

*AMC GRATEFULLY ACKNOWLEDGES THE WORK OF DAVID J. KENNEDY, KENNEDY & GRAVEN, CHARTERED, MINNEAPOLIS, MINNESOTA\*, IN THE ORIGINAL WRITING OF THIS CHAPTER.*

**PART VI**  
**FINANCE, BUDGETING, AND DEBT**

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# 1. Debt and borrowing

From time to time counties must acquire capital equipment, construct public facilities or install infrastructure improvements. Unlike private corporations, counties may not finance these needs by conventional bank loans or stock offerings, but rather must use procedures specified by state law. The most common method of raising capital is the issuance and sale of municipal bonds.

While the sale of bonds occurs with regularity in many counties, the process is somewhat mysterious to many elected officials, primarily because of the jargon connected with the bond industry and the host of technical specialists involved in even the simplest transaction. The basic elements of the transaction are not beyond the understanding of anyone who has a mortgage on a house, invests in a municipal bond fund, or borrows money for a business. It is important that decision-makers serving on county boards have a relatively clear idea of what process ensues when they approve resolutions authorizing or awarding the sale of municipal bonds.

The primary purpose of issuing municipal bonds is to raise money for capital purposes (a building, sewer system, or any asset with a measurable economic useful life). Bonds are occasionally issued for other related purposes (tax anticipation, emergency expenses, working capital), and some indirectly related purposes (industrial and economic development, health care facilities, tax increment programs). These latter types of bonds will be discussed only briefly due to their specialized nature.

This chapter discusses both the legal and non-legal aspects of debt and borrowing. It supplements the description of statutory requirements with practical suggestions about the administration of capital financing programs and descriptions of how the process actually works. More specific information should be sought from the county attorney or bond counsel.

This chapter covers the following topics:

## **I. Bonds by type of security**

## **II.**

## **III. Bonds by user**

## **IV. Laws governing bonds**

## **V. Debt service funds**

## **VI. Other bond laws**

## **VII.**

## **VIII. Some other federal requirements**

## **IX.**

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

## XI. Example of a bond sale

Minn. Stat. ch. 475.

Minn. Stat. § 475.51, subd. 3.

The controlling state law, [Minn. Stat. ch. 475](#), rarely uses the term “bond,” employing the more accurate term “obligation.” An “obligation” is defined as “a promise to pay a stated amount of money at a fixed future date, or on demand, made for the purpose of incurring debt.” A municipal bond is, in effect, a contract between the county and the bond owner. There is a vast array of these debt obligations, or bonds, and they can be classified by the security behind the bonds, the purpose for which the proceeds of the bonds will be used, and the user of the capital facility financed by the proceeds of the bonds.

# I. Bonds by type of security

## A. General obligation bonds

Minn. Stat. ch. 475.

Minn. Stat. § 475.51, subd. 10.

Chapter 475 defines a general obligation as an obligation that promises (pledges) the full faith and credit of the issuing governmental unit to payment of principal and interest. The bond owner correctly understands this to mean that all assets and resources of the county, including the unlimited power to tax, will be used by the county to fulfill its contract to pay back the amount of the bond with the amount of interest agreed upon. The security for a general obligation bond is the pledge of those resources and taxing powers.

## B. Revenue bonds

Minn. Stat. § 475.51, subd. 4(3). *Struble v. Nelson*, 217 Minn. 610, 15 N.W.2d 101 (1944).

A revenue bond pledges to pay the bond owner principal and interest only from the revenues of the facility financed by the bond proceeds. The “hell-or-high-water” general obligation pledge is not involved.

The issuing county gives the owner additional assurances in the bond documents that it will operate the facility efficiently; impose the necessary charges for the use of the facility to ensure prompt and full payment of the bond; and give the holder rights to enforce those assurances, or “covenants,” as they are known. This type of bond is used typically for self-supporting utilities, such as health care facilities, electric utilities, and recreational facilities. Revenue bonds typically carry higher interest rates than general obligations because of the slightly higher risk of nonpayment. Normally, “net” revenues (i.e., all, or “gross,” revenues less operating and maintenance expenses) are pledged, but a gross-revenue pledge is permitted by some statutes.

## C. General obligation revenue bonds

Minn. Stat. § 444.075, subd. 2.

Minn. Stat. §§ 447.45 to 447.50.

Minn. Stat. ch. 429.

Minn. Stat. § 469.178, subd. 2.

Minn. Stat. § 469.174, subd. 6.

Minn. Stat. §§ 469.152 - 469.165.

Minn. Stat. §§ 469.142 - 469.151.

Minn. Stat. §§ 469.004 - 469.008.

Some statutes permit the county to pledge the full faith and credit *and* the revenues of the facility. This generally results in more favorable interest rates than for a pure revenue bond because the bond investor looks primarily to the general obligation pledge in analyzing the underlying credit. These types of bonds are widely used for sewer, water and storm sewer utilities and, to a lesser degree, hospitals and nursing homes.

Other common bonds of this type, although not generally known as such, are general obligation improvement bonds and general obligation tax increment bonds, which pledge special assessments against benefited property or tax increments from a financing district as security but are backed by a general obligation pledge. These bonds are viewed by the investor as straight general obligations since the special assessments and increments are roughly equivalent to property taxes in their imposition and collection.

For counties, tax increment bonds are available only for certain purposes. These include:

- Industrial development;
- Rural development; and
- Any project authorized under the powers of a housing and redevelopment authority.

## II. Bonds by purpose

While of no legal significance, municipal bonds are generally identified by the use to which the proceeds are put. Their titles give an indication of both the purpose and security. Thus, a general obligation bond payable in whole or in part from special assessments levied to pay for a public improvement will be called a general obligation improvement bond; a general obligation bond for a new community center will be a general obligation building bond; a sewer utility revenue bond backed by a general obligation pledge, a general obligation sewer revenue bond, and so on.

Grouping a county's outstanding bonds in this way is normally done in financial reports and in bond offering documents. This grouping provides a useful way of presenting a county's overall debt picture. Rating agencies also analyze a county's debt burden and debt ratios (dollars of debt per capita) in terms of the availability of other revenues to pay general obligation tax supported debt. This information is valuable to a board member making judgments about future capital projects.

### III. Bonds by user

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

[Minn. Stat. ch. 462C](#)

Minnesota counties sometimes issue bonds to provide direct aid to private persons or corporations. In federal law terms, these are “private activity” bonds. Common examples are industrial development revenue bonds, housing revenue bonds, and health care facility revenue bonds. The bonds are issued for some redevelopment or economic development purpose. The proceeds are either loaned to a private entity or inure to its benefit in one way or another. There is no financial obligation on the part of the county to pay the bonds, and they do not affect its debt structure or bond rating.

### IV. Laws governing bonds

#### D. The bond code

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

The basic statute governing Minnesota municipal bonds is the bond code, Minnesota Statutes, Chapter 475. Most statutes are impenetrable to the layperson (and to many lawyers), but the bond code in Chapter 475 is relatively understandable and is useful reading for board members. The principal provisions of Chapter 475 are discussed below.

#### E. Debt limit

[Minn. Stat. § 475.53.](#)

Counties may not incur debt in excess of two percent of the market value of taxable property in the county. But excepted from this overall two percent limit are almost all debt obligations for which some other source of revenue is pledged as security. Thus, utility revenue bonds, pure revenue bonds, capital improvement bonds under an approved capital improvement plan, judgment bonds and similar bonds may be issued without regard to the statutory debt limit. The result is that, with only a few exceptions, the only obligations subject to the debt limit are general obligation bonds payable solely from ad valorem property taxes. The legal debt limit has nothing to do with the practical debt limit of a county, which is the debt burden beyond which the credit-worthiness of the county is put into question.

#### F. Voter approval

[Minn. Stat. § 475.58.](#)

Another general rule in the bond code is that the issuance of bonds must be approved by a majority of the county’s voters voting on the question. But, as in the case of the debt limit, a number of exceptions limits this rule to a very few bond issues. The exceptions are:

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

- Bonds to pay a judgment.

[Minn. Stat. § 475.58, subd. 1\(2\).](#)

- Refunding bonds.

- Minn. Stat. § 475.58, subd. 1(3). • Improvement bonds or tax increment bonds where special assessments or tax increments pay at least 20 percent of the cost of the project financed.
- Minn. Stat. § 475.58, subd. 1(4). • Revenue bonds.
- Minn. Stat. § 475.58, subd. 1(5). • Bonds issued under a statute that permits the issuance without an election.
- Minn. Stat. § 475.58, subd. 1(6). • Bonds issued under any law that permits issuing them without voter approval.
- Minn. Stat. § 475.58, subd. 1(7). • Bonds issued to fund some pension and retirement fund liabilities.
- Minn. Stat. § 475.58, subd. 1(8). • Bonds issued county-established capital improvement plans.
- Minn. Stat. § 475.58, subd. 1(9). • Bonds issued for indoor ice arenas for youth athletic activities, with certain restrictions.
- Minn. Stat. § 475.58, subd. 3(b). • Bonds used to finance a street reconstruction program (including turn lanes, improvements having a substantial public safety function, realignments and other street projects), subject to a reverse referendum.

The effect of these exceptions is that, in almost all cases, only general obligation bonds (payable solely from ad valorem property taxes), must be approved by the voters. Voter authorization is always put on the ballot in terms of approval of “not to exceed \$\_.” Voter approval does not require the county to issue the bonds or to issue the full amount authorized.

Minn. Stat. § 275.60 and Minn. Stat. § 275.61. State law requires rather detailed information about the financial effect of approval of bond ballot questions, including a requirement that the ballot must state that a “yes” vote will raise taxes.

There is no clear rule in Chapter 475 or court decisions as to how long voter authorization for a bond issue remains effective. The best policy is to issue the bonds when the money is needed for the project to be financed. If the project is never begun, or ultimately abandoned and not likely to be resurrected, the authorization should be considered inoperative.

Minn. Stat. § 475.58, subd. 1a. If a bond election fails, the same question for the same amount may not be resubmitted to the voters for six months. If it fails a second time, a one-year delay is required.

*See Lindahl v. Independent Sch. Dist. No. 306*, 270 Minn. 164, 133 N.W.2d 23 (1965).

Preparation of the actual ballot question should be left to the county's bond approving counsel since that law firm will be giving an opinion on the validity of the bonds. County boards should resist the temptation to request the grouping of disparate matters in one question (e.g., county courthouse and water tower) or conditional or alternative questions (such as, "If you approve purpose A, then should we issue for purpose B?"). Any phrasing of the question that might compel a voter to approve something the voter opposes, to get something the voter wants, can invalidate the authorization and prevent the sale of the bonds.

[A.G. Op. 159a-3 \(May 25, 1962\)](#).

County officials should be careful not to endorse or campaign in favor of the bond election. Any published materials should be confined to factual statements about the project to be financed. Campaigning should be left to citizen groups.

## G. Public sale

[Minn. Stat. § 475.60](#).

A third general rule riddled with exceptions is that bonds must be sold after published notice to the highest bidder on a purely competitive basis. The principal exceptions are:

[Minn. Stat. § 475.60, subd. 2\(1\)](#).

- Whenever a law permits negotiated (noncompetitive) sale.

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

- Bonds sold by an issuer in amounts not exceeding \$1,200,000 in any period of 12 consecutive months.

[Minn. Stat. § 475.60, subd. 2\(3\)](#).

- Tax anticipation bonds.

[Minn. Stat. § 475.60, subd. 2\(4\)](#).

- Bonds sold to state or federal agencies.

[Minn. Stat. § 475.60, subd. 2\(5\)](#).

- Pension funding bonds, variable rate bonds and crossover refunding bonds.

[Minn. Stat. § 475.60, subd. 2\(6\)](#).

- Taxable bonds.

[Minn. Stat. § 475.60, subd. 2\(7\)](#).

- Installment sale contracts and lease purchase agreements.

[Minn. Stat. § 475.60, subd. 2\(8\)](#).

- Obligations sold under a bond reinvestment program.

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

- Bonds issued with the advice and assistance of an independent financial adviser.

The last exception covers most municipal bonds issued in Minnesota. Because of the desirability of the competitive bidding process, most financial advisers in all but the most exotic financings will advise the county to obtain competitive offers or proposals. The only difference from a true competitive sale is the absence of a published sale notice, which arguably has little practical value.

Private activity bonds described earlier are rarely, if ever, sold competitively. They are, in effect, private financings and the benefiting company chooses its own underwriter to market the bonds. Occasionally, a county will retain an independent financial adviser in these transactions. The choice of bond counsel is up to the board.

It's a good idea for the county to retain its own counsel in these financings if the bond counsel is not the county's regular bond counsel. The regular bond counsel is probably the best choice, unless the county attorney feels comfortable in that role

## H. Tax levies for general obligations

[Minn. Stat. § 475.61.](#)

Chapter 475 requires that in the case of general obligations, the issuing county must levy, at the time the bonds are sold (in the resolution awarding the sale), an irrevocable ad valorem tax for each of the maturity years of the bonds equal to 105 percent of the principal and interest due in that year.

The purpose of the 5 percent over levy is to cover possible deficiencies in tax collection. The resolution must be filed with the county auditor who must levy the tax for the years indicated. If, however, other revenues are pledged as security for the bonds (special assessments, tax increments, revenues, etc.), the amount of the annual tax levies may be reduced by the county's reasonable estimate of expected revenues from those sources. Thus, where 100 percent of the cost of an improvement project is assessed against benefited property, no tax levy need be made; or if 50 percent is to be assessed, the 105 percent rule applies only to the 50 percent levied for the county's share of the cost of the project. In any case, the resolution must still be filed with the auditor. The resolution awarding the sale of pure revenue (non-general obligation bonds or any bonds where no taxes are involved) need not be filed.

If there is excess revenue in the debt service fund for the bonds from prepayments, investments or irrevocable appropriations, the levy for the ensuing year be reduced by that amount. The auditor must make the reduction.

## I. Interest rates

The interest rate on a municipal bond, sometimes referred to as the "coupon rate," is not subject to any statutory limitation. The rates are determined solely by the market rate on the day the bonds are sold or negotiated. Generally, each maturity of a bond issue bears interest at a separately stated rate, and longer maturities bear higher rates. The "total interest cost" of an issue is the total interest at the coupon rates to be paid on the issue plus discount (discussed later), expressed in dollars. The net effective interest rate is the total interest plus discount divided by the total number of years that each \$1,000 of bonds is outstanding (called a "bond year"). The "true interest cost" or "true interest rate" is the percentage rate at which the total payments of principal and interest are discounted to produce the purchase price of the total issue of bonds. Most bond sales in Minnesota are awarded on the basis of true interest cost.

[Minn. Stat. § 475.56\(a\).](#)

Chapter 475 permits, in a roundabout way, the sale of an issue of bonds at a price lower than the face amount (par amount) of the bonds. This amount, called “discount”, may not exceed 2 percent of the amount of bonds otherwise authorized to be sold by the board. Discount is simply interest (just as it is in private borrowing for a mortgage, for example). In the computation of total interest cost, the amount of the discount is added to the total coupon interest. A discount is routinely provided by counties in public offerings of municipal bonds in order to give the underwriters who buy the bonds some working capital to cover their sales and administrative costs in marketing the bonds to the ultimate bond owner. Thus, a \$1 million offering of bonds might specify that the purchaser may not offer less than \$990,000 for the issue—the \$10,000 representing a 1 percent discount.

One curious aspect of the discount is that in the case of general obligation bonds authorized by the voters, a discount amount of up to two percent of the authorized amount may be added to the amount of the bond issue sold. Thus, if the voters authorized \$1 million, a total of \$1,020,000 may be sold—the additional \$20,000 of bonds representing discount.

## **J. Maturities**

[Minn. Stat. § 475.54.](#)

Minnesota municipal bonds, except private activity bonds, industrial revenue bonds and bonds to which Chapter 475 does not apply, must mature serially or, if maturing all at the same time (term bonds), be subject to mandatory sinking fund redemption over a term not to exceed 30 years (except for municipal water and waste water treatment systems and essential community facilities financed or guaranteed by the U.S. Department of Agriculture where a term of up to 40 years is permitted). A certain portion of the principal amount of the issue comes due annually. Generally speaking, no amount in a given maturity year may exceed a maturity amount in a previous year ending three years after date of issue by more than five times. Thus, if the first maturity is three years after the date of the issue and is \$50,000, no subsequent maturity may exceed \$250,000. The law does permit the county to combine the maturity schedule of a bond issue with another new or outstanding issue to comply with this “five times” rule.

## **K. Call for redemption**

[Minn. Stat. § 475.54, subd. 4.](#)

Bonds are normally issued with the county retaining the right to prepay the bonds (call for redemption) on and after some specified future date. It is useful for counties to be able to retire the debt early if possible, or to refund the bonds at a more favorable rate (refunding is discussed later). Bondholders need to ensure the benefit of their investment for at least some period of time. Therefore, there is typically an initial lock-out period (often 10 years) during which the bonds may not be prepaid.

However, as discussed later in connection with refundings, bonds may be defeased prior to the first call date. Notices of redemption must be given to the bondholder, and at least 30 days mailed and published notice is industry standard. Published notice is not required if the bonds are registered bonds. Notice is normally handled by the bond registrar or paying agent at the request of the county. The call amount is normally the par amount of the bonds redeemed, plus accrued interest to the date of redemption. Sometimes, particularly if the first call date is relatively early (say five to eight years) a small premium (half of 1 percent of par) is provided for.

## V. Debt service funds

### L. Investment

[Minn. Stat. § 475.51, subd. 6.](#)

The bond sale resolution will create a fund (or use an existing fund) to which all moneys received for bond payments (taxes, special assessments, tax increments and net revenues) are to be paid. Debt service funds must be kept separate from all other county funds and may not be invaded, even on a temporary basis, for other county needs. A single or common debt service fund may be used, but the better practice is to have separate funds for each issue. This is so not only because of federal arbitrage requirements (discussed later), but also for proper presentation of the county's financial status in financial statements, audits, and bond-offering documents. If a common debt service fund is used to facilitate investment, it is desirable to establish separate accounts for each issue within the fund.

[Minn. Stat. ch. 118A.](#)  
See Handbook, ch. 26

Investment of monies in debt service funds is strictly controlled by state law and the bond code. Only very high quality debt instruments are permitted. Permitted investments are (by operation of other statutory provisions) those investments in which any idle municipal funds may be invested.

Since one class of permitted investments is general obligations of a Minnesota municipality, debt service funds may be invested by the county in its own debt obligations if those obligations are rated at least A for general obligations and AA for revenue obligations. This technique is useful for short-term financings, but great care should be taken that the maturities and redemption features of the bonds purchased by the debt service fund ensure availability of funds for the principal and interest requirements of that fund or account.

## M. Refundings

Minn. Stat. § 475.67.

Chapter 475 permits counties to refund outstanding bonds if the bonds are subject to redemption and if not prohibited by the terms of the bonds themselves. Refunding is another term for re-financing, very much like refinancing a mortgage. A refunding may be: a *current refunding*, that is, the refunding bonds are issued within 90 days of the date on which the bonds are subject to redemption; or an *advance refunding*, where the refunding takes place well before the redemption date. The proceeds are placed in escrow with a banking institution and held until the first redemption date when the refunded bonds are paid.

Refundings are done and permitted for a number of reasons, the most common being to reduce interest costs. The calculation of the amount of savings from a particular refunding requires some arithmetic (very complicated arithmetic in advance refundings). The most important fact to keep in mind is that the savings in real terms must be converted to a present value that takes into account the costs of issuing the refunding bonds. The concept of present value involves recognizing that \$1 today is worth more than \$1 five years hence, and discounting the value of that future dollar to reflect the fact that that dollar won't be available to generate income until that future date.

(Advance refundings, and to a lesser degree current refundings, are surrounded by a network of complex federal rules to be discussed later.)

Counties will sometimes achieve the same result as a refunding by a process known as defeasance. This means that there is enough money in the debt service fund for the bonds, or enough with the addition of other funds, to invest those funds in an escrow account that will pay the principal and interest to maturity or redemption. If that is done, the bonds are defeased and considered paid. This is a particularly useful procedure when there is more money in the debt service fund than is needed for the defeasance (it can happen) since the amount not needed for the defeasance may, under the bond code, be used for any corporate purpose.

## N. Temporary financing

Minn. Stat. § 475.61, subd. 5.

Minn. Stat. § 429.091, subd. 7.

Occasionally a county will find it desirable to temporarily finance a project. A common example is a specially-assessed improvement project where it is relatively certain that substantial prepayments of special assessments will be made. The county will decide to issue temporary improvement bonds for a period of up to three years and delay permanent financing until the actual amount of funds to be financed by long-term bonds is determined.

Minn. Stat. § 475.61, subd. 5.

Temporary bonds are also useful when the county has an approved grant or loan from a state or federal agency and the grant or loan funds are not available until the project is completed.

Minn. Stat. § 475.61, subd. 6.

Finally, temporary financing may be necessary when the county, for whatever reason, will not be certain of the exact project costs or the sources of its funding will not be available until completion of construction.

The temporary bonds available for those purposes are general obligations of the county, but no tax levy is required because the proceeds of the long-term bonds to be issued are pledged to their payment.

## VI. Other bond laws

While Chapter 475 controls most municipal bond issues in one way or another, there are other statutes providing bond-issuing authority. For example, improvement bonds, tax increment bonds, recreational facility bonds, general obligation utility revenue bonds, and health care facility bonds are authorized by separate statutes, which, after laying down some procedural rules, refer over to Chapter 475 for other basic rules. Still other statutes make no reference to Chapter 475. If this is the case, they are self-contained, except perhaps for the debt limit.

[Minn. Stat. § 373.01 subd. 3](#)

For instance, [Minn. Stat. § 373.01 subd. 3](#) authorizes the issuance of certificates of indebtedness for capital equipment. These certificates are general obligations requiring the 105 percent over-levy and are subject to the debt limit, but none of the other provisions of Chapter 475 apply (five times rule, public sale, etc.).

[Minn. Stat. ch. 469.](#)

Private activity bonds are issued, for the most part, without any reference to Chapter 475. The statutes authorizing those kinds of bonds contain their own rules about the structuring, sale, and security of the bonds.

[Minn. Stat. ch. 462C.](#)  
[Minn. Stat. § 469.034](#)

Some county boards also act as housing and redevelopment authorities (HRAs). On occasion, the HRA will issue its own corporate purpose bonds, usually for housing purposes. The issuance of these so-called “essential function” bonds is completely controlled by the authorizing language of the HRA Act.

[Minn. Stat. § 469.034, subd. 2.](#)

A growing use of HRA essential function bonds is for rental and senior rental housing. The HRA finances and owns the projects, and the rental revenues provide debt service for the bonds. Up to \$3 million (or, if greater, half of 1 percent of the county’s taxable market value) of this type of bond can be backed by the county’s and not the HRA’s general obligation pledge.

## O. Lease purchase financings

[Minn. Stat. § 465.71.](#)

Counties may enter into lease-purchase agreements to acquire real or personal property. The lease payments are applied to the purchase price and associated interest cost of acquiring the capital asset. The statute provides that the obligations are not subject to the debt limit, unless in excess of \$1 million, and no election is required. The agreement must give the county the right to terminate the agreement at the end of any fiscal year during its term by a provision called a “non-appropriation clause.” Thus, a county may simply declare at any time that it will not appropriate money in the coming year for the lease payments and the agreement ends.

Because of the non-appropriation feature, a lease-purchase agreement is not an obligation subject to the bond code. The market for such leases fully understands the risk and analyzes it in terms of the likelihood that a county will do such a thing, which is small. On the other hand, some vendors routinely include rather onerous remedies in the event of early termination, and credit rating agencies have lowered municipalities' credit ratings after non-appropriation. The board should be fully aware of the consequences of non-appropriation.

Lease purchases are commonly used for equipment (office equipment, motor vehicles, telephone systems), but it is possible to finance major capital expenditures, such as a municipal building, in this way. If the amount of the transaction is substantial, the lessor may sell certificates of participation (COPs) in the underlying lease. The COPs look like, sound like, and are marketed just like municipal revenue bonds. They are not governed by any of the statutory procedures discussed above relating to municipal bonds.

HRAs and EDAs often act as lessors in these financings. The county's rental payments to the HRA or EDA are not subject to levy limits, but payments to a bank or other corporate lessors are.

## VII. Impact of federal law

Prior to 1968, the exemption of the interest on municipal bonds from state and federal income taxation was a fact of life hardly worthy of discussion. But in the years since, a thicket of federal laws, rules, and regulations has grown and continues to grow around this subject. In simplest terms, the federal government's attacks on tax exemption have arisen from two facts:

- The large growth in private activity bonds.
- The concept of arbitrage.

A discussion of private activity bonds is beyond the scope of this chapter, except to say that, as a matter of policy, the federal law treats interest on such bonds as taxable, permits exemption only for specific purposes (shrinking in number), and subjects them to complex restrictions (growing in number). Arbitrage, on the other hand, pervades almost every aspect of municipal finance and should be understood in principle if not in detailed application.

## P. Arbitrage

The term sounds mysterious, but the concept is relatively simple. In November, A borrows \$1,000 from a bank to make a home improvement at an agreed interest rate of 10 percent, but decides to wait until May to hire a contractor and do the work. Suppose A then uses the loan proceeds to buy a \$1,000 security maturing on May 1 that will pay 11 percent. The 1 percent excess, or “spread,” that A earns in the period from November to May is arbitrage profit. What is a prudent decision for A is deemed by the federal government to be contrary to public policy for counties and other local governments. The arbitrage rules all but eliminate arbitrage profit for a county that invests the proceeds of its bonds until those proceeds are needed to pay bills. Violation of these rules can result in the interest on the bonds becoming taxable and the county being blacklisted by the treasury department.

Internal Rev. Code, 26  
U.S.C. § 148.

The federal arbitrage rules are far too complex to present in this discussion. The county’s financial advisers and bond counsel must make sure that the county takes the necessary precautions to avoid violation. The general idea is that the proceeds of a bond issue may not be invested, except for certain defined short temporary periods, at a rate (the term “yield” is used) materially higher than the yield on the bonds. “Materially higher” generally means .125 percent, or one-eighth of 1 percent. In the case of counties issuing more than \$5 million in a single calendar year, all arbitrage in any amount (again with some detailed exceptions) must be paid, or “rebated,” to the United States Treasury.

When the county’s bonds are delivered to the underwriter or bank that buys the issue, a county officer, such as the board chair, auditor, or administrator/manager, must certify that the county reasonably expects the bond proceeds will not be invested or used in a way that violates the rules, and that those reasonable expectations control, for the most part, the arbitrage status of the bonds. That certificate should be read a bit more carefully than many of the other routine certificates made about the bond issue. Any doubt about the certificate’s accuracy should be cleared up with the appropriate county officer, the financial adviser or bond counsel.

The arbitrage rules have been revised and “simplified” several times, but they are still formidable reading.

## VIII. Some other federal requirements

### Q. Registration

All municipal bonds issued in 1983 and thereafter must be registered in the name of the owner. Prior to 1983, bonds had coupons attached showing the interest payment due, hence the term, “coupon rate.” Typically, a bank or trust company is selected by the county to act as bond registrar. The registrar keeps track of owners and makes periodic payments of principal and interest from funds supplied by the county.

### R. Bank qualified bonds

[Internal Rev. Code, 26 U.S.C. § 265\(b\)\(3\).](#)

Since 1986, banks must offset the tax exempt interest they receive on municipal bonds against the interest expense they incur in paying depositors, unless the bonds are designated by the issuing county as bank qualified bonds. Any county may so designate its bonds—and should—unless it plans to issue more than \$10 million in any calendar year, in which case the designation can’t be made. If the bonds aren’t so designated, banks won’t normally buy them. Private activity financings of health care and housing facilities by 501(c)(3) tax-exempt organizations may also be designated as bank qualified bonds.

### S. IRS filing

Counties must file a form with the Internal Revenue Service for each issue of bonds. The form 8038-G contains the basic data about the issue. Bond counsel usually completes the form and files it on behalf of the county.

### T. SEC disclosure rules

In the wake of some spectacular municipal bond defaults in the 1970s and 1980s, the Federal Securities and Exchange Commission (SEC) adopted a rule governing the form, content, and use of offering materials (official statements) for municipal bonds. The rule is aimed at uniformity in presenting essential information about the bonds and the issuers, and ensuring the timely supply of complete and accurate offering material to bond holders.

[SEC Rule 15C2-12.](#)

An SEC rule also requires issuers to make continuing disclosure reports on an annual basis where the amount of the bond issues exceeds \$1 million or where the issuer has more than \$10 million in bonds outstanding. The county’s financial adviser and bond counsel can assist in complying with this rule.

For more information, visit the [MSRB](#).

The Municipal Securities Rulemaking Board (MSRB) also promulgates rules governing the conduct of underwriters and other municipal bond dealers.

For more information, visit the [CUSIP](#).

Another agency, the Committee on Uniform Securities Identification Practices (CUSIP), is really a joint agency of the securities industry as a whole. Its function is to assign discrete certificate numbers to each bond or certificate. All but the smallest bond issues are assigned CUSIP numbers.

## U. Reimbursement: Official intent

A county must formally declare an official intent to reimburse itself from tax exempt bond proceeds for construction costs (not engineering and planning costs) incurred prior to the issuance of the bonds. The notion with this rule is apparently to prevent counties from financing long-past expenditures from newly-issued bonds, thus avoiding the arbitrage rebate requirement. (The rebate is not necessary if the proceeds are promptly spent.)

The official intent can be expressed in any number of ways. Typically a blanket resolution is adopted designating some county officer to make the declaration and keep it on file. It is advisable to have bond counsel prepare this resolution. Once the declaration is made (within 60 days after the expenditure) bonds must be issued no later than 18 months after the later of:

- a) the date of expenditure for project costs; or
- b) the date the project is placed in service, but
- c) in no event later than three years after expenditure is made.

(There are some exceptions to this general rule for certain portions of bond issues and counties that issue small amounts of bonds.)

## V. Taxable municipal bonds

If the proceeds of a municipal bond issue somehow, either directly or indirectly, inure in part (10 percent or more) to the benefit of a private person or corporation (that is not otherwise exempt from federal taxation) and that person, directly or indirectly, can make a payment that support the bonds, the bonds are taxable—unless one of the narrow exemptions for tax-exempt private activity bonds is met.

The most common example is an issue of tax increment bonds for a redevelopment project to finance a write-down of land costs to a developer who, in turn, enters into an assessment agreement assuring that the assessed value of the project to be built will not go below a certain figure. The land is used by a private person, and that person is, in effect, guaranteeing a certain level of tax increment. Both the private-use test and the security test must be met.

Thus, tax-exempt tax increment bonds are possible for financing purely public improvements (streets, sewers, and the like used by the general public) even though the tax increment payment is somehow guaranteed by the developer. Conversely, tax exemption is possible where there is a private use but no payment guaranty of any kind. The situations where this can be accomplished are extremely rare.

The interest rate spread between tax exempt and taxable bonds is about 1.5 percent to 2 percent.

## **IX. Private activity bonds**

### **W. Allocations**

[Minn. Stat. ch. 474A.](#)

When tax-exempt private activity bonds can be issued, the total amount of such bonds in any year in any state is governed by a federal allocation, or “cap,” based on population. Each state decides how much of the total cap may be assigned to industrial development revenue bonds (almost completely limited to manufacturing facilities), housing revenue bonds, and exempt facility bonds, respectively. In Minnesota, most of the allocation goes to housing revenue bonds.

Each issuing local government must, in turn, receive an allocation from the state of the respective portion of the overall cap for each issue. Bonds issued for the benefit of charitable organizations (those qualified under Section 501(c)(3) of the Internal Revenue Code) are not subject to the cap. The Internal Revenue Code treats these “qualified” 501(c)(3) bonds in virtually the same way as a municipal bond for traditional municipal purposes.

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

When a county issues bonds, it is selling its debt on the open market. The structuring and marketing of that debt requires the assistance of technical experts. The pervasiveness of federal law and regulations makes it imperative that those experts be fully aware of the rules about tax exemption. For those reasons, a county board will find itself dealing with a wider array of technical advisers in a bond financing than is usual in its other activities.

The most important players are as follows, not necessarily in order of importance.

### **X. Bond counsel**

The investing public will not buy municipal bonds that are not accompanied by an opinion of a law firm having recognized expertise in municipal law. The opinion states that the bonds have been properly issued in accordance with law; that the bonds are a binding obligation of the issuing county payable from a described source of revenue; and, describes the tax-exempt nature of the interest to be paid on the bonds, assuming the interest is exempt. Since the bond counsel is retained to give this opinion, most counsel will prepare all of the necessary resolutions, election proceedings, certificates, and the bonds themselves. The bond counsel will work closely with the county’s staff and other consultants on virtually all aspects of the financing, including those troublesome arbitrage and related federal tax questions.

The bond counsel's approving opinion is unique. It is not qualified in any way; that is, the opinion states that the bonds *are* valid and the interest *is* tax exempt as described. If the bonds aren't valid or the interest is taxable, the bond owner will look to the bond counsel for payment. This fact may explain why bond counsels are sometimes viewed as overly precise at best and obstructionist at worst. These characterizations are inaccurate. Indulgence of the bond lawyer's insistence on detail by county officials is recommended.

The selection of bond counsel is a matter solely in the discretion of the board. A long-standing relationship with a bond counsel firm and an individual attorney within that firm is in the best interest of the county. In a good working relationship, the bond counsel becomes intimately familiar with the financial workings of the county, and can offer many helpful suggestions beyond the simple structuring and marketing of a bond issue.

## **Y. Financial adviser**

In all but the simplest financings (for example, a sale of a small issue to a local bank that can be handled by the county attorney and bond counsel), the county will want to retain a financial advisory firm. The financial adviser assists in:

- 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.

A good financial adviser and bond counsel can make the daunting business of successfully bringing an issue of municipal bonds to market truly worry free. The financial adviser and bond counsel work in close cooperation on virtually all aspects of the transaction. As in the case of bond counsel, and for the same reasons, a long-term relationship with a financial adviser is highly desirable.

## **Z. Underwriters**

The county sells its bonds at wholesale to the highest bidder rather than directly to individuals, although that is also possible. The entire issue of bonds is purchased by either an underwriting firm or bank, either alone or in association with others (a syndicate). The award of the sale is made to the underwriter offering the price that results in the lowest interest cost to the county. (More about this later.) The underwriter then sells or re-offers the bonds to individuals and institutional purchasers, usually at the par value of the bond but sometimes at a slight premium or discount. On occasion, the underwriter will hold the bonds as its own investment. The competition for municipal bond issues among underwriters is intense. It is almost always advisable to obtain a number of competitive bids or proposals.

The market for municipal bonds is nationwide. A Minnesota municipal bond may ultimately end up in a mutual fund in California, or with a private investor in Alaska.

## **AA. Rating agencies**

There are two primary municipal bond rating agencies in the United States: Moody's Investors Service and Standard and Poor's Ratings Group. Virtually all rated Minnesota issues are rated by Moody's. The highest rating is "Aaa"; the lowest investment grade rating is "Baa." The rating is assigned prior to the bond sale. It reflects the agency's judgment of the credit-worthiness of the issuer, and is based on a number of objective and subjective criteria including debt per capita, overlapping debt of other political subdivisions, tax collection experience, tax base, employment levels, and the quality of the primary source of repayment of the bonds.

Obtaining a rating is relatively expensive. The cost is normally recovered in more favorable interest rates on the bonds. In addition, most institutional investors (banks, insurance companies) may not or will not buy unrated bonds. If an issue is relatively small (say, less than \$1 million), unrated bonds can be and have been successfully sold, but the market is limited and the purchasing underwriter will offer a price that reflects the additional costs of re-offering the bonds.

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

Most local governments are not equipped and unwilling to take on the task of keeping track of the ownership of bonds, and making periodic payments of principal and interest to the bondholders. After a bond sale, the financial adviser or bond counsel will suggest a number of banks or trust companies for the task, and may actually take bids for that service. The registrar can be changed at any time by the county.

## CC. Book entry bonds

Individual bond purchasers used to like to see a printed, engraved bond or know that one exists. But almost all bond issues are now issued in book entry form, just like federal treasury notes and bonds. Under this system, no bonds are printed. The county finance officer can act as registrar, but usually a bank or trust company is selected for this task. A central clearing agency, the Depository Trust Company (DTC), issues certificates of participation to the underwriter or syndicate. Those certificates, simply a confirmation of the purchase of a stated amount of bonds of the issue, are held by the bond purchaser. The county saves the cost of a registrar and bond printing. The county's payment agent simply remits payment to DTC.

## DD. Insurance

Some counties may choose to have their bonds insured by one of a number of municipal bond insurance companies. The insurer agrees to pay the bond owner in the event of default. The bonds carry the rating of the insuring company, usually the highest rating. This results in low interest on the bonds. That savings must be offset against the cost of the insurance, which can be rather high. The financial adviser will prepare this analysis and make a recommendation. Occasionally, the purchasing underwriter will buy the insurance if the cost of the insurance can be recouped by selling the higher rated bonds at a premium.

## XI. Example of a bond sale

Assume that a county has ordered the construction of a street improvement project under Minn. Stat. Ch. 429, and now faces the reality of having to pay for it as the engineer's preliminary report says it must. The engineer also has recommended, and the board has agreed, that only 50 percent of the cost of the project be assessed. The cost of construction contracts is estimated to be \$900,000.

## EE. Planning

The county staff will first meet with the financial adviser to determine the size of the bond issue, the dating of the bonds, the first redemption date, and a schedule for the bond sale. The first meeting should take place well in advance of when bond proceeds are needed to allow time for an orderly, unhurried process. The total amounts of bonds to be sold should cover total costs of the project, which might look like this:

Construction contracts	\$900,000
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Engineering costs	30,000
Capitalized interest	20,500
Contingencies and administrative	20,000
Costs of issuance	20,000
(Less interest earnings)	(500)
Sub total	990,000
Discount	<u>10,000</u>
Total costs to be financed by bonds	\$1,000,000

The capitalized interest is necessary to pay interest on the bonds until the first settlement of one-half taxes and special assessments is received. Costs of issuance include financial adviser, bond counsel, bond document preparation, rating agency fees, and registration. The discount is 1 percent of the issue and if the full discount is taken (a price of \$990,000 offered for the bonds), the underwriter's working capital and profit will be \$10,000, or \$10 per \$1,000 bond. The financial adviser will usually summarize its recommendations on these matters in a formal report to the county.

If bond counsel attorneys are not involved in the planning session, they should be contacted immediately after the planning session for two reasons. First, counsel will prepare the initial resolution calling for the sale of the bonds. Second, counsel will want to look at the Chapter 429 proceedings to see that the project was properly ordered. If some defect is present, there will be ample time to take necessary corrective action.

An official declaration of intent to reimburse costs of the project from bond proceeds should be made promptly, particularly if there is any possibility that costs of the project (other than engineering and planning fees) are to be paid before the bond proceeds are received by the county.

The elements of the financial adviser's recommendations for the bonds might look something like this:

**Title:** General Obligation Improvement Bonds, Series 2005. (Subsequent issues will be identified as Series 2005B, etc.)

**Principal Amount:** \$1,000,000

**Date of Bonds:** Dec. 1, 2005 (This is a nominal date from which interest begins to be computed: the actual delivery date of the bonds will probably be a few weeks later.)

**Interest:** First interest, Aug. 1, 2006, and each Feb. 1 and Aug.1 thereafter. (Six-month intervals are standard, as is first interest within one year.)

<b>Maturity:</b>	Feb. 1 in years and amounts:	
	2006-07	\$80,000
	2007-08	90,000
	2009-11	100,000
	2012	110,000
	2013	120,000
	2014	130,000

(The county will assess over a 10-year period with first collections in 2005. The February-August cycle fits best for improvement bonds payable from special assessments because of the timing of tax settlements.)

**Redemption privilege:** Bonds maturing in 2012, and thereafter, are callable on Feb. 1, 2013, and on any date thereafter at par, plus accrued interest. (A call feature on improvement bonds is desirable because prepayments of assessments are likely. This eight-year call normally will not require a redemption premium.)

**Rating:** Moody's Investors Service: applied for. (The actual rating is seldom assigned until just before the sale.)

**Minimum price:** \$990,000 (The county will not accept offers for less than this figure. The \$10,000 is the discount.)

**Good faith deposit:** \$20,000 (This may be retained as damages if the successful bidder doesn't take delivery of the bonds.)

**Denomination:** Integral multiples of \$5,000. (If an ultimate buyer purchases \$100,000 of bonds, a single bond of \$100,000 denomination will be delivered.)

**Form:** Book entry.

## FF. Authorizing the sale

Next, the board will adopt an initial resolution determining to issue the bonds, setting the sale date, and approving the terms of offering of the bonds. These terms are expressed in a notice of bond sale specifying, among other things, the details of the bonds, time for receipt of the bids or proposals, time of award and sale, and the minimum price that will be accepted (par amount less discount, \$990,000). The sale date is normally set for about 20 days after the initial resolution.

## GG. Official statement

The financial adviser then prepares a prospectus for the bond called an official statement. The official statement contains:

- The official notice of sale and terms of proposals.
- A description of the issue.

- Financial and other economic data on the county.
- The proposed form of the bond counsel's opinion.
- Forms for use in submitting offers.

The official statement is then circulated by the financial adviser to prospective purchasing underwriters locally and nationally and to the rating agency for its analysis. The official statement is a preliminary official statement. The final official statement showing actual interest rates and yield is completed after the sale. The preliminary official statement is used by the underwriter in analyzing the market for the bonds. The final official statement is used in actual marketing and sales.

The official statement should be reviewed carefully by an appropriate county staff member prior to circulation and should be read by each member of the board. Everything in the statement must be accurate, and the board chair and some other official, usually the administrator or county auditor, will be required to sign a certificate as to its accuracy and truthfulness at the time of bond delivery.

A well-prepared official statement is useful reading for the board and staff. There is probably no more concise presentation of the county's financial status.

## **HH. Sale of bonds**

On the bond sale date, underwriters submit their offers to the financial adviser no later than the time specified in the notice of sale, usually about mid-day. In practice, the bids or proposals are received by phone or fax. In the offer, each underwriter will specify the price that will be paid for the bonds; the coupon interest rate for each maturity; the total interest cost or true interest cost; and the net effective or true interest rate on the entire issue.

The lowest interest cost is the controlling factor in the award because it results in the highest price being paid for the bonds. The total interest is the sum of the coupon interest over the life of the issue, plus the discount offered for the bonds. The price offered in the example will probably not be the minimum of \$990,000. If the underwriter thinks it can successfully market the bonds at a cost of \$8,000, the price will be \$992,000. Since the county must pay back \$1,000,000, the \$8,000 is interest.

At the board meeting on the day of sale, the adviser presents a tabulation of offers, then the county chooses the best offer and awards the bonds by a bond resolution that fixes all of the details of the bonds, makes the necessary pledges, levies the required taxes (in this case 50% of principle and interest for each year of maturity), appoints a registrar; and makes the necessary promises to abide by all of the federal rules and regulations about tax exemption. Bond counsel prepares this resolution.

## **II. Preparing to deliver the bonds**

During the next few weeks, the adviser arranges for bond printing, finalizes the official statement, sets up a closing date with the purchaser, files the bond resolution with the county auditor, and addresses a host of other details. Bond counsel collects and reviews all the necessary proceedings (a list of necessary documents is normally supplied by bond counsel), examines the bond proof, and prepares a series of county certificates (called “closing papers”) that are customarily delivered to the purchaser with the bonds.

When the bond resolution is adopted and the bonds are sold, the county and purchaser agree that the bonds will be physically delivered to the purchaser or DTC within a specified time (usually 40 days). At that time, the purchaser will pay the county the purchase price plus interest accrued from the date of the bonds to the date of delivery. (Accrued interest is paid because the county’s first interest payment covers the period beginning with the date of the bonds.)

During this period, the purchaser takes orders for the bonds from its customers and agrees to deliver the bonds to them on the date the bonds are received from the county. Once a closing (delivery) date is agreed upon, it is critical that delivery take place on that date. County staff should respond promptly to the financial adviser’s and bond counsel’s instructions during this pre-delivery period. Failure to deliver on the agreed date will cause great confusion and unhappiness, and should be scrupulously avoided.

## **JJ. Closing and delivery**

On the delivery date, the bonds, closing papers, final official statements, and bond counsel’s opinion are physically delivered to the underwriter by the adviser. The underwriter electronically transfers the purchase price and accrued interest to the county’s depository bank. Bond counsel completes the Form 8038-G and files it with the Internal Revenue Service. The process is then complete.

## **G. Summary**

The process of issuing municipal bonds is complex in detail, but relatively simple in principle. The use of financial advisers to assist in bringing an issue of substantial size to market is highly desirable, and the retention of bond counsel is imperative. Careful and continuing attention to the many federal rules and regulations about tax exemption is necessary. Any question about the application of these rules should be addressed to bond counsel. The municipal bond industry in Minnesota is of the highest quality, integrity, and efficiency. County boards and staff will find that with proper technical help, the process of raising money for capital needs will be smooth and relatively enjoyable.

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