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## California to Issue Registered Warrants – Implications for Financial Institutions and the State’s Creditors

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*The State of California is on the verge of issuing registered warrants, or IOUs, to its creditors. These registered warrants will have important implications for financial institutions and entities that do business with the State. This client alert addresses some of the challenges that the issuance of registered warrants will present to State creditors and financial institutions, drawing from the State’s previous experience with registered warrants.*

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The State of California normally pays its obligations with regular warrants issued by the State Controller’s office, which are akin to checks and are payable on presentment to the State Treasurer’s office. The current California budgetary crisis, unless resolved, may cause the State of California to begin, on or shortly after July 2, 2009, to pay its vendors and other entities with “registered warrants.” These registered warrants are not payable on demand, and are essentially “IOUs” from the State that will be repaid when the State has sufficient funds to do so. The issuance of these registered warrants will have important consequences for vendors that do business with the state as well as financial institutions that may be asked to accept such registered warrants as deposits.

This is not the first time that a budgetary crisis has caused the State of California to issue registered warrants instead of regular warrants. Registered warrants were issued during the Great Depression and again in 1992, when a similar budget crisis occurred. For an initial period in the 1992 crisis, many banks and financial institutions were willing to accept (“negotiate”) registered warrants, giving immediate credit to depositors. Some financial institutions, however, refused to accept them or accepted them only conditionally. As the budget crisis continued, several of the larger financial institutions publicly advised that they would no longer accept registered warrants.

The California Attorney General issued an opinion on June 30, 2009 stating that registered warrants issued after July 2, 2009, bearing a maturity date of October 1, 2009,<sup>1</sup> when registered in accordance with Cal. Govt. Code 17200 *et. seq.* are, or will be when so issued, valid and binding obligations of the State. This opinion follows the opinion rendered in 1992 by the California Attorney General to the same effect. Bank of America, Wells Fargo and JPMorganChase have indicated that they will accept registered warrants from existing customers and clients through July 10.

## Issues for Financial Institutions

### Applicability of limits on debt of individual obligors

The OCC, FDIC, FRB and OTS issued an Interagency Position on California Registered Warrants on June 30, 1992 that stated that the federal banking and thrift regulators would consider registered warrants as having the same regulatory characteristics as general obligation bonds issued by the State of California. Thus, the regulators stated that there was no express regulatory limit on a bank's or thrift's investment in such warrants. Additionally, it was stated that the registered warrants would receive the same risk-based capital treatment as general obligation bonds. On July 3, 1992, the California State Banking Department (now the Department of Financial Institutions) issued a bulletin that echoed the Interagency Position, finding that obligation and debt limits contained in California Financial Code Sections 1221 and 1226 (which set limits on the amount of obligations that any one person may owe to a bank at any one time) and Section 1336 (which limited the amount a bank may invest in the securities of any one obligor) were not applicable to registered warrants. Effective January 1, 2009, Section 1336 of the Financial Code was repealed, leaving the cross-reference in Section 1226 to a section that no longer exists. This may call into question the basis for the earlier opinion of the Department. Note, however, that State of California obligations continue to be excluded from the investment limitation of Section 1330 of the Code (limiting the amount invested by a bank in the securities of any one person to no more than 15 percent of shareholders' equity, allowance for loan and lease losses, capital notes and debentures).

At the same time, federal and state regulators counseled caution. The federal regulators noted that "banks and thrifts should exercise prudent judgment in determining whether and the extent to which they should accept" registered warrants. Federal regulators also advised banks to establish policies regarding concentration limitations for such investments based on liquidity and other safety and soundness considerations. The Banking Department similarly noted that the acceptance and holding of registered warrants remained subject to general principles of safety and soundness, including, for example, the avoidance of undue concentrations.

Federal regulators noted in the 1992 Interagency Position that the registered warrants at the time had the same credit quality characteristics of the State's general obligation bonds, which bore a "AA" rating. In 2009, California's overall credit rating has been downgraded by Standard & Poor's to "A," the lowest of all 50 states, and is currently on "negative credit watch," meaning the rating is at risk of a further downgrade.

We understand that the federal bank regulators are considering issuing updated guidance but this has not occurred at this writing.

The decision to accept registered warrants and, if so, under what conditions, should be made by each bank individually and not in conjunction with any other banks or financial institutions.



<sup>1</sup> On July 2, the California Pooled Money Investment Board ruled that registered warrants will have a maturity date of October 2, 2009.

## Implications of registered warrants as “negotiable instruments” and the midnight deadline return rule

In 1992, the Federal Reserve was of the opinion that the expedited funds availability rules of Regulation CC normally applicable to checks do not apply to registered warrants. However, the Federal Reserve held the view that the midnight deadline return rules of the Commercial Code are applicable to registered warrants because registered warrants are considered “negotiable instruments” under California Government Code Section 17205. Therefore, financial institutions that decide to accept registered warrants as deposits should have internal controls in place to assess the validity and authenticity of registered warrants.

Additionally, if a bank decides to accept registered warrants as deposits, it must be careful to only accept registered warrants that have not been endorsed by the payee in favor of the State. Such endorsed registered warrants may essentially be used to pay the payee’s tax bill to the State as described below. If a registered warrant has been endorsed, then the interest due on that registered warrant will not be paid upon redemption of the registered warrant.<sup>2</sup>

## Other Considerations


### Tax treatment of interest

For federal income tax purposes, section 103 of the Internal Revenue Code provides generally that gross income does not include interest on any eligible state or local bond or obligation. Under section 149(a) of the Internal Revenue Code such interest is not exempt unless the bond or obligation is in registered form. Despite their name, the registered warrants are not in registered form for these purposes. However, the registered form requirement does not apply to bonds or other obligations that have a maturity of not more than one year.

In Announcement 92-111, the Internal Revenue Service determined that registered warrants issued by California in 1992 were “obligations” of the State of California under section 103(c)(1) of the Internal Revenue Code, and that they qualified for the section 149(a)(2)(B) exception to the registered form requirement because they were obligations that had a maturity of not more than one year. The IRS stated that so long as the warrants satisfied the other applicable requirements for tax-exempt obligations, the interest on the warrants would be excludable from gross income under section 103 of the Internal Revenue Code.

In making this determination, the IRS relied on the fact that California planned to redeem all the registered warrants in substantially less than one year and in most cases within one to four months. Registered warrants issued by California on or after July 27, 1992 contained a legend to the effect that California would redeem those warrants within one year from the date of issuance.

According to the California State Controller, registered warrants to be issued at this time will have a maturity date of October 1, 2009 printed on the warrant. However, under State law and as acknowledged by the Controller, registered warrants will only be redeemed at that time if there is sufficient cash in the State of California General Fund to do so. In 1992, there was little doubt that California would make good on its redemption obligations. The situation today, given the weakness of the California economy and severity of the budget crisis relative to 1992, may be different. If there is the possibility that registered warrants may not be redeemed for more than one year, the IRS may revisit its 1992 determination regarding the tax-exempt status of registered warrants.

 <sup>2</sup> The interest rate on the registered warrants has been set by the California Pooled Money Investment Board at 3.75%.

### Payment of taxes with registered warrants

One option for holders of registered warrants is to use these warrants to pay their California state income and franchise taxes. California Government Code Sections 17280.1 and 17280.2 provide that if a check for payment of State income or franchise taxes is accompanied by a copy of a registered warrant in the amount of the check, then that check will not be deposited until the registered warrant is redeemed. In this way, the registered warrant serves as payment of the taxpayer's franchise or income tax obligations.

Several issues have yet to be resolved with regard to such tax payments. First, it remains to be seen whether taxpayers who are required to pay by electronic funds (EFT) will be penalized for submitting a registered warrant for payment of tax. Additionally, it is unclear whether registered warrants issued in the name of the taxpayer's affiliate may be tendered by the taxpayer. The California Franchise Tax Board (FTB) has indicated that it plans to issue guidance in the form of FAQs on the FTB's website within the next few days. As of this writing, neither the State Board of Equalization (SBE) nor the Employment Development Department (EDD) have issued any formal guidance regarding their policies on accepting registered warrants for payment of taxes other than franchise and income taxes (e.g., sales and payroll taxes).<sup>3</sup>

### Options for vendors that do business with the State

Vendors that do business with the State are likely to find that they will be paid with registered warrants. However, the State has some 1,100 "special funds," distinct from the General Fund, and State law requires that regular warrants be used to pay obligations of approximately 500 of those funds. Therefore, payees should examine whether they have a basis to insist that the State pay them with regular warrants. Other vendors that do business with the State may be able to claim additional penalties under the California Prompt Payment Act ("CPPA"). The CPPA, at California Government Code Section 927.1(a)(1), provides that "[a] state agency that acquires property or services pursuant to a contract with a business [...] shall make payment to the person or business on the date required by the contract and as required by Section 927.4 or be subject to a late payment penalty." California Government Code Section 927.4 provides that "[e]xcept as otherwise provided in this chapter, to avoid late payment penalties, the maximum time from state agency receipt of an undisputed invoice to issuance of a warrant for payment is 45 calendar days, including not more than 30 calendar days from the state agency to submit a correct claim schedule to the Controller, and not more than 15 calendar days for the Controller to issue the warrant." Vendors may be able to argue that payment by registered warrant subjects the State to a late payment penalty under the CPPA. Conceivably, the penalty will be in addition to the interest component that is included in registered warrants. Vendors should be cautioned not to treat receipt of registered warrants as a "breach" of contract as would entitle them to cease performance of a state contract. Many state contracts require continued performance in the presence of disputes and so a vendor that repudiates a contract for non-performance could be exposed to default consequences.

<sup>3</sup> Informal comments by the SBE indicate that it is reviewing the IOU situation. Last July, when the state was operating without a budget, the SBE issued a notice saying it would give certain state creditors extensions on paying sales tax and waive certain fees. An SBE spokesperson has stated that the state likely will grant a similar extension and waive late-payment penalties if California issues registered warrants this year. However, as of the date of this writing, no formal statement has been forthcoming from the SBE. Legislation (AB 1506, Anderson) is pending that would allow registered warrants to be used to pay any obligation owed to the State.

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