

## CHAPTER 2

# Issuing Municipal Bonds

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With the federal government largely removed from the regulation of municipal bonds, the issuance of municipals differs procedurally from state to state. General obligation bonds, for example, require voter approval in most states, but not all. A vote might require a two-thirds majority, a 60% plurality, or a simple majority. The remaining states only need the approval of the governing body of the issuer. Revenue bonds do not generally need voter approval, but in some places they do.

In many states, municipal bonds must be approved by one or more state agencies (such as the Attorney General's office) to provide a degree of oversight over the process. The scope of an agency's review will vary. In some states the agency will simply review the documents to see that they comply with state law. In other cases, the agency will analyze the feasibility of the project and its impact on the state's overall debt.

In every case, a project must be defined and its technological feasibility and revenue sources assessed before a government issuer will be ready to begin the difficult process of authorizing, pricing, and selling a bond. Here we examine the general events of a municipal bond issuance common to most jurisdictions.

## Authorizing the Bonds

The first step in issuing a municipal bond is acquiring the authority to issue it. This involves demonstrating the financial viability of the project, defining the terms and conditions of the bond issue, attesting to its legality and tax-exempt status, and ascertaining its impact on the issuer's creditworthiness.

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### KEY PLAYERS

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To help the issuer prepare this material and assure the investor that the material is accurate and complete, the issuer will hire independent consultants from outside the municipality: a financial advisor and a bond counsel.

### FINANCIAL ADVISOR

The **financial advisor** is a consultant retained by the issuer to advise and assist in devising a financing plan for the debt issue. In general, the role of the financial advisor is to:

- Review the financial feasibility of the project and assess the issuer's sources of revenue
- Assess the issuer's ability to stay under the debt ceiling
- Recommend a financing structure and maturity schedule
- Recommend a call schedule for the bonds and the timing of their sale
- Assess the bond's impact on the community's credit rating
- Prepare an **official statement** for distribution to potential underwriters and investors

The extent of the financial advisor's role may depend on the financial sophistication and workload of the issuer. Sometimes, advisors are retained for the sole purpose of assessing market conditions and the appropriateness of the underwriter's offer to buy the bonds. A financial advisor is usually a bank, investment bank, or private consultant.

The MSRB generally prohibits a financial advisor from acting as an underwriter on the same issue. Financial advisors are allowed to assist the issuer in arranging the placement of the new issue, but they may not receive any underwriting compensation. They may only be paid in their capacity as financial advisor. A financial advisor is permitted to buy the securities from an underwriter for his own account or for the account of his customers. However, he must disclose the conflict of interest to his customers at or before confirmation of the sale.

### BOND COUNSEL

The **bond counsel** is an independent attorney or firm of attorneys hired to provide an objective legal opinion that the bonds are valid and binding obligations of the issuer, and that interest in the bonds is exempt from federal and state income taxes. The bond counsel is not an advocate and does not make financial judgments as to the merits or suitability of the bond for an investor. Its role is to assure underwriters and/or investors that an independent legal expert has verified the issue meets its legal requirements and standards.

The bond counsel may issue an **unqualified legal opinion** if it is confident that the issue meets all legal requirements. Or it may offer a **qualified legal opinion**, signifying a lesser degree of confidence. A qualified opinion might be made if certain important information is missing in the official statement, if the accounting method used does not follow generally accepted practices, or if a pending lawsuit might potentially affect an issue's future legality.

## COMPETITIVE BID AUTHORIZATION

Most states require local governments that issue general obligation bonds to select an underwriter by competitive bidding for the sale of their bonds in the market. Since the bidding process cannot begin until after the bonds are authorized, the issuer itself must oversee the preparation of the preliminary materials and present them to the governing

body for a decision. When the governing body of the issuer approves the proposal, it will authorize the issue by signing a bond resolution. Drafted by the bond counsel, the bond resolution describes the project, its estimated cost, and the financing plan. It also lays out the issuer’s duties to the bondholder, and it pledges the full faith and credit of the issuing authority. The bond resolution is then brought before the voting public for its approval. Only after the public vote approves the bond resolution does the process begin for the selection of an underwriter to sell the bonds.

## NEGOTIATED SALE AUTHORIZATION

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Revenue bonds do not require a public vote of approval, so it is not necessary to demonstrate through a competitive bidding process that they are being sold at the lowest possible cost. The issuer of a revenue bond, therefore, may select an underwriter earlier in the process through a negotiated bid. With a negotiated sale, an underwriter may even be selected before the bond issue has been structured. Part of the underwriter’s role is to lead the structuring and other origination tasks on behalf of the issuer. The underwriter may serve as an issuer’s de facto financial advisor, as long as its primary role as underwriter is clearly understood (see MSRB Rule G-23 on page 208). Sometimes, an independent financial advisor will also be selected solely to assess the work of the underwriter. The issuer will choose an underwriter based on the underwriter’s reputation, which usually reflects its knowledge of the market, financial resources, and experience.

Since the underwriter is involved in the preparation of the issue, it will employ its own legal counsel, known as the underwriter’s counsel. The **underwriter’s counsel** performs a due diligence review of the issuer to ensure its financial condition and plans are accurately disclosed. The underwriter’s counsel also helps prepare the bond purchase agreement, the contract between the issuer and the underwriter.

When the governing body of the issuer approves the proposal, it signs a trust indenture, which is the issuing document for a revenue bond. A **trust indenture** is a contract between the issuer and a trustee who will administer the borrowed funds as a fiduciary for the bondholders. The **trustee** has the power to enforce the terms of the indenture. Where a general obligation bond carries the full faith and credit of the taxing authority, a revenue bond has no such guarantee, and so a trustee is employed to look out for the interests of the investor. While a **bond resolution** remains as part of the bond documentation, it only attests to the issuer’s approval and authorization of the execution of the indenture. It is the trust indenture that defines the legal terms and financing specifications of the bond.

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### AUTHORIZING THE BONDS

Competitive Bid Offering (Typically GO Bonds)	Negotiated Sale Offering (Typically Revenue Bonds)
Financial advisor helps prepare offering	Underwriter helps prepare offering
Bond counsel provides objective legal opinion on offering	Bond counsel provides objective legal opinion on offering

<b>AUTHORIZING THE BONDS</b>	
<b>Competitive Bid Offering (Typically GO Bonds)</b>	<b>Negotiated Sale Offering (Typically Revenue Bonds)</b>
Issuer prepares materials to present to governing body	Issuer and underwriter prepare materials to present to governing body
<b>Bond resolution</b> signed by governing body	<b>Trust indenture</b> signed by government body
Voter approval required	Voter approval NOT required