Types of Bonds

Part 2 of Financing Options Using Bonds

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In the last issue we discussed what bonds are and why a city or village would want to issue them. This month we will review the major types of bonds.

A city or village may issue several types of debt to meet its financing needs. These include, among others, general obligation bonds, revenue bonds, alternate revenue source bonds, debt certificates/installment contracts, leases, special service area bonds, special assessment bonds, working cash bonds, tax anticipation warrants, tax anticipation notes, revenue anticipation notes, funding bonds and tax increment bonds. Refunding bonds can save municipalities interest costs and have been issued more frequently in recent years due to the lower interest environment.

A. GENERAL OBLIGATION BONDS

General obligations bonds or "G.O.'s" are debt issued by a municipal issuer representing its full faith and credit and backed by its ad valorem taxing power. A general obligation can be issued for any lawful purpose for which ad valorem taxes may be levied subject to constitutional, statutory or other limitations (such as debt limitations discussed further below) and pursuant to proper constitutional, statutory or other procedures. Unless an exception applies, the Illinois Municipal Code, as amended (the "Code") requires that general obligation bonds secured by an ad valorem tax must be approved by voters of the issuer in a referendum. However, the referendum requirement has many exceptions, including, but not limited to, alternate revenue bonds (as discussed below), refunding bonds, bonds to fund or refund debt related to judicial judgments, working cash fund bonds, bonds used to pay pollution abating costs mandated under the Environmental Protection Act, bonds issued to pay for costs related to improvements of water or wastewater treatment facilities mandated by federal or state regulators, or bonds issued pursuant to the Code in an amount not to exceed one-half of one percent of the equalized assessed value of the taxable property of the issuer. Additionally, differences in procedures and limitations may apply to cities or villages depending on their status as a home rule or non-home rule unit of government and whether the city or village is located in a county subject to a tax cap on property taxes.

1. HOME RULE

Under the 1970 Illinois Constitution, home rule power shifts decision making from the state level to the local level, enabling more flexibility. Home rule communities are granted a broad range of powers unless exempted by the state. Municipalities with populations over 25,000 are automatically granted home rule status, while smaller communities can put the question on a ballot and let voters decide. Home rule units can constitutionally tax anything that is not income, occupations or earnings and they are not susceptible to a tax cap on property taxes unless imposed by further voter action. Aside from not being able to issue bonds payable from ad valorem property taxes maturing more than 40 years from the time of issuance, home rule units do not adhere to any statutory debt limit. For example, home rule units can issue general obligation bonds without the need to secure voter approval through a referendum or backdoor referendum.

2. NON-HOME RULE

Non-home rule cities and villages are subject to the statutory debt limit of 8.625 percent of equalized assessed value as set forth in the Code. The principal amount, and only the principal amount, of all outstanding general obligation bonds and debt of a city or village is counted for purposes of the statutory debt limit. Also, the principal amount due under an installment contract or lease agreement constitutes municipal debt subject to statutory limits. On the contrary, any obligation of a city or village that is payable solely and only from a limited source or fund of the municipality is not considered debt subject to the statutory debt limit. Obligations excluded from the debt limit include alternate revenue source bonds, revenue bonds, special assessment bonds and tax anticipation warrants.

B. ALTERNATE REVENUE BONDS

Alternate revenue bonds or "double-barreled" bonds are essentially revenue bonds issued under the Local Government Debt Reform Act (the "Debt Reform Act") with the general obligation of the municipality serving as backup security for the bonds. Cities and villages are authorized to use revenue from a municipal enterprise such as water, sewer, electric, gas, municipal stadiums, etc., or other revenue sources such as sales taxes, motor fuel taxes, state income taxes, etc., and pledge such revenue sources to the payment of principal and interest on alternate bonds. The intent of the Debt Reform Act is to permit the issuance of the alternate revenue bonds assuming the pledged revenue source is sufficient so that the

tax levy relating to the debt service on the alternate bonds does not need to be extended. The coverage requirements provide that the municipality must demonstrate that such pledged revenue source be sufficient in each year the bonds remain outstanding to provide not less than 1.25 times debt service on all outstanding alternate bonds payable from such revenue source and on the alternate bonds proposed to be issued. Note that the coverage requirement is 1.10 times if the revenue source is either (i) federal or state funds that the village or city unit has received in some amount during each of the three fiscal years preceding the issuance of the alternate bonds or (ii) revenues to be received from another governmental unit under an intergovernmental cooperation agreement.

Apart from coverage requirements, the alternate bonds must meet two other conditions before being issued. First, the alternate bonds must be issued for a lawful corporate purpose and be payable from a revenue source limited to that purpose. For example, a waterworks and sewerage alternate revenue bond cannot be payable solely from motor fuel taxes. Instead, such a bond would need to be payable from revenues derived from the operation of the waterworks and sewerage system of the municipality. However, a waterworks and sewerage alternate revenue bond may be payable from sales taxes and/or the local share of state income taxes in addition to the system revenues. Such "multi-barreling" is a common practice used to supplement system revenues so as to meet coverage requirements. Second, alternate bonds are subject to a backdoor referendum. The backdoor referendum gives registered voters the opportunity to petition the municipality to submit the question of issuing the alternate bonds to referendum. However, the petition must be submitted within 30 days after publication of the authorizing ordinance and be signed by the greater of (i) 7.5% of the registered voters of the municipality or (ii) the lesser of 200 of the registered voters or 15% of the registered voters.[1]

C. DEBT CERTIFICATES/INSTALLMENT CONTRACTS

Cities and villages are authorized to borrow money by entering into installment finance agreements. There are statutory specifications as to what constitutes an installment contract. The Debt Reform Act authorizes municipalities to purchase or lease either real or personal property through the use of installment contracts not exceeding 20 years in length. The Debt Reform Act also authorizes municipalities to issue debt certificates to evidence payment obligations under a lease or installment contract subject to statutory debt limit. Generally, however, no separate tax levy is available for the purpose of making such lease or installment payments; it is considered a promise to pay by way of budgetary appropriation. However, a municipality not subject to the Limitation Law may enter into an installment contract payable from the levy of a direct, unlimited ad valorem property tax sufficient to pay the installments if certain backdoor referendum requirements are satisfied.

D. PROMISSORY NOTES

Cities and villages may also borrow money from a financial institution pursuant to a promissory note or similar debt instrument that is a lawful direct general obligation of the city or village, payable from the general funds of the city or village and other sources of payment as are otherwise lawfully available, subject to the statutory debt limit.

E. REVENUE BONDS

Cities and villages may issue revenue bonds for a proper public and corporate purpose, which includes a variety of potentially revenue-producing undertakings such as facilities financed with tax increment, transportation facilities, water and sewer systems, solid waste operations, libraries, sports facilities, exhibition facilities, housing, parking and jails. Revenue bonds generally do not require voter approval. There are two main limitations for revenue bonds in the case of non-home rule units. First, there must be a revenue source related to the purpose for the bond issuance. For example, water revenue bonds may be issued to acquire or improve water systems, but they may not be issued to acquire new police cars in a non-home rule unit. Second, for non-home rule units, there must be a specific statutory grant of power to operate the revenue-producing undertaking as listed above. A positive aspect of revenue bonds is that there is no legal limit on the amount of revenue bonds that may be issued by a non-home rule unit. Revenue bonds are often subject to a backdoor referendum. Revenue bonds are not considered debt for purposes of statutory debt limits.

F. SPECIAL SERVICE AREA BONDS

A special service area is a contiguous area within a municipality in which special governmental services are provided in addition to those services provided generally throughout the municipality. The cost of providing the special services is paid from revenues collected from taxes levied upon the property within the contiguous area receiving the special services. In order to establish a special service area, the city or village must publish notice and hold a hearing allowing the public and any interested person to object to the creation of the special service area. Such notice and hearing must be done no sooner than 60 days after adoption of the ordinance proposing the creation of the special service area. The area may not be created, the tax may not be levied and the bonds may not be issued if within 60 days after the public hearing at least 51 percent of the electors area and 51 percent of the land owners within the special service area file a petition objecting to the creation of the special service area, the levy of a tax or the issuance of bonds. Assuming no such petition is filed, the municipality must file with the county recorder within 60 days after final adjournment of the public hearing.

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Bonds may be issued for the purpose of financing the costs related to providing the special service. The special service area bonds are secured by the full faith and credit of the taxable real property in the special service area. To provide for the special tax, the county clerk where the municipality is located will extend an annual tax against all of the taxable real property in the special service area in amounts sufficient to pay the debt service on the bonds. The tax is typically allocated to the property owners on an ad valorem (property or transaction value), benefits, acreage or other rational basis.

G. TAX INCREMENT FINANCE BONDS

Tax increment finance ("TIF") bonds are those issued by cities or villages to finance a project and use the future incremental property tax growth from that project or other projects in the TIF district or a contiguous district to repay the debt service on the TIF bonds. Before issuing bonds and collecting incremental property tax revenues, the municipality must form a TIF district by ordinance. However, prior to adopting the ordinance the municipality must hold a public hearing and convene a joint review board to consider the proposed TIF district. After considering comments from the public and the joint review board, the municipality may adopt the ordinance creating the TIF district. Statutory controls require that: (i) the TIF is used for a legitimate public purpose (improve a blighted area); (ii) the TIF is necessary ("but for" test); (iii) TIF projects are feasible (feasibility study or cost-benefit analysis); (iv) TIF projects are appropriately planned (a formal project plan); (v) TIF projects perform as intended; and (vi) the municipality files a timely annual report with the Illinois Comptroller. Once a TIF district begins to perform and the municipality begins to receive the incremental revenues, those revenues can be pledged to secure the issuance of TIF bonds. TIF bonds may be issued as general obligation bonds usually by a home rule unit, alternate bonds issued pursuant to the Debt Reform Act or general obligation TIF bonds issued using the specific procedures in the TIF Act, which do not have a coverage requirement but do have a backdoor referendum requirement.

H. LIMITED BONDS

Under the Debt Reform Act, limited bonds may be issued, supported by a tax unlimited as to rate, but limited as to amount. The bonds are commonly used for general capital related infrastructure projects.

I. CONCLUSION

This brief summary of types of debt available to cities and villages raises the question of how to sell the debt so that the community can benefit. We will tackle that topic next month.

[1] In governmental units with fewer than 500,000 inhabitants, other than most public infrastructure projects, the necessary number of necessary petition signers for a governmental unit with more than 4,000 registered voters is the lessor of (i) 5% of the registered voters or (ii) 5,000 registered voters; and the necessary number of electors for a governmental unit with 4,000 or fewer registered voters is the lesser of (i) 15% of the registered voters or (ii) 200 registered voters.

Note: This article is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

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