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E. UNDERSTANDING BOND DOCUMENTS

by

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1. Introduction

Two questions most frequently asked by agents examining bond financings are, "is it necessary to read all of the documents in the bond transcript in order to examine a bond issue?" and, "which documents are important?" The size of a bond transcript and the number of documents included in a transcript can be overwhelming to a person not familiar with bond financings. The purpose of this article is to assist agents examining bond financing to understand the basic bond documents. The article is directed towards the agent and, to receive maximum benefit, you should use it interactively with a bond transcript. If you have a bond transcript available, use the particular documents in the bond transcript as you read the corresponding sections of this article.

There are a wide variety of different types of municipal financing arrangements. These include general obligation bonds, various type of revenue bonds, special tax bonds, tax increment bonds, lease and installment sale financings (including certificates of participation), assessment bonds, and conduit bonds issued for the benefit of nongovernmental persons. One reason there are so many types of municipal financing arrangements is that different state laws place different constraints on the borrowing and taxing powers of state and local governments. This means that municipal financing practices can vary widely from state to state.

This article does not attempt to describe all of these types of municipal financing arrangements. Rather, we attempt to provide an overview of the documents that will usually appear in most types of financings.

2. What is a Bond Transcript?

As the *Examination Guidelines for Municipal Financing Arrangements* state, an examination of a bond transaction is conducted at the issuer level. After you have informed the issuer that its bonds are under examination, you should request to review the bond transcript. The bond transcript or the "bound volume", as it may be called, is prepared by bond counsel after the bonds have been issued. Bond counsel provides a copy of the bond transcript to each major party to the financing and its attorneys. An issuer who cannot locate its copy of the bond transcript may be able to obtain a copy from its lawyer, bond counsel or other parties to the financing. If faced with a situation where the

issuer cannot locate its bound volume, you may suggest that the issuer obtain it from its counsel or bond counsel. The bond transcript contains those documents which were considered necessary by the parties to the transaction. The issuance and sale of the bonds would not have occurred without the execution and/or delivery of such documents. Because the bond transcript includes only certain documents which were available at the time of the issuance and sale of the bonds, you will, in most instances, need to review additional documents which are not a part of the bond transcript. For example, requisitions, income statements, cash flows and other documents reflecting events occurring after the issuance of the bonds. The bond transcript, however, should be your starting point and, if at all possible, it should be reviewed before you request other documents. This will permit you to make a reasonable and focused inquiry rather than asking for all and any documents related to the financing. However, nothing is cut and dry and there will be instances where you will sense that all documents should be requested the first time around.

3. What Does a Bond Transcript Contain?

There are no requirements in the municipal finance industry regarding the sequence of documents in a bound volume. This is not to say that there is no rhyme or reason as to how a particular bond transcript is arranged. However, the sequence of the documents in a bond transcript depends entirely upon bond counsel. All bond transcripts contain the following categories of documents:

Offering Documents

- Preliminary Official Statement
- Official Statement
- Bond purchase agreement
- Blue sky survey

Basic Legal Documents

- Indenture/resolution
- Loan/lease agreement
- Mortgage/deed of trust
- Request to authenticate and deliver bonds
- Credit enhancement documents
- No arbitrage certificate/tax regulatory agreement
- Form 8038/8038-G
- Land use restriction agreement
- TEFRA approval/volume cap certificate

Resolutions and Certificates of the Parties

- Copy of the relevant state law
- Organizational documents of the issuer

- Resolution(s) of the issuer authorizing the financing
- Certificates of the issuer
- Organizational documents of the conduit borrower
- Resolutions of the conduit borrower
- Certificates of the conduit borrower
- Certificate of the credit enhancer
- Certificate of the Trustee

Legal Opinions

- Opinions of bond counsel
- Opinion of underwriter's counsel
- Opinion(s) of the counsel to the conduit borrower
- Opinion of issuer's counsel
- Opinion of credit enhancer's counsel

Miscellaneous

- Rating letter(s)
- Receipts for the bonds and proceeds
- Feasibility study/engineer's report
- Title insurance
- Financing statement
- Appraisal

4. Alternative Sources of Information

A. Need for Alternative Sources

Although a bond transcript is part of the public record of the issuer and may be subject to state and local sunshine laws, a person desiring to review the transcript generally will request it from the proper administrative officer of the issuer. Because bond transcripts contain information which does not interest an average constituent and because bond transcripts are not the most sought after public documents, most issuers receiving a request to review a bond transcript will want to know the requesting person's identity and reasons for review. There will be situations where you desire to gain sufficient information to determine whether an examination is warranted, but do not want to alarm the issuer that its bonds are, or may be, subject to an examination. In such a situation, you may not want to review the bond transcript at the issuer's offices. You should attempt to obtain information regarding the financing through independent sources. The municipal securities industry has established numerous sources from which such information may be obtained. The quickest way to learn about a bond financing is to read its Official Statement. After reviewing the Official Statement you may determine that an examination is not warranted. This result is desirable for both the Service and the issuers because it avoids involving the issuer in an unnecessary examination.

B. Public Sources of Offering Documents

(1) MSRB

The Municipal Securities Rulemaking Board ("MSRB") is a self-regulating board established by broker-dealers of municipal securities. The underwriter for a bond financing is required to deliver to the MSRB, no later than 10 business days after the execution of the bond purchase agreement, copies of the Official Statement and Form G-36(OS). In the case of advance refunding of bonds, the participating underwriter is required to file with the MSRB, copies of the final Official Statement, the related escrow agreement and Form G-36(ARD). This filing must be made within five business days of the issuance of the refunding bonds. The information filed by the underwriter is available through MSRB's Municipal Securities Information Library. The Municipal Securities Information Library is located at: 1640, King Street, Alexandria, Virginia 22314. Its telephone number is (202) 223-9508. The Library will, for a price (at this time, 20 cents a page), mail a copy of an Official Statement upon request. You can also go to the Library and review the Official Statement and make copies (20 cents a page) of the necessary pages. Contact your headquarter's contact person if you need help getting documents from the MSRB.

(2) NRMSIRS and SIDS

In addition to the MSRB, other available sources of information are, the nationally recognized municipal securities information repositories ("NRMSIRs") and the state information depositories ("SIDs"). Since July 3, 1995, the Securities and Exchange Commission ("SEC") has required that all underwriters participating in the issuance and sale of municipal bonds file annual financial information. This requirement is contained in SEC Rule 15c2-12, as amended. Filings are required to update the financial information provided in the final Official Statement and to provide notice of certain material events. Filings are made with each NRMSIR and SID (if any). The MSRB approves the creation of NRMSIRS and SIDs. Material events include, but are not limited to: delinquencies in payment of principal and interest; unscheduled draws on the reserve fund or the credit enhancement reflecting financial difficulties; bond calls; defeasance; release, substitution or sale of property securing repayment of the bonds; and, modifications to rights of bondholders. Material tax events must also be reported. The participating underwriter may, but is not obligated to, file the final Official Statement for the bonds with each NRMSIR. Starting January 1, 1996 issuers and conduit borrowers are required to begin filing the updated information, described above. Therefore, much of the financial information regarding the issuer and the conduit borrower will be available from the NRMSIRs and SIDs (if any).

The three existing recognized NRMSIRs are Bloomberg L.P., J.J. Kenny Co. and The Bond Buyer. At present, NRMSIRS serve as depositories for final Official Statements only, if submitted by the participating underwriter. In the future, NRMSIRS will clearly play a much greater role.

Numerous exemptions apply to Rule 15c2-12. The most important are for bonds with a stated maturity of 18 months or less, certain private placements of bonds, and certain small issues with principal amounts less than \$10,000,000. However, for such bonds, the MSRB still serves as a good source.

Whether you have access to the entire bond transcript or you are doing pre-examination research and desire to learn more about the financing, the best document to begin with is the Official Statement for the transaction.

5. The Official Statement

A. Preliminary Official Statement and Final Official Statement

The Official Statement (it may be referred to as the offering memorandum or the private placement memorandum) is the document used by the underwriter to sell the bonds to potential buyers. The Official Statement is the counterpart of the prospectus in the corporate finance industry. In order to protect purchasers, the Securities and Exchange Commission has promulgated rules which govern the information necessary to be included in the Official Statement of a municipal financing. The bonds are actually sold by the issuer to potential purchasers through the "preliminary Official Statement." This is not a "draft" of the Official Statement. In fact, under SEC Rule 15c2-12 the preliminary Official Statement (referred to as "deemed final" Official Statement in the Rule), may exclude only the information stated in the Rule. Except for the information permitted to be excluded under the Rule, the preliminary Official Statement must be "final" in all respects. The information permitted to be excluded under the Rule is: the interest rate(s), the offering price, the redemption provisions, delivery dates, ratings and certain other terms of the bonds which are dependent upon the market. In most instances, the aggregate principal amount of the bonds will be different in the preliminary Official Statement than that stated in the Official Statement. You have probably gathered by now that the preliminary Official Statement is, just preliminary, and you can safely ignore it and focus only on the Official Statement.

B. Preparation of the Official Statement

The issuer sells the bonds to the underwriter(s) through a competitive bid or a negotiated sale process. In a competitive bid, the issuer, with the assistance of its financial adviser and bond counsel, structures the financing and prepares the preliminary Official Statement. The issuer advertises the sale of the bonds in financial newspapers (such as

The Wall Street Journal and *The Bond Buyer*) and requests sealed bids from underwriters. The issuer selects the bid of an underwriter or a team of underwriters with the best price (which provides the least interest cost to the issuer). In a negotiated sale, when the issuer determines that it needs to issue bonds for a project, it hires an underwriter or a team of underwriter(s) to assist the issuer in structuring the transaction. In a conduit financing, the underwriter may be engaged by the conduit borrower. The issuer may engage the underwriter after requesting proposals from a number of investment banking firms or the issuer may engage an underwriter with which it has previously done business. In a negotiated sale, the underwriter and its counsel are involved in structuring the transaction and drafting the bond documents. The underwriter also negotiates its fee or discount with the issuer or the conduit borrower, before the pricing of the bonds.

The Official Statement for a negotiated sale is generally prepared by the underwriter's counsel. In all public offerings and most private placements, the underwriter's counsel renders an opinion that the Official Statement does not contain any untrue statement of a material fact and does not omit to state a material fact which was necessary to be disclosed. To be able to render this opinion, the underwriter's counsel reviews records of the issuer, the conduit borrower and the information pertaining to the project. The rules for disseminating true and correct information in the Official Statement to potential purchasers of the bonds are promulgated by the SEC and the penalties for violation of such rules are under the jurisdiction of the SEC. For examination purposes, the Official Statement serves as a source of information regarding the bond financing. Because the Official Statement is prepared to provide the potential purchasers of the bonds with all material information regarding the financing, it should also serve to give you an overview of the financing before you examine the entire bond transcript.

C. Contents of the Official Statement

(1) The Cover Page

The cover page of the Official Statement provides in large letters the name of the bond issue and the principal amount. The name of the bond issue gives very basic information regarding the financing. The name indicates whether the bonds are general obligation or revenue bonds. If a conduit borrower is involved, the name may include the name of the borrower, but it more often includes the name of the project financed with the proceeds of the bonds. Some examples are listed below.

\$2,000,000
CITY OF LEAF, STATE OF OAK
GENERAL OBLIGATION BONDS
SERIES 1995

\$10,000,000
CITY OF LEAF, STATE OF OAK
SEWER REVENUE BONDS
SERIES 1994-A

\$12,000,000
INDUSTRIAL DEVELOPMENT AUTHORITY OF LEAF,
STATE OF OAK
REFUNDING BONDS, SERIES 1994
(ABC MEMORIAL HOSPITAL)

\$10,000,000
LEAF HOUSING FINANCE AGENCY
FHA-INSURED MULTI-FAMILY HOUSING BONDS
GARDEN APARTMENTS PROJECT
SERIES 1987A

The remainder of the cover page provides a quick summary of the bond issue. It states the interest rate(s), the redemption provisions, the purpose for which the bonds were issued, the name of the conduit borrower, the name of the project, the security for the bonds, the name of the credit enhancer (if any), the date of issuance of the bonds, the name of the trustee and the names of the legal parties involved in the transaction.

The cover page also contains a short statement regarding the exclusion of interest on the bonds from the gross income of the bondholders. From this statement one can discern whether the bonds are governmental bonds or private activity bonds.

(2) The Introduction

The "Introduction," like the cover page, provides a quick overview of the financing.

(3) The Issuer

In a conduit borrowing, the section captioned, "The Issuer" provides minimal information on the issuer. This section contains: the names of the persons on the governing board of the issuer at the time of the financing; the number of bond financings done by the issuer; if the issuer has paid employee(s), the number of employees and the name(s) of key employees at the time of the bond financing; and, the address of the issuer's offices. In a general obligation financing the issuer is the ultimate source of debt

service on the bonds. Therefore, an Official Statement for general obligation bonds provides detailed information regarding the issuer. It includes demographic and economic data regarding the governmental unit, the tax base and tax rate(s), audited financial data (including financial statements for last 2-3 years), proposed budgets and other information which would describe the creditworthiness of the issuer. Generally speaking, most of this information should not be of much concern to you. This is because you are examining the financing and not the governmental unit. Moreover, by the time the financing is under examination, the information is stale. However, this information may be helpful if you are trying to ascertain the "reasonable intent" of the issuer at the time of the financing.

(4) The Project

In the case of governmental revenue bonds, *e.g.*, bonds issued for a sewer system, housing project owned by the municipality, municipal office building, or courthouse, the section captioned "The Issuer", similar to an Official Statement for a conduit financing, contains minimal information. This is because in a governmental revenue bond the debt service on the bonds is secured by the revenues generated from the project rather than the taxing powers of the issuer. However, unlike a conduit financing, additional information regarding the issuer and the project is available in detail under the caption "The Project" or "The System" or some similar caption. Some Official Statements for general obligation bonds and governmental revenue bonds, have minimal information regarding the issuer and the project in the body of the Official Statement, but provide detailed information in an appendix. The audited financial statements, if provided, are also included as appendices to the Official Statement.

In a conduit borrowing, the Official Statement describes in detail the project financed with the proceeds of the bonds. For example, if the bonds are issued to acquire an existing multi-family housing project or to refund prior bonds issued for the project, the description includes: the address of the project; the square footage; the number of units; the income restrictions; the occupancy rates for the last 3-5 years; financial information (operating revenues and expenses) for the last 3-5 years; etc. If the bonds were issued to finance the construction of a project, this section will have a short description of the plan for financing the project and the use of the project. The project may be more fully described in a feasibility study attached as an appendix to the Official Statement.

Official Statements for qualified 501(c)(3) bond issues where the conduit borrower is a hospital, a university, a nursing home, or a retirement facility, only have a short description regarding the borrower and the project. Detailed information regarding the borrower and the project (hospital, university or nursing home) is frequently included as an appendix to the Official Statement.

(5) Plan of Finance

This section is generally found in Official Statements for refunding bonds. The Official Statement for refunding bonds contains information regarding the refunded bonds and the use of the proceeds of such bonds. This information may be provided in a separate section, "Plan of Finance" or may be included under the section describing the project. The information under this section is important because an examination of refunding bonds will necessarily involve an examination of refunded bonds, and this will probably be the first source providing you with the name and use of proceeds of the refunded bonds.

(6) The Sources and Uses of Funds

An Official Statement usually includes a section called, "The Sources and Uses of Funds." This section is a short table, like a balance sheet, stating the source of all the money available for the financing. If moneys from sources other than bond proceeds are used to finance the project, such as equity of the borrower, this section should include those amounts. The list of the uses of bond proceeds and other moneys may include: construction, refunding, acquisition, costs of issuance, working capital, capitalized interest and reserves.

(7) The Security for the Bonds

One of the most important sections from the perspective of the potential purchasers of the bonds is, "The Security for the Bonds" or a similarly named section. This section explains to the purchasers all funds and properties available to the issuer to pay the debt service on the bonds. It lists all the funds pledged by the issuer or the conduit borrower, or funds reasonably expected to be used by the issuer or the conduit borrower, to pay the debt service on the bonds. It describes any mortgage or security interest granted by the issuer or the conduit borrower in connection with the bonds.

If the issuer or the conduit borrower have granted a negative pledge as security for the bonds, this section contains a description of the negative pledge. A negative pledge is a pledge of the borrower or the issuer providing that, as long as the bonds are outstanding the borrower or the issuer will not pledge, mortgage or assign any of the property or revenues designated to pay debt service on the bonds to a third party. A negative pledge is sometimes used in situation where the issuer or the borrower, due to state law or other restrictions, is prohibited from granting a pledge or mortgage to the bondholders. The negative pledge may state that the issuer or the borrower covenant not to expend moneys set aside in a fund for any purposes other than the payment of debt service of the bonds in the event of a shortfall. The issuer or the borrower may not have affirmatively agreed to allow the trustee to use the moneys in this fund to pay shortfall of debt service. The set aside of the moneys and the negative pledge must be examined closely to determine if

section 148 and the related regulations are applicable. The Indenture or the Loan Agreement may not contain a description of the negative pledge. The absence of a description does not necessarily mean that a negative pledge did not exist.

(8) Description of the Bonds

The Official Statement contains a section called, "The Bonds" or "Description of the Bonds." This section provides the following information:

1. Whether the bonds are book-entry only (see below).
2. The dated date of the bonds.
3. The authorized denominations.
4. The interest payment dates.
5. The interest rate(s).
6. The redemption provisions.

Although all of the information under this section is also contained in the Indenture or the Resolution (as described later in this chapter) it is important to read this section because the format of the Official Statement makes it easier to understand the terms of the bonds. Having read this section, you will find it much easier to follow the Indenture or the Resolution.

a. Book-entry

Bonds may be issued in certificated or book-entry only form. Since the last 7-8 years, a large portion of bonds are issued in book-entry form. When bonds are issued as book-entry bonds, the bondholders do not receive certificates for their records. Instead, the issuer prints just one bond for each maturity (say, \$22,000,000 term bond @ 5% maturing on 7/1/2017). When a person purchases a bond of this maturity, (say, \$100,000) the purchaser does not receive a certificate stating that the purchaser is the registered owner of \$100,000 principal amount of the bonds. Instead, the purchaser's name is entered into a register kept by the registrar, which is usually the trustee. The bondholder receives its interest and principal payments in accordance with the bond provisions and the registrar makes a notation of each payment on the bond register. If the bond is traded, instead of authenticating a new bond, as must be done with certificated bonds, the registrar simply changes the name of the bondholder on its register. The old bondholder does not have to mail in his or her bond certificate before receiving payment of principal. The cover page of the Official Statement states that the bonds are issued as book-entry bonds.

The text of the Official Statement has a separate section or subsection captioned, "Book-Entry" or "Depository Trust Company." This section describes how the payment of principal and interest on the bonds is passed from the trustee to the bondholders. This

section also describes the Depository Trust Company ("DTC") which is a repository for the bonds. One day before the closing date (the date of issuance of the bonds), bond counsel delivers one printed bond of each maturity to DTC. The financing with book-entry bonds is closed when the issuer receives the purchase price from the bondholders and DTC, on behalf of the underwriter, receives the bonds. Before the bond issue is closed, the trustee and the underwriter make a telephone conference call to DTC, whereby the trustee notifies DTC that it has received the money for the account of the issuer and the underwriter notifies DTC that all conditions for the bond issuance have been satisfied. The trustee then releases the book-entry bonds delivered to DTC. In a transaction with certificated bonds, the bonds are not issued and the financing is not closed until the underwriter has delivered the proceeds to the issuer and the bonds have been delivered to the underwriter.

If a transaction under examination is a book-entry transaction, you may need to use several John Doe summons to request the names of the bondholders. This is because bonds held by DTC are always registered under the name of Cede & Co. Cede & Co. in turn holds the bonds for the benefit of another party. Therefore, once an examination has begun, you should establish whether the bonds are issued in certificated form or book-entry form. This will give you a sense of how much time you need if it becomes necessary to tax the bondholders.

b. Variable Interest Rate Bonds

If the bonds bear interest at a variable rate, the section "Description of Bonds" will describe how the interest rate on the bonds is determined. The interest rate is generally determined by the remarketing agent and may be based upon financial indices available in the market (for example Kenny Index or Bond Buyer Index) or may be determined by an actual remarketing of the bonds. Common types of variable interest rates you may see are, weekly floaters, semiannual interest rates, dutch auction securities, embedded caps and other synthetic financial products. In an Official Statement for a variable rate bond issue, the section captioned "Description of Bonds" may be the longest portion of the Official Statement because it provides detailed description of how the interest rate is determined. Although this section is a summary of portions of the Indenture or the Resolution and other documents, it is important for you to understand this section. Having read this section will make it much easier to follow the legal documents.

(9) Credit Enhancement

In some financings the payment of the debt service on the bonds is secured by a bond insurance policy, a letter of credit, a collateral agreement, a guarantee, or mortgage insurance. This is referred to as credit enhancement. The Official Statement for such financings contains a separate section describing the credit enhancement and the credit enhancer. This section describes under what circumstances the credit enhancer will pay

the debt service on the bonds. This section usually follows the section captioned "Security for the Bonds" but in some instances may be a subsection under such caption. The subsection or section describing the credit enhancer provides corporate information regarding the credit enhancer.

(10) Tax Exemption

The information included under this section is provided by bond counsel. It states that on the date of issuance of the bonds, bond counsel will render an opinion that the interest on the bonds will be excludable from the gross income of the owners of the bonds for federal income tax purposes.

(11) Litigation

The Official Statement contains a section stating that no litigation is pending or threatened against the issuer or the conduit borrower which would have an adverse impact on the bondholders. If the issuer or conduit borrower are party to litigation which they feel should be disclosed, this section will describe the litigation.

(12) Other Sections

If the bonds were rated by one or more rating agencies, the Official Statement contains a section providing the ratings assigned to the bonds. Another caption usually found is, "Underwriting," which provides the name(s) of the underwriter(s) and the amount of underwriter's discount or fee. The names of the attorneys representing the issuer, the underwriter, the borrower and the credit enhancer and the name of the bond counsel are listed under a separate heading, "Legal Proceedings."

(13) Appendices

Depending upon the complexity of the transaction, the Official Statement may contain many appendices. Most transactions involving general obligation bonds or revenue bonds secured by the general credit of the issuer or the conduit borrower include audited financial statements. Bonds secured only by a mortgage on the asset financed with the proceeds of the bonds, such as, multi-family housing bonds do not include audited financial statements in the Official Statement.

If the bonds are issued to finance construction of a project, the Official Statement may contain the Feasibility Study or the Engineer's Report.

The appendices also contain a summary of the basic legal documents, such as the Indenture or the Resolution, the Loan Agreement, the Mortgage or Deed of Trust and the Land Use Restriction Agreement. The summary of the documents may be included as an

appendix or may be in the text of the Official Statement. There are no hard and fast rules regarding this and the format of the Official Statement is left solely to the judgement of the various parties to the transaction. If you have the entire transcript available, you will not need to read the summaries of legal documents.

Most Official Statements include an appendix which contains the "Form of the Opinion of Bond Counsel." The actual dated and executed opinion cannot be included because bond counsel does not execute and deliver its opinion until the closing date and the Official Statement is printed before the closing. However, except for the date and the signature, the opinion in the Official Statement is usually the same as that rendered by bond counsel.

If the bonds are secured by a bond insurance policy, the Official Statement includes an appendix which contains the "Bond Insurance Policy." Like the bond counsel opinion, this is a sample bond insurance policy because the actual policy is not issued until closing.

In certain complex transactions involving derivatives, the Official Statement may include summaries of additional documents, such as auction documents and swap documents. A review of these summaries may be helpful in understanding the actual documents.

Having reviewed the Official Statement, you have an overview of the financing structure. At this point you will be able to determine which documents in the bond transcript should be reviewed.

6. The Indenture

A. General

Most bonds are issued pursuant to a Trust Indenture. In certain instances, bonds are issued pursuant to a Resolution of the issuer. Unless otherwise stated, the term Indenture, as used in this chapter, includes the Resolution.

The Indenture is a contract between the issuer and the bond trustee. The Resolution, just like any other resolution or ordinance of a state or local government, is the evidence of an official action taken by the issuer with regard to the bonds. If the bonds are issued pursuant to an Indenture, the issuer always approves and authorizes the execution and delivery of the Indenture by adopting a resolution. This resolution is also made a part of the bond transcript and may be called the bond resolution or issuer's resolution. If the bond transcript contains an Indenture, then you should know that the bond resolution included in the transcript is not the issuing document.

In certain instances, especially in the case of an active issuer, the issuer will adopt what is called a "General Resolution" for issuing its bonds. A city may adopt a General Resolution pursuant to which it will issue all of its general obligation bonds or a housing agency may adopt a General Resolution pursuant to which it will issue all of its single family bonds. This General Resolution is much like an Indenture. It includes the general redemption provisions, provisions regarding funds and accounts, trustee's duties and obligations, and default provisions. The General Resolution requires that each time that the issuer issues a new series of bonds, it adopt a "series resolution" which contains specific provisions regarding the series of bonds. Therefore, when examining a transaction where the bonds were issued under a General Resolution, you should review both the General Resolution and the series resolution. The bond transcript should include copies of each of these documents and any amendments made to the General Resolution over the years (sometimes a General Resolution may have been adopted as much as 15 years ago). If the General Resolution, including all amendments to it, is not included in the transcript, you should request a copy.

B. Recitals and Granting Clauses

The Indenture begins with paragraphs called "Recitals." These paragraphs recite the facts underlying the transaction and state the issuer's desire to enter into the transaction and to issue the bonds. Next come the "Granting Clauses." This portion of the Indenture creates the trust corpus for the benefit of the bondholders. Under these paragraphs, the trust estate is granted to the trustee for the benefit of the bondholders. The trust estate secures payment of debt service on the bonds. In the event of a default, the bondholders may look solely to the items listed under the Granting Clauses. The information in the Official Statement under the caption "Security for the Bonds" describes this portion of the Indenture.

C. Definition of Terms

This section contains definitions of the various capitalized terms used in the Indenture and other legal documents. You will need to refer to this section from time to time to understand the meaning given to the capitalized terms throughout the Indenture and other bond documents.

D. Authorization, Authentication and Delivery

This section authorizes the issuer to issue the bonds and the trustee to authenticate the bonds. It also contains conditions which must be met prior to the authentication and delivery of the bonds by the trustee. This section also provides the interest rate(s) on the bonds, the final maturity date (also called the stated maturity date). Each bond is first executed and sealed by an authorized officer of the issuer. The trustee then executes the bonds. This execution by the trustee is called "authentication." Before authenticating the

bonds the trustee reviews the final bond to ascertain that the bond is in the form approved by the issuer and conforms to the Indenture. A bond is ready to be authenticated by the trustee when it has the correct interest rate, principal amount, maturity date and other specific provisions relating to the bonds, as described in the Indenture. The bond should also have the correct CUSIP number. CUSIP stands for the Committee on Uniform Security Identification Procedures.

E. Interest Rate Determination Method

If the bonds are fixed rate bonds, the interest rate(s) for each maturity is determined on the date the bonds are priced and are provided in the section "Authorization, Authentication and Delivery" discussed in the immediately preceding paragraph. Indentures for bonds bearing interest at a variable rate, cannot provide the interest rate(s) on the bonds for their entire term. The Indenture does provide the method by which the interest rate must be determined. When the method for determining the interest rate is unusually complicated, it is provided in a separate section. There are many different rate determination methods in the municipal finance industry. Full understanding of the rate determination methods includes understanding of other areas of the Code and provisions of the securities laws. For help, contact your Headquarters contact person.

F. Redemption

(1) General

This section describes the optional, mandatory, extraordinary, and special redemption provisions with respect to the bonds. The provisions of this section should be compatible with other sections of the Indenture and other financing documents. The following examples illustrates how the redemption provisions in the Indenture work with the other documents:

Example 1 The borrower's note permits the borrower to prepay the note on or after the fifth anniversary of the bonds. The Indenture provides that the bonds may not be called prior to their tenth anniversary. If the borrower prepays the note on its fifth anniversary date, the trustee will have to hold the prepayment proceeds for five years. This may cause arbitrage problems.

Example 2 The loan agreement permits the conduit borrower to sell the project financed with the proceeds of qualified 501(c)(3) bonds. Three years after the issuance of the bonds, the borrower sells the project to a for-profit purchaser which causes the bonds to become taxable bonds. The Indenture permits a mandatory redemption of bonds upon a determination of taxability. The trustee uses the proceeds of the sale to redeem the bonds.

Example 3 One year after the construction is complete, the project is destroyed by fire. The trustee and the issuer determine that reconstruction is not practical. The Indenture permits the extraordinary redemption of bonds upon the destruction of the project. The fire insurance proceeds deposited with the trustee are used to redeem the bonds.

The remainder of the redemption section provides the manner and timing of providing notice to the bondholders and the payment requirements in case of partial redemption.

(2) Optional Redemption

Optional redemption is the redemption of bonds at the option of the issuer. This section permits the conduit borrower or the issuer to prepay its debt or to refinance its debt at a lower interest rate or under more favorable conditions. Cost-saving refundings can only occur if the issuer is permitted to optionally redeem the bonds prior to their maturity date. In a conduit financing, because the borrower is the actual debtor, the borrower usually initiates the process of optional redemption. This is done when the borrower pays off all or a portion of its debt to the issuer before it is due and payable. Generally speaking, most fixed rate bonds are callable on and after their tenth anniversary date. This is referred to as, the "first call date." The issuer usually has to pay a premium if it chooses to optionally redeem the bonds on the first call date. The optional redemption section states the first call date. It also provides the premium, if any, to be paid on the first call date and subsequent years. The optional redemption section may require that the bonds may not be called for redemption until a certain time period (ranging from 123 days to one year) after the conduit borrower has paid its obligation to the issuer. This is to protect the bondholders from a subsequent bankruptcy of the conduit borrower.

(3) Mandatory Redemption

a. Sinking Fund Redemption

If all or a portion of the bonds are issued as term bonds, instead of making one balloon payment on the final maturity date, the issuer usually establishes a schedule to amortize the principal of the bonds during the term of the bond. These payments are called sinking fund redemptions. These are mandatory redemptions. If the issuer is unable to make one principal payment on a sinking fund redemption date, the entire bond financing usually is in default.

b. Other Mandatory Redemptions

The Indenture sometimes requires that the issuer redeem the bonds upon the occurrence of certain events. These events include the determination of taxability of the

bonds and transfer or sale of the project. See Example 2 above. Unlike the extraordinary mandatory redemption provisions, these events are within the control of the issuer or the conduit borrower.

c. Extraordinary Mandatory Redemption

The bonds may be subject to mandatory redemption upon the occurrence of certain events which are usually out of the control of the issuer or the conduit borrower. Such events may include destruction or condemnation of the project financed with the proceeds of the bonds, or change in law having an adverse impact on the security of the bondholders. See Example 3 above.

(4) Special Redemption

Although not very common, you may see special redemption provisions in some transactions. An example is single family housing bonds. The underlying debt on a single family bond is the money loaned to the homeowner to purchase a residence. The homeowner may pay off the mortgage at any time, either by selling the home or refinancing the mortgage. Although the bonds are subject to optional redemption, the first call date may be more than 90 days from the prepayment by the homeowner. To provide for this situation, the Indenture permits a special redemption of the bonds, at par, from proceeds received by the issuer from prepayment of the mortgages.

G. Funds and Accounts

(1) General

This section establishes the funds and accounts which form a part of the trust estate and also those funds which are established under the Indenture but are not part of the trust estate. In some transactions the issuer may establish a fund which is not held by the trustee and is not dedicated to pay debt service on the bonds, but is nevertheless an important part of the financing. An example of this would be the replacement reserve fund which is used to replace obsolete equipment or to do maintenance on the project. This section describes the deposit of bond proceeds and other moneys by the trustee to various funds established under the Indenture and the flow of revenues received by the trustee from the conduit borrower or the issuer. This section should account for the entire principal amount of the bond proceeds and other moneys used in the financing. If the Indenture fails to provide for the use of all the bond proceeds, you should inquire about the discrepancy. If the financing included moneys other than bond proceeds, those moneys should also be traceable under this section.

(2) Deposit of Bond Proceeds

All transactions are unique and each bond counsel will draft an Indenture differently. Yet all indentures include certain funds. Each Indenture establishes a fund into which a majority of the bond proceeds are deposited on the date of issuance. The moneys in this fund is used to achieve the purposes for which the bonds were issued. This fund may be called, the acquisition fund, the proceeds fund, the construction fund, the refunding fund or something equivalent. The Indenture directs the trustee as to the use of moneys deposited in the fund.

If the bond proceeds are to be used for acquisition purposes, the Indenture directs the trustee to transfer moneys in the acquisition fund to the seller of the project when all conditions for the acquisition have been met. In almost all instances the acquisition of the project occurs on the same day as the issuance of the bonds. If the acquisition is to transpire sometime after the issuance of the bonds, the Indenture directs the trustee to invest the proceeds to be used for acquisition purposes until such time that the acquisition occurs.

If the bonds were issued for construction purposes, the Indenture directs the trustee to invest the moneys in the construction fund and to permit withdrawals from such fund as needed. If the bond proceeds are used to refund prior bonds, the trustee is instructed to transfer the moneys to the trustee for the refunded bonds or an escrow agent and invest the moneys until the redemption date of the refunded bonds. It is important to note that because the Indenture uses the term "acquisition fund" does not necessarily mean that the bonds were issued for acquisition purposes. The headings are used for the sake of convenience and do not control the content.

A smaller portion of the bond proceeds or other moneys may be deposited in the cost of issuance fund, the working capital fund, the capitalized interest account and the reserve fund. Some of these funds are described below.

(3) Deposit of Revenues

Each Indenture establishes a fund to deposit the revenues used to pay debt service on the bonds. It may be called the bond fund, the revenue fund, the debt service fund, or something equivalent. Revenues to pay debt service on the bonds can come from a variety of sources. In a general obligation financing, the moneys deposited in the revenue fund come from the general fund of the issuer. In case of revenue bonds, the revenues come from an enterprise fund. This fund can include: Rentals from the project, payment by the borrower on its note, the water and sewer revenues. Revenues also include the insurance proceeds and condemnation awards, proceeds from the credit enhancer, moneys from the sale or transfer of the project. Certain Indentures will create separate accounts within the revenue fund. The Indenture may create the principal account into which the revenues to

be used to make each principal payment are deposited. The revenues to be used to make the interest payments may be deposited into a separate interest account. You may find a redemption account within the revenue fund. This is created to hold all moneys which will be used for the redemption of bonds, other than sinking fund redemptions. The creation of the funds and accounts is entirely up to the issuer, the trustee and bond counsel. The Indenture also instructs the trustee about when it should receive revenues from the issuer or the conduit borrower to enable the trustee to pay debt service on the bonds when due. The trustee is also instructed regarding the method of paying principal and interest to the bondholders.

(4) Reasonably Required Reserve Fund

If the issuer has determined that a reasonably required reserve fund is necessary, the Indenture establishes such a fund and instructs the trustee to deposit the required amounts into this fund. The reserve fund requirement is determined on the date of issuance of the bonds. The reserve fund (may be called the debt service reserve fund) may be funded with a portion of bond proceeds, other moneys of the issuer or the borrower, or a surety bond. The moneys in the reserve fund may be invested in a guaranteed investment contract ("GIC"). A GIC is a contract between the trustee and a financial institution, under which the financial institution agrees to pay a guaranteed interest rate to the trustee on the invested money. The GIC is for a term of years, which may be extended, and it also permits the trustee to withdraw the money from the GIC at short notice. The moneys in the reserve fund may be invested in other investments, such as treasury bills or certificates of deposit. In such a case, the trustee is required to value the reserve fund at least annually. The valuation is done to determine if the investments in the reserve fund are valued at the same amount as the reserve fund requirement. The following example illustrates how the valuation works.

Example The reserve fund requirement for the bonds is at 1,000,000. The moneys in the reserve fund are invested in treasury bills. The trustee is required to value the investments on each June 1. On June 1, 1995 due to a rise in interest rate, the value of all of the treasury bills held in the reserve fund is \$900,000. The issuer or the conduit borrower must deposit \$100,000 in the reserve fund to bring the value of the reserve fund to the reserve fund requirement. Suppose on June 1, 1997, the interest rates have fallen below the rate on the treasury bills held in the reserve fund. The value of the investments in the reserve fund is now \$1,005,000. The Indenture permits the issuer or the conduit borrower to withdraw the amount in excess of the reserve fund requirement.

A GIC is not subject to such valuation because a GIC is not a marketable security and its value does not fluctuate based upon the market interest rate. You must determine the amount of the reserve requirement and the source of the moneys deposited in the

reserve fund. You will then have to determine if the issuer has complied with section 148 of the Code and the related regulations. Note that the valuation method under an Indenture may not be the same as the valuation methods referred for arbitrage purposes.

(5) Cost of Issuance Fund

The Indenture may establish a cost of issuance fund to deposit costs of issuing the bonds. The amounts deposited in this fund may or may not be bond proceeds. Because moneys in this fund are spent a short time after the closing date, many Indentures do not establish a separate cost of issuance fund. In such case, issuance costs are paid out of the construction fund, acquisition fund or another fund.

(6) Rebate Fund

Most Indentures also establish a rebate fund into which the issuer or the conduit borrower must deposit amounts to pay rebate to the United States. The fact the Indenture does not establish a rebate fund is not an indicia of bad faith by the issuer or an inclination not to pay the rebate if any is due. There are no arbitrage rules that a fund must be established, only that rebate must be paid. The rebate fund is bond counsel's method of making sure that the issuer is aware of its obligation to the United States.

H. Covenants of the Issuer

This section contains the basic covenants of the issuer. Since the conduit borrower is not a party to the Indenture, the covenants of the conduit borrower are included in the loan/lease agreement. In a conduit transaction, the issuer's covenants are boilerplate and include the following:

1. covenant to pay debt service on the bonds.
2. covenant to file, when necessary, all financing statements and other recorded documents.
3. covenant to maintain the priority of the bondholders' security interest in the trust estate.
4. covenant to file all reports received from the borrower with the trustee.
5. covenant to take steps as necessary to maintain the tax exempt status of the bonds.

You may encounter difficulty in obtaining financial and other reports regarding the project or the bonds from the trustee or the issuer. You may have been informed that the issuer and the trustee do not possess the reports. A review of the covenants may disclose that the information you have requested is required to be filed with the issuer and the trustee. When applicable, you may therefore wish to cite the particular sections in the Indenture when requesting additional information.

I. Default and Remedies

This section describes what constitutes an event of default under the Indenture and what remedies are available to the trustee in the event of such default. It also describes the rights of the bondholders in the event of default.

J. Rights and Obligations of the Trustee

This section provides the rights and duties of the trustee. It provides the manner for removing the trustee, appointing a new trustee, and the requirements to be followed upon the resignation of the trustee. This section is boilerplate and not of much interest to you. However, if a question arises regarding the duties of the trustee you will find them spelled out in here.

K. Discharge of the Indenture

This short section describes under what circumstances the bonds will be considered paid in full (defeased) and the lien of the Indenture discharged even though the bonds are still outstanding. Most advance refundings of bonds are made possible by these provisions. This section permits the issuer to deposit with the trustee or escrow agent, for the benefit of the bondholders, enough cash or securities to pay the principal of and interest on the bonds to the redemption date or the maturity date of the bonds. If the issuer deposits sufficient moneys and meets the other requirements of this section, the bonds are defeased and the Indenture is discharged. The types of securities which must be included in the escrow to effectuate an advance refunding are stated in this section. The requirement of particular types of investment in the escrow (obligations backed by the full faith and credit of the United States government) is to maintain the security of the bondholders and to provide assurance that the issuer will pay debt service on the bonds when due.

L. Miscellaneous

This section has the catch-all provisions, such as the governing law, rights of third-party beneficiaries, successors and assigns, notice, and addresses. The addresses of the issuer, the trustee, the borrower, the credit enhancer and the rating agencies as of the issuance date are provided in this section.

M. Exhibits

An Indenture generally includes the form of the bonds as an exhibit. The Indenture may have the form of requisitions submitted to the trustee in a construction financing. In case of variable rate bonds, the Indenture will have additional exhibits relating to mandatory or optional tender by the bondholders, form of notices to be sent in the case of resetting of the interest rate or conducting an auction, and additional exhibits specific to the financing.

7. The Loan Agreement

A. General

In a conduit transaction the issuer loans the proceeds of the bonds to the conduit borrower to finance the project. In such cases, the transcript will contain a loan agreement. Under some state laws, the issuer is not authorized to loan bond proceeds but is authorized to lease the project to the conduit borrower. Where this is necessary, the issuer "acquires" the project and immediately leases it to the conduit borrower for the term of the bonds and at the end of the lease term, the borrower becomes the owner of the project. This is called a financing lease and, although the end result is the same, in this case the bond transcript will have a lease agreement rather than a loan agreement.

In certain cases, a non-profit borrower may enter into a true lease for the term of the bonds. In the case of qualified 501(c)(3) bonds, this could involve a non-profit borrower which has been created solely to operate and maintain the project for political reasons or for the sake of expediency. In the case of private activity bonds (other than qualified 501(c)(3) bonds) it may involve a lease of the project to a for-profit entity for the term of the bonds. Unlike a financing lease, in a true lease the issuer remains the owner of the project.

In some instances, you may find an installment sale agreement between the issuer and the conduit borrower. In this case, the issuer owns the project and the borrower has use of the project and will purchase it from the issuer over the term of the bonds. The Loan Agreement, the Lease Agreement and the Installment Sale Agreement are few simple examples of how a transaction may be structured. The term "Loan Agreement" as used in this chapter includes the Lease Agreement or Installment Sale Agreement or similar document.

Depending upon the requirements of state law and provisions of the Code and the financing strategies, the structure of the transaction may become extremely complex. Having reviewed the Official Statement and the Indenture, you should have a general idea of the financing arrangement. At this point you should have a diagram of the transaction

as described in the financing documents. The diagram should show the flow of the bond proceeds from the trustee to the borrower or until spent by another party. The diagram should also trace back the flow of the revenues from their source all the way to the payment of debt service to the bondholders. You may need to revise the diagram a few times. However, over time and with practice, you will realize that diagramming a transaction will prove to be a helpful tool not only for arbitrage analysis, but also for determining private use.

The Loan Agreement is heavily negotiated and varies from transaction to transaction. The debt obligation of the conduit borrower may be non-recourse or recourse. In a non-recourse obligation, the general corporate credit of the borrower does not secure the borrower's obligation. Rather, the borrower's obligation is secured only by the revenues from the project, including a mortgage on the project. On the other hand, in a recourse obligation the general credit of the borrower secures the obligation.

B. Definitions

The Loan Agreement, like the Indenture, will begin with recitals and have a definition section. Depending upon the transaction, the Loan Agreement may incorporate by cross-reference all of the definitions provided in the Indenture.

C. Representations, Warranties and Covenants

This section describes the organizational status of the parties and states the covenants made by each party. The conduit borrower will represent its status as a validly created and organized corporation or a partnership. If the transaction involves qualified 501(c)(3) bonds, the borrower will represent and warrant as to its exempt status.

The representations, warranties and covenants of the conduit borrower are generally very inclusive and sometimes are a result of a lengthy negotiation process. This section may include tax covenants of the borrower which are also repeated in the tax agreement (see below). It is important to note that all the covenants of the borrower are made on the date of issuance of the bonds and drafted by bond counsel. Which means that the covenants basically serve to inform the borrower what it must do, or refrain from doing, in order to maintain its tax exempt status and the tax exempt status of the bonds. You must verify for yourself whether the borrower kept its covenants after the issuance of the bonds.

D. Acquisition/Construction of the Project

In a financing involving construction or substantial rehabilitation, this section describes the conditions under which the bond proceeds may be disbursed from the construction fund. A requisition form may be attached to the Loan Agreement as an

appendix. The borrower uses the requisition form to withdraw bond proceeds from the construction fund held by the trustee. The requisitions will be essential to determine the date the bond proceeds were spent for arbitrage and rebate purposes. You should request requisitions from the trustee. This section also directs the use of any remaining money after the construction is complete.

E. Repayment of the Loan

In a Loan Agreement this section provides the requirements for the repayment of the loan of the bond proceeds. In a lease agreement such payments are called rental payments. The amount to be paid and the due dates are set so that the trustee has sufficient moneys to make the interest and principal payments on the bonds when due. The borrower may be committed to pay more than debt service on the bonds. The borrower usually pays the administrative cost of the financing, makes payments into a replacement reserve fund (if any), makes up any shortfalls in the reserve fund and other amounts stated in the Loan Agreement.

F. Special Covenants

In transactions where the bonds are secured by the gross revenues of the project or the gross revenues of the borrower, the loan agreement contains financial covenants. These covenants include reporting requirements of the borrower. The borrower agrees to file financial statements, annual budgets, balance sheets, occupancy rates, and other financial data. The borrower covenants to file these documents with the trustee, the issuer and other third parties.

The borrower may also covenant regarding the use of the project. These covenants may include the following:

1. sale, transfer or leasing of the project.
2. rates and charges at the project.
3. maintenance of a debt service coverage ratio.
4. incurring additional debt.
5. management of the project by the borrower or a third party.
6. payment of insurance premiums and the amount of insurance coverage.
7. dissolution or merger of the borrower into another entity.

These covenants are generally required by the credit enhancer, if any, or by the bondholders where the bonds are privately placed. When examining qualified 501(c)(3) bonds, you should review these covenants carefully and determine whether these covenants can be considered to provide private benefit or inurement. Private benefit and inurement questions might be raised if the 501(c)(3) organization has lost its ability to make independent charitable decisions. If the organization can only make decisions according to profitability, it may have negotiated away its ability to act as a charity. If the organization's actions cause the organization to lose its exempt status, the interest on the bonds would no longer be excludable from gross income for federal tax purposes.

G. Damage, Destruction and Condemnation

The Loan Agreement directs the trustee how to use insurance proceeds or condemnation awards. The agreement provides when the project may be rebuilt and when it is a total loss and bonds must be redeemed. Under the extraordinary mandatory redemption section we discussed redemption of bonds in case of damage, destruction or condemnation of the project. Without such a provision, the issuer would have to hold the insurance proceeds or condemnation awards, which may cause arbitrage problems. If the project must be rebuilt, this section, much like the construction proceeds section, provides the use of the insurance proceeds or condemnation award.

H. Default and Remedies

Similar to the Indenture, the Loan Agreement also defines an event of default and the cure provisions in the event of a default. If the default is not cured in a timely manner, the Loan Agreement provides the remedies available to the trustee.

8. Master Indenture

In certain qualified 501(c)(3) bond transactions, especially those involving a large healthcare corporation, a Master Indenture may be part of the bond transcript. The Master Indenture is not the same document as the Indenture and the bonds are not issued under the Master Indenture. The parties to the Master Indenture are the conduit borrower and a bank, usually referred to as the master trustee. The master trustee and the bond trustee may or may not be the same party. Not all 501(c)(3) organizations execute a Master Indenture nor are they required to do so.

The sole purpose of the Master Indenture is to provide the conditions to be met prior to any borrowing undertaken by the exempt organization. Just as the Indenture serves to protect bondholders, the Master Indenture serves to protect all lenders (both bonds issuers and others) of the conduit borrowers. The debt issued under the Master Indenture may be a long term loan from a bank or may be the borrowing of proceeds of

tax exempt bonds. The Master Indenture is to the borrower, what the General Resolution (discussed above) is to the issuer. Just as the issuer issues bonds under its General Resolution as an evidence of its indebtedness, the borrower issues notes under its Master Indenture as an evidence of its indebtedness.

The Master Indenture, like the Indenture, is a trust agreement securing the notes issued by the borrower. The Master Indenture provides the following: (i) the trust estate securing the notes; (ii) the conditions for authenticating each note; (iii) the representations and warranties of the borrower; (iv) the funds and accounts established by the borrower to pay the notes; (v) the financial covenants of the borrower; (vi) the debt service coverage ratios which must be met before and after the issuance of the notes; and, (vii) defaults and remedies.

Because each debt of the borrower will have different terms (interest rate, maturity, prepayment provisions, etc.), the Master Indenture does not include specific provisions for each borrowing. The Master Indenture provides that at the time of the issuance of each note, the borrower must enter into a Supplemental Master Indenture to provide the specific provisions of the note evidencing that specific debt. Accordingly, the bond transcript will include a Supplemental Master Indenture. Depending upon the number of borrowings made by the conduit borrower, the Supplemental Master Indenture may be the first, second or seventh Supplemental Master Indenture (as the case may be). Similarly, the note issued under the Supplemental Master Indenture has a specific number or series (such as Series 1993 Note or Series B Note). Because each bond issue relates to a particular Supplemental Master Indenture and a note of the borrower, the bond transcript will only include that particular Supplemental Master Indenture, the note, and the Master Indenture. The following example illustrates the relationship between the Indenture, the bonds, the Master Indenture and the notes issued under the Master Indenture:

Example Oak Memorial Hospital executed a Master Indenture in 1987. In 1987 Oak Memorial borrowed \$5,000,000 from a local bank under the provisions of the Master Indenture. It executed a First Supplemental Master Indenture providing the terms of its loan from the bank. It also issued Series A Note to the bank as evidence of its debt. In 1989, Oak Memorial borrowed \$20,000,000 of proceeds of tax-exempt bonds issued by the City of Leaf. Before executing the Second Supplemental Master Indenture and authenticating the Series B Note, the master trustee determined that the new borrowing met the requirements of the Master Indenture. Oak Memorial executed a Second Supplemental Master Indenture providing the terms of this borrowing and issued a Series B Note under the Master Indenture. The Series B Note was issued to the City of Leaf, as the lender and is held by the bond trustee as security for the bondholders. The Series A Note and the Series B Note are equally secured by the gross revenues of Oak Memorial.

The Master Indenture provides how the gross revenues of Oak Memorial are deposited into various accounts and used to pay all the notes issued under the Master Indenture.

Now Oak Memorial needs to add a wing to its facilities. It wants to borrow \$35,000,000 of tax-exempt bond proceeds from the County of Willow. This debt must meet the conditions stated in the Master Indenture. It cannot have priority over the Series A Note and the Series B Note and nor can this borrowing jeopardize the security of the previous two debts. The master trustee must ascertain that after the issuance of this debt, the financial covenants in the Master Indenture will be met. If all conditions are met, the master trustee will approve this debt and authenticate the Series C Note and execute the Third Supplemental Master Indenture. When the bonds are issued, Oak Memorial will enter into a loan agreement with the County of Willow. As security for this loan, the master trustee will execute and deliver the Series C Note to the bond trustee. Although the Series C Note is issued to the County of Willow, it is security for the payment of debt service on the bonds, it is therefore held by the bond trustee.

If an exempt organization has executed a Master Indenture, in almost all instances its covenants are stated in the Master Indenture and not the Loan Agreement. If you are examining qualified 501(c)(3) bonds issued on behalf of an organization which is party to a Master Indenture, you should request a copy of the Master Indenture and all of the outstanding Supplemental Master Indentures and notes.

9. Tax Documents

A. General

The number of tax documents in a bond transcript will depend upon bond counsel. Bond counsel may choose to draft the Tax Regulatory Agreement separate from the Arbitrage Certificate, or bond counsel may draft one document called the Tax Regulatory Agreement and No Arbitrage Certificate, or the Tax Agreement and Certificate as to Arbitrage. In transactions involving a multi-family housing project where the Code requires numerous income restrictions, the bond transcript will include a Land Use Restriction Agreement. If a Land Use Restriction Agreement has been executed, a separate Tax Regulatory Agreement is not necessary. In such a case, the bond transcript will only include an Arbitrage Certificate. In some bond transcripts you may find a document called Investment and Rebate Instructions. This document is usually short and reiterates, in simpler terms, some of the provisions of the Arbitrage Certificate. In the Arbitrage Certificate the issuer certifies how it reasonably expects to use and invest the bond proceeds. Because the issuer depends upon bond counsel and/or tax counsel to advise it regarding the tax issues, bond counsel often prepares the Investment and Rebate

Instructions. These Instructions serve as bond counsel's advice, in layman's terms.

B. Tax Regulatory Agreement

The Tax Regulatory Agreement ("TRA") is generally between the issuer and the trustee, however, in the case of a conduit financing, the conduit borrower will also be party to the TRA.

The TRA states the representations and warranties of the issuer or the conduit borrower regarding the use of the project in accordance with the purposes for which it was financed. If the transaction involves qualified 501(c)(3) bonds, the conduit borrower will make representations regarding its exempt status and that it will not perform any acts or enter into any agreements which will adversely affect its exempt status. If the project involves a multi-family housing project, the TRA will include representations regarding the occupancy at the project and the low-income limitations. The TRA will have a section regarding the change in use of the project and the conditions under which a change will be permitted.

The TRA may include the following representations of the issuer and/or the conduit borrower regarding the information to be included in Form 8038:

1. the issue price.
2. the stated redemption price at maturity of the final maturity of the bonds.
3. the issue price and the stated redemption price at maturity of the entire issue.
4. the yield and the net interest cost of the entire issue.
5. the interest rate of the final maturity.
6. information regarding the refunded bonds, if applicable.

The absence of these representations does not mean that the TRA is misleading or insufficient. Because the issuer executes Form 8038, which provides this information, these representations do not have to be included in the TRA.

Although a separate Arbitrage Certificate may be executed, the TRA may also include the representations regarding rebate and arbitrage. This is especially the case in a conduit financing because the Arbitrage Certificate is the certificate of the issuer, whereas, the TRA serves as an agreement of the conduit borrower regarding the use of

the bond proceeds and use of the project.

In drafting the TRA, bond counsel includes the reasonable expectations of the parties as of the issuance date and representations and warranties of the parties regarding their future acts in order to maintain the tax exempt status of the bonds. The TRA is just a road map, which may or may not be complete and may or may not be accurate in its description of the Code provisions. You must ascertain if the issuer and the conduit borrower complied with all of their representations and warranties as stated in the TRA, and if all the requirements of the Code and regulations were met. The TRA may assist you in preparing and asking the appropriate questions.

C. The Arbitrage Certificate

Section 1.148-2(b)(2) of the regulations provides that an officer of the issuer must certify the issuer's reasonable expectations as of the issuance date. The regulations provide that the certificate of the issuer's expectations is evidence of the issuer's expectations but does not establish conclusions of law or presumptions. Moreover, it does not establish the reasonableness of the issuer's expectations. The Arbitrage Certificate will state the facts and estimates that form the basis of the issuer's expectations. The Arbitrage Certificate will state the issue price of the bonds, which is generally based upon the certificate of the underwriter or the financial adviser. This certificate may be attached to the Arbitrage Certificate or may be a separate document in the transcript. The use of bond proceeds in the Arbitrage Certificate should conform with the Indenture. If it does not, you should find out which numbers are accurate. You should then find out whether the proceeds were spent as stated in the two documents.

In a transaction involving new construction, the Arbitrage Certificate will provide the issuer's reasonable expectations regarding the expenditure of the moneys in the construction fund. You should request invoices and withdrawal statements from the appropriate funds to determine if the bond proceeds were spent as intended.

D. Land Use Restriction Agreement

In most instances the TRA will state the representations and warranties regarding the use and occupancy of the multi-family housing project financed with the proceeds of bonds. However, the issuer, the conduit borrower and the trustee will also execute and deliver the Land Use Restriction Agreement ("LURA"). The LURA is recorded in the land records and the covenants run with the land.

The issuer and the conduit borrower covenant that the project will be operated as a "qualified residential rental project," as defined in section 142(d) of the Code. The issuer and the conduit borrower covenant that during the "qualified project period" the project will be rented to persons meeting the income limitations. The issuer and the conduit

borrower elect the income limitation test on the date of issuance of the bonds (i.e., 20% of the units at 40% of median or 40% of the units at 60% of median). The issuer or the borrower agree to maintain a file for each lower-income tenant residing in the project and also agree to request income certifications from each tenant prior to initial occupancy and annually. If the project is owned by a conduit borrower, the borrower agrees to furnish the issuer and the trustee copies of the certifications. You should request all income certifications from the issuer to determine if the income limitation requirements have been met. The LURA will have the form of the income certifications included as an appendix.

10. Other Tax Documents

Sections 146 and 147 of the Code contain provisions which must be met for the interest on certain qualified private activity bonds to be excluded from gross income of the bondholders. The bond transcript will contain documents which evidence compliance by the issuer with the requirement of these sections of the Code.

A. Volume Cap

Section 146 of the Code limits the amounts of private activity bonds which can be issued by a state, a state agency and other issuers within the state. This section does not apply to certain types of private activity bonds, including, qualified 501(c)(3) bonds and qualified veterans' mortgage bonds. The formula stated in section 146 is based upon the population of the state in which the issuer is located. The state allocates a portion of its state ceiling to the local political subdivisions. This amount, which is the volume cap, may not be exceeded in such year. If an issuer does not use its entire volume cap in the year in which it was allocated, it may make an election to carryforward the unused amount.

When examining private activity bonds, you should determine whether the bonds under examination meet the requirements of section 146. The bond transcript may include a certificate of a state official certifying that the principal amount of the bonds is within the volume cap. The only way to determine if the volume cap certification is correct is to ask about any other private activity bonds issued by the issuer in the calendar year in which the bonds under examination were issued. The amount of the bonds issued in such year may exceed the volume cap allocated to the issuer if the issuer had made a valid carryforward election. In this situation, you should review the carryforward election(s) made with regard to the excess amount.

Form 8328, pursuant to which a carryforward election is made, requires the issuer to list the carryforward purpose. The bonds issued in any subsequent year pursuant to a carryforward election should be issued for the same purpose as the carryforward purpose listed in Form 8328. For example, if the issuer carried forward \$20,000,000 of its volume

cap for the purpose of issuing qualified mortgage revenue bonds, then, when the issuer uses this \$20,000,000 volume cap, it must use this volume cap for issuing qualified mortgage revenue bonds and not multi-family residential rental housing bonds.

Section 146(i) contains a special rule for private activity bonds. Under this rule, refunding bonds do not need new volume cap so long as, the amount of the refunding bond does not exceed the amount of the refunded bonds and the refunding bonds meet the other requirements of section 146.

B. TEFRA Notice and Public Approval

If the bonds under examination are private activity bonds, you should review the resolution of the issuer regarding the TEFRA hearing and the TEFRA notice. TEFRA stands for Tax Equity and Fiscal Responsibility Act of 1982. The principal amount of the bonds approved by the issuer's resolution and advertised in the TEFRA notice, should not be less than the principal amount of the bonds issued. However, there is a de minimus exception in the regulations. The description of the project, the address and the name of the borrower should be substantially accurate.

C. Reimbursement Bonds

If the bonds under examination are reimbursement bonds, you should review the "issuer's" resolution(s) to determine whether the requirements of section 1.150-2 of the regulations have been satisfied. If the bonds are private activity bonds, but are not qualified 501(c)(3) bonds, qualified student loan bonds, qualified mortgage bonds or qualified veterans' mortgage bonds, the regulations define the "issuer" to be the issuer of the bonds. In all other instances, the "issuer" is either the issuer of the bonds or the conduit borrower who has borrowed the proceeds of the bonds. You should therefore first determine who is the "issuer" for purposes of the reimbursement regulations. Having done that, you should review the resolutions and/or minutes of the appropriate party to determine if, the "issuer" originally intended to reimburse itself with bond proceeds and the reimbursement bonds have been issued within the reimbursement period. The 1994 CPE Text contains an article on reimbursement bonds on pages 310-321 which describes the requirements to be met for a proper reimbursement. See also, the Arbitrage Article in this text.

11. Other Documents

A number of documents in the transcript may not be of any relevance to the tax analysis. However, it will help you to understand the entire transaction if you know the purpose of these documents. A short description of the most frequently seen documents is provided below.

A. Bond Purchase Agreement

This is an agreement between the issuer and the underwriter of the bonds. In case of a conduit financing, the conduit borrower is also a party to the Bond Purchase Agreement. The Bond Purchase Agreement provides: (i) the terms of the bonds; (ii) the conditions which must be met before the purchase of the bonds by the underwriter; (iii) the delivery date and place of the bonds; (iv) the conditions under which the underwriter may withdraw from the contract; (v) the underwriter's fees; (vi) the expenses to be paid by various parties; and, (vii) certain SEC requirements to be followed by all parties. This agreement is executed after the bonds have been priced. The Official Statement is dated the same date as the Bond Purchase Agreement.

B. Blue Sky Survey

This document describes whether the securities laws of any state require the underwriter to register the bonds or meet any other state law requirements.

C. Deed of Trust/Mortgage

These documents, together with any security agreements and financing statements, evidence the security of the bondholders in the real or personal property securing the bonds. All these documents are recorded in accordance with state law.

D. Certificates of the Issuer

The issuer executes and delivers certificates attesting to its creation and the incumbency of its officers and directors. The issuer also certifies regarding the absence of litigation which would affect its ability to issue the bonds. The issuer certifies that it has the corporate powers and authority to issue the bonds and execute and deliver the documents to which it is a party. The certifications made by the issuer may be included in one certificate or may be in two or three certificates. These certifications may become important to your tax analysis if the issuer is an "on behalf of" issuer. You should determine whether an "on behalf of" issuer has been validly established and meets all of the requirements of Rev. Rul 63-20, 1963-1 C.B. 212 and Rev. Proc. 82-26, 1982-1 C.B. 758. These certificates will help you determine whether the bonds were issued by a validly created issuer.

E. Certificates of the Conduit Borrower

Similar to the issuer's certificates and resolutions, the borrower certifies that it is validly existing and established under state law and has the authority and power to borrow. The transcript will include the articles of incorporation and by-laws of a corporate borrower and the applicable resolutions authorizing the borrower to enter into

the transaction. In a qualified 501(c)(3) bond issue, the transcript will also include the determination letter received by the borrower from the Service.

F. Credit Enhancement Documents

(1) Bond Insurance

If the bonds are insured, the transcript will include a specimen copy of the insurance policy which is a one page document and is stamped "specimen." The transcript may also include an agreement between the insurer and the issuer regarding reimbursements. Bond insurance is an absolute and irrevocable obligation of the bond insurer to pay, when due, if the issuer or the conduit borrower fail to pay, the debt service on the bonds. The bond insurance policy is issued for the entire term of the bonds. The rating(s) on the bonds reflect the rating(s) of the long term debt of the bond insurer.

(2) Letter of Credit and Reimbursement Agreement

A letter of credit ("LOC") is issued by a bank to the trustee, on behalf of the issuer or the conduit borrower. An LOC may be issued to provide credit enhancement or liquidity or both. At the time of issuance of the LOC, the issuer or the conduit borrower enter into the reimbursement agreement with the LOC bank. Under the reimbursement agreement, the issuer or the conduit borrower agree to reimburse the LOC bank for all draws made on the LOC. The issuer or the conduit borrower also issue a note to the LOC bank which is evidence of their agreement to reimburse the LOC bank upon a draw on the LOC. This note is separate from the note discussed under the Loan Agreement and the deed of trust. Do not confuse the reimbursement agreement with the arbitrage issues regarding "reimbursement bonds."

a. LOC as Credit Enhancement

An LOC which provides credit enhancement serves essentially the same purpose as a bond insurance policy. The LOC is issued by a bank and provides security to the bondholders regarding the timely payment of debt service on the bonds. As long as the credit enhancement LOC is outstanding it will secure all principal and interest payments to the bondholders. The LOC bank will only make a payment on a principal and interest payment date if the trustee provides the LOC bank with a demand notice conforming with the terms of the LOC. The demand notice requests payment from the LOC bank in an amount equal to the debt service payment on the bonds on that date. Upon receiving the demand notice, the LOC bank pays the trustee the amount requested by the trustee. The trustee uses the bank's money to pay debt service on the bonds.

As you have probably gathered by now, the bondholders look to the credit of the LOC bank. As in the case of bond insurance, the rating(s) on the bonds is based upon the

rating(s) of the LOC bank. The LOC bank directly pays the debt service on the bonds and then gets reimbursed from the issuer or the conduit borrower. This kind of LOC is called a "direct-pay LOC." The bond insurance policy is issued for the entire term of the bonds, whereas, LOCs are never issued for the entire term of the bonds. The term of an LOC usually varies from five to seven years.

b. LOC as Liquidity

In case of variable rate bonds which may be tendered by the owners at their option or bonds which are subject to mandatory tender at the option of the issuer, the issuer or the conduit borrower may obtain a direct-pay LOC which solely provides liquidity. The purpose of this type of LOC is to provide sufficient money to pay the principal and accrued interest (the "purchase price") on the bonds when tendered by the bondholders. This LOC does not secure the sinking fund payments or other debt service payments on the bonds. If the issuer or the conduit borrower fail to provide sufficient money to pay debt service on the bonds, the bonds are in default regardless of the presence of this LOC.

G. Stand-By Bond Purchase Agreement

In certain transactions involving variable rate bonds which are subject to tender, instead of obtaining a direct-pay LOC to provide liquidity, the issuer or the conduit borrower may enter into a stand-by bond purchase agreement with a bank. The stand-by bond purchase agreement serves essentially the same purpose as a direct-pay LOC, however, its payment mechanism is different from a direct-pay LOC. Under the stand-by bond purchase agreement, the bank does not automatically pay the purchase price of the bonds. When the trustee receives notice from a bondholder that the bondholder desires to tender its bond on the next tender date, the issuer's remarketing agent attempts to remarket that bond. If the remarketing agent is successful, the money received from the new bondholder is used to pay the purchase price to the old bondholder. If the remarketing agent is unsuccessful, the bank providing the stand-by bond purchase agreement purchases the unremarketed bonds. The bank thus becomes a bondholder. The remarketing agent then remarkets the bank's bond.

H. Guaranteed Investment Contract

A guaranteed investment contract ("GIC") is an agreement between the trustee and the GIC provider. The GIC is used by the trustee to invest the proceeds of the reserve fund or a construction fund. The GIC provides a guaranteed rate of return on the money invested under the GIC. The arbitrage regulations require the issuer to receive and review at least three bids for a GIC and enter into the highest yielding GIC.

I. FHA Documents

In certain housing bonds, the transcript may include other forms of credit enhancements, such as, a collateral agreement with FNMA, FHA mortgage insurance or a GNMA security. These securities do not directly secure the debt service on the bonds, but secure the payments to be made under the mortgage. FHA, GNMA or FNMA will require other agreements with the issuer or the conduit borrower to secure their position. Such agreements will be included in the bond transcript.

J. Feasibility Study

If the bonds are issued to construct a new project, the issuer or the conduit borrower may hire a consultant to perform a feasibility study. The study is included in the Official Statement and is used to market the bonds. By the time the bonds are under examination, the feasibility study may be old. If the project is never constructed or fails soon after construction, you may want to challenge the feasibility study if you can show that there was no reasonable possibility that the project could have been constructed or operated as stated in the study.

K. Engineer's Report

This is usually included in bond transcripts for exempt facility bonds, such as resource recovery, electric output, water and sewage disposal. This is the report of the engineering team constructing the project or acting as a consultant to the project. It describes in detail the plans and specifications, any permits to be obtained from federal and local governments before the construction of the project, the financial feasibility of the project, and the legal impediments (court decisions or legislation pending or threatened which may affect the particular industry). This report may prove to be helpful to the agent in making determinations regarding when the solid waste is no longer "solid" or "waste" or at what stage does the project become an output facility. It is valuable in understanding the project and the scientific information underlying the transaction.

12. Lease-Backed Financings

Most states and local governments have constitutional limitations on the amount of debt they can incur. Under most state constitutions, prior to incurring debt which is secured by its taxing powers, a state or the local government must either hold a voter referendum or show that the new debt will not cause the entire outstanding debt of the state or the local government to go above permissible limits. To avoid voter referendum and other requirements of the state constitutions, states and local governments structure transactions in a manner that the financing is not considered "debt" under state law. One manner for doing this is to enter into lease-backed financings. A majority of lease-backed financings are done in the form of certificates of participation ("COPs"). The following

example illustrates the financing:

Example City of Leaf determines that it needs a new governmental building. X, a for-profit developer owns a building in the City's business area which would serve the needs of the City. The City could issue bonds and acquire the building. Because the bonds will mature more than one year after their issuance, the bonds would be "debt" of the City and subject to constitutional restraints. The City does not desire to hold a voter referendum. The City creates a corporation Y. The City enters into a lease agreement for the building with Y. The lease agreement, which is between the City and Y, provides that at the end of the term the City will own the building. The trustee issues certificates of participation in the lease agreement which entitle the purchasers of the COPs to receive a participation, or share, in the lease payments made by the City to Y. The purchase price received from the purchasers of the COPs is paid to X and during the term of the lease, Y owns the building. Y assigns the lease payments to the trustee as security for the COPs.

In the above example it is not necessary for Y to be a 501(c)(3) corporation. The lease payments are divided into an interest component and a principal component matching the principal and interest due on the COPs. To avoid the lease agreement, which is for the term of the COPs, being labelled "debt," some lease agreements provide that the lease payments to be made by the state or local government are subject to annual appropriation. This means that in each year that the lease is outstanding, the government will use its best efforts to include the lease payments in its fiscal budget. However, the state or local government may, at its option, decide not to budget the lease payments and thus terminate the lease agreement. Because the lease payments are equivalent to principal and interest payments on a loan to the state or the local government, the interest received by the COP holders may be excludable from their gross income for federal tax purposes.

When examining a COPs transaction, you must determine whether the lease is a financing lease. In a financing lease, the lessee (in this case the state or local government) generally becomes the owner of the facility at the end of the lease term. You should also determine whether there is any private use of the facility.

The documentation in a COPs transaction is similar to that in a regular revenue bond transaction. Instead of a loan agreement, you will find a lease agreement or an installment sale agreement. The COPs are issued pursuant to an Indenture or Trust Agreement. The Indenture, which is between the trustee and the state or local government, directs the trustee to execute the COPs. The lease payments are assigned to the trustee and secure the debt service on the COPs.

13. Conclusion

The purpose of this article is to assist you in understanding the basic bond documents. Although no two transactions are absolutely alike, we hope this article will give you some familiarity with basic bond documents to facilitate your examination of different and complex transactions. While the bond transcript is only a snap shot taken on the closing date, the information in it should help you to focus on the issues and plan your examination.