226. Weikel, supra note 12.
227. Lovett, supra note 12.
228. Lisheron, supra note 12.
B. **Limits on CABs in California**

California AB 182 took effect in January 2014.\(^{235}\) The legislation narrowed the parameters within which school districts and community college districts (but not other local governments) could issue general obligation new money CABs.\(^{236}\) In particular, the new law reduced the maximum term for these CABs from forty to twenty-five years,\(^{237}\) and the maximum interest rate on these CABs from 12% to 8%.\(^{238}\) In addition, AB 182 added a requirement that general obligation new money CABs with terms of more than ten years be subject to redemption at the option of the issuer no later than ten years after their date of issuance.\(^{239}\) This means that rather than having to keep its CABs outstanding through their final maturity, a school district would be able to repay them after ten years, should it desire to do so, without having to negotiate with bondholders or obtain their consent. AB 182 also added a requirement that the ratio of debt service (for CABs, the maturity amount) to principal for a series of CABs not exceed four to one.\(^{240}\)

Like governing boards of all local governments in California, school boards are subject to open meeting and public notice requirements.\(^{241}\) AB 182 added additional notice and information requirements for school board approvals of general obligation new money CABs issuances.\(^{242}\) Public notice of the proposed approval of a general obligation new money CABs issuance must be given for two consecutive school board


\(^{236}\) The State Board of Education may waive these provisions for bonds that refinance bond anticipation notes issued before December 31, 2013, if certain conditions are met. CAL. EDUC. CODE § 15144.3 (Deering Supp. 2017).

\(^{237}\) CAL. EDUC. § 15144 (Deering 2013); CAL. GOV’T CODE §§ 53508(b), 53508.5 (Deering 2011 & Supp. 2017).

\(^{238}\) CAL. EDUC. § 15143 (Deering 2013); CAL. GOV’T §§ 53508(d), 53508.5, 53531 (Deering 2011 & Supp. 2017).

\(^{239}\) CAL. EDUC. § 15144.2 (Deering 2016); CAL. GOV’T § 53508.5. Presumably, this option has some cost in the form of higher yields, particularly when interest rates are high, since it creates the risk that investors will have to reinvest not only earning on, but also principal of, the CABs in lower yielding securities before the scheduled maturity date of the CABs.

\(^{240}\) CAL. EDUC. § 15144.1 (Deering Supp. 2017); CAL. GOV’T § 53508.5.

\(^{241}\) See CAL. GOV’T §§ 54950–54963 (Deering 2016) (defining “local agency” as including “school district[s] . . . or any board, commission or agency thereof” and stating the chapter’s provisions for open and public meetings).

\(^{242}\) These requirements also apply to CIBs that mature more than 30 years after issuance. CAL. GOV’T § 53508.6 (Deering Supp. 2017).
meetings, and the resolution approved by the school board authorizing the issuance must include the financing term and time of maturity, the ratio of debt service to principal, and the estimated change in assessed value of taxable property in the district over the term of the bonds. In addition, the board must be presented information concerning the overall cost of the CABs, a comparison to the overall cost of CIBs, the reason CABs are being recommended, and a copy of required disclosures regarding underwriter conflicts of interest.

The provisions of AB 182 do not apply to bonds that are issued to refinance existing debt. In California, school districts may issue general obligation refunding bonds only if they result in overall debt service savings and do not mature any later than the bonds that are being refinanced.

C. Limits on CABs in Texas

Texas HB 114 took effect September 1, 2015. HB 114 applies to CABs issued by local governments and secured by ad valorem taxes. HB 114 reduced the maximum term of CABs from forty to twenty years. The new law also added a provision that allows CABs to be issued only if the total debt service on all the local government’s general obligation CABs will be no more than 25% of total debt service on all the local government’s outstanding general obligation bonds.

Texas local government boards, like those in California, are subject to open meeting and public notice requirements. HB 114 imposed additional informational requirements for the issuance of CABs. Specifically, governing boards must receive information about the total

243. CAL. EDUC. § 15146(b)(2) (Deering 2016); CAL. GOV’T § 53508.5.
244. CAL. EDUC. § 15146(b)(1)(E) (Deering 2016); CAL. GOV’T § 53508.5.
245. CAL. EDUC. § 15146(c) (Deering 2016); CAL. GOV’T § 53508.5.
246. CAL. GOV’T § 53552 (Deering 2011).
247. Id. § 53553(e).
250. TEX. EDUC. CODE ANN. § 45.001(b) (West 2012); TEX. GOV’T § 1201.0245(b)(1) (West Supp. 2017).
251. TEX. GOV’T § 1201.0245(g) (West Supp. 2017).
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255. Id. § 1201.0245(b)(3).
256. Id. §§ 1201.0245(b)(4), (d).
257. Act of May 22, 2017, 85th Leg., R.S., ch. 529, § 1, sec. 1201.0245(j), 2015 Tex. Sess. Law Serv. (codified at TEX. GOV’T § 1201.0245(j)). The amendment addressed unintended consequences of HB 114, such as prohibiting issuers that were already over the 25% limit from issuing refunding CABs unless the refunding brought the issuer below the limit, even if the refunding resulted in a lower debt service attributable to CABs and debt service savings, with limited exceptions.
259. TEX GOV’T: § 1207.008 (West 2012). However, refunding bonds guaranteed by the Texas Permanent School Fund Bond Guarantee Program cannot have a later final maturity date than the bonds they are refinancing and must result in present value debt service savings. 19 TEX. ADMIN. § 33.65(d)(2)(C) (2017). Most Texas school district bonds are guaranteed by this program. See TEXAS PERMANENT SCHOOL FUND DISCLOSURE STATEMENT, supra note 32 and accompanying text.

debt service to maturity, the fees to be paid to financing team members and other outside vendors, the projected tax impact and assumptions on which the projected tax impact is based.254 The governing board also must determine whether there are any potential conflicts of interest with any of the professionals involved in the bond issuance.255 Amended Texas law also requires that local governments post information about the proposed issuance and existing debt, including the information described in the two preceding sentences, to their websites and update the information about outstanding debt and total debt service regularly.256

As of September 1, 2017, general obligation refunding bonds are exempted from the requirements of HB 114.257 HB 114 prohibits local governments from extending the maturity date of CABs, including by refinancing them, unless the extension reduces the amount of debt service payable through maturity or in other limited circumstances.258 Unlike California law, Texas law does not otherwise prohibit extending the maturity of refinanced general obligation bonds and allows refunding transactions that do not result in debt service savings if the governing body of the issuer makes a finding that the issuance is in the best interests of the issuer.259

D. Comparing the Two Approaches

There are significant similarities between the California and Texas CAB legislation. Both reduce the maximum term of capital appreciation
bonds, likely in response to concerns about the higher cost of CABs and possibly, to some extent, to address concerns about interperiod equity (though this remains an issue even with the shorter terms). Both include additional information requirements and, while those requirements are not identical, both require the provision of information about overall debt service and the assumptions that are being made about growth in assessed valuations, suggesting that these are important for both governing board members and the public. Further, both endeavor to make the public more aware of the issuance of CABs and the impact on the district's debt service levels and on property taxes. California requires the issuance of CABs to be discussed at two board meetings for which public notice has been given and requires certain information be presented to the board. Texas goes further and requires that, in addition to being presented to the board, information must be posted on the issuer's website and updated regularly. Both pieces of legislation require disclosure to the board of conflicts of interest, likely in response to concerns that issuers are being encouraged to issue CABs when it is not in their best interests to do so.

General obligation refunding bonds need not comply with the new limitations in either California or Texas. This is likely because the expectation is that refunding bonds are issued only if they result in overall debt service savings to taxpayers. As noted above, in California this is the only circumstance in which general obligation refunding bonds can be issued. While Texas law allows refunding transactions that do not result in debt service savings, the vast majority of refunding transactions probably create savings for two reasons: (1) it is a requirement for bonds

260. CAL. EDUC. CODE § 15144 (Deering 2013); CAL. GOV'T CODE §§ 53508(b), 53508.5 (Deering 2011 & Supp. 2017); TEX. GOV'T § 1201.0245(b)(1) (West Supp. 2017); TEX. EDUC. CODE ANN. § 45.001(b) (West 2012).

261. CAL. EDUC. §§ 15146(b)–(c) (Deering 2013); CAL. GOV'T § 53508.5; TEX. GOV'T §§ 1201.0245(b), (d).

262. CAL. EDUC. §§ 15146(b)–(c); CAL. GOV'T § 53508.5.

263. TEX. GOV'T §§ 1201.0245(b), (d).

264. CAL. EDUC. § 15146(c)(4) (Deering 2013); TEX. GOV'T § 1201.0245(b)(3); CAL. GOV'T § 53508.5.


266. See CAL. GOV'T §§ 53552, 53553(e) (Deering 2016) (stating California school districts may issue general obligation refunding bonds only if they result in overall debt service savings and do not mature later than the bonds that are being refinanced).
to be guaranteed by the Texas Permanent School Fund Bond Guarantee Program; and (2) because if they do not create savings, board members must make a public determination to proceed despite the increased costs. 267 School districts in California and, in most instances, in Texas, may not extend the maturity of previously issued CABs. 268

One significant difference between the two laws is that the California limits apply only to school districts and community college districts, while the Texas limits apply to all local governments. 269 This may be because school districts and community college districts dominate general obligation bond issuances in California in a way that they do not in Texas, 270 presumably a reflection of the fact that school districts and community college districts in California can use the California 55% Regime, while other California local governments must use the California Two-Thirds Regime. 271 In both states, the controversy surrounding CABs focused on school districts; and school districts were responsible for

267. TEX. GOV’T § 1207.008 (West 2012); 19 TEX. ADMIN. § 33.65(d)(2)(C) (2017). Most Texas school district bonds are guaranteed by the Texas Permanent School Fund Bond Guarantee Program.

268. Refunding bonds guaranteed by the Texas Permanent School Fund Bond Guarantee Program cannot have a later final maturity date than the bonds they are refinancing. 19 TEX. ADMIN. § 33.65(d)(2)(C). Most Texas school district bonds are guaranteed by this program. See U.S. ADVISORY COM’N ON INTERGOVERNMENTAL RELATIONS, supra note 35.

269. Compare CAL. GOV’T § 53508.5 (imposing capital appreciation bond limits on school and community college districts), with Tex. Gov’t § 1201.0245(b) (West Supp. 2017) (restricting authority to issue capital appreciation bonds for a broad range of local governmental bodies).

270. School districts and community college districts were responsible for 95.1% of California local government general obligation bond issuances and 89.5% of the total principal amount of such bonds issued in 2015. See CDIAC, 2015 SUMMARY, supra note 28, at 2–4 (showing community college and K–12 school districts issued $13,512,973,914 of $15,095,823,914 in aggregate principal amount of government general obligation bonds in 409 transactions out of a total of 430 local government general obligation bond issuance in 2016). School districts and community college districts were responsible for 57.9% of the outstanding principal amount of debt supported by ad valorem property taxes in Texas as of August 31, 2015. See 2016 TEX. BOND REV. BD., LOCAL GOVERNMENT ANNUAL REPORT 5 (2016), www.brb.state.tx.us/pub/lgs/fy2016/2016LocalARFinal.pdf [https://perma.cc/H3QB-NCUB] (detailing public school and community college districts held $78,278.3 million of $135,185.1 million in local government debt). While these figures are not entirely comparable, they suggest that local governments other than school districts and community college districts, issue a significantly greater proportion of general obligation bonds in Texas than they do in California.

271. See DAYTON, supra note 42, at 16 (noting only 110 of the 1,147 local educational bond measures from 2001 through 2014 were presented to voters under the California Two-Thirds Regime). All Texas local government general obligation bonds are subject to approval by a majority of residents voting at an election. TEX. CONST. art. VII, § 3(e); TEX. EDUC. CODE ANN § 45.003(a) (West 2012).
most of the CABs issued in the five years leading up to the passage of the relevant legislation. Both pieces of legislation are limited to bonds that are paid from *ad valorem* property taxes.

Another notable difference is that Texas legislation focuses on the issuer’s overall debt portfolio, while California legislation focuses on the cost of a series of CABs in isolation. Even though both states place limits on debt service, Texas compares debt service on CABs to overall debt service, while California evaluates the debt service on each series of CABs in isolation. This is generally consistent with the two states’ approaches to expected rate limits; the focus in Texas is on overall debt portfolio and the focus in California is on a more limited universe (a series of bonds in the case of the ratio of total debt service to principal, and bonds authorized at a single election in the case of expected rate limits). It is surprising, though, that the California test looks at the series of bonds on its own and not in conjunction with all the bonds that are issued at the same time, or at all the bonds that were authorized at a particular election.

VI. WHAT IS THE SOLUTION?

There are several ways that misuse of CABs could be—and in the case of AB 182 and HB 114, has been—addressed. This section discusses several potential solutions, which fall within three broad categories: prohibiting or restricting the use of CABs; reducing the incentives to issue CABs; and providing additional information to local governments and communities, and additional guidance to local governments. While this discussion is focused on school districts, the analysis also applies to other local governments.

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272. Based on data provided to the author by CDIAC, school districts in California were responsible for 72.5% of the aggregate principal amount of CABs issued in California during the period from 2008 to 2012. In Texas, 65.5% of the total principal amount of CABs issued during the period from state fiscal years 2009 through 2013 were issued by public school districts. *See TBRB*, 2013 REPORT, *supra* note 131, at 10 (computing the percentages by adding the public-school district CAB amount for fiscal years 2009–2013 and dividing that number by the total principal amount of CABs issued for fiscal years 2009–2013).


A. Prohibiting or Restricting the Use of CABs

Misuse of CABs could be eliminated by prohibiting or restricting their use. The focus of these solutions is preventing districts from taking advantage of incentives to benefit today’s population at the expense of tomorrow’s, and addressing concerns about the lack of expertise of school district officials. However, an outright prohibition—or even carefully drafted restrictions—on the use of CABs could prevent their use in circumstances where the benefits outweigh the costs (especially when the expected rate limit or another legal constraint would otherwise prevent the issuance of debt at all) and likely would have disparate impacts on districts with different characteristics. These concerns might be addressed by allowing districts to issue CABs, or CABs outside specified parameters, with the approval of a state agency, or by providing alternative funding sources.

Prohibiting the Use of CABs. One means of eliminating the misuse of CABs is to ban them entirely. School districts in Michigan were banned from issuing capital appreciation bonds in 1994. In 2013, legislation was unsuccessfully introduced in California that declared the legislature’s intent to prohibit school districts from issuing CABs. Similarly, legislation that would have prohibited the issuance of all CABs by Texas local governments was introduced in 2013, and legislation that would have prohibited the issuance of CABs payable from ad valorem property taxes by Texas local governments was introduced in 2014 and 2015, though none of these measures passed.

Restricting the Use of CABs. The misuse of capital appreciation bonds could be reduced or eliminated by restrictions on the issuance of this type of debt. Both California’s AB 182 and Texas’s HB 114 adopted this approach (as well as that of providing additional information), narrowing the parameters within which school districts (and, in the case of Texas, other local governments) can issue CABs payable from ad valorem property taxes. While one can debate whether the restrictions in

AB 182 or HB 114 strike the appropriate balance, carefully tailored legislation could prevent the most problematic CABs issuances.

Problems with Prohibiting or Restricting the Use of CABs. A prohibition or restriction that applied only to CABs, but not to other back-loaded debt structures, would only partially address concerns about interperiod equity, though it would eliminate one of the most egregious violations of the principle. However, the restriction could be drafted to apply to all back-loaded debt structures. For example, prior to 2010, many California local government general obligation bond issuances (including school district bonds with maturities in excess of twenty-five years) were required to have substantially level debt service with limited exceptions.279

An outright prohibition or even the most carefully drafted restrictions on the use of CABs—or back-loaded debt structures, generally—might preclude districts from beneficial transactions such as financing needed facilities or obtaining savings by refinancing debts,280 or might push them towards using less desirable financing options. These issues would be of particular concern for rapidly growing school districts, property-poor districts and districts where assessed valuations have declined—all of which may be particularly likely to issue CABs to avoid violating estimated tax rate limits.281

Waivers. Allowing a state entity to authorize CABs issuances that would otherwise be prohibited would provide additional flexibility and input from experts.282 A statewide agency approving bonds or waiving

280. Supra note 257 and accompanying text.
281. See supra Section IV (discussing rapidly growing school districts, property-poor districts, and districts where assessed valuations have declined).
282. Another alternative would be to give a county official or agency, such as the County Treasurer or County Department of Education, authority to grant a waiver. See Statement by Dan McAllister, San Diego County Treasurer-Tax Collector, Capital Appreciation Bonds 5 Point Plan Goals (2016) (on file with author) (suggesting, prior to the passage of AB 182, that school district CABs be approved by either the County Superintendent of Schools or the County Board of Supervisors, and that issuances outside of certain parameters be approved by the County Superintendent of Schools); see also CAL. ASSN OF CTY. TREASURERS & TAX COLLECTORS, SCHOOL FINANCE COMMITTEE, SCHOOL FINANCE HANDBOOK FOR TTCs 18–19 (2015) (suggesting greater county involvement in school district general obligations that fall outside of specified parameters); L.A. Cty. CIV. GRAND JURY REPORT, supra note 86, at 127 (recommending greater involvement by County Office of Education, Auditor, Treasurer-Tax Collector and others in school district financings). While county officials and agencies would be more familiar with the needs of the region, allowing waivers at the county level is likely to lead to inconsistent policies within the state and,
restrictions on bond issuances is not a novel concept. In California, the State Board of Education currently waives the limit on general obligation debt as a percentage of assessed valuation for school districts and is authorized to waive some of the new restrictions on CABs in limited circumstances.\footnote{See \textit{Dayton}, supra note 42, at 45 (noting that between 2000 and 2014, fifty-one waivers of the limit on general obligation debt as a percentage of assessed valuation were requested, of which forty-eight were approved).} In North Carolina, local governments cannot issue any general obligation bonds without the approval of the North Carolina Local Government Commission.\footnote{\textit{N.C. Gen. Stat. Ann.} \S\ 159-51 (West 2016).} CDIAC and the TBRB might be the appropriate entities to grant waivers of restrictions on CABs in California and Texas, respectively.\footnote{\textit{Tex. Bond Review Bd.}, \textit{Agency Overview}, http://www.brb.state.tx.us/agency/about_brb.aspx [https://perma.cc/HEY3-GUKP].} CDIAC’s role is to provide “information, education and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals,”\footnote{\textit{Cal. Debt & Inv. Advis. Comm’n}, \textit{About CDIAC}, \textit{Cal. St. Treasurer}, http://www.treasurer.ca.gov/cdic/cdic/introduction.asp [https://perma.cc/H6GU-GYLB].} while TBRB’s mission is, in part, “to support and enhance the debt issuance and debt management functions of state and local entities.”\footnote{See David Gamage & Darien Shanske, \textit{The Case for a State-Level Debt-Financing Authority}, 67 ST. TAX NOTES 188, 193 (2013) (identifying CDIAC as an appropriate entity to approve debt issuances in conjunction with a reduction in voter approval thresholds for local government debt).} CDIAC and TBRB would have the general financial expertise and, particularly if they were responsible for granting waivers of the limitations on CABs, the expertise with CABs specifically, to determine whether a waiver was appropriate in a particular case. In California, the State Board of Education would be another possibility—this board already provides some waivers.\footnote{\textit{Dayton}, supra note 42, at 44–45 (analyzing waiver requests and approvals between 2000 and 2014).} particularly in smaller counties, the person or people responsible for granting the waiver may not have significantly more expertise than the individuals at the school district.
Alternative Funding. Banning or restricting the use of CABs would have the effect of restricting the funding available to school districts that could not issue CIBs without violating the applicable expected rate limit. If the facilities these districts would otherwise finance are needed, an alternative funding source would have to be found.

In new developments, developer fees are one option. California school districts are authorized to levy fees on developers for the construction or reconstruction of school facilities, though Texas school districts do not have this authority under current law. Bonds payable from other property-based taxes that are not subject to the expected rate limit, such as Mello-Roos taxes in California, are another alternative, particularly for new developments (where a developer can approve the tax before there are multiple property owners). However, both of these forms of financing are more advantageous to developing areas than to existing communities, and increasing their use may further encourage urban sprawl and exacerbate already existing funding disparities.

Alternatively, the state could provide additional loans and grants, ideally in a way that targets districts with the greatest needs and that are most adversely impacted by the prohibition or restriction on the use of CABs. It is likely there would be political resistance to perceived redistribution of wealth from some regions of the state to others, and there is a risk that

289. CAL. EDUC. CODE § 17620(a)(1) (Deering 2016).
290. See TEX. LOC. GOV'T CODE ANN. §§ 395.001, 395.012 (West 2015 & Supp. 2017) (providing impact fees may be collected only for specified purposes, which do not include schools).
292. See Darien Shanske, Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis, 43 U. MICH. J.L. REFORM 663, 669 (2010) (suggesting Mello-Roos taxes encourage urban sprawl).
293. Some suggest “[p]eople are much more willing to tax themselves to pay for public education in their own local communities” than in other communities. Isabel Rodríguez-Tejedo & John Joseph Wallis, Lessons for California from the History of Fiscal Constitutions, 2 CAL. J. OF POL. & POL'Y, no. 3, 2010, at 1, 15, available at http://escholarship.org/uc/item/72b124q1 [https://perma.cc/L857-B46P]; see FISCHEL, supra note 104, at 98–118 (asserting the court-mandated shift of school funding from local communities to the state led to the 1978 voter approval of Proposition 13, which severely limits property taxes in California). This proposition was debated in the UCLA Law Review. See Kirk Stark & Jonathan Zasloff, Tribute and Tax Results: Did Serrano Really Cause Proposition 13?, 50 UCLA L. REV. 801, 801 (2003); see also William A. Fischel, Did John Serrano
political factors would result in a less than optimal distribution of these resources. Nevertheless, grants or loans may be a better solution than the alternatives of denying these districts needed facilities, allowing them to issue CABs through a waiver program, or pushing them towards using more expensive and less desirable lease revenue bonds or certificates of participation. 294 A targeted state grant or loan program could instead assist in addressing some of the inherent inequity of a system that relies largely on property tax revenues to finance capital projects for school districts: that tax rates in property-poor districts must be higher than in property-rich districts to pay for comparable facilities.

B. Reducing Incentives to Use CABs

Reducing incentives to use CABs could eliminate many instances of misuse, and might have other benefits as well. While some circumstances that encourage the use of CABs—such as rapidly growing student populations or the desire to maintain substantially level tax rates—cannot be changed, others can. Some of these are discussed below.

Re-evaluating Tax Rate Limitations. Debt limits and other restrictions may simply encourage the development of alternative means of accomplishing the same objectives; means that are “usually more complex, more expensive, and typically are not discussed in public forums in ways that are intelligible to the public and elected officials.” 295 CABs are an
example of this to the extent they are used to avoid violating the expected rate limits. Thus, it is critical that the expected rate limits be evaluated to determine whether they are appropriate or should be modified.

Current expected rate limits may be unduly restrictive and create more problems than they solve. Assessed valuations may have increased at a slower rate than inflation, and as a result, taxes at the specified limit may be less burdensome than was contemplated when the restrictions were put in place. A legislature might conclude that the relevant expected rate limit should be higher or even eliminated in some or all circumstances. For example, in 2015, the Texas Legislature considered a proposal to raise the estimated tax rate for rapidly growing school districts as long as they met certain conditions. A 2011 Texas bill would have replaced the current test with a cap on the amount of outstanding debt as a percentage of assessed valuation. While these bills ultimately failed, it is possible a legislature would find a different modification appropriate (or find the same modification appropriate at a different time). The elimination or relaxing of expected rate limits almost certainly would reduce the use of CABs.

On the other hand, a legislature might determine that the applicable expected rate limitation is appropriate, or even that the limit should be more restrictive. Expected rate limits certainly provide protection to current taxpayers and at least some protection to future taxpayers. If a limit is retained, additional protection should be provided to future more expensive and less transparent). But see Farnham, supra note 34, at 1198 (finding limits reduce debt levels but voter approval requirements do not).

296. This is particularly true in California, where Proposition 13 (passed in 1978) limits assessed valuation increases. CDIAC PRIMER, supra note 30, at 85–86. Inflation has averaged 4.1% per year since 1978 while assessed valuation increases are capped at the lesser of inflation or 2% absent a change in ownership or new construction. CAL. LEGIS. ANALYST’S OFFICE, CALIFORNIA’S PROPERTY TAX 1 (2012), http://www.lao.ca.gov/handouts/state_admin/2012/CA_Property_Tax_4_11_12.pdf [https://perma.cc/E3QD-MNWP].


299. A binding limit on tax rates would provide greater protection, but because it also would increase the risk to bondholders, interest rates on the bonds would be higher and the ability to issue debt might be constrained. The expected rate limit for California school districts was originally drafted as a tax rate cap, but was transformed into an expected rate limit before it took effect because of these concerns. See Assemb. B. 1908, 1999–2000 Leg., Reg. Sess. (Cal. 2000) (authorizing a cap on the tax rate to be levied to pay debt service on bonds authorized under the California 55% Regime); SCOTT, supra note 49, at 12–14 (explaining the initial requirement of California AB 1908 as an “absolute, ironclad limit on tax rates to be levied to repay bonds under Prop. 39” and the change to a limit on the projected tax rate, and describing its replacement with an expected rate limit).
taxpayers. For example, the legislature could impose reasonable parameters on assessed valuation growth assumptions for purposes of calculating compliance as the Texas legislature has endeavored to do, or could require that projections take into account those made by the county assessor, as a new California law requires for school boards ordering bond elections.\textsuperscript{300} Reducing the ability of school districts to issue bonds based on overly optimistic assumptions about assessed valuation growth would be likely to reduce the use of CABs and other back-loaded debt structures. A prohibition on CABs or a requirement that property taxes be levied as interest compounds also would protect future taxpayers, though these options come with significant problems.\textsuperscript{301}

**Par to Par Refunding Requirement.** The Texas constitutional provision that limits the amount of school district general obligation refunding bonds that can be issued without voter approval to the principal amount of the bonds being refinanced,\textsuperscript{302} and similar provisions, should be reevaluated. It may be that replacing this restriction with one that requires that the refunding bonds result in overall debt service savings or even annual debt service savings would better protect taxpayers and would eliminate one of the motivators for CABs in states that have provisions of this type.\textsuperscript{303}

**Modifying the Promises Made to Voters.** School districts use CABs to simultaneously meet commitments to voters about tax rates and capital projects.\textsuperscript{304} While a state would not be likely to (nor should it) prohibit school districts from disclosing planned capital projects or estimated tax rates to voters, it could require that other information be provided to change the perception of what is being promised. This could discourage, or at least reduce the motivation for, using CABs. For example, requiring the total expected cost of repayment of the debt to be included with ballot

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\textsuperscript{300} TEX. EDUC. CODE ANN. §§ 45.0031(b), (c) (West 2012); see CAL. EDUC. CODE § 15100(c) (Deering 2016) (requiring school boards ordering bond elections to obtain assessed valuation projections that take into account those made by the county assessor). Although there is no similar mandate for determinations of compliance with expected rate limits, having the requirement in another context increases the likelihood that the same practice will be followed here.

\textsuperscript{301} See supra Section VI.A., “Problems with Prohibiting or Restricting the Use of CABs” and infra “Collecting Property Taxes Throughout the Life of the CABs.”

\textsuperscript{302} See supra Section IV.F.

\textsuperscript{303} Admittedly, where, as in Texas, the provision is in the state constitution, it will be more difficult to modify the provision since doing so would require a constitutional amendment.

\textsuperscript{304} See supra Section IV.B., “Keeping Promises to Voters.”
materials, as became required in California beginning in 2015, might deter districts from using more expensive debt structures. Similarly, requiring disclosure of the assumptions used in estimated tax rate calculations, a clear statement that actual rates may be higher in ballot materials—and perhaps anywhere else that districts publish the estimated rates—and statements that projects might not be completed in some circumstances (for example, if issuing the bonds necessary to complete them were projected to raise tax rates over specified levels), or some combination of or all of the above, could reduce the sense that estimated rates and listed projects are “promises.” Even if this did not reduce the use of CABs, it would make important information more readily available to the public.

Establishing reasonable parameters for assessed valuation growth assumptions for purposes of calculating projected tax rates included with ballot materials also might reduce the use of CABs because there would be less likelihood that school district boards and officials would face difficulties keeping the “promise[s]” made to voters about tax rates and capital projects. A California law that requires school boards ordering an election to obtain “reasonable and informed projections of assessed property valuations that take into consideration projections of assessed property valuations made by the county assessor” beginning in 2017 is a step in the right direction. Although the new law does not specify a projection methodology or require that the assessor’s projections be used, there likely is a benefit to the board having this information from the party that is responsible for determining the taxable value of property in the county. Further, while the requirement does not speak directly to the projections that are provided to voters, it is likely that school boards would provide tax rate estimates based on these projections or if they did not, that they would have a reasoned basis for basing estimates on different projections.

In addition, counting interest on CABs against voter authorization and, in California, limits on debt as a percentage of assessed valuation, would

305. CAL. EDUC. CODE § 9401(a)(4) (Deering 2016).
306. See ORANGE CTY. GRAND JURY, SCHOOL BONDS, supra note 83, at 31, 33 (suggesting districts make assessed valuation assumptions supporting historical data and an explanation of the basis for the assumptions available to voters).
307. See supra Section IV.E. for discussion of these assumptions.
308. CAL. EDUC. CODE § 15100(c) (Deering 2013 & Supp. 2017).
more clearly comply with the binding promises made to the voters not to issue debt exceeding these limits. This is discussed in Section VI.C.

**Re-evaluating Matching Fund Requirements and Providing Alternative Funding Sources.** State grants that cannot be accessed unless the district is contributing funds to the project encourage districts to issue CABs to maximize the amount the district can contribute to the project (and hence the amount of state funding it can receive). These incentives should be considered when evaluating the costs and benefits of matching fund programs and contemplating alternative funding approaches. Similarly, alternative funding sources for school districts, particularly for districts that may have stronger incentives to issue CABs, may alleviate some of the pressures to use this financing structure.

**Collecting Property Taxes throughout the Life of the CABs.** If state law required school districts to collect property taxes to pay interest as it compounded, they likely would issue far fewer capital appreciation bonds since one of the principal reasons they use CABs is to avoid tax increases in the near term (because of expected rate limits or otherwise). Districts would still have the flexibility to issue CABs (at least if they weren’t constrained by expected rate limits) if doing so were the most cost-effective financing method in the circumstances.

To the extent a district did issue CABs, taxpayers would be paying for debt service through the life of the bonds, addressing one of the major problems with this type of debt. School districts and other issuers could either pay the principal and interest compounded on that principal over a period of several years, or invest amounts collected until the time payment is due on the bonds. While requiring funds to be put aside far in advance of scheduled payment dates is uncommon for tax-exempt bonds, some taxable municipal bond transactions include these provisions.

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309. In the case of tax-exempt bonds, school investment of these amounts would be subject to provisions of Section 148 of the Internal Revenue Code and related regulations that restrict the yield on such investments to the yield on the bonds. 26 U.S.C. § 148 (2012).

Requiring taxes to be levied as interest compounds would be consistent with accrual accounting principles, under which interest would be treated as an expense as it compounds.311 Such a requirement also would be consistent with the treatment of interest that is not paid until maturity (such as interest on CABs) and original issue discount for federal income tax purposes. Under the Internal Revenue Code and related regulations, these amounts generally are included in income and deducted as expenses as they accrue over the term of the debt.312

However, requiring the collection of taxes to pay interest as it compounds would prevent districts that were constrained by expected rate limits from issuing general obligation bonds at all. Like prohibiting or restricting the use of CABs, this approach could prevent districts from completing needed projects, and might disproportionately affect rapidly growing and property-poor districts. As a result, a waiver program or alternative funding sources might be needed.

C. Providing Additional Information, Training, Guidance, or a Combination of These

A third approach, driven by concerns that school districts issue CABs without understanding the ramifications of doing so, is to require that additional information be presented to district officials and the public, to provide training and support to governing boards and officials, and to strengthen the ability of districts to negotiate with financial advisors and underwriters. In a similar vein, counting compounded interest against voter-authorized amounts and, in California, the limit on debt as a percentage of assessed valuations, would make the true amount of debt being incurred clearer both to school district board members and officials, and to the public.

311. See supra notes 123–29 and accompanying text.

Requirements to Provide Information. Both AB 182 and HB 114 require that school boards and the public receive additional information about CABs issuances, including information on overall debt service and the assumptions that are being made about growth in assessed valuations. Some districts have refinanced their CABs in recent years, even when doing so increased taxes in the short run, presumably in response to greater awareness and negative public attention given to CABs. On the other hand, issuances of general obligation CABs by California school districts increased significantly in 2015 despite the additional information requirements included in AB 182. However, even if additional information does not ultimately reduce issuances of CABs, it will increase board members’ and district officials’ understanding of the implications of the actions they are taking and public awareness, thereby possibly preventing some of the most problematic issuances.

313. See Assemb. B. 182, 2013–14 Leg., Reg. Sess. (Cal. 2013) (mandating the presentation of additional information to school boards and the public on bonds sales that allow for the compounding of interest); see also TEX. GOV’T CODE ANN. §§ 1201.0245(b), (d) (West Supp. 2017) (requiring additional information be provided to the school board, included in the board’s minutes and posted on the district’s website). The California Association of County Treasurers and Tax Collectors similarly recommends that boards considering a bond measure receive information about the assumed assessed valuation growth rates reflected in tax rate projections and information about historic assessed valuation growth. See CAL. ASS’N OF CTY TREASURERS AND TAX COLLECTORS, supra note 283, at 9, 18 (recommending the board be presented with information about assumptions, expected use of CABs and other information).


315. See CAL. DEBT & INV. ADVISORY COMM’N, Capital Appreciation Bond Issuance – After the Passage of AB 182, DEBT LINE, June 2016, at 3 (showing an increase in CAB issuance of $665 million from 2014 to 2015).
Another step in the direction of transparency would be to require school districts and other issuers to post debt service schedules for all their general obligation bonds as well as estimates of future tax rates and the assumptions underlying those estimates on their websites, or, better yet, to provide this information to the state for posting on sites like the Texas Comptroller’s “Texas Transparency” site and the California Treasurer’s “Debt Watch” site. While, at least in many cases, overall debt service schedules can be located on the MSRB’s electronic municipal market access web site, members of the public likely would not know to go to a site designed for municipal bond investors and might have difficulty locating the information. Information about estimated future tax rates and the assumptions underlying those estimates would be even more difficult to locate. Having this information readily available would improve transparency and would be a step towards capitalization of debt service structures into home values.

Training and Other Support. Additional education of school boards and district staff members would increase their understanding of the implications of capital appreciation bonds, and of debt financings generally.

In addition to training, information about what other districts are doing and the fees and interest rates that other districts pay could assist districts in their decision-making. It is particularly difficult for issuers and their advisors to compare fees and valuations for more complicated types of bonds (since CABs are far less common than CIBs they likely would fall in this category). While some information about costs of issuance and

318. ELECTRONIC MUN. MKT. ACCESS (EMMA), supra note 223.
319. Others have recommended providing more education and training about bonds and debt management. See U.S. ADVISORY COMM’N, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT, supra note 212, at 43–45 (“Just as many State tax agencies are now providing in-service training for local assessors, so should the States be instructing local finance officers in the intricacies of borrowing money.”); see also Bill Simonsen, et al., supra note 214, at 715 (recommending counties or states provide “advisory services and technical assistance,” including training, to smaller governments, though noting that training alone may not be sufficient).
320. Ang & Green, supra note 77, at 10.
interest rates is available from CDIAC and the TBRB, the information is not complete. For example, the yield is provided for the entire bond issue, not for each series or maturity, and there is a lag between the time fees and interest rates are established and the time the information is available through these entities; other local governments are unlikely to know the specific reasons for variations in costs. While this information is valuable, it does not provide issuers with all the information they need to evaluate the rates they are receiving.

Other types of assistance also would be beneficial. For example, the Los Angeles County Treasurer and Tax Collector’s Office developed a set of form documents that several school districts used to competitively bid for bond counsel, financial advisors and underwriters. Such forms have reportedly saved the districts “tens of thousands of dollars.” The availability of one-on-one guidance from an entity like CDIAC or the TBRB, or even the option of having one of these entities or another state agency manage the bond issuance process for school districts on a purely voluntary basis would be valuable. In addition to potentially preventing school districts from entering into transactions that would be disadvantageous and helping eliminate information asymmetries regarding fees and interest rates, access to disinterested technical expertise could enable districts to evaluate the risks of more complex or unusual transactions and enter into these transactions when it was beneficial to do so.

Additional Regulation of Financial Advisors and Underwriters. Financial advisors and underwriters are already regulated at the federal

323. Id.
324. The Advisory Commission on Intergovernmental Relations made similar suggestions in 1965. U.S. ADVISORY COM’N, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT, supra note 212, at 46–47, 55–58. More recently, commentators suggested creating a nonprofit that, among other things, would provide affordable, independent advice to municipalities. Ang & Green, supra note 77, at 6, 13–15, 17.
325. See Whitaker, supra note 213 (noting lack of expertise may lead smaller local governments to avoid complex transactions even when they would be beneficial).
level, but additional state regulation also may be appropriate. This would not be unprecedented. California already has laws that regulate some aspects of the relationship between local governments and their financial advisors and other laws have been proposed but not adopted.

State and local government agencies might also take independent actions to curtail underwriter and financial advisor behavior that they deem inappropriate. For example, in 2012 the California Treasurer threatened to exclude underwriters involved in “egregious” California school district CABs issuances from state bond issuances if they did not restructure the transactions, though he ultimately did allow them to participate in the state’s bond issuances. In 2016, the California treasurer announced that underwriters, financial advisors, and bond counsel that make cash or in-kind contributions to, or provide certain types of services in support of, bond election campaigns in the state would not be eligible to provide services on state bond issuances. Similarly,

326. For example, the activities of underwriters and municipal advisors are regulated under the Securities Exchange Act of 1934 (which is codified at Title 15 of the United States Code at Section 74(o-4)) and the Municipal Securities Rulemaking Board establishes rules that underwriters and municipal advisors must follow. See MSRB Rules and Guidance, MUNICIPAL SEC. RULEMAKING BOARD., http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx [https://perma.cc/WFD6-QQ5B] (providing text of the MSRB rules governing underwriters and municipal advisors).

327. See, e.g., CAL. GOV’T CODE §§ 53591, 53592 (Deering 2011) (requiring written contracts and prohibiting financial advisors from being compensated on the basis of a percentage of the amount of bonds sold and from purchasing bonds for which they served as financial advisor directly from the issuer).

328. For example, bills have been introduced that would have prohibited local governments from hiring underwriters, financial advisors, or lawyers to provide services for issuances of general obligation bonds if those outside consultants had provided campaign services in support of or contributed to the ballot measure under which the bonds were approved. Assemb. B. 621, 2013–2014 Leg., Reg. Sess. (Cal. 2014); Assemb. B. 1045, 2011–2012 Leg., Reg. Sess. (Cal. 2012); S.B. 623, 2009–2010 Leg., Reg. Sess. (Cal. 2010); S.B. 1461, 2009–2010 Leg., Reg. Sess. (Cal. 2010); Assemb. B. 2011, 2007–2008 Leg., Reg. Sess. (Cal. 2008). One of these bills also would have prohibited local governments from hiring the same firm as financial advisor and as underwriter for a bond issue. Assemb. B. 621, 2013–2014 Leg., Reg. Sess. (Cal. 2014).


Los Angeles County prohibits underwriters that make cash contributions or provide in-kind services to promote school district or community college district general obligation bond ballot measures in California from selling county debt.331

Counting Compounded Interest Against Debt Limits. As was discussed in Section III.C., interest that compounds on capital appreciation bonds is not counted against voter-authorized amounts and limits on total debt outstanding. Counting compounded interest for these purposes would be consistent with its accounting and tax treatment and would make the true amount of debt clearer to both school district officials and to the public.

Rather than requiring school districts to determine compliance with debt limits as the interest compounds, state law could instead mandate that the anticipated compounded interest (to the extent not already included in the portion of original issue premium counted against voter authorization) be included in compliance calculations at the time the bonds are issued. This would eliminate the risk that a limit would not be met at the time the interest compounds. For example, if assessed valuations declined after bonds were issued, the interest might violate a limit on debt as a percentage of assessed valuations like the one applicable to California school districts even if it would not have (had it been included at the time the bonds were issued)—a risk that bond purchasers presumably would be unwilling to bear without charging higher interest rates as compensation. In addition, this approach would impose a smaller administrative burden on districts than a requirement that they recalculate compliance each time interest compounds. If a series of CABs were to be repaid prior to maturity, any interest that did not ultimately compound could be available again for a concurrent or future bond issuance.

331. See CTY. OF L.A. TREASURER AND TAX COLLECTOR, REQUEST FOR STATEMENT OF QUALIFICATIONS LOS ANGELES COUNTY UNDERWRITER POOL app. A at 2 (2015), [https://perma.cc/4XQK-YLKV] (“Firms in the Underwriter Pool are prohibited from making cash contributions or providing in-kind services to promote or facilitate California school or community college district campaigns for general obligation bond ballot measures.”); see also Memorandum from Mark J. Saladino, supra note 322 (describing the reasons for the prohibition).
Counting the full amount of interest at the time the debt is issued would arguably result in over-counting against the voter-authorized amount since the present value of interest that will compound in the future is less than the total dollar amount of that interest. Furthermore, counting all interest that is expected to compound against limits on outstanding debt as a percentage of assessed valuations—such as the limit that applies to California school districts—at the time of issuance would, in effect, make these limits more restrictive to the extent that a district had outstanding debt that was scheduled to be repaid before the interest would compound. Nevertheless, the cost of this approach is small when compared with the problems created by testing the total debt against the limit as interest compounds.

While the result of such legal changes might simply be that voters are asked to (and do) approve higher amounts of debt and that California school districts apply for waivers of the outstanding debt limit more frequently, these changes would still have a positive impact in that the full amount of debt would be clearer to elected officials, administrators and voters.

VII. CONCLUSION

As the use of CABs by California and Texas school districts demonstrates, local governments have incentives to defer debt service to benefit today’s population at the expense of future residents, and these incentives are intensified in some circumstances.

In theory, the problems associated with CABs and with back-loaded debt service structures, generally, could be solved by requiring substantially level debt service (allowing adjustment for expected inflation) on all bond issuances, and by treating compounding interest as debt service and requiring taxes to be levied in an amount sufficient to pay the interest as it compounds. This would prevent the disproportionate burdening of future taxpayers while still allowing CABs to be used when they resulted in lower debt service costs.

In practice, however, this solution would make it more difficult for issuers to maintain level tax rates, and in many instances, would result in higher near-term tax rates—particularly in districts that already have outstanding debt and in rapidly growing areas. Districts that already have outstanding debt would not be able to structure new debt around their existing debt. In rapidly growing areas, facilities are being constructed to
support a growing population and are expected to be paid by a larger future assessed valuation base. Higher near-term tax rates would make it politically more difficult to issue debt and might result in underinvestment in infrastructure. Furthermore, requiring substantially level debt service would prevent some issuers that are subject to expected rate limits from incurring any debt or making any significant investment in infrastructure.

Thus, states are confronted with the challenge of restricting the ability of local governments to issue CABs (or back-loaded debt generally), or reducing their incentives to do so without driving them to use less desirable financing options, preventing the construction of needed facilities, or impeding refinancings that result in lower debt service. The appropriate solution will vary from state to state and may differ for different types of local governments depending on factors such as: other state laws, the importance that a state places on local control, the severity of infrastructure needs, and the availability of alternate funding sources. Nevertheless, some general principles apply.

First, addressing the incentives that lead local governments to issue CABs is likely to be more effective than restricting or prohibiting CABs or back-loaded debt. Even the most carefully tailored restrictions will prevent some transactions that are socially desirable and allow some transactions that are not. Further, issuers and their advisors will search for ways to meet their objectives without violating the restrictions. The means they employ—such as lease revenue bonds, COPs, and potentially others—are likely to be more expensive or less transparent than general obligation CABs would have been, and may also create other problems.

Thus, as an initial step, states should evaluate their existing laws to determine whether these laws are fulfilling their intended purposes and to what extent they are increasing incentives to issue CABs. For example, states that impose expected rate limits on some or all local governments (as California and Texas do on school districts), should evaluate these limits since they are one of the principal reasons that CABs are used. If these limits are to be retained, states should consider setting reasonable parameters for calculating projected assessed valuations. States with par-to-par refunding restrictions should consider the merits of those limits and whether they can be modified.

States also should consider whether aspects of their systems for financing infrastructure are increasing incentives to issue CABs and, if so, whether these systems should be modified. States that only provide funding for capital projects if local governments provide matching funds
may choose to reconsider these requirements. States may also consider implementing or expanding grant or loan programs that target areas of particular need such as rapidly growing districts or property-poor districts with aging infrastructure. Of course, infrastructure funding is complex and there are numerous considerations involved in the structuring of financing programs. Incentives to issue CABs are but one factor that should be evaluated.

Second, adequate training about debt and capital financing for local government board members and officials and access to expertise is very important. Training and access to experts would allow local governments to make better decisions for their communities not only with respect to CABs and other back-loaded debt, but with respect to infrastructure financing generally. The extent to which the involvement of state experts in financings is mandated or is at the option of the local government, likely will vary from state to state depending on the importance that a state and its residents place on local control.

Finally, making information about the amount and structure of local government debt and about expected future tax rates and the assumptions underlying them to both local government board members and officials, and to the public is important. Counting compounded interest against debt limits (at least absent a requirement that taxes be levied to pay that interest as it compounds) is a critical component of this. Clear, accurate, and accessible information is important for local governments to make good decisions and for the public to be able to effectively participate in the democratic process.

Given the important role that local government debt plays in the construction of public infrastructure in United States and the country’s looming infrastructure needs, these problems cannot be ignored.
CHAPTER 4
A LITTLE HELP FROM OUR FRIENDS: MOVING BEYOND ENFORCEMENT TO IMPROVE STATE AND LOCAL GOVERNMENT COMPLIANCE WITH FEDERAL SECURITIES LAWS

[attached]
A LITTLE HELP FROM OUR FRIENDS: MOVING BEYOND ENFORCEMENT TO IMPROVE STATE AND LOCAL GOVERNMENT COMPLIANCE WITH FEDERAL SECURITIES LAWS

Heather G. White*

State and local government borrowing affects Americans’ daily lives. Most of this borrowing is in the form of bonds sold to investors. These bonds are used to finance schools, roads, airports, power transmission systems, hospitals, and other infrastructure that we use regularly. The U.S. Securities and Exchange Commission (the “SEC”) has an important role in protecting investors that buy and sell these bonds, including by ensuring that investors have accurate and complete information about the securities they are buying. The SEC is in a position to see what state and local governments are doing throughout the country, and its actions impact these governments nationwide. This article discusses several aspects of the internal policies and practices of state and local governments that have been identified by the SEC as leading to inadequate disclosure, how the SEC has responded to these factors, and whether there are better ways for the SEC, for states, or for other entities to address them in the future. The article concludes that although recent SEC enforcement of securities laws has caused state and local government issuers to make positive changes, there is little to be gained by additional aggressive enforcement. Instead, interpretive guidance from the SEC and support and guidance from state governments and others could more effectively guide issuers towards improved disclosure, and towards better debt management in general.

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* Ms. White is a practicing public finance lawyer affiliated with Nixon Peabody LLP and is a fellow in the Taxation Law and Policy Research Group at the University of Western Australia Law School. Thanks to Rick Krever and to my professional colleagues for helpful comments. All errors are my own. The information contained herein is of a general nature and meant for educational purposes. No legal advice is being provided and no one should rely on the information contained herein with respect to a specific legal issue they may have; you are advised in the event you need specific legal advice to seek your own counsel.
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INTRODUCTION

Although most people give them little (if any) thought, “municipal bonds touch every aspect of our lives.”¹ State and local governments issue hundreds of billions of dollars of debt securities (referred to as “municipal bonds”) annually.² These bonds are important not only because of the volume of issuance, but because they provide funds to build and improve vital public infrastructure ranging from schools, hospitals and roads to airports, power transmission systems and ports.³ They matter not only to the investors that buy and trade them, but to taxpayers and residents of every community in the United States.

Like corporate securities, municipal bonds are sold to and traded by investors. A well-functioning municipal bond market is essential to these investors, to the state and local governments that issue and sell bonds, and, ultimately, to the nation’s economy.⁴ It is important to state and local governments and to investors that municipal bonds are priced fairly and that investors have confidence in the market.⁵

The U.S. Securities and Exchange Commission (the “SEC”) plays an important role in maintaining the integrity of U.S. securities markets, including the municipal bond market. Its duties include enforcing the Securities Act of 1933, as amended (the “Securities Act”), and the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), the two principal bodies of law governing the sale of securities in the United States. The purposes of the Securities Act include “provid[ing] full and fair disclosure of the character of securities


³. See Ceresney, supra, note 1 (“[I]f your children attend a public school or a university; if you have been treated at a local hospital; if you have visited a library, park or sports facility; if your parents reside in an assisted living facility; if you took the subway, or drove on roads or bridges or through a tunnel today; even if you turned on your tap water this morning, you are likely seeing the tangible results and benefits of the municipal securities marketplace.”).

⁴. See infra Section II.A.

⁵. See Paul S. Maco, Building A Strong Subnational Debt Market: A Regulator’s Perspective, 2 Rich. J. Glob. L. & Bus. 1, 4 (2001) (noting that fair and efficient markets are important to subnational governments and to investors buying their securities). See also infra section II.A.
sold . . . and prevent[ing] frauds in the sale thereof . . . .”\textsuperscript{6} The purposes of the Exchange Act include “provid[ing] for the regulation of securities exchanges and of over-the-counter markets . . . [and] prevent[ing] inequitable and unfair practices on such exchanges and markets.”\textsuperscript{7}

The SEC is in a position to see what state and local governments issuing bonds (sometimes referred to in this article as “municipal issuers” or “issuers”) are doing throughout the country, and its actions influence the behavior of issuers nationwide. In recent years, the SEC has increased the level of enforcement activity in the municipal market and has acted against state and local governments that do not appear to have intentionally or recklessly deceived investors, but rather have internal practices that have unwittingly led to inaccurate or misleading disclosure. It also has required modifications to internal policies and practices as part of settlements with state and local governments. As one commentator put it, “. . . the new frontier in municipal securities enforcement is as much about imposing discipline on poorly managed local governments as it is about policing fraud.”\textsuperscript{8}

The SEC has identified several factors that are common among local governments and that result in inadequate disclosure—in particular, political pressure to avoid giving bad news, compartmentalization, failure to clearly identify who is responsible for disclosure and compliance, lack of training and experience with municipal securities and disclosure, and failure to recognize the importance of compliance with disclosure obligations. While the SEC’s purpose in addressing these factors is to protect investors, doing so may also benefit citizens and taxpayers. However, the SEC’s use of enforcement actions as a principal means of communicating with the municipal market is costly to state and local governments (particularly those against which the SEC has taken enforcement proceedings), and ultimately to taxpayers.

This article discusses the SEC’s increased activity vis-à-vis state and local governments, the factors that it has identified as leading to


deficient disclosure by state and local governments, and how it has addressed them through recent enforcement actions. It considers the effectiveness and costs of the SEC’s actions and suggests that while enforcement has served an important purpose and has led to positive changes in municipal issuer behavior, there are better means for the SEC and others to address these issues going forward.

Parts I and II of this article provide context for the discussion. Part I provides an overview of the municipal securities market. Part II presents the relevant aspects of federal regulation of municipal securities, then describes the SEC’s role in enforcing federal securities laws and constraints on its ability to act with respect to municipal bonds. The SEC’s recent activity in the municipal securities market, the problems the agency identified, and how the agency addressed these problems are then discussed in Part III.

Part IV of this article considers the impact of the SEC’s enforcement actions and explores alternative methods of addressing the problems identified by the SEC. The article concludes that although the SEC’s recent enforcement actions have been effective, there is little to be gained by ongoing aggressive enforcement actions by the SEC, and that additional interpretive guidance from the SEC and additional support and guidance from state governments and others would be a better means of improving disclosure, and potentially could improve debt management in general.

I. OVERVIEW OF THE MUNICIPAL SEcurities MARKET

A. Municipal Bonds

Approximately $448 billion of municipal bonds were issued by more than 7,500 unique state and local government issuers and more than $3.8 trillion of municipal bonds were outstanding in 2017.9 The

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state and local governments issuing municipal bonds range from small school districts and special districts to large states with populations of tens of millions. They issue bonds primarily to finance and refinance capital projects.10

1. Municipal Bonds Are Not All the Same

There are a wide variety of municipal bonds. Municipal bonds may bear interest at a rate that does not change (a “fixed rate bond”) or at a rate that changes periodically based on market conditions or a predetermined index (a “variable rate bond”).12 Principal and interest on municipal bonds may be paid from a single source or a combination of sources, including property taxes, sales taxes or other taxes, the local government issuer’s general fund, or revenues from a particular project, such as a utility system or an airport.13 Municipal bonds may also include other terms, such as a requirement that they be repaid before their final maturity date on a predetermined schedule or upon the occurrence of specified events, or at the option of the issuer or the owner of the bond.

Payment of principal and interest on some municipal bonds is guaranteed by a bank or a bond insurer, though this has become less common since the 2008 global financial crisis.14 Use of bond insurance declined from approximately 57% of issuances being insured in confinement of public finance to the debt markets is both historical and a by-product of the economics of capitalism.”). Local governments also issue shorter term debt securities referred to as “notes,” which are subject to some, but not all, of the same regulations.


11. See DRIESEN, supra note 9, at 6 (“Long-term tax-exempt bond issues also can be characterized by their status as new issues or refunding issues (refundings). New issues represent bonds issued to finance new capital facilities. Refundings usually are made to replace outstanding bonds with bonds that carry lower interest rates or other favorable terms.”).


13. See id. at 7 (describing some sources of payment for municipal bonds). Principal and interest on some municipal bonds are paid by a non-profit or for-profit third party. Id. The involvement of a third party raises distinct issues that are beyond the scope of this article.

14. Id. at 10–11.
2005 to approximately 19% in 2008 and approximately 4% in 2012.\footnote{15} Before rebounding slightly to approximately 6% in 2015 and 2016.\footnote{16} Prior to the global financial crisis, bond insurance was primarily provided by insurers that had AAA credit ratings (the highest rating),\footnote{17} and the large number of bonds insured by highly rated insurers provided a perception of greater similarity among bonds to investors, who believed they could rely on the insurer to pay debt service if the issuer could not.\footnote{18} As bond insurers were downgraded or went bankrupt in the wake of the global financial crisis,\footnote{19} and as fewer bonds were insured, this perceived homogeneity was lost, and investors focused more on disclosure and the risks of the bonds they were buying.\footnote{20}

2. Municipal Bond Defaults Are Rare, But They Do Occur

Defaults on municipal bonds are rare, but they do occur, and defaults have been somewhat more frequent since 2008 than they were in the preceding thirty-seven years. The five-year default rate for municipal bonds rated by Moody’s Investors Service, one of the three main organizations providing credit ratings of municipal bonds, between 2008 and 2017 was 0.18%, as compared to 0.09% for the period from 1970-2017.\footnote{21} Fifty-five defaults of Moody’s rated bonds oc-

\footnote{15. Oliver Renick & Maria Bonello, Bond Insurance Then & Now: The Revival of an Industry, BOND BUYER (Apr. 30, 2014), https://www.bondbuyer.com/news/bond-insurance-then-now-the-revival-of-an-industry. See also SEC. & EXCH. COMM’N, supra note 12, at 10–11 (more than half of municipal bonds issued in each year from 2000-2007 were supported by bond insurance or a bank guarantee, as compared to 17% in each year from 2009-2011).}


\footnote{17. See Bernard Garruppo & Gary Binkiewicz, The Municipal Bond Insurance Industry: A Chronology, MUNICIPALBONDS.COM (Sept. 6, 2016), http://www.municipalbonds.com/bond-insurance/the-municipal-bond-insurance-industry-chronology/ (noting that historically, the principal municipal bond insurers had AAA ratings, though there were other bond insurers that did not).}

\footnote{18. See U.S. GOV’T ACCOUNTABILITY OFF., supra note 7, at 14, n.29 and accompanying text (referring to the prior “homogenization of the credit quality of most municipal securities” and reporting that some bond market participants had indicated that the decline in bond insurance increased the importance of independently evaluating credit quality).}

\footnote{19. See Renick & Bonello, supra note 15 (describing changes in the bond insurance industry).}

\footnote{20. See SEC. & EXCH. COMM’N, supra note 12, at 51–52 (discussing the perceived “commoditization” of the bond market as a result of insurance and the greater focus on disclosure following the 2008 global financial crisis).}

curred in the period from 2007-2017.\textsuperscript{22} Several highly-publicized defaults on municipal bonds have occurred since 2008, including defaults by Jefferson County, Alabama, the City of Stockton, California, the City of Detroit, Michigan, and the Commonwealth of Puerto Rico.\textsuperscript{23} In addition, even where there hasn’t been a default, some state and local governments have experienced major financial challenges in recent years.\textsuperscript{24} Despite the low default rate for municipal bonds, investors have been “forced to recognize that . . . there are clear differences among municipal credits.”\textsuperscript{25} Even in the absence of a default, the financial condition of the issuer can affect the price at which municipal bonds are purchased and sold in both the primary and secondary markets.\textsuperscript{26} Without accurate and complete disclosure, investors may not have the necessary information to determine a fair price for the securities they are buying or selling.

3. \textit{Federal and State Tax Exemption}

The U.S. federal government and state governments subsidize most local government borrowing. The federal government reduces the cost to state and local governments of issuing debt by making interest earnings on most of such debt exempt from federal income tax.\textsuperscript{27} Tax-exempt debt typically bears interest at a lower rate than taxable debt of identical credit quality because lenders receive the

Moody’s-rated corporate securities was 6.6\% in the period from 2008-2017 and 6.7\% in the period from 1970-2017. \textit{Id.}

\textsuperscript{22} \textit{Id.} at 3. There have been periods with much higher rates of default, most recently during the Great Depression. There were more than 4,700 issuers who defaulted on municipal bonds reported in the period from 1929-1937. \textsc{George H. Hempel, The Postwar Quality of State and Local Debt} 19, 22 (1971).


\textsuperscript{24} \textit{See Robert Doty, Expanding Municipal Securities Enforcement: Profound Changes for Issuers & Officials} 39 (2016) (noting the financial deterioration of issuers including the City of Chicago, the Chicago Public School System and the State of Illinois); \textit{Moody’s Investors Serv., supra} note 21, at 86–90 (describing “near misses”).

\textsuperscript{25} Doty, \textit{supra} note 24, at 39.

\textsuperscript{26} \textit{See Section I.B} for a discussion of the primary and secondary markets.

\textsuperscript{27} In 2011, 90.6\% of state and local government securities were issued on a tax-exempt basis. \textsc{Sec. & Exch. Comm’n, supra} note 12, at 11. In 2017, the loss of federal tax revenue (also referred to as a “tax expenditure”) resulting from the exemption from income of interest on public purpose tax-exempt bonds was $28.6 billion. \textsc{Driesen, supra} note 9, at 3.
benefit of tax exemption.\textsuperscript{28} Interest on most state and local government debt is also exempt from home state taxation.\textsuperscript{29}

4. \textit{State Regulation}

Most states have constitutional and/or statutory restrictions on the amount of debt that local governments within their borders may issue (or the amount that they can issue without voter approval) and impose constraints on the structure and terms of that debt and the purposes for which it can be borrowed.\textsuperscript{30} These restrictions are intended to serve a variety of purposes, including promoting fiscally sound decision-making, reducing the risk of default, preventing excessive burdens on taxpayers, and promoting interperiod equity—the concept that the burden of paying for a facility should be spread fairly over the period during which the facility is used.\textsuperscript{31}

\textbf{B. Issuing and Trading Municipal Bonds}

The sale of municipal bonds by or on behalf of the issuer of those securities is referred to as a “primary offering” and the market for newly issued bonds is referred to as the “primary market.”\textsuperscript{32}

\begin{footnotesize}
\begin{enumerate}
\item See Driessen, \textit{supra} note 9, at 1 (explaining that investors are willing to earn a lower interest rate on tax-exempt bonds because their earnings after taxes are the same as if they had earned interest at a higher rate but had to pay taxes on the interest).
\item See U.S. Advisory Comm’n on Intergovernmental Relations, M-186, \textit{State Laws Governing Local Government Structure and Administration} 10 (1993) (describing the prevalence of several types of restrictions, including debt limits, voter approval requirements and restrictions on the purposes for which debt can be used); Clayton P. Gillette, \textit{Fiscal Home Rule}, \textit{86 Denv. U. L. Rev.} 1241, 1255 (2009) (“Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects . . . .”); James E. Spiotto, \textit{The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress}, \textit{Mun. Fin. J.}, Spring 2013, at 1, 6–8 (noting that all but three states have debt limits and describing some of these).
\item See U.S. Advisory Comm’n on Intergovernmental Relations, State Constitutional and Statutory Restrictions on Local Debt 37–39 (1961) (identifying potential negative impacts of excessive debt on the borrowing government, other local governments and the state as reasons for restrictions and describing the purpose of debt limits as allowing local governments to borrow responsibly); Gillette, \textit{supra} note 30, at 1256 (identifying protection of taxpayers and interperiod equity as justifications for restrictions on debt); Spiotto, \textit{supra} note 30, at 10 (identifying prevention of financial crises and defaults as reasons for the imposition of debt limits).
\end{enumerate}
\end{footnotesize}
of municipal bonds after issuance is referred to as the “secondary market” for the bonds. Municipal bonds are traded through dealers in what is referred to as an “over-the-counter” market, not on a securities exchange as with corporate stock. The following sections provide general descriptions of primary offerings and secondary market trading of municipal bonds.

1. Primary Offerings of Municipal Bonds

Newly issued municipal bonds are typically sold to the public through an investment bank acting as an underwriter in either a competitive or a negotiated sale. In a competitive sale, an issuer sells the bonds to the lowest bidding underwriter. In a negotiated sale, the issuer selects an underwriter to purchase the bonds on negotiated terms. In both cases, the underwriter then sells the bonds to investors. The underwriter in a negotiated sale usually plays a much more active role in the transaction than an underwriter does in a competitive sale. Federal securities laws regulate underwriters; the aspects of


34. U.S. GOV’T ACCOUNTABILITY OFF., supra note 7, at 1; SEC. & EXCH. COMM’N, supra note 12, at 19.

35. SEC. & EXCH. COMM’N, supra note 12, at 15. Sometimes issuers borrow directly from banks or sell securities directly to a single investor or small group of investors rather than offering them to the public. See Proposed Amendments to Municipal Securities Disclosure, 82 Fed. Reg. 13928, 13929 (proposed Mar. 15, 2017) (noting that direct purchases of securities by investors and bank loans have increased since 2009). Not all of the same rules apply to these transactions and these transactions are not addressed in this article.

36. SEC. & EXCH. COMM’N, supra note 12, at 17.

37. Id. at 16.

38. Id. at 15.

39. See CAL. DEBT AND INV. ADVISORY COMM’N, CDIAC NO. 06-04, CALIFORNIA DEBT ISSUANCE PRIMER, 10–12 (2006), http://www.treasurer.ca.gov/cdiac/debtpubs/primer.pdf (describing the roles played by an underwriter in a competitive and a negotiated sale); Jun Peng et al., Method of Sale in the Municipal Bond Market, in THE HANDBOOK OF MUNICIPAL BONDS 51, 57 (Sylvan G. Feldstein & Frank J. Fabozzi eds., 2008) (noting that underwriters in negotiated sales have much more time to become familiar with the issue and that as a consequence, underwriters in negotiated sales are expected to perform more “due diligence,” or investigation into the accuracy and completeness of an offering document).
that regulation that are relevant to the discussion in this article are discussed in Sections II.C.2 and II.C.3.

State and local governments often engage an external advisor (referred to as a “municipal advisor” or “financial advisor”) to assist in developing a financing plan, structuring the transaction, and negotiating with underwriters.\(^{40}\) Federal securities laws regulate municipal advisors as discussed in Section II.C.4.

State and local governments issuing bonds engage lawyers to serve as bond counsel; the primary role of these lawyers is to provide an expert opinion as to the validity of the bonds and the tax treatment of interest on the bonds.\(^{41}\) Increasingly, issuers also engage lawyers as disclosure counsel to assist them in complying with their disclosure obligations under federal securities law.\(^{42}\)

2. The Secondary Market for Municipal Bonds

In addition to buying bonds in primary offerings, investors also buy and sell municipal bonds through dealers in the secondary market.\(^{43}\) In 2011, there were more than 10 million transactions in the secondary market totaling more than $3 billion dollars.\(^{44}\) While state and local government issuers are not directly involved in secondary trading of their bonds, ongoing disclosure requirements discussed in Section II.C.2.b stem from the possibility of investors buying or selling municipal bonds years after they are issued.

II. Federal Regulation of Municipal Bonds

This Section discusses federal regulation of municipal bonds, the roles that the SEC and the Municipal Securities Rulemaking Board (the “MSRB”) play in enforcing federal securities laws, and constraints on their abilities to act. This discussion provides a framework for understanding the enforcement actions discussed in Part 4 of this

\(^{40}\) See Cal. Debt and Inv. Advisory Comm’n, supra note 39, at 8–9 (describing the types of services provided by municipal advisors). Municipal advisors were used in 60.2% of reported municipal debt issuances in California in 2017. Jeff Field, Top Municipal Market Financing Team Participants: Calendar Year 2017, Debt Line, Feb. 2018, 3–4.

\(^{41}\) SEC. & Exch. Comm’n, supra note 12, at 47.

\(^{42}\) Id. at 48.

\(^{43}\) Id. at 19–20.

\(^{44}\) Id. at 21. This despite the fact that trading is relatively infrequent, with only about 1% of outstanding municipal bonds being traded on any given day in 2010. U.S. Gov’t Accountability Off., supra note 7, at 6.
A LITTLE HELP FROM OUR FRIENDS

article and the analysis of the effectiveness and cost of the SEC’s actions and alternative approaches discussed in Part 5.

A. The U.S. Government Regulates the Sale of Securities, Including Municipal Bonds

The U.S. government regulates the sale of securities, including municipal bonds, “in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and the Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.”45 The Securities Act and the Exchange Act were passed during the Great Depression, a time when “the broad base of public confidence upon which our economic structure depends” had been largely destroyed, with the purpose of restoring public confidence.46 The Securities Act generally regulates initial offerings of securities and the Exchange Act regulates trading of securities in the secondary market and regulates underwriters and other participants in securities markets.47 The Exchange Act also established the SEC.48

Investors are more likely to invest securities if they know they are paying a fair price.49 Companies depend on investors to provide money to expand and governments depend on investors to lend them money to complete infrastructure projects. Furthermore, accurate and complete information improves the efficiency of markets, which in turn should result in an overall allocation of resources that is more beneficial to society as a whole.50 Thus, the principal purposes of the Securities Act and the Exchange Act, and of the regulations promul-

46. New U.S. Securities Law: Speech of Hon. Garland S. Ferguson, Jr., Federal Trade Commissioner (National Broadcasting Company broadcast Sept. 12, 1933). See also Doty, supra note 24, at 40 (attributing the functioning of the municipal securities market after recent highly publicized defaults as largely due to “the existence . . . of well-defined disclosure and due diligence practices”).
47. 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 57–60 (6th ed. 2011).
49. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988), quoting Schlanger v. Four-Phase Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982) (“[I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?”); Lisa M. Fairchild & Nan S. Ellis, Municipal Bond Disclosure: Remaining Inadequacies of Mandatory Disclosure Under Rule 15c2-12, 23 J. CORP. L. 439, 456 (1998) (noting that when investors have confidence that relevant information is reflected in securities prices, they are more likely to invest and their transaction costs are reduced).
50. See Fairchild & Ellis, supra note 49, at 456 (noting that information improves efficiency and that efficiency improves resource allocation).
gated under these acts, are promoting accurate and complete disclosure about securities sold to the public and preventing fraudulent or unfair practices in the sale of securities.  

The U.S. Securities and Exchange Commission plays an important role in maintaining the integrity of U.S. securities markets. Its mission is "to protect investors – including investors in municipal securities – maintain fair, orderly, and efficient markets, and facilitate capital formation."  

B. Municipal Securities Are Less Regulated than Corporate Securities  

Although municipal securities are subject to some federal regulation as described in Section II.B, they are exempt from significant portions of both the Securities Act and the Exchange Act.

51. See supra notes 6 & 7 and accompanying text; New U.S. Securities Law, supra note 46 ("[T]he principal purpose . . . of the [S]ecurities [A]ct is that full disclosure shall be made of all material facts concerning an issue of securities that is offered for sale to the public."); What We Do, SEC. & EXCH. COMM’N, https://www.sec.gov/Article/whatwedo.html#intro (last modified June 10, 2013) ("[T]he laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it.").  

52. SEC. & EXCH. COMM’N, supra note 12, at 2.  

53. Commentators have suggested several reasons for the different treatment of state and local government securities, including the federal form of U.S. government and politics, a perceived lack of abuses in municipal markets, the historic relative sophistication of municipal investors, and the traditional local nature of municipal securities markets. See, e.g., Municipal Securities Disclosure, 53 Fed. Reg. 37778, 37786 (proposed Sept. 28, 1988) (identifying "the local nature of markets, the absence of demonstrated abuses, and the sophistication of investors" as influences and noting that Congress was "persuaded that direct regulation of the process by which municipal issuers and municipalities raise funds to finance governmental activities would place the [SEC] in the position of gate-keeper to the financial markets, a position inconsistent with intergovernmental comity"); Fairchild & Ellis, supra note 49, at 441 (referring to "Constitutional concerns regarding congressional authority to regulate the issuance of securities by state and local governments" and noting that "it was believed that the improprieties which prompted federal regulation of the corporate securities market were less likely to arise in the municipal market."); James M. Landis, The Legislative History of the Securities Act of 1933, 28 GEO. WASH. L. REV. 29, 39 (1959) (noting that municipal bonds were included in the initial draft of the Securities Act but were ultimately exempted for "obvious political reasons"); Maco, supra note 5, at 4 (citing the federal form of government and resulting political considerations at the time the securities laws were adopted). It is beyond the scope of this article to discuss the appropriateness of these exemptions, though others have done so. For some critical commentary, see, e.g., Luis A. Aguilar, Statement on Making the Municipal Securities Market More Transparent, Liquid, and Fair, SEC. & EXCH. COMM’N (Feb. 13, 2015), https://www.sec.gov/news/statement/making-municipal-securities-market-more-transparent-liquid-fair.html (advocating for the repeal of the Tower
The Securities Act exempts securities issued by state and local governments from all of its provisions, except where it specifically provides otherwise.\(^{54}\) Unlike corporations issuing securities for sale to the public, municipal issuers do not need to file a registration statement with the SEC and are not subject to detailed requirements specifying what needs to be included in the document by which the securities are offered (a prospectus for a publicly sold stock, an official statement for municipal bonds).\(^{55}\)

The Exchange Act exempts securities issued by state and local governments from specifically identified provisions, including the requirements for periodic reporting.\(^{56}\) This means that unlike public companies, state and local governments are not required to file detailed annual and quarterly reports.\(^{57}\) Instead, state and local governments are indirectly required to provide updates to some of the information in their offering documents annually and to disclose the occurrence of certain events as described in Section II.C.2.b.

Furthermore, neither the SEC nor the MSRB is authorized under the Exchange Act to impose rules or regulations directly or indirectly requiring an issuer of municipal bonds to file any application, report, or document with the SEC or the MSRB before selling securities.\(^{58}\) The Exchange Act also expressly states that it does not authorize the MSRB to directly or indirectly require an issuer of municipal securities disclosure.


55. See 15 U.S.C. § 77f (2012) (requiring registration of securities generally, but without stating that the provision applies to exempt securities). The Securities Act and regulations detail the type of information to be included in a prospectus. See 15 U.S.C. § 77g (2012); 17 C.F.R. pts. 210 and 229 (setting forth requirements for prospectus). In contrast, while state and local governments are indirectly required to provide offering documents for their bonds, there are very limited rules about the content of those documents. See Section II.C.2.a infra for more detail.
57. Public companies file annual reports on Form 10-Q and quarterly reports on Form 10-K. The content of these reports is addressed in Regulations S-K and S-X.
ties to provide the MSRB or a purchaser of the securities with any information or document about the issuer.\textsuperscript{59} These provisions, which are sometimes referred to as the “Tower Amendment,”\textsuperscript{60} were added to the Exchange Act in 1975 in conjunction with legislation that created the MSRB and empowered it to impose rules on municipal brokers and dealers, with SEC approval, and provided for enforcement of the MSRB’s rules by the SEC and other entities.\textsuperscript{61}

As a result of the exemptions described above, and of the Tower Amendment, the SEC regulates municipal disclosure indirectly by regulating underwriters and uses enforcement actions to provide guidance to municipal issuers.\textsuperscript{62}

\textbf{C. Regulation of Municipal Securities}

Municipal bonds are nonetheless subject to the “antifraud provisions”\textsuperscript{63} of the Securities Act and the Exchange Act and are regulated by the SEC and the MSRB. The SEC’s activities include adopting rules and interpreting and enforcing federal securities laws and regulations.

The MSRB is a self-regulatory organization created through amendments to the Exchange Act in 1975.\textsuperscript{64} The MSRB is required to adopt rules that, among other things, are “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, . . . and the public interest . . . .”\textsuperscript{65} The MSRB is authorized to make rules regarding, among other matters, municipal

\textsuperscript{59} 15 U.S.C. § 78o-4(d)(2) (2012). The MSRB can require an underwriter to provide information about an issuer to the MSRB or a purchaser of the issuer’s securities, but only if the information is available from another source. 15 U.S.C. § 78o-4(d)(2) (2012).

\textsuperscript{60} Named for Senator John Tower, who proposed the amendments.

\textsuperscript{61} \textit{Sec. & Exch. Comm’n, Staff Report on the Municipal Securities Market} 6–8 (1993). Prior to the 1975 amendments, which were adopted because of abusive practices by municipal securities professionals, the growth of the municipal securities market, the variety of municipal securities being offered and changes in the typical investor, the municipal securities market was “largely unregulated.” \textit{Id.} at 6.

\textsuperscript{62} \textit{See infra} Section II.C.2 and note 110 and accompanying text.

\textsuperscript{63} \textit{See infra} Section II.C.1.

\textsuperscript{64} \textit{Sec. & Exch. Comm’n, supra} note 12, at 33. The composition of the MSRB and the scope of its powers and obligations are set forth in 15 U.S.C. § 78o-4(b).

securities transactions by underwriters and advice provided to municipal entities by underwriters and municipal advisors concerning municipal bond issuances and municipal financial products. The MSRB’s rules generally are subject to SEC approval and are enforced by the SEC and other agencies.

The antifraud provisions and the most relevant SEC and MSRB rules are discussed in the remainder of this Section II.C.

1. Antifraud Provisions Apply to Municipal Securities

Like corporate securities, municipal bonds are subject to Section 17(a) of the Securities Act (“Section 17(a)”), Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated pursuant to the Exchange Act (“Rule 10b-5”), which are collectively referred to as the “antifraud provisions.”

The provisions under the two acts are similar to each other, but not identical. Most relevant for purposes of this article, both Section 17(a) and Rule 10b-5 prohibit fraud and the use of “any untrue statement of a material fact” or the omission of “a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading” to obtain money or property, in the case of Section 17(a), and in connection with the purchase or sale of securities, in the case of Rule 10b-5.

67. 15 U.S.C. §§ 78o-4(c), 78s(b) (2012); SEC & EXCH. COMM’N, supra note 12, at 34.
69. Section 17(a) provides that:

“It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”
Both Section 17(a) and Rule 10b-5 refer to “material” facts. Information is “material” if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available” and if “there is a substantial likelihood that a reasonable [investor] would consider it important.”

The antifraud rules apply to offering documents delivered to investors, to the continuing disclosure filings described in Section II.C.2.b, and to any other information that an issuer provides to the public “that is reasonably expected to reach investors and the trading markets,” even if that information is made public for other reasons. This is significant because state and local governments routinely provide a wide range of information to the public and state and local government officials regularly make public statements.

The SEC pursues actions against state and local governments under both Section 17(a) and Rule 10b-5. While the SEC must prove “scienter” in order to prove a violation of Section 17(a)(1) and Rule 10b-5, it need not do so for violations of Section 17(a)(2) and (3).

This means that a material misstatement or omission need only be negligent for the SEC to prevail in an action under Section 17(a)(2),

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15 U.S.C. § 77q(a) (2012). “Person” as used in the Securities Act includes a government or a political subdivision, and the exemptions provided in Section 3 of the Securities Act, including the exemption for municipal bonds, do not apply to Section 17. 15 U.S.C. §§ 77b(a)(2), 77q(c) (2012). Section 10(b) of the Exchange Act makes it illegal to use interstate commerce, the mails or a national securities exchange in order to “use or employ, in connection with the purchase or sale of . . . any security . . . any manipulative or deceptive device or contrivance” in violation of rules promulgated by the SEC. 15 U.S.C. § 78j(b) (2012). Rule 10b-5 provides that:

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”


72. Id. at 12756.

73. Actions by private parties under the antifraud provisions are beyond the scope of this article.

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though at least recklessness would be required under Rule 10b-5.\textsuperscript{75} The SEC’s enforcement methods are discussed in Section II.D.

2. Underwriters of Municipal Bonds are Required to Provide Disclosure to Investors

Underwriters of municipal securities are regulated by the SEC and the MSRB. These regulations impose a framework of disclosure requirements on underwriters. These requirements have the effect of indirectly requiring issuers to prepare offering documents and to agree to provide certain information subsequent to the sale of bonds.

a. Offering Documents (Preliminary Official Statements and Official Statements)

Before bidding for, purchasing, offering or selling municipal bonds in a primary offering, underwriters must obtain an offering document that the state or local government issuer considers final, other than specified information such as the principal amount, interest rate and offering price of the bonds, underwriters’ compensation, and credit ratings on the bonds.\textsuperscript{76} This document is referred to as a “preliminary official statement.”\textsuperscript{77} A preliminary official statement is used by underwriters to market bonds in advance of their sale.\textsuperscript{78} Underwriters in negotiated primary offerings are required to provide a copy of the preliminary official statement to any potential customer upon request until the final official statement is available.\textsuperscript{79}

\textsuperscript{75} See id. at 686, n.5 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976) (“scienter” as a “mental state embracing intent to deceive, manipulate or defraud”; the court did not address whether “scienter” might include recklessness in some circumstances)); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) (observing that every court of appeals that has considered the issue has found that “scienter” includes recklessness, but the degree of recklessness has varied); Ann M. Olazábal & Patricia S. Abril, Recklessness as a State of Mind in 10(B) Cases: The Civil-Criminal Dialectic, N.Y.U. J. LEGIS. & PUB. POL’Y 305, 319–25 (2015) (discussing various interpretations by federal courts of the level of recklessness that can result in a violation of Rule 10b-5).

\textsuperscript{76} 17 C.F.R. § 240.15c2-12(b)(1) (2019).


\textsuperscript{78} Brooke D. Abola & Stephen A. Spitz, Orrick, Herrington & Sutcliffe LLP, Disclosure Obligations of Issuers of Municipal Securities 7 (2011). Sometimes only a final official statement is prepared for an issuance of variable rate bonds and is used to market the bonds as well as to meet the final official statement delivery requirements.

\textsuperscript{79} 17 C.F.R. § 240.15c2-12(b)(2) (2019).
Underwriters also are required to contract with state and local government issuers to receive a final official statement (typically referred to simply as an “official statement”) from the state or local government issuer in time to deliver it to those buying the bonds from the underwriter at the time a confirmation of the order requesting payment is sent, and are required to deliver an official statement to any potential customer upon request for at least 25 days after the bonds are issued and to post the official statement on the MSRB’s Electronic Municipal Market Access website (www.emma.msrb.org) (“EMMA”).

The official statement must include the terms of the bonds, information about the issuer and other entities, enterprises, funds and accounts material to the evaluation of the offering, including operating data and financial information, a description of the continuing disclosure undertakings of the issuer, and any instances of material noncompliance with prior continuing disclosure undertakings in the last five years.

While the ultimate responsibility for the official statement rests with the issuer, underwriters recommending securities must have a reasonable basis for their recommendation, and the SEC has stated that the participation of an underwriter in an offering is an “implied recommendation” of the securities being offered. This includes exercising reasonable care in reviewing and evaluating the accuracy of the official statement for the bonds being offered. Underwriters also must review the official statement to comply with their obligation to “deal fairly with all persons” under MSRB Rule G-17 and their obligations to have a reasonable basis to believe that the bond is a suitable


81. 17 C.F.R. § 240.15c2-12(f)(3) (2019). See infra Section II.C.2.b for discussion of continuing disclosure undertakings. In contrast, the requirements for offering documents for corporate securities offerings are very detailed. See 17 C.F.R. pts. 210, 229 (2019).


83. Id. at 37,787–88. The level of care required in negotiated transactions is higher than in competitive transactions. Id. at 37,789-90.
investment for their customers under MRSB Rule G-19. The SEC has noted that the lack of detailed disclosure requirements increases the importance of underwriter review of the official statement “as a means of guarding the integrity of new offerings.”

b. **Underwriters Must Determine that Issuer Is Obligated to Provide Ongoing Disclosure**

Underwriters may not buy or sell municipal bonds in a public offering unless they have reasonably determined that the issuer has agreed in writing to provide annual updates of financial information and operating data that is included in the official statement, audited financial statements (if available) and notice of certain enumerated events such as payment delinquencies, material defaults, credit rating changes, insolvency, and the incurrence of or default under certain debt obligations. These written agreements are referred to as “continuing disclosure undertakings.” Updates and notices are posted on EMMA. Annual updates are not required to be comprehensive updates of the entire official statement, but rather of operating data and financial information included in the official statement; typically, the undertaking includes a list of specific information that is required to be updated.

While the relevant SEC rule does not include a deadline for the filing of annual financial information, 35% have deadlines of 180 days after the end of the fiscal year, and fewer than 20% have deadlines in

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84. **MUN. SEC. RULEMAKING BD., MSRB NOTICE, supra note 80.**
86. 17 C.F.R. § 240.15c2-12(b)(5) (2019). These requirements also apply to any other entity or person that is obligated to support payment on the bonds, including nonprofit or for-profit entities (referred to herein as “other obligated entities”). In transactions where a state or local government is issuing bonds on behalf of another entity and that other entity is solely responsible for paying debt service on the bonds, the issuer is not required to enter into such an agreement. For the sake of simplicity, this article does not address these types of financings. There are some limited exceptions to this rule. 17 C.F.R. § 240.15c2-12(d) (2019).
excess of 270 days. Notices of enumerated events must be filed within 10 business days after the occurrence of the event.

Continuing disclosure undertakings cannot be enforced by the SEC or by underwriters. Typically, the holders of a specified percentage of the bonds can take legal action to compel performance with the agreement, but a violation of the agreement is not a default on the bonds and the bondholders have no right to recover monetary damages. If bondholders have ever taken such a legal action, it was an uncommon occurrence.

Official statements for bonds being issued must disclose material noncompliance with any continuing disclosure undertakings during the preceding five years. The SEC has noted that the likelihood that an issuer will comply with its continuing disclosure undertaking is important to investors. The requirement that past noncompliance be disclosed also is intended to incentivize issuers to comply with undertakings. This incentive is likely weaker for issuers that do not expect to issue bonds, and therefore prepare official statements, in the future. Issuers have not always complied with this disclosure requirement.

89. MUN. SEC. RULEMAKING BD., TIMING OF ANNUAL FINANCIAL DISCLOSURES BY ISSUERS OF MUNICIPAL SECURITIES 12–13 (2017), http://www.msrb.org/msrb1/pdfs/MSRB-CD-Timing-of-Annual-Financial-Disclosures-2016.pdf; see also Abola & Spitz, supra note 78, at 22 (“Most issuers agree to provide the annual report for a given fiscal year within six to nine months of the fiscal year close. . .”); Peter J. Schmidt, DPC Data Inc., Recent Trends in Municipal Continuing Disclosure Activities 21 (2011) (indicating that the mean number of days after the end of the fiscal year agreed to was 222.2).

90. 17 C.F.R. § 240.15c2-12(b)(5)(C)(2019).

91. See Pica & Reimers, supra note 88, at 35 (default provision in form continuing disclosure undertaking); Schmidt, supra note 89, at 14 (noting that a failure to make continuing disclosure filings “never constitutes an event of default under a bond resolution or trust indenture”).


95. Municipal Securities Disclosure, Release No. 34-34961, supra note 94, at *8; MCDC Initiative, supra note 94.

96. See infra notes 180–85 and accompanying text for further discussion.
3. **Underwriters of Municipal Bonds are Required to Provide Information to Municipal Issuers**

Underwriters have a duty to “deal fairly with all persons” (including state and local government issuers) and are prohibited from engaging in “any deceptive, dishonest, or unfair practice.” The MSRB has interpreted this rule to require underwriters in negotiated offerings to provide specified information to state and local government clients, including a statement that the underwriter does not have a fiduciary duty to the issuer, and information about whether the underwriter’s compensation is contingent on the closing of the transaction and any conflicts of interest. In addition, underwriters must disclose the material aspects of the financing structures they recommend, taking into account the level of expertise of the issuer and the complexity of the transaction structure.

4. **Municipal Advisors Are Regulated and Have a Fiduciary Duty to State and Local Government Clients**

While historically municipal advisors were largely unregulated, in 2010 the U.S. Congress passed legislation which required municipal advisors to register with the SEC, gave the MSRB the power to regulate them, and imposed a fiduciary duty on them when advising state and local governments. This was a reaction to abuses against local governments that came to light during the 2008 global financial crisis. This fiduciary duty includes a duty of loyalty and a duty of care. The duty of loyalty includes dealing honestly and in good faith and acting in the client’s best interest regardless of the interests of the municipal advisor.

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99. Id.


101. Id. at 28–29.


priate knowledge and expertise and having a reasonable basis for advice provided to the client and for representations and information provided to the client or other parties involved in a transaction.\textsuperscript{104} Municipal advisors are also required to “deal fairly with all persons.”\textsuperscript{105}

\textbf{D. The SEC Enforces Federal Securities Laws and MSRB Rules}

The SEC has the power to enforce federal securities laws, including against state and local governments, government officials, underwriters, municipal advisors and others.\textsuperscript{106} In addition, the SEC has the power to enforce MSRB rules against municipal advisors and underwriters in municipal financings.\textsuperscript{107} The SEC exercises these powers through its Division of Enforcement, which “conducts investigations into possible violations of the federal securities laws, and litigates the [SEC’s] civil enforcement proceedings in the federal courts and in administrative proceedings.”\textsuperscript{108} The Division’s Public Finance Abuse Unit, which was created in 2010 in response to perceived abuses in the municipal finance market, is responsible for proceedings against state and local governments and other municipal securities market participants.\textsuperscript{109}

The SEC uses enforcement actions not only to punish those that have violated federal securities laws, but also to provide guidance to other state and local government issuers, municipal underwriters, municipal advisors, and other participants in the municipal securities markets.\textsuperscript{110}

\begin{itemize}
\item \textsuperscript{106} See \textit{Fippinger}, \textit{supra} note 9, §§ 15:2-3, 15.8.1 (describing the SEC’s enforcement powers with respect to state and local governments, government officials and legislators, underwriters and municipal advisors, among others).
\item \textsuperscript{107} See \textit{Fippinger}, \textit{supra} note 9, § 15:8.1 (describing, among other things, the SEC’s authority to enforce the MSRB’s rules). Other organizations also enforce the MSRB’s rules, including the Financial Industry Regulatory Authority and bank regulators.
\item \textsuperscript{108} \textit{About the Division of Enforcement, Sec. & Exch. Comm’n}, https://www.sec.gov/enforce/Article/enforce-about.html (last modified Aug. 2, 2007). The SEC does not prosecute criminal offenses, but it can refer matters to the U.S. Department of Justice. \textit{See Fippinger}, \textit{supra} note 9, §15:9 (describing authority to transmit evidence and parallel SEC and criminal actions).
\item \textsuperscript{109} Ceresney, \textit{supra} note 1.
\item \textsuperscript{110} See \textit{Doty}, \textit{supra} note 24, at 42 (describing SEC enforcement as “a highly successful regulatory tool”); \textit{Fippinger}, \textit{supra} note 9, § 15:1 (noting that part of the Division of Enforcement’s mission is to “influence and improve standards of conduct and practices by issuers and other market participants”).
\end{itemize}
1. Administrative Proceedings

The SEC adjudicates some alleged securities law violations itself through a proceeding before an administrative law judge, who is an independent employee of the SEC. As a result of these proceedings or due to settlement of them, the SEC sometimes issues “cease-and-desist orders,” which direct a person to refrain from conduct that violates the law. Because the SEC writes the cease-and-desist orders itself, these orders “provide the SEC with an opportunity to comment on the application of the securities laws . . .” and to “explain its theory of the case.” This makes cease-and-desist orders a more effective way for the SEC to communicate its views to the municipal securities market than an injunction in a court proceeding. The SEC can also impose penalties and disgorgement of illegal profits in an administrative proceeding. If the person or entity against which a cease-and-desist order was issued violates that order, the SEC can seek a monetary penalty in federal court.

2. Action in Federal Court

The SEC also brings actions against alleged violators of federal securities laws in federal court. If the SEC prevails, the court will issue an injunction, which is an order that prohibits future violations. The court can also impose monetary penalties and disgorgement of illegal profits. A person or entity that violates an injunction may have to pay fines or (in the case of a person) go to prison for contempt of court. The SEC is more likely to pursue an injunction in federal court rather than a cease-and-desist order in an administrative proceeding when the conduct of the alleged violator is particularly egregious.

111. George E. Greer, Orrick, Herrington & Sutcliffe LLP, SEC Investigations and Enforcement Actions: A Practical Handbook for Municipal Securities Issuers 18 (2011); About the Division of Enforcement, supra note 108.
112. See Fippinger, supra note 9, § 15:8.2 (describing cease-and-desist orders as the result of an administrative hearing or settlement).
113. Id. §§ 15:1, 15:8.3[B].
114. Id. § 15:8.3[E]; About the Division of Enforcement, supra note 108.
115. Greer, supra note 111, at 19.
116. Fippinger, supra note 9, § 15:1; About the Division of Enforcement, supra note 108.
117. Greer, supra note 111, at 17.
118. About the Division of Enforcement, supra note 108.
119. Fippinger, supra note 9, § 15:1; About the Division of Enforcement, supra note 108.
120. Fippinger, supra note 9, § 15:8.3[B].
3. Public Report of Investigation

Sometimes, the SEC concludes an investigation into misconduct by issuing a public report instead of or in addition to pursuing an administrative proceeding or civil action.\textsuperscript{121} These reports are relatively rare,\textsuperscript{122} but are used when (a) the SEC wishes to discuss the application of federal securities laws to “controversial and timely legal issues in public finance” and to encourage commentary and discussion; (b) the SEC wishes to avoid imposing monetary penalties on taxpayers; (c) the settlement negotiations with the subject of the investigation dictate such a result; or (d) the subject has taken remedial steps to prevent future wrongdoing and has cooperated with the SEC during the investigation, or the officials who engaged in the misconduct are no longer associated with the investigated party.\textsuperscript{123}

III. RECENT SEC ENFORCEMENT ACTIVITY AGAINST STATE AND LOCAL GOVERNMENTS

In recent years, the SEC’s Enforcement Division has been more active in the municipal securities market, including against municipal issuers, than it has been in the past. Prior to 2010, the SEC had not devoted “sustained enforcement attention” to municipal bonds, nor had it developed “deep expertise regarding abuses in public financing.”\textsuperscript{124} In January 2010, the Division created a new specialized unit (later renamed the Public Finance Abuse Unit) to focus on misconduct in the municipal securities market and with respect to public pension funds,\textsuperscript{125} presumably at least in part as a response to changes in the market and problems that had come to light as a result of the 2008 global financial crisis.\textsuperscript{126} The volume of enforcement actions against state and local government issuers increased dramatically beginning in 2013, likely in part as a result of the creation of the Public Finance

\textsuperscript{121} These reports are authorized under Section 21(a) of the Exchange Act and are sometimes referred to as Section 21(a) reports.


\textsuperscript{123} Fippinger, supra note 9, § 15:6.1.

\textsuperscript{124} Ceresney supra, note 1.


\textsuperscript{126} See supra notes 19–20 & 101 and accompanying text.
Abuse Unit in 2010, and consistent with the SEC’s approach to enforcement at that time, which was described by the Chair of the SEC in 2013 as being driven by the theory that “minor violations that are overlooked or ignored can feed bigger ones, and, perhaps, more importantly, can foster a culture where laws are increasingly treated as toothless guidelines.”127 In the three and a half years from 2013 through mid-2016, the SEC brought enforcement actions against seventy-six state or local governments and sixteen public officials, as compared to six state and local governments and twelve public officials over the period from 2002 to 2012.128 The SEC has been “sounding a message to the market participants, especially the issuers of municipal bonds really, that they need to be out there taking seriously their obligations under the federal securities laws.”129

The nature of the SEC’s enforcement activity has changed in recent years. Since 2013, the SEC has imposed tougher penalties on state and local government issuers and municipal officials, including the first civil penalties imposed on local government issuers, the first prohibitions of municipal officials from participating in future bond offerings, and more frequent imposition of substantial civil penalties

127. Mary Jo White, Chair, Sec. & Exch. Comm’n, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), https://www.sec.gov/news/speech/spch100913mjw. This is sometimes referred to as “Broken Windows” enforcement. Id.

128. Ceresney supra, note 1. Many of the state and local governments were under the MCDC Initiative discussed in Section III.E.1, infra; even without these, actions against state and local governments increased dramatically. While the SEC highlighted no new enforcement actions against state or local governments under the antifraud provisions on the relevant portion of its web site in 2018 or the first half of 2019, see Recent Municipal Securities Enforcement Actions, SEC & EXCH. COMM’N, https://www.sec.gov/municipal/oms-enforcement-actions.html (last visited Nov. 7, 2019), and the SEC may be focusing less on “technical errors or smaller transgressions” in the municipal market going forward, Kyle Glazier, Outlook 2018: SEC’s Top Muni Cop Lists Enforcement Priorities, BOND BUYER (Dec. 26, 2017, 6:00 AM), https://www.bondbuyer.com/news/secsc-top-muni-cop-lists-2018-enforcement-priorities, the SEC’s Enforcement Division continues to be active in the municipal market. For example, an investigation of Dallas County Schools in Texas was reported in 2018 and another of Sweetwater Union High School District in California was reported in 2019. Scott Friedman, Feds Expand Investigation of Dallas County Schools, NBC 5 DALL.-FORT WORTH, https://www.nbcdfw.com/investigations/Feds-Expand-Investigation-of-Dallas-County-Schools-481977041.html (last updated May 7, 2018, 6:33 PM); Will Huntsberry, The SEC Is Looking into Sweetwater Union’s Financial Dealings, VOICE OF SAN DIEGO (Jan. 28, 2019), https://www.voiceofsandiego.org/topics/education/the-sec-is-looking-into-sweetwater-unions-financial-dealings. Of course, an investigation does not necessarily lead to an enforcement action.

129. Elaine Greenberg, Chair, Public Finance Abuse Unit, Div. of Enf’t, Sec. Exch. Comm’n, quoted in GREER, supra note 111, at 6.
on municipal officials. In the last few years, the SEC has also required issuers to take specific steps to improve disclosure. In addition to acting in cases of what appear to be intentional or reckless deception of investors, over the last several years, the SEC has acted against state and local governments with internal practices that appear to have led to inaccurate or misleading disclosure. Cease-and-desist orders have discussed not only why the disclosure was false or misleading, but also the circumstances that led to false or misleading disclosure being prepared. The following sections will discuss a few of the factors that the SEC has identified as leading to violations of the antifraud provisions, and how it has responded to them.

A. Avoiding Giving Bad News

One problem that the SEC has identified is the tendency of politicians and state and local government officers to avoid “acknowledging that anything bad has happened on their watch.” In part, this probably is a general human inclination. However, it is likely to be intensified in a political environment in which there are regular elections and administration changes. “An administration facing an election may be disinclined to make public disclosure of issues that are likely

130. Dory, supra note 24, at 5–6. See also Guidotti, supra note 8, at 2062–63 (describing the SEC’s “recent zeal” for monetary penalties); Kevin J. Harnish et al., A Series of Firsts in Muni Bond Enforcement Since 2010, LAW360 (Nov. 17, 2016, 11:29 AM), https://www.law360.com/articles/863361/a-series-of-firsts-in-muni-bond-enforcement-since-2010 (noting that while the imposition of civil penalties on government officials used to be “extraordinary,” it should “now be considered the norm”).
132. See, e.g., Complaint at 1–3, SEC v. City of Harvey, No. 1:14-cv-047744 (N.D. Ill. June 24, 2014), (alleging, among other things, that a town official had diverted bond proceeds to improper purposes, including to the town’s comptroller); Complaint & Jury Demand at 2–3, SEC v. Town of Oyster Bay, No. 1:17-cv-06809 (E.D.N.Y. Nov. 21, 2017) (alleging, among other things that the Town of Oyster Bay and its Chief Executive Officer had intentionally concealed indirect guarantees of more than $20 million of loans to a concessionaire that had given substantial gifts to town officials); Luke Torrance, Oyster Bay Covered Up Singh Loan Guarantee: Auditor, ISLAND Now (May 9, 2018), https://theislandnow.com/news-98/oyster-bay-covered-up-singh-loan-guarantee-auditor/ (“Singh testified . . . that he provided Venditto with gifts . . . in exchange for $20 million in town loan guarantees”); Complaint & Jury Demand at 2–5, SEC v. Town of Ramapo, No. 16-cv-2779 (S.D.N.Y. Apr. 14, 2016) (alleging, among other things, that several individuals knowingly falsified financial statements) [hereinafter Ramapo Complaint].
134. The Director of the SEC Division of Enforcement noted that corporate officers and directors have the same tendency. Id.
to be embarrassing during an election campaign, and financial problems may be pushed forward to be dealt with by a new administration.”\textsuperscript{135} The SEC has undertaken enforcement actions in several instances where it appears that this tendency led to inadequate disclosure.

For example, the desire to continue telling a positive story when things were going wrong seems to have led the City of Allen Park, Michigan to make false and misleading disclosure. The city had planned a $146 million movie studio in partnership with a private developer.\textsuperscript{136} The studio was described in local news as “a shot in the arm to an area hurt badly by the recession and a steep downturn in the auto industry.”\textsuperscript{137} The scope and expected revenue-generating capacity of the project had been dramatically reduced by the time the city issued bonds to finance the project in November 2009 and June 2010.\textsuperscript{138} However, the city disclosed neither the reduction in scope in its Official Statements, nor that the city’s budget included a substantial donation connected to the project that the city knew it would not receive.\textsuperscript{139} The SEC pointed out in its cease-and-desist order that the plans for the full project were maintained on the city’s web site until at least June 2010, even though the project had been scaled back by mid-2009.\textsuperscript{140} The SEC also described the city’s Mayor, who settled separate charges with the SEC, as “an active champion of the project.”\textsuperscript{141}

\textsuperscript{135} Fippinger, supra note 9, § 15:3.2. Others have noted that local governments may tend to overutilize debt for the same reason. See, e.g., Robert S. Amdursky et al., Municipal Debt Finance Law: Theory and Practice 208 (2d ed. 2013) (“Local officials, who will want to demonstrate constructive activity to constituents before the next election, have incentives to overutilize debt, paying scant attention to long-term adverse effects.”); Richard Briffault, Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law, 34 Rutgers L.J. 907, 917–18 (2003) (“the ability to shift the costs forward may . . . induce elected officials to incur too much debt” because “they can get the credit for the new project immediately, while the blame for the additional taxes needed to pay off the debt will be borne by their successors”).


\textsuperscript{138} City of Allen Park, 2014 WL 5764984, at *2–3.

\textsuperscript{139} Id. at *3–4.

\textsuperscript{140} Id. at *2.

The SEC similarly identified “avoid[ing] further political fallout” as one of the reasons that officials in the Town of Ramapo, New York alleged falsified the town’s financial statements by “recognizing fraudulent receivables, omitting unpaid liabilities, and improperly recording transfers from other funds.”

Even large issuers can be vulnerable to political pressure. The Port Authority of New York and New Jersey (the “Port Authority”), which provides “transportation, terminal and other facilities of commerce” in parts of New York and New Jersey, is one of the largest municipal issuers in the U.S. and has a budget of $7 to $8 billion per year. The SEC issued a cease-and-desist order against the Port Authority relating to its failure to disclose to investors or to the Port Authority’s Board of Commissioners that there was question about whether the Port Authority could legally provide funding for the projects for which the bonds were being issued. In its order, the SEC highlighted some of the political pressure on the Port Authority, emphasizing announcements by the New Jersey Governor about a transportation plan that included Port Authority funding for the projects.

The SEC identified written policies and procedures, use of outside counsel and training as measures to help address these problems. These topics are discussed in greater detail in Sections III.C and III.D.

B. Compartmentalization

The SEC also has identified compartmentalization within state and local governments as a contributor to violations of the antifraud provisions. Compartmentalization, as used in this article, occurs when expertise and information about various aspects of the government and

142. Ramapo Complaint, supra note 132, at 2.
144. Id. at *1–2.
145. Id. at *5–6.
146. See, e.g., City of Allen Park, Securities Act Release No. 9677, Exchange Act Release No. 73539, 2014 WL 5764984, at *5–6 (Nov. 6, 2014) (noting remedial actions the city had taken and that these were taken into consideration in agreeing to enter into the cease-and-desist order); Port Auth. of N.Y. & N.J., 2017 WL 83465, at *8–10 (describing remedial actions taken by the Port Authority and requiring the Port Authority to establish written policies and procedures and provide training regarding disclosure, among other things); Ramapo Complaint, supra note 132, at 39 (requesting that remedies include requiring the retention of outside experts and an independent review of the town’s financial reporting procedures and controls).
its operations are held within separate departments or divisions that do not effectively communicate with each other.

For example, the SEC stated in a 2013 cease-and-desist order that the failure by the State of Illinois to disclose material information about underfunding of the State’s pension plans and related risks to the State stemmed in part from the State’s failure to implement policies “designed to ensure that material information was assembled and communicated to individuals responsible for disclosure determinations”; that “[a]s a result, the State lacked proper mechanisms to identify and incorporate into its official statements relevant information held by the pension systems and other bodies within the State.”\footnote{147} The SEC also criticized the State’s lack of disclosure counsel and training as “institutional failures.”\footnote{148} Among the remedial measures that the SEC took into account in accepting the State’s settlement offer were the formation of a disclosure committee responsible for collecting information and evaluating the State’s disclosure obligations, and the establishment of a practice that ensures that the appropriate individuals review the State’s pension disclosure.\footnote{149}

Similarly, the SEC identified “insufficient procedures and poor communication” between two state agencies as the reason the State of Kansas failed to provide material information about its unfunded pension liabilities in its official statements.\footnote{150} The SEC took into account remedial actions taken by the State—including mandating closer cooperation and communication, designating responsible parties within state agencies, establishing a disclosure committee and requiring training of personnel—in agreeing to accept the State’s settlement offer.\footnote{151}

C. Lack of Clear Policies and Procedures

The SEC has repeatedly emphasized how important it is that state and local governments have and follow clear policies and procedures that identify specific individuals responsible for disclosure.\footnote{152} At a

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\item 148. Id. These topics are discussed in Section III.D, infra.
\item 149. Id. at *8-9.
\item 151. Id. at *6–7.
\item 152. The focus on policies and procedures also extends to corporate issuers; the prevention of fraud through policies and procedures by corporate issuers and other entities regulated by the SEC is seen by some as a “fundamental new theme” of the Exchange Act. See Fippinger, supra note 9, § 1:7.7[B] (noting that changes in law have had this effect). NABL noted that “the importance of written disclosure policies . . . appear to represent one of [the SEC’s] major emphases in the municipal securities

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minimum, these policies and procedures should identify responsible
individuals, state the process by which disclosure is drafted and re-
viewed, and provide appropriate checks and balances.¹⁵³

Recent SEC actions have highlighted the importance of policies
and procedures. For example, in 2017, the SEC found that the City of
Beaumont, California’s Financing Authority failed to disclose that its
affiliated community facilities district had “regularly failed to com-
ply” with its continuing disclosure undertakings due to a failure to
exercise reasonable care.¹⁵⁴ In particular, the SEC noted that the Au-
thority and the district did not have “formal written policies or proce-
dures for the preparation of accurate, complete and timely official
statements or post-issuance continuing disclosures,” did not maintain
appropriate records of bond transactions, and did not clearly delineate
responsibilities among staff, officers and others, but instead relied on
one individual “without any significant governance, oversight or su-
ervision.”¹⁵⁵ The SEC required the Authority to establish appropriate
policies and procedures, to retain an independent consultant and adopt
all recommendations made by the consultant unless agreed to by the
SEC, and to provide periodic training, among other things.¹⁵⁶

The SEC indicated that the State of New Jersey’s lack of written
policies and procedures relating to the review and updating of offering
documents and failure to provide training to employees about the
State’s disclosure obligations caused its antifraud provision violations
that led to a 2010 cease-and-desist order against the State.¹⁵⁷ The SEC
also noted that the City of Harrisburg, Pennsylvania lacked policies
and procedures to ensure that its publicly released financial informa-
tion was materially accurate or to ensure compliance with its continu-
ing disclosure undertakings during the time that the City made
materially inaccurate public statements about its finances and had not
complied with its continuing disclosure undertakings.¹⁵⁸

¹⁵³ Thomsen, supra note 133. For detailed discussion of what should be included in
policies and procedures, see Nat’l Ass’n of Bond Lawyers, Crafting Disclosure Policies A-4
¹⁵⁵ Id. at *4.
¹⁵⁶ Id. at *5–7.
18, 2010) (cease-and-desist order); Press Release, Sec. & Exch. Comm’n, SEC
Charges State of New Jersey for Fraudulent Municipal Bond Offerings (Aug. 18,
*5–6, 8 (May 6, 2013) (cease-and-desist order). As noted previously, the SEC also
This emphasis was also apparent in the cease-and-desist orders against more than sixty state and local governments as part of the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC"), which all included a requirement to establish appropriate policies and procedures. Additionally, in at least eleven cases since 2010, the SEC has required the adoption or review of written policies and procedures or has indicated that it accepted a settlement offer in part because such policies and procedures had been adopted.

Of course, once policies and procedures are adopted, it is important that issuers comply with them.

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158. MCDC is described in detail in Section III.E.1.
159. See note 150 and accompanying text.
160. See infra note 190 and accompanying text.
162. See Jack Casey, Lawyers Say Policies, Procedures Key for Issuers Amid SEC Focus on Enforcement, BOND BUYER (May 24, 2017, 12:50 PM), https://www.bondbuyer.com/news/lawyers-say-policies-procedures-key-to-helping-issuers-as-sec-continues-emphasis-on-enforcement (quoting former SEC lawyer Peter Chan as saying that it is important for issuers to be able to demonstrate compliance if the SEC asks); NAT’L ASS’N OF BOND LAWYERS, supra note 152, at 6 (noting that documenting compliance is particularly important in the case of an SEC or other investigation).
D. Lack of Expertise and Insufficient Training

Many local governments do not have internal expertise regarding municipal bonds.\(^{163}\) The SEC has pointed to lack of expertise and lack of training as contributing to disclosure problems. In a 2013 cease-and-desist order against the City of South Miami, Florida, which had risked the tax-exempt status of its bonds because of misrepresentations and noncompliance by the issuer but continued to make certifications to the contrary, the SEC highlighted “significant turnover” in the City’s Finance Department as an issue and noted that “[t]he City’s finance directors, while responsible for receiving, signing, and returning the annual compliance certifications, had no previous experience completing, reviewing, or assessing disclosure requirements or tax issues in bond offerings and did not receive any training or guidance on the subject.”\(^{164}\) As noted above, the SEC also highlighted a lack of training as one of the causes of the State of New Jersey’s securities law violations in its 2010 cease-and-desist order against the State of New Jersey and related press release.\(^{165}\)

Training has thus been a priority in crafting remedies. The SEC required each of the state and local governments against which it issued cease-and-desist orders as part of MCDC to implement a periodic training program.\(^{166}\) In each of the eleven cases since 2010 requiring the adoption or review of written policies and procedures, the SEC either mandated the implementation of a training program or accepted a settlement offer because one had been implemented.\(^{167}\)

The SEC also has required state and local governments to retain outside experts or has agreed to accept a settlement offer in part be-

\(^{163}\) See, e.g., Jack Casey, MCDC’s Appropriateness, Effect on Market Disclosure Debated, BOND BUYER (May 5, 2016, 10:20 AM), http://www.bondbuyer.com/news/washington-securities-law/mcdcs-appropriateness-effect-on-market-disclosure-debated-1102961-1.html (stating that some panelists indicated that the main problem with disclosure is lack of resources, and that officials for small issuers sometimes have multiple responsibilities; one panelist cited the example of a finance director for a small school district who also drives the school bus); Monique Moyer, Current Issues Facing Bond Issuers and Their Financial Advisors, MUN. FIN. J., Summer 2003, at 17, 18 (noting that most cities and counties have few resources dedicated to debt management and that their advisors frequently know more about the cities’ or counties’ own bonds than the cities and counties do); Justin Marlowe, GOVERNING INST., GOVERNING GUIDE TO FINANCIAL LITERACY: CONNECTING MONEY, POLICY AND PRIORITIES 5 (2014), https://media.erepublic.com/document/GOV14_FinancialLiteracy_v.p.pdf (reporting that only thirty-eight percent of federal, state, county, and local government leaders consider themselves very knowledgeable in public finance).

\(^{164}\) City of S. Miami, 2013 WL 2244383, at *5.

\(^{165}\) See infra note 190 and accompanying text.

\(^{166}\) See infra note 190 and accompanying text.

\(^{167}\) See supra note 161.
cause they have already done so in several instances. For example, when it agreed to accept a settlement offer from the State of New Jersey, the SEC specifically noted the involvement of disclosure counsel in enhancing the State’s disclosure process, both as a participant in the committee overseeing the process and as a provider of disclosure training.\footnote{168} Similarly, in the Allen Park matter, the city’s agreement to adopt written policies and procedures drafted by disclosure counsel, to involve disclosure counsel in any bond offerings by the city for two years, and to designate disclosure counsel to train personnel was incorporated in the cease-and-desist order.\footnote{169} The SEC identified retention of outside bond counsel for all of its bond offerings as one of the remedial actions taken by the Port Authority and retention of disclosure counsel as one of the remedial actions taken by the State of Illinois.\footnote{170} The SEC has also required independent consultants to be involved in reviewing and, where needed, improving disclosure policies in cases against several local governments.\footnote{171}

\subsection*{E. Failure to Recognize Importance of Compliance with Disclosure Obligations}

The SEC also seems to be concerned that some state and local governments do not take their disclosure obligations seriously and that there is “an entrenched culture of noncompliance.”\footnote{172} The lack of expertise and lack of training discussed in Section III.D may contribute to the failure to recognize the importance of compliance with federal securities laws.\footnote{173} In addition, officials’ focus on and dedication of resources to the government’s core mission may come at the expense of compliance with obligations that may be perceived as ancillary, in-

172. See Aguilar, supra note 53.
173. See U.S. Gov’t Accountability Off., supra note 92, at 14–15 (noting that some issuers fail to comply with their continuing disclosure undertakings because they do not understand or are not aware of their obligations, and that staff turnover can contribute to the problem).}
cluding disclosure obligations.\textsuperscript{174} Ironically, the fact that state and local governments release a “wide range of information routinely . . . to the public, formally and informally . . . in their day-to-day operations”\textsuperscript{175} may cause them to focus less on federal securities laws and disclosure directed to investors; they may be releasing a lot of information, but could still be making material misstatements or omissions in official statements, failing to make required continuing disclosure filings, or releasing improperly vetted information to the public that is misleading to investors.\textsuperscript{176}

The SEC’s Enforcement Division has sent a clear message that state and local governments should take their disclosure obligations under federal securities laws seriously through a “bold and unrelenting”\textsuperscript{177} approach to enforcement, including MCDC, other increased enforcement activity, tougher penalties for government issuers, and a more aggressive approach towards municipal officials.

\textbf{1. The Municipalities Continuing Disclosure Cooperation Initiative}

The SEC’s 2014 Municipalities Continuing Disclosure Cooperation Initiative was the first self-reporting initiative taken by the Enforcement Division since 1975\textsuperscript{178} and one of the most significant actions taken by the Enforcement Division with respect to the municipal market in recent years.

\textsuperscript{174} See id. at 14–15 (noting that “completing priorities in times of budgetary challenges” may result in noncompliance). State and local governments must invest time and money to prepare quality official statements and comply with continuing disclosure obligations. While monetary costs for preparing an official statement, such as the charges of disclosure counsel and the printer, are often paid out of bond proceeds (so the government pays them over time as it pays debt service on the bonds), costs associated with continuing disclosure undertakings, such as charges of disclosure counsel or a municipal advisor that assists in the preparation of filings, cannot be paid this way.

\textsuperscript{175} Statement of the Commission Regarding Disclosure Obligations, supra note 71, at 12755.

\textsuperscript{176} For example, the SEC acted against the City of Harrisburg, Pennsylvania, because there were material misstatements and omissions in information posted on the City’s website at a time when the City was experiencing financial difficulties and was not complying with its continuing disclosure undertakings. City of Harrisburg, Exchange Act Release No. 69515, 2013 WL 1869030, at *1–2 (May 6, 2013).

\textsuperscript{177} Mary Jo White, then chair of the SEC, used this phrase to describe her approach. See Mary Jo White, Chair, Sec. & Exch. Comm’n, Speech at the New York University Program on Corporate Compliance and Enforcement: A New Model for SEC Enforcement: Producing Bold and Unrelenting Results (Nov. 18, 2016), https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html.

\textsuperscript{178} Ceresney, supra note 1.
a. Reasons for MCDC

MCDC was intended to address instances in which issuers had failed to disclose prior noncompliance with continuing disclosure undertakings in official statements. As described in Section II.C.2.b, underwriters are prohibited from buying or selling municipal bonds in a public offering unless they have reasonably determined that the issuer has entered into a continuing disclosure undertaking to post updated information annually and to provide notice of specified events. Official statements are required to disclose any instances of material noncompliance in the preceding five years.179

The SEC perceived noncompliance with continuing disclosure undertakings and failure to disclose material noncompliance as “widespread,”180 and there is reason to believe that the SEC was correct in its assessment. In a 2002 study, the National Federation of Municipal Analysts (“NFMA”) found that approximately fifty-eight percent of issuers and other obligated entities did not deliver all of the information that was required by their continuing disclosure undertakings.181 A NFMA official noted that compliance declined as years passed and that noncompliance was more common among small and medium issuers.182 She also noted that many material event notices were “filed weeks or months after the event, or they are not filed at all.”183 In addition, the California Debt and Investment Advisory Commission (“CDIAC”) determined in 2011 that over twenty percent of a random sample of California state and local government issuers either filed their financial statements with EMMA more than thirty days later than they had agreed to in their continuing disclosure undertakings or did not file them at all.184 Another report indicated that for the period 2005-2009, over fifty-six percent of issuers or other obligated entities failed to make a filing for at least one year, and nineteen percent made

180. MCDC Initiative, supra note 94, at § I.
181. Press Release, Nat’l Fed’n of Mun. Analysts, NFMA Releases Results of Disclosure Survey (May 23, 2002), http://www.nfma.org/assets/documents/disclosure_survey.pdf [https://perma.cc/T2MB-E3DC]. The study also evaluated the adequacy of the undertakings and concluded that 40.9% of issuers and other obligated entities had inadequate undertakings, failed to comply with undertakings, or both. Id.
183. Id. at 47.
no filings at all during the period and described noncompliance as “broad based and pervasive across the market,” rather than limited to small issuers, a specific type of bond or specific region.  

b. Provisions of MCDC

MCDC provided issuers and underwriters with an opportunity to self-report failures to disclose noncompliance with prior continuing disclosure undertakings in official statements. In exchange, the SEC offered to recommend standardized settlement terms that would be more lenient than the SEC would offer to entities that did not self-report. For instance, the standardized terms did not include any monetary penalties for issuers. The terms included standardized monetary penalties for underwriters for each violation, but there were caps on the total penalty that an underwriter would be charged based on the underwriter’s total revenue. Settlements for issuers would require the issuer to comply with existing undertakings and to establish policies and procedures and a training program regarding continuing disclosure obligations, among other things. Settlement agreements with underwriters would require the implementation of processes and procedures recommended by an independent consultant. Self-reporting would not protect municipal officials or employees of underwriting firms.

c. Response to MCDC

Because underwriters’ total civil penalty was capped, they had incentives to report as many transactions as possible once they were reporting enough transactions to reach the cap.

185. SCHMITT, supra note 89, at 11, 18.
186. Even though the official statement is the issuer’s document, an underwriter may violate the antifraud provisions if it does not perform adequate due diligence to form a reasonable basis for believing the accuracy of the official statement. See supra notes 82–84 and accompanying text. See also MCDC Initiative, supra note 94, § II (emphasizing the underwriter’s obligation to have a reasonable basis to believe the accuracy of key representations in an official statement applies to representations about past compliance with continuing disclosure undertakings).
187. The SEC specifically indicated that it would likely seek stronger remedies for violations that were not self-reported, including financial sanctions for issuers and higher financial sanctions for underwriters. MCDC Initiative, supra note 94, § III.E.
188. Id. § III.C.3.
189. Id.
190. Id. § III.C.2.
191. Id.
192. Id. § III.D.
Furthermore, because both underwriters and issuers could self-report the same failure to disclose past noncompliance under MCDC, and because the SEC had indicated that settlements with parties that had not self-reported could include more stringent terms, including higher monetary penalties, there were incentives to report failures to disclose noncompliance because the issuer and the underwriter would each be in a worse position if the other reported an instance of noncompliance and they did not.

MCDC received a great deal of attention in the municipal market. Organizations such as the Government Finance Officers Association (“GFOA”), the National Association of Bond Lawyers (“NABL”), and the CDIAC provided materials to assist issuers in determining how to respond.\footnote{See Cal. Debt & Inv. Advisory Comm’n, Municipalities Continuing Disclosure Cooperation Initiative, CAL. ST. TREASURER, https://www.treasurer.ca.gov/cdiac/mnra/mcdc.asp (last visited Feb. 17, 2019).} Law firms sent out alerts to clients and gave presentations about MCDC.\footnote{See, e.g., The SEC’s MCDC Initiative: Where to Go From Here, KATTEN MUCHIN ROSENMAN LLP (Oct. 14, 2014), https://www.kattenlaw.com/files/72574_The_SECs_MCDC_Initiative_Where_To_Go_From_Here.pdf [https://perma.cc/SHZG-HJSV]; Daniel M. Deaton et al., New Initiative from the SEC Encourages Municipal Issuers and Underwriters to Self-Report Material Misrepresentations Regarding Continuing Disclosure Failings or Risk Harsher Penalties, NIXON PEABODY LLP (May 8, 2014), https://www.nixonpeabody.com/-/media/Files/Alerts/169096_MCDC_Initiative_Public_Finance_Alert_8MAY2014.ashx [https://perma.cc/3WEF-ANY4]; The S.E.C. Is Serious About Continuing Disclosure: What Issuers, Obligors and Underwriters Need to Know About the New Self-Reporting Initiative, ORRICK (May 14, 2014), https://www.orrick.com/Insights/2014/05/The-SEC-is-Serious-About-Continuing-Disclosure.} Eighty-three percent of respondents to a GFOA survey reported that an underwriter had contacted them about continuing disclosure compliance as a result of the survey, thirty-nine percent said an underwriter had reported them to the SEC under MCDC, and seventy-nine percent reported that they had hired outside professionals to assist in determining whether and how to respond to MCDC.\footnote{MCDC Initiative Survey, GOV’R FIN. OFFICERS ASS’N, (June 2, 2015), http://www.gfoa.org/sites/default/files/MCDC%20Survey%20Results_Web.pdf [https://perma.cc/6VS6-9RBC].}

It was reported that at least 1,000 self-reports were filed under MCDC.\footnote{Hilary Russ, U.S. Towns, Schools Admit to Failing to Filing Financial Disclosures, REUTERS (Dec. 1, 2014, 7:20 PM), https://www.reuters.com/article/us-municipals-filings/u-s-towns-schools-admit-to-failing-to-filing-financial-disclosures-idUSL2N0TL14X20141202.} Ultimately, the SEC entered into settlements with more than seventy underwriters as a result of the initiative, comprising approximately ninety-six percent of the market share for municipal un-
The SEC also entered into settlements with more than seventy issuers and other obligated entities, including more than sixty state and local governments. Issuers with which the SEC entered into settlements under MCDC included states, municipalities, school districts, and special districts, among others. These issuers were “of all types and sizes, not just small, infrequent issuers.”

2. Increased Enforcement Activity and Tougher Penalties for Government Issuers

In addition to sending the message through MCDC that issuers need to take their disclosure responsibilities seriously, the SEC has conveyed this message by taking more enforcement actions against government issuers and by imposing tougher penalties on them. As was noted earlier in this article, the SEC has focused on the municipal market in recent years and has significantly increased the number of enforcement actions against state and local governments (even if MCDC is excluded from the calculation). Since 2013, the SEC has taken action against a government on the basis of political speech (public statements by its mayor) and has taken action against an issuer for statements made in certificates never expected to be seen by investors, both for the first time. It appears that the SEC also may have begun pursuing more cases involving municipal bonds in federal


199. For a list of all of the cease-and-desist orders and links to the cease-and-desist orders, other than Kings Canyon Joint Unified School District, see Press Release, Sec. & Exch. Comm’n, supra note 197. The Kings Canyon Joint Unified School District Order is available at SEC Charges California School District with Misleading Investors, supra note 198.


201. See supra notes 125–29 and accompanying text.

court\textsuperscript{203} and that the SEC is coordinating more with criminal authorities on municipal matters.\textsuperscript{204}

The SEC has also imposed tougher penalties on issuers. It assessed its first civil penalty against a government issuer ($20,000) in its 2013 cease-and-desist order regarding a misleading official statement of a municipal corporation formed to finance an arena and hockey rink.\textsuperscript{205} Referring to this cease-and-desist order, the co-director of the SEC’s Enforcement Division stated that “financial penalties against municipal issuers are appropriate for sanctioning and deterring conduct when, as here, they can be paid from operating funds without directly impacting taxpayers.”\textsuperscript{206} An agricultural water district in California was required by the SEC to pay a $125,000 civil penalty because of its violation of Securities Act antifraud provisions.\textsuperscript{207} The City of Miami agreed to pay $1,000,000 to the SEC as part of a settlement of a case that the SEC brought in federal court alleging that the city had violated a prior cease-and-desist order and the antifraud provisions of the Securities Act and the Exchange Act by falsely inflating the City’s general fund balance in its financial statements and official statements.\textsuperscript{208} The Port Authority of New York and New Jersey was required to pay a $400,000 civil penalty as part of a settlement.\textsuperscript{209} In addition, in recent years the SEC has required issuers to retain independent consultants and to take other actions.\textsuperscript{210}

\begin{thebibliography}{99}
\bibitem{203} See \textit{id.} at 113–14 (referring to the appearance of a strategy to do this).
\bibitem{204} Id. at vii, n.4 (describing coordination with the U.S. Department of Justice and indicating that the SEC intends to increase its coordination with criminal authorities in the future).
\bibitem{206} Press Release, Sec. & Exch. Comm’n, \textit{supra} note 205 (quoting Andrew Ceresney, Co-Dir., Sec. & Exch. Comm’n, Div. of Enf’t).
\bibitem{209} Port Auth. of N.Y. & N.J., Securities Act Release No. 10278, 2017 WL 83465, at *10; see \textit{supra} notes 143–45 accompanying text for further discussion of this action.
\bibitem{210} Some of these are discussed \textit{supra} Sections III.C–D.
\end{thebibliography}
3. More Aggressive Action Against Government Officials

Consistent with the view that “[h]olding individuals liable for wrongdoing is a core pillar of any strong enforcement program,” the SEC has taken a more aggressive approach towards individual government officials in recent years. For example, in 2014, the SEC for the first time held a municipal official responsible for misrepresentations in official statements because he controlled the issuer, even though he was not directly accused of knowledge of misrepresentations in official statements.

Since 2013, more aggressive enforcement has also involved more frequent and steeper civil penalties on municipal officials. While the SEC imposed a total of $85,000 of civil penalties on five officials from 1998-2012 (and no civil penalties on officials before 1998), it imposed a total of $180,000 on eight officials from 2013 to mid-2016. The $50,000 penalty imposed on a government official in 2016 was more than double the largest civil penalty previously imposed on a government official. More recently, the former executive director of a California joint powers authority agreed to a $37,500 civil penalty in a 2017 settlement with the SEC, and in 2018, two officials of a New York town agreed to civil penalties of $10,000 and $25,000, respectively, and a federal court imposed $327,000 in civil penalties.

211. White, supra note 177.
212. Allen Park Press Release, supra note 141. The SEC did this again in 2016. Press Release, Sec. & Exch. Comm’n, Mayor in Illinois Settles Muni Bond Fraud Charges, May 19, 2016, https://www.sec.gov/news/pressrelease/2016-93.html [hereinafter Harvey Press Release]. Some commentators have suggested that in both of these circumstances, the SEC believed the official in question knew or should have known of the fraud. See Leonard Weiser-Varon, John R. Regier & Breton Leone-Quick, Current and Former SEC Officials Speak About Enforcement Issues Concerning Municipal Securities, Mintz Brcko (Mar. 14, 2015), https://www.mintz.com/insights-center/viewpoints/2891/2015-03-current-and-former-sec-officials-speak-about-enforcement (“[i]t appears as if the SEC believed they had proof that Allen Park’s mayor was complicit in the alleged fraud.”); Dory, supra note 24, at 117 (“One is left to infer in both the Harvey and Allen Park actions . . . that the Mayors ‘must have known’ or ‘should have known’ what was occurring.”).
213. Dory, supra note 24, at 6.
214. Id. at 31 (referring to the penalty levied on the general manager of Westlands Water District in a 2016 cease-and-desist order).
penalties on another official of the same town. In some instances, the SEC imposed penalties when officials did not personally benefit from the alleged violations of the antifraud provisions.

In addition, in recent years, the SEC has begun prohibiting some municipal government officials from further participation in municipal bond offerings. Both the former mayor and the former city administrator of Allen Park, Michigan agreed not to participate in future municipal bond offerings as part of their settlements with the SEC. The mayor of an Illinois city and the executive director of a California joint powers authority similarly agreed to be barred from participating in future municipal bond offerings. These prohibitions can have severe effects on an individual’s career.

IV. THE IMPACT OF THE SEC’S ACTIVITY AND OTHER AVENUES FOR IMPROVEMENT

The SEC’s recent enforcement activity appears to have been effective in changing issuer behavior in ways that lead to improved disclosure, but also has been costly. Section IV.A discusses the changes to issuer behavior that have resulted from the SEC’s activity, while


217. Id.


219. Allen Park Press Release, supra note 141. See supra notes 136–141 for a description of the circumstances that led to the SEC charges against these officials.

220. Harvey Press release, supra note 212; Kapanikas Release, supra note 215. Officials of the Town of Ramapo also agreed as part of a settlement to be barred from participating in future municipal bond offerings. June Ramapo Release, supra note 216.

221. See Dever, supra note 218 (noting that a ban on participating in municipal bond issuances “will undoubtedly affect that individual’s current and future employment in the public finance sector” and may be a “career-ending sanction”); Guidotti, supra note 8, at 2087–88 (noting that the SEC fraud settlement will make it harder for the former mayor of Allen Park to be elected to public office and would make it difficult for him to work for a city in any capacity).
Section IV.B touches on the associated costs. The remainder of Part IV discusses alternative means for the SEC and others to address the issues that the SEC has identified in the future.

A. The SEC’s Actions Appear to Have Changed Issuer Behavior

The SEC’s recent enforcement activity appears to have changed the behavior of government issuers. One commentator noted that “[t]hrough MCDC and other enforcement actions, the Securities and Exchange Commission has led virtually all underwriters of municipal securities, and many issuers, to change their internal practices” and has “revolutionize[d] . . . municipal securities due diligence practices by underwriters and disclosure practices by issuers.”

1. Continuing Disclosure

It appears that the Chair of the SEC was correct in her assessment that “All indications are that MCDC has vastly increased issuer compliance with their continuing disclosure obligations.” A 2016 survey of municipal analysts revealed that “there is agreement among analysts that disclosure had improved dramatically” as a result of MCDC.

Submissions of financial information to EMMA increased from approximately 72,000 in 2012 to over 101,000 in 2014. Filing levels remained relatively high in 2015–2018 (approximately 97,000 in 2015, 98,000 in 2016, 102,000 in 2017, and 96,000 in 2018). The continued higher levels of filing are arguably more significant because some of the filings in 2014 may have been filings made to correct prior failures to file during the period when issuers were determining how to respond to MCDC. While it may be that some of the increase in the number of submissions is because of growth in the number of outstanding bond issuances subject to continuing disclosure

222. Doty, supra note 24, at 42, 79.
223. White, supra note 177.
226. Mun. Sec. Rulemaking Bd., 2018 Fact Book 66 (2019). The decline in 2018 is curious; it may be a result of fewer issuers with obligations outstanding or might be a result of waning attention a few years after MCDC. Further inquiry into this is merited.
227. See Casey, supra note 163 (quoting Lisa Washburn, Chair, Nat’l Federation of Mun. Analysts, as saying that analysts saw a lot of filings on EMMA after MCDC was announced).
undertakings or for other reasons, it is probable that a significant portion of the increase is attributable to increased focus on continuing disclosure compliance by both issuers and underwriters (and their respective counsel) post-MCDC.\footnote{228}{This is both because of greater awareness of continuing disclosure obligations and the need to disclose material noncompliance, and because underwriters comprising approximately 96% of market share in municipal bond offerings are subject to cease-and-desist orders issued under MCDC. See supra note 197 and accompanying text.}


2. Adoption of Policies and Procedures

Anecdotally, at least, there also is more focus on policies and procedures related to disclosure. The State of Illinois began to implement remedial measures following the release of the SEC’s order against the State of New Jersey in 2010, including retaining disclosure counsel, enhancing its pension disclosure, developing training materials, adding formal disclosure controls regarding pension information and establishing a disclosure committee that collects information, approves the state’s disclosure and ensures that offering documents have been reviewed.\footnote{232}{Illinois, Securities Act Release No. 9839, 2013 WL 873208 at *8 (Mar. 11, 2013). These remedial measures were taken into consideration by the SEC in agreeing to the settlement with Illinois. \textit{Id.} at *9.} Commentators at The Bond Buyer’s 2016 California Public Finance conference emphasized the importance of written disclosure policies for issuers.\footnote{233}{Casey, supra note 230.} State agencies and other organiza-
tions have provided numerous trainings on disclosure policies.\textsuperscript{234} NABL prepared a guide to drafting disclosure policies,\textsuperscript{235} the GFOA published articles emphasizing the importance of disclosure policies,\textsuperscript{236} public finance law firms have disseminated articles and alerts with titles like “On the To Do List for Municipal Bond Issuers: Disclosure Policies and Procedures,”\textsuperscript{237} and trade publications have published articles with titles like “Sound Continuing Disclosure Policies and Procedures are Critical.”\textsuperscript{238}

\section*{B. The SEC’s Actions Are Costly}

While it does appear that the SEC’s recent enforcement actions have had some success in changing market practices, this success does not come without a cost. A local government that is charged with, or even investigated for, antifraud violations by the SEC is likely to incur substantial legal fees and spend many hours of staff time addressing

\begin{footnotesize}
\begin{enumerate}
\item See Understanding Your Continuing Disclosure Responsibilities, Gov’t Fin. Officers Ass’n, https://www.gfoa.org/understanding-your-continuing-disclosure-responsibilities-0/ (last visited Aug. 23, 2019) (recommending adoption of a “thorough continuing disclosure policy” and describing policies and practices that should be considered); Primary Market Disclosure, Gov’t Fin. Officers Ass’n, http://www.gfoa.org/primary-market-disclosure (last visited Aug. 24, 2019) (noting the importance of written procedures and identifying practices that should be included).
\item Bienstock, supra note 229.
\end{enumerate}
\end{footnotesize}

MCDC was costly for state and local governments throughout the country, and not only for those that participated. The Florida Director of Bond Finance referred to it as a “monumental waste of resources.”\footnote{Casey, \textit{supra} note 163 (quoting J. Ben Watkins, III, Dir., Fla. Div. of Bond Fin.).} A survey by the GFOA reportedly found that government issuers of different sizes spent an average of between $2,000–$18,000 (and an overall average of $6,000) as well as between 20–250 hours responding to MCDC.\footnote{Kyle Glazier, \textit{GFOA’s Watkins: MCDC Cost Issuers; SEC Initiative ‘An Abuse of Power’}, \textit{Bond Buyer} (June 2, 2015, 1:13 PM), https://www.bondbuyer.com/news/gfoa-watkins-mcdc-cost-issuers-sec-initiative-an-abuse-of-power. While the results of the survey may not be representative of issuers as a whole due to small sample size, \textit{id.}, it is clear from the survey that expenses were incurred by issuers.} These figures include not only issuers that self-reported, but issuers that did not; 65\% of the issuers participating in this survey ultimately did not self-report.\footnote{MCDC Initiative Survey, \textit{supra} note 195 (pie chart “Did your entity self-report to the SEC under the MCDC Initiative?”). This percentage may not be representative of the market as a whole due to the small sample size, Glazier, \textit{supra} note 242, but certainly many issuers spent time and money evaluating whether to self-report and concluded that they did not need to do so. My personal experience and anecdotal evidence from other public finance professionals with whom I am acquainted also suggests that numerous issuers retained outside experts to advise them whether to self-report and ultimately concluded that they did not need to do so.} Underwriters also in-
curred costs determining how to respond to MCDC, and the SEC incurred costs processing a large number of responses.\footnote{Reportedly, at least 1,000 responses were filed. Russ, \textit{supra} note 196.}

Complying with SEC orders or injunctions also can be costly, and not only in terms of monetary penalties. Retaining outside experts, developing and implementing policies and procedures and training programs use resources that otherwise could be used for other purposes. To the extent that governments that are not involved in SEC actions voluntarily undertake these activities, they incur costs as well.

SEC enforcement actions and remedies can also be expensive in other ways. More aggressive treatment of public officials may make government employment less attractive, which may exacerbate the lack of expertise that the SEC has identified as a problem.\footnote{Guidotti, \textit{supra} note 8, at 2088.} Furthermore, the time and resources of issuer and underwriter personnel and outside professionals are limited, and the heightened, sometimes excessive, focus on disclosure of past noncompliance with continuing disclosure undertakings may in some cases take time and attention away from more fundamental credit issues that should be disclosed in an official statement. For example, a participant in a 2016 conference mentioned that nearly half of the 38 questions on a due diligence call had focused on disclosure.\footnote{Casey, \textit{supra} note 230 (citing Eric Goldstein, Principal Administrative Analyst, The Metropolitan Water District of Southern California).} Time and resources spent on disclosure also are not available for the state or local government’s core functions. The Assistant Finance Director of Oklahoma City pointed out at a recent SEC conference that one result of past enforcement actions against other issuers has been higher legal expenses and higher costs of responding to underwriter due diligence.\footnote{Kenton Tsoodle, U.S. Sec. & Exch. Comm’n, \textit{The Road Ahead: Municipal Securities Disclosure in an Evolving Market} (Dec. 6, 2018), https://www.sec.gov/video/webcast-archive-player.shtml?document_id=municonference120618, at approx. 1:47.}

The benefits of the SEC’s approach to enforcement in the municipal market may outweigh the costs, but the costs should be considered, particularly to the extent that the actions are being used to send a message rather than to punish a particular violator. Furthermore, alternative ways for the SEC, or for other entities, to achieve the same ends going forward should be considered. This is the subject of the next three sections of this article.
C. What Approach Should the SEC Take in the Future?

As is discussed in Section II.B, the SEC does not have the authority to specify the contents of official statements, to require issuers to make periodic filings, or to compel government issuers to implement particular procedures or training requirements. Nevertheless, there are several approaches that the SEC could take to send messages to the municipal market about the issues it has identified and to change practices in the municipal market.248

1. Interpretive Release and Publicity

One option that the SEC has is to issue updated interpretive guidance and to publicize that guidance through discussions with and presentations to prominent industry groups and at conferences. The SEC last provided interpretive guidance to the municipal market in 1994 and has suggested that it could do so again.249 The SEC’s Investor Advisory Committee supports updated interpretive guidance,250 and the GFOA has expressed interest in working with the SEC on updated guidance.251

An interpretive release could address specific aspects of disclosure and responsibilities of specific market participants for disclosure and could highlight the importance of having good disclosure practices in place and retaining qualified outside experts to assist with the transaction. Because the SEC’s role is to enforce the securities laws,

248. This article does not address the possibility of expanding the SEC’s powers. However, even if the SEC did have broader power over state and local governments in the future, it would not be appropriate for it to regulate the internal procedures of state and local governments. The SEC’s role is limited to protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation. Sec. & Exch. Comm’n, The Role of the SEC, INVESTOR.GOV, https://www.investor.gov/introduction-investing/basics/role-sec (last visited Feb. 18, 2019). It would be beyond the scope of this role to dictate the internal workings of state and local governments, at least to the extent that there is not a clear and direct effect on the quality of disclosure. Arguably this would also violate concepts of “intergovernmental comity,” the concept that governments should respect the internal workings of other governments (or as one commentator more bluntly put it, “making nice to another government;” see Gabaldon, supra note 53, at 754). Furthermore, the policies and procedures that will be most effective for a particular local government will vary, and even if requirements were fairly general, enforcing the requirements likely would use a substantial amount of limited resources that could be better used elsewhere.

249. SEC & EXCH. COMM’N, supra note 12, at 139.


not to control the internal workings of state and local governments, it should refrain from making specific recommendations to state and local governments about their internal operations beyond what is necessary to prevent violations of the antifraud provisions.\footnote{See supra note 248 for a discussion of some of the reasons the SEC should not regulate internal procedures of municipal issuers.} That said, the SEC could identify problems that it has seen in the past that have led to misleading disclosure and indicate that an entity following thoughtfully developed policies and procedures—including regular training, review and discussion of disclosure by appropriate individuals within the organization—is less likely to violate Rule 10b-5, for which scienter is required.\footnote{See supra note 74 and accompanying text. See also Nat’l Ass’n of Bond Lawyers, supra note 152, at 2 (noting that compliance with disclosure policies can help establish a defense of reasonable care in the event of an alleged material misstatement or omission).} It could also identify specific aspects of disclosure policies that it views as important, such as specifically identifying responsible individuals, including checks and balances, and retaining outside counsel.\footnote{See supra note 153 and accompanying text.}

While an interpretive release and publicity might not have the same impact as the recent enforcement actions (particularly MCDC) have had in terms of persuading issuers to take their disclosure obligations seriously, it would have some advantages. Unlike in a cease-and-desist order, where it is constrained by the specific facts of the case, the SEC would be able to craft an interpretive release to state precisely what it believes the responsibilities of market participants are. Furthermore, the SEC would be able to gather input from market participants on an interpretive release.\footnote{For example, the GFOA provided comments at the time the 1994 interpretive release was drafted and adopted and has indicated its desire to do so again. Brock, supra note 251, at 2. The 1994 interpretive release also invited comment. Statement of the Commission Regarding Disclosure Obligations, supra note 71, at 12758.} Ambiguities that might be present in a cease-and-desist order could be avoided in an interpretive release, increasing the likelihood that a greater proportion of the public finance market gets the intended message, particularly as it is summarized in two or three talking points in publications geared towards the municipal market and by market participants at conferences and in newsletters and other publications. This may be particularly important for government issuers that do not have high quality experts advising them on disclosure issues.

Of course, interpretive guidance will only be effective if the SEC’s message reaches government issuers. To reach the largest num-
ber of issuers, the SEC will likely need to publicize its message through many channels, including its own conferences, through organizations that represent categories of local governments, such as the National League of Cities, the National School Boards Association and Airports Council International North America, as well as through broader organizations like the GFOA and NABL and state organizations like CDIAC and the Oregon Municipal Debt Advisory Commission. It may be easier for the SEC to publicize a new interpretive release than a particular enforcement action or series of enforcement actions. While no amount of publicity will ensure that all local governments have heard and understand the SEC’s messages, greater dissemination of information should improve market practices generally.

2. Enforcement of Existing Underwriter and Municipal Advisor Rules

Government issuers, particularly small ones, sometimes lack the expertise necessary to understand the instruments and the financial agreements into which they are entering, much less to accurately describe the material terms and risks of these instruments and agreements to investors. The SEC has identified lack of expertise as an issue, as have others. While they are not perfect solutions to this


257. A former SEC lawyer noted that SEC staff was surprised that even after they announced MCDC and after he had spoken at a GFOA conference, there were “quite a number of issuers” that had not heard of MCDC or prior SEC statements on continuing disclosure. Casey, supra note 162 (quoting Peter Chan).

258. See supra notes 164–165 and accompanying text.

259. See supra note 163. See also SAN MATEO CTY. CIV. GRAND JURY, CAPITAL APPRECIATION BONDS: TICKING TIME BOMBS 7 (2013), http://www.sanmateocourtoffice.org/documents/grand_jury/2012/bonds.pdf (“A southern California school chief business officer lamented the lack of financial expertise that leaves many districts unqualified to navigate complex bond deals – or to do business with high-powered financial advisers[:]. ‘They’re swimming with the sharks […] These are principals and assistant superintendents of curriculum, and they’re being promoted to the role of a chief business officer.’”); Stephan Whitaker, Financial Innovations and Issuer Sophistication in Municipal Securities Markets 4 (Fed. Reserve Bank of Cleveland, Working Paper No. 14-04, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446979 (identifying the entry into contracts they didn’t understand as a contributor to the Orange County, California and Detroit, Michigan bankruptcies); Bill Simonsen et al., The Influence of Jurisdiction Size and Sale Type on Municipal Bond Interest Rates: An Empirical Analysis, 61 PUB. ADMIN. REV. 709, 715 (2001) (reporting the conclusion of an empirical study of municipal bond sales in Oregon that small communities pay
problem, the fiduciary duty imposed on municipal advisors in 2010 and the interpretation by the MSRB of Rule G-17 that requires underwriters to explain the material aspects of the financing structures it recommends, taking into account the level of expertise of the issuer, should contribute to addressing this issue.\(^{260}\)

The SEC has taken several enforcement actions against municipal advisors for violating their fiduciary duties to government clients, including in instances that highlighted the reliance of the government on the advisor’s expertise. For example, a 2018 cease-and-desist order indicated that a municipal advisor had violated its fiduciary duty to a school district client by misrepresenting its municipal finance experience and by failing to disclose a conflict of interest (the sole member of the municipal advisory firm also worked as a paralegal at the district’s bond counsel firm).\(^{261}\) In another instance, the SEC determined that a municipal advisor violated its fiduciary duty of care by failing to advise its government client that purported amendments to the client’s continuing disclosure undertakings were not legally effective, even though the individuals at the municipal advisory firm had concerns about the effectiveness of amendments; the client made continuing disclosure filings as if the amendments had taken effect and as a result violated its continuing disclosure undertakings.\(^{262}\) The SEC should continue to enforce the fiduciary duty that municipal advisors owe to their government clients. While government issuers do not always retain municipal advisors,\(^{263}\) when they do, they should be receiving competent advice from firms that are fulfilling their obligations to the issuer.

The SEC also has acted against underwriters that violated their Rule G-17 obligations to deal fairly with government issuers. For example, in 2018, the SEC issued a cease-and-desist order indicating that an employee of an underwriter had violated several of the antifraud provisions and numerous MSRB rules by working with unregistered brokers who posed as retail investors in order to obtain higher interest rates on their general obligation bonds than larger communities, all else being equal, and attributing this to their having more limited staffs with less expertise).

260. See supra notes 97–104 and accompanying text.
263. See supra note 40.
priority in purchasing newly issued municipal bonds. Among these violations were breaches of the underwriter’s obligation under Rule G-17 to deal fairly with municipal issuers. The SEC and other enforcement organizations such as the Financial Industry Regulatory Authority (“FINRA”) (a self-regulatory organization that has the power to enforce MSRB rules on broker-dealers) should continue to enforce the Rule G-17 requirement to deal fairly with municipal issuers, including the requirement to explain the role of the underwriter and the material aspects of the financing structures they recommend.

3. Adding Additional Requirements for Continuing Disclosure Undertakings

The National Federation of Municipal Analysts has suggested that the SEC amend Rule 15c2-12 to require that continuing disclosure undertakings include a statement regarding the issuer’s policies for complying with the undertakings. This might have the benefit of increasing the issuer’s awareness of the need for policies and might encourage underwriters to ask about policies as these agreements are prepared. It also might provide an opportunity for the SEC to publicize the importance of policies. Agreements could either include a representation that there is a policy or a description of the policy.

However, as a practical matter, these provisions likely would add little value. Because policies and procedures can and should change over time as circumstances change, the policies identified in an agreement would very likely be described very generally—probably too generally to provide meaningful information about what the policies are—or would simply state that there is a policy in place. If policies were described in detail, it is not likely that this information would be meaningful to investors, who generally are not privy to the internal workings of the issuer, and neither they nor the underwriter would be in a good position to know whether the policies that the issuer has are

suitable. Furthermore, any detailed description of the policies likely would become outdated as circumstances caused changes in policies, and the mere fact that they were in the agreement might make issuers more reluctant to change policies even when they should. What is important to investors is that issuers prepare complete and accurate disclosure and comply with continuing disclosure undertakings, not the procedures they use to do so. What’s more, the only policies that would be appropriately identified in a continuing disclosure undertaking would be those relating to continuing disclosure (not those related to the quality of disclosure in offering documents).

4. Other Additional Requirements on Underwriters or Municipal Advisors

Theoretically, the SEC could take the position that the description in an official statement of the continuing disclosure undertaking is an implied representation that the issuer will (or at least is likely to) comply with the undertaking, that this is a material representation, and that in order for an underwriter to have a reasonable basis for believing that the representation is accurate, the underwriter must evaluate the suitability of the issuer’s disclosure policies. However, this would not be appropriate. While the SEC has suggested some characteristics that disclosure policies should have (such as being in writing, providing for periodic training and designating responsible individuals), policies must be customized for the specific issuer to be effective. Outsiders, such as underwriters, are not in a good position to identify issues within the government’s operating practices that have

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267. See infra Section IV.C.4 for discussion of reasons underwriters should not be required to judge the quality of issuers’ disclosure policies.

268. Foreclosing or restricting the ability to change policies or requiring that changes to policies be disclosed would be worse. If issuers lose flexibility to adapt as circumstances and organizational structure change, this could actually reduce compliance in the future. If issuers are permitted to change their policies, but are required to or feel that they ought to file a notice of changes, they may be more reluctant to make changes even when they should, and giving notice would give disproportionate significance to the change (surely the significance of a change to a policy or procedure to promote compliance with continuing disclosure undertakings is not comparable to current material events such as declaring bankruptcy or failing to make a payment on bonds). Furthermore, the information provided in such a notice is no more likely to be meaningful to investors than the initial description of the policy was in the first place.

269. See supra notes 82–84 and accompanying text for discussion of underwriter obligations with respect to official statements.

270. See Nat’l Ass’n of Bond Lawyers, supra note 152, at 2 (“Consequently, to provide the most benefit, disclosure policies should be tailored to the size, complexity, and other relevant features of particular issuers . . . [and] should be consistent with the issuer’s particular needs and capabilities.”)
not even been recognized by the government itself. If, for example, issuers like the State of Illinois and the State of Kansas did not recognize that internal communication failures were leading to deficient disclosure, it is unlikely that their underwriters, which only work with them intermittently, would be able to do so. Underwriters are not in a position to monitor and evaluate the appropriateness of the policies and procedures adopted by a particular issuer or the degree to which the issuer is complying with its policies and procedures. Requiring underwriters to do this would be unduly burdensome and inappropriate.

Similarly, it generally would not be appropriate to put this burden on municipal advisors. While there are some instances in which a municipal advisor has a long-term relationship with an issuer and may know more about the issuer than would a municipal advisor or underwriter working on a particular transaction, a municipal advisor, like an underwriter, would not have knowledge of the internal workings of the issuer sufficient to know whether the issuer’s disclosure policies are appropriate. That said, there could be limited circumstances in which a failure to recommend appropriate disclosure policies would violate a municipal advisor’s duty of care, particularly if the advisor has been retained by the issuer to review or prepare its policies. Even in these circumstances, the responsibility for policies or procedures should ultimately be the government issuer’s, not the municipal advisor’s.

5. Additional Enforcement Actions

The SEC can and should continue to pursue enforcement actions against municipal issuers when appropriate. Enforcement actions are certainly warranted when circumstances are serious enough that an issuer or individual officials should be censured for its behavior.

However, they may be less effective as a means of delivering a message to other market participants at this time. While MCDC and recent enforcement actions, together, seem to have improved awareness of the antifraud provisions and changed practices in the municipal market, it seems unlikely that additional enforcement actions will increase awareness any further, at least unless another specific area of concern comes to light. Furthermore, as was discussed in Section IV.C.1, interpretive releases and publicity are a better mechanism for the SEC to clearly communicate its expectations.

271. See supra notes 147–151 and accompanying text.
272. See supra Section IV.A.1.
D. States

States may be able to address some of the problems highlighted by the SEC.273 Local governments derive their powers from the states in which they are located.274 States routinely regulate the internal behavior of local governments. For example, many states set fiscal years, mandate a particular form of budget, require uniform accounting procedures, and specify required purchasing standards for some or all local governments within the state.275

In particular, states impose restrictions and requirements on issuances of debt by local governments within their boundaries. Most states have restrictions on the amount of debt that state and local governments can issue, and typically states impose restrictions on the terms and structure of debt and the purposes for which it can be issued.276 Some states require that debt issuances and/or information about outstanding debt be reported to a state agency.277 California requires that local governments issuing bonds certify that they have debt policies that meet certain general standards;278 Nevada requires local governments that have certain types of debt outstanding or plan to issue debt of those types file a description of the local government’s debt management policy (which must include certain provisions) with the Nevada Department of Taxation and the applicable county debt

273. This section discusses ways that states could encourage local governments to improve their disclosure practices, rather than the state as an issuer. States could also apply some of these suggestions to state agencies that issue bonds.


276. See supra note 30 and accompanying text.


278. CAL. GOV’T CODE § 8855(i)(1) (West 2019). Policies must include the types of debt and the purposes for which debt may be issued, the relationship of debt to the issuer’s capital plan or budget, policy goals and internal control procedures to ensure that proceeds of debt are applied to the intended use. Id.
A LITTLE HELP FROM OUR FRIENDS

States Have an Interest in Promoting Good Disclosure

States have an interest in protecting their residents, including by promoting compliance with federal securities laws by local governments in their states. Noncompliance with federal securities laws can hurt residents of the affected community in several ways. First, while official statements are written for the benefit of investors, rather than for members of the community, they are a source of information for community members. If they are materially inaccurate or misleading, community members may not discover the information they should. Second, if the SEC pursues an enforcement action against a local government, the government is likely to incur significant costs in defending or settling the action, costs that likely will ultimately be paid by community residents. Third, investors may require local governments that are found to have violated federal securities laws to pay higher interest rates when they borrow in the future; higher rates that are ultimately paid by residents. Other local governments in the state or even the state government itself could also be affected if investors believe that poor disclosure practices are pervasive in the state; conversely, it is possible that if investors believe governments in a state have particularly good disclosure practices, they will be willing to purchase bonds at interest rates lower than they otherwise would.

279. Nev. Rev. Stat. Ann. § 350.013(1)(c) (2019). Policies must cover the issuer’s sources to pay and the affordability specified debt and capacity to incur such debt within legal limitations, the amount of property tax-supported debt per capita and as a percentage of total assessed property values, the method by which the issuer expects to sell debt, and the expected operating costs and revenues of some projects in the issuer’s capital plan. Id.


283. See supra notes 239-240 and accompanying text.
2. The Problems Identified by the SEC Affect Other Government Activities

While the SEC has identified problems and suggested solutions in the context of disclosure, some of these problems impact other government activities.

Local officials’ tendency to want to avoid giving bad news can be a problem for residents of the community, as well as for bondholders. Local residents may be deprived of accurate information, which will reduce their ability to meaningfully participate in local government. Furthermore, the tendency may lead local officials to proceed with unwise projects, the costs of which are ultimately paid by local residents in one way or another.

While there are benefits to specialization, and some compartmentalization may promote transparency and accountability, a variety of problems can be avoided, or solved more effectively, when separate groups share information and work collaboratively. For example, the fragmented structure of Jefferson County’s government was one of the (many) factors that contributed to a failing sewage system, a very expensive agreement with the U.S. Environmental Protection Agency to repair the system, risky and complex financing of those repairs, and ultimately the bankruptcy of the county. On a more positive note, New York City increased the effectiveness of fire inspections by combining data from several departments to determine

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285. See id. at 12 (quoting Mike Flowers, City of New York, noting the importance of combining fragmented information); Scott D. Pattison, Eliminating Silos in Government, Gov. Fin. Rev. Oct. 2006 at 71 (“At the very least, government should be structured to ensure that people working in various silos are working together, communicating and pursuing broader goals together.”).

286. See Bachus, note 53, at 762–68 (describing the county’s governance structure and the county’s path to bankruptcy and noting that “By fragmenting responsibility for county-wide problems among individual commissioners [each of whom was elected by and represented a single district and each of which was assigned a substantive area of responsibility], Jefferson County’s commission form of government all but guaranteed that the county’s sewer system would fall into neglect . . . .”). Some of the other factors that contributed to the bankruptcy included lack of expertise of commissioners, political considerations, corruption, unregulated (at the time) municipal advisors, failures of bond insurers and credit rating agencies. See generally, id. See also Theresa A. Gabaldon, The Sewers of Jefferson County: Disclosure, Trust and Truth in Modern Finance, in THE PANIC OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR REFORM, 255, 257–59 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr. eds., 2010) (describing some of the systemic problems and corruption that contributed to Jefferson County’s financial collapse).
which buildings were most likely to have fire hazards.287 The State of Hawaii’s Department of Human Services created a program to bring multigenerational services to Hawaii families in need by “tear[ing] down . . . silos, think[ing] beyond the limitations of funding streams, and work[ing] across divisions, programs, and teams.”288 The Department’s director points to improved efficiency resulting from integration.289

The benefits of clear policies and procedures also extend beyond disclosure. While ill-considered procedures can result in inefficiency, a study involving city employees concluded that certain types of rules are helpful, particularly those that were written; had means that were logically connected to ends; provided an appropriate amount of flexibility; were applied consistently; and had purposes that were understood.290 Formalized, written rules tend to be more effective than informal, unwritten practices because the rules are more carefully considered during the process of writing them, and because they are more likely to be followed.291

Similarly, many local governments lack the training and expertise relevant to debt management generally, not only regarding federal securities laws.292 Arguably, “debt contracts that they did not fully understand” contributed to the bankruptcies of Orange County, California and Detroit, Michigan, both relatively large issuers.293 Failure to take post-issuance obligations seriously can lead not only to noncompliance with continuing disclosure obligations, but also to bonds losing their tax-exempt status if an issuer fails to comply with federal tax law requirements after the bonds are issued. Local governments sometimes have other important post-issuance obligations as well, such as state reporting requirements or contractual obligations to provide specified information to a third party.

292. See supra note 163.
293. See Whitaker, supra note 259, at 4.
3. What States Could Do

There are things states can do to encourage local governments to address some of the issues identified by the SEC.

a. Requiring Adoption of Disclosure Policies and/or Debt Policies

States could require local governments that issue debt to adopt disclosure policies, policies related to debt more generally, policies regarding compliance with post-issuance obligations (including continuing disclosure obligations), or a combination of the three.\footnote{294} California already requires that local governments certify that they have certain debt policies in place when they issue debt, and Nevada requires local governments that have or intend to have certain types of debt to file a copy of their debt management policies with the Nevada Department of Taxation and the relevant county debt commission; a similar requirement could be added for disclosure policies.\footnote{295} For other states that have reporting requirements when debt is issued, this could be added to their requirements as well. While limiting the requirement to governments that are presently issuing debt would mean that local governments that issue infrequently and already have debt outstanding would not be required to adopt policies and procedures, over time the percentage of issuers with policies in place would grow, and this approach would avoid the costs of imposing and enforcing the requirements more broadly.

Requiring the adoption of policies and procedures would have the benefit of emphasizing the importance of written disclosure and debt policies and procedures. Like California’s and Nevada’s debt policy requirements,\footnote{296} the state could specifically require that policies and procedures include certain provisions. For example, states could require that policies specifically identify individuals responsible for certain actions and include checks and balances. An additional benefit would be that at least some local governments would be thoughtful and deliberate about the policies and procedures that they adopt. Along with the imposition of such a requirement, the state could provide trainings and sample policies. The state also could provide additional guidance and support as discussed in subsection IV.D.3.d.

\footnote{294} The Securities Industry and Financial Markets Association (“SIFMA”), which represents broker dealers, investment banks and asset managers, has suggested that states require local governments to adopt disclosure policies. \textit{Sec. Indus. \\& Fin. Mkt. Ass’n}, supra note 277, at 2.
\footnote{295} \textit{See supra} notes 278–279 and accompanying text.
\footnote{296} \textit{See id.}
On the other hand, mandating policies does not mean that the policies adopted will be effective, or that they will be followed. It is likely that some local governments would simply adopt boilerplate policies and procedures without considering their specific circumstances, and state requirements could not be specific enough to address all situations (for example, a standardized policy or state requirement for inclusion couldn’t specifically address the specific compartmentalization issues faced by a particular government; at best, the state could urge issuers to consider that issue). As a result, the benefit that comes from the scrutiny of written policies would be lost. Requiring the adoption of policies would impose costs on issuers (to adopt and implement the policies) and on the state agency responsible for enforcing the law. Furthermore, having a policy and failing to comply with it could put a local government in a worse position if it is investigated by the SEC. The costs and benefits of a particular policy would need to be carefully considered before such a change in law were made.

b. Mandating Training

States could mandate that local governments issuing bonds have had disclosure training for their boards and/or relevant staff within an appropriate time period, such as the last three years prior to the date of the planned issuance. States require training in other contexts. For example, many states require training for school district governing board members. For states that already require reporting of debt issuances, this could be another box to check on the report. The state also could provide training programs that local governments could use to meet this requirement. Although these trainings would not be tailored to the specific local government, they still could provide valuable information. There would be costs to the local governments and to the state, and again the costs and benefits of a particular proposal would need to be carefully considered before a change in law was made.

297. See supra note 291 and accompanying text.
298. A good starting point would be evaluating compliance with Cal. Gov’t Code 8855(i) (discussed supra note 279), and the compliance with and effectiveness of the policies adopted pursuant to that law.
300. See supra note 277.
c. Promoting Continuing Disclosure Compliance

States could promote compliance with continuing disclosure obligations by requiring that compliance be reported to the state or that financial auditors or others check compliance with continuing disclosure obligations. States could require local governments issuing bonds to indicate when annual continuing disclosure filings for the bonds are due, and to certify as to material compliance with prior continuing disclosure undertakings or disclose material noncompliance (this would be duplicative of information already disclosed in official statements).\(^{301}\) States that wanted to go further could require reporting when continuing disclosure filings are made or an annual certification that filings were current. Some local governments might simply check the appropriate box without having made their filings, it would be burdensome for a state agency to check the accuracy of the representations made, and these requirements would not ensure that the filings that had been made were complete. However, these requirements could increase issuer awareness of continuing disclosure obligations and result in more filings being made on time (or at least being made before the next report was made to the state government), and the relative costs and benefits should be considered.

Louisiana law requires that financial auditors of local governments review a sample of continuing disclosure filings to determine whether the local government has complied with its obligations.\(^{302}\) Other states could impose a similar requirement,\(^{303}\) though the additional fees that would be charged by auditing firms to perform the additional work (which could be very time consuming for issuers with numerous debt issuances outstanding) likely would outweigh the benefits.

States also could identify or have issuers report to them the annual continuing disclosure obligations of their local governments and remind local governments when filings are due. This could help with compliance, but would be relatively costly, particularly when local governments could instead simply sign up for EMMA to provide them with reminders.\(^{304}\)

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301. See supra note 81 and accompanying text.
303. SIFMA has recommended this. SEC. INDUS. & FIN. MKTS. ASS’N, supra note 277, at 2.
304. States might instead recommend or require that local governments sign up for EMMA reminders and keep the contact information with EMMA up to date as part of their disclosure policies.
d. Providing Training and Other Support

One way that states could provide significant benefit to local governments would be to provide training and materials highlighting the issues identified by the SEC and ways that local governments can address them. Having sample policies and other resource material available would also be valuable. Some states already provide training and educational materials about municipal bonds to local governments. For example, California and Oregon provide trainings or educational information about municipal bonds to local governments.\footnote{305} The Missouri state auditor provides information to local governments about debt issuance and bidding processes and best practices, as has been required by law since 2017.\footnote{306} Some states already provide or have provided training on disclosure policies.\footnote{307}

If they have the internal expertise or access to outside expertise to do so, states could also provide consultation services about these issues to local governments on an elective basis either without charge or at a relatively low cost.\footnote{308} This might be particularly valuable to smaller issuers that do not have regular interaction with outside counsel and municipal advisors.


307. See supra note 234.

308. Similar suggestions have been made concerning debt issuance. See, e.g., U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, STATE TECHNICAL ASSISTANCE TO LOCAL DEBT MANAGEMENT 46–47 (1965) (suggesting that states provide advice concerning debt issuances as requested by local governments); Andrew Ang & Richard C. Green, Lowering Borrowing Costs for States and Municipalities Through CommonMuni 6 (The Hamilton Project, Discussion Paper 2011-01, 2011) (proposing creation of nonprofit that, among other things, would provide affordable, independent advice to municipalities issuing bonds); Darien Shanske, The Feds are Already Here: The Federal Role in Municipal Debt Finance, 33 REV. BANKING & FIN. L. 795, 810 (2014) (recommending that states provide expertise to local government issuers).}
E. Other Entities

In addition to state and local government issuers themselves, which should obtain training on and information about the issues identified by the SEC, work with outside experts to the extent feasible, and consider the applicability of the issues raised by the SEC to their own organizations, other entities can play a role in improving state and local government disclosure practices.

1. MSRB

The MSRB launched the EMMA website in 2008 as a central repository for official statements, continuing disclosure filings and other information about municipal bonds.\(^{309}\) Anyone can go onto the EMMA website and find this information using the site’s search functions.

EMMA has dramatically improved access to information in the municipal market. While official statements were filed with the MSRB before the establishment of EMMA, they were only available for free by visiting the MSRB in Alexandria, Virginia.\(^{310}\) Unlike the prior system, under which filings were available from four different national repositories for a fee,\(^{311}\) continuing disclosure filings are made on EMMA and are all available from a single, free site. This makes it easier for investors to access filed information. It also makes it easier for issuers to file and makes it easier for issuers to verify that their filings appear correctly and are linked to all of the bonds they should be.\(^{312}\)

The easy availability of these documents has the potential of improving the quality of disclosure generally because state and local government issuers and their advisors can access documents from other similar issuers on EMMA and see what they are disclosing.\(^{313}\)

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\(^{310}\) Stanley, supra note 92, at 105.

\(^{311}\) Amendment to Municipal Securities Disclosure, 73 FR 76103, 76106 (Dec. 5, 2008).


\(^{313}\) Transcript of Securities and Exchange Commission Field Hearing on The State of the Municipal Securities Market at 101 (July 29, 2011), https://www.sec.gov/spotlight/municipalsecurities/munifieldhearing072911-transcript.txt [hereinafter Field Hearing] (statement of Hobby Presley) (“It’s not at all unusual now for an issuer to search EMMA just for the purpose of determining how to structure and improve their..."
Their lawyers and consultants can do the same. This may result in issuers deciding to provide fuller disclosure about topics they might not have considered otherwise. One government official suggested that EMMA has changed the culture of disclosure so that issuers now see disclosure as a way of improving relationships with investors rather than merely as a legal requirement. Furthermore, having access to their own continuing disclosure filings on EMMA means that issuers can see tangible results of their filing preparations and may make them more likely to comply with obligations. Issuers can also more easily make their own filings and can see that they were made correctly.

Issuers can register on the EMMA system to have reminders sent to them when annual filings are due. Additional publicity about this service to issuers and municipal advisors may increase the use of the service, which could, in turn, increase the timeliness of continuing disclosure filings.

When issuers and others register to make filings on the EMMA website, they must provide an email address. The MSRB could send reminders to these email addresses before and at the time annual filings are due. This would require MSRB personnel to review the summaries of continuing disclosure undertakings included in the official statements for all bonds to determine the deadlines, or require underwriters, issuers, or other registered users to provide due dates. The costs of this might outweigh the benefits, but it should be considered.


314. See Mun. Sec. Rulemaking Bd., supra note 312, at 19 (“Meanwhile, EMMA also has provided municipal advisors, bond lawyers and other market participants—whose direct experience might be limited to particular regions or types of transactions—the ability to access information about other regions, structures and projects.”).

315. Id. (quoting Alan Anders, Deputy Dir., N.Y.C. Office of Budget and Mgmt.).

316. See Field Hearing, supra note 313, at 101 (suggesting that being able to see the results of their efforts will make issuers more likely to “accept their burdens” and “appreciate the process”).


The MSRB also provides a complimentary online course for municipal government employees that covers a wide range of matters related to issuing bonds, including compliance with federal securities laws. Additional promotion of this course, as well as provision of courses focused on federal securities laws and continuing disclosure compliance and on disclosure policies could also contribute to better informed issuers and ultimately better disclosure.

2. **Industry Organizations and Outside Experts**

Industry organizations such as the GFOA, organizations of county treasurers, organizations representing cities, counties, school districts and other governments, and outside experts including bond counsel, disclosure counsel and municipal advisors also have important roles to play in improving state and local government disclosure practices by providing training, guidance, and educational materials. In addition, underwriters and their counsel can contribute to better disclosure by asking issuers about disclosure practices early in a transaction, causing issuers to focus more on these issues.

**Conclusion**

In the process of enforcing the antifraud provisions of the federal securities laws, the SEC has identified several factors that are common among state and local governments and that result in inadequate disclosure, including political pressure to avoid giving bad news, compartmentalization, failure to clearly identify who is responsible for disclosure and compliance, lack of training and experience with municipal securities and disclosure, and failure to recognize the importance of compliance with disclosure obligations. These same deficiencies can also have damaging effects in other aspects of debt management and other areas of government operations. It is imperative that state and local governments consider how to mitigate these weaknesses themselves, but also that the SEC, states and others take appropriate actions to assist in this process. In particular, the SEC should consider issuing an interpretive release emphasizing the impor-

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tance of disclosure policies and some of the key contents of such poli-

cies. States should provide training and other support to local
governments within their boundaries to the extent they are able to do
so, and should consider taking other actions such as mandating train-
ing about disclosure and disclosure policies for local governments that
issue bonds. Outside experts and trade organizations should also pro-
vide training, support and guidance to state and local governments as
they work to improve their internal practices. With a little help from
their friends, state and local governments will do more than just get
by.320

320. Apologies to John Lennon and Paul McCartney. See generally THE BEATLES,
With A Little Help From My Friends, on SGT. PEPPER’S LONELY HEARTS CLUB BAND
Note: The article on which this chapter is based indicated that the Securities and Exchange Commission (the “SEC”) has not issued an interpretive release on this subject since 1994. While the SEC itself still has not released formal interpretive guidance, on February 7, 2020 (after the publication of the article), the staff of the SEC’s Office of Municipal Securities issued a staff legal bulletin providing guidance with respect to public statements made by issuers in the secondary market.¹ The bulletin brings together previous statements of the SEC about the application of the antifraud provisions of the federal securities laws to statements made by municipal issuers in the secondary market.² It also confirms, that, as was noted at the text in the article accompanying notes 71 and 72, information released publicly by municipal issuers that can reasonably be expected to reach investors or securities markets is subject to the antifraud provisions even if it was for a different purpose, and it provides some examples.³ The bulletin notes the importance of policies and procedures that designate an individual responsible for compliance, establish training schedules, and identify the types of information covered.⁴ These statements are consistent with those discussed in sections III.C and section D of the article.

² Id. at Summary and Part I.
³ Id. at Parts III.C and IV.
⁴ Id. at Part V.
CHAPTER 5
CONCLUSION

This thesis has addressed several aspects of the regulation of municipal bonds, and how to best protect current and future community members and investors from poor decisions and practices of local governments with respect to borrowing and related disclosure responsibilities.

As local governments are creatures of the states, a logical starting point for the study was at the state level, examining the types of state laws that govern local government bonds and the varying ways that states have crafted legislation to address the issues raised by local government borrowing. Chapter 2 showed there was considerable room for improvement, identifying a number of ways that bond laws could better provide flexibility for local governments to innovate, make decisions, and adapt to changing circumstances while protecting current and future residents from unwise borrowing. The chapter also highlighted the importance of providing information to the public and opportunities for community involvement.

One particular borrowing instrument that has proven to be both problematic and popular with local governments in some jurisdictions is capital appreciation bonds. As Chapter 3 explained, these bonds have been widely used by California and Texas school districts. That chapter set out several reform options to reduce the use of this problematic form of financing, including changing state laws that incentivize local governments to issue capital appreciation bonds, reevaluating matching fund requirements for grants, imposing requirements that important information be provided to board members and made available to the public, and providing additional training and support to local governments.

The U.S. Securities and Exchange Commission (the “SEC”), an agency of the federal government, has an important role in regulating municipal bonds, including protecting investors that buy and sell state and local government bonds by ensuring that investors have accurate and complete information about the securities that they are buying. The SEC’s actions in fulfilling this role impact the behavior of state and local governments. Chapter 4 reviewed the SEC’s shift to prosecuting not only state and local governments that appear to have intentionally or recklessly misled investors but also those that have internal practices that have led to violations of the antifraud provisions of the federal securities laws. In enforcement actions during the last decade, the SEC has identified factors that are common among local governments and increase
the likelihood of inadequate disclosure. Some of these deficiencies can also have damaging
effects in other aspects of debt management and other areas of government operations. The
chapter discussed these enforcement actions and proposes alternative approaches to addressing
these deficiencies and others of this type going forward, including interpretive guidance by the
SEC, state mandates concerning training or policies, and state- or third-party-provided training
and support.

The thesis shows that the state and federal governments have complementary roles to
play in promoting good borrowing and disclosure practices by local governments. The logical
starting point for reform is the state government, given that local governments are created by
state law and have only the powers given to them by the state.1 As the thesis described, states
regulate local government borrowing to varying degrees. State bond laws play a critical role in
protecting investors and current and future citizens from unwise borrowing by local
governments.2 However, they also can prevent desirable borrowing, increase costs for local
governments, and cause local governments to structure transactions in less desirable ways.3 For
example, because general obligation bonds typically are subject to debt limits and voter approval
requirements but revenue bonds often are not, local governments often issue revenue bonds
rather than general obligation bonds in order to avoid these limits and requirements. The result is
more expensive debt and less transparency. In many states, bond laws have been developed
piecemeal over the years, and this has led to more complicated laws and inconsistencies in
treatment of different types of bonds and issuers (not always intentional).4

Because of the critical role that local government borrowing plays in the development of
public infrastructure, existing bond laws should be carefully evaluated and reforms should be
considered. The same rules should apply to different types of local governments and debt except
where there are compelling reasons for them not to do so, and bond laws should focus on the
economics of the transaction rather than the structure so that local government decisions about
the type of bonds to issue and the structure of the transaction are driven by what makes the most
economic sense rather than by legal requirements. Bond laws also should provide flexibility for

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1 See Section 3.2 of Chapter 2 for further discussion.
2 Some of the reasons that states regulate borrowing are described in Section 3.3 of Chapter 2.
3 For further discussion, see Sections 5.1.2, 5.2.2, 5.3, and 6.2.2 of Chapter 2 and Sections IV.C and F of
Chapter 3.
4 See Section 3.4 of Chapter 2 for further discussion.
changing circumstances and conditions and where possible should be consolidated and streamlined. For the law to adapt more easily to changing circumstances and to allow for financings that are desirable but do not comply with some types of statutory restrictions, states may want to delegate some details of their bond laws to a state agency or give a state agency the authority to waive some requirements in appropriate circumstances. This thesis proposes a number of specific potential reforms, such as replacing or eliminating debt limits,\(^5\) modifying voter approval requirements and possibly replacing them with permissive referendum requirements,\(^6\) tying borrowing limits to the proceeds of the bonds received rather than the principal amount and counting compounded interest against debt limits,\(^7\) modifying or eliminating maximum interest rate requirements,\(^8\) eliminating limits on debt service as a percentage of aggregate property value,\(^9\) adjusting limits on final maturity dates and amortization schedules,\(^10\) and including requirements to provide additional information to governing bodies and the public before bonds are issued or on an ongoing basis.\(^11\) If wholesale reform is not feasible, states should consider making changes to specific portions of their bond laws that are particularly problematic and, in those states where bond laws are scattered throughout numerous statutes and codes, consolidating them in a single location.

States’ roles in improving borrowing practices can and should extend beyond legislation. States can make a tremendous contribution to the quality of borrowing decisions and disclosure by providing education and training to local government officials. The SEC has identified lack of expertise and training and failure to recognize the importance of compliance with disclosure obligations as two of the factors that contribute to unintentional violation of federal securities laws by state and local governments.\(^12\) Similarly, commentators have noted that local officials are not always experienced enough or knowledgeable enough to make good decisions about

\(^5\) See Section 5.1.2 and 5.3 of Chapter 2 for further discussion.
\(^6\) See Section 5.2.3 and 5.3 of Chapter 2 for further discussion.
\(^7\) See Section 6.2.1 of Chapter 2 and IV.C—Counting Compounded Interest Against Debt Limits of Chapter 3 for further discussion.
\(^8\) See Section 6.2.2 of Chapter 2 for further discussion.
\(^9\) See Section IV.B—Re-evaluating Tax Rate Limitations of Chapter 3 for further discussion.
\(^10\) See Section 6.2.3.3 of Chapter 2 for further discussion.
\(^11\) See Sections 7.2 and 7.4 of Chapter 2 and Section IV.C—Requirements to Provide Information of Chapter 3 for further discussion.
\(^12\) See Sections III.D and E of Chapter 4 for further discussion.
An empirical study of municipal bond sales in Oregon concluded that small communities pay higher interest rates on their general obligation bonds than larger communities, all else being equal, as a result of this lack of expertise. Some states already provide relevant trainings and educational materials to local governments. States should evaluate the trainings and materials provided to local government officials and consider whether additional trainings or materials should be provided. A state agency could partner with law firms, municipal advisory firms, academic institutions, or organizations such as the National Association of Bond Lawyers or the Government Finance Officers Association to provide training and educational materials. For topics such as the importance of and recommended content for debt policies and disclosure policies that do not involve laws that are vary among states, multiple states could collaborate to provide training and educational materials. States also should consider whether training on some topics should be mandatory. Better informed officials are likely to make better decisions about borrowing.

States also can provide other support to local governments. This support could include collecting and providing data about bond transactions, as some states including California and Texas already do. States could provide form documents such as debt policies, disclosure policies, and requests for proposals to be used in hiring bond counsel, municipal advisors, and underwriters. States (acting through a state agency with financing experience such as the state treasurer’s office or through a group of experts assembled for the purpose) could also provide technical support and expert advice to local governments for a reasonable fee on a voluntary basis, and could even mandate consultation with a state agency in some circumstances. The entity providing technical advice would have more experience with bond issuances than many individual local government issuers in the state would have, and would have the opportunity to see problems that arose in, and interest rates, yields, and pricing of services for, a variety of bond

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13 See Section 3.3.2 of Chapter 2 and Section IV.G of Chapter 3 for further discussion of the lack of expertise of some local government finance officials.
15 See Section 8.2 of Chapter 2 and Section IV.D.3.d of Chapter 4 for some examples.
16 See Section 7.4 of Chapter 2 and Section VI.C of Chapter 3.
17 Chapter 2 suggests some circumstances in which mandating consultation might be appropriate, such as bond issuances with most of the debt service being payable in later years, or refinancings that do not result in debt service savings or defer a substantial portion of debt service.
issuances by a range of issuers. States could collaborate with each other or with an outside organization to provide this assistance.

States also can play a role in improving the quality of information that is available to community members and investors, and ensuring that community members have the opportunity to provide input on borrowing decisions. For example, states can require information about individual transactions or about local government outstanding debt (and about local government finances generally, for that matter) be made available to the public by local governments or require local governments to report information to the state for publication. States can mandate that specific information be provided to voters (for voter approved bonds) or more broadly to the public, or ensure that there are opportunities for public comment by requiring a public hearing, one or more public board meetings, or notice and a waiting period during which voters can petition for an election on a bond measure before bonds are issued. States can promote compliance with disclosure obligations (which are intended to meet the needs of investors but also can provide information to community members) by mandating or encouraging local governments to adopt disclosure policies, requiring local governments to certify annually to the state that they have met their obligations or requiring financial auditors to review continuing disclosure compliance, or by providing training, educational materials, or access to expert advice.

At the federal level, the SEC has an important role to play in improving disclosure and borrowing practices of local governments.

In the last decade, the Securities and Exchange Commission has more actively pursued enforcement actions against state and local governments violating the antifraud provisions of federal securities laws than it had historically and has imposed tougher penalties on state and local governments and government officials than it had historically. In addition to acting in cases of what appear to be intentional or reckless deception of investors, over the last several years, the SEC has acted against state and local governments with internal practices that appear to have led to inaccurate or misleading disclosure, and has identified some factors that have led to the false or misleading disclosure, including political pressure to avoid giving bad news,

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18 More information about some of the things states already do and additional things they could do that are summarized in this paragraph appears in Sections 5.2., 7.2, 7.3, and 7.4 of Chapter 2, Section VI.C of Chapter 3, and Section IV.D of Chapter 4.
19 See Section III.E.2 and 3 of Chapter 4 for further discussion.
compartmentalization, lack of clear policies and procedures that identify who is responsible for disclosure and compliance, lack of training and expertise, and failure to recognize the importance of compliance with disclosure obligations.\textsuperscript{20} While the focus of the SEC’s actions is protecting investors from inadequate disclosure, some of these deficiencies can also have damaging effects in other aspects of debt management and other areas of government operations.\textsuperscript{21} These enforcement actions by the SEC have sent an important message to local governments about some of their internal practices.

The SEC could provide clearer and more specific guidance by issuing an interpretive release about the factors that can prevent local governments from providing accurate and complete disclosure and suggest ways to address these factors. Unlike in a cease-and-desist order, the SEC would not be constrained by the specific facts of a single case when drafting an interpretive release and as a result the SEC would be able to more precisely identify its concerns and recommendations. A well-publicized interpretive release could reach many state and local governments and provide them with valuable information about how to improve some of their practices.\textsuperscript{22}

The SEC can improve not only disclosure, but also decisions about structuring of municipal bonds, by continuing to enforce the fiduciary duty that municipal advisors have to their local government clients.\textsuperscript{23} Municipal advisors play an important role in helping inexperienced issuers make better decisions about whether to issue bonds and how to structure them.\textsuperscript{24} As one commentator noted, municipal advisors “… probably know 10,000 times more about bonds than their issuer clients know …” and “in all likelihood … know more about their municipal clients’ debt portfolio and bond covenants than their clients know.”\textsuperscript{25} It is for these reasons that states may want to recommend or require that local governments work with

\textsuperscript{20} See Section III of Chapter 4 for further discussion.
\textsuperscript{21} Some examples are described in Section IV.D.2 of Chapter 4.
\textsuperscript{22} Additional discussion of the benefits of an interpretive release and how it might be most effective are included in Section IV.C.1 of Chapter 4.
\textsuperscript{23} For discussion of the fiduciary duty that municipal advisors have to their local government clients, see Section II.C.4 of Chapter 4. For discussion of enforcement actions against municipal advisors, see IV.C.2 of Chapter 4.
\textsuperscript{24} For discussion of the role of municipal advisors, see Section 2.5 of Chapter 2 and Section I.B.1 of Chapter 4.
\textsuperscript{25} Monique Moyer, Current Issues Facing Bond Issuers and Their Financial Advisors, MUN. FIN. J. 17, 18 (Summer 2003).
municipal advisors in some circumstances. Should they do so, SEC enforcement of municipal advisors’ fiduciary duties would be even more important.

Other organizations also can play an important role in improving local government borrowing and disclosure practices.

The Municipal Securities Rulemaking Board (“MSRB”) operates the Electronic Municipal Market Access website (emma.msrb.org) (“EMMA”) as a central repository for initial offering documents and subsequent disclosure filings for municipal bonds. EMMA is a valuable tool used by issuers and their lawyers and consultants to see what others are disclosing and what the terms of their bonds are, information that is immensely valuable for improving the quality of disclosure and the structure of transactions. Continuing to improve the functionality and searchability of EMMA would make it even easier to utilize it for these purposes. In addition, the MSRB could more heavily promote to issuers that they can sign up for emails to notify them when annual filings are due; this could improve the timeliness of compliance with continuing disclosure obligations.

Industry organizations such as the Government Finance Officers Association and the National Association of Bond Lawyers, as well as academic institutions and individual law firms and municipal advisory firms can contribute to the effort to improve borrowing and disclosure practices by providing trainings and educational materials, model disclosure and debt policies and even model bond laws, and by working with state legislators to improve bond laws.

The detailed analysis of some aspects of state laws governing local government borrowing, discussion of different approaches taken by different states, and presentation of a variety of ways to improve these laws and local government borrowing and disclosure practices provided in this thesis are valuable tools for policymakers and others interested in improving bond laws and borrowing practices. The discussion in the thesis of the factors that the SEC has identified as inadvertently leading state and local governments to provide inadequate disclosure, and ways that the SEC, states, the MSRB, and others can assist local governments in addressing these factors provide local governments, state legislators, and others with valuable information that can be used to improve the quality of disclosure by local governments. My hope is that the

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26 This option is suggested in Chapter 4 for transactions that may give cause for concern, including refinancings that do not result in debt service savings or defer a significant portion of debt service and negotiated sales.
27 The EMMA website is discussed in greater detail in Section IV.E.1 of Chapter 4.
articles that comprise the body of this thesis bring additional attention by academics, politicians, and practitioners to these important issues, to which insufficient attention has been paid in the past. Given the important role that state and local governments and their borrowing play in developing and maintaining infrastructure in the United States, it is essential that the issues discussed in this thesis be addressed, perhaps even more so as the nation strives to recover from the COVID-19 pandemic. Hopefully this thesis inspires conversation about these issues that leads to concrete action.
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