

Types of Bond Laws

Part 4 of Financing Options Using Bonds

BY JIM SNYDER, ENZO INCANDELA AND MARK HUDDLE, ICE MILLER LLP

In the last issue we covered the types of bonds sales. In this article, the last of the series, we'll discuss the laws that govern bonds.

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ILLINOIS STATE LAW

The Illinois Municipal Code, the Local Government Debt Reform Act (the "Debt Reform Act"), the Property Tax Extension Limitation Law (the "Limitation Law"), the Bond Issue Notification Act ("BINA"), the Bond Authorization Act, the Registered Bond Act, and the Bond Replacement Act, all authorize and govern the issuance of municipal bonds. A detailed analysis of these laws is beyond the scope of this article, but below we briefly summarize aspects of the key laws.

The **Debt Reform Act** was adopted by the Illinois General Assembly to provide supplemental authority to local governmental units to issue and sell bonds to accommodate the effect of market practices that resulted in additional costs for those citizens residing in local governmental units because of high interest rates. The Debt Reform Act, among other things, provides for back door referendum procedures and also the issuance of alternate revenue source bonds and limited tax bonds, which can provide significant advantages to issuers in the State of Illinois. Under the Debt Reform Act, voter referendum or back door referendum approval, once obtained, remains effective (a) for five years after the date of the referendum or (b) for three years after the end of the petition period for the back door referendum.

BINA requires non-home rule cities and villages proposing to sell non-referendum general obligation bonds or limited bonds, except refunding bonds, to hold a public hearing concerning its intent to issue such bonds. Issuers must follow the specific requirements of BINA regarding publication of notice and timing of the public hearing in order to conform to Illinois law when issuing general obligation bonds through non-referendum procedures. The city or village clerk must publish notice of the hearing at least once in a newspaper of general circulation in the municipality not less than seven (7) and not more than thirty (30) days before the date of the hearing and must post notice of the hearing at the principal office of the municipality at least forty-eight (48) hours before the hearing. The governing body must then wait at least seven (7) days following the hearing before adopting an ordinance providing for the issuance of the bonds.

The **Limitation Law** limits the annual growth in the amount of property taxes to be extended for certain Illinois non-home rule units of government. In general, the annual growth permitted under the Limitation Law is the lesser of 5% or the percentage increase in the Consumer Price Index during the calendar year preceding the levy year. Taxes can also be increased due to new construction, referendum approval of tax rate increases, mergers and consolidations. The Limitation Law currently applies to Cook County, the collar counties and counties that have specifically approved the Limitation Law by referendum. County boards of any county may decide whether or not to allow voters to choose if property tax extension increases should be limited. The county board can place the issue on the ballot at any election other than a consolidated primary election by passing an ordinance or resolution at least 79 days before the election. If the referendum is successful, then the Limitation Law will become applicable to those non-home rule taxing bodies having all of their equalized assessed valuation in the county beginning January 1 of the year following the date of the referendum. Villages and cities subject to the Limitation Law are able to issue limited bonds in lieu of general obligation bonds authorized by applicable law payable from a separate tax levy unlimited as to rate but limited by amount pursuant to the Limitation Law. Limited bonds are payable from the city or village's debt service extension base (generally the amount of the non-referendum bond levy (excluding alternate bonds) for the year to which the Limitation Law first applied). The

Limitation Law does not restrict referendum-approved general obligation bonds and alternate bonds.

FEDERAL INCOME TAX LAW

The Internal Revenue Code of 1986 as amended and its arbitrage and rebate regulations govern the tax-exempt status of municipal bonds. Upon issuance of any municipal bond, the city or village will covenant to follow certain federal rules and regulations in order to maintain the tax-exempt status of the bonds. These covenants include reasonable expectations that the bonds are not private activity bonds (meaning they would benefit a private entity), or arbitrage bonds (which are issued to profit from the difference between tax-exempt and taxable rates).

SECURITIES LAWS

Rule 10b-5 of the Securities Exchange Act of 1934 (the "Rule 10b-5"), states 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 that operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 sets out the general statement of federal intent to protect investors against misleading statements or omissions of important facts in official statements or other documents pertaining to the bond issuance. Full disclosure for bond purposes means disclosure of all information material to investors. The federal government's MCDC effort (described below) reflected a vigorous enforcement initiative against bad disclosure practices, and targeted issuers and their officials. Issuers should adopt "best practices" to protect themselves and their officials from antifraud provisions including, but not limited to, hiring of disclosure counsel, which is a law firm that typically represents the issuer on disclosure issues, and the adoption of effective disclosure policies and procedures that ensure appropriate disclosure. Based on recent enforcement actions against big and small issuers (ranging from large states to small local municipalities), claiming "small unsophisticated issuer" as a defense may not be viable. See below for an example.

CONTINUING DISCLOSURE

Rule 15c2-12 governs the preparation and distribution of official statements for municipal securities. While this rule applies primarily to directly regulated entities such as underwriters, broker-dealers and dealer banks, a significant portion of the burden of compliance with Rule 15c2-12 falls on the issuer to supply certain information and disclosure and to take the proper steps to comply with Rule 15c2-12 in a timely fashion. As an example of the importance of meeting continuing disclosure requirements, the Securities and Exchange Commission ("SEC") recently charged a school district in Indiana and a municipal bond underwriter with falsely stating to bond investors that the school district had been properly providing annual financial information and notices required as part of its bond offerings. The school district was ordered to cease and desist from violating securities laws and undertake remedial actions, and the underwriter agreed to a \$580,000 fine along with a one year collateral bar and permanent supervisory bar for one of its employees.

The SEC's Municipalities Continuing Disclosure Cooperation Initiative (the "MCDC Initiative") addressed what the SEC believed to be widespread violations of the federal securities laws by municipal issuers and underwriters of municipal securities in connection with certain representations about disclosures in bond offering documents and mandated continuing disclosure post issuance. The MCDC Initiative provided issuers and underwriters an opportunity to self-report materially inaccurate statements made in final official statements regarding prior compliance with their continuing obligations as described in Rule 15c2-12. In connection with the MCDC Initiative, the SEC has released three separate waivers of settlement agreements with underwriters. As of the date of this article, no settlement agreements with municipal issuers have been released in connection with the MCDC Initiative.

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.

Jim Snyder, Enzo Incandela and Mark Huddle are municipal finance attorneys with Ice Miller LLP. They can be reached at (312) 726-7127 or by e-mail at james.snyder@icemiller.com, enzo.incandela@icemiller.com, mark.huddle@icemiller.com

