



**HANDBOOK FOR MINNESOTA CITIES**

**Chapter 24  
Debt and Borrowing**

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## HANDBOOK FOR MINNESOTA CITIES

# Chapter 24 Debt and Borrowing

*Find information on the legal aspects of debt and borrowing such as laws governing bonds, debt service funds, and the impact of federal law. Read also practical suggestions about the administration of capital financing programs and descriptions of how the process actually works.*

The League gratefully acknowledges the work of Stephen J. Bubul, Kennedy & Graven, Chartered, Minneapolis Minnesota, in the complete revision of this chapter.

### RELEVANT LINKS:

[Minn. Stat. ch. 475.](#)  
[Minn. Stat. § 475.51, subd. 3.](#)

## I. Basis for city debt and borrowing

From time to time cities must construct public buildings and facilities, install infrastructure improvements, and acquire capital equipment. In some circumstances, cities (and their related development authorities) may also assist in the financing of private facilities to further redevelopment and economic development. Cities finance these activities in a variety of ways, including through dedicated funds, specific revenue streams, and the general tax levy.

But in many situations, the only practical way to provide the funds needed for initial construction is to borrow money. However, unlike people and business entities, cities may not borrow money simply by obtaining a conventional bank loan. Rather, they must use procedures specified by state law.

The statutory procedure for municipal borrowing is known to the general public as issuing “bonds,” which in many respects are similar to the bonds issued by private corporations. However, municipal bonds are unique in the world of finance and are strictly governed by state statutes (and, in the realm of tax-exemption, by complex federal laws and regulations).

The bonds most commonly issued by cities are governed by Minn. Stat. ch. 475, though that chapter interacts with many other statutes that address specific types of borrowing. Confusingly, Chapter 475 does not use the term “bonds,” but instead refers only to the issuance of “obligations.” Many other statutes use only the term “bonds.” For practical purposes, these terms are synonymous, and this chapter will reference both terms as the context requires.

This material is provided as general information and is not a substitute for legal advice. Consult your attorney for advice concerning specific situations.

## RELEVANT LINKS:

[Minn. Stat. § 475.51, subd. 3.](#)

See Section X *Participants in a bond sale.*

[Minn. Stat. § 475.51, subd. 10.](#)

Chapter 475 defines the term “obligation” as “any promise to pay a stated amount of money at a fixed future date or upon demand of the obligee, regardless of the source of funds to be used for its payment, made for the purpose of incurring debt, . . . *for which funds are not appropriated in the current year’s budget.*” (emphasis added). The clause in italics is the key concept: by issuing an “obligation,” the city is committing to pay money in a future year—which in effect trumps the often-stated (but not entirely accurate) principle that a sitting city council may not bind a future council. It can, and does, every time it issues a bond.

In effect, an obligation is a contract between the city and the bond owner: the bond owner agrees to purchase the bond, and the city agrees to repay the owner over time, subject to various terms and conditions. The details in these contracts vary widely. Bonds can be classified in various ways, such as by: the source of payment (often referred to as the “security”), what type of facility will be financed from proceeds of the bonds (often referred to as the “purpose” of the bonds), and what entity will own the facility financed from the bonds (i.e., who is the “user” of the bond proceeds).

The process of issuing bonds is complex and requires assistance from attorneys, known as “bond counsel,” and (in most cases) from businesses that specialize in public finance, known as “financial advisors.” City staff should consult these parties for more detailed information about both legal and non-legal aspects of issuing bonds.

## II. Bonds by type of security

### A. General obligation bonds

The most common type of bonds issued by cities are “general obligations,” which are defined in Chapter 475 as “obligations which pledge the full faith and credit of the municipality to their payment.” (Note that Chapter 475 also broadly defines “municipality” to include counties, towns, and school districts; but this chapter will of course focus just on cities).

The pledge of “full faith and credit” means that the issuing city must use any assets it owns to pay the bonds—including use of its power of ad valorem tax levy. In effect, when a city issues a general obligation bond, it is promising to levy a tax in the amount needed to pay principal and interest on the bonds for their entire term. That tax levy is unlimited by any statute, and is not affected by any other tax the city may already impose.

Therefore, when investors purchase a general obligation bond, they are relying upon the general financial condition of the city and, indirectly, upon the condition of the city’s residents and businesses, which may be required to pay an additional property tax.

## RELEVANT LINKS:

[Minn. Stat. § 475.51, subd. 4\(3\).](#)

See Section IV-A *Conduit bonds*.

See Section VII-E *Tax anticipation certificates*.  
See Section VII-F *Lease-purchase financings*.

This type of bond is, by far, the most secure—the type most likely to be repaid in full—and therefore carries the lowest interest rates. (In public finance as well as private, higher risk generally means higher interest rates; lower risk, lower rates). Therefore, general obligation bonds are usually the most inexpensive method for cities to finance their capital needs.

Because general obligation bonds bind the city in a significant way, for many years to come, statutes impose more rules and restrictions on these type of bonds than most other types. These rules will be discussed in detail throughout this chapter.

## B. Revenue bonds

Revenue bonds are obligations for which the issuing city promises to pay principal and interest only from a specific revenue source. If the revenues are not sufficient to pay debt service, the city has no obligation to levy a tax or otherwise make a payment—bond holders simply get paid less (which may or may not trigger a “default” in the bonds). Obviously, revenue bonds are less secure than general obligation bonds, as the likelihood of repayment depends on the long-term strength of the revenue stream pledged to the bonds. As a result, interest rates on this type of bond are higher (to compensate the investor for increased risk).

Strictly speaking, Chapter 475 does not define “revenue bonds.” In most cases, if the city does *not* pledge its full faith and credit, the bond is a revenue bond (though occasionally bonds may be secured by a limited tax pledge that is something less than a true “general obligation.”) Further, certain revenue bonds are authorized by other statutes altogether. The three most common types of revenue bonds issued by cities are:

- Bonds issued to finance “revenue producing conveniences,” which are public enterprises that produce their own revenue, such as electric utilities, municipal liquor stores, and municipal golf courses and ice arenas.
- So-called “conduit bonds” issued to finance various private health care, housing, and manufacturing facilities.
- Tax increment financing (“TIF”) bonds, when they are payable solely by the tax increment generated from one or more tax increment financing districts.

Development authorities (such as housing and redevelopment authorities, economic development authorities, and port authorities) are authorized in their separate governing statutes to issue revenue bonds in order to carry out their missions. For the most part, these bonds are not governed by Chapter 475 at all.

## RELEVANT LINKS:

[Minn. Stat. § 444.075, subd. 2.](#)  
[Minn. Stat. § 115.46.](#)

[Minn. Stat. ch. 429.](#)  
See LMC information memo, *Special Assessment Toolkit*.  
[Minn. Stat. § 469.178, subd. 2.](#)

[Minn. Stat. §§ 447.45 to 447.50.](#)

[Minn. Stat. § 475.52, subd. 1.](#)

See Section VII-D *Certificates to make up revenue reductions*.  
See Section VII-E *Tax anticipation certificates*.

However, the principles are the same as revenue bonds issued by a city—the bonds are secured solely by the specific revenues pledged to the bonds.

### C. General obligation revenue bonds

This type of bond is actually just a sub-species of general obligation bond. These are issued when a statute authorizes a city to pledge a specific revenue source and, in addition, pledge the city’s full faith and credit. In most cases, the pledged revenues are expected to pay all (or some designated portion) of the debt service on the bonds, but the full faith and credit pledge means that the city must cover any shortfalls with an ad valorem tax levy.

Bond investors view these hybrid bonds as simply general obligations of the city—the investor looks primarily at the underlying financial strength of the issuing city, and does not rely on the strength of the expected revenue stream. As a result, these type of bonds carry essentially the same interest rates as general obligations that have no additional revenue pledge.

General obligation revenue bonds are probably the most common type of bonds issued by Minnesota cities. The most prominent examples are:

- Bonds used to finance water, sewer, and storm sewer improvements, where the utility revenues are (in most cases) expected to pay debt service.
- Bonds used to finance public improvements that are specially assessed, without voter approval, where special assessments are expected to pay at least 20 percent of the city’s cost to build the project.
- TIF bonds, without voter approval, where tax increments are expected to pay at least 20 percent of the debt service on the bonds.
- Bonds issued to finance municipal hospitals and nursing homes (with voter approval).

### III. Bonds by purpose

The general rule under Chapter 475 is that cities “may issue bonds to provide money for any authorized corporate purpose, except current expenses.” (Expenses *can* be bond-financed under limited exceptions for short-term borrowing). However, the rules for different bond purposes are specified in more detail in other sections scattered throughout Minnesota Statutes.

Bonds are frequently classified by the use to which proceeds are put. The use is normally evident in the name of the bond, which also (usually) describes the type of security, discussed above. Following are the most common types of bonds issued by Minnesota cities, grouped by purpose:

## RELEVANT LINKS:

[Minn. Stat. ch. 429.](#)

[Minn. Stat. § 444.075.](#)

[Minn. Stat. § 475.521.](#)

[Minn. Stat. § 475.58, subd. 3b.](#)

[Minn. Stat. § 412.301.](#)

[Minn. Stat. ch. 475.](#)

[Minn. Stat. ch. 475.](#)

[Minn. Stat. ch. 475. Minn. Stat. § 453.55.](#)

[Minn. Stat. ch. 475. Minn. Stat. § 469.178.](#)

[Minn. Stat. ch. 475. Minn. Stat. §§ 469.1813 to 1815.](#)

- *General obligation improvement bonds*: finance any public improvement that may be specially assessed under Chapter 429; the most common include roads, water improvements, and sewer improvements.
- *General obligation utility revenue bonds*: finance water, sewer, or storm sewer improvements where the bonds are paid primarily from utility system revenues. (The bonds may be named for the specific type of utility being financed—e.g., sewer revenue bonds).
- *General obligation capital improvement bonds*: finance city halls and other specified public facilities (but not roads and utilities).
- *General obligation street reconstruction bonds*: finance street reconstruction (but not construction of new or expanded streets with limited exceptions).
- *Equipment certificates of indebtedness or capital notes*: finance capital equipment. (The terms “certificates” and “notes” are common in public finance for short-term obligations such as these; they have a maximum term of 10 years).
- *General obligation park and recreation bonds*: finance municipal park and recreation facilities.
- *General obligation (building) bond*: finance various types of public buildings (usually ones that do not qualify as “capital improvements” for financing with capital improvement bonds referenced above). Bonds are often named for the specific type of building, e.g., general obligation community center bonds.
- *Electric utility revenue bonds*: finance improvements to a municipal electric utility; in most cases, the utility is governed by a public utilities commission, separate from the city council, but the bonds are issued by the city, or by cities acting jointly as a “municipal power agency.”
- *General obligation tax increment bonds, and tax increment revenue bonds*: finance various public and private improvements that promote economic development or redevelopment, and are eligible for financing under the Tax Increment Financing Act.
- *General obligation abatement bonds*: finance various public and private improvements; usually part of economic development programs, but may also finance public infrastructure in any context.

This list is not exhaustive, but summarizes the bonds that most cities issue in the normal course of business.

## RELEVANT LINKS:

See Section VIII-B  
*Governmental versus private activity.*

[Minn. Stat. §§ 469.152 to 469.1651.](#)  
[Minn. Stat. ch. 462C.](#)

See Section X *Participants in a bond sale.*

Note that bond investors have very little interest in how the proceeds are used, if the bonds are general obligations. Therefore, the classification by use of proceeds is mostly relevant from a standpoint of city policy and financial management.

## IV. Bonds by user

The most commonly-issued bonds represent borrowing by a city to finance public assets—the city itself is the “user” of the proceeds. But Minnesota law authorizes cities to issue bonds where the proceeds are actually used by private parties. These bonds are referred to in most cases as “private activity bonds”—a name derived from federal tax law. Private activity bonds fall into two major categories, discussed in turn below.

### A. Conduit bonds

Unlike almost all other bonds, “conduit bonds” are initiated by and issued for the benefit of private entities. Under the state statutes that authorize these bonds, the city issues the bonds and loans the proceeds to the private entity. That private entity repays the loan in an amount sufficient to pay principal and interest on the bonds. As a practical matter, the loan is (normally) handled entirely by a separate bond trustee (usually the trust division of a bank). After the bonds are issued, the city has almost no role in payment or administration of the bonds.

The bonds are revenue bonds—the city does not pay debt service or any other cost related to the transaction. As such, the bonds have no effect on the issuing city’s credit rating and are not counted against any statutory limitations on borrowing. When the bonds are sold, investors look only to the credit of the private borrower (and any related private security, such as mortgages and guarantees). While the city council must approve issuance of the bonds and all the bond documents, the transaction is largely handled by the private borrower and the underwriter that usually serves as the initial purchaser of the bonds. The bond counsel for conduit bonds may be the city’s regular bond counsel, or may be retained by the private entity (this is a matter of city policy and practice).

The types of private activity bonds are governed primarily by federal tax law. Congress in effect created this kind of bond to provide tax-exempt (and therefore lower cost) borrowing to certain favored activities carried out by private entities.

Much of today’s tax law regarding these bonds originated with the Tax Reform Act of 1986, which sharply narrowed the scope of permissible private activity bonds (previously known as “industrial development revenue bonds” or “IDR bonds”).

## RELEVANT LINKS:

[Minn. Stat. § 469.178.](#) [Minn. Stat. § 469.1814.](#)

See Handbook [chapter 15](#).

The three most common conduit bonds in Minnesota are:

- *Qualified 501(c)(3) bonds*, where the user of bond proceeds is a nonprofit 501(c)(3) entity. Typical examples include nonprofits that own nursing homes, hospitals, senior and other affordable housing, and schools (from K-12 to college). But any nonprofit with 501(c)(3) status is eligible for this type of financing, so bonds have been issued for entities as diverse as the YMCA to Minnesota Public Radio.
- *Housing revenue bonds (exempt facilities)*, where the user of bond proceeds is a private for-profit entity that builds housing intended for occupancy by persons or families who meet specified low-income guidelines.
- *Small issue manufacturing bonds*, where the user of the proceeds is a manufacturing business that constructs manufacturing facilities that meet certain federal requirements.

There are other less common conduit bonds that cities may occasionally encounter, but the three listed above represent the bulk of this bond type.

## **B. Tax increment and abatement private activity bonds**

The other category of common private activity bonds are those issued in the context of economic development and redevelopment. Cities may issue bonds secured by tax increments (all the increased taxes in a TIF district or portion thereof) or abatements (the taxes imposed by a participating taxing jurisdiction, usually just the issuing city).

The city *may* be the “user” of these bonds, for example, when proceeds finance public streets or other public infrastructure needed for a private development project. But bond proceeds may be delivered to a private developer to finance aspects of the private development permitted under law—such as land acquisition, excavation, and other eligible private improvements. In those cases, the private developer becomes the “user.”

In most cases, where the private developer is the user, the issuing city will also require the developer to provide additional security, such as an agreement to maintain a minimum value, or a guarantee to cover debt service if tax increments or abatements fall short of expectations. The result is that these bonds are treated as “private activity bonds,” and must be issued as taxable bonds.

By contrast, conduit bonds are tax exempt despite the fact that they are issued for the benefit of, and secured by, a private entity—but only because the private entity accomplishes some public purpose identified by Congress in federal tax law.

## RELEVANT LINKS:

See Section VII-B  
*Temporary bonds.*

[Minn. Stat. ch. 475.](#)

[Minn. Stat. § 475.53.](#)

[Minn. Stat. § 475.51, subd.  
4.](#)

[Minn. Stat. § 475.521, subd.  
4.](#)

See Section IV *Bonds by  
user.*

It is possible for tax increment or abatement bonds to be used entirely by a private developer, but without the developer providing any “backstop” to pay debt service if those revenues fall short. In those cases, the bonds are not considered to be “private activity” bonds despite clearly having a private user. This is possible because federal tax law actually allows tax-exempt bonds to be issued for private users, as long as the private user does not also *secure* payment of the bonds. Cities only occasionally issue such “private use but no private security” bonds, when the lower cost of tax-exempt bonds and large public benefit from the project is deemed worth the risk.

## V. Chapter 475—the “bond code”

### A. General information

The majority of bonds issued by Minnesota cities (most of them described in Sections II and III above) are governed by the comprehensive “bond code,” Minnesota Statutes, chapter 475. This section describes the key provisions of Chapter 475 in detail.

### B. Debt limit

One of the most significant limitations in Chapter 475—at first glance—is the so-called “debt limit.” The general rule is that cities may not incur “net debt” in excess of 3 percent of the estimated market value of all taxable property in the city (the limit is 2 percent in first class cities unless a charter authorizes a higher rate, but even the charter rate is capped at 3-2/3 percent of market value).

However, the definition of “net debt” excludes from this limit all bonds for which some revenue is pledged, and even bonds that simply finance any “public convenience from which a revenue is or may be derived,” whether or not that revenue is technically pledged to the bonds. Therefore, the vast majority of bonds that cities issue are not subject to the so-called debt limit. This includes improvement bonds (secured in whole or in part by special assessments), utility general obligation revenue bonds (secured by utility revenues), and of course pure revenue bonds of all types.

In addition, other statutes may separately provide an exemption from the net debt limit in Chapter 475, even for bonds that are not secured partly by revenues.

For example, capital improvement bonds issued by cities with a population under 2,500 are exempt from the limit. The result is that only bonds secured solely by an ad valorem tax levy are subject to the 3 percent limit.

## RELEVANT LINKS:

See Section V-C *Voter approval*.

[Minn. Stat. § 475.58, subd. 1.](#)

[Minn. Stat. § 475.58, subd. 1\(3\).](#)

[Minn. Stat. § 475.58, subd. 1\(4\).](#)

[Minn. Stat. § 475.58, subd. 1\(5\), \(6\).](#)

[Minn. Stat. § 475.58, subd. 1\(7\), \(10\).](#)

[Minn. Stat. § 475.58, subd. 1\(9\).](#)

[Minn. Stat. § 444.075, subd. 3l.](#)

In practice, these bonds are issued mostly for these purposes: to finance public buildings (either with voter approval discussed below, or using the capital improvement bond statute for cities of 2,500 or greater); park and recreation facilities (where no revenues are generated); and street reconstruction bonds.

Because of the narrow scope of “net debt,” the statutory limit rarely has a practical significance except for very small cities. However, rating agencies and the broader market of investors still examine the amount of debt that a city carries in evaluating the credit-worthiness of the city. Therefore, the market itself creates informal limits on the amount of debt a city may reasonably incur. Cities’ financial advisors help examine these questions when cities are considering their capital financing needs.

### C. Voter approval

Another general rule in Chapter 475 is that bonds may be issued only “upon obtaining the approval of a majority of the electors voting on the question of issuing the obligations.” However, as with the net debt limitation, the voter approval rule is practically swallowed by the exceptions.

There are 11 exceptions to the voter approval rule in Chapter 475 itself, and many more in other statutes outside that chapter. The most relevant ones are:

- Improvement and tax increment bonds, where the assessments or tax increments are expected to pay at least 20 percent of the cost of the project (or debt service, in the case of tax increment bonds).
- All bonds secured wholly from the income of “revenue producing conveniences” (i.e., pure revenue bonds).
- Bonds issued under any other law or city charter that permits issuance without voter approval.
- Bonds issued to fund certain pension, retirement fund, and other post-employment benefit liabilities.
- Abatement bonds (as long as they do not finance municipal buildings).

Outside Chapter 475, a key exemption to the voter approval requirement is found in Chapter 444, where general obligation bonds to which utility revenues are pledged are “deemed to be payable wholly from the income of the system whose revenues are so pledged.” The effect of that “deemed” provision is to treat such bonds *as if* they were purely revenue bonds and, therefore, exempt from voter approval under Section 475.58, subd. 1(4).

## RELEVANT LINKS:

[Minn. Stat. § 465.73.](#)

Another exemption helpful to small cities found outside the bond code exempts from voter approval loans up to \$450,000 for city and town halls, fire halls, libraries, and child care facilities, but only when financed under certain United States Department of Agriculture programs.

The net result is that very few bonds issued by cities are in fact subject to voter approval, which is why municipal bond elections are now rare. They occur primarily for bonds that finance park and recreation facilities and for city buildings *other than* city halls (such as community centers).

[Minn. Stat. § 275.60.](#)

For bonds that *do* require voter approval, state law requires that the ballot contain the following statement in bold face type: “BY VOTING ‘YES’ ON THIS BALLOT QUESTION, YOU ARE VOTING FOR A PROPERTY TAX INCREASE.” Frequently, that statement is not true, in that many factors could result in taxes remaining flat or even decreasing despite a voter-approved debt levy. However, the ballot may also contain a description of revenues pledged to payment of the obligations that are intended as the primary source of payment—leaving the voter to puzzle over whether those revenues negate the bold-faced statement about increasing taxes.

If the voters approve a bond issue, the city is not *required* to issue the bonds. But if it does issue the bonds, the issue may not exceed the amount authorized in the ballot question, and proceeds must be used for the purpose described in the ballot. There is no clear rule (in Chapter 475 or in court decisions) as to how long voter approval remains effective.

[Minn. Stat. § 475.58, subd. 1a.](#)

If an election is held but it fails, the same question for the same amount may not be re-submitted to the voters for six months. If it fails a second time, a third election may not be held until one year after the second one.

[Minn. Stat. § 475.59.](#)

The ballot question should be prepared by the city’s bond counsel to ensure compliance with all relevant laws that will permit issuance of the bonds if the question is approved. If the city proposes improvement of multiple facilities at one or more location, the ballot may be stated as a single question, or as two or more separate questions stated conjunctively or in the alternative.

[A.G. Op. 159a-3 \(May 25, 1962\)](#), see also *Abrahamson v. St. Louis County School District*, 819 N.W.2d 129 (Minn. 2012).

If a bond election is held, city officials and staff may not campaign in favor of the question. The city may distribute factual information about the bonds and the project, but must be careful not to cross the boundary to advocacy.

## RELEVANT LINKS:

[Minn. Stat. § 475.521.](#)  
[Minn. Stat. § 475.58, subd. 3a.](#)

[Minn. Stat. § 412.301.](#)

[Minn. Stat. § 410.32.](#)

[Minn. Stat. § 475.60.](#)

[Minn. Stat. § 475.60, subd. 2\(9\).](#)

[Minn. Stat. § 475.60, subd. 2\(2\).](#)

## D. Reverse referenda

As an alternative to outright exemptions from voter approval, the Legislature has authorized a hybrid system referred to as “reverse referendum” for three commonly used types of bonds: capital improvement bonds, street reconstruction bonds, and certain equipment certificates.

Capital improvement and street reconstruction bonds follow a similar procedure: the city must approve a plan and hold a public hearing regarding both the plan and issuance of bonds. If a petition requesting a vote on the issuance of the bonds is signed by voters equal to 5 percent of the votes cast in the city in the last municipal general election and is filed with the clerk within 30 days after the public hearing, then the bonds may not be issued unless approved by the voters. If a petition is filed, the city council is not compelled to hold an election—it may decide to abandon the project or seek some alternative financing method.

For equipment certificates, the “reverse referendum” applies only if the amount of the proposed certificates exceeds .25 percent of the estimated market value of taxable property in the city. In those cases, the city must publish a preliminary resolution, and if a petition signed by voters equal to 10 percent of the number of voters at the last regular municipal election is filed with the clerk within 10 days after the publication, the certificates may not be issued without voter approval. Certificates in an amount below the threshold may be issued without voter approval at all.

Charter cities may also issue certificates without voter approval under section 410.32, but that statute imposes a very low annual dollar limit. Section 412.301, with a higher limit that triggers reverse referendum, is almost always more beneficial, and charter cities are expressly authorized to use either statute.

## E. Public sale

A third “general rule” in Chapter 475 is that bonds must be sold after published notice to the highest bidder on a purely competitive basis. However, the exceptions to this rule mean that it rarely applies at all.

The two most relevant exceptions are:

- Bonds issued where the city has retained an “independent financial advisor,” and the council determines to sell the bonds by private negotiation.
- Bonds sold in an amount not exceeding the total sum of \$1.2 million in any 12-month period.

## RELEVANT LINKS:

[Minn. Stat. § 475.61.](#)

The vast majority of bonds issued by Minnesota cities are sold with the assistance of independent financial advisors. In most cases, these advisors in fact recommend a competitive process for each bond sale, but the process does not (and is not required to) follow the strict statutory procedures (such as published notice). Legally, it is a “negotiated sale,” but in practice the sale is a competitive process within the standards of public finance.

The second exception covers smaller cities and low-volume issuers, which may not always engage financial advisors. Some separate statutes expressly exempt certain types of bonds from public sale as well.

The most common truly “negotiated sale” for most cities is a sale to a local bank—usually for smaller issues. This transaction is possible in most cases, but care must be taken to ensure that it falls into one of the exceptions to the “public sale” requirement (again, easily satisfied by simply engaging a financial advisor).

Note that the public sale requirement applies only to bonds issued under Chapter 475. Private activity bonds and bonds issued by development authorities are governed by other statutes, and such bonds are almost uniformly negotiated with underwriters rather than competitively bid.

## F. Tax levies for general obligations

Chapter 475 requires that, in the case of general obligations, the issuing city must levy by resolution an irrevocable ad valorem tax for each year of the term of the bonds, in an amount that, *together with any pledged revenues*, will produce 105 percent of the principal and interest due in each year.

The purpose of this 5 percent “over levy” is to protect bondholders against the possibility of deficiencies in collection of taxes or pledged revenues. The resolution (incorporated into the bond sale resolution) must be filed with the county auditor, and the auditor is legally required to levy that tax (whether or not the city includes this debt levy in its annual tax levies). In practice, cities always incorporate the debt levies for all outstanding bonds in their annual certification of tax levies; but the language in Chapter 475 underscores the importance of the tax levy as security for the bonds.

There are two important caveats to this rule of mandatory tax levies. First, when calculating the levy, the city first deducts the amount of any pledged revenues. So, if a city expects special assessments to cover 105 percent of the cost of improvement bonds, no tax levy at all is required.

## RELEVANT LINKS:

[Minn. Stat. § 475.55, subd. 1a.](#)

See Section X-F *Rating agency*.

[Minn. Stat. § 475.56\(a\).](#)

If only 50 percent of the cost of an improvement project is specially assessed, the city must levy for the difference between 105 percent of the annual debt service and the expected annual assessments.

Second, the city may cancel the levy in any year by irrevocably appropriating an amount to the debt service funds prior to the deadline for certifying tax levies each year; the county auditor is then required to reduce debt levy for that year by the specified amount. A city might do this because the 5 percent over levy from the prior year was not used, or because of increases in available revenues (such as prepayments of special assessments), or because the city decides as a matter of policy to use other legally available funds to reduce the tax levy.

### G. Interest rates

The interest rates on bonds are not subject to any statutory limitation. In competitive sales (including those that are technically exempt from the statutory bid requirement, but are nevertheless handled competitively), the rates are determined by the market. In most cases, the bonds are awarded to the purchaser who proposes the lowest “true interest cost,” which is the rate at which principal and interest payments over the life of the bonds are discounted to produce the purchase price. In true negotiated sales, the rates are simply agreed upon by the issuing city and the initial purchaser (a bank or bond underwriter), but are informed by the broader market.

For general obligation bonds, the interest rate depends on a number of factors—the term of the bonds (those with longer maturities will carry higher rates than short ones), the condition of the bond market generally on the day of sale, and credit of the city itself. One measure of the city’s credit is an analysis obtained from one of the national rating agencies. Most larger cities obtain a credit rating (for which a fee is paid to the agency), which assists in marketing the bonds. The better the rating, the lower the market-priced interest rate on the bonds.

One confusing aspect of bond sales is the concept of “discount” (not to be further confused with “discounting” to purchase price, mentioned above, where discount is a synonym for interest rate in calculating present value). Chapter 475 authorizes cities to increase the interest rate on bonds “by the issuance of additional obligations of the same series, over and above but not exceeding 2 percent of the amount otherwise authorized to be issued.” This additional bond amount—which is a form of interest—is known as discount, which allows sale of bonds at a price up to 2 percent lower than the face amount. The discount represents compensation to the underwriters who buy the bonds (primarily in competitive sales).

## RELEVANT LINKS:

[Minn. Stat. § 475.54, subd. 1.](#)

[Minn. Stat. § 475.54, subd. 1.](#)

One impact of this “extra 2 percent discount” rule is that it permits a city to increase the principal amount of bonds by up to 2 percent in cases where the principal is otherwise capped by some law or statute. The best example is where voters approve bonds in an amount not to exceed X dollars. The city may actually increase the principal amount of the bonds to X plus 2 percent, in order to provide the discount described above.

## H. Maturities

The general rule is that bonds must mature (i.e., the last principal amount paid) no later than 30 years after the date of issue. For municipal water and wastewater treatment systems and essential community facilities financed or guaranteed by the United States Department of Agriculture, the maximum term is 40 years.

One complication is the different way that principal is accounted for in bonds with serial maturities versus “term bonds.” Serial maturities are the most common: a stated principal amount is paid in whole on a specific date in a future year, and a bond issue is the aggregate of a group of serial maturities. In contrast, a term bond has a principal amount that technically “matures” on a specific date in a future year, but portions of that principal amount are paid in installments each year before maturity (referred to as “mandatory sinking fund redemption”). The annual installment payments in a term bond are the functional equivalent of serial maturities. The decision as to term bonds versus serial maturities turns on factors relevant only to bond investors. As such, this distinction is technical, and is relevant here only because these words appear frequently in bond documents (and in Chapter 475).

A further limitation on maturities under Chapter 475 is the so-called “rule of three and five or six.” This rule provides that the first principal maturity (or mandatory sinking fund redemption) must occur within three years after the date of issue, and no subsequent annual principal payment may exceed any *prior* principal amount (excluding any principal payments within the first three years after issue) by more than five times (for bonds maturing less than 25 years after issue) or by more than six times (for bonds maturing 25 years or later after issue). Thus, if the first maturity (more than three years after issue) is \$50,000, no subsequent maturity may exceed \$250,000 or \$300,000 (depending on whether the multiplier is five or six).

The purpose of this convoluted rule is to prevent a city from postponing maturities to the distant future, or “backloading” the issue such that a much greater principal amount is paid in later years.

## RELEVANT LINKS:

[Minn. Stat. § 475.54, subd. 2.](#)

These strategies, if permitted, would have the effect of reducing costs in the near term (attractive to a sitting city council) at the expense of future city residents.

However, as elsewhere in Chapter 475, there are numerous exceptions to the “rule of three and five or six,” which mean that it rarely poses a practical limitation. First, it does not apply if the city estimates that pledged revenues will be sufficient to pay principal and interest when due each year. Second, a city may satisfy the rule by combining the maturities of a new issue with one or more outstanding general obligation bonds (which is accomplished simply by stating this intention in the bond resolution). For cities with customary amounts of debt, this ability to combine maturities means the rule can be easily satisfied when looking at all outstanding debt in the aggregate (which satisfies the ultimate policy concern).

### **I. Call for redemption**

Bonds are normally issued with the city retaining the right to pre-pay all or any portion of the bonds on and after some specified future date. This occurs whenever a city wants to refund the bonds (which is accomplished by issuing new bonds and using the proceeds to pay off all the original bondholders), or when a city has sufficient funds (and it makes financial sense) to retire the bonds before maturity.

The rights of redemption must be stated in the bond documents approved at the time of issuance, so that bond investors understand the terms under which the city may exercise such rights. A city may specify redemption at any time it chooses, but the market requires that redemption rights be delayed for a significant time period, to ensure that the bondholders retain the benefit of their investment. Therefore, most long-term bonds may not be prepaid for eight to 10 years. (An earlier “call date” is sometimes used in unusual circumstances, but such bonds normally carry a higher interest rate).

[Minn. Stat. § 475.54, subd. 4.](#)

Since almost all bonds issued in today’s market are “registered” (i.e., a registrar has a record of each owner), redemption is accomplished by direct notice to each holder (rather than through publication, as was once the general practice). The bond registrar and/or paying agent normally handles redemption notices on behalf of the issuing city.

### **J. Funds and accounts**

Each bond sale resolution creates (or designates existing) funds to handle the bond transaction.

## RELEVANT LINKS:

[Minn. Stat. § 475.51, subd. 6.](#)

See Section VIII *Federal Tax Law*.

[Minn. Stat. ch. 118A.](#)  
LMC information memo,  
*City Deposits and Investments*.

See Section VI *Refunding bonds*.

[Minn. Stat. § 475.61, subd. 4.](#)

[Minn. Stat. ch. 118A.](#)

### 1. Debt service fund

The most important is the debt service fund to which all monies (whether revenues or tax levies) that are pledged to the bonds are paid. Debt service funds must be kept separate from all other city funds and may not be invaded, even on a temporary basis, for other city needs.

Chapter 475 allows cities to establish a single common debt service fund for its general obligations, but in practice, most bond documents establish a separate fund for each bond issue, which is needed to ensure compliance with federal tax laws.

All money in the debt service fund (and any other funds created in the bond documents) must be invested in accordance with Chapter 118A. That is, debt service funds are subject to the same limitations as all city funds, except that money in a refunding escrow account is subject to more strict requirements. One permitted type of investment is bonds issued by any other city, or even the issuing city itself, if they are rated at least A for general obligations and AA for revenue obligations. However, as with all investments of money in a debt service fund, great care must be taken that the maturities and redemption features of all securities held in the fund ensure availability of money at the times needed to pay principal and interest on the bonds.

Generally, when all bonds of an issue have been paid in full, any balance of tax levies remaining in the debt service fund may be appropriated for any other general municipal purpose.

### 2. Construction fund

The other common account established in bond resolutions is a construction fund, where proceeds of the bonds are placed while the project to be financed by the bonds is under construction. As noted, these funds must also be invested in accordance with Chapter 118A, with care to ensure the availability of money to pay project costs as needed.

As with debt service funds, it is important to maintain a separate account for construction funds in each bond issue in order to track expenditures; this may be needed to ensure compliance with federal tax laws, and sometimes state laws that limit the uses of bond proceeds from a particular type of bond issue.

## RELEVANT LINKS:

[Minn. Stat. § 475.67, subd. 3\(b\).](#)

[Minn. Stat. § 475.67, subd. 3\(d\).](#)

See Section V-H *Maturities*.

## VI. Refunding bonds

### A. General information

Refunding bonds are a special class of municipal bonds, commonly issued but not always well understood by city councils and the general public. Refunding bonds are the way a city refines an initial bond issue, usually to obtain a lower interest rate when market conditions have changed (much like a homeowner refinances his or her mortgage when rates have dropped significantly).

It is not critical to understand all aspects of refunding bonds in general, as the city's bond counsel and financial advisors will help determine which tool is most appropriate in which circumstance. However, city attorneys, staff, and elected officials should be familiar with the terminology and at least the general concepts, as refunding bonds are a key aspect of financial management for most cities.

Under Chapter 475, refunding bonds may be issued where the transaction will accomplish at least one of these four purposes:

- Reduce debt service cost to the city (by far, the most common).
- Extend or adjust maturities in relation to the resources available for payment (such as where revenues are insufficient in the early years, but are expected to increase later).
- Shift from variable rate to fixed rate bonds.
- For pure revenue bonds, relieve the city from restrictions imposed by covenants in the bonds to be refunded.

In most cases, if one of those four requirements is met, the refunding bonds may be issued without repeating the procedures that applied to the initial bonds. For example, if bonds are initially approved by the voters, then refunding bonds may be issued without a new election. However, a city may not refund *revenue bonds* with *general obligations* unless such issuance is authorized by election or some other law or procedure that would have been required as a condition to issue the prior bonds as general obligations.

### B. Current versus advance refunding

As noted above, bonds are most often refunded when interest rates have dropped enough for the city to save money (after transaction costs) by issuing refunding bonds at lower rates.

## RELEVANT LINKS:

[Minn. Stat. § 475.67, subd. 4.](#)

[Minn. Stat. § 475.67, subd. 12.](#)

[Minn. Stat. § 475.67, subd. 5.](#)

[Minn. Stat. ch. 118A.](#)

However, as explained above, most bonds contain covenants that prohibit redemption for some period of years after issuance; and in order to carry out a refunding, proceeds of the new bond issue must be used to redeem the prior one. The existing redemption rights of bondholders therefore affects how and when refunding bonds are issued.

Under Chapter 475, a *current refunding bond* is a series issued no more than six months before the first possible “call date” for the bonds to be refunded. However, federal tax law imposes a more strict 90-day deadline after the first call date, so all current refundings occur within that 90-day window.

An *advance refunding* is any refunding issued more than 90 days before the first call date. (Again, under Chapter 475, the deadline is actually six months, but federal tax law prevails as a matter of practice). Chapter 475 imposes certain additional conditions on issuance of an advance refunding bond, most significantly:

- The refunding must either extend the average maturities of the bonds by at least three years, or must result in a debt service savings of at least 3 percent.
- Proceeds of the refunding bond must be invested (until used to redeem the prior bonds) with a “suitable banking institution...whose deposits are insured by the Federal Deposit Insurance Corporation, and whose combined capital and surplus is not less than \$500,000.”
- Money in the “refunding escrow” must be invested in specified types of securities (more limited than the general rules under Chapter 118A).

The class of advance refunding bonds is further divided into two sub-types: gross or net refundings and crossover refundings. In a gross or net refunding, proceeds of the refunding bonds are invested in the refunding escrow until the first call date, at which time the accumulated funds in the escrow (with interest earnings) are applied to redeem the entire prior bond issue. In a crossover refunding, proceeds of the refunding bonds are used to pay debt service on the refunding bonds themselves until the first call date on the prior bonds. During that period, the prior bonds continue to be paid from the sources originally pledged to those bonds. On the call date, the accumulated funds in the refunding escrow are applied to redeem the outstanding prior bonds, and whatever revenues had been pledged to the prior bonds now “cross over” to secure the refunding bonds.

Crossover refundings are subject to slightly different rules than gross and net refundings, but the differences are not significant to policymakers. Perhaps the most important thing that policymakers should know about this topic is that any bond issue may be advance-refunded only once.

## RELEVANT LINKS:

Therefore, the council should be satisfied that the interest savings in any proposed advance refunding justifies the one-time use of this tool.

## VII. Miscellaneous other bond types

### A. General information

Parts II through VI of this chapter have described the most common types of bonds issued by cities. However, cities sometimes encounter additional specialized types of bonds, including tools that at first glance would not even appear to be “bonds.” This section briefly discusses some (but not all) of these specialized types.

### B. Temporary bonds

Most bonds have terms of 10 to 30 years, both to reduce annual debt service costs and to share the cost of capital assets between present and future beneficiaries of those assets. However, there are several situations where cities find it useful to issue short-term bonds (maturing in no more than three years) as a temporary financing tool.

A relatively common example is a specially assessed improvement project where the city expects substantial prepayments of the assessments. If the city issued long-term bonds (with a call date 10 years in the future), a large amount of prepaid assessments might sit in the debt service fund until the call date, and interest earnings would (usually) be insufficient to match the debt service payments. Instead, the city might issue temporary improvement bonds, and when the amount of prepayments is known, refund those temporary bonds with long-term bonds in the amount that wasn't prepaid.

Another type of temporary bond is issued when a city has obtained approval of a grant or loan from a state or federal agency, but the funds will not be available until the project is completed. The city issues grant or loan anticipation bonds with a two- or three-year term, and those bonds are paid off when the grant or loan is funded.

More generally, a city may issue temporary bonds in any situation where there is considerable uncertainty about the project being financed or the revenues available for payment. This may occur with tax increment financing projects, where other funds (such as land sale proceeds) may be available to reduce the long-term borrowing needs, but the amount of those funds is unknown at the outset.

[Minn. Stat. § 429.091 subds. 5 and 7. Minn. Stat. § 475.61, subd. 6.](#)

[Minn. Stat. § 475.61, subd. 5.](#)

[Minn. Stat. § 475.61, subd. 6.](#)

## RELEVANT LINKS:

[Minn. Stat. § 475.61, subds. 5 and 6.](#)

[Minn. Stat. § 475.61, subd. 6.](#)

[Minn. Stat. § 475.754.](#)

[Minn. Stat. § 475.755.](#)

[Minn. Stat. § 475.58, subd. 1\(11\).](#)

Temporary bonds may be (and usually are) issued as general obligations, provided that at the time they are issued, the city *could have* issued them as long-term bonds without obtaining voter approval. In other words, temporary bonds, by themselves, do not provide an exception to the voter approval rule in Chapter 475.

However, the mandatory tax levy rule *is* relaxed for temporary bonds, in that the bonds are considered to be secured by the proceeds of subsequent long-term bonds (or grants or loans, as the case may be).

Accordingly, no tax levy is required at the time of issuance of the temporary bonds.

If conditions are not ripe for issuance of long-term bonds within the three-year maturity of the temporary bonds, a city may issue additional temporary bonds, provided that two series of temporary bonds combined may not mature more than six years after issuance of the first series.

### **C. Public emergency certificates**

If a city must make extraordinary expenditures due to a natural disaster or other public emergency, and taxes and other funding are insufficient to cover the cost in a given year, the city may authorize the sale of certificates of indebtedness. The certificates must mature within three years, are exempt from public sale requirements, and are not included in the “net debt” of the issuing city. All certificates and interest thereon must be payable from taxes levied within existing limitations or from other available revenue. Curiously, nothing in Chapter 475 expressly exempts these certificates from voter approval, but such exemption is implied by the fact that they are authorized only in public emergencies (i.e., the time-consuming election would defeat the purpose of the borrowing). This curiosity is an example of a technical flaw that might be addressed in future public finance legislation, which is offered almost annually.

### **D. Certificates to make up revenue reductions**

If the income of a city is reasonably expected to be reduced below the amount anticipated in its budget when the final property tax levy was certified, and those receipts are insufficient to meet the expenses incurred or to be incurred during the fiscal year, a city can issue certificates of indebtedness that mature within two years or less from the end of that fiscal year. The maximum amount the certificates may be issued for in a fiscal year is the expected reduction and the costs of issuance.

The certificates must be repaid by a levy that, according to the Department of Revenue, is not subject to or included in a city’s levy limit.

## RELEVANT LINKS:

[Minn. Stat. § 412.261.](#)

[Minn. Stat. § 465.71.](#)

[A.G. Op. 125-a-40 \(June 11, 1979\). A.G. Op. 166-b \(April 27, 1986\).](#)

If these certificates are used to compensate for unallotment or loss of other state aid, the same amount cannot be again recouped under a separate special levy. These certificates are expressly exempted from the voter approval requirement.

### **E. Tax anticipation certificates**

Cities may also issue certificates of indebtedness in anticipation of the collection of taxes levied for any fund and not yet collected.

They may be issued on or after the first day of the year following the annual tax levy, and must be payable no later than April 1 of the following year. These “tax anticipation certificates” may be tax-exempt, but in that case are subject to strict rules under federal laws and regulations. Tax anticipation certificates are relatively uncommon, and often reflect financial stress or other unusual factors that require this type of interim borrowing.

### **F. Lease-purchase financings**

As an alternative traditional bond financing, cities are authorized to acquire real or personal property by entering into a “lease-purchase agreement,” under which the seller (or an assignee) retains title to the asset until the lease is fully paid. The city, as lessee, pays rent that includes an interest component—lease payments are the functional equivalent of principal and interest on a bond. At the end of the lease term, the city takes title to the subject asset.

The key feature of a lease-purchase agreement is that the city must retain the right to terminate the agreement at the end of any fiscal year during its term, by a provision known as a “non-appropriation clause.” This right must not be burdened by penalties so great that they make termination a practical impossibility. Because of this non-appropriation right, a lease is not an “obligation” as defined in Chapter 475—it is not a promise to pay money at a fixed future date, precisely because a city may choose simply to terminate and make no further payment.

A lease-purchase transaction is therefore not subject to voter approval or any other portion of Chapter 475, with one exception: if the amount of the lease exceeds \$1 million, that amount *is* treated as net debt for the purposes of the debt limit under Minn. Stat. § 475.53.

Despite the fact that leases are not treated as debt under Minnesota law (except as noted above), a properly structured lease *is* debt for the purposes of federal income tax law.

## RELEVANT LINKS:

[Lakes Area Business Association v. City of Forest Lake](#), 842 NW 2d 320 (Minn. App. 2014).

[Minn. Stat. § 275.70, subd. 5\(3\)](#).

Accordingly, if the lease satisfies the customary requirements for tax-exempt bonds, the interest component of lease payments are treated as tax-exempt interest on municipal debt. The result is that a lease-purchase agreement can be economically identical to a tax-exempt municipal bond in the hands of the lessor.

Lease-purchase agreements usually occur in one of three ways. One is to purchase city equipment (such as office equipment, motor vehicles, and the like), where the vendor of the asset is the lessor and the city buys the equipment under a tax-exempt lease-purchase agreement. The tax-exempt feature reduces the cost otherwise payable for that asset.

The second use is to finance major capital expenditures, such as a city hall or community center. In these cases, a bank functions as the lessor and technically holds title to the building being financed until the lease is paid in full. Again, the tax-exempt nature of the interest payments embedded in the lease make this equivalent to a bank simply purchasing a tax-exempt bond issued by the city.

If the dollar amounts are large, a variation on the direct lease-purchase with a bank is for the bank to sell “certificates of participation” (COPs) in the lease. That is, investors purchase the right to receive an allocated share of the lease payments, including the tax-exempt interest included in those payments. COPs are essentially the same as traditional bonds in most respects.

The third form of lease-purchase is where the city (as lessee) enters into a lease with a housing and redevelopment authority or economic development authority (as lessor). The authority then issues *revenue bonds* that are secured by the lease payments made by the city to the authority. In this transaction, the authority’s bonds are the tax-exempt instrument sold to investors, rather than the lease itself. This transaction is primarily used where the city will levy taxes to make its lease payments, because the levy is outside levy limits under current law (as a levy to pay the bonded indebtedness of another political subdivision). In contrast, levies to pay a direct lease with a bank, or holders of COPs, are subject to any levy limits that may be in effect.

In all three contexts, lease-purchase financing carries somewhat higher interest costs than general obligation bonds. The reason is that the bank (or COPs investor) is subject to the risk that the city may actually terminate the lease. Banks and investors enter into these transactions with the expectation that a city is highly unlikely to terminate the lease—if the city does so, it loses the asset it was paying for, and also suffers long-term consequences in reduced credit ratings.

## RELEVANT LINKS:

[Minn. Stat. § 469.034.](#) [Minn. Stat. § 469.061.](#) [Minn. Stat. § 496.103.](#)

[Minn. Stat. § 469.034, subd. 2.](#)

[Minn. Stat. § 469.060.](#)

However, Minnesota cities *have* exercised their right of termination in unusual situations, and the market factors this risk into these leases.

## G. Development authority bonds

As mentioned earlier in this chapter, development authorities created by cities under various statutes—economic development authorities (EDAs), housing and redevelopment authorities (HRAs), and port authorities—have powers to issue bonds under this own name. Though created by cities, these entities are separate political subdivisions of the state.

The statutes provide broad authority for these authorities to issue revenue bonds in order to carry out their missions.

Normally, such bonds may be issued without approval by the city council of the authority's city (unless local policies dictate otherwise). The statutes also provide limited authority for general obligation bonds in special circumstances, but always subject to approval by the city council in that city (and subject to voter approval unless an exception is provided).

There are two significant circumstances where authorities may issue general obligation bonds with city council approval, but without voter approval. The most common are qualified housing bonds issued by an HRA, which finance affordable rental housing owned by the HRA itself. These are tax-exempt, general obligation bonds—tax-exempt because the bonds are used to finance an essential governmental function of the HRA, which is to provide affordable housing, and the asset is owned by the HRA rather than a private party; and general obligations because the HRA statute expressly authorizes the city to pledge its full faith and credit if certain tests are met.

A less common example is when general obligation bonds are issued by a port authority for economic development purposes. Thus, a port authority might issue bonds to finance some aspect of a private development project. The bonds might be taxable (for reasons explained below), but could nevertheless be secured by the city's full faith and credit if the proper procedures are followed.

## VIII. Federal Tax Law

### A. General information

Federal tax law pervades the topic of municipal bonds, because tax-exemption is a primary benefit of bond financing—the ability of bond investors to exclude bond interest from their taxable income means that they will accept lower interest rates on the bonds they purchase.

## RELEVANT LINKS:

The issuing city thus reduces its borrowing cost by the difference between taxable and tax-exempt interest rates (and that gap varies widely over time, from very narrow to quite large).

The bulk of current federal tax law regarding municipal bonds originated with the Tax Reform Act of 1986, which sharply narrowed the scope of tax exemption and introduced many limitations and regulations. There have been significant amendments and new regulations since 1986, but the core of the 1986 federal law remains intact.

This chapter will summarize the key provisions of federal tax law that affect municipal bonds. City officials need not absorb this material, but they should be aware of the broader concepts, as those concepts affect policy decisions that city councils face on a regular basis.

### **B. Governmental versus private activity**

Municipal bonds are not tax-exempt simply because they are issued by a unit of government; only bonds that *do not* meet certain “private activity” tests enjoy tax exemption. In simplified terms, bonds are considered to finance private activity—and hence lose their qualification for exemption—if *both* more than 10 percent of the proceeds are used in a private trade or business, *and* more than 10 percent of debt service is secured by a property used in a private business. That is, if a bond finances a private activity, but has no private security (or vice versa), it is not a “private activity bond.”

Most routine city bonds are clearly not private activity bonds—they finance assets owned and used by the city to carry out an essential governmental function, and debt service is paid with property taxes or other clearly public revenues. In tax terminology, they are “governmental bonds” and are issuable on a tax-exempt basis.

Questions of private use arise in more complex financings, such as municipal hospitals, community centers, or ice arenas, where the facilities being financed from bond proceeds may be leased to or otherwise used by private entities. Private use and security are even more often a concern in tax increment and abatement bonds, where the proceeds often finance a clear private activity—development or redevelopment of private land. In those situations, there is often private security as well, in the form of developer guarantees or agreements to maintain a specified property value. Where those facts occur, the bonds must be issued on a taxable basis.

Conduit bonds are a special case—they are unambiguously private activity bonds in that they expressly benefit, and are secured by, private parties.

See Section IV-B *Tax increment and abatement private activity bonds*.

See Section IV-A *Conduit bonds*.

## RELEVANT LINKS:

However, federal tax law carves out exceptions for specific types of bonds that merit tax exemption despite the private benefit—creating the anomaly of tax-exempt private activity bonds. Generally, tax exemption is provided for private activities that accomplish some broader public purpose, such as assisting the development of nonprofit nursing homes and health care facilities, affordable housing, and job-creating manufacturing facilities.

Finally, besides the private activity and private security tests, federal law creates an alternative test for determining whether bonds will be treated as private activity bonds: the “private loan test.” This more nuanced test results in taxable bonds whenever the substance of a bond transaction is essentially a loan to a private party. The details are not important here, but bond counsel may raise this question in some circumstances.

### C. Arbitrage

Arbitrage is the term used to describe a potential “profit” to be gained when a city issues tax-exempt bonds. The city may borrow money at a low tax-exempt rate (say, 2 percent), but invest the bond proceeds at a much higher rate (say, 4 percent). That additional interest enjoyed by the city is deemed “arbitrage,” which is disfavored by federal tax law because it was gained at the expense of U.S. taxpayers as a whole (through issuance of the tax-exempt bonds).

A host of complex regulations govern how arbitrage is prevented, and sometimes allowed, in municipal bond transactions. For the purposes of this chapter, it is sufficient to highlight these points:

- The law recognizes that cities will hold bond proceeds in a construction fund for some period while the project is being constructed. Within certain limits, these funds may be invested without limitation—so a city may in fact earn arbitrage, though in practice the amounts are very small.
- Even in cases where a city properly earns arbitrage, it may be required to “rebate” those funds to the federal government. Thus, the federal rules both strictly limit the ability to earn arbitrage, and also require it to be rebated to the United States in cases where it is earned.
- There are numerous exceptions to the rebate requirement, the most prominent of which is that cities expecting to issue no more than \$5 million of tax-exempt bonds in a calendar year are exempt from rebate. So those small issuers may, in fact, earn and keep modest amounts of arbitrage. Maybe more importantly, these “small issuers” are relieved of the tedious record-keeping that arbitrage rebate requires.

## RELEVANT LINKS:

- When bonds are delivered, city officers (including the mayor, city administrator or manager, and finance director) must certify that the city reasonably expects that bond proceeds will not be invested or used in a way that violates the arbitrage rules (referred to as “arbitrate certificate” or “tax certificate”). The city’s bond counsel prepares this document, but these key city officials should understand the content enough to certify its accuracy.

### **D. Reimbursement**

Federal tax regulations also strictly limit a city’s ability to pay for a project first, then later issue tax-exempt bonds to reimburse that prior expenditure. Absent regulation, a city could finance a city hall with other available funds, then issue tax-exempt bonds five years later, claiming that the proceeds simply reimburse those prior city hall expenditures.

It’s clear the city did not really need the bond proceeds five years later, and the tax-exempt bonds were used to finance city operations (or something besides the five-year-old city hall).

The federal response to this problem is to permit early expenditures, as long as the city declares its intent to later reimburse those funds from proceeds of bonds. The regulations also impose certain time limits on the period between the expenditure (or the date the project is placed in service) and the actual bond reimbursement. In most cases, the maximum gap between expenditure and bond issuance is three years. City councils will frequently be asked to approve such declarations of intent (prepared by bond counsel or a financial advisor) or authorize their administrator or finance directors to make such declarations on their behalf.

### **E. Bank qualification**

Tax regulations negate the benefits of tax exemption for banks that own tax-exempt bonds, unless the bonds are “bank qualified.” Therefore banks will not purchase tax-exempt bonds at all unless they carry the designation of “bank qualified bonds.” Cities may designate their bonds as bank qualified as long as they expect to issue no more than \$10 million in tax-exempt bonds in that calendar year. Bank qualified bonds carry slightly lower interest rates, because the market includes all banks as well as the other institutions and individuals who regularly buy municipal bonds—a larger group of potential buyers yields more competitive rates.

Many Minnesota cities easily qualify all of their bonds under this provision.

## RELEVANT LINKS:

However, one anomaly is that qualified 501(c)(3) bonds—which are conduit bonds issued for the benefit of nonprofit entities—are also eligible for bank qualification, and any such bonds issued by a city count against the city’s own \$10 million annual limit. This is one circumstance where conduit bond issuance does affect city finances in some material way. However, cities routinely address this problem by requiring that a nonprofit entity compensate the city for any increased borrowing cost if the nonprofit’s bonds cause the city to lose bank qualification for the city’s own governmental bonds.

## IX. Federal securities law

Almost as important as federal tax law in municipal finance is federal securities law, which is intended to protect investors who purchase securities of all types. Municipal bonds are exempt from most of the onerous requirements that apply to private securities (such as corporate bond offerings).

However, municipal bonds remain subject to the anti-fraud provisions of federal securities statutes (which date to the 1930s), and also to more recent Securities and Exchange Commission (SEC) regulations (dating from the 1980s and subsequently) that specify how and when information about bond issues is disclosed to prospective and current bond investors.

The most relevant SEC rule (15C 2-12) requires bond underwriters to provide a timely offering document referred to as an “official statement” in connection with each offering of at least \$1 million. The official statement describes the proposed bond issue and the security for payment, and is intended to disclose all information to potential bond investors that might materially affect their decision about whether to purchase the bonds.

In the case of general obligation bonds, the bulk of the official statement describes the city’s financial condition, including detailed financial statements. The official statement is typically prepared by the city’s financial advisor (or in unique circumstances by special “disclosure counsel” retained by the city). The city (in most cases) formally approves and authorizes delivery of the official statement in the resolution approving sale of the bonds.

The official statement is an important document in any bond transaction. The city council approves it, and key city officials (mayor, administrator or manager, and finance director) are typically required to sign a certificate upon delivery of the bonds that the official statement does not contain any untrue statement of a material fact, or omit to state a material fact that should be included for the purpose for which the official statement is to be used. This means the documents should be read very carefully.

## RELEVANT LINKS:

In recent years, the SEC has increased its attention to disclosure regarding municipal bonds, and has taken enforcement action against cities that failed to adequately disclose their true financial condition. This has not been a large concern in Minnesota, but the official statement is probably the most important document in a bond transaction for city council members and other officials to read and understand.

Before 1995, a city's only obligation under Rule 15C 2-12 was to provide the official statement at the time of bond issuance. Amendments effective in that year added a requirement for continuing disclosure—the filing of annual reports that update what was in the original official statement, and the obligation to provide other reports at any time if certain specified “material events” occur. These reports are typically handled by the city's financial advisor, with the assistance of the city's finance director or other relevant staff.

## **X. Participants in a bond sale**

Because the laws and regulations regarding municipal bonds are complex and specialized, cities must engage specialized advisors to accomplish a bond transaction. This section will summarize the key players in all aspects of a typical bond sale.

### **A. Bond counsel**

Bond counsel is an attorney who specializes in the area of public finance. His or her central role is to provide an opinion to bond investors to the effect that the bonds have been properly issued in accordance with law; they are binding obligations of the city enforceable in accordance with their terms; and (for tax-exempt bonds) that interest on the bonds is excludable from federal and state income taxes.

Bond counsel, and the bond opinion, are not required by any law or regulation, but they are demanded by the market. The practice dates to the 19th century, when the marketing of dubious bonds led to a reluctance by investors to purchase municipal bonds without assurance from a competent attorney that the bonds were enforceable. It is important to understand, however, that bond counsel does not offer an opinion about the wisdom of the investment, or the likelihood of a bond default. Those are matters of risk assessment for the investor to determine, assisted by the rating assigned by a rating agency (whose job is to assess the credit), and by the disclosure provided in the offering materials (hence, the importance of the official statement discussed above).

See Section IX *Federal securities law*.

## RELEVANT LINKS:

Because bond counsel provides an unqualified opinion about the bonds, most counsel will prepare all the necessary bond resolutions, certificates, and the bonds themselves. In cases where voter approval is required, bond counsel also drafts the bond questions and assists with election proceedings. Bond counsel works closely with the city staff and financial advisor, and with the city attorney in some circumstances.

The selection of bond counsel is solely in the discretion of the city council. Most cities find that a long-standing relationship with a bond counsel firm, and often an individual in that firm, is beneficial because that attorney becomes intimately familiar with the city's financial needs and practices. Bond counsel also provides general advice on financing strategies beyond the work undertaken in a specific bond issue.

### **B. Financial advisor**

Financial advisors provide a wide array of services in almost every bond transaction, including:

- Structuring the bond issue (maturities, interest payment dates, computation and timing of required fund flows, proper sizing of the issue).
- Preparing the offering material for the bonds.
- Soliciting bids and proposals.
- Obtaining a bond rating.
- Conducting the sale and coordinating the logistics of preparing and delivering the bonds to the purchaser.

Beyond those tasks, financial advisors help in short- and long-term financial management of the city, as well as assist in the financial aspects of economic development and redevelopment programs. The financial advisor and bond counsel work in close cooperation in all aspects of a bond transaction. As in the case of bond counsel, and for the same reason, a long-term relationship with a financial advisor is desirable.

### **C. Underwriter**

Underwriters are the entities that initially purchase an entire series of bonds from a city, then reoffer the bonds for sale to individuals and institutional purchasers. In a so-called competitive sale, underwriters submit proposals to the city on the day of the sale, and the city awards the bonds to the underwriter, who offers a price that produces the lowest true interest cost to the city. The underwriter may resell the bonds to end-purchasers at a slight premium or discount.

## RELEVANT LINKS:

See Section VI-A *General information*.

In a true negotiated sale, the underwriter and city will enter into a bond purchase agreement specifying the general terms of the sale. This process is uniformly used for conduit bonds, and some municipal revenue bonds.

### **D. Bond registrar and paying agent**

Most cities engage a bank to handle the logistics of administering bonds after they are issued. The registrar and paying agent makes the actual payments to bondholders and manages all communications between holders and the issuer.

Some financial advisors have established subdivisions that serve as registrar and paying agents in bond transactions. A few larger cities with sophisticated finance staff will serve this function directly without engaging an outside entity. If the city retains a third-party registrar and paying agent, that decision can be changed at any time (but rarely is).

### **E. Bond trustee**

A bond trustee is not present in most general obligation bond transactions, where that function is provided by the registrar and paying agent. However, in almost all conduit bonds and complex municipal revenue bond transactions (such as an electric utility revenue bond), the bonds are administered by a third party known as the trustee—usually the trust division of a major bank.

When a trustee is used, the bonds are issued not by a bond resolution, but under a “trust indenture.” The indenture is a complex agreement between the issuer and the trustee under which the trustee handles all bond funds and accounts, makes investments, pays bondholders, and otherwise administers the bonds for the life of the issue. The trust indenture is part of the bond documents approved by the city council at the time of bond issuance.

In Minnesota, many of the same banks that serve as trustees under trust indentures also serve as registrar and paying agent in general obligation transactions.

### **F. Rating agency**

Rating agencies are third parties that analyze municipal bonds (and many other types of securities) for their credit-worthiness, as a service to issuers and investors. There are three national agencies operating in Minnesota: Moody’s Investors Service, Inc., Standard and Poor’s Ratings Services, and Fitch Ratings, Inc. An issuer may choose to obtain a rating from more than one agency, or even all three.

## RELEVANT LINKS:

The agency assigns a bond rating prior to the sale, and it reflects the agency's judgment of the issuer's overall credit based on a number of objective and subjective criteria, such as debt per capita; overlapping debt of other political subdivisions; tax collection experience; tax base, including trends; employment levels, overall financial management of the city; and the nature and quality of the primary source of repayment for the bonds.

The city must pay a fee to obtain a rating, and that cost is normally recovered in more favorable interest rates on the bonds. In addition, institutional investors might not buy unrated bonds, reducing the market and leading to higher interest rates. Smaller cities often issue bonds without ratings because the cost of the rating exceeds the interest rate benefit. The city's financial advisor helps determine whether a rating makes economical sense and which agency is most appropriate.

### **G. Bond insurer**

Bond insurers provide insurance against default. The insurer agrees to pay debt service if the issuer fails to do so. If insured, the bonds will carry the rating of the insurer, usually the highest rating, which results in lower interest rates on the bonds. Bond insurance makes economic sense only when the (relatively high) cost of the insurance premium will be offset by interest savings provided by the insurer's high rating. The city's financial advisor prepares this analysis and makes a recommendation. Occasionally, the purchasing underwriter will buy bond insurance if the cost can be recouped by selling the higher-rated bonds at a premium.

Before the financial crisis of 2008, bond insurance was relatively common in Minnesota. That crisis severely impacted the bond insurance industry (for reasons not caused by defaults in general obligation bonds), and fewer companies offer that service now than in the past. However, bond insurance remains an option and is occasionally purchased when the economics of the transaction so warrant it.

### **H. Depository Trust Company (DTC)**

One of the more arcane players in a bond transaction is the Depository Trust Company, or DTC. This entity handles evidence of ownership whenever an investor purchases a bond (the process is known as "book entry"). Except in rare circumstances, bonds are no longer printed in the form of an engraved certificate—they are entered in the computers at DTC, which serves this function for virtually all publicly sold bonds in the United States. Most bond documents contain provisions about the agreement between the issuer and DTC, which entails payment of a modest fee.

## RELEVANT LINKS:

[Minn. Stat. § 475.58, subd.1 \(5\).](#)

[A.G. Op. 36-a \(Dec. 6, 1978\).](#)

DTC is not used in bonds that are privately placed with a few individual owners. In those cases, the purchasers typically receive an original type-written bond.

## **XI. How this chapter affects home rule charter cities**

Most modern city charters simply provide that the city may incur debt “in the manner provided by law” or equivalent language. In those cities, everything in this chapter applies. Some charters incorporate a broad exemption from the voter approval requirement, as expressly permitted under law.

A more difficult question is the extent to which a charter may impose restrictions more severe than would apply under Chapter 475. Section 475.753 provides: “All municipalities are subject to the provisions of this chapter in the issuance of obligations and may incur indebtedness to the extent of but not in excess of the debt limit in said chapter notwithstanding any home rule charter provision or charter law adopted prior to April 1, 1951. Nothing herein shall prevent the adoption after that date of additional debt limitations or restrictions.”

Under that language, it is clear that a charter amendment adopted after April 1, 1951, may impose “additional debt limitations or restrictions.” Thus, a charter could impose a limit lower than the 3 percent limit on net debt under Section 475.53. But it is less clear that a post-1951 charter provision can supersede other aspects of Chapter 475. For example, the attorney general has advised that a charter may not *require* an election for tax increment bonds where none is required under Chapter 475.

Cases of conflict in bond provisions between a city charter and Chapter 475 (or other state statutes) should be reviewed by the city’s bond counsel.