Types of Bond Sales

Part 3 of Financing Options Using Bonds

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In the last issue, we covered the major types of bonds. This month, we'll discuss how to sell the bonds. Once the city or village makes a decision to raise capital by means of issuance of bonds, it must next consider which method of finding a "lender" or buyer of the bonds works best. Illinois cities and villages have flexibility as to the method of sale. A competitive sale is not required. The method by which to attract potential investors of bonds can be a critical component to the resulting interest rate the city or village will pay to service its bonds. A credit rating is not legally required to be obtained by the village or city in order to issue a bond, but may help lower the interest costs, particularly in the case of a public bond sale. Below are four typical ways to offer bonds to investors or "lenders."

1. NEGOTIATED SALE

In a negotiated sale, the process begins with the village or city, as issuer, choosing an underwriter (or managing underwriter if more than one underwriter). The issuer and the underwriter then negotiate the terms of the offering. Assuming all procedural issuance requirements are met by the issuer, the underwriter purchases the bonds from the issuer and sells the bonds to its investors.

2. COMPETITIVE SALE

In a competitive sale, bonds are advertised for sale. The announcement, by way of a notice of sale, includes both the terms of the sale and the terms of the bond issue. Any investment bank, broker-dealer or dealer bank may bid on the bonds at the designated date and time in a "blind" fashion, meaning each bidder does not have knowledge of the other bids. The bidder with the lowest interest cost is awarded the bonds.

3. DIRECT PLACEMENT

Direct placement or direct lending in the context of municipal bonds refers to any arrangement in which a single lender/buyer, such as a bank, pension fund, mutual fund, etc., purchases the bonds of the city or village directly. This form of sale may also be described as a private placement, a direct purchase or a bank loan. Advantages include avoiding instability in public markets, avoiding continuing disclosure requirements and avoiding the rating process, which make direct placements an attractive option for issuers.

4. BANK QUALIFIED OR NON-BANK QUALIFIED

Pursuant to the Internal Revenue Code, banks and savings and loans are not generally permitted to deduct interest expenses attributable to tax-exempt bonds acquired, unless the "small issuer exemption" applies. The exemption for small issuers states that if an issuer reasonably expects to not issue more than $10 million of tax-exempt bonds during the calendar year and it designates the bonds as "qualified tax-exempt obligations," the restriction on the deduction for interest expense does not apply. Issuing so called bank-qualified bonds or "BQ" bonds can reduce the interest rate on the bonds since banks that purchase bank-qualified bonds do not have a restriction on their interest expense deduction.

In the next issue, we will explain the numerous laws governing bond issuance.

Note: This article is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

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