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memorandum

TO	Gavin Cohen Debra Y. Daniel	DATE	October 17, 2011
FROM	James E. Cumbie	EMAIL	jecumbie@venable.com
CC	Paul T. Glasgow Walter R. Calvert	PHONE	410-244-7806
RE	Proposed Economic Development Revenue Bond Financing for National Lutheran Home & Village at Rockville Project		

You have asked me to advise you as to various matters relating to the proposed issuance by the Mayor and Council of Rockville of its economic development revenue bonds on behalf of the National Lutheran Home & Village at Rockville.

Background

The National Lutheran Home & Village at Rockville, Inc. (the "Borrower"), through its counsel, sent a letter to the City requesting that the City issue up to $25 million of its non-recourse economic development revenue bonds (the "Bonds") and lend the proceeds of those Bonds to the Borrower. The Borrower would use the Bond proceeds to finance and refinance the costs of various improvements to its existing senior living facilities on Viers Drive (the "Project"), and to pay various costs associated with the issuance of the bonds.

Structure and Process

The proposed transaction structure is a very common one. Under the relevant provisions of the Internal Revenue Code, a state or local governmental entity, such as the City, may issue its tax-exempt bonds and lend the bond proceeds to a 501(c)(3) corporation such as the Borrower. The Borrower therefore gets the benefit of low tax-exempt interest rates, which makes it easier for the Borrower to fulfill its charitable mission.

The transaction would work like this:

- First, the Borrower formally requests that the City issue the Bonds. As part of that formal request, the Borrower agrees to pay all costs relating to the Bond issue and to indemnify the City against any losses relating to the Bond issue.

- The City then adopts a resolution authorizing the issuance of the Bonds and the loan to the Borrower. The resolution provides that the Bonds are non-recourse obligations of the City. That is to say that the City has no obligation to pay the Bonds back; only the Borrower is obligated to do so.

- The City also holds a so-called "TEFRA Hearing". This is a public hearing required by federal tax law. The hearing can be held as part of a regular meeting of the Mayor and

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Council, such as the meeting at which the resolution is considered; or it can be a one-time hearing conducted by a member of the City staff such as the Director of Finance or the City Manager. The City must hold the hearing in order for the bonds to be tax-exempt, but does not have to take any specific action in response to the testimony received at the hearing (if any; most TEFRA Hearings draw no comment).

- The Borrower has sole responsibility for selecting an underwriter for the Bonds. The City takes no responsibility for marketing or selling the Bonds. The Bonds are sold on the credit strength of the Borrower, not of the City. The rating agencies do not take the Bonds into account when analyzing the City's finances, and do not take the City's finances into account when analyzing the Bonds. The Bonds do not appear in the City's audited financial statements as obligations of the City, though they do get mentioned in one footnote.

- The transaction documents contractually reaffirm the non-recourse status of the Bonds and the Borrower's indemnification of the City.

- Under the transaction documents, the City would assign all its administrative duties and the right to receive debt service payments on the Bonds to a trustee. The trustee (a financial institution selected by the Borrower subject to the City's approval) would have all authority to enforce the Bond documents against the Borrower, if necessary, would hold the Bond proceeds until disbursed to pay Project costs, and would receive all debt service payments from the Borrower and route them to the Bond holders. At no point would the Bond proceeds or the debt service payments on the Bonds be routed through the City's accounts.

Legality

The Maryland Economic Development Revenue Bond Act (codified as Sections 12-101 through 12-118 of the Economic Development Article of the Annotated Code of Maryland, as amended) specifically authorizes any "public body", which includes a municipal corporation such as the City, to issue its bonds to finance projects for borrowers. The public purpose of the bonds is economic development: the theory is that the issuance of the bonds will spur economic activity and enable the Borrower to maintain or increase its employment, all of which will benefit the citizens of the City. This Act also codifies as a matter of Maryland law the non-recourse nature of the Bonds.

Benefits to the City

The City gets two main benefits from issuing the Bonds. First and foremost, the City would be assisting one of its corporate citizens in obtaining favorable financing, which in turn would enable the Borrower to fulfill its charitable mission more effectively. This in turn would benefit

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the citizens of the City by helping to ensure that they have options for senior living within the City.

Second, the City would receive an issuer's fee for as long as the Bonds are outstanding. It is standard practice for issuers of bonds like these to charge an administrative fee of 1/8 of 1 percent of the outstanding principal amount of the Bonds, payable every year. If the Bonds are issued in the amount of $25 million, that amount would be $31,250 in the first year; the amount payable would be reduced as the principal amount of the Bonds is amortized.

Risks

The primary risk to the City is related to the possible issuance of so-called "bank-qualified" bonds. Federal tax law generally discourages commercial banks from purchasing tax-exempt bonds. However, there is a special exception for certain small issuers; i.e., state and local governments that issue $10 million of bonds or less in one calendar year. Commercial banks can purchase the bonds of those small issuers in a tax-efficient manner, which results in lower overall interest rates on those bonds. The proposed Bonds would count against the City's $10 million in the calendar year in which they are issued. The Bonds are proposed to be issued in calendar year 2012, and so would effectively preclude the City from issuing "bank-qualified" bonds in that year. If the City has plans to issue tax-exempt bonds in an amount up to $10 million for its own financing needs in calendar year 2012, then the City should not issue the Bonds for the Borrower. If the City does not plan to issue tax-exempt bonds at all in 2012, or if its plans would entail an issuance of more than $10 million, then the "bank-qualified" point should not be a factor in the City's decision process.

A second risk is that the City would be publicly associating itself with the Project. For most such projects, this kind of association does not create any problems. However, if there is some degree of controversy about the Project (such as neighborhood objections, for example), the City should carefully weigh whether to get involved with it.

A more remote set of risks relate to the possibility that the Borrower could default on the Bonds. The non-recourse status of the Bonds is established in three independent places (the Maryland authorizing statute, the City's authorizing resolution and the contractual provisions of the Bond documents). Bondholders understand this fact, and therefore typically do not waste time chasing after issuers when underlying borrowers default. Nevertheless, it is conceivable that the City could incur litigation expenses if the Borrower defaults on the Bonds and some bondholder decides to sue everybody involved. The Borrower's indemnification of the City would be broad enough to cover such litigation expenses.