Bond Case Briefs

Municipal Finance Law Since 1971

Katten: Municipal Advisors and "Bank Purchase" Bonds: What's All the Commotion About?

There has been a renewed focus in recent months on how to determine which regulatory regimes apply to the various parties involved in private placements of municipal debt. The very public controversy over the question of whether a municipal advisor that is not a registered broker-dealer may facilitate the purchase of a municipal loan by a bank directly from the municipality is an example of this renewed attention. This advisory summarizes the applicable legal tests and briefly describes their implications for stakeholders in a typical transaction.

As shown in the chart below, the determination of whether the debt instrument in a private placement should be treated as a loan or a security has significant legal and regulatory implications for borrowers, lenders and advisors:

PARTY	**REGULATORY IMPLICATIONS**
Issuer or Borrower	• Treatment as a security as opposed to a loan would invoke applicable federal securities laws, including anti-fraud provisions (SEC Rule 10b-5). • State and local law may treat a security differently from a loan for purposes of authorization, pledge of security, tax levy and many other pivotal considerations.
Lender	• Treatment as a security as opposed to a loan may have the effect of converting a loan participation or assignment into a transfer of securities, exposing the lender to federal securities laws (including anti-fraud provisions) and broker-dealer regulations.
Municipal Advisor	• Treatment as a security as opposed to a loan may subject municipal advisors to broker-dealer regulations, federal securities laws and several additional MSRB rules. • If a municipal advisor were to be reclassified as a placement agent its participation in the transaction may be restricted under MSRB Rule G-23.

While the determination of whether a municipal debt in a private placement constitutes a loan or a security is based on many factors, as a whole, the factors that have been identified comprise a vague “facts and circumstances” test rather than a bright-line safe harbor. The Securities and Exchange Commission (SEC) has issued no-action letters[1] advising intermediaries to register as broker-dealers if they are engaged in making introductions to, or negotiating with, potential investors on behalf of an issuer of securities and receive transaction-based compensation from the issuer (e.g., fees conditioned on the closing of the transaction and/or representing a percentage of the transaction amount). Regarding whether a note does or does not constitute a security, the US Supreme Court[2] has held that a note would generally be presumed to be a security unless it (1) fell within a limited category of non-security notes[3] or (2) shared a strong “family resemblance” to such non-security notes based on an analysis of the following factors:

Family Resemblance Factors
1. Would reasonable parties be motivated to enter the transaction for commercial or investment purposes?
2. Does the plan of distribution involve common trading for speculation or investment?
3. What are the reasonable expectations of the investing public?
4. Are there any other risk-reducing factors, such as an alternate regulatory regime?

The first factor (commercial vs. investment purpose), oft-criticized for vagueness[4] and subject to varied interpretations by subsequent courts[5], is likely to be the most concerning for typical private placement structures—particularly those that relate to instruments secured by enterprise revenues. Regarding the second and third factors (plan of distribution; investor expectations), many common traits of private placements, including one-on-one negotiations[6], a lack of an offering prospectus[7] or CUSIP number and transfer restrictions, should weigh significantly toward the determination that the instrument in question is not designed for, and would not be viewed by the public as intended for, common trading. Additionally, insofar as it relates to the fourth factor (alternative regulatory protections), many private placements involve lenders that are qualified institutional buyers, entitled to only limited protections even if the transaction were subject to federal securities laws.

While the stakes in how the securities laws are applied to these transactions remain high, the standards for applying the laws are still unfortunately far from clear. We hope to keep you advised of developments as they occur.

Expanded Options for Qualified Management Contracts: IRS Notice 2014-67

Late last year, the IRS "amplified" the rules for qualified management contracts currently contained in Rev Proc 97-13 by, among other things, providing a new five-year term category for ordinary management contracts. This category now permits many types of compensation other than net revenue (replacing the specified compensation types that were permitted before) and eliminates the need for two- or three-year terms and early termination rights by the qualified user. Consumer Price Index and similar adjustments are permitted as are certain incentive and productivity rewards and renewals that can be vetoed by the qualified user. The chart below summarizes these changes.

Type of Compensation	**Maximum Term**
95% periodic fixed fee	Lesser of (1) 80% of project useful life and (2) 15 years (20 years in the case of certain public utility property)
80% periodic fixed fee	Lesser of (1) 80% of project useful life and (2) 10 years (20 years in the case of certain public utility property)
Any combination of a stated amount; periodic fixed fee; capitation fee; per-unit fee; or percentage of gross revenues, adjusted gross revenues or expenses of the facility (but not both revenues and expenses)	5 years

Please note that the IRS left the other principles of its management contract guidelines untouched. For example, the following tests must still be satisfied even if the terms of the contract satisfy the revised compensation and term provisions described above:

- compensation and expense reimbursement to service provider must be "reasonable";

- service provider (including directors, officers, shareholders and employees) may not control more than 20 percent of the voting power on the board of the facility owner;
- any overlapping board members may not include the chief executive officers of the service provider or the facility owner; and
- facility owner and service provider may not be related persons.
- And the following arrangements continue to be generally exempt from these guidelines entirely:
- services that are incidental to the primary function of the facility (such as janitorial, equipment repair and billing services);
- hospital admitting privileges on an equal basis to all qualified doctors;
- public utility property, where compensation is limited to reimbursement for the service provider's expenses (including overhead); and
- non-public utility property, where compensation is limited to reimbursement for the service provider's expenses (excluding overhead).

[1] See C&W Portfolio Management, Inc. (July 20, 1989); Davenport Management, Inc. (Apr. 13, 1993); John Wirthlin (Jan. 19, 1999); and Revocation of Prior No-Action Relief Granted to Dominion Resources, Inc. (March 7, 2000).

[2] Reves v. Ernst & Young, 494 U.S. 56 (1990).

[3] Notes evidencing consumer loans, mortgage loans, certain short-term secured small business loans, short-term accounts receivable loans, "character" loans to bank customers and notes formalizing open-account debt incurred in the ordinary course of business.

[4] See Cori R. Haper, Sometimes Promising Is Not So Promising: The Breakdown of the Family Resemblance Test, 29 Dayton L. Rev. 71, 71 (2003) describing it as "unpredictable," "confusing," "jumbled," and "haphazard."

[5] See, for instance, the US Court of Appeals for the Sixth Circuit decision in Bass v. Janney Montgomery Scott, Inc.,210 F.3d 577, 585 (6th Cir. 2000) which determined that a financing "to launch a new enterprise" was "a washout, since the motivation prompting the transaction on [borrower]'s end is one typical in commercial loan transactions … but from [lender]'s perspective looks more like a transaction for profit." A description that would likely fit almost every lending transaction.

[6] See e.g. Marine Bank v. Weaver, 455 U.S. 551, 560 (1982) and Bass at585.

[7] See e.g. Marine at560.

Published in National Law Review

April 23, 2015

About the Authors:

Michael J. Diver
Partner
Michael J. Diver is the head of Katten's Chicago Securities Litigation and Enforcement practice. He represents public companies, financial services firms and other regulated entities, as well as their individual officers and directors, in matters before the Securities and Exchange Commission (SEC) and other regulatory bodies. A former Branch Chief in the Division of Enforcement of the SEC's

Chicago Regional Office, Diver's experience covers virtually all areas of capital markets regulatory enforcement, including matters related to securitization and other…

michael.diver@kattenlaw.com
312-902-5671
www.kattenlaw.com

Chad Doobay
Associate
Chad R. Doobay concentrates his practice in public finance. Chad has broad experience representing issuers, underwriters, borrowers and banks in financings related to nonprofit hospitals, museums, charter schools, retirement communities and transportation agencies. He advises clients throughout the United States on issues related to disclosure obligations, corporate approvals and contract compliance.

chad.doobay@kattenlaw.com
312.902.5435
www.kattenlaw.com

Renée M. Friedman
Partner
Renée M. Friedman devotes her practice to all aspects of public finance. She primarily handles financings for health care systems, cities, school districts, municipal utilities and nonprofit institutions involving both tax-exempt and taxable issues. She serves as bond counsel, underwriter's counsel, bank counsel and borrower's counsel in these financings.

As a result of her work in debt finance, Renée has experience with a variety of derivative products as well as regulatory compliance. She often participates as a…

renee.friedman@kattenlaw.com
312-902-5422
www.kattenlaw.com

Aharon S. Kaye
Associate
Aharon S. Kaye concentrates his practice in complex commercial litigation. His experience encompasses consumer class action defense, antitrust actions, consumer fraud actions, white collar defense, tax controversy and tax litigation. He has represented numerous clients in enforcement proceedings and investigations before the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC) and other regulatory bodies. He also has experience litigating a full spectrum of securities class action and derivative lawsuits.

aharon.kaye@kattenlaw.com
312.902.5477
www.kattenlaw.com

Michael G. Melzer
Associate
Michael G. Melzer concentrates his practice in public finance matters serving in project finance and regulatory capacities as bank counsel, bond counsel, borrowers' counsel, disclosure counsel, regulatory counsel, special finance counsel, special tax counsel, tender counsel and underwriters' counsel.

Michael’s practice relates primarily to public, private and restricted bond and other debt offerings, public-private partnerships, commercial paper offerings, project finance, Special Inspector General for Troubled Asset Relief…

michael.melzer@kattenlaw.com
312.902.5564
www.kattenlaw.com

James D. Van De Graaff
Partner
James D. Van De Graaff primarily represents broker-dealers, investment banks and market-making firms in the regulatory aspects of their business. He has more than 20 years of experience representing financial services clients in compliance reviews and training, mergers and acquisitions and responding to inquiries or investigations involving the US Securities and Exchange Commission (SEC) and securities self-regulatory organizations.

james.vandegraaff@kattenlaw.com
312-902-5227
www.kattenlaw.com