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Tax-Free Industrial Revenue Bonds

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These bonds (IRBs for short) as a class, probably have the highest credit risk that you may not be repaid on time or in full. That said, the interest rate yields are the highest in the industry.

Simply put, a corporation issues bonds through a "shell" authority, to obtain lower cost tax-exempt municipal bond rates. The municipal "shell" corporation doesn't require or even promise to pay from city or state's tax revenue. The city/county/state is insulated: you can only look to the corporate borrower for repayment, and in most cases, bondholders don't even have collateral protection. Because this could lead to the abuse of tax-exemption benefits, Congress & the President passed strong laws limiting the amount of bonds that could be issued for the benefit of these private corporations in 1986.

In 1995, United Airlines could get tax-exempt interest rates by using industrial revenue bonds for a major maintenance/repair facility. That investment was only about 20% of the total investment planned by United, and the airline put in about $800 million of its own money as a symbol of their interest in the project, because they believed United's commitment to this facility would be their major repair/restoration/refurbishing facility for United's entire airline fleet, bolstering investor demand. In 2002, United defaulted on this debt, basically leaving bondholders in default. The bonds are "guaranteed" by United/Continental, but the guarantee does not give bondholders any preference: basically, they are last in line to be paid before stockholders.

So, if you have any desire to buy IRBs, realize that the risk of being repaid may not be much more than if you were a corporate stockholder. As the old Latin proverb says: "Caveat emptor": Buyer Beware.

About the Author

RICHARD P. LARKIN, Stoever Glass & Co., Inc.

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.

Disclosures: