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## “BOND FAQ’S”

### Questions and Answers About Industrial Development Revenue Bonds

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## “BOND FAQ’S”

### Introduction

In today’s world, “FAQ’s” means “Frequently Asked Questions.” These are the questions about a topic that tend to recur. When you have the answers to these questions, you will have basically what you need to know in order to understand the topic.

With this White Paper, the topic is bonds; specifically, industrial development revenue bonds. I think there is a need for a “Plain English” explanation of this complex subject. The goal of this White Paper is to provide you with just such an explanation.

This White Paper discusses bonds informally, in a “Question and Answer” format. If you have other questions, please let me know.

With that background, let’s turn to the topic of industrial development revenue bonds. In this case, we are concerned with bonds used primarily for financing purposes. (In Georgia and some other states, regardless of whether or not true financing is involved, a bond-financed sale-leaseback transaction is need to provide *ad valorem* property tax “abatment” and certain other incentives; see our White Paper, “Bonds for Title”).

### What Is a Bond?

A bond is just a way to borrow money. A company should not confuse the community’s agreeing to issue industrial development revenue bonds through a development authority, with the community’s promising to sell bonds backed by the community’s own credit to raise money for the company. On the contrary, in a bond issue, the development authority is just a conduit (i.e., a “conduit issuer”) for issuing bonds representing a financing by the company (i.e., the company is a “conduit borrower.”) The development authority’s name is on the bonds, but the development authority is not liable for the repayment of the bonds, except from funds received from the company and any other “pledged security.”

### **If the Development Authority isn’t liable on the bonds, what about the county or city?**

The bonds are revenue bonds, repayable from revenues derived from the company that are pledged by the development authority (and other bond security, such as a security deed on the project itself) and any other security pledged by the company. Neither the general credit of the development authority nor the credit of the county or city is liable on the bonds.<sup>1</sup> Note—some incentives structures involve credit enhancement by the community. This still doesn’t make the community liable on the bonds; all that’s happening is that additional security (such as an intergovernmental contract) is being provided for the bonds. These incentives structures are

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<sup>1</sup> In rare cases, the Constitutional amendment for a particular community’s “Constitutional” development authority can affect this rule.

outside the scope of this issue of this White Paper, which deals only with a straightforward financing for the company.

### **What are the types of bonds that a development authority can issue?**

A development authority can issue bonds for any purpose permitted by the Georgia Constitution and the governing law (the Development Authorities Law, for “statutory” development authorities, and their respective Constitutional amendments and related local legislation, in the case of Constitutional development authorities). However, the bonds may be issued as federally tax-exempt bonds only if the financing qualifies under the Internal Revenue Code. Federally tax-exempt bonds include, most commonly, bonds for certain “exempt facilities” (including certain utility projects), “qualified 501(c)(3) bonds” issued for the benefit of 501(c)(3) organizations (such as non-profit private high schools, colleges and medical facilities), and “exempt small issue” bonds for certain manufacturing facilities. Some manufacturing facilities will not qualify for tax-exempt financing, because the tax rules (i) within the “test period” described below, impose “caps” on the amount of the tax-exempt bonds (including certain prior issues of tax-exempt bonds, this amount may not exceed \$10 million) and on certain non-bond-financed capital expenditures within the city or county with respect to facilities used by the conduit borrower (under this limit, the total amount of bonds and other capital expenditures cannot exceed \$20 million) and (ii) limit to \$40 million nationwide the amount of tax-exempt bonds applicable to each conduit borrower (for purposes of this test only bond balances, not capital expenditures are material).

Compliance with the other rules for such tax-exempt financings is still required, of course, and in addition-

- Expenditures on more than just a single manufacturing project in a single location may be counted against the capital expenditure limitation. Capital expenditures by the “principal user” of the project and certain of its related parties are also counted, and these expenditures would be counted if they were made, for example, on a sister plant located in the same city or unincorporated portion of the same county.
- Bond issues closed before 2007 remain subject to more restrictive capital expenditure rules that applied when the bonds were issued. This means, for example, that proceeds of a tax-exempt bond issue for a manufacturing project that closes in 2007 would be included in the capital expenditures counted against an earlier tax-exempt bond issue that closed within three years prior to the 2007 bond issue (as would non-bond financed capital expenditures for the earlier project). The tax laws count capital expenditures for such purposes during a “test period” beginning three years for a bond issue closes, and ending three years thereafter.

Finally, “taxable” bonds (see below) are the most flexible way to finance with bonds, although the interest rates are not as low.

### **Why use bonds?**

Tax-exempt bonds are the best way to borrow money, if just the interest rate is considered (other considerations are overall cash flow requirements, balance sheet treatment, etc- bonds often have to compete with other financing structures<sup>2</sup> in order to be selected by the company as the one to be used). The lower interest rate results from the interest being tax-exempt to the bond buyer (the buyer can afford to accept a lower rate of interest, if the buyer doesn't have to pay federal income tax on the interest). There are other reasons, too (see below).

### **How are tax-exempt and “taxable” bonds different?**

The interest on “taxable” bonds is not exempt from federal income taxation. Taxable bonds can be used for any type of project that the development authority is authorized to finance, without any kind of capital expenditure limitation, and without the need for an allocation of the State’s “bond cap” from the Georgia Department of Community Affairs (an “allocation” is a federal requirement that is a normal part of the process of issuing “small issue” manufacturing bonds; an allocation is not required for qualified 501(c)(3) bonds). Even though the interest is not federally tax-exempt, the interest on taxable bonds is exempt from Georgia income tax, which can provide a limited interest rate benefit. Good examples of how to use taxable bonds include financing distribution projects (or other non-manufacturing projects that don’t qualify for tax-exempt financing), manufacturing projects that are disqualified for tax-exempt financing because their capital expenditures are too high, and projects that would qualify for tax-exempt financing except that the way that the financing is structured violates one of the tax rules; e.g., a development authority leases a manufacturing plant to a company under an operating lease (so it will be off the company’s balance sheet), but the development authority stands to receive too much value from regaining the plant at the end of the lease if the lessee doesn’t exercise the purchase option in the lease.

What do tax-exempt and taxable bonds have in common? Most bonds sold publicly in recent years,<sup>3</sup> whether tax-exempt or taxable, have been structured as “lower floaters”; *i.e.*, variable rate demand bonds. Not only is the interest rate reset frequently (most commonly, weekly) to reflect current bond market rates, but the structure allows the bondholder to “cash in” the bond, if he or she prefers. Short term interest rates like this, are lower than longer-term interest rates, like 10 or 30 year corporate bonds. Lower floaters are always an investment grade (see below) investment, that pays a lower interest rate, because they are always secured by an investment grade bank letter of credit<sup>4</sup>. Finally, in Georgia, bonds, whether they are tax-exempt or taxable, are the keys to many types of incentives, such as *ad valorem* property tax abatement.

### **What’s the “cap” on development authority charges to do a bond financing?**

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<sup>2</sup> We can provide information about alternative financing structures upon request.

<sup>3</sup> The alternative structure (fixed rate bonds) is available, but has been less attractive economically.

<sup>4</sup> See our White Paper, “Introduction to Taxable Floaters.”

The IRS' "arbitrage" rules prevent public bodies from selling tax-exempt bonds as a way to make money (by reinvesting the proceeds), as opposed to financing projects approved by the tax laws. The spread between the yield on purpose investments (the approved project) and the yield on the tax-exempt bonds is limited by these rules to 1/8 of 1%. Present value calculations are used to determine the spread. What this means to a development authority that wants to charge a financing fee for issuing bonds, is that its fee (together with anything else that might be considered yield), can't exceed 1/8 of 1% of the principal amount of the bonds as of the date(s) used in the calculation. As an example, a one-time upfront financing fee of 1/8 of 1% of the original principal amount of the bonds would be OK. These arbitrage rules don't apply to taxable bonds.

Among the other transactional costs of a bond deal will be the fees charged by the development authority's counsel.

### **How are the bonds sold?**

In order to be marketable, the bonds must be backed by a good enough credit. The company will sign a lease or a note, promising to pay basic rent or note payments to the development authority. The basic rent or note payments match the debt service on the bonds. However, public investors usually aren't willing to just look to the basic rent or note payments for repayment of the bonds; they want to be able to look up a credit rating for the bonds, find that it is investment grade, and know that they will be paid through a bank letter of credit (that has been issued to secure the bonds), without having to worry about defaults by the company.

### **What does "investment grade" mean?**

In the terminology used by S&P and Fitch, for example, investment grade is a rating of BBB- through AAA (Moody's is the other major rating agency, and has its own terminology). If the bonds are secured by a bank letter of credit, the bank's letters of credit must be rated investment grade. On the strength of the letter of credit, the rating agency will assign a rating (the same rating as the letter of credit) to the bonds. Frequently, the bonds themselves are not rated, but still sell on the basis of the rating of the bank that issues the letter of credit.

### **What type of letter of credit is needed?**

The letter of credit for a bond deal is issued by a commercial bank. A letter of credit is a separate document, in which the bank itself undertakes to make stipulated payments on the conditions specified in the letter of credit itself. This means that the bank's own credit<sup>5</sup> is passed

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<sup>5</sup> In cross-border transactions, it should be possible for a company's bank abroad to issue a standby letter of credit and for the company then to use that to back a "direct pay" letter of credit issued in the U.S. by a U.S. bank (that would have a banking relationship with the company's bank abroad). This is called a "back to back" letter of credit structure. Of course if the bank abroad is investment grade rated and has a regulated U.S. branch, it could provide the direct pay letter of credit, without the need for a second bank to be involved.

through to the bonds. In bond financings, the type of letter of credit that is involved is called a “direct pay” letter of credit (as opposed to a “stand-by” letter of credit). Instead of the company making basic rent or note payments directly, the bank, under the letter of credit, pays the amount thereof to the trustee for the bondholders (and is reimbursed by the company), rather than “standing by” in case the company defaults on its basic rent payments or note payments. This is done to avoid problems under the Bankruptcy Code if the company goes bankrupt.

### **Can bonds be issued without a letter of credit?**

In some cases, a company with good, but unrated, credit may be able to privately place the bonds with a bank or financial institution with which it regularly deals, without a letter of credit. Sometimes community banks will buy the bonds on the same basis. The process can be simplified in either case if the bonds are drawdown bonds (funds are drawn down as needed and there is no trustee for the bondholders). Privately placed bonds can be sold through a placement agent or underwriter to investors that do not have a pre-existing relationship with the company (often a letter of credit is required, even if the bonds are being privately placed). If the bonds are publicly sold, they are sold to (or through) an underwriter, who sells or resells them publicly to such investors as tax-exempt money market funds, bank trust departments, and profitable corporations.

Regardless of whether a bank issues a letter of credit to support the bonds, or buys the bonds directly into its portfolio, the transaction is an extension of credit<sup>6</sup> by the bank to its customer. The bank will underwrite the extension of credit in accordance with its normal policies. If the company has strong credit of its own, perhaps the extension of credit will not be collateralized. Otherwise, the bank would require collateral, perhaps including personal guaranties from the company’s principals, and could be expected to impose such requirements as a debt-to-equity ratio for the project being financed. More stringent underwriting requirements can be expected for start-up projects.

### **What’s the list of participants in a bond issue?**

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<sup>6</sup> If the bank is buying the bonds directly into its portfolio, the loan documents between the bank and its customer (the company) that are being collateralized will include, for example, a “Credit Agreement” or a “Bond Purchase Loan Agreement”. If the bank is providing a letter of credit, the comparable agreement might be termed a “Reimbursement Agreement” or “Credit Agreement”. An example of the collateral typically required is a first priority security deed or mortgage on the project and a pledge of inventory. In the case of tax-exempt bonds, the federal income tax rules usually make it impractical (by restricting yield or requiring yield reduction payments) to directly or indirectly use as collateral “replacement proceeds” (including cash, bank deposits, securities and other types of investment property). If “back to back” letters of credit are used, the bank issuing the direct pay letter of credit to secure the bonds would not normally need more collateral than the stand-by letter of credit from the other bank, but the other bank might require collateral, and providing this collateral would also be subject to the “replacement proceeds” rules.

In the case of a typical private placement of bonds, there would be the conduit borrower (the prospect/company), the conduit borrower's counsel, the issuer (the development authority), the issuer's counsel, the bond counsel, the bond purchaser and perhaps a bond purchaser's counsel, and, perhaps guarantors that are stockholders or affiliates of the company.

In the case of a public offering of lower floaters, there would be the conduit borrower, the conduit borrower's counsel, the issuer, the issuer's counsel, the bond counsel, the underwriter, an underwriter's counsel, the bond trustee, the trustee's counsel, the remarketing agent, the letter of credit bank, the letter of credit bank's counsel and there may be guarantors that are stockholders or affiliates of the company that would guarantee the obligation of the company to reimburse the letter of credit bank for amounts drawn under the letter of credit.

### **What are all of the steps in a bond issue?**

All (tax-exempt or taxable) bond issues in Georgia follow these steps-

- The company files a request with the development authority for bond financing. This is not a legal requirement, but is typical. Some development authorities have formal application procedures and forms. Please contact me if you are interested in obtaining a specimen "Application for industrial development revenue bond financing."
- The development authority adopts an inducement resolution, and the development authority and the company execute a letter of intent and inducement agreement. Please contact me if you are interested in obtaining a specimen inducement resolution.
- The company finds<sup>7</sup> a purchaser for the bonds (a bank, financial institution or underwriter). If a letter of credit is needed, the company finds a letter of credit bank. The company will obtain written commitments from these participants. The commitment(s) will dictate the terms of the bonds.
- Once the financing commitments have been received, bond counsel can begin drafting documents, which are then distributed to all of the participants for review and comment.
- When these documents are finalized, the development authority then adopts a bond resolution approving the bonds and the final bond documents. (If the bonds are subject to SEC disclosure requirements, underwriter's counsel around this time will be preparing the disclosure document: the Official Statement or Offering Memorandum).
- The parties involved in the judicial validation (district attorney, clerk of court, etc) are then brought into the process, and the impending validation is advertised in the local newspaper two weeks in a row.
- The bonds are then judicially validated.

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<sup>7</sup> We can assist the company with this, particularly in assembling the financing team.

- After the parties sign closing documents and the required documents are recorded, the bond issue is closed.

In the case of tax-exempt bonds, the following additional steps are involved-

- As bond counsel, we try to get the company to fill out a tax questionnaire we provide as soon as possible. We discuss this questionnaire with the company, and determine if the bonds can be issued as tax-exempt bonds.
- Notice (called a “TEFRA Notice”) of a public hearing is published in the local newspaper at least 14 days in advance of the hearing at which members of the public may appear and comment on the bonds, on the nature and location of the project and on the plan of financing. This advertisement is in addition to the advertisements of the validation. The TEFRA Notice generally runs prior to the validation advertisements.
- The hearing (called a “TEFRA Hearing”) is held before the development authority (or its hearing officer) or the Board of Commissioners of the County (or Mayor and City Council, in the case of a city development authority or its hearing officer). The TEFRA Hearing may be held before or after the adoption of the bond resolution.
- The bonds are then approved (called “TEFRA Approval”) by the appropriate elected official, which will generally be the Board of Commissioners of the County (or Mayor and City Council, in the case of a city development authority), or a designated elected official, such as the Chairman of the Board of Commissioners or Mayor. The schedule for this Approval is usually dictated by the meeting schedule of the County or City.
- An application is filed with the Department of Community Affairs for an allocation of a part of the State of Georgia’s private activity bond volume cap (an allocation is not needed for qualified 501(c)(3) bonds). The development authority and the company will sign the application, which usually will be filed by bond counsel. We try to file the application as soon as all the requirements have been met (obtaining financing commitment and TEFRA approval, etc).
- DCA issues the private activity bond volume cap allocation.
- At the closing, the development authority and the company execute a tax compliance certificate and certain other tax-related documents are executed in addition to the other bond documents.
- After the closing, an IRS Form 8038 is filed.

The company is responsible for the costs of issuing the bonds to the extent not paid from bond proceeds (only 2% of the proceeds of tax-exempt private activity bonds may be applied to costs of issuance). The development authority should be sure that this obligation is set forth in the inducement agreement that the company signs early in the process.

The bond issuance process generally takes 60-90 days from receipt of the financing commitment from the letter of credit bank or bond purchaser. If the company needs funds for the project prior to closing, once the inducement resolution has been adopted, it could either use its own funds or obtain a “bridge loan” from a bank, either of which could be repaid out of bond proceeds

### **More Information**

This paper is a quick-reference guide for company executives and managers, economic developers, participants in the real estate and financial industries, and their advisors. The information in this paper is general in nature. Various points which could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

Additional information concerning this topic, as well as White Papers and references on other topics, can be found at <http://danmcræ.info/>.

If you have any questions or comments, we would be pleased to provide more information. Please contact:

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