

ANATOMY OF AN INDUSTRIAL DEVELOPMENT FINANCING: THE PARTICIPANTS AND THE STEPS

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Since the 1930's, industrial development authorities (called "IDAs" in this article) have been able to issue bonds or notes for the purpose of financing certain projects for private entities (called "borrowers" in this article). An IDA is a local industrial development authority created by a Pennsylvania county, city, borough or township. Bonds may also be issued by state agencies, such as the Pennsylvania Economic Development Financing Authority (PEDFA), which is not an IDA. In many cases, the borrowers are nonprofit corporations such as health systems, higher educational institutions, private secondary schools or YMCAs. Sometimes the borrowers are small for-profit manufacturing companies. The types of projects which may be undertaken are driven by a combination of Federal tax law and state law.

The purpose of this article is not to describe what kind of projects can be undertaken, but to describe the process for accomplishing the financing once an eligible project has been identified.

The financing involves the issuance of debt (in the form of bonds or notes) by the IDA which then loans the proceeds of the debt to the borrower. The borrower uses the money to finance its project, and the borrower makes payments to repay the principal and interest on the IDA's debt. The IDA is only a "conduit issuer" acting on behalf of the borrower - the IDA is not liable for paying the debt. The true obligated party is the borrower.

There are two basic structures used in these financings. First, the IDA may undertake a public bond issue in which bonds are sold to many investors (referred to herein as a "public bond issue"). Second, the IDA may issue a single note to a lender, usually a commercial bank (referred to herein as a "private loan").

In most cases, the goal is to have the interest on the bonds or note be federally tax exempt to the purchaser of the debt. In Pennsylvania, all bonds issued by an IDA are also exempt from Commonwealth taxation. Sometimes the financing is structured to have some or all of the interest to be taxable to the purchaser.

For most borrowers, a debt issue is a rare occurrence perceived to be shrouded in mystery. Like most things in life, it is only mysterious because it is unfamiliar. Once you understand the participants and the steps, the process makes more sense.

In recent years, the securities and tax regulations governing this type of debt have grown increasingly complex. More so than ever before, it is important for the IDA and the borrower to understand what they are getting into and what their responsibilities are when they undertake a debt issue.

A. The Participants.

The IDA - Issuer. The entity issuing the debt is the IDA. As described above, the IDA is a "conduit issuer" which means it is a facilitator for the borrower. The IDA is required to be the issuer of the debt if the interest on the debt is intended to be tax-exempt. Nonprofits and for profit companies may not issue tax-exempt debt directly. It is very important to an IDA that it not be obligated to pay the debt. The documentation for the financing needs to be clear that the IDA is not directly obligated but is only passing on the payments received from the borrower.

The Borrower. The nonprofit or for-profit company borrowing the money is the borrower. The borrower is using the proceeds either for a capital project or to refinance existing debt. The borrower is obligated to pay the costs of issuance at closing and to pay the principal and interest on the debt over time.

IDA's Solicitor. The IDA's regular lawyer is referred to as the solicitor. The solicitor represents the IDA in the financing and delivers a legal opinion at the closing. The solicitor's opinion usually covers the following matters: that the IDA is validly existing, that the IDA's officers validly hold their offices and are authorized to execute documents, that the public meeting at which the financing is approved was properly called and held, and that there is no material litigation pending against the IDA which would adversely impact upon the financing.

Borrower's Counsel. The lawyer representing the borrower in the financing is the borrower's counsel. This lawyer also delivers a legal opinion at the closing usually covering the following matters: that the borrower is validly existing, that the borrower's officers validly hold their offices, that the resolution of the borrower's board was properly adopted, that the financing documents are enforceable against the borrower, and that there is no material litigation pending against the borrower which would adversely impact upon the financing.

In many cases, the solicitor and the borrower's counsel are not experts in public finance. But they are usually experienced lawyers who understand their respective client's operations better than any of the other professionals involved in the bond issue. Therefore, they should be diligent in protecting the interests of their clients by asking questions. If they are not comfortable with anything related to the financing, then they should slow down the process until they are comfortable. In a public bond issue, it is particularly important that they review the description of the IDA and the borrower in the disclosure document for the bonds (commonly called the official statement, or "OS"), and that they make sure their clients are prepared to comply with their post-issuance responsibilities (described below).

Bond Counsel. Because the solicitor is often not an expert in public finance, the IDA usually also retains a law firm (paid for and sometimes chosen by the borrower) which specializes in public finance to work with the solicitor on the legal aspects of the financing. This lawyer is commonly referred to as bond counsel. Bond counsel typically identifies the IDA as its client.

Bond counsel cooperates with the IDA, the borrower and the financial advisor or underwriter in structuring the transaction, with particular emphasis on legal matters related to state law approvals and compliance with the federal tax and securities laws. Bond counsel also delivers an opinion at the closing which covers the following points: the IDA has properly authorized and issued the debt; the debt is enforceable under the law; and interest on the debt is exempt from federal income tax and certain state taxes (to the extent applicable). Purchasers of the debt rely on the bond counsel opinion when they buy the debt.

In some financings, one law firm may serve both as solicitor to the IDA and bond counsel or as both borrower's counsel and bond counsel.

Financial advisor and/or underwriter. There are two financial functions that take place in a public bond issue. First, the IDA and borrower may retain a financial firm (paid for by the borrower) to advise them on the structuring of the bond issue. Second, the IDA and borrower may retain a financial firm to buy the bonds with the intent to sell them to purchasers.

The rules governing what types of firms can perform these two functions are currently in flux.

Traditionally, the IDA and borrower could hire an underwriter (also called an investment banker) to perform both of these functions in a negotiated offering. In a negotiated offering, an underwriter is selected to purchase the bonds. The underwriter, in turn, sells the bonds to its investor customers. The terms of the bonds are tailored to meet the demands of the underwriter's investor clients, as well as the needs of the issuer. Negotiated sales also involve a process known as a presale in which underwriters seek customer indications of interest in the issue before establishing final bond pricing. Or, the IDA and borrower could hire a financial advisor solely to advise the issuer and borrower on structuring the bond issue. (The financial advisor would not sell the bonds.) The IDA and borrower would then, with the advice of the financial advisor, sell the bonds either through a negotiated offering or through a competitive sale. In a competitive sale, bonds are advertised for sale. The advertisement, by way of a notice of sale, includes both the terms of the sale and the terms of the bond issue. Any broker dealer or dealer bank may bid on the bonds at the designated date and time. The bonds are awarded to the bidder offering the lowest interest cost. .

Financial advisors were seen as having a fiduciary duty to the IDA or borrower, but financial advisors were largely unregulated. Underwriters did not have a fiduciary duty to the IDA or borrower (just an obligation to deal fairly), but underwriters were heavily regulated.

In response to the financial crisis of 2008, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank created a new category of "municipal advisors" and invested the Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB) with jurisdiction over financial advisors and other participants in municipal bond transactions.

In 2010, the SEC required municipal advisors to register with it. On September 20, 2013, the SEC published final regulations which are over 700 pages long and are quite complex. Suffice it to say that underwriter groups and financial advisor groups are debating with each other and with the SEC and the MSRB over who can provide what structuring advice to IDAs and borrowers. Stay tuned for further developments in this area.

Paying agent or trustee. Once the public bond issue has closed, debt service payments are made by the borrower (on behalf of the IDA) to the bondholders through a paying agent or trustee, which is a commercial bank chosen by the IDA or borrower. Depending on the structure of the bond issue, the paying agent or trustee may also hold certain moneys in a reserve fund or other funds. If the bond issue ever goes into default, the paying agent or trustee often represents the bondholders in any remedial proceedings against the IDA and borrower.

The Lender. In a private loan, a financial entity (referred to herein as the "lender"), usually a commercial bank, loans the money and receives a note from the IDA in return. The lender does not have a fiduciary duty to the IDA or the borrower, so oftentimes the borrower will retain a financial advisor to help in the structuring of the loan and in negotiating with the lender. The lender will usually have its own lawyer.

Credit Enhancers. It sometimes makes economic sense for the borrower to utilize a third party to guarantee the debt -- this is called credit enhancement. For instance, an insurance company may issue an insurance policy guaranteeing payment of debt service on the bonds; or a bank may issue a letter of credit to guarantee the payment of principal and interest on the bonds. If the credit enhancer ends up paying on its guaranty, the borrower is obligated to repay the credit enhancer.

B. The Steps.

Selection of participants and structuring the transaction. The first step is for the IDA and borrower to select bond counsel and the financial advisor or underwriter. This selection should be undertaken almost immediately after the IDA and the borrower have identified the project to be financed.

The IDA and the borrower work with these participants to structure the financing. Some basic questions need to be answered: (1) What is the purpose of the issue -- to fund a capital project, to refund prior debt, or a combination of both? (2) What are the legal parameters involved -- does the capital project serve a proper legal purpose, can the debt be refunded under the federal tax rules? (3) Will the financing be structured as a public bond issue or as a private loan? (4) If a public bond issue is chosen, how should the bonds be sold -- through negotiation with one underwriter or through a bidding procedure with multiple underwriters? (5) Does credit enhancement make economic sense (that is, is the cost of the insurance or letter of credit less than the resulting debt service savings)?

Once the structure is formulated, the IDA and the borrower need to select the paying agent or trustee and the credit enhancer, if any. Once this is accomplished all of the participants begin to prepare the required documentation. If it is a public bond issue, the underwriter or financial advisor and the IDA and the borrower prepare the disclosure document which is usually called the preliminary official statement. Bond counsel drafts the resolution, the indenture and other legal documents. The indenture is a legal and binding contract between the issuer and the bondholders. The indenture specifies all the important features of a bond, such as its maturity date, timing of interest payments, method of interest calculation, callable/convertible features if applicable and so on. The indenture also contains all the terms and conditions applicable to the bond issue. Other critical information in the indenture includes the financial covenants that govern the issuer and the formulas for calculating whether the issuer is within the covenants.

Application to DCED. The IDA and the borrower are required to apply for approval by DCED of the project and financing using a standard form. The application is composed of the Department of Community and Economic Development's "Single Application for Assistance" form as well as appendix pages specific to the IDA bond financing program. The application describes the IDA, the borrower and the project. The IDA and borrower must submit with the application: (1) a resolution of the IDA's board approving the project, (2) a letter of intent from the underwriter or the lender, (3) a preliminary opinion of bond counsel, (4) a list of the parties involved in the financing, and (5) proof that the IDA has held a public hearing on the project (called a TEFRA hearing) and has obtained approval of the TEFRA proceedings from the highest elected official of the municipality.

Once DCED has received the application, it will review and approve or disapprove the application. DCED approval must be received before the financing may close.

IDA and borrower board approvals. Before the debt is marketed and priced, the IDA and the borrower will normally adopt resolutions or other authorizing action approving the debt within certain parameters (e.g., maximum principal amount, maximum interest rate, maximum length of final maturity) and then delegate to one or more of their officers the power to approve and accept the final terms of the debt within those parameters. In the alternative, the boards may wait until the debt is priced and then have the boards approve and accept the final terms; but this method is cumbersome and is rarely used in industrial development financings.

Marketing and pricing the debt. For a public bond issue, when the preliminary official statement is in proper form, it is distributed by the underwriter to potential purchasers. The period during which the bonds are marketed to potential purchasers usually lasts about one week.

At the end of the marketing period, if the IDA and the borrower have chosen a negotiated offering with one underwriter, then the underwriter presents the IDA and the borrower with a firm purchase proposal. If the IDA and the borrower have chosen an offering with bids from multiple underwriters, then the financial advisor collects the bids on a specified day, usually utilizing an internet bidding

process. The designated officers of the IDA and the borrower then accept the purchase proposal by executing it.

The purchase proposal contains the specific terms of the bond issue: principal amount of the bonds, interest rates, amortization schedule, and prepayment provisions. It also sets forth the conditions of closing. Once the deal is "cut" at the bond sale, a final official statement is prepared and sent by the underwriter to the purchasers, and the participants proceed toward the closing.

For a private loan, the process is much simpler. Once the IDA, the borrower and the lender agree on terms, the designated officers of the IDA and the borrower accept the purchase proposal of the lender by signing it.

The Closing. Prior to the closing, the bond counsel will distribute for review drafts of various agreements, certificates and legal opinions. The participants negotiate changes to the documents. At the closing, the participants execute the various closing documents.

In a public bond issue, at closing, the underwriter wires the purchase price for the bonds to the paying agent or trustee. The paying agent or trustee, at the direction of the IDA and the borrower, pays the costs of issuance and applies the balance to fund a construction or project fund or to refund the prior debt.

In a private loan, the lender, at the direction of the IDA and the borrower, pays the cost of issuance. If it is a drawdown loan, the lender will advance the balance of the loan overtime as requisitioned by the borrower to pay project costs. If the loan proceeds are fully disbursed at closing, then the proceeds are placed in a construction fund or are used to refund the prior debt.

After the closing, bond counsel distributes a complete set of the closing documents to each participant (often on a CD/DVD).

Post-issuance compliance. After the financing closes, there are requirements under the tax code and under the securities laws that continue to apply to the bonds or note. On the tax side, there are regulations governing the investment and spending of debt proceeds and the use of the debt-financed facilities. On the securities law side, there are requirements to make annual financial disclosures and special event disclosures with the MSRB for public bond issues.

Both the Internal Revenue Service and the SEC strongly encourage IDAs and borrowers to adopt and follow written post-issuance compliance policies. And all of the regulators are becoming more and more aggressive in supervising the post-issuance requirements (through regulation and oversight). Before the financing closes, the IDA and the borrower should work closely with bond counsel and the financial advisor or underwriter to help the IDA and the borrower develop these post-issuance compliance

policies. After the closing, the IDA and the borrower should make sure they take these policies seriously and follow them.

C. Miscellaneous Points

Now that we have reviewed the participants and the steps, here are a few miscellaneous points to consider:

In a public bond issue, although the financial advisor or underwriter usually prepares the first draft of the preliminary official statement and the final official statement, it is really the IDA's and the borrower's disclosure document. The IDA, the borrower and their counsel should carefully review its contents. The official statement should contain no misstatement of a material fact, and no material fact about the IDA or the borrower should be omitted from the official statement.

If the debt is being issued to finance a capital project, the borrower should focus well before the closing on the investment strategy for the debt proceeds.

If the borrower plans to enter into an interest rate swap agreement in connection with the financing, the borrower should retain an experienced financial advisor and lawyer to advise it on the swap, and the borrower should make sure it understands the risks involved in the transaction.

Good luck on your bond issues!

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