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MEMORANDUM

To: Joseph F. Beach
Montgomery County, Maryland
Director of Finance

Marc P. Hansen
Montgomery County, Maryland
County Solicitor

From: Paul D. Shelton
Carlos J. Santos

Date: November 17, 2015

Re: Legislation Creating New Class A Beer, Wine and Liquor License

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ATTORNEY-CLIENT PRIVILEGED COMMUNICATION

You have asked us to review Bill No. MC3-16 (the "Legislation") and provide you with advice related to its impact, if any, on the outstanding bonds issued as Montgomery County, Maryland Revenue Bonds (Department of Liquor Control) (the "Revenue Bonds"), and the possible reaction of rating agencies and the market to the passage of the proposed Legislation.

Background Statement

Montgomery County, Maryland (the "County") has over $100,000,000 in Revenue Bonds outstanding. Since 2009, the County has continually represented in Official Statements, rating agency presentations, and annual financial disclosures posted on EMMA, that the Revenue Bonds are secured by the net revenues from the sale of alcoholic beverages in the County over which the County exercised a virtual monopoly under state and local laws. The bondholders purchased the Revenue Bonds and the rating agencies rated the Revenue Bonds in reliance on data produced to them by the County, demonstrating the strength and consistency of this pledge. The data produced by the County provided charts and statements setting forth the amount of net revenues deposited annually in the County's General Fund for a five-year period. It is likely that the ratings and the confidence of the bondholders is at least partially based on the evidence of hundreds of millions of dollars generated annually and the legal foundation that creates the near monopoly for the County with respect to the sale of alcoholic beverages in the County. Such a monopoly provides assurance to the bondholders that the generation of net revenues will continue as long as the Revenue Bonds are outstanding and the County maintains its monopoly on the sale of alcoholic beverages. The rating agencies did not provide their ratings on the Revenue Bonds and bondholders have not purchased the Revenue Bonds in reliance on the County's full faith and credit, but rather, on a system that generates hundreds of millions of dollars of net revenues each year.

Resolution No. 16-676 Creates an Irrevocable Pledge of the Net Revenues

The County Council of the County (the "Council") adopted Resolution No. 16-676 on July 29, 2008 (the "Resolution") and in Section 4 of the Resolution created the pledge of the net revenues to pay bondholders. Section 4 reads as follows:

> The County hereby covenants that the timely payment of the principal of and interest on the Bonds issued to finance or refinance the Projects shall be secured equally and ratably by the net revenues of the Department (the "Net Revenues") without priority by reason of number or time of sale or delivery; and the Net Revenues are hereby irrevocably pledged to the timely payment of both principal, premium (if any) and interest on the Bonds issued to finance the Projects as set forth in executive orders of the County Executive passed subsequent to the adoption of this Resolution.

The Council also authorized the County Executive of the County (the "County Executive") to enter into the Trust Agreement (as defined below) and other bond documents in connection with the sale of the Revenue Bonds. Section 6 of the Resolution reads as follows:

> The County Executive may, by executive order or otherwise, approve the form and provisions of, execute and deliver the Bonds, and specify, prescribe, determine, provide for, approve, execute and deliver (where applicable) such other matters, details, forms, documents, or procedures, including (without limitation), bond purchase agreements, lines of credit, liquidity facilities, bond insurance agreements and trust agreements, as are necessary, proper or expedient to consummate the authorization, sale, security, issuance, delivery or payment of or for the Bonds, including (without limitation) prescription of covenants relating to the operation of the Department.

The Council clearly stated its intention to enter into a binding legal agreement with the bondholders to grant them an irrevocable pledge in the Net Revenues as set forth in Section 10 of such Resolution:

> The provisions of this Resolution shall constitute a contract between the County and the holder or holders of the Bonds, and after the issuance of the Bonds no change, variation or alteration of any kind in the provisions of this Resolution shall be made in any manner, except as the County Executive, by executive order or otherwise, shall provide, until such time as the Bonds, and interest due thereon, shall have been satisfied and discharged as provided by the County Executive, by executive order or otherwise, prior to such issuance.
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> The County has agreed not to make any changes in the property right granted to the bondholders in the Net revenues until the Revenue Bonds are satisfied or discharged. If the Legislation or similar legislation is adopted and the County takes actions to materially reduce or eliminate the Net Revenues, bondholders will have a cause of action against the County for breach of contract.

Trust Agreement is a Legal Contract

In reliance on the authority provided in the Resolution, the County Executive issued the Revenue Bonds as special obligations of the County under the provisions of the Trust Agreement between the County and U.S. Bank National Association, as Trustee (the "Trustee"), dated May 1, 2009 (the "Trust Agreement"). The Trust Agreement, like the Resolution, creates contractual obligations of the County. The contractual relationship between the County and the Trustee created under the Trust Agreement is for the benefit of all purchasers of the Revenue Bonds. In accordance with the provisions of the Trust Agreement, the Revenue Bonds are payable solely from the net revenues derived by the Department of Liquor Control from the sale of alcoholic beverages after the required deposit into the working capital reserve fund (the "Working Capital Reserve"). The net revenues remaining after the deposit into the Working Capital Reserve are transferred into the County's General Fund (the "General Fund"). The County has assigned all rights, title and interest in the net revenues deposited into the General Fund to the Trustee. These net revenues are the Pledged Revenues under the Trust Agreement that secure the Revenue Bonds and can only be used in accordance with the Trust Agreement, because as stated above, the County assigned all of its rights, title and interest in the net revenues to the Trustee for the payment of the Revenue Bonds. This assignment and pledge has been in place since 2009 and is binding on the County as long as any Revenue Bonds remain outstanding. Consistent with the Resolution, the Trust Agreement states in the Granting Clauses that the County's assignment of all of its interest in the net revenues is irrevocable except as otherwise provided in the Trust Agreement. The relevant language of the Granting Clauses is as follows:

> NOW, THEREFORE, this Trust Agreement witnesseth, that the County, in consideration of the premises, of the acceptance by the Trustee of the trusts hereby created, of the purchase and acceptance of the Bonds by the Owners thereof, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, in order to secure (i) the payment of the principal of, premium, if any, and interest on the Bonds according to their tenor

> and effect, (ii) to the extent provided herein and in any Supplemental Trust Agreement, the payment of the principal of, premium, if any, and interest on any Additional Bonds, and (iii) the performance and observance by the County of all the covenants herein, express or implied, and in the Bonds, does hereby irrevocably pledge, transfer and assign unto the Trustee under this Trust Agreement and unto its successors in trust and assigns, forever, but as hereinafter provided subject to the rights and privileges reserved and referred to in this Trust Agreement, for the securing of the performance of the obligations of the County hereinafter set forth (the "Trust Estate"):
>
> GRANTING CLAUSE FIRST
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> All right, title and interest of the County in and to the Pledged Revenues[.]

The Trust Agreement is clear that it covers not just the net revenues in 2009 but all future net revenues. Granting Clause Third states in relevant part:

> TO HAVE AND TO HOLD all and singular the Trust Estate, whether now owned or hereafter acquired, unto the Trustee and its respective successors and assigns forever.

The Trust Agreement contains the details of the Revenue Bonds and the contractual arrangement regarding the flow of net revenues that are defined as Pledged Revenues. The County is required to transfer Pledged Revenues to the Trustee on the 25th day of each March, June, September and December to be deposited by the Trustee into the Bond Fund created under the Trust Agreement. If the County fails to make these deposits the bondholders could bring an action against the County for breach of contract. The net revenues must pass through what is commonly called a "water fall" before the County has the right to make use of the Pledged Revenues. This "water fall" is set forth in Section 4.3 of the Trust Agreement:

> (a) On or before the 25th day of each March, June, September and December, beginning on June 25, 2009, the County shall pay or cause to be paid to the Trustee, but only from the Pledged Revenues, amounts sufficient to make at least all of the payments referred to in clauses (i), (ii) and (iii) below, which amounts shall be deposited by the Trustee into the Revenue Fund. On the first day of each January, April, July and October, the Trustee shall transfer amounts in the Revenue Fund as follows:
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> (i) to the Bond Fund, the sum of:
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> (A) one-half (1/2) of the amount of the interest becoming due on the Bonds on the immediately succeeding Interest Payment Date;

(B) one-fourth (1/4) of the amount of any principal of the Bonds Outstanding becoming due on the immediately succeeding April 1;

(C) one-fourth (1/4) of the amount of any Sinking Fund Installment for the Bonds Outstanding becoming due on the immediately succeeding April 1; and

(D) any deficiency in the amount required to be deposited in the Bond Fund in any prior month in accordance with this paragraph;

(ii) to the payment of any fees and expenses of the Trustee then due and any other administrative expenses then due under this Trust Agreement; and

(iii) any remaining amount shall be transferred to the Redemption Fund or the Bond Fund or shall be returned to the County, as the County shall direct in writing.

Section 5.8 of the Trust Agreement Prohibits the County from Disposing of the Pledged Revenues

If the State enacts the Legislation and the County issues the Class A licenses, such that there are no longer Pledged Revenues placed in the General Fund to make the deposits required by Section 4.3 of the Trust Agreement, the Bondholders could bring an action for breach of contract, despite the County locating another source of funds to make the quarterly payments. Section 5.8 of the Trust Agreement prohibits the County from disposing of the Pledged Revenues. The Trust Estate created under the Trust Agreement consists of the rights, title and interest in the Pledged Revenues that the County assigned to the Trustee. The County cannot take actions that would diminish the Trustee's interest in the Pledged Revenues. Setting up a system that diminishes the availability of net revenues for deposit into the General Fund would violate the Trust Agreement. Indeed, Section 5.8 of the Trust Agreement states as follows:

> Except as permitted by this Trust Agreement, the County shall not sell, lease, pledge, assign or otherwise dispose of, and shall neither create nor suffer to remain any lien, encumbrance or charge upon, its interest in the Trust Estate ranking prior to or on a parity with the claim, lien and pledge created by this Trust Agreement as security for the Bonds issued within the limitations of this Trust Agreement. The County from the Pledged Revenues will cause to be discharged, or will make adequate provisions to satisfy and discharge, within 60 days after the same shall accrue, all lawful claims and demands that, if unpaid, might by law become such a lien upon its interest in the Trust Estate, *provided* that nothing contained in this Section shall require the County to pay or cause to be discharged, or make provision for, any such lien, encumbrance or charge so long

> as the validity thereof shall be contested in good faith and by appropriate legal proceedings.

Section 6.1 of the Trust Agreement Would be Violated Even if the Debt Service is Paid from Another Source.

If the State were to enact the Legislation and the County issue the Class A licenses and substantially reduce the amount of net revenues deposited into the General Fund that become Pledged Revenues, but continue to make debt service payments, the Bondholders could argue that the change was a reduction in their security caused by the State ending the monopoly on the sale of alcoholic beverages and the County acting to issue the licenses. As a defense, the County could take the position that it never covenanted that there would be a particular amount of Pledged Revenues, but only that there would be an irrevocable pledge of the net revenues in an amount sufficient to meet the requirements of the Trust Agreement. While one cannot predict with certainty what would happen in litigation, this would not likely be a successful defense for the County's actions because, as stated in the Trust Agreement, the availability of the net revenues was part of the consideration for the bondholders to purchase the Revenue Bonds.

The County has continued to give assurances to the bond market by annually publishing the accounting of the deposits into the General Fund and the existence of the County's monopoly control, to induce bondholders to purchase the Revenue Bonds and continue to have faith in the security for the debt service payments. A total disposal of the source of payments would be a clear breach of the Trust Agreement; what is not clear is what level of reduction in security for the bond payments through the issuance of the new licenses would prompt an action by the bondholders.

Section 6.1 of the Trust Agreement defines "the failure to observe or perform in any material way any covenant, condition, agreement or provision contained in the Bonds or in this Trust Agreement" as a default. The relevant language of Section 6.1 is as follows:

> <u>Events of Default</u>. If any of the following events occur, it is hereby declared to constitute an "Event of Default":
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> * * *
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> (c) The County shall fail to observe or perform in any material way any covenant, condition, agreement or provision contained in the Bonds or in this Trust Agreement on the part of the County to be performed other than those set forth in Section 5.1 hereof, and such failure shall continue for sixty (60) days after written notice specifying such failure and requiring the same to be remedied shall have been given to the County by the Trustee, which notice may be given by the Trustee in its discretion and shall be given by the Trustee at the written request of

> the Owners of not less than twenty-five percent (25%) in aggregate principal amount of all Bonds then Outstanding.

Clearly there is a level of reduction in the net revenues that would be deemed material and create the risk of legal action against the County. Moreover, even if legal action were not instituted by the bondholders themselves, Section 6.1 of the Trust Agreement provides the Trustee with the discretion to given written notice of a default by the County under such Section.

Failure to Meet the Additional Bonds Test will be An Event of Default under the Trust Agreement

The County is required to meet the Additional Bonds test each time it issues Additional Revenue Bonds, which are Revenue Bonds issued after the initial 2009 issuance. In 2011 and 2013, the County provided a certificate that the Pledged Revenues in 2011 and 2013, respectively, were not less than 150% of the Debt Service Requirements of the Revenue Bonds outstanding at that time plus the amount equal to the Maximum Annual Debt Service on the Revenue Bonds issued in 2011 and 2013. As part of the compliance with the Additional Bonds test, the County certified that in 2011 and 2013, respectively, the Pledged Revenues would not be less than 150% of the Maximum Annual Debt Service for all outstanding Revenue Bonds for five years following the 2011 and 2013 issuances. While this was based on estimates, the County remains within the five-year periods for both bond transactions. If the County takes action under any legislation that causes it to fail the Additional Bonds test, the market will react very negatively and the Revenue Bonds will likely be downgraded.

Reduction in Pledged Revenues Caused by the Legislation Could Lead to Bondholder Claims Under the Contracts Clause of the United States Constitution

The Contracts Clause of the United States Constitution (Article I, Section 10, Clause 1) (the “Contracts Clause”) prohibits states from enacting laws that have a retroactive effect of impairing the obligations and rights arising under contracts entered into prior to the enactment of the state law in question. Here, bondholders have entered into a contractual agreement with the County, under the Resolution and the Trust Agreement, to purchase bonds secured by the Pledged Revenues. This right cannot be impaired by the enactment of state legislation.

If the Legislation is passed, making it mandatory for the County to privatize, or take steps to privatize, the sale of alcoholic beverages in the County, the Pledged Revenues will be impacted and reduced significantly, thus impairing the contractual rights of bondholders. As discussed in this Memorandum, the Resolution and the Trust Agreement are legal contracts binding the County to certain contractual obligations pertaining to the Pledged Revenues. These obligations, specifically those located within the Resolution, provide bondholders with security for their Revenue Bonds. In particular, Section 10 of the Resolution demonstrates the County’s intention to enter into a binding legal, contractual agreement with the bondholders. The Resolution, along with the Trust Agreement, creates a contractual structure binding the County to provide the bondholders with security, in the form of the Pledged Revenues. If a bondholder deems the Resolution and the Trust Agreement (based on the benefits the bondholder is promised under the Trust Agreement) to be a binding contract between the County and bondholder, then the passage of the Legislation will impair existing contractual rights between the bondholder and County. This may allow bondholders to bring a claim under the Contracts Clause, to prevent the impairment of their security and rights under the Pledged Revenues created by their contractual agreement with the County. Finally, since the challenge by bondholders is constitutional in nature, bondholders may request and be awarded attorney's fees upon the conclusion of any filed litigation.

The Actions by the State and the County Would Create a Risk to Bondholders

The Official Statements for the 2009, 2011 and 2013 Revenue Bonds contain risk factors that the bondholders should consider in making a decision to purchase Revenue Bonds. Such risks do not include the County deliberately creating competition that would result in a decrease of the Pledged Revenues. We think that the bond market would react negatively to the County creating a risk of payment for its own Revenue Bonds. It is likely that the rating agencies would downgrade the County's Revenue Bonds.

If the General Assembly enacts the legislation and the voters approve it at referendum, even if the County does not issue new licenses immediately, the rating agencies will likely place the Revenue Bonds on negative outlook. The likelihood that the private sector share in the alcoholic beverage market would increase over time and continue to cause reductions in the Pledged Revenues would be the basis for the negative outlook. It would be difficult to convince the rating agencies and the bond market that the County could successfully compete with the private market and maintain substantially the same level of net revenues that have historically been deposited into the General Fund to secure the Revenue Bonds. Upon passage of the Legislation, the rating agencies will request that the County provide financial information on the expected impact on the County's ability to meet the 150% Maximum Annual Debt Service test for all outstanding Revenue Bonds through 2018 and the projected decrease in Pledged Revenues through 2033. If the data shows a material change in the security for the Revenue Bonds, the negative watch will be changed to a downgrade. If the County does not take any corrective actions, the Revenue Bonds could be downgraded to junk bonds.

Avoiding a Downgrade and Legal Actions by the Bondholders

The County has several options that it could consider if it reasonably expects the alcoholic beverage business to become privatized before the final maturity of the Revenue Bonds in 2033. The County could issue general obligation bonds and refund all of the outstanding Revenue Bonds. Since the Revenue Bonds are not callable, the proceeds from the refunding general obligation bonds would need to be placed into an escrow account until the earliest call dates for the Revenue Bonds. This option could be exercised without seeking the approval of the bondholders or rating agencies and would not have any adverse effects on the County's current ratings or standing in the bond market.

The County could amend the Trust Agreement to remove the Pledged Revenues as security for the Revenue Bonds and provide a different source of payment; however this could only be done with the written approval of a majority of the bondholders. The prospect of getting a majority of the bondholders to approve a substitution will partly depend on the quality of the substitute security. The process itself can be time-consuming and could not be accomplished without some costs to the County. Further, there is no assurance that a majority of the bondholders would consent to this change. If the County failed to obtain the consent of a majority of bondholders, it would need to either refund the Revenue Bonds or defend the legal actions that bondholders would likely initiate.

Instead of substituting the security, the County could seek the consent of the bond trustee to amend the Trust Agreement by adding, as a backup, a full faith and credit pledge on the net revenues. This pledge would commit the County to levy taxes to cover any deficiency in the Pledge Revenues. Section 8.1 of the Trust Agreement allows the Trustee, with a favorable opinion of bond counsel, to enter into an amended or supplemented trust agreement without consent of the bondholders. The relevant language of Section 8.1 is as follows:

> (b) This Trust Agreement, the Bonds and the rights and obligations of the County, the Trustee and the Owners hereunder may also be amended or supplemented at any time by an amendment hereof or supplement hereto which shall become binding upon execution without the written consent of any Owners, and (if the amendment or supplement modifies any of the rights or obligations of the Trustee hereunder) with the written consent of the Trustee, only after receipt of a Favorable Opinion of Bond Counsel and only for any one or more of the following purposes:
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> > (i) to add to the conditions, covenants and terms contained herein required to be observed by the County, other conditions covenants and terms thereafter to be observed or performed by the County, or to surrender any right reserved herein to or conferred herein on the County, and which in either case shall not adversely affect the interest of the Owners[.]

If the County could obtain the consent of the Trustee, the County would not need to issue general obligation bonds; however there is no assurance that the trustee would agree to this amendment as it would need to determine that the substitute security would not adversely affect the interest of the bondholders. Also, the County may need to create a sinking fund to meet the additional bonds test if the Pledged Revenues decrease below the required 150% of the Maximum Annual Debt Service for all Revenue Bonds before 2018.

The first option of refunding the Revenue Bonds, would be the most costly for the County, but would be the option received most favorably in the bond market.

If the County could convince the bond market that, despite the passage of the Legislation and approval of the citizens, it would limit the issuance of licenses to private persons so that there would not be a material reduction of the Pledged Revenues, it is possible that the County could avoid a downgrade or legal action by bondholders. In addition, the County will need to convince the bond market that this is not the beginning of a trend towards the eventual privatization of the entire alcoholic beverage market, leaving the bondholders without any security or with materially reduced security while the Revenue Bonds are outstanding.

The County should proceed with caution when supporting legislation that completely or partially leads to a change in the alcoholic beverage market monopoly control that has been the cornerstone of the security for the Revenue Bonds. The risk of legal action against the County and the risk of downgrading will be significant without remedial action by the County such as a refunding of the Revenue Bonds.