CASH FLOW AND BUDGET RELIEF

For Local Governments and Borrowers In California

orrick

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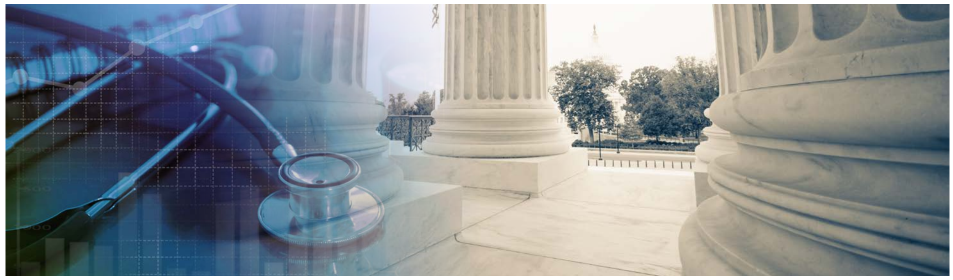


As a result of the COVID-19 virus, local governments in California are facing sudden, unexpected, unprecedented, dramatic shortfalls or delays in a number of their core revenue streams, in some cases combined with significantly increased expenses. To assist in addressing these issues, the following is a quick review of some potentially relevant financing tools available in California. Some address budget relief, some cash optimization, some structural deficit financing and some cash-flow financing. Some are based on tools used when the State of California was running huge deficits affecting local governments. Some are based on techniques used in the 2008 financial crisis, which also disrupted the municipal bond market. Some are new. Some are also relevant to private nonprofit and other borrowers from state and local government issuers. Because it is changing every day, the condition of the bond market is not generally addressed. 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 group to discuss further. The following are in no particular order.

Tax and Revenue Anticipation Notes (TRANs)

TRANs are the simplest and most traditional method of cash flow deficit financing.

In California, they are an exception to the State Constitutional requirement for voter approval before cities, counties, school districts or community college districts may incur debt. However, while the debt may mature and be payable in the next fiscal year, it must be paid with revenues attributable to the fiscal year in which incurred. The federal tax rules do permit arbitrage to be earned, kept and applied to any lawful purpose, if short term taxable investment rates are higher than tax-exempt TRAN rates. Similar in a sense to interfund borrowing, which generally requires true up before the end of the fiscal year, TRANs address unevenness in cash flow but not really budget relief.

Any city, county, school district, community college district, county board of education, or other municipal or public corporation or district may issue TRANs, for any purpose for which the local government is authorized to expend money. The TRANs are general obligations of the issuer. Generally, in order to be tax-exempt, the maximum size of these financings is limited by the size of the projected deficit for the fiscal year of the borrowing plus a reasonable working capital reserve that is not in excess of 5% of working capital expenditures during the preceding fiscal year. COVID-19 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 obtain better market access, (ii) sizing the notes based on different deficit dates than 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 (iv) combining traditional cash flow analysis with the tax exemption for extraordinary working capital expenses (that doesn't require a deficit). In addition, we anticipate some formal guidance from the IRS relating to tax-exempt financing of working capital expenses relating to COVID-19.

Several TRAN pool programs are available to join and others may be created.

TRANs, together with bond anticipation notes and other similar short-term notes (with a term not longer than 24 months), are the types of obligations the Federal Reserve will purchase from eligible issuers pursuant to its Municipal Liquidity Facility. The details of this program and other federal programs aimed at providing relief to state and local governments are beyond the scope of this survey, in part because those programs and details are still in development.

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

TRANs 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 in future years may be financed on a longer-term tax-exempt basis, subject to an annual re-testing requirement. On the first day of each fiscal year after the debt 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 deficit projections. With a couple of technical exceptions, within the first 90 days of that fiscal year, the Issuer must apply the available amounts in excess of the 5% amount (or less, the available amount on the date of the required redemption or investment) to redeem or to invest in eligible tax-exempt bonds.

In addition, long-term tax-exempt bonds 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 to finance extraordinary expenses without regard to 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 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.

Working Capital Financing for Nonprofit Borrowers

Although not all that common, tax-exempt working capital borrowing (either short-term or long-term) is also allowed for 501(c)(3) borrowers. The tax limitations discussed above apply equally to such nonprofit borrowers. In addition, such nonprofit borrowers often have endowments or other investment assets that must fit into a specific tax exception in order to be treated as "unavailable" and not offsetting the up-front or post-closing deficit calculations discussed above. This tax exception requires generally that (i) the endowment or other investment assets were derived from sources not reasonably expected to be used to pay working capital expenditures, (ii) the nonprofit has designated and consistently operated the fund as a permanent endowment fund or quasi-endowment fund restricted as to use, and (iii) the fund is reasonably necessary as part of the organization's permanent capital.

Sale of Delinquent Property Taxes

Counties in the Teeter Program that have not already pledged their delinquent taxes to a Teeter financing, cities and other entities in Teeter counties that do not participate in the Teeter program, and counties not in the Teeter Program, may be able to monetize all or part of their delinquent property taxes in a joint powers authority financing or simply sell them to an independent third party for cash.

Securitization of Other Municipal Assets

There may be assets, in addition to delinquent tax liens and tobacco settlement payments, that local governments can monetize by securitizing. Possible examples include state and federal grants, fines, parking tickets, special fees, possibly cannabis revenues and the like.

With respect to grants from the state or federal government, another alternative is grant anticipation notes, provided note proceeds are used for same purposes for which the grants could have been used.

Pension Obligation Bonds

Most public entities in California (except school districts) are required to make annual contributions to their city or county pension fund or to PERS. This annual contribution consists of two components: (i) amortization of its unfunded accrued actuarial liability (UAAL), which is the actuarially determined amount by which the pension fund is short of the amount needed (without further payments but with investment income at an assumed rate) to pay benefits already earned by current and former employees, and (ii) the current year contribution in respect of the present value of benefits being earned by current employees.

The UAAL for most pension funds will increase markedly (at least for a while) as a result of COVID-19 related investment losses and, in some cases, loss of employees. More than 80 entities in California have issued pension obligation bonds, for a variety of purposes, such as (i) interest rate savings from lower interest rate on the bonds (even though not exempt from federal income taxes) compared to the interest rate assigned to the UAAL (generally 7 - 7½%), (ii) investment earnings derived from the usually high investment performance by most pension systems (an informal study showed that over 90% of POB issues by California local governments had been profitable compared to borrowing costs as of the end of 2019 (no study has been made since)), and/or (iii) budget relief from (a) reamortizing the UAAL by using POBs with a longer term and/or lower payments (or even no payments) in the early years and/or (b) by funding the current year contribution and/or (c) in some cases by negotiating a discount with the pension system for early payment of the annual contribution.

Lease - Leasebacks

By leasing existing, unencumbered property to another public entity (for example, a joint powers authority) 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 long-term borrowing 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 Non-Essential Property

Issuers and borrowers can, of course, raise cash by selling non-essential property, either outright, or by a long-term lease, with either of those potentially 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 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 couple 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 the rights to which the private party is often willing to pay 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.

Refunding

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 upfront 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 current 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.

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 of the bond documents that provide for the issuance of those bonds permit substitution of a letter of credit or similar credit facility for that cash, 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, revenue stabilization or repair and replacement funds for example) that might offer similar opportunity.

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.

A variation involves using taxable line of credit to manage cash flow and allocate the proceeds of draws to capital expenditure no later than 60 days after the expenditure, and later refinance 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).

Repayment of Loans and Other Contributions

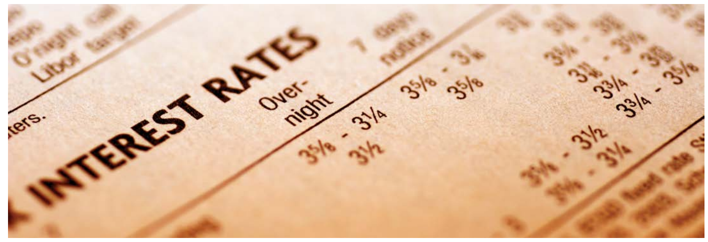
Local governments that have loaned money or contributed property, facilities or other assets to their water, sewer or other utility enterprises or to other special authorities or districts may be able to structure lump sum repayments which can be funded by those enterprises, agencies, etc., whose cash 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.

Renegotiate Terms

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 should be easier to renegotiate for cash flow relief, possibly for some concession in interest rates or other terms or perhaps just in recognition of the serious financial position issuers or borrowers



may be in leaving investors with a choice between default or renegotiation. Most banks and other financial institutions want to avoid defaulted loans on their books.

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 Treasuries. 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 refunding 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 municipal bonds to be used as defeasance obligations, and what is permitted by the escrow agreement.

Bankruptcy

Because of the cost, effort and market penalty normally associated with municipal bankruptcy, it is sometimes referred to as a "nuclear option" or the worst option until it's the only option. However, it offers the immediate benefit, that could be of particular value in COVID-19 driven circumstances, of automatically staying payment obligations, law suits and creditor remedies, providing 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; after which a long term plan of adjustment can be submitted to the bankruptcy court (if the entity that filed for bankruptcy is still insolvent and in need of structural adjustments) or the case can simply be dismissed. It is unclear, whether and how the bond market or creditors might penalize entities that use bankruptcy in this limited manner under these unique circumstances.

Reimbursement Resolution

Although not a source of current cash or relief, issuers will be spending a lot of money addressing COVID-19 or otherwise, and by adopting a reimbursement resolution now, the issuer or borrower can refinance these 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.

CARES Act; Municipal Liquidity Facility

Of course, in addition to and perhaps before any of the foregoing, recourse should be had to the $2.2 Trillion Coronavirus Aid, Relief and Economic Stabilization (or CARES) Act and the Federal Reserve's Municipal Liquidity Facility (MLF) for purchase of state and local government bonds. Several of Orrick's public finance partners have self-selected to become expert in providing advice about these programs: Marcus Deitz (general local government assistance), Robyn Helmlinger (healthcare), Marc Bauer and Eileen Heitzler (education), Kevin Roche, Mary Collins, Devin Brennan and Adrian Patterson (transit), Greg Blonde (airports), Jerry V. Kyle, Jr., Adrian Patterson, Bryan Victor, Greg Harrington, Kevin Roche, Christine Reynolds and others (MLF).

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 municipal obligations. 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 Roger Davis (415-773-5758; *rogerdavis@orrick.com*), or any other public finance attorney at Orrick or by emailing *publicfinance@orrick.com*.

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