

**INTERNATIONAL MUNICIPAL
LAWYERS ASSOCIATION**



Work Session: IV - Public Finance - Dollars and Sense

Title: What Every City Attorney Should Know About Bonds

by

Presenter: Susan Pease Langford

Presenter's Title: Attorney

Presenter's Office: Peck, Shaffer & Williams LLP

MUNICIPAL BONDS BASICS

I. Background

What exactly are municipal bonds?

A municipal bond is a debt security that evidences a promise to repay a loan. As a bond purchaser, you are lending money to the municipality. In return, the municipality promises to pay an agreed upon amount of interest over an agreed upon amount of time and to repay the principal amount of the loan as it matures.

How do municipalities use bonds?

A municipality will use bond proceeds to finance its own public purpose or to finance one of several public purposes that benefit a private activity.

What are some public purposes for which municipal bonds may be used?

Municipal bonds may be used to fund regular government services, revenue producing projects like water systems or sewer systems and other “qualified” projects.

How are municipal bonds repaid?

Municipalities may use their “full faith and credit and resources” (property taxes and other general revenue) to repay general obligation bonds (G.O. bonds) or they can use the revenue from a specific project to repay revenue bonds. For example, a municipal water and sewer revenue bond is repaid with the fees paid by the users of the municipal water and sewer system while general obligation bonds are repaid with the revenue from the municipality’s general unrestricted funds.

What authorizes the income tax exemption on municipal bonds?

The Internal Revenue Code Section 103 allows a state or political subdivision to issue bonds that qualify for tax exemption subject to the requirements of Sections 141 through 150 of the Code.

What does it mean for a bond to “qualify” for tax-exemption?

The Internal Revenue Code, Section 103, provides that interest on any State or local bond (with specific limited exceptions) is not included in a taxpayer’s gross income. A bondholder is not required to include interest income from tax-exempt bonds in the calculation of gross income for income tax purposes.

How does state law impact tax-exempt bonds?

Each state has its own statutes regarding the extent to which individuals or corporations who pay income taxes to that state may exclude interest income from their gross income for state income tax purposes.

What is a tax-exempt qualified private activity bond?

A private activity bond is a bond that meets the private business use test and the private payment test. A private activity bond is tax exempt only if it is a qualified private activity bond. A qualified private activity bond is a bond that fits in one of seven categories: a) exempt facility bond, b) qualified mortgage bond, c) qualified veterans' mortgage bond, d) qualified small issue bond, e) qualified student loan bond, f) qualified redevelopment bond or g) qualified 501(c)(3) bond. There are 13 types of facilities that can be financed with exempt facility bonds including governmentally owned airports, docks and wharves, mass commuting facilities; sewage facilities, solid waste disposal facilities and qualified residential rental projects.

II. Parties

Who are the parties to a typical G.O. bond issue?

In a typical G.O. bond issue there will be: 1) an Issuer, 2) a Financial Advisor, 3) Issuer's Counsel, 4) Bond Counsel, 5) Senior Underwriter, 6) Co-Senior Underwriter 7) Selling Group, 8) Underwriter's Counsel, 9) Trustee or Paying Agent, 10) Insurer, 11) Rating Agency.

Who is the Issuer?

The Issuer is the governmental entity issuing the bonds.

What role does the Financial Advisor ("FA") play?

The FA provides the issuer with general guidance and advice related to its financing needs, debt and capital plans. The FA may also assist in the structuring of a bond issue and the selection of the financing team.

What role do the Underwriters play?

The Underwriters serve as the bankers in the financing. The Underwriters commit to market and sell and, if necessary, purchase the bonds.

What role does the Senior Underwriter play?

The Senior Underwriter is the lead banker and works directly with the issuer to design the financing plan, draft documents along with the attorneys, create the credit package for rating

agencies and insurer presentations, run numbers, manage the pricing process and the sale and closing of the financing.

What role does the co-senior and syndicate members or selling group play?

The underwriters that are not “Senior” have varying levels of risk and responsibility for the marketing and sale of the bonds. Each underwriter shares in the “underwriting” risk.

What role does the Trustee play?

The Trustee holds the bond proceeds and acts in a fiduciary role for the benefit of the bondholders. The Trustee is responsible for the disbursement of bond proceeds in accordance with the bond documents. Before the financing closes the Trustee establishes all funds and accounts required by the bond resolution or trust indenture. The Trustee is paid an annual fee for its services.

What role does the Rating Agency play?

The rating agencies assign a rating to the bond issue. They are occasionally consulted on potential credit structures.

What role does the Insurer play?

The Bond Insurers provide insurance for the bondholders by agreeing to pay the debt if the borrower fails to do so. Insurance is one form of credit enhancement for a bond issue. Other forms of credit enhancement include a line of credit, a surety bond, a guaranty or a letter of credit. Credit enhancement has the effect of raising the security and therefore reducing the interest rate.

What is Issuer’s Counsel’s role?

Issuer’s counsel may be an in-house attorney or a law firm or individual attorney hired by the issuer. Issuer’s counsel advises the issuer and opines as to items such as whether the issuer’s proceedings have been conducted legally, in accordance with the applicable laws like the open meetings laws, and whether the issuer has the authority to execute the documents and the enforceability of the issuer documents.

What is Bond Counsel’s role?

Bond counsel is an attorney or firm qualified in the area of municipal finance. Bond counsel drafts the bond documents, confirms that the issuer has complied with all legal requirements for the issuance of the bonds and opines to the validity, enforceability and tax status of the bonds.

What role does Underwriter's Counsel play?

Underwriter's Counsel represents the underwriter in the financing, drafts documents including the bond purchase agreement, the official statement, blue sky memorandum, and the agreement among underwriters. Underwriter's Counsel assists the underwriter with the necessary "due diligence" investigation of the issuer, the project being financed and the security to repay the bonds. Underwriter's Counsel delivers an opinion at closing as to the adequacy and accuracy of the disclosure. Often the opinion will state that the opinion is given in reliance on other opinions.

What is DTC and Book-Entry?

DTC is the Depository Trust Company Corporation. Since 1982, with limited exceptions, all municipal bonds are required to be registered as to principal and interest with DTC. DTC acts as a central clearinghouse for records of ownership and sales information for municipal bonds. Issuers deposit a single bond for each maturity with DTC. DTC records are shared with financial institutions nationwide. The use of this DTC system for municipal bonds is referred to as book-entry. Using the DTC eliminates the need for the issuer to produce physical bonds.

What is a bond's dated date?

The dated date is the date on a bond from which interest begins to accrue. The dated date may not be the date on which the bonds are actually sold or delivered.

III. The Bond Transaction Documentation

What initiates a bond financing?

Typically the governing body determines that there is a capital need or other need that must be met for which it does not want to pay directly from the municipality's cash on hand and instead wants to finance the expenditure over a period of time. The issuer then proceeds to introduce and pass the appropriate legislation to commence the financing. This legislation is typically a bond resolution. This can also serve as the issuer's declaration of official intent.

What is the purpose of a bond resolution?

The bond resolution is adopted by the issuer to authorize the issuance of bonds and to set the final terms of the financing, including dollar amount of the bonds, interest rate and term. The resolution can also serve as the issuer's declaration of official intent. Some issuers are authorized to pass a parameters resolution, which set the range of the rates for the transaction and a not to exceed dollar amount of the financing. The bond resolution also grants the authority to enter into all of the documents necessary to close the financing. Local and State laws differ significantly on the local process required to authorize the issuance of bonds.

What is the purpose of a declaration of official intent?

Treasury Regulations generally prohibit reimbursing the issuer from tax-exempt proceeds for expenditures made more than 60 days before the issuer adopted a "Declaration of Official Intent" to reimburse. An issuer's Declaration of Official Intent must contain the general nature of the project to be permanently financed with tax-exempt obligations as well as the maximum amount of the reimbursement.

What are the primary documents in a bond financing?

The primary financing documents include: 1) the bond resolution, 2) the trust indenture, 3) the preliminary official statement, 4) the final official statement, 5) the bond purchase agreement, 6) the agreement among underwriters, 7) the tax certificates and agreements, 8) the credit enhancement documents, 9) the continuing disclosure document, 10) the rating letters, 11) the bond counsel opinion and supplemental opinion, 12) underwriter's counsel opinion, 13) issuer's counsel's opinion.

Who are parties to the Indenture and what is its purpose?

The Indenture is a contract between the issuer and the trustee stating the terms under which the bonds are to be issued. The terms outlined in the Indenture include the responsibilities of the trustee, the interest rate, the maturity date, the redemption provisions, the funds and accounts in which the bond proceeds will be held, the method for disbursing the proceeds, the requirements for issuing additional bonds, permitted investments, events of default and other terms.

What is the Preliminary Official Statement?

The Preliminary Official Statement or the "POS" is the document executed by the issuer that is intended to disclose to potential investors the material facts and circumstances about the issuer and the terms of the bonds being offered. The POS contains language printed in red on the side of the front cover informing potential investors that the document is not final and that the document is not an offer to sell securities. This is often referred to as the red herring. The POS does not generally include the final bond numbers.

What is the Official Statement?

The official statement or "OS" is the final version of the POS with all current information, specific bond terms and without the red herring language on the side of the front cover. The OS is generally virtually identical to the POS, but for the insertion of the numbers and the removal of the red herring language. The underwriter is required to provide copies of the OS within 7 business days of any agreement to purchase bonds.

Who are parties to the Bond Purchase Agreement and what is its purpose?

The Bond Purchase Agreement or “BPA” is an agreement between the underwriters and the issuer. The agreement includes the purchase price of the bonds, the principal amount of the bonds, the maturities, the interest rate and an estimate of the closing date. The BPA also sets forth the conditions that have to be met to bind the underwriter and the representations and warranties of the issuer. The BPA will generally list the documents that are required to close the financing.

What is the Agreement Among Underwriters?

The Agreement Among Underwriters or “AAU” is just as its title suggests. It is the contract between the senior underwriter and each member of the syndicate or selling group in which the percentage of participation of each underwriter is established and the syndicate members contract to become a part of the financing or withdraw from the financing.

What is the Tax Certificate?

Tax-exempt bonds by definition are subject to and must comply with complex tax regulations. The Tax Certificate documents the transaction from a tax perspective. The Tax Certificate sets forth the provisions of the tax code that apply to the transaction to maintain its tax-exempt status. The Tax Certificate may also include a non-arbitrage or section 148 certificate. The structure of the Tax Certificate for every financing is largely a matter of bond counsel preference.

What are the Credit Enhancement documents?

Tax exempt bonds may be credit enhanced in order to achieve a more favorable interest rate for the financing. Each form of credit enhancement will be outlined in specific documents. Bond insurance will have an actual policy issued by the insurer to the benefit of the bondholders. A letter of credit will have a reimbursement agreement setting out the terms under which the issuer will repay the letter of credit provider if there is a draw on the letter of credit. Credit enhancers will also want input into the terms of the indenture in order to protect their security position, additional debt provisions and coverage requirements.

What are the Continuing Disclosure requirements for bond issues?

The POS and the OS are the initial documents disclosing material information to potential investors. The information disclosed in the POS and the OS is likely to become stale. In order to keep this information fresh, the issuer signs a certificate or enters into an agreement to update its disclosure on an annual basis. The issuer can sign a certificate agreeing to provide this information or the issuer can enter into a continuing disclosure agreement with a third party and transfer the responsibility for gathering and submitting the updated information to that third party. The updated disclosure information is sent to a national, and in some states state, repository.

What is a Rating Letter?

Some bond financings are rated by a national rating agency. If the transaction is rated the rating agency will produce a letter officially stating the rating. The rating can be a rating based on the credit enhancement or can be an underlying rating based on the credit of the borrower. The ratings are typically placed on the front cover of the OS.

What is the purpose of opinions of counsel in bond financings?

Bondholders want comfort that they are purchasing legitimate tax-exempt securities. The tax code, the securities regulations, state and local law all have provisions that impact the legality or tax-exempt status of a municipal bond. It was found, as early as the 1870's that receiving an opinion from an attorney that a security is validly issued provided an adequate amount of comfort to the investing public.¹ The provision of opinions by other attorneys is an extension of the comfort provided to the investing public by bond counsel. The additional opinions indicate that other areas of the financing have been conducted in a manner consistent with the applicable laws. Each opinion is addressed to the party or parties who wants or needs to rely on a finding that that aspects of the financing have been conducted in a manner that conforms to the applicable laws.

What are the opinions given by the attorneys and to whom is each opinion directed?

Bond Counsel – The opinion is given to the Issuer and is expected to address that the bonds constitute legal, valid and binding obligations of the issuer and that the interest on the bonds are exempt from taxation under the applicable tax laws. The bond counsel opinion may also be referred to as the approving opinion.

Bond Counsel Supplemental Opinion – The opinion is given to the underwriter and is expected to address that the underwriter: 1) may rely on the bond counsel opinion; 2) that the summaries of the bond documents included in the official statement are accurate; 3) that the tax-exemption section of the official statement accurately states the bond counsel's position; 4) the bonds are exempt from registration under the Securities Act of 1933; and 5) that the indenture is exempt from qualification under the Trust Indenture Act of 1939.

Underwriter's Counsel – The opinion is given to the underwriter and is expected to address that nothing material to the transaction has been omitted from the disclosure process and everything material to making an investment decision has been included.

Issuer's Counsel – The opinion is given to the Issuer, the Bond Counsel, and the underwriters and is expected to address the Issuer's authority to Issue the bonds; the procedures utilized to do so; the accuracy of the Issuer's statements in the official statement; and any material litigation pending or threatened.

¹ National Association of Bond lawyers, Fundamentals of Municipal Bond Law, 2003

IV. Relevant Laws

The United States Code, Title 26 contains much of the tax law applicable to tax-exempt municipal bonds. The Securities Act of 1934 contains provisions regarding the exemption of bonds from the registration requirement. The Securities Act of 1934 contains provisions applicable to disclosure required in the purchase or sale of securities. The Trust Indenture Act of 1939 contains provisions regarding the qualification of indentures.

Internal Revenue Code Section 103

1. Obligations issued by a state or political subdivision qualify for tax-exemption subject to requirements of Sections 141 through 150 of Internal Revenue Code. The obligation must be issued in compliance with substantive and procedural requirements of state law.
2. Obligations must be in registered form under Section 149 of the Internal Revenue Code (no bearer bonds).
3. Political subdivision means having sufficient taxing powers, eminent domain powers and/or police powers (all 3 not needed, but must be more than an insubstantial amount of at least one of the powers).

Internal Revenue Code Sections 148 and 149 (applicable to all tax-exempt bonds)

1. Section 148 – Arbitrage Compliance – Bonds cannot be arbitrage bonds and rebate obligation to United States Treasury must be complied with
2. Section 149 – Miscellaneous Requirements –
 - a) Registration
 - b) No federal guarantee generally; exceptions for certain obligations issued for housing programs
 - c) Refunding Requirements: Current refundings of outstanding obligations (i.e. redemption of prior obligations within 90 days of issuance of new obligations) are generally permitted without limitation as to the number of refundings. Advance refundings (i.e. prior obligations will be retired more than 90 days after issuance of new obligations, for example through an escrow) require yield limitations on the escrow (yield not greater than yield on the refunding obligations) and there are limits on the number of advance refundings that can be done (dependent on date original obligations were issued and when the various advance refunding obligations were issued)
 - d) Information reporting; Filing of IRS Form 8038 (for private activity bonds), Form 8038-G (for true government issues over \$100,000) or form 8038-GC (annual composite filing for issues individually under \$100,000) required within prescribed time periods.

Securities Act of 1933

1. Section 5 - prohibits the use of interstate commerce or the mails to sell or deliver any security unless a registration statement is in effect
2. Section 3(a) exempts most municipal bonds from registration required by section (5) of the Act

Securities Act of 1934 Section 10(b)

1. prohibits the use, in connection with the purchase or sale of any security any manipulative or deceptive device or contrivance in contravention of any rules and regulations prescribed by the Securities Exchange Commission in the public interest for the protection of investors

General Rules and Regulations promulgated under the Securities Act of 1934

1. Rule 10(b)-5 Prohibits the use of any means or instrumentality to a) employ any devise or scheme to defraud; b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or c) to engage in any act or practice which would operate as a fraud or deceit upon any person.
2. Rule 15c2-12 requires an underwriter to:
 - a. obtain and review an official statement that an issuer deems final
 - b. contract to receive, within 7 business days after any final agreement to purchase, offer or sell the municipal bonds, an official statement to accompany any confirmation that requests payment from any customer
 - c. to provide that a municipality has agreed to provide specific disclosure information for the benefit of bondholders prior to purchasing or selling securities

Trust Indenture Act of 1939

1. requires the filing of an application for qualification for certain indentures under which certain securities are issued
2. exempts certain indentures, including municipal bonds exempted from registration under the Securities Act of 1933, from the qualification requirement

SAMPLE TRUST INDENTURE DEFINITIONS

In addition to the words and terms defined elsewhere in this Indenture, the words and terms defined in this Section shall have the meanings herein specified unless the context or use clearly indicates another or different meaning or intent. Those words and terms not expressly defined herein and used herein with initial capitalization where rules of grammar do not otherwise require capitalization, or which are otherwise defined terms under the Reimbursement Agreement, as hereinafter defined, shall have the meanings assigned to them in the Reimbursement Agreement.

"Act" means Section 66.011 et. seq. of the Kentucky Revised Statutes, as amended.

"Alternate Letter of Credit" means an irrevocable letter of credit issued by a commercial bank organized and doing business in the United States of America and meeting the requirements of Section 5.09 hereof, which Alternate Letter of Credit requires such bank to pay when due, to and upon request of the Trustee, the same amounts payable under the initial Letter of Credit.

"Authenticating Agent" means the Trustee and the Registrar for the Series 2004 Bonds and any bank, trust company or other person designated as an Authenticating Agent for the Series 2004 Bonds by or in accordance with Section 6.13 of this Indenture.

"Authorized Issuer Representative" means the person or persons designated from time to time by a certificate signed by an authorized representative of the Issuer and delivered to the Trustee to act on behalf of the Issuer.

"Bank" means U.S. Bank National Association, a national banking association, and its successors and assigns. Upon issuance and effectiveness of any Alternate Letter of Credit, "Bank" shall mean the Issuer thereof and its successors and assigns.

"Bank Insolvency Date" means the date on which the Bank notifies the Trustee or the date that the Trustee otherwise ascertains that a decree or order of a court or agency or supervisory authority, having jurisdiction in the premises for the appointment of a conservator or receiver or liquidator of any insolvency, readjustment of debt, marshalling of assets and liabilities or similar proceeding, or for the winding-up or liquidation of its affairs has been entered against the Bank or the Bank has consented to the appointment of a conservator or receiver or liquidator in any such proceedings of or relating to the Bank or relating to all or substantially all of its property.

"Beneficial Owner" means, while the Series 2004 Bonds are held in book-entry form, the beneficial ownership interests of each actual purchaser of each Series 2004 Bond.

"Bond Fund" means the City of Covington, Kentucky – Bond Payment Fund created in Section 5.04 hereof.

"Bond Purchase Date" means any Bond Purchase Date as defined and provided for in Section 2.03 or 2.04 hereof.

"Bond Service Charges" means, for any period or payable at any time, the principal of, premium, if any, and interest on the Series 2004 Bonds for that period or payable at that time whether due at maturity or upon acceleration or redemption.

"Business Day" means a day of the year, other than (a) a Saturday; (b) a Sunday; (c) a day on which commercial banks located in the cities in which the principal corporate trust office of the Trustee and the principal office of the Bank are located are required or authorized by law to remain closed; or (d) a day on which the New York Stock Exchange is closed.

"Counterparty Exchange Payment" means a payment due from an Exchange Counterparty to the Issuer pursuant to the applicable Exchange Agreement (including, but not limited to, payments in respect of any early termination date, as defined in the applicable Exchange Agreement).

"DTC" means The Depository Trust Company, a limited purpose company organized under the laws of the State of New York, and its successors and assigns.

"DTC Participant" means banks, brokers or dealers who are participants of DTC.

"Eligible Investments" means at the time of purchase:

(a) obligations of the United States and of its agencies and instrumentalities, including obligations subject to repurchase agreements, provided that delivery of these obligations subject to repurchase agreements is taken either directly or through an authorized custodian and may be accomplished through repurchase agreements reached with sources including, but not limited to, national or state banks chartered in the Commonwealth of Kentucky;

(b) obligations and contracts for future delivery or purchase of obligations backed by the full faith and credit of the United States or a United States government agency, including but not limited to:

- (i) United States Treasury;
- (ii) Export-Import Bank of the United States;
- (iii) Farmers Home Administration;
- (iv) Government National Mortgage Corporation; and
- (v) U.S. Maritime Administration;

(c) obligations of any corporation of the United States government, including but not limited to:

- (i) Federal Home Loan Mortgage Corporation;
- (ii) Federal Farm Credit Banks;
- (iii) Bank for Cooperatives;
- (iv) Federal Intermediate Credit Banks;
- (v) Federal Land Banks;
- (vi) Federal Home Loan Banks;

- (vii) Federal National Mortgage Association; and
- (viii) Tennessee Valley Authority;

(d) certificates of deposit issued by or other interest-bearing accounts of any bank or savings and loan institution which are insured by the Federal Deposit Insurance Corporation or similar entity or which are collateralized, to the extent uninsured, by the following:

- (i) bonds, notes, or other obligations of or guaranteed by the United States, or those for which the credit of the United States is pledged for the payment of the principal and interest thereof, and any bonds, notes, debentures or any other obligations or securities issued or guaranteed by any federal governmental agency, presently or in the future established by an Act of Congress, as amended or supplemented from time to time;

- (ii) obligations of the Commonwealth of Kentucky including revenue bonds issued by its statutory authorities, commissions or agencies;

- (iii) revenue bonds issued by educational institutions of the Commonwealth of Kentucky as authorized by KRS 162.340 to 162.380;

- (iv) obligations of any city of the first, second, and third classes of the Commonwealth of Kentucky, or any county for the payment of principal and interest on which the full faith and credit of the issuing body is pledged;

- (v) school improvement bonds issued in accordance with the authority granted under KRS 162.080 to 162.100; or

- (vi) school building revenue bonds issued in accordance with the authority granted under KRS 162.120 to 162.300, provided that the issuance of such bonds is approved by the state board for elementary and secondary education; and

(e) shares of mutual funds, each of which shall have the following characteristics:

- (i) the mutual fund shall be an open-end diversified investment company registered under the Federal Investment Company Act of 1940, as amended;

- (ii) the management company of the investment company shall have been in operation for at least five (5) years; and

- (iii) all of the securities in the mutual fund shall be investments described in (a) - (d) above.

provided, however, that "Eligible Investments" with respect to any proceeds resulting from a remarketing or a draw under the Letter of Credit shall mean only Government Obligations maturing as needed but not more than thirty days after purchase.

"Event of Default" means an Event of Default hereunder.

"Exchange Agreement" means an interest rate exchange agreement between the Issuer and an Exchange Counterparty, as originally executed and as amended or supplemented, or a similar interest rate hedge agreement, as originally executed and as amended or supplemented.

"Exchange Counterparty" means any party with whom the Issuer shall, from time to time, enter into an Exchange Agreement.

"Exchange Payment" means a payment due from the Issuer to an Exchange Counterparty, pursuant to the applicable Exchange Agreement (including, but not limited to, payments in respect of any early termination date, as defined in the applicable Exchange Agreement).

"Extraordinary Services" and "Extraordinary Expenses" mean all services rendered and all reasonable expenses properly incurred by the Trustee under this Indenture, other than Ordinary Services and Ordinary Expenses.

"Five Year Interest Rate" means (a) the rate of interest per annum determined by the Remarketing Agent, on the Interest Rate Determination Date immediately preceding the applicable Interest Rate Adjustment Date, to be the interest rate necessary, during the Interest Rate Period commencing on the applicable Interest Rate Adjustment Date and ending on the May 31 or November 30 nearest to but not later than the date which is five years from such Interest Rate Adjustment Date, in the judgment of the Remarketing Agent (taking into consideration current transactions in comparable securities with which the Remarketing Agent is involved or of which it is aware and prevailing financial market conditions) to produce a par bid for the Series 2004 Bonds on such Interest Rate Determination Date, or (b) in the event that the Remarketing Agent has been removed or has resigned and no successor has been appointed or the Remarketing Agent has failed to determine the Five Year Interest Rate for whatever reason, or the Five Year Interest Rate cannot be determined pursuant to clause (a) for whatever reason, the interest rate then in effect with respect to the Series 2004 Bonds, without adjustment; provided that in no event shall the Five Year Interest Rate exceed the Maximum Interest Rate.

"Fixed Interest Rate" means (a) the fixed rate of interest per annum determined by the Remarketing Agent, on the Interest Rate Determination Date immediately preceding the applicable Interest Period Reset Date, to be the interest rate necessary, during the Interest Rate Period commencing on the applicable Interest Period Reset Date and ending on the final maturity date of the Series 2004 Bonds, in the judgment of the Remarketing Agent (taking into consideration current transactions in comparable securities with which the Remarketing Agent is involved or of which it is aware and prevailing financial market conditions) to produce a par bid for the Series 2004 Bonds on such Interest Period Reset Date or (b) in the event that the Remarketing Agent has been removed or has resigned and no successor has been appointed or the Remarketing Agent has failed to determine the Fixed Interest Rate for whatever reason, or

the Fixed Interest Rate cannot be determined pursuant to clause (a) for whatever reason, the interest rate then in effect with respect to the Series 2004 Bonds, without adjustment; provided that in no event shall the Fixed Interest Rate exceed the Maximum Interest Rate.

"Government Obligations" means obligations of, or guaranteed as to principal and interest by, the United States or any agency or instrumentality thereof when the prompt payment of such obligations are backed by the full faith and credit of the United States.

"Holder" or "Holder of a Bond" or "Bondholder" means the Person in whose name a Bond is registered on the Register.

"Indenture" means this Trust Indenture, as amended or supplemented from time to time.

"Interest Payment Date" or "Interest Payment Dates" means the first Business Day of each June and December, commencing December 1, 2004.

"Interest Period Reset Date" means the date on which the interest rate on the Series 2004 Bonds converts from the Interest Rate Mode applicable to the Series 2004 Bonds prior to such date to a different Interest Rate Mode. An Interest Period Reset Date shall be the first day of a month and, unless the Series 2004 Bonds bear interest at the Weekly Interest Rate, and may not occur prior to the conclusion of the preceding Interest Rate Period.

"Interest Rate Adjustment Date" means any date on which the interest rate on the Series 2004 Bonds is adjusted, either as the result of the conversion of the interest rate on the Series 2004 Bonds to a different Interest Rate Mode, or by adjustment of the interest rate on the Series 2004 Bonds within the applicable Interest Rate Mode. Unless the Interest Rate Mode is the Weekly Interest Rate, an Interest Rate Adjustment Date shall be the first day of a month. With respect to the Weekly Interest Rate, the Interest Rate Adjustment Date shall be a Thursday, provided that upon conversion to the Weekly Interest Rate from a different Interest Rate Mode, the Interest Rate Adjustment Date shall be the first day of a month.

"Interest Rate Determination Date" means (a) with respect to the Five Year Interest Rate and the Fixed Interest Rate, the tenth Business Day preceding an Interest Rate Adjustment Date, and (b) with respect to the Weekly Interest Rate, not later than 2:00 p.m. according to local time at the principal corporate trust office of the Trustee on Wednesday of each week, or the next preceding Business Day if such Wednesday is not a Business Day; provided that upon any conversion to the Weekly Interest Rate from a different Interest Rate Mode, the first Interest Rate Determination Date shall mean not later than 2:00 p.m. according to the local time at the principal corporate trust office of the Trustee on the Business Day preceding the Interest Period Reset Date.

"Interest Rate for Advances" means a rate per annum which is equal to two percent (2%) plus the Prime Rate.

"Interest Rate Mode" means any of those modes of interest with respect to the Series 2004 Bonds permitted by this Indenture, specifically, the Weekly Interest Rate, the Five Year Interest Rate and the Fixed Interest Rate.

"Interest Rate Period" means that period of time during which the interest rate with respect to the Series 2004 Bonds has been determined by the Remarketing Agent or otherwise as provided in the definition of the applicable Interest Rate Mode, commencing on the applicable Interest Rate Adjustment Date, and terminating on the day immediately preceding the following Interest Rate Adjustment Date.

"Issuer" means City of Covington, Kentucky, a municipal corporation and political subdivision of the Commonwealth of Kentucky.

"KRS" means Kentucky Revised Statutes.

"Letter of Credit" means (a) the irrevocable letter of credit to be issued by the Bank with respect to the Series 2004 Bonds, and delivered to the Trustee on the same date as the delivery of the Series 2004 Bonds to the Original Purchaser and being an irrevocable obligation to make payment to the Trustee of up to the amounts therein specified with respect to (i) the principal amount of the Series 2004 Bonds outstanding to enable the Trustee to pay (A) the principal amount of the Series 2004 Bonds when due at maturity or upon redemption or acceleration upon the occurrence of an Event of Default, and (B) an amount equal to the principal portion of the purchase price of any Series 2004 Bonds tendered for purchase by the Holders thereof, plus (ii) the amount of interest due on the Series 2004 Bonds but not to exceed 195 days' maximum accrued interest (computed at the Maximum Interest Rate) to enable the Trustee to pay (A) interest on the Series 2004 Bonds when due, and (B) an amount equal to the interest portion of the purchase price of any Series 2004 Bonds tendered for purchase by the Holder thereof; as the same may be transferred, reissued, extended or replaced in accordance with this Indenture and the Letter of Credit; and (b) upon the issuance and effectiveness thereof, any Alternate Letter of Credit.

"Letter of Credit Termination Date" means the expiration date of the Letter of Credit.

"Letter of Representations" means the Blanket Letter(s) of Representations dated on or before the date of initial delivery of the Series 2004 Bonds from the Issuer to DTC.

"Maximum Interest Rate" means a rate of interest equal to 10% per annum.

"Ordinance" means the ordinance of the Issuer adopted August 24, 2004 approving the Indenture and the issuance of the Series 2004 Bonds.

"Ordinary Services" and "Ordinary Expenses" means those services normally rendered, and those expenses normally incurred, by a trustee under instruments similar to this Indenture.

"Original Purchaser" means Seasongood & Mayer, LLC.

"Outstanding Series 2004 Bonds", "Series 2004 Bond outstanding" or "Series 2004 Bonds outstanding" mean, as of the applicable date, all Series 2004 Bonds which have been authenticated and delivered, or which are being delivered by the Trustee under this Indenture, except:

(a) Series 2004 Bonds cancelled upon surrender, exchange or transfer, or cancelled because of payment or redemption on or prior to that date;

(b) Series 2004 Bonds, or the portion thereof, for the payment, redemption or purchase for cancellation of which sufficient money has been deposited and credited with the Trustee or any Paying Agent pursuant to this Indenture on or prior to that date for that purpose (whether upon or prior to the maturity or redemption date of those Series 2004 Bonds); provided, that if any of those Series 2004 Bonds are to be redeemed prior to their maturity, notice of that redemption shall have been given or arrangements satisfactory to the Trustee shall have been made for giving notice of that redemption, or waiver by the affected Holders of that notice satisfactory in form to the Trustee shall have been filed with the Trustee;

(c) Series 2004 Bonds, or the portion thereof, which are deemed to have been paid and discharged or caused to have been paid and discharged pursuant to the provisions of this Indenture; and

(d) Series 2004 Bonds in lieu of which others have been authenticated under Section 3.05 of this Indenture.

"Paying Agent" means any bank or trust company designated as a Paying Agent by or in accordance with Section 6.12 of this Indenture.

"Person" or words importing persons mean firms, associations, corporations, limited liability companies, partnerships (including without limitation, general and limited partnerships), joint ventures, societies, estates, trusts, public or governmental bodies, other legal entities and natural persons.

"Pledged Series 2004 Bonds" means Series 2004 Bonds pledged by the Issuer to the Bank pursuant to the Reimbursement Agreement.

"Predecessor Bond" of any particular Bond means every previous Bond evidencing all or a portion of the same debt as that evidenced by the particular Bond. For the purposes of this definition, any Bond authenticated and delivered under Section 3.05 of this Indenture in lieu of a lost, stolen or destroyed Bond shall, except as otherwise provided in Section 3.05, be deemed to evidence the same debt as the lost, stolen or destroyed Bond.

"Prime Rate" means the interest rate per annum established by the Bank from time to time as the Bank's prime commercial rate, based on its consideration of economic, money market, business and competitive factors, and is not necessarily the Bank's most favored rate. Subject to any minimum or maximum rate limitations specified by applicable law, the Prime Rate will automatically and immediately change from time to time effective as of the effective date of each such change in the prime rate of the Bank.

"Project Fund" means the Project Fund created in Section 5.01 hereof.

"Project" means the funding of the Issuer's unfunded liability to its F&P Pension Fund and its ER Fund.

"Project Purposes" means the purchase of certain fixed assets and payment of certain costs of issuance of the Series 2004 Bonds.

"Rating Agency" means either Moody's Investors Service or Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., corporations organized under the laws of the States of Delaware and New York, respectively, and their successors and assigns.

"Register" means the books kept and maintained by the Registrar for registration and transfer of Series 2004 Bonds pursuant to Section 3.04 hereof.

"Registrar" means, as to the Series 2004 Bonds, the Trustee until a successor Registrar shall have become such pursuant to applicable provisions of this Indenture.

"Regular Record Date" means the Business Day next preceding an Interest Payment Date applicable to the Series 2004 Bonds.

"Reimbursement Agreement" means the Reimbursement Agreement dated as of even date with this Indenture, between the Bank and the Issuer, as amended or supplemented from time to time, and any replacement thereof in connection with an Alternate Letter of Credit.

"Remarketing Agent" means, initially, Seasongood & Mayer LLC and any Person meeting the qualifications of Section 6.17 hereof and designated from time to time to act as Remarketing Agent under Section 6.16 hereof.

"Series 2004 Bonds" means the Taxable Variable Rate General Obligation Funding Bonds, Series 2004 of the Issuer issued hereunder.

"Supplemental Credit Facility" means a credit facility, agreement or arrangement in addition to the Letter of Credit, including, without limitation, a bond insurance policy, collateral arrangement, surety bond, standby purchase agreement, confirming letter of credit or any similar arrangement the purpose of which is to enhance the credit of the Series 2004 Bonds in order to obtain or maintain a rating on any series of Series 2004 Bonds and which is an exempt security within the meaning of Section 3 of the Securities Act of 1933, as amended, and the applicable regulations thereunder.

"Supplemental Indenture" means any indenture supplemental to this Indenture entered into between the Issuer and the Trustee in accordance with Article VIII hereof.

"Trustee" means the Trustee at the time acting as such under this Indenture, originally U.S. Bank National Association, as Trustee, and any successor Trustee as determined or designated under or pursuant to this Indenture.

"Weekly Interest Rate" means the interest rate set weekly and accruing for seven days beginning each Thursday (or later in case the Issuer has elected to convert from another Interest

Rate Mode to the Weekly Interest Rate and Thursday is not the first day of the month, in which case the Interest Rate Period will begin on the first day of the month) and ending on each Wednesday (or ending sooner in case the Issuer has elected to convert to a different Interest Rate Mode and Wednesday is not the last day of the month, in which case the Interest Rate Period will end on the last day of the month). The rate of interest accruing weekly on the Series 2004 Bonds shall be (a) the interest rate per annum determined by the Remarketing Agent, on the Interest Rate Determination Date immediately preceding the applicable Interest Rate Adjustment Date, to be the interest rate necessary during the Interest Rate Period of one week (or less) commencing on the applicable Interest Rate Adjustment Date in the judgment of the Remarketing Agent (taking into consideration current transactions in comparable securities with which the Remarketing Agent is involved or of which it is aware and prevailing financial market conditions) to produce a par bid for the Series 2004 Bonds on such Interest Rate Determination Date, or (b) in the event that the Remarketing Agent has been removed or has resigned and no successor has been appointed or the Remarketing Agent has failed to determine the Weekly Interest Rate for whatever reason, or the Weekly Interest Rate cannot be determined pursuant to clause (a) for whatever reason, the interest rate then in effect with respect to the Series 2004 Bonds, without adjustment; provided that in no event shall the Weekly Interest Rate exceed the Maximum Interest Rate.

HELPFUL SOURCES

The Fundamentals of Municipal Bonds, Judy Wesalo Temel, Fifth Edition, 2001

National Association of Bond Lawyers Fundamentals of Municipal Bond Law, 2003

National Association of Bond Lawyers Bond Attorneys' Workshop, 2005

National Association of Bond Lawyers, Legal Assistant's Handbook, 2006

Cornell Law School Legal Information Institute, U.S. Code Title 26 (Income Taxes)
http://www.law.cornell.edu/uscode/html/uscode26/usc_sup_01_26_10_A.html

Cornell Law School Legal Information Institute, U.S. Code Title 15 (Trust Indentures)
http://www4.law.cornell.edu/uscode/html/uscode15/usc_sup_01_15_10_2A_20_III.html

University of Cincinnati College of Law, Securities Lawyers Deskbook
<http://www.law.uc.edu/CCL/index.html>

Peck Shaffer & Williams LLP, All About Bonds, Bond Types
<http://www.peck-shaffer.com/bonds.php?page=types>