Coates' Canons Blog: Security for a Local Government Loan

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May a unit pledge town hall as security for an installment finance loan, where the borrowed monies will be used to fund road and sidewalk construction and improvements? If a municipality issues revenue bonds to fund an expansion to its water system, may it repay the loan with general fund monies? May a county pledge local sales and use taxes as security for special obligation bonds used to fund a landfill? May a unit use property tax dollars generated by new development to repay a loan even if it pledges land purchased with the borrowed funds as security for the loan?

This post answers these and other common questions about pledging security for a local government loan.

When a local unit borrows money it has a contract with its lenders. The contract typically is referred to as a debt instrument or a debt security. Under that contract, the local unit agrees to pay the principal and the interest on the loan as they come due and to honor any other promises that it has made as part of the loan transaction.

When a unit borrows money, the most fundamental promise it makes is to pay the money back. Closely associated with and reinforcing this promise is the pledge or the designation of one or more forms of security. The security for a debt is defined by reference to the contractual rights of the lender—what the lender can require the borrowing government to do, or to give up, should it fail to repay the loan. If the government does not repay its loan, the lender may look to the security to compel repayment or otherwise protect itself. The security for a borrowing affects what form the loan transaction takes, whether voter approval is required, how the bond will be marketed and at what cost, among other things.

There are five authorized methods through which North Carolina local governments may borrow money. The major distinguishing feature among the different methods is the nature of the primary security pledged for the borrowing.

General Obligation Bonds

The strongest form of security that a county or municipality can pledge for debt is its full faith and credit, making the debt a general obligation of the borrowing unit. All of the resources of that government stand behind such a pledge, but specifically, a full-faith-and-credit pledge is a promise to levy whatever amount of property tax is necessary to repay the debt. In fact, generally a governing board may not levy a property tax in a rate that exceeds $1.50 per $100 valuation without voter approval. A board, however, could be forced to raise its property tax rate beyond this level (without voter approval) to meet its general obligation debt service obligations. *See* **G.S. 160A-209** (municipalities) & **G.S. 153A-149** (counties).

The primary authority to incur a general obligation debt is the Local Government Bond Act, **G.S. 159, Art. 4**, which authorizes the issuance of general obligation (GO) bonds. State law specifies the types of capital projects that a county or municipality may fund with GO bonds. *See* **G.S. 159-48**. Although the legal authority to issue GO bonds is very broad, practically it is much more limited. That is because the North Carolina Constitution generally requires that a unit hold a successful voter referendum before pledging its full faith and credit. *See* **NC Const. Art. 5, Sect. 4(2); G.S. 159-49**. (There are some exceptions to the voter approval requirement–the most significant of which are for refunding bonds and **two-thirds bonds**.)

Revenue Bonds

The primary security for a revenue bond is the revenue generated by the financed asset or the system in which the financed asset becomes a part. By law such a pledge creates a lien on the pledged revenues in favor of the bondholders, and normally the bondholders have the contractual right to demand an increase in the user charges generating the revenues if those revenues prove inadequate to service the debt. If the revenue pledge is the only security,

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however, the bondholders do not have any right to demand payment from any other source, or to require an increase in taxes, if the pledged revenues are inadequate even after charges are increased. Unlike with general obligation bonds, state law prohibits a unit from using any revenues, other than those pledged, to make revenue bond debt service payments. **G.S. 159-94.** That means that a unit may only make its principal and interest payments from the revenues that are pledged as security for the loan.

A variety of statutes permit counties and municipalities to borrow money and secure the loan by a pledge of the asset-or system-generated revenues. The principal statute is the State and Local Government Revenue Bond Act, **G.S. 159, Art. 5**, which authorizes the issuance of revenue bonds. Revenue bonds are most commonly issued to fund water and sewer utility projects, although they are legally authorized to fund a variety of other revenue-generating capital assets, including gas facilities, solid waste facilities, parking, marine facilities, auditoriums, convention centers, economic development, electric facilities, public transportation, airports, hospitals, stadiums, recreation facilities, and storm water drainage. **G.S. 159-81.** A unit also may pledge special assessments levied under the newer special assessment authority as security for a revenue bonds used to finance the specially-assessed project(s).

Because the security for the debt is the revenues from the debt-financed asset, or the system of which the asset is a part, the lenders are naturally concerned about the construction, operation, and continued health of the financed asset or system. This concern is expressed through a series of covenants, or promises, that the borrowing government makes to the lenders as part of the loan transaction. The most fundamental of these is the rate covenant, under which the unit promises to set and maintain the rates, fees, and charges of the revenue-producing facility or system so that net revenues will exceed annual debt service requirements by some fixed amount or by some percentage. Other common covenants require the unit to commission an independent feasibility study, maintain a debt service reserve fund, and enlist a trustee to escrow the borrowed funds and authorize their disbursement.

Special Obligation Bonds

A special obligation is secured by a pledge of any revenue source or asset available to the borrowing government, except the unit's taxing power. In a broad sense a revenue bond is a type of special obligation bond. The term special obligation, as used in North Carolina, however, refers to debts secured by something other than (or in addition to) the revenues from the asset or system being financed. For example, a county might pledge proceeds from fees charged for building rentals or from special assessments. The county, however, could not pledge local sales tax, animal tax, privilege license tax, or property tax proceeds because these are locally-levied taxes.

The authority to issue special obligation (SO) bonds is very limited. **G.S. 159I-30** permits a county or municipality to issue special obligation bonds for solid waste projects, water projects, wastewater projects. It also allows a municipality to issue SO bonds for any project for which a municipality is authorized to create a municipal service district (MSD). (**G.S. 160A-536** lists the authorized MSD projects.)

Because the debt market perceives the security for special obligation debt as weaker than the security for general obligation debt, the market normally demands of special obligation debt some of the same covenants and other safeguards demanded of revenue bonds.

Project Development Financings

The newest form of borrowing available to counties and municipalities in North Carolina is project development financing. Project development financing is structurally equivalent to a type of borrowing prevalent in other states, known as tax increment financing or TIF. In fact, this form of borrowing is often referred to as TIF or TIF bonds by practitioners in this state.

The security for a project development financing is very complicated. A unit designates an area that is blighted or otherwise underdeveloped as a project development financing district. The unit borrows money to fund public improvement projects that are in the district or that benefit the district. **The unit pledges the expected increase in property tax revenues due to an expected increase in property values in the district due to private investment that is incentivized by the public improvement projects funded with the borrowed monies.** Thus, the security for the loan is the projected increase in property tax proceeds due to new private development in the district.

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The Project Development Financing Act, codified as **Article 6 of Chapter 159** of the General Statutes, permits counties and municipalities to issue project development financing bonds and to use the proceeds for many, but not all, the purposes for which either taxing unit may issue GO bonds. **G.S. 159-103**. It also authorizes local governments to use the proceeds for any service or facility that is authorized to be provided in an MSD, although no district actually need be created.

Installment Financings

The final borrowing method is an installment financing. This is the borrowing structure most commonly used by local governments in North Carolina. It differs from the other mechanisms in that it often does not involve the issuance of bonds.

An installment finance agreement is a loan transaction in which a local government borrows money to finance or refinance the purchase of a capital asset (real or personal property) or the construction or repair of fixtures or improvements on real property owned by the local unit. **The unit takes legal title to the asset and grants a security interest in the asset, or a portion of the asset, to the lender.** (Note that a unit may not grant a security interest in an asset that is not being funded with the borrowed monies.)

The authority for this type of borrowing transaction, as well as the procedural requirements and limitations, is found in a single statute—**G.S. 160-20**. That is why installment financings often are referred to as 160-20s.

Installment finance contracts generally take one of three basic forms. The simplest form is commonly referred to as "vendor financing." The parties enter into a contract under which the vendor conveys the equipment or property to the local government and the local government promises to pay for the equipment or property through a series of installment payments. The contract gives the vendor a lien in the equipment or a deed of trust on the property to secure the government's payment obligations under the contract. If the government defaults under the contract, the vendor may repossess the equipment or foreclose on the property.

A more common form of an installment finance contract transaction involves two different contracts—one between the unit of government and the vendor or contractor and one between the unit of local government and the lending institution. The government enters into a purchase contract with a vendor or contractor, who is paid in full upon delivery of the asset or completion of the construction project. The government enters into a separate installment finance contract with a financial institution; under this contract the institution provides the moneys necessary to pay the vendor or the contractor and the local government agrees to repay those moneys in installments with interest. The financial institution takes a security interest in the asset being purchased or constructed (or the land on which it is constructed), to secure the government's payment obligations under the installment finance contract.

The third type of installment financing is much more complicated. If a unit borrows more than $10 million in a calendar year the loan typically is sold publicly. That is, rather than the government borrowing the money from a single bank or vendor, the loan is sold to individual investors through the issuance of certificates of participation (COPs), or more recently, limited obligation bonds (LOBs).

Secondary Security

In addition to pledging the primary security state law allows a unit to pledge additional security for some borrowing transactions. Pledging additional security may be necessary to satisfy the lender(s) and make the borrowing feasible, or more affordable, for the unit. The following chart lists the primary security and additional authorized securities that may be pledged by a unit for each of the authorized debt structures.

	General Obligation Bonds	**Revenue Bonds**	**Special Obligation Bonds**	**Project Development Financing Bonds**	**Installment Financings**

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Primary Security	Full faith and credit (taxing power)	Revenues generated by revenue generating asset or system Special assessments	Any unrestricted revenues other than unit-levied taxes	Incremental increase in property tax revenue within defined area due to new private development	Asset or part of asset being financed
Authorized Secondary Securities	Revenues generated by revenue generating asset or system	Asset or part of asset being financed	Asset or part of asset being financed	Asset or part of asset being financed Any unrestricted revenues other than unit-levied taxes Special assessments	

Quiz Question Answers

Turning back to our original "quiz" questions:

May a unit pledge town hall as security for an installment finance loan, where the borrowed monies will be used to fund road and sidewalk construction and improvements?

> No. Under **G.S. 160A-20**, a unit must pledge the asset or a portion of the asset that is being financed by the borrowed funds.

If a municipality issues revenue bonds to fund an expansion to its water system, may it repay the loan with general fund monies?

> No. **G.S. 159-94** specifies that only the pledged revenues may be used to meet a unit's debt service obligations on revenue bonds. Note, however, that a unit may appropriate general fund monies to cover enterprise operating expenses, thereby freeing up the pledged enterprise revenue to be used to make the debt payments.

May a county pledge local sales and use taxes as security for a special obligation bond used to fund beach a landfill?

> No. When issuing special obligation bonds, a unit only may pledge unrestricted non-levied tax revenues. Counties levy local sales and use taxes, therefore, counties may not pledge this revenue source as security for a special obligation bond. (Municipalities can, though.)

May a unit use property tax dollars generated by new development to repay a loan even if it pledges land purchased with the borrowed funds as security for the loan?

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Maybe. If a unit borrows money through an installment financing, a unit is free to use any unrestricted revenues to make its loan payments. Sometimes a unit will borrow money through an installment financing but treat the loan internally as if it was a project development financing. This type of loan is commonly referred to as a **synthetic project development financing** (or synthetic TIF). A synthetic project development financing occurs when a local government determines that the projected increment revenue from proposed new private development in the unit justifies issuing debt to fund a public infrastructure project that will benefit and/or incentivize the new private development. The unit does not issue project development bonds, however. It uses another form of financing, usually an installment financing—whereby the unit pledges the financed asset as security for the loan—to fund the public improvement. If the private development occurs according to projections, the unit is able to use the new revenue generated to repay the loan.

Links

- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-209.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_153A/GS_153A-149.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_159/Article_4.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-48.html
- www.ncga.state.nc.us/legislation/constitution/ncconstitution.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-49.html
- canons.sog.unc.edu/?p=3542
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-94.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_159/Article_5.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-81.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159I/GS_159I-30.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-536.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_159/Article_6.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-103.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-20.html

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