

Reviewing Bond Offering and Legal Documents

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Review of POS and Bond Legal Documents

- Municipal analysts are often responsible for their own document review.
- The starting point for this review is usually a preliminary official statement (a “POS”).
- Certain provisions of the underlying bond legal documents will be discussed in the body of the POS.
- A “summary” of certain provisions of the bond legal documents, or sometimes, copies of the bond legal documents themselves, may be attached to the POS as an appendix.
- Any “summary” attached as an appendix is not really a summary, and is prepared by bond counsel by copying selected provisions from the bond legal documents and making only technical changes (e.g., use of defined terms in a manner consistent with the rest of the POS).
- Municipal analysts and investors may request copies of, and review the underlying legal documents, if they are not otherwise attached to the POS.

Categories of Bonds to Review

- Governmental Bonds (Bonds issued for governmental use/purposes)
 - General Obligation (“GO”) Bonds
 - Revenue Bonds
 - Nonappropriation deals (e.g., COPs)
- Conduit Revenue Bonds (Bonds issued for conduit borrower use/purposes)
 - 501(c)(3) organizations
 - Health care organizations
 - Educational institutions
 - For-profit entities
 - Exempt facility bonds (e.g., multifamily housing, solid waste disposal, etc.)
 - Qualified small issue bonds for manufacturing facilities

General Obligation Bonds

- Recent events, including the Detroit bankruptcy case, are causing municipal market participants to reexamine assumptions they may hold about general obligation bonds of local governments.
- In reviewing documents relating to a general obligation bond of a local government, the first question that should be asked is whether the bond is:
 - An unlimited tax general obligation bond, supported by ad valorem property taxes, unlimited as to rate or amount, levied by an issuer on all property within its territorial limits and taxable by it.
 - A limited tax general obligation bond, supported by ad valorem property taxes, levied by an issuer on all property within its territorial limits and taxable by it, subject to a limitation on the tax rate, or the aggregate tax that can be levied.
 - Supported only by a general fund pledge, not any ad valorem taxing power.

General Obligation Bonds (Cont'd)

- General obligation bonds may be supported by:
 - A “full faith and credit” pledge and/or
 - A pledge of a taxing power.
- Full Faith and Credit
 - MSRB Glossary defines this as a term normally used in connection with general obligation bonds to express the commitment of the issuer to repay the bonds from all legally funds, including a good faith commitment to use its legal powers to raise revenues to pay the bonds.
 - If a GO bond is backed by the issuer’s full faith and credit, which funds (e.g., the general fund, or only unrestricted funds) are pledged?
 - Is there a statutory first budget priority to pay debt service?

General Obligation Bonds (Cont'd)

- Pledge of a taxing power
 - Which taxes are pledged for repayment?
 - Are there limits as to rate or amount of the pledged taxes?
 - If so, consider whether the current rates or amounts imposed are at or close to the cap.
 - Are additional taxes being specifically levied for the payment of the debt service on the bonds being reviewed?
 - If so, was voter approval or other approval needed for such additional taxes and, if needed, was such approval obtained?
 - Were the additional taxes levied at rates or amounts in excess of otherwise applicable limits?

General Obligation Bonds (Cont'd)

- Pledge of a taxing power (Cont'd)
 - If additional taxes may need to be levied in the future to pay debt service on the bonds being reviewed, is the issuer's power to raise taxes conditioned upon the approval of another governmental entity?
 - Are tax collections for debt services required to be segregated from other general fund revenues and used only to pay debt service?
 - Is there a statutory lien on certain revenue?
 - Is there a contractual security interest in certain revenue? Is this security interest perfected by statute or are UCC methods of perfection (e.g., filing, possession) required?

General Obligation Bonds (Cont'd)

- Remedies: Under applicable state law, what remedies are available to enforce a tax pledge?
 - Writ of mandamus
 - Appointment of receiver
 - State intercept program (What is the trigger and who decides?)
- Chapter 9 bankruptcy
 - Is the issuer authorized to file a Chapter 9 bankruptcy case?
 - If the authorization to file is subject to certain conditions, what are those conditions?

Governmental Revenue Bonds

- Security and Source(s) of Payment
 - Review the definition of “revenues” being pledged as security.
 - “Gross” revenue pledge or “net” revenue pledge? Does it matter?
Practically, operating expenses must be paid or “revenues” will dry up.
 - Perfection of the pledge (i.e., validity of the pledge against other creditors of the issue) typically occurs pursuant to the bond statute without further action. Validity of the pledge should be addressed in the form of bond counsel’s approving opinion that is attached to the POS as an appendix.
 - Is debt service on the bonds payable solely from pledged revenues, or is the issuer authorized to use other funds to pay debt service?
 - Security for payment and source(s) of payment can be different.

Governmental Revenue Bonds (Cont'd)

- Security and Source(s) of Payment (Cont'd)
 - Application of Revenues (“waterfall”)
 - Review how revenues are to be applied once collected.
 - If operating expenses are required to be paid before debt service, then what may initially appear to be a “gross” revenue pledge is in substance a “net” revenue pledge.
 - Are pledged revenues required to be deposited with the trustee upon an event of default (automatically or at the trustee’s request)?
 - Do the trustee or bondholders have any control over payment of operating expenses from the lockbox?
- Protection of Revenues
 - Review covenants limiting liens on Revenues and on the Revenue-producing assets and sale or transfer of the Revenue-producing assets.

Governmental Revenue Bonds (Cont'd)

- Rate covenant
 - Is the denominator actual annual debt service or maximum annual debt service (“MADS”)?
 - Review “smoothing” provisions in denominator definition (e.g., balloon debt, variable rate debt, derivative obligations).
 - Review provisions in numerator definition that eliminate non-cash items (e.g., unrealized gains and losses on investments, unrealized change in value of derivative agreements).
 - Is the sole remedy for a violation a consultant call-in? If not, under what circumstances can failure to comply with the rate covenant result in an event of default?
- Additional Bonds/Debt
 - Review tests for incurrence of additional bonds/debt that may be secured with a parity or subordinate lien on pledged revenue.
 - May derivative obligations (e.g., interest rate swap obligations) be secured with a parity or subordinate lien on pledged revenues? Is parity lien treatment limited to regularly scheduled payments, or does it include termination amounts? Is a pledge of cash or securities to secure derivative obligations a permitted lien?

Governmental Revenue Bonds (Cont'd)

- Debt service reserve fund
 - Parity fund for all bonds or dedicated fund for a particular series of bonds?
 - Any specific provisions for resizing (e.g., upon a refunding, etc.)?
 - How funded? Cash or surety bond? Under what conditions can a surety bond be substituted for cash? Under what conditions can the issuer be required to replace a surety?
- Accounting
 - Are financial statements required to be prepared in accordance with GAAP?
 - Are rate covenant definitions required to be computed in accordance with GAAP?

Governmental Revenue Bonds (Cont'd)

- Exercise of remedies/voting
 - Confirm that exercise of remedies is based on voting by holders of all parity bonds.
- Amendments to bond documents
 - Confirm that amendments generally require approval by holders of at least a majority of parity bonds.
 - Confirm that certain fundamental changes (e.g., extension of maturity of principal or interest, reduction in principal amount or rate of interest, etc.) require approval by all affected holders or all holders.
- Defeasance
 - Review scope of obligations permitted to be used for defeasance.

Nonappropriation deals

- Contractual Obligation
 - Source of payment of the security described in the POS (e.g., certificates of participation (“COPs”), limited obligation bonds (“LOBs”)) is payments made by a governmental entity pursuant to a contractual obligation, e.g., a lease, an installment financing agreement.
 - What is the source of payment of the underlying contractual obligation? All funds legally available to the governmental entity?
- Nonappropriation
 - The contractual obligation of the governmental entity is usually subject to annual appropriation.
- Nonrecourse
 - There is usually no recourse to the governmental entity upon an event of default, i.e., the sole remedy is to foreclose on any real property (e.g., land, buildings) or personal property (e.g., equipment) pledged as collateral.

Nonappropriation deals (Cont'd)

- Collateral
 - If real property is being pledged, a mortgage/deed of trust will be recorded. Is a lender's title insurance policy insuring the mortgage being obtained?
 - If personal property is being pledged, is the pledge subject to Article 9 of the Uniform Commercial Code? If so, confirm that UCC financing statements to perfect the security interest are being filed.
 - Review provisions regarding release/substitution of collateral and permitted liens on collateral.
- Other issues
 - Like governmental revenue bonds, review provisions relating to additional bonds, exercise of remedies/voting, amendments and defeasance.

Conduit Revenue Bonds

- Security and Source of Payment
 - There are two levels of analysis.
 - The bonds will be limited obligations of the conduit issuer, payable solely from the “revenues” pledged by the conduit issuer. The “revenues” pledged by the conduit issuer will be the loan (or lease) payments made by the conduit borrower (lessee), not revenues from the bond-financed property.
 - The ultimate source of payment is the payments made by the conduit borrower (lessee) pursuant to the conduit loan (lease) agreement. Usually, the borrower’s obligation to make these payments is a general obligation of the borrower, payable from all available funds.
 - The borrower’s obligation to make loan (lease) payments may be secured by a pledge of personal property or real property.

Conduit Revenue Bonds (Cont'd)

- Security and Source of Payment (Cont'd)
 - Any pledge of personal property by a borrower is subject to, and must be perfected pursuant to, Article 9 of the Uniform Commercial Code.
 - For example, the borrower may pledge its “revenues” as security for its obligations to make the loan (or lease) payments that are pledged as security for the bonds; however, Article 9 of the UCC does not contain provisions for revenue pledges. Confirm that the definition of “revenues” being pledged by the borrower includes key Article 9 terms such as “accounts” and “general intangibles.”
 - Confirm that UCC financing statements will be filed to perfect security interests in personal property pledged by the borrower.
 - If real property is being pledged, a mortgage/deed of trust will be recorded. Is a lender’s title insurance policy insuring the mortgage being obtained?

Conduit Revenue Bonds (Cont'd)

- Use of Master Indentures
 - In some conduit revenue bond deals, particularly health care deals, the borrower may enter into a master indenture, which is intended to be the superstructure for all of its borrowings, in addition to the conduit loan (or lease) agreement for the bond issue being reviewed. A master indenture can serve three purposes: (1) to create a common pool of collateral to secure all of a borrower's financings, (2) to create a common set of covenants for all of a borrower's financings, and (3) to create a credit group (an "obligated group") that is jointly and severally liable for all obligations issued under the master indenture. If a master indenture is used, the borrower will pledge collateral to the master trustee.
 - A bond indenture that contains provisions for issuance of additional parity bonds is also, in substance, a "master indenture."
 - Some master indentures contain replacement master indenture provisions to facilitate mergers and acquisitions.

Conduit Revenue Bonds (Cont'd)

- Application of Revenues (“waterfall”)
 - Highly rated conduit borrowers will not be required to deposit pledged revenues into a revenue fund.
 - Lower rated or start-up conduit borrowers may be required to deposit pledged revenues into a revenue fund.
 - Review how revenues are to be applied once collected.
 - Are operating expenses required to be paid before debt service?
 - Are pledged revenues required to be deposited with the trustee upon an event of default (automatically or at the trustee’s request)?
 - Do the trustee or bondholders have any control over payment of operating expenses from the lockbox?

Conduit Revenue Bonds (Cont'd)

- Rate covenant
 - Is the denominator actual annual debt service or maximum annual debt service (“MADS”)?
 - Review “smoothing” provisions in denominator definition (e.g., balloon debt, variable rate debt, derivative obligations).
 - Review provisions in numerator definition that eliminate non-cash items (e.g., unrealized gains and losses on investments, unrealized change in value of derivative agreements).
 - Is the sole remedy for a violation a consultant call-in? If not, under what circumstances can failure to comply with the rate covenant result in an event of default?
- Additional Bonds/Debt
 - Review tests for incurrence of additional bonds/debt that may be secured with a parity or subordinate lien on pledged revenue.
 - May derivative obligations (e.g., interest rate swap obligations) be secured with a parity or subordinate lien on pledged revenues? Is parity lien treatment limited to regularly scheduled payments, or does it include termination amounts? Is a pledge of cash or securities to secure derivative obligations a permitted lien?

Conduit Revenue Bonds (Cont'd)

- Debt service reserve fund
 - Dedicated fund for the particular series of bonds being reviewed or a parity fund for multiple series of bonds under a master indenture/bond indenture with additional bond provisions?
 - Any specific provisions for resizing (e.g., upon a refunding, etc.)?
 - How funded? Cash or surety bond? Under what conditions can a surety bond be substituted for cash? Under what conditions can the issuer be required to replace a surety?

Conduit Revenue Bonds (Cont'd)

- Exercise of remedies/voting
 - Note any differences in voting rights under the bond indenture versus the master indenture. Holders of the bonds being reviewed may be able to force acceleration of their bonds under the bond indenture, but may not have the votes to force acceleration and exercise of remedies (e.g., foreclosure of collateral) under the master indenture.
- Amendments to bond documents
 - Confirm that amendments generally require approval by holders of at least a majority of bonds/master obligations. Again, bondholders may not have the votes to cause or prevent amendments to the master indenture.
 - Confirm that certain fundamental changes (e.g., extension of maturity of principal or interest, reduction in principal amount or rate of interest, etc.) require approval by all affected holders or all holders. Note, however, that some documents may now permit these changes after an event of default if at least two-thirds of affected holders consent, which mirrors the class voting requirement in Chapter 11 cases.

Conduit Revenue Bonds (Cont'd)

- Defeasance
 - Review scope of obligations permitted to be used for defeasance.
- Bankruptcy considerations
 - 501(c)(3) and for-profit borrowers will be eligible to file a Chapter 11 reorganization case.
 - Creditors cannot file an involuntary bankruptcy petition against a 501(c)(3) borrower.
 - In Chapter 11, 501(c)(3) borrowers may be able to confirm a plan of reorganization under which unsecured creditors are not paid in full even though the board retains control of the organization post-confirmation (i.e., the absolute priority rule may not apply to retention of control of a charitable nonprofit organization).

Questions?

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