FCMAT
FISCAL CRISIS & MANAGEMENT ASSISTANCE TEAM

Fiscal Alert
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Ongoing Disclosure Related to Outstanding Debt

This fiscal alert serves as a reminder to local educational agencies (LEAs) about required disclosure to lenders, investors, credit rating agencies and credit enhancers (banks and insurance companies). LEAs have a high degree of transparency of financial information based on state-required budget adoption and reviews as well as financial reporting at local public school board meetings and may not realize other parties have a contracted right to receive information updates (disclosure).

Background

When an LEA borrows, the lender or investor and often one or more credit rating agencies and bond insurers perform due diligence to determine the credit quality of the borrowing. Credit quality will influence the costs of issuance, the interest rates and sometimes the repayment structure of a borrowing. While the lender or investor expects the borrower to make all payments on time, many market participants have an interest in current information relating to the value of the debt to the lender or investor.

Some market participants may have been involved in the original borrowing, and have a contracted right to directly receive specified information on particular occasions, and others have a contracted right to receive these updates via published information. This reception often occurs via the Electronic Municipal Market Access (often referred to as "EMMA") website of the Municipal Securities Rulemaking Board (often referred to as "MSRB"), particularly in the case of publicly offered securities. With privately placed securities (which is how many banks lend to LEAs), direct reporting is often required.

Existing Debt

If an LEA has outstanding debt on its balance sheet, ongoing disclosure may be required. The annual independent audit report will detail the LEA's outstanding debt. Examples of debt are as follows:

- Bonds: General obligation (GO) bonds, revenue bonds, special tax bonds, qualified zone academy bonds, Build America bonds, qualified school construction bonds, etc.
- Lease purchase financings including certificates of participation (COPs)
- Loans
- Notes: Bond anticipation notes (BANs), revenue anticipation notes such as tax revenue anticipation notes (TRANs), grant anticipation notes (GANs)

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After identifying existing debt, LEAs should review the underlying contracts agreed to and representations made when the debt was issued. Many statutory requirements regarding the disclosure are identified in the original documentation of the borrowing. If documentation is missing or incomplete, LEAs could check with external parties (external auditor, bond counsel, general counsel, financial advisors, underwriters or lenders) that may have a transcript or files that can be shared.

Borrowings with a transcript likely include a document called "Continuing Disclosure Certificate" that describes the LEA's responsibilities. This should be carefully reviewed to determine the deadlines for providing information, both regularly prepared by the LEA (e.g., an adopted budget or unaudited financial statements) and separately obtained.

The LEA should identify material events that may trigger a special disclosure, usually within 10 business days of occurrence. A material event could be a rating downgrade, a qualified or negative interim report or an annual audit with other than an unmodified opinion. An effective practice is to review the list of material events once a week to determine whether any occurred. A relevant event (i.e., material to timely repayment of debt) may also distract staff from performing such a review (e.g., a global pandemic resulting in an emergency closure of schools) so making this a routine duty promotes compliance. The task should be assigned to a staff member who can complete the review weekly and who will refer any events to the appropriate individual (e.g., the district chief business official, legal counsel). Agreements with credit rating agencies and credit enhancers (such as a bond insurer or a letter of credit provider) should be reviewed to determine their reporting requirements. Securities can be rated or credit enhanced after the issuer has sold them. Unless the LEA has entered into an agreement with these parties, it usually has no obligation to report directly to them, and any inquiries can be directed to EMMA if the LEA is filing disclosure there.

When locating the transcript proves difficult, it may be possible to obtain the official statement (the original disclosure document) from the EMMA website. Finding a particular LEA may require searching under several variations of the entity's name. Once an official statement is located, this document should have a continuing disclosure certificate in one of the appendices.

For borrowings with no transcript (which is often the case with a private placement), it is important to review all documents on file to determine if they include a clause requiring reporting or levying penalties for nonreporting.

COVID-19 Pandemic

For some LEAs, depending on the terms of the outstanding debt and the repayment sources, the COVID-19 pandemic may require a material event notice. The key is whether there is potential impact on the repayment of debt, or an element that affects the value of the securities, such as a credit rating downgrade or a late payment. Some LEAs have had material events to disclose for natural disasters such as fires or flooding. Others that are also affected do not disclose because there is no material impact on the value of outstanding securities.

Additionally, LEAs should review the contents in their certificate(s) of disclosure for information regarding the disclosure of the annual audit. The state of California extended the deadline for the completion of the 2019-20 annual independent audit from December 15, 2020 to March 31, 2021. Certificates may have broad language allowing for the submission of the unaudited financial statements until the audited financial statements become available. If the certificate has no such allowance, an LEA that does not have a completed independent audit for 2019-20 by December 15, 2020 (or such other date provided in the disclosure covenant), may need to file a notice of failure to comply.

Issuing New Debt

The LEA assumes the responsibilities of disclosure at the time of borrowing. Because LEAs often rush to complete financing, they may pay little attention to ongoing disclosure requirements. Many times, an LEA has agreed to more than necessary or has agreed to provide information before it is available. An LEA should carefully review compliance steps at the time of borrowing. If a particular requirement seems onerous, an LEA should discuss its concerns with its financial advisor and bond counsel, and with a disclosure counsel or underwriter if these parties are also engaged. Finally, an LEA should review its debt management policy and update its description of how ongoing disclosure will be addressed as the business processes for compliance are established.

Ongoing Compliance

Once an LEA's ongoing obligations are clear, it may find that many of them are redundant. For example, a common requirement is providing the annual audited financial statements. Compliance could be included in an LEA's budget adoption-and-review cycle and year-end closing activities, with responsibilities assigned to appropriate staff.

When contracting for ongoing compliance services is considered, the LEA should carefully review the terms of the contract and ensure they take advantage of the economies of scale afforded by the common duplication of information for many disclosure purposes. Many LEAs have contracted for the service at high expense, but still retain the liability of reporting the information.

LEAs should be careful about responding to random phone calls or emails requesting information on finances. This communication could be related to insider trading, which is when a market participant tries to gain nonpublic information. The inquiry could be an unrelated private business interest, such as compiling a database, which does not justify an individualized response. In these cases, the LEA may appropriately refer them to the EMMA website.

Failure to Comply

The worst consequence of failure to comply is called an acceleration, which is when the entire borrowing is immediately due (all principal and interest). The original documentation should clearly explain what triggers an acceleration. The second most damaging consequence is when a penalty interest rate is triggered by a compliance failure, and the debt service is adjusted to reflect a higher interest rate. These two consequences can bring about an immediate crisis of affordability, and therefore should be avoided as options in an original borrowing.

A more common consequence is a notification of failure to comply. When failure to comply for publicly offered securities becomes known, the LEA must provide a material event disclosure regarding the failure. In issuing additional publicly offered securities, the LEA will have to disclose any of these failures going back five years. As a result, failures to comply can cause higher interest rates for new borrowings because of an underwriter's perception of lower credit quality.

Conclusion

LEAs should establish a business process for compliance. At the time of borrowing, an LEA should also ensure that ongoing obligations are only those necessary and feasible when it comes to compliance. A compliance process should reflect economies of scale and thoughtful management of disclosure requirements. Steps should be taken to align LEA practice and policy, and this should be revisited a few times as the practice evolves.

This fiscal alert does not constitute legal advice. LEAs should consult with their financial advisor and/or bond counsel for recommendations specific to their unique situation.

Additional Resources

Government Financial Officers Association (GFOA): https://www.gfoa.org/

California Debt and Investment Advisory Commission (CDIAC): https://www.treasurer.ca.gov/cdiac/

Code of Federal Regulations (CFR): https://www.govinfo.gov/app/collection/cfr

Municipal Securities Rulemaking Board (MSRB): http://www.msrb.org/

The United States Securities and Exchange Commission (SEC): https://www.sec.gov/