

CHAPTER 7

FINANCE

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7:1 PURPOSE

This chapter of the Drain Commissioners Procedure and Practices Manual is intended to provide the Drain Commissioner and members of the Drain Commissioner's office staff with basic information about financing of the drain projects in Michigan. The chapter will define and discuss all currently known possibilities for financing drain work. The chapter will provide guidance in: evaluating the various financing alternatives available; the federal tax considerations; hiring a Financial Advisor and Bond Counsel; the timing considerations of project financing; evaluating the possibility of federal, state or local grants; working with the State revolving fund for financing projects; issuing drain orders; the issuance of bonds and notes and other financing alternatives. This chapter will be the Drain Commissioner's one-stop-shopping place for learning about financing public projects through the drain office.

7:2 DEFINITIONS

The following general definitions currently apply to the methods of financing a public project:

Grants: Currently (2001) there are very few, if any, grant programs available to finance public project through the drain office. However, the definition of a grant is money received from the federal and/or state and/or local government(s) and is used to pay project costs. There is usually not a requirement to repay any portion of the money, as long as the funds have been spent in the appropriate fashion and the required documentation is provided to the granting government.

Notes: Generally speaking a note is a short-term obligation, less than five years. The drain office may sell notes to finance projects. Specifically the Drain Code in Sections 434, 479 and 531 speaks of selling a note to pay project costs. The note may pledge the full faith and credit of the drainage district.

Bonds: Bonds issued to finance a project are long term obligations, more than five years.

Drain Orders: Drain orders are like post-dated checks issued by the Drain Commissioner to pay a contractor for work performed on a drain. Payments are made over time...say three years. These would be called "three year drain orders". They are presented to the County Treasurer for cashing, as example, 1/3 of construction costs upon completion of the work, 1/3 a year later and the final 1/3 the next year.

State Revolving Fund: The Michigan Department of Treasury, through the Michigan Municipal Bond Authority operates the Clean Water Assistance Revolving Loan Fund, more commonly known as the "State Revolving Fund". The fund was established in 1988 when the US Congress under Title VI of the Clean Water Act eliminated the Construction Grants program.

7:3 GENERAL CONSIDERATIONS

7:3.1 Selecting Financing Alternatives

In all but the most extreme situations, the financing alternative is not a mystery. The nature of the project, the location of the project and/or the size of the project will force the decision in one direction or the appropriate alternative. Bond Counsel and Financial Advisor can provide all the answers to any question a drain office may have about which section of the code or which statute should be used to finance a project.

7:3.2 Federal Tax Considerations

Borrowing money means someone or something (a bank) is going to earn interest on the money lent to the drain office to pay for the project. In almost all cases, that interest earned is exempt from federal, state and local taxes. Sometimes the interest is not exempt. Bond counsel will be able to provide the experience and knowledge to make a determination as to the tax-exemption of the interest.

7:3.3 Hiring Public Finance Professionals

(1) Bond Counsel

In almost all situations where it is necessary to finance a project through the use of borrowed money, regardless of whether notes or bonds are used, the drain office will need the assistance of a bond counsel firm to prepare the appropriate documents. One of the services, if not the most important service the bond counsel renders, is to issue the opinion of tax exemption. This opinion assures that, if certain conditions are met, then, at that moment in time, the interest earned by the holder of the note or bond is exempt from federal, state and local taxes. Bond Counsel also provides the knowledge of the drain code and the appropriate section of the code to be used for the financing, assuming the code allows for the financing in the first place.

(2) Financial Advisor

In certain circumstances it is necessary to hire a Financial Advisor to assist the drain office in financing a project. There are rules that the Michigan Department of Treasury has concerning the issuance of bonds and notes. Not all notes issued by the Drain Code are subject to Treasury rules. Specifically if the borrowing is a bond issue in excess of \$1,000,000 or a note issue in excess of \$5,000,000, the issue must be rated by a national rating agency. Also the Securities and Exchange Commission requires all borrowings in excess of \$1,000,000 to have an "Official Statement" produced in connection with the borrowing. The Official

Statement is a document that discloses information about the County and any local unit involved with the project, to those investors that may be interested in buying the bonds or notes. The Financial Advisor on behalf of the drain office prepares the Official Statement and handles the relations with the rating agency.

(3) Timing Considerations

For the purposes of this manual, timing will be taken to mean when should the drain office complete the financing and obtain the money. The actual act of getting the money to pay the contractors working on a drain office project is the last step in the process. The drain office will have made a determination as to the project's necessity; bond counsel (and the Financial Advisor) will have assisted in the determination of the appropriate financing statute; working with the independent engineer or the drain office staff, the Financial Advisor will have completed cash flow studies to assure there is sufficient revenue to pay the debt service. The engineer will have provided a time line of the project and recommended when to start construction. Ideally the financing should be completed so the funds are in the bank when the start-work order is given to the contractor.

7:4 GRANTS

Grants are funds made available from federal, state governmental units or their agencies to local governmental units to assist in defraying part of the cost of constructing projects with no requirements for repayments. As of December, 2000, the only grant programs available for drain, storm and sanitary sewer projects, all of which can be financed under the Drain Code, are through the Federal Emergency Management Agency (FEMA).

Between 1972 and 1994, Federal grants were available for storm, sanitary and drain projects through the United States EPA, pursuant to the Clean Water Act, commonly known as Public Law 92-500. Beginning in 1987, these grants were phased out and the United States Congress through the USEPA continued to provide funding to the states, provided they established a Revolving Fund. Each year, congress appropriates an amount for the Program, which is then allocated amongst the various states. To receive federal funds, the state must contribute one dollar in matching funds for each five dollars given by the Federal Government. In response to the change in the federal funding, the State of Michigan, in 1988, enacted Public Act 317, the Clean Water Assistance Act, and established the State Revolving Fund ("SRF").

While the present SRF program are not grants, it provides low interest financing to assist “qualified” municipalities that have documented water quality needs. Under the SRF Program the Michigan Department Of Environmental Quality (“DEQ”) and the Michigan Municipal Bond Authority (“MMBA”) jointly administer the SRF Program. Each agency lends its expertise for the efficient operation of the program.

In order to qualify for funding, a project must go through a prequalification and project prioritization by the DEQ in order to determine its eligibility for the program. Once projects are determined to be eligible, they are prioritized by the DEQ and funding is then based upon the amount of funds available to the DEQ for that fiscal year.

Projects which wish to consider the SRF Funding Program, should contact:

Thomas Kappinen
Chief Municipal Facilities Section
Michigan Department of Environmental Quality
Telephone Number (517) 373-2161

7:5 REVOLVING FUND

7:5.1 Established by County Board of Commissioners under the Drain Code

Chapter 12 of the Drain Code, Section 280.301 through 280.307, provides the procedures for establishing of a Revolving Fund for a Drain. The Revolving Fund is created by action of the County Board of Commissioners (“the Board”). Each year, in October, the Board may appropriate and collect, by the levy of general ad valorem property taxes on all taxable property within the County, an amount the Board deems necessary for the creation a Revolving Drain Fund.

7:5.2 Purpose and use

The Revolving Fund is then used to pay the costs of engineering, surveying and establishing and laying out of a Drainage District and all other expenses necessary to pay any and all of the services for the establishment of a Drainage District to the date of letting the Drain Contract, including paying for members of Boards of Determination for services provided under the Drain Code, repairs to established drains and for paying drain orders.

Drain Orders (defined in Section 7:6) are then issued by the Drain Commissioner payable out of the Revolving Fund to pay for the eligible services. **Drain Orders may only be issued upon the performance of the services.**

7:5.3 Reimbursement

Section 280.303, prescribes the accounting and reimbursement procedures of the Revolving Fund. Briefly stated, the Drain Commissioner is responsible for maintaining separate records for **each** Drainage district that draws upon the Revolving Fund. In other words, the Drain Commissioner must maintain separate “sub-accounts” within the overall Revolving Fund. Upon the levy and collection of the taxes assessed upon the benefited properties with each Drainage District, the Revolving Fund is replenished and thus can be used for future Districts.

Section 280.304, sets forth the depository requirement for the Revolving fund and states that all interest accruing to the Revolving Fund becomes part of the Revolving Fund and must be allocated to the appropriate Drainage District sub-accounts.

Section 280.306, addresses the expenditure and apportionment of costs for projects that have not been completed within five years, subsequent to the Drain Commissioner’s order, designating a Drainage District or for the entering of the first order of determination. If this were to occur, the Drain Commissioner shall report to the County Board of Commissioners such event and, in its (the Board’s) sole discretion, the County Board of Commissioners may order the sum to be spread against the property of the original petitioners according to such percentage as the Drain Commissioner shall deem just and equitable, based on the benefit theory, as if the improvement had been completed. If the sum is large enough, in the opinion of the County Board of Commissioners, to create undo hardship on the original petitioners, the Board may order the roll to be spread over such designated district and the Drain Commissioner shall apportion the cost thereof to the party benefiting the District as provided in Chapter 7 of the Drain Code.

Section 280.307, addresses the apportionment and cost and recovery of funds as described above for an Inter-county Drain project.

7:6 DRAIN ORDERS

7:6.1 Authority

Drain Orders are authorized in Chapter 10 of the Drain Code, specifically Sections 280.244 and 280.245

7:6.2 Use and limitations

Drain Orders are basically a promissory note to pay the provider of services to a Drainage District, a certain amount, at a stated interest rate, at a date not sooner than the 15th day of April, nor later than the 1st day of August in the year on which the drain taxes (assessments on benefited properties or installments of assessments) are due. Each Drain Order is drawn on the particular drain fund that received services. The Drain Commissioner shall not issue Drain Orders which are payable in any one year for an amount larger than that year's assessments against benefited properties in the particular Drainage District. If bonds are issued to pay the cost of the drain, then the Drain Order(s) shall be paid out of Bond Proceeds.

Section 280.245, sets forth the form and substance of Drain Orders, as well as the accounting required for the Drain Order.

In recent years Drain Orders are seldom used for the payment of services rendered. Most projects are financed either pursuant to Sections 280.434 or under the bonding provisions of the Drain Code.

7:7 NOTES AND BONDS

There are three principal areas of concern with respect to the legal requirements that relate to the issuance of notes and bonds under the Drain Code:

1. Validity of notes and bonds under state law;
2. Federal tax requirements applicable to notes and bonds; and
3. Securities law requirements applicable to notes and bonds.

7:7.1 Validity of Notes and Bonds under State Law

1. Michigan law requires specific authority for borrowing. There is no implied power to borrow. The authority for drainage districts to borrow is found in the Drain Code.
 - a. For drainage districts constructing/improving drains under Chapters 4, 6 and 8, notes may be issued under Section 434 and bonds may be issued under Section 275.
 - b. For drainage districts constructing/improving drains under Chapter 20, notes may be issued under Section 434 or 479 and bonds may be issued under Section 476.
 - c. For drainage districts constructing/improving drains under Chapter 21, notes may be issued under Section 434 or 531 and bonds may be issued under Section 528.

2. Notes and bonds for drain projects under Chapters 4, 6 and 8.
 - a. *Security.* The principal security for notes or bonds issued to finance drain projects under Chapters 4, 6 and 8 is special assessments (drain taxes) levied by the Drain Commissioner against benefiting lands and public corporations in the drainage district. The assessments are levied on the basis of benefit derived. Assessments against a county and the State of Michigan are permitted for benefits to county and state highways, respectively. Assessments against cities, villages and townships at large are permitted for reasons of benefit to public health, convenience or welfare or to any highway under control of the city, village or township. Special assessments levied by the Drain Commissioner are due December 1st of each year and if not paid by February 14th are reported as delinquent and collected in the same manner as other delinquent taxes. If the County Treasurer issues notes in anticipation of the collection of delinquent taxes, all delinquent special assessments will be paid when the County Treasurer receives the note proceeds (generally in May or June).
 - b. *Pledge of full faith and credit.* A County Board of Commissioners may pledge the county's full faith and credit as additional and secondary security for notes or bonds. The risk of nonpayment of the notes and bonds is diminished if the County Treasurer issues delinquent tax notes as described above. As a result of the Headlee Amendment to Michigan Constitution (Article 9, Section 6), in the absence of a favorable vote of the county's electors, the ability of a county to levy taxes to satisfy its full faith and credit pledge is subject to constitutional and statutory limitations on the taxing power of the county. This is known as a limited tax general obligation ("LTGO"), where the county is required to pay debt service on the notes or bonds as a "first budget obligation" in the event the assessments against property and public corporations are insufficient to pay the debt service.
 - c. *Bonds issued under Section 275.* Bonds issued under Section 275 must be approved by Michigan Department of Treasury ("MDOT") and, subject to certain exceptions discussed below, sold at a public sale following published notice in a newspaper approved by MDOT (i.e., Detroit Legal News or Bond Buyer). The bonds are payable in annual installments equal to number of drain tax installments, must mature between March 1st and June 1st following the due dates of such installments, and can have a term not to exceed 20 years (30 years in the case of a closed drain

any part of whose cross section has an area exceeding 60 square feet). Normally it will be necessary to capitalize one year's interest on the bonds. The county treasurer holds and invests the bond proceeds until needed for the drain project. The Drain Commissioner generally pledges the full faith and credit of the drainage district to the bonds, and the County Board of Commissioners, by a majority vote of its members elect, may pledge the full faith and credit of county to the bonds.

d. *Notes issued under Section 434.* For notes issued under Section 434, there is no requirement for MDOT approval if the principal amount is \$300,000 or less; the Drain Commissioner can therefore negotiate a sale to a local bank or other purchaser. Section 434 notes can be structured like a bond issue. Depending on negotiations with purchaser, if interest is payable annually, the Drain Commissioner normally will need to capitalize only six months' interest. In addition, the Drain Commissioner may pledge the full faith and credit of the drainage district to the notes. Section 434 notes may be payable out of drain assessments made against public corporations at large or against lands in the drainage district, or out of drain orders, notes or bonds issued by the drainage district or any other available funds. In addition, the County Board of Commissioners, by a 2/3 vote of its members elect, may pledge the full faith and credit of the county to the notes.

3. Notes and bonds for drain projects under Chapter 20

a. *Security.* The principal security for notes or bonds issued to finance drain projects under Chapter 20 is special assessments assessed by a statutory drainage board (consisting of the Drain Commissioner, the Chairperson of the Board of Commissioners and the Chairperson of the Finance Committee of the Board of Commissioners) against public corporations at large. The county and the State of Michigan may be assessed at large for benefits to county and state highways, respectively. A city, village or township has flexibility in managing its indebtedness to the drainage board and may use more than one revenue source to pay its assessment - e.g. taxes, special assessments and/or user fees. If a city, village or township wishes to specially assess all or any part of its drain assessment against benefiting lands, the governing body must comply with the notice and hearing requirements of Section 489a of the Drain Code before filing a petition with the Drain Commissioner.

Obligation), once approved, results in the issuance of an order providing an exception from prior approval. The latter is an expedited process requiring payment of a \$400 fee (\$100 if the issue is less than \$500,000) and requires MDOT action (approval or disapproval) within 10 days of filing.

- b. *Rating.* Bond issues of \$1,000,000 or more must be rated by a nationally recognized rating agency (e.g. Moody's Investor Services, Inc., Standard & Poor's Ratings Group) unless waived by the State Treasurer or sold to a government agency.
- c. *Public sale.* Generally, notes or bonds subject to the Municipal Finance Act must be sold at a public sale following at least seven (7) days published notice in an authorized newspaper (Bond Buyer, Detroit Legal News), except where
 - the principal amount thereof is less than \$100,000;
 - the obligation is payable prior to maturity at the option of the holder;
 - the obligation is for the purpose of refunding or advance refunding;
 - the obligation is sold to a government agency (e.g. Rural Development);
 - the obligations appreciate in principal amount or are to be sold at a discount in excess of 10%;
 - a private sale is otherwise provided by law; or
 - the issue is for \$12,000,000 or more (and the private sale is only available upon a waiver of public sale by the State Treasurer).
- d. *Official statement.* The official statement for the notes or bonds may not be mailed or distributed before the issuance by MDOT of an order of approval or an order providing exception from prior approval.

7:7.2 Federal Tax Requirements Applicable to Notes and Bonds

The requirements of federal income tax law applicable to the issuance of notes and bonds under the Drain Code are found in Sections 103 and 141-150 of Internal Revenue Code of 1986 ("Code").

1. Arbitrage (Section 148 of the Code). In general terms, arbitrage is the difference between what a drainage district earns on the investment of note or bond proceeds (or moneys deemed to be note or bond proceeds) and what a drainage district would earn from similar investments at the true interest cost (yield) on the notes or bonds. Assuming that the drainage district has certain expectations at the time the notes or bonds are issued, note or

bond proceeds can be invested for temporary periods without regard to yield restriction: original proceeds are three (3) years; and bona fide debt service funds are 13 months.

- a. *Rebate.* In general, all arbitrage profits earned by a drainage district must be rebated to the federal government at periodic intervals. There are some exceptions to this rule. The first is the small issuer exception, which provides that a small issuer with general taxing powers is exempt from rebate, so long as the issuer, together with its subordinate entities, issues no more than \$5,000,000 of tax-exempt obligations in any calendar year. Under certain circumstances, a county may allocate all or a portion of this \$5,000,000 limit to a drainage district. There are also spending exceptions to the rebate rules: (i) six (6) month - all proceeds must be spent within six (6) months of the issue date; (ii) 18 month – proceeds must be spent as follows: 15% within 6 months of the issue date, 60% within one year of the issue date, and 100% (subject to certain de minimis exceptions) within 18 months of the issue date; and (iii) two years - applies to so-called construction bonds (at least 75% of proceeds must be used for construction) the proceeds of which must be spent as follows: 10% within 6 months of the issue date, 45% with 1 year of the issue date, 75% with 18 months of the issue date, and 100% (subject to certain de minimis exceptions) within two years of the issue date.
 - b. *Reimbursement rules.* These rules affect the ability of drainage districts to use note or bond proceeds to reimburse prior expenditures. In order to be able to reimburse prior expenditures from note or bond proceeds, a drainage district must declare, no later than 60 days after the date on which the expenditure is made, a reasonable intent to reimburse the expenditures with proceeds of a borrowing: a drainage district may not use note or bond proceeds to reimburse an expenditure after the date which is the later of one year after the expenditure was paid or one year after property was placed in service. The expenditure to be reimbursed must be a capital expenditure and cannot be used for working capital items. There is a special exception (limited to 20% of the note or bond issue) for preliminary expenses for architectural, engineering, surveying, soil testing, etc. The official intent requirement does not apply to such preliminary expenses.
2. Information reporting requirements (Section 149(e) of Code). For note or bond issues of \$100,000 or more, drainage districts must file an IRS Form 8038-G with IRS no later than

the 45th day of the calendar quarter following the calendar quarter in which the notes or bonds were issued. For note or bond issues of less than \$100,000, issuer must file a consolidated information reporting statement (IRS form 8038-GC) on each February 15th covering all such notes and bonds issued during the preceding calendar year. There is a procedure for late filing set forth in Rev. Proc. 88-10.

3. Qualified tax-exempt obligations ("QTEO's") (Section 265(b)(3) of the Code). The designation of notes or bonds as QTEO's enables a bank to deduct a portion of interest expense allocable to purchasing or carrying such notes or bonds and generally results in lowest possible interest rate on notes or bonds to the drainage district. In order to designate notes or bonds as QTEOs, a drainage district at time of issuance must reasonably anticipate that it (and, if the county has pledged its full faith and credit to the notes or bonds, the county and its subordinate entities) will not issue more than \$10,000,000 of tax-exempt notes or bonds in the then current calendar year.

7:7.3 Securities Law Requirements Applicable to Notes and Bonds

1. SEC Rule 15c2-12

- a. *Initial offering requirements.* Although intended to regulate underwriter conduct, the initial offering requirements of the rule has the effect of requiring a drainage district to prepare an official statement for all note and bond issues of \$1,000,000 or more. The requirements are as follows:
 - (1) Prior to the time the underwriters bid for, purchase, offer or sell the securities, to obtain and review copies of official statements deemed final by a drainage district of the securities, except for the omission of specified information, such as offering prices, interest rates, selling compensation, aggregate principal amount, principal amount per maturity delivery dates, other information required by an issuer of such securities to be specified in a competitive bid, ratings and identity of the underwriters;
 - (2) In non-competitive offerings, until a final official statement is available, to mail or deliver upon request to any potential customer the most recent preliminary official statement, if any, no later than the next business day;
 - (3) To contract with issuers of the securities, or with their agents, to obtain final official statements within seven business days in sufficient quantities to comply

with the provisions of Rule 15c2-12 and any other rules established by the Municipal Securities Rulemaking Board; and

- (4) From the time the final official statement becomes available and for at least 25 days and up to 90 days following the end of the underwriting period, to mail or deliver copies of the final official statement to potential customers upon request no later than the next business day. The shorter 25-day period applies if the official statement is available to any person from a nationally recognized municipal securities information repository.

b. *Continuing Disclosure Requirements.* The continuing disclosure requirements of Rule 15c2-12 are intended to improve the quality of disclosure in the secondary marketplace so that adequate information is available to investors to assist them in making an informed decision to purchase notes or bonds in the secondary market. The continuing disclosure rules apply to note and bond issues of \$1,000,000 or more and, while purporting to regulate underwrite conduct, impose indirectly new requirements on drainage districts and counties. The continuing disclosure rules, which became effective on July 3, 1995, may be summarized as follows:

- (1) An underwriter is prohibited from purchasing or selling municipal securities in connection with a new offering of municipal securities unless the underwriter has reasonably determined that an issuer of municipal securities or an obligated person for whom financial or operating data is presented in the final official statement has undertaken in a written agreement or contract to provide either directly or indirectly through an agent:
 - i. Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement to each NRMSIR and to the appropriate state information depository so designated by the SEC (a "SID");
 - ii. If not submitted as part of the information described in (i) above, audited financial statements for each obligated person to each NRMSIR and the appropriate SID when and if available;
 - iii. In a timely manner, to each NRMSIR or the MSRB and to the appropriate SID, notice of any of the following events which are material:

- Principal and interest payment delinquencies;
 - Non-payment related defaults;
 - Unscheduled draws on debt service reserves reflecting financial difficulties;
 - Unscheduled draws on credit enhancements reflecting financial difficulties;
 - Substitution of credit or liquidity providers, or their failure to perform;
 - Adverse tax opinions or events affecting the tax-exempt status of the securities;
 - Modifications to rights of security holders;
 - Bond calls;
 - Defeasances;
 - Release, substitution or sale of property securing repayment of the securities; and
 - Rating changes.
- iv. In a timely manner, to each NRMSIR or the MSRB and the appropriate SID, notice of failure to provide the required financial information described in (i) above on or before the date specified in the written agreement or contract.

As used in the continuing disclosure rules, "obligated person" means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund or account of such person committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities. An obligated person does not include providers of municipal bond insurance, letters of credit or other liquidity facilities, but would include, in cases of notes or bonds issued by a drainage district, any county that has pledged its full faith and credit to such notes or bonds.

Small issuer exception. If each obligated person for an issue of municipal securities will not, after the issuance of such securities, be an obligated person for more than \$10,000,000 in aggregate amount of outstanding municipal

securities, then the undertaking may be more limited than described above. Obligated persons qualifying for the small issuer exception must agree in their undertaking to provide (1) upon request to any person or at least annually to the appropriate SID, financial information or operating data, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available and (2) in a timely manner, to each NRMSIR or the MSRB and to the appropriate SID, notice of any of the events described in (c) above that are material.

2. Accuracy of disclosure. A drainage district is primarily and ultimately responsible for the content of its disclosure documents and may be held liable under the antifraud provisions of the securities laws for misleading disclosure. The Government Finance Officers Association, in January 1991, published revised Disclosure Guidelines, which contains recommendations as to the format and content of disclosure documents. The guidelines give guidance with regard to disclosure involving the original offering of securities, continuing disclosure of current information to secondary municipal markets, and procedures to be followed in supplying information to existing and potential investors. While the guidelines state that they are not intended to create disclosure requirements or a legal obligation to provide any or all items of information, they do recommend careful adherence to their provisions. The goal of the guidelines regarding disclosure in original offerings is to "provide a complete, accurate and objective description of all relevant factors to enable a reasonable investor to make an informed investment decision."

7:8 OTHER FINANCING ALTERNATIVES

- Cross reference to the chapter discussing "other statutes"
- Act 185, P.A. of 1957, as amended
- Act 342, P.A. of 1939, as amended