Leveraging Municipal Bonds For Green Energy Finance

By **Ann Fillingham** (October 12, 2023)


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The U.S. is at a crossroads. If a keen eye looks in the rearview mirror, it will see the responsibility for addressing the deferred maintenance of our historic infrastructure, which is in C-minus condition, according to the most recent report card of the American Society of Civil Engineers.

If that same keen eye peers through the front windshield, it will discern the opportunities and obligations that are upon us with respect to transitioning to more renewable energies, the White House having set a target of 80% renewable energy generation by 2030.

The energy transition alone includes not just understanding and implementing whole new and innovative sources of energy — like offshore wind turbines erected on our outer continental shelf, expanded solar generation and energy storage facilities, and hydro, biomass, biofuel, and geothermal projects — but also upgrading infrastructure as fundamental as our core electrical grid.

We need to ensure the grid's generation interconnectivity, and protect it from the risks of climate change-related weather events, both recently recognized by the Federal Energy Regulatory Commission at its summer meetings, where it also adopted new rules designed to make the grid connection process more efficient. As the saying goes, there can be no transition without transmission.

But successfully meeting these infrastructure challenges will be expensive. The ASCE has estimated the 10-year price tag to upgrade our nation's historic infrastructure at $2.6 trillion. Princeton University's Net-Zero America report estimates a required energy supply-side construction investment of $600 billion by 2030.

Even with the expansion of production and investment tax credits under the Inflation Reduction Act, there is not a limitless pool of tax equity capital for renewables. Success will require coordination and collaboration among commercial finance, public finance, and federal tax credit and subsidy programs in ways that have not always existed historically.

Just as the learning curves of the bankruptcies of Detroit and Puerto Rico showed that public finance lawyers and bankruptcy lawyers rarely used to work together, so too will the infrastructure and energy challenges demonstrate that even within the finance community, the corporate, municipal and tax credit finance lawyers are not yet always adept at partnering.

In order to effectively partner, we first need to understand our fundamental differences as lawyers. The U.S. municipal bond market is highly fragmented and diverse, but, Detroit and Puerto Rico notwithstanding, its 0.1% average five-year default rate is much lower than the 7.2% average five-year default rate of the global corporate finance market, per Moody's.

Both characteristics are the direct result of the municipal market's roots in the U.S. Constitution. The municipal securities market is fundamentally guided by certain inviolate constitutional provisions, beyond its applicable statutory and regulatory parameters. Only by embracing the municipal bond market's distinct core legal framework will we be able to fully leverage its strength.

Public and private entities are both creatures of statute, but states, municipalities and other governmentally created entities derive their authority from federal and state constitutions. Many securities market differences are directly attributable to these constitutional roots. A brief introduction to a few of the most relevant follows.

Federalism

In rejecting England's unitary system, the U.S. Constitution delegated some powers to the national government and protected by the Constitution's principles of supremacy, and other powers reserved exclusively to states. The constitutional tension between these principles of supremacy and federalism — think Jefferson versus Hamilton — was intentional.

Federalism has evolved over time, with strength now existing in large part because of the substantial interdependence of states and the federal government. 10th Amendment threads continue to explain many of the structural differences, however — not just in the legal framework of the municipal and corporate bond markets, but also in totally distinct areas of law, such as corporate and municipal bankruptcies.

For example, under federal bankruptcy law, governmental units cannot liquidate. Only a governmental debtor can commence a Chapter 9 bankruptcy proceeding — its creditors cannot. And it can do so only if authorized by state law — states and federal territories have no authority to commence Chapter 9 proceedings.

Similarly, the municipal debtor, not the bankruptcy court, controls all post-petition operations in a municipal bankruptcy. All of this is counterintuitive to a corporate lawyer, yet entirely logical when viewed through a constitutional lens.

This lens is also helpful in understanding the exemption of municipal securities from registration under the Securities Act and the Securities Exchange Act, as well as their exemption from the Trust Indenture Act. Municipal securities are, however, subject to the antifraud provisions of federal securities laws.

General 10th Amendment case law, and more specific anti-commandeering case law, helps further illuminate the intentional lack of securities law symmetry between the municipal and corporate securities markets. Fundamentally, Congress' power to regulate the two markets is not identical.

Sovereignty and Sovereign Immunity

The existence of state sovereignty affects the structure of the municipal securities market. State sovereignty includes the grant of sovereign powers like legislative, taxation and police powers — the latter derived from the Latin polita, and, in the 18th century, referring to the inherent powers of civil administration, not just law enforcement — all of which cannot be contractually transferred or hypothecated.

The existence of 11th Amendment and general sovereign immunity rights also affect municipal securities. Additionally, the federal government's ability to abrogate these powers and immunities is generally more limited in the governmental context than in the corporate context.

The scope of federal abrogation authority is defined in part by various federal constitutional provisions. The due process, bankruptcy and equal protection clauses frequently trump the 11th Amendment, but that amendment's battle with federal powers under the commerce clause is more balanced.

This interplay results in tangible securities market differences. The general lack of Rule 10b-5 civil remedies in the municipal bond space is one such example.

Structural Diversity of State and Local Governments

The Constitution only required a "republican form of government." States therefore evolved differently structurally — some from colonies, others from federal territories or other states, and a few others even from other sovereign entities.

Some are formally known as states, others as commonwealths. Each has its own independent constitution, legislative structure and unique set of state laws.

Likewise, there is no homogeneity to the municipal securities market. There is no general legislative uniformity. In fact, there are fundamental differences in the power and authority of the same units of government — cities, for example — in different states, including with respect to corporate finance basics like the existence of securitization and monetization authority, the availability of bankruptcy protection, and the scope of statutory lien coverage.

Analyzing a state's constitution and laws to discern a particular governmental unit's approach can be unwieldy, but it is important and is fundamentally intertwined with the very deliberate constitutional definition of federalism that pervades the structure of the municipal securities market.

In short, the structure of the municipal bond market is in part the result of the intentional dual sovereignty envisioned by the framers of the U.S. Constitution. Understanding and embracing this framework is key to the coordination and collaboration among commercial finance, public finance and federal tax credit and subsidy professionals that will be necessary to successfully address upcoming public and energy infrastructure needs.

A variety of public-private partnership approaches will undoubtedly be required. Traditional P3 financings in this country are not yet the norm, in part because they lack the structural uniformity that is available in many other countries. Transactional and market uniformity, however, is not the answer here.

Our unique system has its own real advantages. Recognizing the distinct constitutional nature of individual U.S. states and municipalities is the first step to fully leveraging the power of the municipal securities market to assist in our country's upcoming infrastructure endeavors.

As we collectively undertake our nation's infrastructure challenges — including on the energy side — leveraging all available capital resources will be critical. It is essential for attorneys in this space to understand the different capital stack options, and why they work the way they do.

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