Conduit Financing With Tax-Exempt Bonds

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Introduction

Conduit financing has a specific meaning in the municipal bond market: *a state or local government issues bonds and provides the bond proceeds to another party (frequently called a conduit borrower) who takes responsibility for repaying the bonds*. The conduit issuer is only obligated to make payments on the bonds to the extent it receives funds for that purpose from the conduit borrower or some other party, such as a third-party credit enhancer, and therefore the issuer's credit is not part of the transaction and the issuer is not a "real party in interest" to the economic substance of the transaction. Rather, the conduit issuer's role is to provide tax-exemption or tax credits related to the bonds or to otherwise provide the borrower access to the municipal bond market. This is a rare example of the Internal Revenue Code respecting form over substance.

The conduit issuer and the conduit borrower enter into a contractual arrangement. The form of contractual arrangement can vary due to statute or policy—it can be a loan agreement, a lease/leaseback structure, an installment sale agreement or some other contract to provide for the repayment of the bonds. By far the most common structure, described herein under "Conduit Financing Basics", involves the conduit issuer loaning the bond proceeds to the conduit borrower pursuant to a loan agreement and the right to receive payment under that loan agreement is collaterally assigned by the conduit issuer to the bondholders (or to a trustee for the bondholders) to secure and provide for repayment of the bonds.

Conduit borrowers are usually private parties, such as:

- Hospitals and/or health systems,
- private k-12 schools,
- private colleges and universities,
- other charitable organizations,
- affordable housing developers, or

- other for-profit businesses involved in certain public benefit projects (e.g. water, wastewater, solid waste, or certain energy projects)[1]

Bonds issued for the benefit of private parties like those identified above are called private activity bonds, which make up the majority of all conduit financing activity. In some instances states and local governments also issue conduit bonds on behalf of governmental borrowers or other public entities. This can occur in a *"bond bank" or other pooled financing* program.

The purpose of this pamphlet is to assist conduit issuers in identifying issues and setting up policies and procedures related to their tax-exempt bond programs and their relationships with other participants in conduit financings. While conduit issuers do not directly put their own credit on the line, by entering the bond market they confront what can be an intimidating array of legal and practical considerations. In some ways the most difficult task for the conduit issuer and its staff can be determining which issues really matter to them and which are simply best left to be dealt with by the conduit borrower or another party. This pamphlet aims in particular to offer conduit issuers some framework for making these determinations.

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[1] Certain types of nonprofit corporations are eligible to issue their own tax-exempt bonds without going through a governmental conduit issuer: (1) an "instrumentality" of a governmental entity as described in IRS Revenue Ruling 57-128 (which involves a good deal more control by the governmental entity than is the case in most 501(c)(3) corporations) and (2) a so-called "63-20 corporation," which is a nonprofit corporation considered to be acting on behalf of a governmental entity in accordance with the requirements of Revenue Ruling 63-20 as updated by Revenue Procedure 82-26, including a requirement that any property financed by the 63-20 corporation vest in the governmental entity at the end of the term of the bonds. In New York State, bonds are also often issued by "local development corporations" created pursuant to New York's Not-For-Profit Corporation Law.

CHAPTER 1

Background and History

State and local governments at one time borrowed only on a general obligation basis, meaning they issued bonds and put their full faith and credit behind those bonds, as the United States does today with Treasury bonds. Over the course of the late 19th and early 20th centuries, the municipal bond market came to include and accept revenue bonds payable from specifically identified sources or funds, such as a water or wastewater enterprise system, as opposed to the taxing power and taxable property of the governmental issuer. In the 1930s and 1940s, local governments began issuing revenue bonds not for governmental enterprises, but to finance private development. These industrial development bonds were issued to finance the construction of factories and other privately-owned facilities during and after the Great Depression.

Industrial development bonds were attractive to governmental issuers because they stimulated much-needed economic development, and to private borrowers because they provided advantageous financing terms and rates. Because interest paid on tax-exempt debt is exempt from federal (and often state) income tax, investors require less interest than they would from taxable debt to produce the same after tax return. This taxable/tax-exempt spread varies from time to time based on market factors and marginal income tax rates. **In recent decades tax-exempt rates have generally been 30% to 35% lower than rates for comparable taxable debt, although in recent years the spread has narrowed considerably.**

Conduit revenue bonds present unique regulatory issues in that the issuer of the securities and the real party in interest to the financing are not the same. Various regulatory authorities at state and local levels have wrestled with conduit revenue bonds for decades and continue to do so:

- Congress
- The Internal Revenue Service
- The United States Treasury

- The Securities and Exchange Commission
- State legislatures, and
- Other state and federal regulatory bodies

Both the IRS and Congress raised questions about the tax-exemption of interest on industrial development bonds as they became more widespread after World War II. Legislation was even introduced in Congress which would have specifically ended the tax-exemption for interest on industrial development bonds. In 1982, however, the federal tax court formally blessed conduit revenue bonds in the landmark case *Fairfax County Economic Development Authority v. Commissioner*. Also in 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA) which imposes a requirement that the issuance of conduit revenue bonds be approved by an elected official or a body of elected officials after a public hearing following public notice in the local jurisdiction in which the facilities being financed are to be located. *(See Tax Considerations, page 26 and Document Standardization, page 11)*

Congress and the SEC have also provided guidance from time to time regarding conduit revenue bonds from a securities law perspective. Historically, the SEC has looked through conduit issuers and viewed conduit borrowers as the true parties involved in bond issuance. In 1968, the SEC went so far as to adopt Rule 131 declaring that a separate security such as a loan, lease or guarantee by a private party, including a conduit borrower, is not covered by the general exemption from registration enjoyed by governmental bonds under the Securities Act of 1933. Had this rule remained in place, conduit bonds would be subject today to SEC registration requirements, like securities issued by public companies. Congress subsequently overruled the SEC on this point, so that conduit bond issues continue to be exempt from registration, but the SEC retains its focus on conduit borrowers in other contexts, including continuing disclosure.

CHAPTER 2

Conduit Financing Basics

TRANSACTION TYPES

As described above, a conduit financing can be almost any limited obligation financing undertaken by a governmental entity to provide proceeds to a conduit borrower to be used for a specific project or purpose. While there are examples of taxable conduit financings and also governmental conduit financings, the market is dominated by tax-exempt private activity bonds issued for Congressionally-approved purposes, including:

- 501(c)(3) (charitable organization) bonds for:
  - health care
  - private elementary and secondary schools
  - private higher education
  - cultural institutions and other charitable organizations; and
- exempt facility bonds for:
  - multifamily rental housing
  - solid waste disposal facilities
  - water furnishing
  - local furnishing of gas and electricity
  - certain renewable energy and green technology projects;
  - other Congressionally-approved exempt facilities; and
- qualified mortgage loan and student loan programs[2]

[2] Single-family mortgage loan programs and student loan programs are typically managed actively by the bond issuers in a way that distinguishes them from pure conduit financings.

PARTIES AND PARTICIPANTS

Anyone who has been on a conference call for a large health care or multifamily housing bond financing knows that conduit financings can involve a dizzying number of bankers, lawyers and other professionals in addition to the conduit issuer and the conduit borrower.

Each of these parties has a unique role to play in a transaction, and it is important for the conduit issuer to understand each parties' various roles and motivations. In a number of jurisdictions, conduit issuers choose their own bond counsel, as well as exercise some control over the selection of the other member of the working group. *(See Selection of Professionals, page 11.)* In other jurisdictions, it is left to the conduit borrower to form the financing team.

Parties and Participants

- bond counsel
- issuer's counsel (if different from bond counsel)
- trustee
- trustee's counsel
- underwriter (investment banker)
- underwriter's counsel
- credit enhancer
- credit enhancer's counsel
- borrower
- borrower's counsel
- financial advisors
- equity investor (e.g. low-income housing tax credit investor)
- investor's counsel
- rating agencies
- rebate or other post-issuance compliance consultant

LEGAL REQUIREMENTS

Each conduit financing brings with it not only a whole body of federal income tax law but also a variety of local laws and regulations, such as:

- state laws authorizing the issuance of bonds by the issuer;
- laws relating to exemption from state (and sometimes city) income tax;
- local laws applicable to the bond issuer and/or the project being financed (including city and state environmental laws, real estate law and zoning laws); and
- state or local regulations relating to the allocation of volume cap *(see Tax Considerations, page 26.)*

Parties to a conduit transaction should note that federal income tax law is only one of several bodies of law applicable to most conduit financings and should consult with bond counsel regarding all applicable laws and regulations.

DOCUMENTATION

The core legal documents for most conduit bond transactions are:

- an indenture trust agreement or bond resolution
- a loan agreement, lease agreement, installment sale agreement or type of financing agreement
- a bond purchase agreement (which can be a tri-party agreement or may include a letter of representations)
- a continuing disclosure agreement, and
- an official statement or other disclosure document

The indenture referred to above may be a "stand-alone" indenture relating only to a single bond issue, or it may be an open "master indenture" under which collateral is pledged on a parity basis to multiple series of bonds that may be issued from time to time by way of supplemental indentures.

In addition to these documents, variable rate bond transactions usually include a remarketing agreement to which the issuer may be a party, and multifamily housing deals almost always include a regulatory agreement (also called a Land Use Regulatory Agreement or "LURA"). All of these

documents are typically authorized by a resolution of the conduit issuer and accompanied by a tax certificate or arbitrage certificate and assorted closing certificates. Conduit issuers may also have their own forms of TEFRA materials and a form of inducement resolution (also known as a "reimbursement resolution" or "official action"). *(See Tax Considerations, page 26.)*

CHAPTER 3

Designing A Successful Conduit Program

A successful conduit financing program furthers the mission of the conduit issuer, which is typically economic development projects of one form or another, while at the same time protecting the conduit issuer as much as possible from legal liability, headline risk, and other potential problems. The program needs to be user-friendly enough to enable private borrowers to work effectively with the conduit issuer while not excessively taxing the issuer's staff and resources. In this chapter we explore some of the major questions that issuers face in designing a conduit financing program.

IDENTIFYING AND APPROVING PROJECTS

The first and most fundamental question for many conduit issuers is "how do we decide which projects to finance?" In all cases, conduit issuers are best served by considering this question carefully and developing principles or rules to be applied consistently, as opposed to approving or denying financing for projects on an *ad hoc* basis. But what should those principles or rules be? Among other factors, issuers should consider the following:

- the issuer's statutory powers
- the issuer's particular mission or public purpose (e.g. health care, housing, education, economic development, etc.)
- commitment of staff time and other resources
- fees and other revenues to be collected
- risk tolerance—how comfortable is the issuer with aggressive structures or deals?
- political considerations—are certain projects or transactions off limits?
- reputational considerations—are there certain borrowers the issuer will not work with?

Risk tolerance deserves particular consideration. Risk may come in the form of project risk—projects of questionable credit quality or sustainability—or

legal, structural, headline, political or other risks. While conduit issuers by definition do not directly take on project risk, conduit issuers generally face a variety of problems when projects are unsuccessful and bonds face potential or actual defaults, including bad headlines, litigation expenses and commitment of substantial staff time, often without limited potential for compensation or reimbursement.

Some conduit issuers approach project risk by performing their own underwriting and due diligence just as if they were extending their own credit to the underlying project. This has the advantage of giving the issuer its own independent view on the viability of the project and the financing plan and can give issuer staff and management comfort in deciding which projects to approve. It also takes a great deal of time, expertise and resources to underwrite projects effectively, which among other things may make the overall conduit issuance program less profitable from the issuer's perspective and also may leave less in the way of reserves to deal with litigation and other expenses where projects do fail. Sometimes other members of the working group, particularly project sponsors and developers, become frustrated with the involvement of conduit issuers who pursue this more active approach and may even view the issuer as meddling unnecessarily.

Other conduit issuers pointedly avoid any project underwriting or credit analysis. They establish rules for investment suitability (minimum ratings, bond denominations, investor letters) and other basic parameters and let bondholders, rating agencies and credit enhancers worry about credit. A passive approach of this kind permits the issuer to disclaim in the future any responsibility for potential project performance issues—"Don't look at us; we're just the conduit issuer!" Because it requires less work and staff time this approach also generally produces a more profitable conduit program if that is an objective. On the other hand, pure conduit issuers may in fact have a very limited understanding of the projects they are financing or the financing structures being used, which puts them at risk of having their names attached to failed deals and then of having to defend against allegations that they should have known better.

Conduit issuers that are also regular issuers of non-conduit governmental debt (such as cities, counties and state agencies) often have significant staff and resources that they can commit to the active administration of a conduit program, including performing credit underwriting on projects or ensuring post-issuance compliance with tax and securities laws. Many conduit

issuers, on the other hand, are special legal entities created solely to issue conduit bonds and they have relatively few employees and limited resources. Resource-constrained conduit issuers in particular should consult with counsel and advisors about how to engage third parties to perform certain crucial functions and otherwise transfer responsibilities and risks to other parties in such a way as to protect themselves.

SELECTION OF PROFESSIONALS

Some of the parties in a conduit transaction *(See Parties and Participants, page 6)* have an attorney-client or other fiduciary relationship with the conduit issuer, while others may have little or no direct contact with the issuer and may even be "adverse" in some technical sense to the issuer. Issuers may be able to protect their own interests and mitigate the risks associated with conduit financings by influencing the selection of the professionals involved in the transaction. On the other hand, in a competitive environment in which conduit borrowers may have more than one potential conduit issuer to choose from, conduit borrowers may prefer an issuer that permits more flexibility in the appointment of professionals.

Nationally, conduit issuers' practices vary widely in terms of the degree of influence they exert over the selection of professionals. Some issuers dictate the selection of virtually the entire financing team, including the lawyers or law firms that are permitted to represent other parties in the transaction such as the underwriters. Other issuers permit the conduit borrower to hand-pick the financing team, including the bond counsel that will ultimately represent the issuer. There is also considerable variation among issuers as to how much they rely upon an RFP and bidding process for the selection of professionals or to the duration of any such appointments.

DOCUMENT STANDARDIZATION

Conduit issuers also must decide how much they want to dictate and standardize the forms of the legal documents used for their programs. Document standardization affords the issuer a certain degree of protection *(See Protections for Issuers, page 13)* but it may put the issuer into repeated conflict with financing participants who have their own forms and conventions that they want to follow. Looking around the country, some conduit issuers have successfully developed and required the use of standard forms of core

transaction documents. The more common practice, however, seems to be to let the financing team determine the underlying template documents while the issuer requires inclusion in the documents of certain standard provisions designed for its protection.

Issuers are advised to take care in creating templates for TEFRA notices and approvals and to take particular care in verifying adherence to the forms with bond counsel, as even minor technical deviations from the tax rules can render a TEFRA process invalid. *(See Tax Considerations, page 26.)*

CHAPTER 4

Protections for Issuers

Issuers are advised to develop both standard document provisions and certain internal procedures to protect themselves from liability in conduit transactions. This section describes some of the more common forms of issuer protections.

INDEMNIFICATION AND PAYMENT OF EXPENSES

It is standard in conduit programs for the conduit borrower to indemnify the issuer completely for essentially all liability arising out of the transaction except as a result of the issuer's gross negligence or willful misconduct, and to permit the issuer to select and engage counsel at the expense of the conduit borrower in the event of any proceeding giving rise to indemnification. Similarly, conduit borrowers usually covenant to pay all fees and expenses arising out of a conduit transaction, including both ordinary expenses (annual trustee and issuer fees, for example) and extraordinary expenses (costs of attorneys and consultants in the event of difficulties with the financing).

It is worth noting that the party providing the indemnity is often a start up or special purpose entity with little or no assets other than the transactions, and may be in default or insolvent when indemnification is triggered. Moreover, public entity conduit borrowers may not have the legal authority to provide indemnification to another party. An important policy consideration for issuers is therefore whether to seek indemnification from a corporate parent or other creditworthy party or to accept indemnification from special purpose borrower entities (LLCs, LPs, and so forth) that likely have limited assets.

SUITABILITY PROTECTIONS

Conduit bonds are almost always exempt from SEC registration requirements and are theoretically eligible to be sold directly to retail investors, no matter the credit quality of the bonds. Many conduit issuers have found, however,

that lower-rated bonds may not be suitable for sale to retail investors, and that permitting retail distribution of unrated or lower-rated bonds exposes the issuer to potential liability in the event of a bond default. Conduit issuers often impose restrictions on sale and distribution to ensure that unrated or lower-rated bonds are only placed with sophisticated investors, including:

- large minimum denominations (generally range from $25,000 to $250,000)
- sales only to "accredited investors" as defined in Regulation D or "Qualified Institutional Buyers" as defined in Rule 144A (each promulgated under the Securities Act of 1933); and
- initial purchasers required to sign an investor letter or "big boy letter" certifying their expertise and sophistication. If subsequent purchasers are required to sign the same form of investor letter it is called a "traveling letter."

POLICIES AND PROCEDURES

Both the SEC and the IRS emphasize that issuers should have written procedures relating to matters of disclosure and compliance and with respect to federal income tax law, respectively. For example, in 2010 the SEC charged the State of New Jersey with fraud for failing to disclose underfunding of its pension plan, citing the absence of written procedures or formal training relating to disclosure as presumptive evidence that the State's disclosure process was inadequate. In 2011, the IRS added to Forms 8038 and 8038-G a box for the issuer to check if it has established written procedures to monitor compliance with arbitrage and certain other requirements.

Issuers should consult with bond counsel and other counsel to determine whether written procedures relating to disclosure and tax compliance are appropriate—conduit issuers' disclosure responsibilities are in many cases different from those of an issuer that is borrowing for its own purposes—and, if so, for assistance in developing and implementing those procedures.
(See Disclosure, page 22; and Tax Considerations, page 26.)

OPINIONS AND CERTIFICATIONS

Because conduit issuers are in many ways passive transaction participants—they are neither extending credit nor borrowing on their own account—it is appropriate and customary for other parties to the transaction to assume

many of the legal risks associated with the transaction. So, for example, the issuer usually provides a closing certificate providing only minimal assurances or "comfort" as to the accuracy of any disclosure material provided by the issuer for inclusion in the official statement or other disclosure document. Typically, the conduit issuer covers only its disclosure section and any section discussing any litigation related to it. The issuer typically disclaims any responsibility for other elements of the disclosure document, leaving it to the other parties to provide certifications and opinions regarding the completeness and accuracy of the other information. Similarly, the issuer itself usually provides minimal certifications and covenants regarding tax compliance, but must be certain that the conduit borrower and other parties are providing all necessary comfort relating to tax matters.

The final closing papers for a conduit financing form a complex web of certifications, covenants and opinions working together to cover and apportion to various parties most of all of the salient and foreseeable transaction risks. Issuers are strongly advised to consult with knowledgeable and experienced counsel regarding market standard practices for each of these documents. Counsel should be able to assist the issuer in developing standards for opinions and certifications to be given and received that will protect the issuer to the greatest extent possible within the current marketplace.

What about policies on investments, post issuance compliance (tax and documentation), continuing disclosure, covenants (and the difficulty of the monitoring of such covenants without infrastructure), requisition process, or debt service reserve fund requirements and releases?

CHAPTER 5

Structuring Considerations

A conduit bond issue and the conduit loan funded by that bond issue are a single, integrated transaction in which, with limited exceptions, bonds are issued and a related loan is originated at the same time. There is a direct, pass-through relationship between the bond terms and the loan terms, such that if $100 of interest is paid on the loan on the first of the month, the issuer passes that $100 through to the bondholders. Similarly, 0.10% increase or decrease in the bond rate, for example, produces a 0.10% increase or decrease in the loan rate paid by the conduit borrower. The conduit borrower is, therefore, generally the party most interested in structuring and executing the bond transaction to produce the lowest possible overall borrowing cost.

One of the basic choices to be made in a conduit financing is whether the Bonds should be:

- Publicly-offered; or
- Privately-placed

Publicly sold bonds generally offer the lowest interest rates, but this is not the best structure for every conduit financing. Because the costs of offering bonds to the public are largely fixed, but project sizes and costs vary widely, some transactions are too small to justify the cost of a public offering. Placing bonds directly with a single investor or lender is often the most cost-effective structure for those transactions.

PUBLIC OFFERING STRUCTURE

A public offering typically involves some or all of the following parties as active participants in the working group:

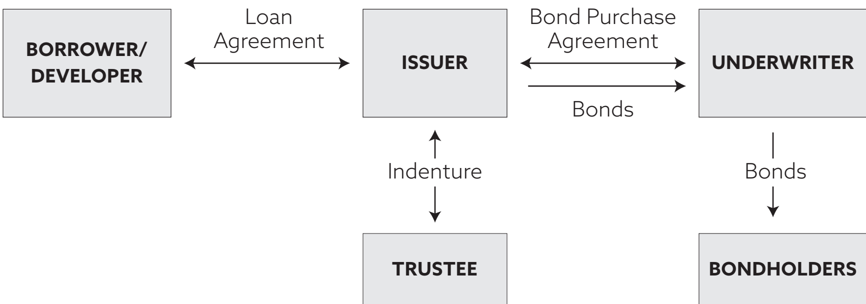
- trustee
- underwriter/investment banker
- credit enhancer/bank

- equity investors/guarantors
- bond counsel
- issuer's counsel
- borrower's counsel
- underwriter's counsel
- counsel to the bank/credit enhancer

In this structure, the conduit issuer issues the bonds and an underwriter sells the bonds to retail and/or institutional bond investors, who are typically not directly involved themselves in structuring or underwriting the transaction. The bonds are issued pursuant to an indenture or trust agreement (the "Indenture") between the Issuer and a bond trustee (the "Trustee") who, for the benefit of the bondholders and (to a limited extent) the Issuer, holds the funds and any other collateral pledged under the Indenture to secure payment of the Bonds and, if necessary, enforces certain rights of the bondholders and the conduit issuer.

The conduit issuer loans the proceeds of the Bonds to the conduit borrower pursuant to a Loan Agreement or Financing Agreement (the "Loan Agreement"). The Issuer assigns all of its rights (except limited rights to receive fees and indemnification), including the right to receive repayments of the loan from the conduit borrower, to the Trustee as security for the Bonds pursuant to the Indenture. Under the Loan Agreement, the Issuer loans the bond proceeds to pay the costs of acquiring, constructing, rehabilitating or refinancing the project as applicable. The Loan Agreement sets out the terms of repayment of and security for the loan. For certain types of financings, a deed of trust or mortgage may recorded as an encumbrance upon the project to further secure the loan, which is then also assigned to the Trustee.

DOCUMENTS



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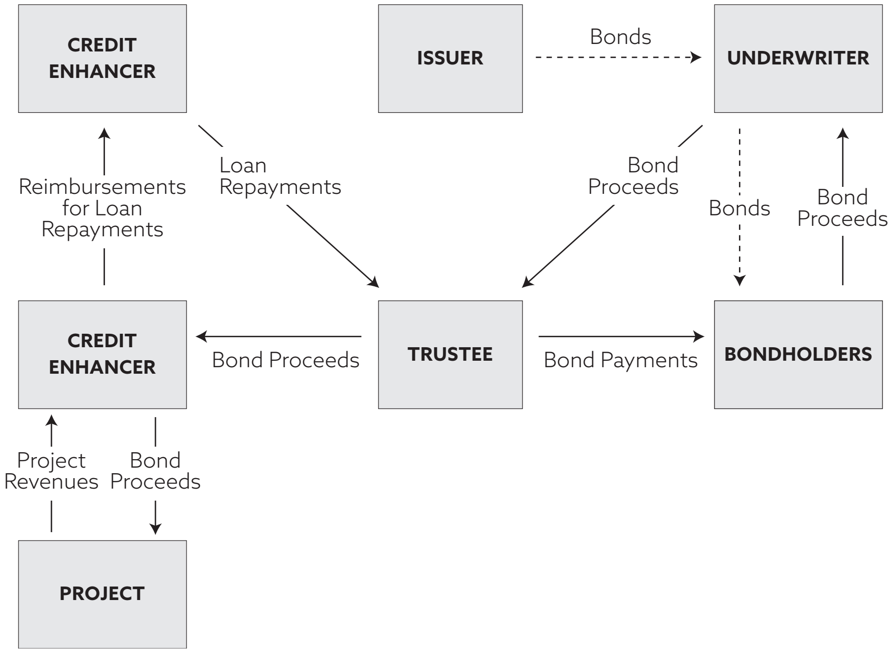

RATINGS; CREDIT ENHANCEMENT

In some sectors of the conduit financing market, such as healthcare, conduit borrowers are typically large, creditworthy entities that are able to borrow in the capital markets without any third-party credit support. In other cases, such as small-issue industrial development bonds or multifamily housing revenue bonds, conduit borrowers are generally not as creditworthy and the transactions are structured as non-recourse project financings, in which case investors typically demand third-party credit enhancement for the bonds. In the case of variable-rate demand bonds that may be tendered by the bondholders, liquidity support is also required. These bonds receive long-term and, if applicable, short term credit ratings based on the ratings of the credit enhancer and liquidity support provider (which are often the same party), not the creditworthiness of the project.[3]

[3] Because multifamily housing finance is fundamentally a form of project financing, the creditworthiness of the Borrower is rarely an issue, even where there is no credit enhancement.

Credit enhancement may take any of the following forms, among others:

- Direct-pay letter of credit[4];
- Standby letter of credit[5];
- Bond Insurance; or
- Guaranty from third-party (sometimes related to Borrower).

Credit enhancement allows bondholders to lay off the risk that the conduit borrower will be unable, as a result of an under-performing project or for any other reason, to make payments of principal and interest on the bonds.[6] Purchasers of these bonds, such as money-market funds and investors in such funds, are not in a position to evaluate and absorb the credit risks inherent in individual project financings and other more speculative ventures. Credit enhancers, however, are equipped to perform this kind of underwriting; they evaluate a project and, if it meets their requirements, provide insurance, a letter of credit or some other kind of guaranty for the benefit of the bondholders. The credit enhancers essentially fill the role of lender, and the bondholders then look only to the creditworthiness of the credit enhancer.

Before 2008, the most common form of credit enhancement in the conduit bond market was bond insurance issued by "monoline" bond insurers such as Ambac, FSA and MBIA. Since the 2008 financial crisis, credit enhancement has become much less widely available in the municipal bond market. When conduit transactions do include credit enhancement it is now typically provided in the form of a is a direct-pay letter of credit issued by a commercial bank or, in the case of multifamily housing, Fannie Mae or Freddie Mac. In this structure, the Trustee draws on the letter of credit to make all principal and interest payments on the Bonds, and the credit enhancer is reimbursed

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[4] A direct-pay letter of credit allows the trustee to draw on the letter of credit to pay scheduled payments of principal and interest. The letter-of-credit provider then looks to the Borrower/Developer for reimbursement, usually on the same day on which the Trustee draws on the letter of credit. Bondholders effectively receive payment directly from the provider of the letter of credit.

[5] A standby letter of credit may be drawn upon only if there is a failure by some other party to make a payment. For example, a bank with a particularly strong credit rating (such as the Federal Home Loan Bank) might issue a standby letter of credit to back up a direct-pay letter of credit issued by a bank with a lower credit rating. If the first bank fails to make a payment requested by the Trustee, the Trustee can draw on the standby letter of credit. Standby letters of credit can also be issued to support payments directly from the Borrower/Developer to the Trustee (so that if the Borrower/Developer fails to make a payment, the Trustee draws on the standby letter of credit), but this is no longer common.

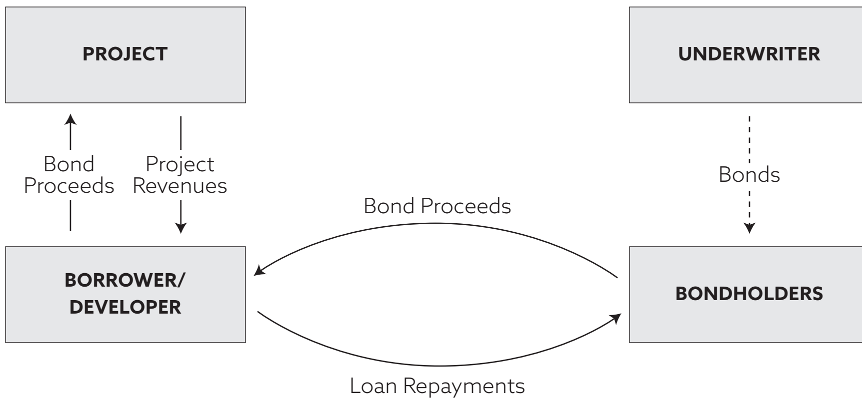
[6] In most cases, the Issuer of the bonds is technically the party obligated to make debt service payments but only to the extent it receives funds from the Borrower/Developer under a loan agreement. If the Borrower/Developer defaults under the loan agreement, the Issuer has no money with which to pay bondholders and no obligation to use any of its own funds to that end.

by the conduit borrower from project revenues or, during construction, from reserves held under the Indenture.

DIRECT LENDING STRUCTURE AND DOCUMENTATION

In the conduit financing context, "private placement" or "direct lending" typically refers to a transaction in which a single party, such as a bank, purchases and holds an entire bond issue issued to fund a conduit loan to a conduit borrower. In other words, direct lending is not a capital markets transaction in which bonds are sold to a variety of investors. Rather, in economic substance, these are two-party transactions consisting of a loan (funded by way of a governmental conduit issuer) from the bond purchaser to the conduit borrower. Because the bond purchaser is really acting as a lender it almost always participates in structuring the transaction and conducts its own investigation into the creditworthiness of the conduit borrower and any underlying project.

MONEY FLOW



Direct lending is, as the name implies, essentially a direct loan by the bondholder. The conduit borrower borrows money from a bank or other lender, just as it would if no bonds were issued, but the debt takes the form of a bond transaction—the bonds are usually tax-exempt—in which the lender holds bonds issued by the conduit Issuer and secured by the loan made from the bond proceeds.

These transactions are generally simpler and, as a result, are cheaper to execute than public offerings because there are fewer parties and a full

blown disclosure document is not needed. For example, there may be no need for a trustee and fewer documents involved than in a public offering. Like bank loans, private-placements are often funded on a draw-down basis, meaning that bond proceeds are advanced when and as needed to pay for project costs. In certain interest rate environments, this dramatically reduces the "negative arbitrage" cost that results from fully funding a project or construction fund with bond proceeds and drawing it down over time.

There is typically no credit enhancement in a direct lending transaction, and the bonds are not rated. The same tax rules that apply to publicly-sold bonds, such as the requirements that proceeds be spent on capital costs and limits on costs of issuance, apply to direct lending transactions.

Comment direct lenders (purchasers of privately placed bonds) include:

- regional banks;
- national commercial/investment banks; and
- specialized non-bank financial institutions.

Different lenders and finance teams have developed different instruments to accomplish the task of documenting the issuance of the bonds and the making of a loan to the conduit borrower. Conduit borrowers should consult with bond counsel about the documents to be used in a specific direct lending structure.

CHAPTER 6

Disclosure

Governmental bonds, notes, certificates of participation and other securities, including conduit obligations, are generally exempt from the registration requirements of federal and state securities laws, but are subject to securities law disclosure rules–generally referred to as antifraud rules. Statements by municipal issuers to investors, or potential investors, and even statements to the public generally, if likely to be heard and relied upon by the securities market, are subject to regulation by the SEC under two key antifraud provisions of federal law:

- Section 17(a) of the Securities Act of 1933; and
- Rule 10b-5 promulgated by the SEC pursuant to Section 10 of the Securities Exchange Act of 1934

These laws and regulations are designed to ensure that parties buying or selling securities have access to the information necessary to make an informed investment decision. In order to comply with these laws for a public offering of municipal securities, issuers generally prepare a document analogous to a corporate prospectus, called an Official Statement, that includes all of the information an investor would need to decide whether to purchase the offered securities. Various state laws also impose liability for inadequate disclosure, and securities sales are also subject to general statutory and common law rules such as those prohibiting fraud. Inadequate disclosure practices can lead to investigation by the SEC, investigation by a local district attorney or the U.S. Justice Department, imposition of fines or penalties, civil suits for damages, substantial out-of-pocket costs to defend against government or private investigations or suits, and other adverse consequences. In recent years, the SEC has become increasingly vocal about its desire to enhance municipal disclosure and bring it into closer alignment with the corporate securities law regime, raising the importance of the quality and timeliness of disclosure as an issue of concern throughout the municipal marketplace.

In most conduit offerings, information on the financial condition of the conduit issuer is not necessary (and could be misleading) and should not be included in the Official Statement. The Official Statement should, moreover, make clear that the conduit issuer is assuming responsibility only for the limited material included in the Official Statement that has been provided by the issuer, generally only a brief description of the issuer and a statement that there is no pending litigation against the issuer challenging the financing. It is important for conduit issuers to recognize, however, that they may nonetheless be named as a defendant in the event of actual litigation regarding the disclosure provided for bonds or other obligations of the issuer.

15C2-12 CERTIFICATE

Because in many transactions the Official Statement cannot describe the securities completely until after they have been sold, a Preliminary Official Statement or POS is made available and distributed in advance of the offering. SEC Rule 15c2-12 requires the POS to be deemed final by an issuer of the Bonds except for pricing and information dependent upon or determined as part of the pricing. This is typically accomplished by way of a certificate, called a 15c2-12 Certificate, delivered by the Issuer or the conduit borrower (either of whom may be considered an issuer for the limited purpose of Rule 15c2-12) or both, sometimes with the conduit issuer and the conduit borrower certifying as to different portions of the POS. The 15c2-12 Certificate is not a representation as to the completeness or accuracy of the POS, and should not be confused with the level of assurance provided, and therefore risk assumed, by provision of a certificate or opinion tracking the language of Rule 10b-5.

CONTINUING DISCLOSURE

Rule 15c2-12 also requires the underwriter of an issue of governmental securities to obtain a commitment (also known as an undertaking) by the issuer of the securities to provide this ongoing disclosure. This undertaking generally takes the form of a Continuing Disclosure Certificate or Continuing Disclosure Agreement executed by the issuer of the securities, or other obligor, at closing. Rule 15c2-12 requires two types of ongoing disclosure: an annual report, containing updated financial information, and notices of certain material events, if and when any occur. The table below shows the enumerated material events contained in Rule 15c2-12 as of December 1, 2010.

MATERIAL EVENTS

Events that Always Require Notification	Events that Require Notification if Material
• Principal and interest payment delinquencies; • 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; • Issuance by the Internal Revenue Service of proposed or final determination of taxability or of a Notice of Proposed Issue (IRS Form 5701 TEB); • Tender offers; • Defeasances; • Rating changes; or • Bankruptcy, insolvency, receivership or similar event of the obligated person.	• Unless described in the left-hand column, adverse tax opinions or other material notices or determinations by the Internal Revenue Service with respect to the tax status of the securities or other material events affecting the tax status of the securities; • Modifications to rights of holders of the securities; • Optional, unscheduled or contingent Bond calls; • Release, substitution or sale of property securing repayment of the securities; • Non-payment related defaults; • The consummation of a merger, consolidation or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms; or • Appointment of a successor or additional trustee or the change of name of a trustee.

In the conduit context of a conduit financing, the conduit borrower, not the Issuer, is almost always the appropriate party to make a formal continuing disclosure undertaking and to provide ongoing disclosure. The conduit issuer should nonetheless ensure that the conduit borrower executes a continuing disclosure undertaking that complies with Rule 15c2-12 and conduit issuers may want to conduct some oversight or monitoring to ensure compliance with such undertakings on an ongoing basis.

WRITTEN PROCEDURES

The SEC has recommended that issuers establish formal, written procedures to be followed for the preparation of disclosure. Such procedures might include establishment of a disclosure review committee, a detailed process for compiling information for inclusion in the Official Statement and for issuer staff review and formal sign-off on disclosure documents, and systematic training of staff and board members in the discharge of disclosure responsibilities. These recommendations were developed and promulgated in the context of purely governmental bond issuances, as opposed to conduit bonds, and it is not clear how they are best applied in the conduit context. Issuers should consult with bond counsel and disclosure counsel, if applicable, regarding the possible adoption of written procedures relating to disclosure.

GOVERNING BOARD APPROVAL

As a general matter, conduit issuers should bring a full, near-final draft of the Official Statement to their governing board for approval prior to publication. The conduit issuer's governing board has a legal responsibility to ensure that the issuer complies with all applicable securities laws, and governing board members may be subject to personal civil and criminal penalties for failure to discharge such responsibility. As in the case of the written procedures discussed above, however, the SEC's recommendations in this area were developed in the purely governmental setting and their application to conduit bonds is somewhat uncertain.

CHAPTER 7

Tax Considerations

As discussed elsewhere in this pamphlet, conduit borrowers typically assume most or all of the risk and liability associated with tax-exemption in a conduit transaction, so that if there is an IRS audit and the bonds are declared taxable or a settlement with the IRS needs to be reached, the conduit borrower is on the hook to deal with the tax problem. Nonetheless, tax-exemption is a driving force behind most, if not all conduit bond transactions, so it is important for conduit issuers to take reasonable steps to ensure that interest on their bonds will in fact be exempt from federal income tax. Moreover, just as conduit issuers have certain disclosure obligations that cannot be delegated or transferred to other parties, there are also certain tax-related requirements and responsibilities contained in the Internal Revenue Code (the "Code") and related Treasury Regulations (the "Regulations") that always fall to the governmental issuer of the bonds. This is especially true in the event of an IRS audit, as the IRS typically views the conduit issuer's bonds as **the Issuer's bonds** and may expect to interact directly or even exclusively with the conduit issuer in the course of an audit.

Key tax requirements applicable to conduit financings typically fall into the following broad categories:

- **Use of Proceeds.** Generally at least 95% of the bond proceeds must be used to finance eligible capital costs of a project. Additional use of proceeds requirements relate to timing of expenditures, limitations on costs of issuance, limitations on expenditures on land, and limitations on reserves.

  Use of proceeds issues are in most cases primarily the responsibility of the conduit borrower, and should be documented accordingly.

- **Use of the Project.** If the conduit bond issue involves financing a capital project such as a medical, educational or rental housing facility, there will be restrictions on the use of that project. Generally the project must be used for its intended purpose at least for the life of the bonds and there are limitations on its use by non-qualifying parties for non-qualifying purposes, even in part and even for a short period of time. Non-compliance may in

some, but not all, cases be addressed by way of remedial action provided for in the Regulations.

Like use of proceeds, use of the project is in most cases primarily the responsibility of the conduit borrower, and should be documented accordingly.

- **Arbitrage.** The Code and the Regulations distinguish between purpose investments, meaning the use of bond proceeds for the purpose for which they were issued, such as making a loan to finance a project, and non-purpose investments, meaning investment of bond proceeds in a project fund or reserve fund or other similar fund or account. As a general rule, with a number of exceptions, Issuers are permitted to earn a maximum spread on purpose 1.5% over the bond yield, while no spread is permitted on non-purpose investments.

  Issuance fees and ongoing administrative fees collected by the Issuer are included in the 1.5% allowable spread on purpose investments, so compliance with this rule is in many ways the primary responsibility of the Issuer. Because the conduit borrower typically directs discretionary investment of bond proceeds in various funds and accounts, ensuring that there is no impermissible arbitrage earned on non-purpose investments generally falls to the conduit borrower.

- **Procedural and Preliminary Requirements.** In addition to the core requirements described above, there are certain procedural requirements that must be satisfied for bonds to be tax-exempt. These include, in most conduit financings, the following:
  - Issuer adoption of an inducement resolution (also called a reimbursement resolution or "official intent")—borrower must adopt
  - TEFRA approval by the conduit issuer and, if applicable, the jurisdiction in which the project will be located
  - Issuer receipt of an allocation of volume cap or state ceiling limiting the dollar amount of private activity bonds that may be issued in the Issuer's state in any given year – this requirement does not apply to health care or other 501(c)(3) financings, which comprise a substantial portion of all conduit financing activity
  - Issuer filing of IRS Form 8038 and, if applicable, 8328; and
  - Issuer identification (as that term is used in the Regulations) of any swaps or other hedges related to the Bonds

- **Post-Issuance Compliance.** IRS Forms 8038 and 8038G were changed in 2011 to require conduit issuers to indicate whether or not they have procedures in place to ensure post-issuance compliance with tax requirements, principally requirements relating to arbitrage and use of financed facilities. Many conduit issuers have since written down and formally adopted such procedures.

43 Check the box if the issuer has established written procedures to ensure that all nonqualified bonds of this issue are remediated in accordance with the requirements under the Code and Regulations (see instructions) . . . . ▶ ☐

44 Check the box if the issuer has established written procedures to monitor the requirements of section 148 . . . . ▶ ☐

Issuers should be particularly careful to consult with bond counsel regarding the above-mentioned tax requirements and how responsibility for these issues should be allocated among financing participants and documented.

CHAPTER 8

Other Considerations

The forgoing chapters constitute a partial list of the issues a conduit issuer may face in establishing and administering a conduit financing program. Issuer staff and attorneys need to remain alert and flexible as new situations arise, while remembering that the role of a conduit issuer is inherently limited and that not every problem that arises in a transaction is the Issuer's to resolve. This chapter presents some of the additional questions and considerations that conduit issuers may face from time to time.

COORDINATION WITH OTHER AGENCIES

Conduit issuers rarely operate in a vacuum; rather, they are connected formally and informally to other conduit issuers and governmental agencies. A state may have, for example, a health care financing authority, an exempt-facility financing authority, a housing finance agency, an education financing authority, and a handful of other conduit issuers, as well as an agency running a state general obligation bond program or other non-conduit financing programs, not to mention a variety of local conduit issuers located within the state. In such cases, a conduit issuer's decisions on the policy and legal issues of the sort described in this booklet may have significant effects on the positions that other issuers and agencies are able to take in running their bond programs. For example, if a conduit issuer accepts a particular underwriter termination event in its bond purchase agreement, or agrees to a lesser standard of borrower indemnification in its loan agreement for a particular transaction, that concession may later be used by third parties in negotiations with other, related issuers. Conduit issuers therefore need to consider coordinating with their sister agencies in such a way as to maintain consistency in developing and implementing their programs.

SECURITY INTERESTS

Certain conduit financings, especially those for housing, certain types of energy facilities and certain types of health care facilities, often include a

mortgage or other encumbrance granted by the conduit borrower on the assets being financed. In these cases, the conduit issuer is often the party secured by the conduit borrower's pledge; the conduit issuer then further assigns its security interest to the trustee on behalf of the bondholder(s) or to a credit enhancer to secure the bonds. Because the conduit issuer remains a secured party with a legal interest in the collateral being pledged, the Issuer often has rights of consent over any sale or disposition of the collateral. Conduit issuers need to consider in advance procedures and policies for dealing with requests from the conduit borrower or other parties to permit sale of the collateral or release all or a portion of the collateral from the conduit issuer's lien. In addition, because the Issuer typically assigns its security interest to a third party to secure its own bonds, Issuers and their attorneys should be familiar with state and local laws regarding security interests granted by governmental entities and the perfection or enforceability of those interests against third parties.

ENVIRONMENTAL LAWS

Environmental laws and issues may present serious complications in the course of a conduit financing, both before and after closing. Some states have environmental protection laws that must be complied with in advance of any bond financing, and failure to comply with such requirements may in some cases result in invalidation of any bonds or other financing-related actions of an Issuer. Environmental problems arising after closing may result in extraordinary expenses (attorneys and consultant costs, among others) and/or significant delays in completing projects. Issuers should develop a general sense of the environmental laws applicable to the projects and facilities they intend to finance and, at least as importantly, should develop policies and form documents that protect the Issuer from bearing costs of environmental problems.

INVESTMENTS AND DERIVATIVES

Active conduit issuers should generally have adopted policies describing and defining the Issuer's approach both to investments of bond funds and to entering into interest rate swaps or any other derivative contracts. These policies may delegate responsibility to conduit borrowers and give conduit borrowers a relatively free hand in directing investments and entering into derivative contracts, or they may impose strict guidelines based on the

Issuer's views on prudent investment and hedging strategies. Either way, it is generally in the interest of the Issuer and its staff to have formal policies in place. The Government Finance Officers Association (gfoa.org) maintains a publicly-available sample investment policy and bond counsel and other parties often have examples of investment and derivative policies available to be shared with Issuer clients.

For additional information concerning conduit financings, please contact any of the attorneys listed below:

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