



National Association of Health and Educational Facilities Finance Authorities

Tax-Exempt 501(c)(3) Bonds 101

Basic Concepts

What is a Municipal Bond?

- A debt instrument issued by a governmental or quasi-governmental issuer.
- To issue a bond is to borrow money. A bond is the evidence of the debt.
- A bond typically specifies: (1) an obligation to pay, (2) a stated amount (the “principal”), (3) at a given time (the “maturity”), (4) with interest at a stated rate or stated interest rate formula.
- Structure and security for the bond may vary. For example: general obligation bonds, limited obligation bonds, bonds with one maturity, bonds with multiple maturities, fixed rate bonds and variable rate bonds.
- Municipal bonds must be issued by a governmental or quasi-governmental issuer. The issuer can be almost any governmental entity or an authority created by state statute. There are two primary types of bonds issued:
 - Governmental Bonds – issued to provide funding for governmental projects (water, sewer, etc.); and
 - Conduit Bonds – issued in order to loan the bond proceeds to a third party authorized by law to use municipal bond proceeds (e.g. municipal bonds issued to provide funds for a tax-exempt university or tax-exempt hospital).

Basic Concepts

Why Use Tax-Exempt Bonds?

- Tax-exempt bonds benefit from federal (and sometimes state) income tax-exemption on the interest earned on the bonds.
- Investors will buy tax-exempt bonds at a lower interest rate than a taxable bond on which they would have to pay federal (and state) income tax on interest.
- The issuer (or conduit borrower) will therefore have a lower interest rate to pay on its debt.
- This interest savings is viewed as a federal subsidy by the federal government; tax policy includes certain limits on the subsidy.

Tax Law Basics

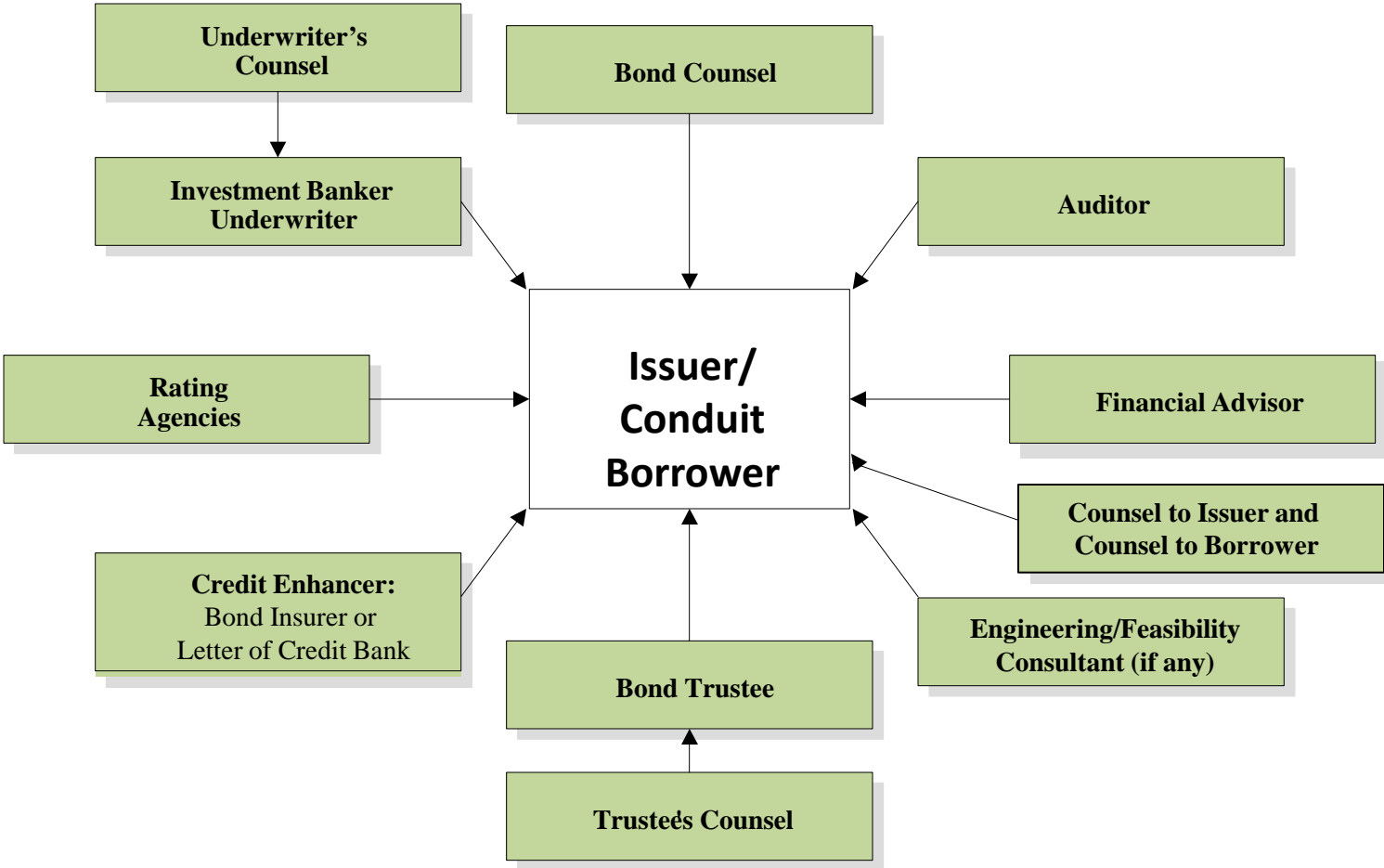
- Bonds will be tax-exempt only if the financing is for a permitted qualified private activity bond purpose and other general private activity limitations and rules are met.
- Qualified 501(c)(3) bonds are a category of qualified private activity bonds (IRC Section 145).
- 95% test – a private activity bond is not a “qualified” bond unless at least 95% of the bond proceeds are used to finance or refinance a permissible project for the tax-exempt entity.
- Working capital and costs of issuing the bonds are NOT qualified costs.

Basic Concepts

Requirements for Qualified 501(c)(3) Bonds

- Financing resolution – issuer (or conduit borrower) must execute a valid official resolution that authorizes expenditures to be financed by the bonds.
- TEFRA notice and hearing process – bonds must be subject of public notice, a public hearing and public approval
- 2% limit on costs of issuance – only 2% of bond proceeds can be used to pay the costs of issuing the bonds (payments for qualified guarantees not subject to limit, treated as additional interest).
- Maturity limitation – average maturity of the bonds must not exceed 120% of the reasonably weighted expected useful life of the facilities being financed by the bonds.
- Arbitrage restrictions – no additional benefit from exploitation of the difference between interest rates on municipal debt and the often higher rates on investments.
- Arbitrage – when borrowing in one market (tax-exempt) and investing in a different market (taxable) at a higher rate, the spread earned is arbitrage profit.
- Basic rule – an issuer may be permitted to earn arbitrage but probably will not be permitted to keep it. Required to rebate 90% of amount every 5 years, 100% when bonds are fully retired or redeemed.

Bond Participants



Bond Participants

Bond Counsel

- Drafts bond documents that reflect the structure of the transaction.
- Delivers an unqualified legal opinion that the bonds are validly issued and binding, tax-exempt and in compliance with all laws governing the issuance of debt.

Issuer

- An Authority created by state statute; acts as a conduit.
- Conduit Borrower is the entity borrowing the bond proceeds and responsible for debt service.

Issuer's Counsel

- Reviews all legal documents on behalf of the Issuer; represents the interests of the issuer.
- Provides disclosure about the issuer in the offering document.
- Delivers a written legal opinion relating to the power of the issuer to issue the bonds.

Bond Participants

Borrower

- Creates and approves financing terms and documents and selects financing team members.
- Responsible for repayment of debt.
- Provides data and responsible for accuracy of the Offering Statement (i.e. Prospectus, Official Statement, Private Placement Memorandum).
- Responsible for complying with terms and covenants in financing documents, including post-closing tax law compliance.

Borrower's Counsel

- Assists in drafting Offering Statement and additional disclosure documents, and opines as to accuracy.
- Reviews all legal documents on behalf of Borrower; represents the legal interests of the borrower.
- Delivers a written legal opinion concerning the organization's corporate powers and the disclosure on the organization contained in the offering document.

Bond Participants

Financial Advisor

- Issuer makes a decision to include a Financial Advisor on some or all bond transactions.
- Borrower makes a decision to include a Financial Advisor representing their interests, not a participant on every bond transaction.
- Investment bank or financial advisory firm acting on behalf of the Issuer and/or Borrower.
- Advises Borrower on wide range of financial management issues; may be issue/debt management specific or ongoing.
- Assists Borrower during the Underwriter selection process.
- Acts on behalf of Borrower in financing process; role overlaps with Investment Banker.
- Reviews pricing and advises Borrower on fairness of rates and fees.

Underwriter

- Primary role is to sell the bonds. Responsible for developing the plan of financing, credit rating process and leading pricing and marketing efforts.
- Prepares presentations for rating agencies and credit enhancers (bond insurer or letter of credit bank) or , directs investor pre-sale bond marketing efforts, sets interest rates and offering terms of the bonds, accepts orders from investors and underwriters and commits capital to underwrite unsold bonds.
- Responsible for ensuring commitment of borrower to comply with ongoing disclosure requirements.

Bond Participants

Underwriters' Counsel

- Primary responsibility is drafting the offering document; represents the Underwriter.
- Advises and opines on matters relating to the Offering Statement, including matters relating to disclosure under SEC regulations and other standards; principal role in drafting Offering Statement.
- Prepares underwriting documents – Blue Sky Survey, Legal Investment Memorandum, Agreement Among Underwriters, Selling Group Agreement and the Bond Purchase Contract.
- Responsible for participating in “due diligence” before the bond issue is offered to investors.

Auditor

- Provides most recent annual Audited Financial Statements for inclusion in the Offering Statement to:
 - Present Conduit Borrower’s financial condition and historical performance; and
 - Facilitate year-to-year comparisons of financial information.
- Prepares “stub period” income statement for partial year after latest annual audit.
- Provides the “Cold Comfort” letter, or Statement of Agreed Upon Procedures.

Bond Participants

Engineering/Feasibility Consultant, if applicable

- Performs study covering new project construction, projected sales and peak demand, comparative retail and industrial rates, and competitive conditions
- Forecasts financial results.
- Opines on viability of a new project or system.

Insurer/Guarantor

- Bond insurance company, financial services company or bank may be used to provide credit enhancement.
 - Municipal Bond Insurance – repayment of debt service upon a default
 - Surety Policy – satisfy requirements of debt service reserve fund, pays debt service if needed
 - Letter of Credit – credit enhancement and liquidity
- Decision to utilize credit enhancement is primarily a financial decision (minimize effective interest cost), but must also consider covenants demanded by credit enhancer.

Bond Participants

Rating Agencies

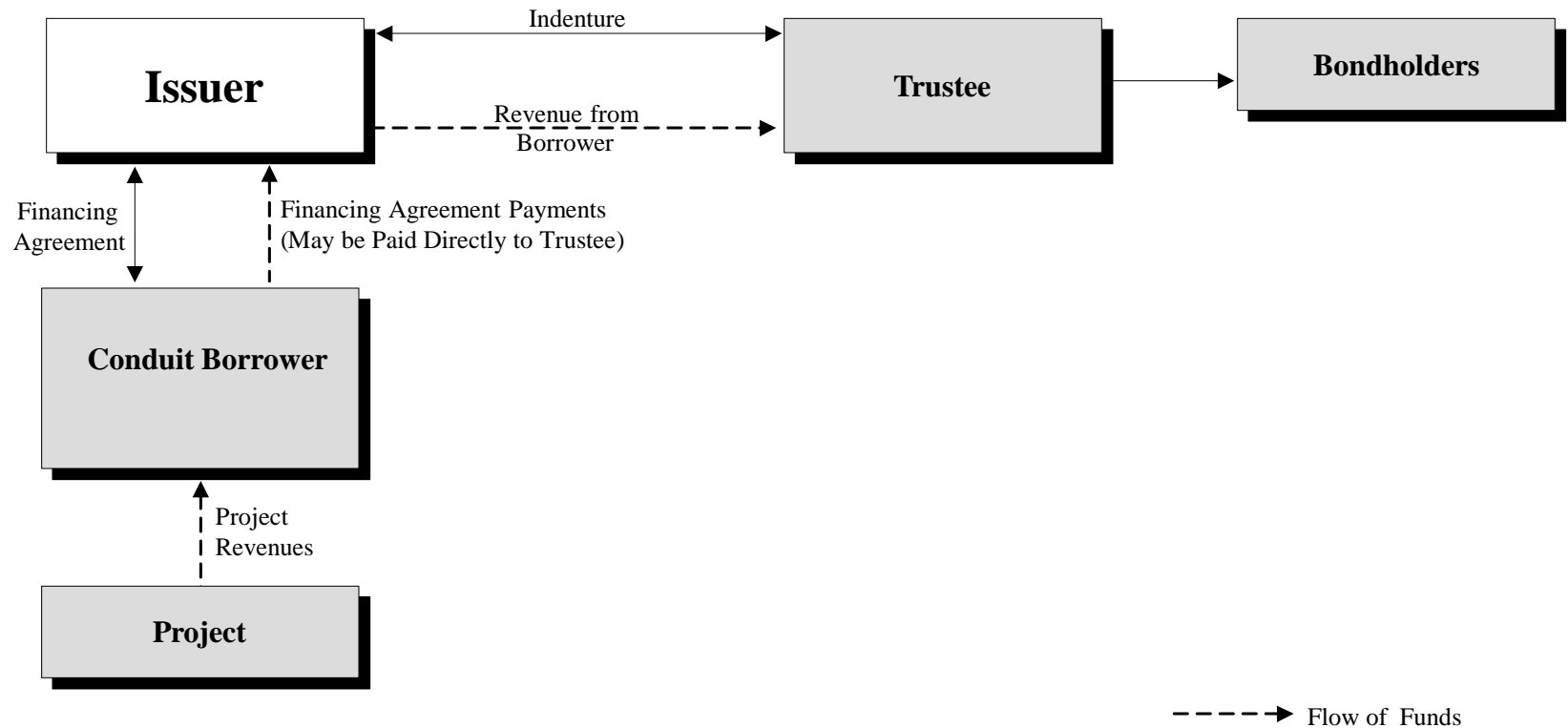
- National organizations that provide ratings on debt of public and private organizations:
 - Standard & Poor's Corporation
 - Moody's Investors Service, Inc.
 - Fitch Investors Service, Inc.
- Authoritative sources that assess a borrower's ability to repay.
- Ratings have direct impact on cost of money.

Bond Trustee

- Acts in a fiduciary capacity for the benefit of bondholders in enforcing terms of the bonds.
- Manages Trustee-held bond funds, reserves and construction funds.
- Receives interest and principal payments from Issuer/Borrower and distributes to Bondholders.
- Serves as Bond Registrar and Transfer Agent.
- Holds liens and security interests and exercises remedies for bondholders in the event of a default.

Types of Financings

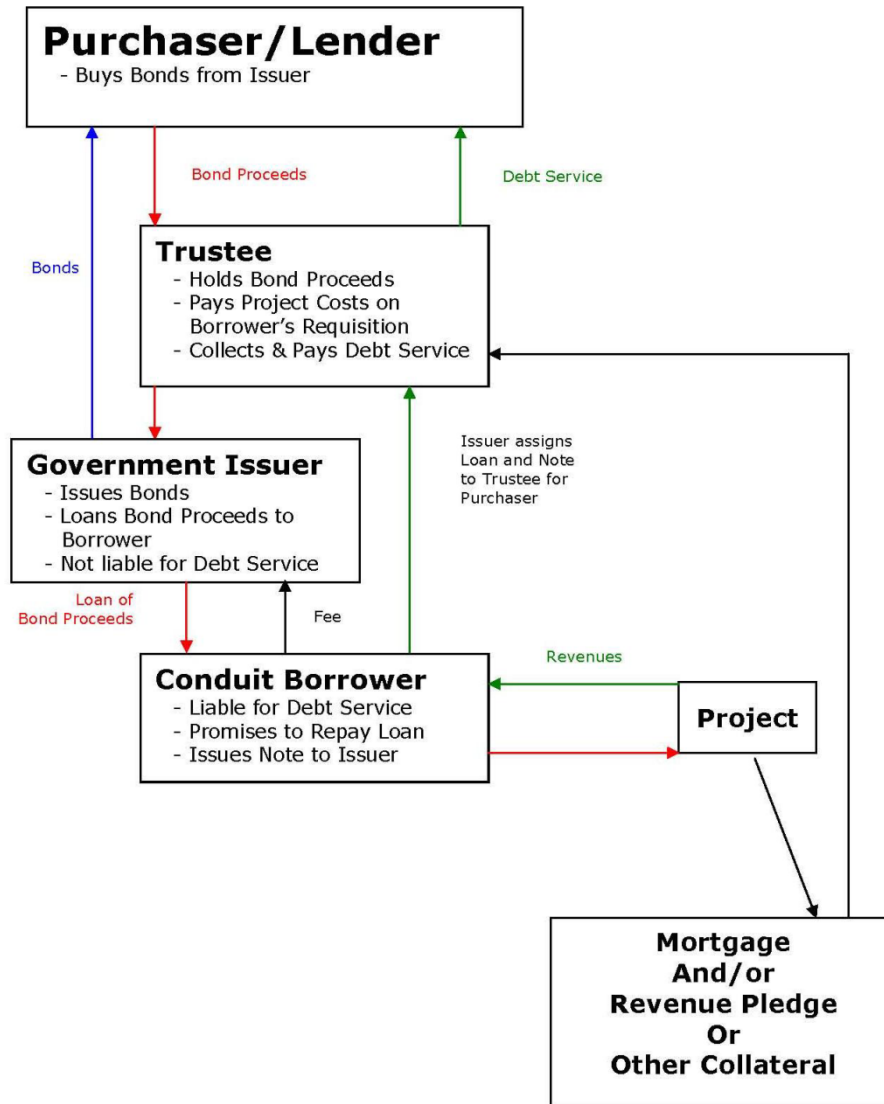
Project Financed by Issuer but Constructed and Operated by Conduit Borrower



Types of Financings

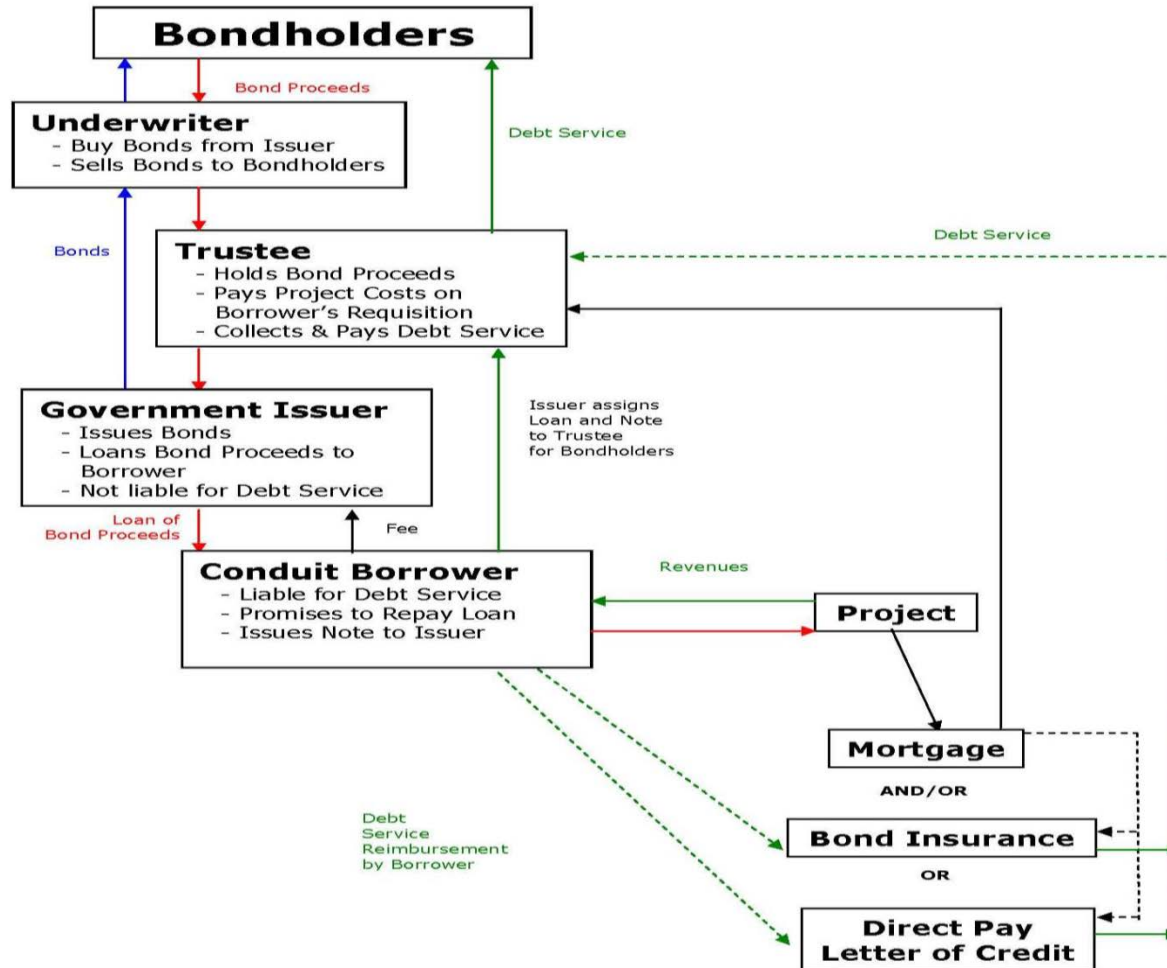
Direct Purchase Bonds

(May not have Trustee involved)



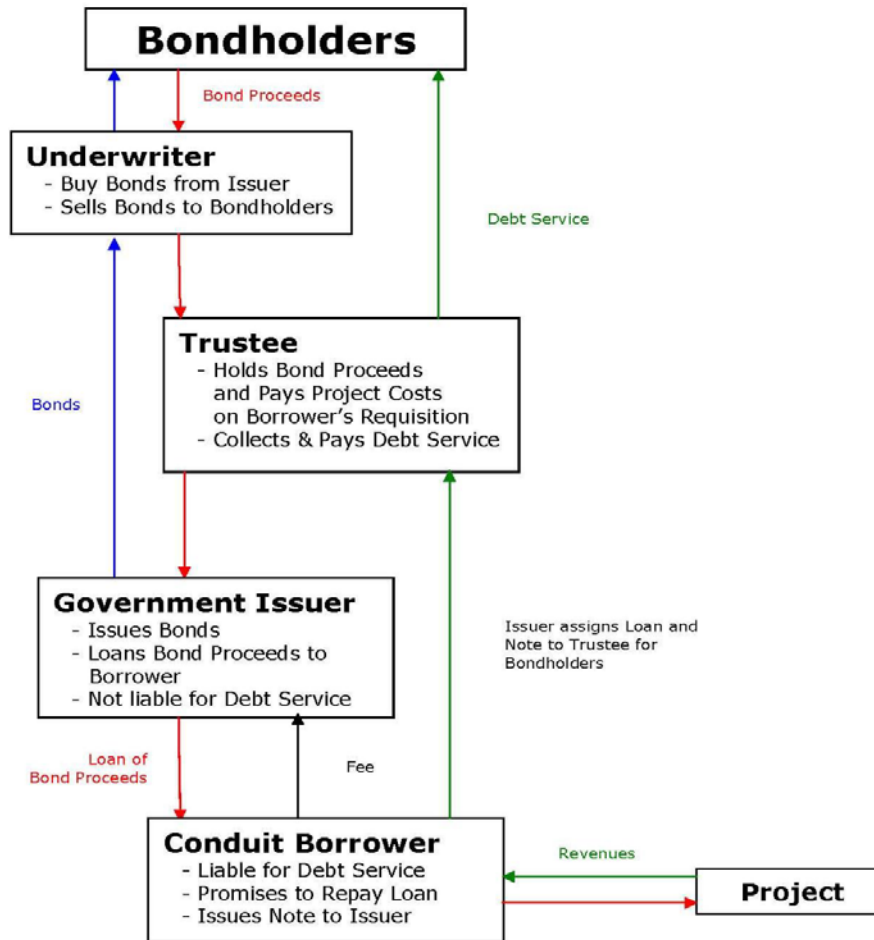
Types of Financings

Credit Enhanced Public Offering



Types of Financings

Unenhanced Public Offering



Key Documents

Authorizing Resolution

- Governing board of the conduit borrower authorizes the sale of debt through a resolution.

Bond Resolution

- Governing board of the conduit issuer authorizes the issuance of the Bonds and execution and delivery of the legal documents and distribution of an Official Statement, if part of the transaction. The resolution will state the general terms of the financing, such as the size of debt (limited to a not-to-exceed amount), the maximum interest cost allowable and the legal basis for the debt.

Trust Indenture

- Bonds are issued pursuant to an indenture between the Issuer and the Trustee. The Trustee holds the bond proceeds until requisitioned for the project, plus the debt service reserve fund and the bond repayment fund.

Loan Agreement

- Bond proceeds are loaned to the conduit borrower pursuant to a loan agreement between the conduit borrower and the issuer. Sets out the terms of repayment and security for the loan.
- The issuer assigns most of its rights to the trustee as security for the Bonds pursuant to the Indenture.

Key Documents

Bond Purchase Agreement

- Bonds are sold by the Issuer to an underwriter in a public offering pursuant to a bond purchase agreement between the Issuer and underwriter, which is approved by the borrower, for resale to investors in the tax exempt market.

Official Statement

- The disclosure document used in public offering tax-exempt bond financings. It describes the Bonds and contains the information material to bond investors in deciding whether or not to purchase the Bonds.
- The Borrower will be responsible for certifying that the portion of the Official Statement pertaining to it meets the federal securities laws standard of not containing any misstatement of material fact or omitting to state any material fact necessary to make the statements contained therein, in light of the circumstances under which made, not misleading.

Tax Certificate

- A document executed by the [issuer](#) of [tax-exempt](#) or other federally tax-advantaged [bonds](#) at the time of initial [issuance](#) certifying as to various matters relating to compliance with federal income tax laws and regulations, including arbitrage rules.

Timing of a Bond Transaction

- Selection of financing team (Underwriter, Placement Agent, Direct Lender, Credit Enhancer, Bond Counsel, Borrower's Counsel, Issuer, Trustee, Financial Advisor).
- Determination of financing structure (public offering, direct purchase, security, covenants, credit enhancement).
- Borrower may adopt a reimbursement resolution.
- Initial drafts of documents circulated (e.g. Indenture, Loan Agreement, Preliminary Official Statement, Bond Purchase Contract).
- Due Diligence.
- Draft documents submitted to rating agencies, bond insurers, bank credit enhancement providers or bank purchasers.
- Borrower board approval.
- TEFRA hearing and approval.
- Issuer board approval.
- Underwriter prints the Preliminary Official Statement in a public offering.
- Marketing of the Bonds.
- Pricing of the Bonds.

Timing of a Bond Transaction

- Sale of the Bonds and execution of the Bond Purchase Contract.
- Closing – delivery of the Bonds to the Underwriter or Lender in exchange for purchase price, simultaneously with delivery of final executed copies of the legal documents, and various certificates, receipts and opinions.
- Post-Closing – reporting required under financing documents, continuing disclosure, arbitrage rebate.
- A typical Bond issue for a 501(c)(3) corporation takes approximately 90 - 120 days from start to finish.

Cost of Financing

The Underwriting Discount Components

- Average Takedown
- Management Fee
- Underwriting Fee
- Expenses of Underwriters
 - Underwriters' Counsel
 - Blue Sky Qualification
 - Federal Funds/Day Loan
 - Regulatory Fees (MSRB, PSA)
 - Wire/Communications Costs (Dalcomp)
 - Out-of-pocket

Issuer/Conduit Borrower Expenses

- Bond Counsel
- Issuer Counsel
- Trustee
- Auditors
- Feasibility Consultants
- Printing
- Insurance or Credit Enhancement
- Financial Advisor
- Travel, etc.
- Borrower Counsel



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