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April 21, 2008

Opinion No. 08-95

Cost of Terminating Interest Rate Swap Agreement as Expense of Refunding

## QUESTION

Tenn. Code Ann. §§ 9-21-901, *et seq.,* authorize local governments to issue general obligation refunding bonds. Under Tenn. Code Ann. § 9-21-904(a)(4), the principal amount of an issue of general obligation refunding bonds may include expenses of the issuance and sale of the bonds. Do "expenses" under this statute include the costs of terminating interest rate swap agreements that the local government entered into in connection with its obligations under the bonds being refunded?

## OPINION

Yes, so long as the facts show that the swap agreement being terminated and the termination fee required to end the agreement are integrally related to the bonds being refunded.

## ANALYSIS

This opinion concerns local governments' authority to issue general obligation refunding bonds. This authority appears at Tenn. Code Ann. §§ 9-21-901, *et seq.* Before a local government may adopt the resolution authorizing the issuance of general obligation refunding bonds, it must submit its plan of refunding to the State Director of Local Finance. Tenn. Code Ann. § 9-21-903(a). The director has fifteen days to review the plan to determine whether it complies substantially with State Funding Board guidelines governing refundings. If the director determines that the plan does not substantially comply with the guidelines, the local government must file a notice in a newspaper of general circulation. The notice must contain the director's report and a statement that the bonds may be issued unless a petition against the bonds signed by at least ten percent of the registered voters of the local government is filed with the local government. Tenn. Code Ann. § 9-21-903(c).

Tenn. Code Ann. § 9-21-904(a) provides:

> The principal amount of any issue of general obligation refunding bonds shall not exceed the sum of the following:

(1) The principal amount of the outstanding obligations to be refunded; provided, that general obligation refunding bonds may be issued in such amounts to permit any part of the bonds to reflect a zero (0) rate of interest on an original issue discount.

(2) The redemption premium, if any, thereon;

(3) The interest due and payable on such outstanding obligations to and including the first or any subsequent available redemption date or dates selected, in its discretion, by the governing body, or to the date or dates of maturity, whichever shall be determined by the governing body to be most advantageous or necessary to the local government; and

(4) *Any expenses of the issuance and sale of such general obligation refunding bonds*, *including* bond discount, credit enhancement, engraving, printing, and advertising fees, the creation of initial debt service reserve funds, and reasonable and necessary fees of financial and legal advisors deemed by the governing body to be necessary for the issuance of the general obligation refunding bonds.

(Emphasis added).

Tenn. Code Ann. § 9-21-914 provides:

(a) The principal proceeds from the sale of any general obligation refunding bonds shall be applied *only* as follows, either to the:

(1) Immediate payment and retirement of the obligations being refunded; or

(2) [To the] [e]xtent not required for the immediate payment of the outstanding obligations being refunded, the proceeds of the general obligation refunding bonds shall be deposited in escrow . . . to provide for the payment of the outstanding obligations *and to pay any expenses incurred in connection with the refunding*[.]

(Emphasis added).

The request asks whether the cost to terminate an interest rate swap agreement is an "expense of the issuance and sale of . . . general obligation refunding bonds" within the meaning of Tenn. Code Ann. § 9-21-904(a)(4) and part of the "expenses incurred in connection with the refunding" within the meaning of Tenn. Code Ann. § 9-21-914(a)(2).

Local governments are authorized to enter into interest rate swap agreements under Tenn. Code Ann. § 9-21-213(d). This section provides:

> With respect to all or any portion of any issue of general obligation bonds issued or anticipated to be issued hereunder, at any time during the term of the general obligation bonds, and upon receipt of a report of the comptroller of the treasury or the comptroller's designee finding that the contracts and agreements authorized herein are in compliance with the guidelines, rules or regulations as set forth in § 9-21-130, a local government by resolution may authorize and enter into interest rate swap or exchange agreements, agreements establishing interest rate floors or ceilings or both, and other interest rate hedging agreements under such terms and conditions as the governing body of the local government may determine, including, without limitation, provisions permitting the local government to pay to or receive from any person or entity any loss of benefits under such agreement upon early termination thereof or default under such agreement.

Under Tenn. Code Ann. § 9-21-130, the State Funding Board is authorized to establish guidelines, rules, or regulations with respect to agreements and contracts authorized under various provisions of the local government bond statutes, including § 9-21-213(d). Before adopting a resolution authorizing a contract subject to these guidelines, a local government must submit a request to the Comptroller or the Comptroller's designee for a report that the proposed contract substantially complies with the guidelines. Tenn. Code Ann. § 9-21-130(a)(2). If the Comptroller finds the agreement does not comply with the guidelines, the local government is not authorized to enter into it.

The State Funding Board has adopted guidelines governing interest rate agreements into which a local government may enter. The guidelines define "interest rate agreement" as follows:

> "Interest Rate Agreement" shall mean an interest rate swap or exchange agreement, an agreement establishing an interest rate floor or ceiling or both and any other interest rate hedging agreement, including options to enter into or cancel such agreements, as well as the reversal or extension thereof.

Guidelines, Article II. The guidelines provide the following conditions that a local government must meet before entering into an interest rate agreement. Article IV, § A, of the guidelines provides:

> A. Conditions to Entering into Interest Rate Agreement.
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> Any Governmental Entity is authorized to enter into an Interest Rate Agreement provided such Interest Rate Agreement is entered into for one or more of the following purposes:
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> 1. Reduce the Governmental Entity's exposure to changes in interest rates with respect to a particular borrowing; or

2. Result in a reasonably anticipated lower net cost of borrowing with respect to related obligations; or

3. Accomplish such other purpose as is requested by the Governing Entity and approved by the Comptroller.

Any request by a Governmental Entity to enter into an Interest Rate Agreement shall analyze and describe how the Interest Rate Agreement is intended to accomplish one or more of the foregoing purposes. No Interest Rate Agreement shall be entered into *unless such agreement relates to indebtedness of the Governmental Entity either (i) that is outstanding or (ii) that will be incurred or authorized contemporaneously with either the execution or effective date of the Interest Rate Agreement and the Agreement is contingent on the issuance of such debt.*

(Emphasis added).

In compliance with the guidelines, some cities and counties in the state have entered into swaps in connection with variable rate bonds. For variable rate bonds, the interest rate that the bonds may pay at any given time is determined by a mechanism specified in the bond documents. The rate is set periodically and depends on the market conditions prevailing on each reset date. The local government may then enter into a swap with a financial institution or "swap counterparty." Under the swap, the local government and counterparty are obligated to pay one another the interest on a sum called the "notional amount," related to the government's long term principal obligation, as required by the guidelines. Without going into great detail about the mechanics of swaps, the purpose of a swap, under the guidelines, is either to protect the local government from exposure to changes in interest rates with respect to a borrowing (in effect, approximating a fixed interest rate); to lower the local government's net borrowing costs; or to accomplish some other purpose approved by the Comptroller.

In the past, the local government's variable rate bonds and associated swaps performed as expected by the local government. However, in the last two months, the market for variable rate bonds has been seriously disrupted. As a result, demand for variable rate bonds has dropped, and local governments must pay higher rates on these obligations. The interest rate payable by the counterparty does not cover these higher rates, and the local government must look to other funds to make up the difference. The local governments are now paying an effective interest rate on variable rate bonds that is higher than comparable fixed bond rates.

For these reasons, several Tennessee local governments desire to issue general obligation refunding bonds under Tenn. Code Ann. §§ 9-21-901, *et seq.,* in order to refund their outstanding variable rate bonds. In order to terminate swaps entered into in connection with the refunded bonds, the local governments must pay the counterparty a termination fee. Tennessee law expressly authorizes a local government to agree to pay loss of benefits to the counterparty to a swap on early

termination or default. Tenn. Code Ann. § 9-21-213(d). The local governments wish to use a portion of the proceeds of the refunding bonds to pay any swap termination payment due from the local government. Thus, part of the principal of the refunding bonds would be issued to cover termination costs.

We think the termination cost of swaps integrally related to the variable rate bonds being refunded is an expense of the issuance of the refunding bonds within the meaning of Tenn. Code Ann. §§ 9-21-904(a)(4) and 9-21-914(a)(2). We base this conclusion both on the language of Tenn. Code Ann. § 9-21-904(a)(4) and the purpose of a swap authorized under Tennessee law. Tenn. Code Ann. § 9-21-904(a)(4) refers to "any" expense. The Tennessee Supreme Court has found that the word "any" as used in a statute is often synonymous with "all." *Storey v. Bradford Furniture Co., Inc.,* 910 S.W.2d 857, 860 (Tenn. 1995) (quoting *Black's Law Dictionary* 94 (6th ed. 1990)); *Roddy Manufacturing Co. v. Olsen,* 661 S.W.2d 868, 871 (Tenn. 1983). We note that Tenn. Code Ann. § 9-21-904(a)(4) authorizes the principal amount of bonds to cover "any" expenses:

> *including* bond discount, credit enhancement, engraving, printing, and advertising fees, the creation of initial debt service reserve funds, and reasonable and necessary fees of financial and legal advisors deemed by the governing body to be necessary for the issuance of the general obligation refunding bonds.

(Emphasis added). In this context, the term "any expenses" indicates that the expenses listed after the term "including" are merely examples that do not limit the types of expenses covered.

Whether a particular swap is in fact related to the debt being refunded will depend on the particular facts and circumstances. Obviously, for example, when the swap was entered into at the same time as or contingent on the issuance of the bonds being refunded, the swap is integrally related and the cost to terminate it is an expense of the refunding issue. In other cases where a refunded bond and a swap do not so closely correspond, however, the issuer should be able to articulate the integral connection between them. The issuer's request for permission from the Comptroller to enter into the swap could be useful in this regard. Where one swap was entered into with respect to obligations under more than one variable rate bond issue, only the portion of the termination fee incurred with respect to the refunded obligation may be included in the principal amount of the refunded bonds, if not all bonds are being refunded.

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