COVID-19: What Texas Local Governments and Borrowers Need to Know About Dealing with Anticipated Tax and Revenue Shortfalls

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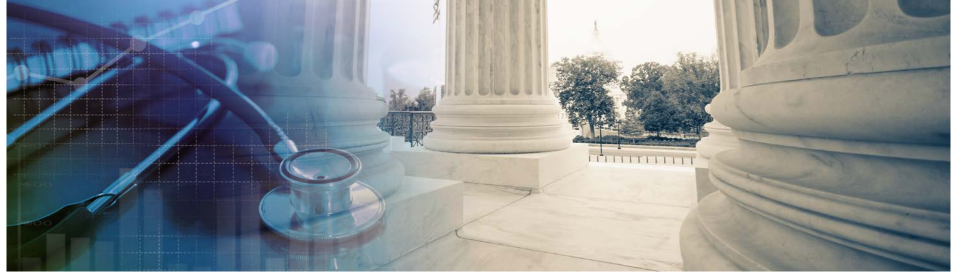


As a result of COVID-19 and also significantly impacted by the recent dramatic declines in oil prices, local governments in Texas are facing sudden, unexpected, unprecedented, shortfalls or delays in a number of their core revenue streams. To assist in addressing these issues, the following is a quick review of some potentially relevant financing tools available in Texas. These tools address budget relief, cash optimization, structural deficit financing and cash-flow financing. Some are based on techniques used in the 2008 financial crisis, which also disrupted the municipal bond market. Others are new. Some are also relevant to private nonprofit and other borrowers from state and local government issuers. The list is not exhaustive and is not a recommendation of specific action. It is intended to offer options, stimulate thinking and invite interested parties to contact any member of Orrick's public finance or tax group to discuss further. The following are in no particular order.

Tax Anticipation Notes (TANs) and Tax and Revenue Anticipation Notes (TRANs)

TANs and TRANs are the most traditional methods of cash-flow deficit financing. Typically, TANs and TRANs are short-term notes that are issued to finance cash-flow deficits and that are repaid with future tax collections and revenues. State and local governments generally use these types of notes to finance short-term cash-flow deficits that arise as a result of the mismatch of revenues and expenditures each year. However, there are two other types of cash-flow borrowing, for long-term cash-flow deficits and for extraordinary working capital expenditures, that will be discussed later in this article.

In Texas, TANs and TRANs are authorized for cities, counties, school districts, junior college districts and various special purpose districts under a variety of Texas statutes.[1] In addition, revenue anticipation notes, which are a version of a TRAN, may be issued for the benefit of 501(c)(3) organizations.[2] TANs and TRANs may be issued for any purpose for which the local government is authorized to expend money. Generally, for federal tax law purposes, the maximum size of these financings is limited by the size of the projected cash-flow deficit for the fiscal year of the borrowing plus a reasonable working capital reserve that is not in excess of 5% of expenditures paid out of current revenues during the preceding fiscal year. Alternatively, subject to any state law restrictions, TANs and TRANs may be issued on a taxable basis without such limitation. In addition, while the TAN or TRAN may mature and be payable in the next fiscal year, it must be paid with revenues attributable to the fiscal year in which it was incurred.

If short-term taxable investment rates are higher than tax-exempt TAN and TRAN rates, the federal tax rules permit positive arbitrage to be earned, retained and applied to any lawful purpose. Somewhat similar to interfund borrowings, which generally requires true up before the end of the fiscal year, TANs and TRANs address unevenness in cash flow but not do not offer budget relief.

COVID-19 and declining oil prices will present a number of new challenges and structuring options for cash-flow borrowing, including (i) using multiple series of notes issued at different times in order to allow more dynamic and accurate sizing and to obtain better market access; (ii) sizing the notes based on different deficit dates than in prior years, using different, and later, maturity dates to allow for delayed revenues and more effective "rollover" of notes in the next fiscal year; and (iii) combining traditional cash-flow analysis with the tax-exempt financing for extraordinary working capital expenses (discussed in more detail below). In addition, we anticipate some formal guidance from the IRS relating to tax-exempt financing of working capital expenses relating to COVID-19.

[1] Although school districts are authorized to issue TRANs, they generally do not meet the requirements to do so because they generally do not have the necessary cash-flow deficits. In Texas, the state "front-loads" its funding for public education, issuing about half of its payments to local school districts in the first three months of each fiscal year.

[2] Generally, financings for the benefit of 501(c)(3) entities must be preceded by public hearing, commonly known as a TEFRA hearing. Currently, most public hearings cannot be held in person, and accordingly we are waiting for emergency guidance from the Internal Revenue Service regarding how these hearings may be conducted in the current circumstances. Contact your Orrick bond or tax lawyer for updates regarding this issue.

Municipal Liquidity Facility

On April 9, 2020 the Federal Reserve announced a Municipal Liquidity Facility (the "Facility") which will support lending to States, the District of Columbia, cities with a population of more than a million residents and counties with a population exceeding two million residents (collectively, "Eligible Issuers"). The lending will be accomplished by the purchase of tax anticipation notes, tax and revenue anticipation notes and bond anticipation notes issued by an Eligible Issuer and purchased by the Facility. Accordingly, the Facility may have some relevance in connection with the TANs and TRANs described in the preceding section.

Long-Term Financing of Longer-Term Cash-Flow Deficits or Extraordinary Working Capital Expenses

Although TANs and TRANs generally are designed to finance short-term deficits that are not expected to persist for more than a fiscal year, current deficits that are projected to recur, or carryover to future years may be financed on a longer-term basis, subject to an annual available cash re-testing requirement. On the first day of each fiscal year after the note is issued, the issuer must determine whether its "available amounts" of unrestricted funds are more than 5% of its operating expenditures during the prior fiscal year. This annual testing can be delayed up to five years depending on the future deficit projections. With a couple of technical exceptions, within the first 90 days of each fiscal year, the issuer must apply the available amounts in excess of the 5% amount (or if less, the available amount on the date of the required redemption or investment) to redeem the note or to invest in eligible tax-exempt bonds. For more information regarding these types of TRANs see our recent Client Alert: Federal Tax Law Considerations for Financings COVID-19 Costs on a Tax-Exempt Basis: What Issuers Need to Know.

In addition, long-term tax-exempt obligations may be used to finance "extraordinary, nonrecurring items that are not customarily payable from current revenues." Said another way, an issuer can use tax-exempt bonds or other obligations to finance extraordinary expenses without regard to whether there is an actual cash-flow deficit. The regulations use casualty losses and extraordinary legal judgments in excess of reasonable insurance coverage as examples of such expenditures. However, it seems reasonable to assume that working capital expenditures made to finance the fight against COVID-19 also will qualify. If such bonds are issued, there may be additional post-issuance requirements that will come into play, similar to the annual testing described above.

If an issuer maintains a reserve or has otherwise set aside funds for items of the same nature as the extraordinary expenditures (e.g., a self-insurance fund or a pandemic relief fund), those funds must be used before the bond proceeds may be allocated to the extraordinary expenditures.

Bank Loans and Lines of Credit

Unfortunately, most Texas local governmental entities do not have the express statutory authority to enter into traditional commercial type loan agreements or lines of credit. However, most of the statutorily authorized forms of borrowings may be modified without negative impact to issuers in the form of direct purchases or private placements with financial institutions to allow such obligations to be treated for regulatory and accounting purposes as evidence of loans. In addition to such technical modifications, the financial terms of a direct purchase or private placement of obligations may be structured to achieve many of the benefits of a loan agreement or line of credit. Examples include but are not limited to the ability to advance funds as needed, variable rates without public market liquidity costs, forward purchase and delivery options and availability to choose either taxable or tax-exempt rates within a single borrowing. In addition, various Texas governmental entities do have statutory credit agreement authority to assist in financing public works (not working capital) under Chapter 1371 of the Texas Government Code.

Unlike Texas governmental entities, nonprofit borrowers in Texas have no statutory restrictions on the form of borrowing and can enter into traditional loan agreements and lines of credit. Consideration should be given to any existing bond obligations (including master indenture requirements) to ensure such agreements are permitted debt and any liens on property to secure the debt are permitted liens.

Bond and Credit Agreement Modifications

It is difficult to renegotiate the financial terms of bonds that are widely held, because of the difficulties in getting bondholder consent (although there are programs and consultants that can assist in getting those consents if necessary). On the other hand, some bond issues are held by just a few investors and many were privately placed to a single investor or were direct loans from a bank. Those may be easier to renegotiate for cash flow or covenant relief, to obtain some concession in interest rates or other terms or perhaps in recognition of the serious financial position issuers or borrowers may be in that could leave investors with a choice between default or renegotiation. Banks and other financial institutions want to avoid defaulted loans on their books.

In addition, many issuers or borrowers may have existing credit or liquidity facilities with commercial banks that operate in connection with variable rate bonds or commercial paper programs. Those agreements may also be candidates for the negotiation and modification of certain covenants or terms to provide relief in connection with the tax and revenue disruption related to COVID-19. For more information see our recent Client Alert: Waivers, Deferrals and Changes to Tax-Exempt Bonds During COVID-19.

Tax-Exempt and Taxable Refundings

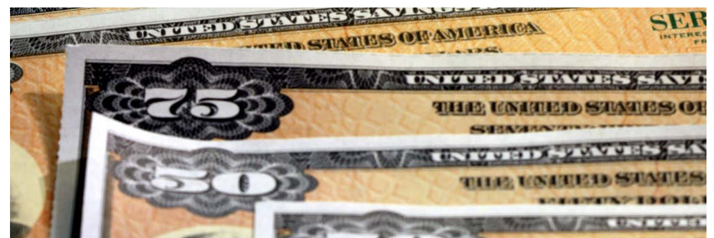
Refunding of outstanding bonds is a common method of budget and other cash-flow relief. By refunding, debt service can be restructured to reduce debt service in the current or next few fiscal years when budget relief is needed. If interest rates have dropped since the original debt was issued, it may be possible to accomplish this without increasing debt service in any year simply by taking those savings in the form of lower current debt service. Alternatively, savings can be taken up front by using a swaption or by issuing additional bonds. If interest rates have not dropped, relief may still be achieved by increasing debt service in later years and/or extending the maturity of the debt.

Unfortunately, tax-exempt advance refundings (refunding bonds issued more than 90 days before the maturity or redemption date of the bonds to be refunded) have been prohibited since the beginning of 2018 by the Tax Cuts and Jobs Act. That leaves tax-exempt current refundings (less than 90 days before redemption) or taxable advance refundings (which were projected to be as high as 25% of the total bond market in 2020 until the market "blew up" in mid-March). However, the market is stabilizing somewhat and will hopefully stabilize further as the Federal Reserve Bank programs are implemented and uncertainty diminishes. These taxable advance refunding bonds can be later refunded by tax-exempt bonds, and there are some structures (aka "Cinderella Bonds") in which the taxable advance refunding bonds can convert to tax exempt without having to issue new refunding bonds.

Another approach is just to currently refund the bonds coming due in the current fiscal year to push out the debt service otherwise due in that year to some future year, perhaps using medium-term notes or obligations that can be easily redeemed whenever sufficient moneys are available. For additional information regarding alternatives to advance refundings, see our recent webinar: Current Thinking on Tax-Exempt Advance Refunding Alternatives.

Extracting Cash from Existing Bond Programs (Without Refunding)

Many bond issues have cash funded reserve funds, usually equal to the maximum amount of debt service that will be due on those bonds in any year. Many bond documents permit substitution of a letter of credit or similar credit facility for that cash deposit, which can then be used for any purpose consistent with the bond authorization and requirements for tax exemption. If the bond documents do not permit such substitution, depending on the terms of those documents, it may be possible to amend them to permit such substitution. In some cases, there may be other cash reserves (working capital or repair and replacement funds for example) that might offer a similar opportunity.



Securitization of Other Municipal Assets

There may be assets owned by local governments that such local governments can monetize by securitizing the future cash flow. Possible examples include state and federal grants, delinquent property taxes, fines, parking tickets, special fees and rights under various third-party agreements and the like.

Lease - Leasebacks

By leasing existing, unencumbered property to another public entity (for example, a local government corporation) and leasing it back, a public entity may extract the value of that property and use it for any lawful purpose, including working capital (except for school districts). This would be the functional (but not legal) equivalent of mortgaging the property. While there may be public policy considerations to borrowing long term against public property to satisfy possible short-term financial needs, this tool has been used to good effect by some entities in times of financial stress, and then paid off when financial conditions improved.

Selling Nonessential Property

Issuers and borrowers can, of course, raise cash by selling nonessential property, either outright, or on a long-term lease, or either of those subject to an agreement with the buyer to use or operate the property in a particular manner directed by the seller issuer/borrower (this latter being a version of P3, discussed further below). It should be noted that there are specific statutory requirements for the sale of surplus public property under Texas law which likely limit the effectiveness to utilize such authority to materially address current COVID-19 related cash-flow concerns.

It may also be possible to sell a percentage interest in the property to a private party. If appropriate, both parties can contribute their interests to a partnership consisting of the two parties.

Public-Private Partnerships (P3)

There are a number of versions of P3 transactions. In one version the municipality enters into a concession or similar agreement with a private party to finance, develop, operate and maintain certain facilities in return for payments from the municipality (usually referred to as "availability payments"). This is a good way to attract private capital to an otherwise public project, but not likely to be of much use in addressing current urgent cash needs. A second version is largely the same as the first except that the property involved is revenue producing and compensation to the private party comes from those revenues. For those rights the private party is often willing to make a substantial up-front cash payment to the municipality. It may also be possible to structure the arrangement to provide the municipality with some ongoing share of the project revenues.

Financing the Capital Improvement Budget

To the extent the capital improvement budget is to be financed from the general fund, but specific moneys have not yet been set aside for that purpose, borrowing to finance those improvements instead could have the effect of releasing those general funds for other budget or cash-flow purposes. However, care must be taken when documenting these transactions to avoid tax issues associated with the creation of "replacement proceeds." For more information regarding financing COVID-19 specific capital expenditures on a tax-exempt basis, see our recent Client Alert: Federal Tax Law Considerations for Financings COVID-19 Costs on a Tax-Exempt Basis: What Issuers Need to Know.

A variation involves using a taxable line of credit to manage cash flow by allocating the proceeds of draws to capital expenditure no later than 60 days after the expenditure, and then later refinancing such draws with tax-exempt obligations. Proceeds of the draws need not be used directly to make capital expenditures, so long as there are capital expenditures to which such draws can be allocated in some fashion (fairly informal). For more information on using lines of credit for this purpose, see the Q&A section of our COVID-19 Resource Center.

Reimbursement Resolution

Although not a source of current cash or relief, issuers will be spending significant amounts addressing COVID-19 or otherwise, and by adopting a reimbursement resolution now, the issuer or borrower can refinance these capital expenditures at a later date on a tax-exempt basis and reimburse itself for those prior expenditures. A reimbursement resolution is a simple, usually one- or two-page document, stating a present intention to reimburse certain current expenditures with future bonds, but without in any way obligating them do so do or otherwise being exposed to any liability. In other words, a free option to issue or not.

Repayment of Loans and Other Contributions

Local governments that have loaned money or contributed property, facilities or other assets to their water, sewer or other utility enterprises, or to other special authorities or districts, may be able to structure lump-sum repayments which can be funded by those enterprises, agencies, etc. whose cash flows are less negatively affected, or not negatively affected at all, by COVID-19.

Sale of Call Rights

Most long-term bond issues have optional redemption provisions enabling the issuer or borrower to redeem (i.e., call) bonds. If those bonds cannot be refunded within 90 days of a call date (i.e., a current refunding), taking into account that tax-exempt advance refundings have been prohibited since 2018, it may be possible for issuers to achieve some of the cost savings that would have resulted from an advance refunding and generate current cash by selling their rights to redeem bonds. Often, there is significant value associated with the call option that investors will pay to eliminate.

Escrow Restructuring

As a result of COVID-19, the value of Treasuries has increased dramatically at the same time that the value of municipal bonds has declined. Most refunding escrows are funded with Treasury securities. It may be possible to sell the Treasuries and substitute pre-refunded municipal bonds resulting in surplus cash in the escrow that can be released and used for any purpose for which proceeds of the refunded bonds could be used, which may include some amount of working capital. Of course, this will depend on the market, the ability to assemble pre-refunded municipal bonds with a cash-flow profile that meets the requirements of the escrow to pay debt service on the refunded bonds, whether the refunded bond documents allow pre-refunded munis to be used as defeasance obligations, and what is permitted by the escrow agreement. An alternative that appears to have similar economics is for an issuer to sell the escrowed Treasuries and to use the proceeds to purchase some of its outstanding defeased (i.e., the refunded bonds). As the value of the Treasuries is higher than the value of the defeased bonds in the current market, the value difference results in a profit to the issuer.

VRDOs and Commercial Paper

Variable rate demand obligations (VRDOs) and commercial paper have interest rates that "reset" periodically. Some issuers have experienced high interest rate resets or have been threatened with remarketing failures due to a lack of demand. There are several strategies that may be employed to address these types of issues. For more information, see our recent Client Alert: Tax Issues for VRDO Liquidity Problems.

Bankruptcy

Sometimes referred to as a "nuclear option", bankruptcy could have the immediate and temporary benefit of automatically staying most claims and payment obligations, giving the issuer or borrower time to get past the shelter-in-place economic shutdown until there is a return to more normal or at least sufficient cash-flow conditions.

CARES Act

In addition to the foregoing, recourse may be available under the $2.2 Trillion Coronavirus Aid, Relief and Economic Stabilization (or CARES) Act, and any subsequent federal plans, which contains a number of programs aimed at providing relief to state and local governments and instrumentalities. Our public finance partners are available to assist in evaluating such potential opportunities. For more information, see our recent Client Alert: President Signs $2.2 Trillion CARES Act.

Disclosure

There are a number of issues that arise regarding disclosure around COVID-19. Although these issues are beyond the scope of this article, please see our recent Client Alert: COVID-19 and Municipal Securities Disclosure.

CONTACT

The foregoing is not an exhaustive list of options nor a full description of why or how to use any of the ideas listed. In most cases, it also does not address issues related to tax exemption of interest on bonds. Nor does it address public policy considerations. It is intended simply as an accessible framework to stimulate further thought and discussion. For more information or discussion, readers are welcome to contact Rick Witte or Todd Brewer or Barbara Jane League – Tax or Larry Sobel – Tax or Tanya Fischer or Nikki Hill or any other Texas Public Finance or Tax team member. To contact a member of our Texas Public Finance team, please click here.

Orrick, Herrington & Sutcliffe LLP orrick.com/publicfinance
609 Main Street | 40th Floor | Houston, TX 77002-3106 | United States | tel +1 713 658 6400
300 West 6th Street | Suite 1850 | Austin, TX 78701 | United States | tel +1 512 582 6950

AUSTIN BOSTON HOUSTON LOS ANGELES NEW YORK ORANGE COUNTY PORTLAND SACRAMENTO
SAN FRANCISCO SANTA MONICA SEATTLE SILICON VALLEY WASHINGTON DC

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