

## **MEMO TO THE PARTNER**

### **PUT OPTION PROVISION FOR BOND MASTER TRUST INDENTURE**

**ANTHONY M. CALDWELL\***

TO: Law Office Partner  
FROM: Associate  
RE: Put Option Provision for Series 2004 Bond Master Trust Indenture

#### **Introduction**

You asked me to draft a put option provision for the Series 2004 Bond Master Trust Indenture (the “Bond Indenture”) between The Health, Educational and Housing Facility Board of the County of Rural, a Tennessee nonprofit corporation (the “Issuer”), and The Bank of New York, a New York banking corporation (the “Bond Trustee”). The proceeds of this bond issuance will be provided to our client, Otis C. Jackson Memorial Hospital, Inc., a Tennessee nonprofit corporation (the “Corporation”), by the Issuer in return for the Otis C. Jackson Memorial Hospital Note, Series 2004 (“Series 2004 Obligation”) in the principal amount of \$60,000,000. The bonds are 5.5% First Mortgage Revenue Bonds Due 2034. The bonds are secured by a first perfected lien on future Corporation revenue and all property and equipment held by the Corporation. Issuer assigns all covenants and payment obligations under this bond issuance to the Corporation.

Attached for your review is Rider A, containing the requested draft put option provision as well as a list of relevant defined terms.

In this memorandum, I detail the transactional context in which this bond issuance will occur, identify the key issues presented within this transactional context, and explain the rationale for most major and minor drafting choices. Unless otherwise indicated, any defined terms in this memorandum have the same meaning given them in the Bond Indenture attached as Rider A; any other defined terms not

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included in the attached Bond Indenture have the meaning given them in the previously drafted portions of the Bond Indenture.

### **Transactional Context**

Construction of Corporation's medical center physical structure (the "Hospital"), has not begun. Based on feasibility studies conducted by Corporation's accountants, Pershing Yoakley & Associates, P.C., and approved by the Tennessee Health Services and Development Agency, the Hospital will be a fifty-bed facility. The purpose of this bond issuance is to raise funds needed to complete construction and furnish the Hospital.<sup>1</sup>

Corporation is a start-up venture made possible by the endowment of the late Beatrice Jackson. Mrs. Jackson was a life-long resident of the City of Rural in Rural County, Tennessee. As Mrs. Jackson experienced medical problems towards the end of her life, she was troubled by the lack of a local facility where she could be treated. Mrs. Jackson graciously left an endowment of \$20,000,000 for the sole purpose of creating a full-service community hospital, named for her late husband, Otis Jackson, to serve the people of Rural County and the surrounding areas. Mrs. Jackson did not restrict the manner in which Corporation may use \$10,000,000 of her bequest so long as the money is used in connection with the ultimate purpose of a local medical center. The remaining \$10,000,000 is to be held in an endowment, only the interest of which is to be used as working capital; the corpus is to remain intact. The corpus may be distributed upon written approval of Mrs. Jackson's estate for the benefit of the Corporation in certain extenuating circumstances.

The Issuer was created under Sections 48-101-301 to -318 (Health, Education and Housing Facility Corporations), inclusive (as may from time to time be amended, "Act"), of the Tennessee Code Annotated for the purpose of, among other things, financing the cost of "projects in the case of hospital institutions" owned and operated by nonprofit hospital institutions. The Act permits issuance of bonds to finance construction and furnishing costs.

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<sup>1</sup> The builders guarantee the Hospital will be completed in time for Corporation to begin operations by July 1, 2005, so I will assume for the purposes of drafting these provisions July 1, 2005 is Corporation's operational start date.

The Certificate of Incorporation<sup>2</sup> for Corporation authorizes debt issuances of this amount and type. Internal Revenue Service (“IRS”) Form 1023 has been filed and approved by the IRS, evidencing Corporation is a 501(c)(3) nonprofit organization. Our law firm will be issuing the opinion of legal counsel upon completion of drafting the Bond Indenture. Our firm has obtained all other permits and authorizations necessary to begin construction of Hospital, including approval of the Certificate of Need by the Tennessee Health Services and Development Agency.

McKinsey & Company, the Corporation’s consultant (the “Consultant”), projects the cost of building and furnishing the Hospital to be approximately \$60,000,000. Notwithstanding the \$20,000,000 from Mrs. Jackson’s estate described above, the Corporation desires to raise \$60,000,000 to complete construction and furnish Hospital from this bond issuance.

The Consultant also project that it will take five years of operation for Corporation to have excess cash reserves and earnings before interest, depreciation, and amortization, (“EBIDA”),<sup>3</sup> to meet debt service requirements on these bonds.

This is a private placement bond issuance where the following four investors each have agreed to purchase \$15,000,000 of the bonds under an acceptable Bond Indenture: Goldman Sachs Group, Inc.; J.P. Morgan Trust Company, N.A.; UBS PaineWebber, Inc.; and Lehman Brothers Holdings, Inc., (collectively, “Investors”). As Corporation is a start-up, Investors are requiring Corporation to maintain a Bond Sinking Fund. However, as described in other sections of the Bond Indenture, Investors have allowed Corporation to delay principal and interest payments to the Bond Sinking Fund for seven years after operations commence.

The provisions of the Bond Indenture must address two competing goals. Corporation desires the bond issuance to carry the lowest interest rate possible. This goal is aided by the tax exempt nature of all interest earned by Investors on these bonds. On the other hand, Investors desire to receive the highest return on the investment by receiving the highest interest rate possible. Investors’ goal is aided because of the inherent risks associated with a start-up ventures.

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<sup>2</sup> The Tennessee Code Annotated makes reference to both a “Charter,” Tenn. Code Ann. § 48-52-102 (2004), and a “Certificate of Incorporation,” Tenn. Code Ann. § 48-101-304 (2004). For consistency, I have used “Certificate of Incorporation” to describe the chartering document for the entity being described whether it would be properly described as a “Charter” or “Certificate of Incorporation.”

<sup>3</sup> We normally speak in terms of EBITDA. However, as this is a nonprofit setting, T (“taxes”) is not at issue.

The put option provision allows Investors to tender their bonds for immediate repayment when the requirements of the put option are met. In essence, this increases the liquidity and attractiveness of the investment, by permitting Investors to choose whether to stay in this investment or tender this investment for repayment and reinvest elsewhere. Corporation desires the put option provision as an added inducement so that Investors may be willing to invest in these bonds at a lower interest rate than would be demanded if not for the provision. However, this provision must not be so Investor-friendly that exercising the option would force Corporation into a situation where it has insufficient funds to make obligation payments.

### Issues Presented

- (1) **(a) Does Issuer have the authority to include the put option provision in Bond Indenture for the upcoming bond issuance?**
  - (b) **What type of restrictions may Issuer place on Investors' right to exercise the put option?**
  - (c) **Does Corporation have the authority to promise to pay obligations in relation to the put option provision in Bond Indenture?**

Two sources must be analyzed to determine (a) whether Issuer may include the put option provision in Bond Indenture, (b) what type of restrictions Issuer may place on exercising the put option, and (c) whether Corporation may promise to pay obligations in relation to the put option provision in Bond Indenture: (1) the Tennessee Code Annotated, and (2) the Certificate of Incorporation. This memo will review the Tennessee Code Annotated to ensure the resolutions to the issues above have satisfactory statutory authority, and then review the Certificate of Incorporation to ensure there is no provision within to the contrary of the chosen resolutions.

- (2) **Of the various restrictions that may be placed on exercising the put option, which restrictions will best serve the goals and address the concerns of both Corporation and Investors?**

The put option provision must be drafted to address the competing goals of Corporation and Investors in a way that induces effectuation of the transaction. As with any investment transaction, the Investors goal is to receive the highest return on their investment by obtaining the highest interest rate possible while Corporation's

goal is to receive the necessary funds with the lowest debt service cost possible. Although the interest earned on these bonds will be tax-exempt, Investors will demand a higher than normal interest rate of return due to the risk involved with a start-up entity. To help negotiate a lower interest rate, Corporation wants to give Investors an option to tender their bonds. However, this put option must be drafted to protect Corporation from the possibility that Investors will tender bonds in excess of Corporation's ability to pay. At the same time, the put option cannot be so restrictive that it is worthless for all practical purposes.

### **Analysis of Drafting Choices**

#### ***Major Drafting Decisions***

#### **Authority for Inclusion of Put Option Provision**

As mentioned above, Issuer is a creature of Tenn. Code Ann. §§ 48-101-301 to -318. Tenn. Code Ann. § 48-101-310 (Bonds of Corporation) directs Issuer on how it may issue bonds. Tenn. Code Ann. § 48-101-310(a)(1) permits Issuer to allow "an option to redeem all or any part thereof . . . at such price or prices and after such notice or notices and on such terms and conditions . . . as may be briefly recited in the face of the bonds." Thus, the Tennessee Code Annotated gives Issuer broad authority to allow redemption of the bonds on terms determined by Issuer and designated on the face of the bonds, including mandatory redemption of the bonds at the option of Investors, as in this case.

Article V of Issuer's Certificate of Incorporation states that Issuer may "exercise the authority . . . as provided in Chapter 11 of Title 48 of [Tennessee Code Annotated] . . . with the intention of the incorporators to make the scope of the authorized activities . . . and corporate power . . . as broad as is permitted by applicable statutes . . . including without limitation powers enumerated in Section 48-11-308." Tenn. Code Ann. § 48-11-308(10) allows the issuance of bonds. As mentioned above, Tenn. Code Ann. § 48-101-310(a)(1) permits the bonds to contain an option to redeem. Thus, Issuer's Certificate of Incorporation provides further authority for inclusion of this put option provision.

#### **Permissible Restrictions on Exercising the Put Option**

While Tenn. Code Ann. § 48-101-310 does not specify restrictions on options that allow redemption of the bonds, the statute does limit the structure of

the bonds in various other ways. Therefore, the put option provision cannot violate these limitations on the bond issuance structure.<sup>4</sup>

For our purposes, the major restrictions are: 1) if bonds are issued to pay for operating expenses, the bond term cannot be longer than three years; and 2) in all other circumstances, the bond term cannot be longer than 40 years. The bonds at issue here are not for operations and have a term less than 40 years. Within these confines, which the bonds have already met, any restrictions agreeable to Investors and Corporation will be permitted.

As discussed earlier, Article V of the Issuer's Certificate of Incorporation provides the Issuer with authority as broad as permitted that by statute. Thus, the restrictions are the same under the Issuer's Certificate of Incorporation, as analyzed above in Tenn. Code Ann. § 48-101-310.

#### **Authority for Promise to Pay Obligations in Relation to Put Option Provision**

Issuer assigns all covenants and payment rights of Bond Indenture to Corporation, a Tennessee nonprofit corporation. As a nonprofit corporation, the Corporation is a creature of the statutes constituting the Tennessee Nonprofit Corporation Act. The Tennessee Nonprofit Corporation Act, Tenn. Code Ann § 48-51-101 (2004). Tenn. Code Ann. § 48-53-102(7) permits Corporation to "make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds, and other obligations ... and secure any of its obligations or those of any other person by mortgage, pledge of, or security interest in, any of its property, franchises, or income." Furthermore, Tenn. Code Ann. § 48-53-102(19) provides Corporation great discretion of "do[ing] all things necessary or convenient, not inconsistent with law, to further the activities and affairs of the corporation." The Tennessee Code Annotated does not direct Corporation as to specific terms or conditions under which it should or should not borrow money. Thus, Corporation has the statutory authority to issue a note in exchange for proceeds of a bond issuance containing a put option provision.

Article XI of Corporation's Certificate of Incorporation allows Corporation "to borrow money to be used in payment of property bought by it and for erecting buildings, making improvements, and for other purposes germane to the object of its creation." The Certificate of Incorporation does not specify terms or conditions

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<sup>4</sup> Tenn. Code Ann. § 48-101-310 (2004) also places limits on refunding bonds, *i.e.*, bonds issued to refund earlier issued bonds. Those restrictions do not apply to our present situation and therefore will not be discussed.

under which it should or should not borrow money. Thus, the Certificate of Incorporation allows Corporation broad discretion in determining the terms under which it will borrow money.

### **Type of Restrictions on Exercising Put Option**

I believe the best way to protect the expectations of both the Investors and the Corporation is to restrict exercise of the put option both by date and by the value of bonds that may be tendered by Investors.

As all parties are aware, the Consultant does not project that the Corporation will be in a position to make debt service payments through build-up of cash reserves and EBIDA during the first five years of operation. Investors already have agreed not to require sinking fund payments until Corporation has had seven years of operation to allow Corporation a two-year period to build net assets. Overall, both Investors and Corporation would like to see Corporation succeed. However, if Corporation is unsuccessful, Investors want to recover as much money as possible as early as possible.

The bonds are long-term obligations of Issuer and carry a fixed rate<sup>5</sup> of 5.5%, which is currently 0.5% above the current Revenue Bond Buyer's Index. Corporation hopes that this premium plus the tax-exempt feature of the interest paid and the proposed put option provision for Investor will effectuate the transaction, even if the put option provision must be relatively restrictive due to Corporation's start-up status.

As illustrated in the attached Rider A, I propose restricting Investors' ability to exercise the put option for ten years after Corporation begins operations. Each Investor may redeem a maximum of 10% of its original investment (or \$1,500,000) per year. Additionally, if an Investor redeems for three years in a row, the Investor must refrain from redeeming for one year before beginning another three-year cycle of redemption. All restrictions on the Investors' put option will be removed after twenty years of Corporation operations.

A provision has been drafted in Bond Indenture that allows Corporation to call the bonds after a certain period of time but prior to the end of the bond term. The call option pays Investors a premium if Corporation decides to call the bonds.

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<sup>5</sup> I did not choose variable rate debt, as the Corporation does not desire to introduce that potential risk into its start-up financial structure.

Corporation would like to maintain control of when the bonds are redeemed and not provide any incentive for the Investors to exercise their put option to force early redemption of the bonds. To that end, Corporation will not pay any premium in any instance in which Investors exercise their put option to redeem the bonds.

This provision benefits both parties. Corporation is provided ten years of operations in which to build cash reserves to make debt service payments and is protected from all the bonds being redeemed at once. Investors may begin redeeming bonds after a relatively short period of time and may tender all bonds nine years before the bonds are due.

### *Minor Drafting Decisions*

I labeled the provision “Optional Tenders” as the term “put option” is not customarily used under precedent bond indentures. The provision was relatively short; therefore, I did not include additional headings or subheadings. Each paragraph is labeled with a separate alphabetic letter, going from (a) through (h), to stay consistent with the other portions of Bond Indenture. The provision contains standard notice provisions.

I included a definition section, which includes reference to relevant definitions of terms used in the drafted put option provision, that should be incorporated in the appropriate section of Article I (Definitions) of Bond Indenture.<sup>6</sup> The optional tender provision should be inserted as the last provision of Article V (Redemption and Optional Tender of Bonds) of Bond Indenture directly after the section titled “Notice of Redemption.” Open brackets represent information that has not been included in Bond Indenture to date. For ease of reading and comprehension, all numerical information is presented in numerical format, and the provision, consistent with the rest of Bond Indenture, is drafted in plain English.

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<sup>6</sup> Defined terms, e.g., “Bondholder,” which already have been defined in early sections of the Bond Indenture, will not be defined again in this definition section.



**Rider A**

**BOND TRUST INDENTURE BETWEEN  
THE HEALTH, EDUCATIONAL AND HOUSING FACILITY BOARD  
OF  
RURAL COUNTY, TENNESSEE  
AND  
THE BANK OF NEW YORK, as Bond Trustee**

*Section 1. Definitions*

The terms defined in this Section 1 shall have, for all purposes of this Bond Indenture, the meanings herein specified in this Section 1 (with terms in the singular having comparable meanings when used in the plural).

- ( ) “Optional Tender” is defined in Section [ ](a).
- ( ) “Optional Tender Date” is defined in Section [ ](a).
- ( ) “Partial Optional Tender” is defined in Section [ ](b).
- ( ) “Partial Optional Tender Date” is defined in Section [ ](b).
- ( ) “Partial Optional Tender Waiting Period” is defined in Section [ ](b).
- ( ) “Purchase Price” is shall be 100% of the principal amount of the Series 2004 Bond to be purchased plus accrued interest to the Optional Tender Date or Partial Optional Tender Date, whichever is applicable.

*Section [ ]. Optional Tenders*

(a) Each Bondholder has the right to tender (an “Optional Tender”) its Series 2004 Bond to the Bond Trustee for purchase in whole or in part on the first business day on or after July 1, 2025 (any such date referred to as “Optional Tender Date”) by rendering payment of the Purchase Price. In order to exercise this option with respect to any Series 2004 Bond, the Bondholder must deliver notice to the Bond Trustee, as provided in this Section, at least 30 days prior to the proposed Optional Tender Date.

(b) Each Bondholder shall have the right to tender (a “Partial Optional Tender”) a maximum of \$1,500,000 in principal amount of its Series 2004 Bonds to the Bond Trustee for purchase on the first business day on or after July 1, 2015 (any such date referred to as the “Partial Optional Tender Date”) by rendering payment of the Purchase Price. Each Bondholder then may tender \$1,500,000 in each subsequent year for an aggregate of 3 years. If any Bondholder exercises a Partial Optional Tender in 3 consecutive years, that Bondholder must not exercise another Partial Optional Tender for one full calendar year after the third consecutive Partial Optional Tender (“Partial Optional Tender Waiting Period”). After completion of the Partial Optional Tender Waiting Period, the Bondholder may exercise a Partial Optional Tender for another 3 consecutive years before being required to wait through another Partial Optional Tender Waiting Period in order to exercise further Partial Optional Tenders. In order to exercise this option with respect to any Series 2004 Bond, the Bondholder must deliver notice to the Bond Trustee, as provided in this Section, at least 30 days prior to the proposed Partial Optional Tender Date. All Partial Optional Tender restrictions referred to in this paragraph (b) are eliminated on or after July 1, 2025, all of which are Optional Tenders covered by paragraph (a) of this Section [ ].

(c) Any notice of Optional Tender or Partial Optional Tender must be duly executed by the Bondholder and must specify (1) the name of the registered Bondholder tendering any Series 2004 Bond for purchase, (2) the Optional Tender Date or Partial Tender Date, (3) the certificate number and principal amount of the Series 2004 Bond being tendered, and (4) the principal amount of the Series 2004 Bond to be purchased.

(d) Not later than the business day after receipt of any notice of Optional Tender or Partial Optional Tender, the Bond Trustee shall deliver notice to the Remarketing Agent and the Corporation specifying (1) the principal amount of the Series 2004 Bond for which a notice of Optional Tender or Partial Optional Tender has been given and (2) the proposed Optional Tender Date or Partial Optional Tender Date.

(e) The Bond Trustee shall, in its sole discretion, determine whether, with respect to any Series 2004 Bond, the Bondholder properly exercised the option to have its Series 2004 Bond purchased pursuant to this Section.

(f) If the Bondholder properly exercised the option to have its Series 2004 Bond purchased as prescribed in this paragraph (e), the Bondholder shall deliver its Series 2004 to the principal corporate trust office of the Bond Trustee on or prior to the Optional Tender Date or Partial Optional Tender Date, together with all

necessary endorsements for transfer. If only a portion of the Series 2004 Bond is to be purchased, the Issuer shall execute and the Bond Trustee shall authenticate and deliver to the Bondholder, without service charge, a new Series 2004 Bond as requested by the Bondholder in aggregate principal amount equal to and in exchange for the unpurchased portion of the principal amount of the Series 2004 Bond tendered for purchase.

(g) If the Bondholder properly exercised the option to have its Series 2004 Bond purchased as prescribed in this paragraph (e), on the Optional Tender Date or Partial Optional Tender Date, the Bond Trustee shall pay to the Bondholder an amount equal to the Purchase Price. Funds for payment of the Purchase Price of the 2004 Bonds shall be drawn by the Bond Trustee from the Bond Purchase Fund as provided in Section [ ] of this Bond Indenture.

(h) Anything in this Bond Indenture to the contrary notwithstanding, Bondholders may exercise their Optional Tender or Partial Optional Tender right notwithstanding the existence of an event of default under this Bond Indenture.