**PRELIMINARY OFFICIAL STATEMENT DATED OCTOBER 4, 2011**



**New Issues** **Book-Entry Only**

*This cover page contains certain information for quick reference only. It is not a summary of the issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.*

# STATE OF TENNESSEE

## $255,480,000*
## General Obligation Bonds, 2011 Series A

## $105,575,000*
## General Obligation Bonds, 2011 Refunding Series B

**Dated: Date of Delivery**

**Due: Series A Bonds – October 1**
**Series B Bonds – August 1**
**as shown on inside front cover**

| | |
|---|---|
| *The Bonds* | Series A Bonds interest is payable semi-annually April 1 and October 1, commencing April 1, 2012.<br><br>Series B Bonds interest is payable semi-annually February 1 and August 1, commencing February 1, 2012.<br><br>Interest rates and reoffering yields/prices as shown on inside front cover.<br><br>Fully registered bonds issued in denominations of $5,000 or any integral multiple thereof.<br><br>Series A Bonds maturing on or after October 1, 20__ are subject to optional redemption by the State on and after October 1, 20__ at par.<br><br>Series B Bonds maturing on or after August 1, 20__ are subject to optional redemption by the State on and after August 1, 20__ at par.<br><br>Term Bonds are subject to mandatory sinking fund redemption at par.<br><br>See "The Bonds" herein. |
| *Security* | Direct general obligations; pledge of full faith and credit. See "Security for the Bonds" herein. |
| *Ratings* | Fitch: AAA Moody's: Aaa S & P: AA+. See "Ratings" herein. |
| *Book-Entry Only System* | The Depository Trust Company will act as securities depository for the Bonds. See "The Bonds" and "Appendix D – Book-Entry Only System" herein. |
| *Tax Exemption* | Interest on the Bonds is excluded from gross income for Federal income tax purposes to the extent and subject to the conditions, limitations and continuing compliance with tax covenants as described herein. The Bonds and the interest thereon are free from Tennessee taxes, subject to certain exceptions. See "Tax Matters" herein. |
| *Issuer's Bond Counsel* | Hawkins Delafield & Wood LLP, New York, New York. |

*The Bonds are offered when, as and if issued and received by the Underwriters subject to certain conditions, including the approval of legality by Hawkins Delafield & Wood LLP, Bond Counsel to the State of Tennessee. Certain legal matters in connection with the Bonds are subject to the approval of the Attorney General and Reporter of the State of Tennessee, as counsel to the State Funding Board. Certain legal matters will be passed upon for the Underwriters by Bass, Berry & Sims, PLC, counsel to the Underwriters. The Bonds are expected to be available through the facilities of The Depository Trust Company on or about October _, 2011.*

**Citigroup**
**Morgan Keegan**
**SunTrust Robinson Humphrey, Inc.**

**Wells Fargo Securities**

**Barclays Capital**
**Morgan Stanley**
**Wiley Bros.-Aintree Capital, LLC**

October ___, 2011

*Subject to change

**MATURITIES, AMOUNTS, INTEREST RATES, PRICES/YIELDS**
**AND CUSIP NUMBERS**

**STATE OF TENNESSEE**

**$255,480,000***
**GENERAL OBLIGATION BONDS, 2011 SERIES A**

| Due October 1 | Amount* | Interest Rate | Price/Yield | CUSIP** 880541 |
|---|---|---|---|---|
| 2012 | $12,770,000 | | | |
| 2013 | 12,775,000 | | | |
| 2014 | 12,775,000 | | | |
| 2015 | 12,775,000 | | | |
| 2016 | 12,775,000 | | | |
| 2017 | 12,775,000 | | | |
| 2018 | 12,775,000 | | | |
| 2019 | 12,775,000 | | | |
| 2020 | 12,775,000 | | | |
| 2021 | 12,775,000 | | | |
| 2022 | 12,775,000 | | | |
| 2023 | 12,775,000 | | | |
| 2024 | 12,775,000 | | | |
| 2025 | 12,775,000 | | | |
| 2026 | 12,775,000 | | | |
| 2027 | 12,775,000 | | | |
| 2028 | 12,775,000 | | | |
| 2029 | 12,770,000 | | | |
| 2030 | 12,770,000 | | | |
| 2031 | 12,770,000 | | | |

**$105,575,000***
**GENERAL OBLIGATION BONDS, 2011 REFUNDING SERIES B**

| Due August 1 | Amount* | Interest Rate | Price/Yield | CUSIP** 880541 |
|---|---|---|---|---|
| 2012 | $170,000 | | | |
| 2014 | 6,430,000 | | | |
| 2015 | 6,445,000 | | | |
| 2016 | 6,485,000 | | | |
| 2017 | 11,480,000 | | | |
| 2018 | 11,550,000 | | | |
| 2019 | 11,755,000 | | | |
| 2020 | 11,835,000 | | | |
| 2021 | 11,910,000 | | | |
| 2022 | 6,830,000 | | | |
| 2023 | 6,825,000 | | | |
| 2024 | 6,910,000 | | | |
| 2025 | 6,950,000 | | | |

***Subject to change**

**These CUSIP numbers have been assigned by Standard & Poor's CUSIP Service Bureau, a Division of The McGraw Hill Companies, Inc., and are included solely for the convenience of the Bondholders. Neither the Underwriters nor the State of Tennessee is responsible for the selection or use of these CUSIP numbers, nor is any representation made as to their correctness on the Bonds or as indicated herein. The CUSIP number for a specific maturity is subject to being changed after the issuance of the Bonds as a result of various subsequent actions, including, but not limited to, a refunding in whole or in part of such maturity or as a result of the procurement of secondary market portfolio insurance or other similar enhancement by investors that is applicable to all or a portion of certain maturities of the Bonds.

## THE FUNDING BOARD OF THE STATE OF TENNESSEE

Bill Haslam, Governor, *Chairman*
Justin P. Wilson, Comptroller of the Treasury, *Secretary*
Tre Hargett, Secretary of State
David H. Lillard, Jr., State Treasurer
Mark Emkes, Commissioner of Finance and Administration

## STAFF

Mary-Margaret Collier, *Assistant Secretary to the Funding Board*
and *Director of the Office of State and Local Finance*
Ann V. Butterworth, *Assistant Secretary*
Sandra Thompson, *Assistant Director of the Office of State and Local Finance*
Cindy Liddell, *Bond Accountant, Office of State and Local Finance*

## ISSUER'S COUNSEL

Attorney General and Reporter of the State of Tennessee, Nashville, Tennessee

## ISSUER'S BOND COUNSEL

Hawkins Delafield & Wood LLP, Attorneys at Law, New York, New York

## FINANCIAL ADVISOR

Public Financial Management, Inc., Memphis, Tennessee

For the purpose of compliance with Rule 15c2-12 of the Securities and Exchange Commission, this document constitutes an Official Statement of the State with respect to the Bonds that has been deemed "final" by the State as of its date except for the omission of no more than the information permitted by subsection (b)(1) of Rule 15c2-12.

This Official Statement does not constitute an offering of any security other than the Bonds specifically offered hereby. No dealer, broker or other person has been authorized by the State to give any information or to make any representation other than as contained in this Official Statement, and if given or made, such other information or representation must not be relied upon as having been authorized by the State. This Official Statement does not constitute an offer to sell or a solicitation of an offer to buy, nor shall there be any sale of, the Bonds by any person in any jurisdiction in which it is unlawful to make such offer, solicitation or sale.

Certain information set forth herein has been provided by the State. Certain other information set forth herein has been obtained by the State from sources believed to be reliable, but it is not guaranteed as to accuracy or completeness, and is not to be construed as a representation, by the Underwriters. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the State since the date hereof. The Underwriters have provided the following sentence for inclusion in this Official Statement: The Underwriters have reviewed the information in this Official Statement in accordance with, and as a part of, their respective responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information. In making an investment decision, investors must rely on their own examination of the State and the terms of the offering, including the merits and risks involved.

The prices and other terms respecting the offering and sale of the Bonds may be changed from time to time by the Underwriters after such Bonds are released for sale, and the Bonds may be offered and sold at prices other than the initial offering prices, including sales to dealers who may sell the Bonds into investment accounts.

**IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS THAT STABILIZE OR MAINTAIN THE MARKET PRICES OF THE BONDS AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.**

**NO REGISTRATION STATEMENT RELATING TO THE BONDS HAS BEEN FILED WITH THE SECURITIES EXCHANGE COMMISSION (THE "SEC") OR ANY STATE SECURITIES AGENCY. THE BONDS HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SEC OR ANY STATE SECURITIES AGENCY, NOR HAS THE SEC OR ANY STATE SECURITIES AGENCY PASSED UPON THE ACCURACY OR ADEQUACY OF THIS OFFICIAL STATEMENT. ANY REPRESENTATION TO THE CONTRARY MAY BE A CRIMINAL OFFENSE.**

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## STATE OF TENNESSEE

## $255,480,000*
## GENERAL OBLIGATION BONDS, 2011 SERIES A

## $105,575,000*
## GENERAL OBLIGATION BONDS, 2011 REFUNDING SERIES B

## INTRODUCTION

This Preliminary Official Statement, which includes the cover page and the inside cover page hereof, and the Appendices hereto, including the financial information incorporated by reference in Appendix A and the statistical information incorporated by reference in Appendix B, is provided for the purpose of presenting information relating to the State of Tennessee (the "State") in connection with the issuance of the State's $255,480,000* General Obligation Bonds, 2011 Series A (the "Series A Bonds"), and $105,575,000* General Obligation Bonds, 2011 Refunding Series B (the "Series B Bonds", and collectively with the Series A Bonds the "Bonds").

The Bonds will be issued pursuant to the authority of and in full compliance with the provisions, restrictions and limitations of the Constitution and laws of the State, including Title 9, Chapter 9, Tennessee Code Annotated, and various bond authorizations enacted by the General Assembly of the State, and pursuant to a resolution (the "Bond Resolution") adopted by the State Funding Board of the State on September 8, 2011. The Series A Bonds are being issued to (i) provide for the retirement at maturity of a portion of the State's outstanding general obligation commercial paper ("CP") issued to fund certain capital projects of the State, (ii) finance certain capital projects and (iii) fund certain costs of issuance. The Series B Bonds are being issued to (i) refund certain outstanding general obligation bonds and (ii) fund certain costs of issuance. See, "Application of Bond Proceeds and Plan of Refunding."

The Bonds are direct general obligations of the State for which the State has pledged its full faith and credit for the payment of both principal and interest. As additional security for the Bonds and the interest thereon, there is also pledged the annual proceeds of certain specific taxes, revenues and fees required to be paid to the State. The Bonds, together with interest thereon, are entitled to the benefit of these taxes, revenues and fees and to share therein pro rata with any other obligations of the State that might be entitled to share therein as provided by Title 9, Chapter 9, Tennessee Code Annotated. See "Security for the Bonds".

The State has also authorized the issuance of its $223,220,000* General Obligation Bonds, 2011 Series C (Federally Taxable) (the "Series C Bonds"). The Series C Bonds are being issued to finance certain capital projects of the State, to provide for the retirement and maturity of a portion of the State's outstanding CP, to refund certain outstanding general obligation bonds of the State, and to pay costs of issuance of the Series C Bonds. The general obligation bonds to be refunded by the Series C Bonds will be selected at or about the time of sale of the Series C Bonds. The Series C Bonds are expected to be delivered at approximately the same time as the Bonds.

## THE BONDS

### Description

The Bonds will be dated the date of their delivery. The Series A Bonds will mature on October 1 as shown on the inside cover page and will bear interest payable semi-annually on April 1 and October 1, commencing April 1, 2012, at the rates per annum as shown on the inside cover page. The Series B Bonds will mature on August 1 of

* Subject to change

each of the years and in the principal amounts as shown on the inside cover page and will bear interest payable semi-annually on February 1 and August 1, commencing February 1, 2012, at the rates per annum as shown on the inside cover page. The Bonds will be issuable as fully registered bonds in denominations of $5,000 or integral multiples thereof.

**Book-Entry Only System**

Upon initial issuance, the Bonds will be available only in book-entry form. The Depository Trust Company ("DTC"), New York, New York, will act as securities depository for the Bonds. The ownership of one fully registered Bond for each maturity of each series of the Bonds bearing interest at each interest rate, each in the aggregate principal amount of such maturity and bearing interest at such rate, will be registered in the name of Cede & Co. (DTC's partnership nominee) and deposited with DTC. Beneficial owners of Bonds will not receive physical delivery of bond certificates, except under limited circumstances.

For a description of DTC and its book-entry only system, see "Appendix D – Book-Entry Only System".

**Redemption***

*Optional Redemption*. At the option of the State, the Series A Bonds maturing on or after October 1, 20___ are subject to redemption prior to their respective stated maturities, from any monies that are available to the State for such purpose, at any time on and after October 1, 20__ as a whole, or in part from time to time in any order of maturity determined by the State, at a redemption price of par, together with accrued interest to the redemption date.

At the option of the State, the Series B Bonds maturing on or after August 1, 20__ are subject to redemption prior to their respective stated maturities, from any monies that are available to the State for such purpose, at any time on and after August 1, 20__ as a whole, or in part from time to time in any order of maturity determined by the State, at a redemption price of par, together with accrued interest to the redemption date.

*Mandatory Sinking Fund Redemption.* The Series __ Bonds maturing on ___ 1, 20__, shall constitute term bonds subject to mandatory sinking fund redemption and shall be redeemed prior to maturity in each of the years and in the respective principal amounts set forth in the table below, at a redemption price of par, together with accrued interest to the redemption date.

| 20XX Maturity | | 20XX Maturity | | 20XX Maturity | |
|---|---|---|---|---|---|
| Year | Amount | Year | Amount | Year | Amount |

*Selection of Bonds to be Redeemed.* If less than all of the Bonds of a maturity of a series are to be redeemed, the particular Bonds or portions thereof of such series and maturity to be redeemed shall be selected by lot.

In any such event, for so long as a book-entry only system is in effect with respect to the applicable Bonds, DTC or its successor and Direct DTC Participants and Indirect DTC Participants (all as defined in Appendix D hereto) will determine the particular ownership interests of the Bonds of such series and maturity to be redeemed. Any failure of DTC or its successor, or of a Direct DTC Participant or Indirect DTC Participant, to make such determination as described above will not affect the sufficiency or the validity of the redemption of the Bonds. See "Book-Entry-Only System" and Appendix D "Book-Entry-Only System".

*Notice of Redemption.* Written notice shall be mailed to registered owners of the Bonds to be redeemed, at least thirty (30) days but no more than sixty (60) days prior to the redemption date, at the address that appears on the

* Subject to change

registration books, but failure to receive any such notice shall not affect the validity of the redemption proceedings. Any notice of redemption may provide that such redemption is conditional on the availability of sufficient moneys to pay the redemption price, plus interest accrued and unpaid to the redemption date. While DTC or its nominee is the registered owner of the Bonds, the State will give notice of redemption of the Bonds to DTC or its nominee or its successor and shall not be responsible for mailing notices of redemption to Direct DTC Participants, to Indirect DTC Participants or to the beneficial owners of the Bonds. Any failure of DTC or its nominee or its successor, or of a Direct DTC Participant or Indirect DTC Participant, to notify a beneficial owner of a bond of any redemption will not affect the sufficiency or the validity of the redemption of such bond. See Appendix D – "Book-Entry Only System". The State can give no assurance that DTC or its successor, the Direct DTC Participants or the Indirect DTC Participants will distribute such redemption notices to the beneficial owners of the Bonds, or that they will do so on a timely basis.

## APPLICATION OF BOND PROCEEDS AND PLAN OF REFUNDING

The Series A Bonds are being issued to (i) provide for the retirement at maturity of a portion of the State's outstanding CP issued to fund certain capital projects of the State, (ii) finance certain capital projects and (iii) fund certain costs of issuance. The Outstanding CP retired from proceeds of the Bonds will be retired on various dates within 90 days after the date of delivery of the Series A Bonds.

The Series B Bonds are being issued to (i) refund certain outstanding general obligation bonds, as indicated in the table below (the "Refunded Bonds") and (ii) fund certain costs of issuance. The refunding is being undertaken to realize debt service savings. The State will select the specific Refunded Bonds (which may include all or a portion of the general obligation bonds listed in the table below, or additional general obligation bonds of the same or additional series) at or about the time of sale of the Series B Bonds. Such selection will be based, in part, upon market conditions existing at that time. Accordingly, no assurance can be given as to the Refunded Bonds finally selected until after the sale of the Series B Bonds.

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**Proposed Refunded Bonds***

| Series | Maturity Date | Interest Rate | Principal Amount | Redemption Date | Redemption Price |
|---|---|---|---|---|---|
| 2003A | 08/01/12 | 5.125% | $ 195,000 | ** | 101% |
| | 08/01/19 | 4.625 | 145,000 | ** | 101 |
| | 08/01/20 | 4.750 | 155,000 | ** | 101 |
| | 08/01/21 | 4.750 | 160,000 | ** | 101 |
| | 08/01/22 | 4.750 | 170,000 | ** | 101 |
| | 08/01/23 | 4.750 | 130,000 | ** | 101 |
| | 08/01/24 | 4.750 | 190,000 | ** | 101 |
| | 08/01/25 | 4.750 | 200,000 | ** | 101 |
| | | | $ 1,345,000 | | |
| 2005B | 08/01/14 | 5.000% | $ 7,250,000 | 08/01/13 | 101% |
| | 08/01/15 | 4.100 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/16 | 4.150 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/17 | 4.250 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/18 | 4.350 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/19 | 4.400 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/20 | 4.450 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/21 | 4.450 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/22 | 4.500 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/23 | 4.500 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/24 | 4.500 | 7,250,000 | 08/01/13 | 101 |
| | 08/01/25 | 4.500 | 7,250,000 | 08/01/13 | 101 |
| | | | $ 87,000,000 | | |
| 2006A | 08/01/17 | 4.250% | $ 5,500,000 | 08/01/14 | 101% |
| | 08/01/18 | 4.000 | 5,500,000 | 08/01/14 | 101 |
| | 08/01/19 | 4.125 | 5,500,000 | 08/01/14 | 101 |
| | 08/01/20 | 4.200 | 5,500,000 | 08/01/14 | 101 |
| | 08/01/21 | 4.125 | 5,500,000 | 08/01/14 | 101 |
| | | | $ 27,500,000 | | |
| Total Refunded Bonds | | | $115,845,000 | | |

*Subject to change
**No later than 90 days after the date of delivery of the Series B Bonds.

The Refunded Bonds will be called for redemption on the redemption dates and at the redemption prices as stated in the table above, plus accrued interest to the respective redemption date. Such designations for redemption will be irrevocable upon issuance of the Series B Bonds.

Pursuant to the Bond Resolution authorizing the Bonds, the State Funding Board will enter into a Refunding Trust Agreement with Regions Bank (the "Refunding Trustee"). Proceeds of the Series B Bonds and other available monies will be deposited into a refunding trust fund (the "Refunding Trust Fund") and used to acquire direct general obligations of or obligations the payment of principal of and interest on which are unconditionally guaranteed by the United States of America (the "Government Obligations"). The Government Obligations and the interest earned thereon will be sufficient, and will be used, together with other available monies, to pay (i) the respective redemption prices of the Refunded Bonds on their respective redemption dates and (ii) the interest on the Refunded Bonds due on and prior to such redemption dates. The Government Obligations will be purchased from the Treasury Department of the United States of America or in the open market through a competitive bidding process. The State is required to deposit in the Refunding Trust Fund any additional amounts that may be necessary for any reason to enable the Refunding Trustee to pay the redemption prices of and interest on the Refunded Bonds.

The State will obtain verification of sufficiency of the amounts and Government Obligations deposited in the Refunding Trust Fund for the Refunded Bonds, and of certain yields, from Robert Thomas CPA, LLC (See “Verification Agent”).

Upon issuance of the Series B Bonds, the Refunded Bonds will be irrevocably designated for redemption as stated in the table above, plus accrued interest to the redemption date and provision will be made by the State in the Refunding Trust Agreement for the giving of notice of redemption of the Refunded Bonds. Written notice of any such redemption shall be mailed to the registered owners of the Refunded Bonds to be redeemed not less than (30) days prior to the redemption date. While DTC or its nominee is the registered owner of the Refunded Bonds, the State shall not be responsible for mailing notices of redemption to Direct DTC Participants or Indirect DTC Participants or to the Beneficial Owners of the Refunded Bonds.

## SOURCES AND USES OF FUNDS

The proceeds of the Bonds are expected to be applied on the date of issue of the Bonds in the estimated amounts as follows:

| **Sources of Funds:** | **Series A Bonds** | **Series B Bonds** | **Total** |
|---|---|---|---|
| Par Amount | $ | $ | $ |
| Original Issue Premium (Discount) | | | |
| Total | $ | $ | $ |
| | | | |
| **Uses of Funds:** | | | |
| Retirement of Commercial Paper | $ | $ | $ |
| Capital Projects Fund | | | |
| Deposit to Refunding Trust Fund | | | |
| Cost of Issuance | | | |
| Underwriters' Discount | | | |
| Total | $ | $ | $ |

## SECURITY FOR THE BONDS

All general obligation bonds of the State, including the Bonds, are and will be direct general obligations of the State, payable as to both principal and interest from any funds or monies of the State from whatever source derived. The full faith and credit of the State is pledged to the payment of principal of and interest on all general obligation bonds. As additional security to support its general obligation bonds, including the Bonds, the State, pursuant to Section 9-9-103(a), Tennessee Code Annotated, has pledged (i) the annual proceeds of a tax of five cents (5¢) per gallon upon gasoline; (ii) the annual proceeds of a special tax of one cent (1¢) per gallon upon petroleum products; (iii) one-half of the annual proceeds of motor vehicle registration fees now or hereafter required to be paid to the State; and (iv) the annual proceeds of the franchise taxes imposed by the franchise tax law of the State (collectively, “Special Taxes”). All general obligation bonds share this pledge of Special Taxes on a pro rata basis. See “State Indebtedness” for the amounts of outstanding debt.

The Special Taxes collected for the last three fiscal years, as reported for each year in the June monthly Statement of Revenue Collections (prepared on a cash basis) were as follows (amounts have been rounded):

| | Fiscal Year Ended | | |
|---|---|---|---|
| | June 30, 2011* | June 30, 2010 | June 30, 2009 |
| Gasoline Tax | $155,799,000 | $151,915,000 | $149,763,000 |
| Special Petroleum Tax | 44,945,000 | 45,140,000 | 44,307,000 |
| One-half of Motor Vehicle Registration Fees | 122,865,000 | 116,113,000 | 117,090,000 |
| Franchise Tax | 450,923,000 | 551,412,000 | 524,685,000 |
| Total | $774,532,000 | $864,580,000 | $835,845,000 |

Source: TN Department of Revenue
*Amounts are unaudited

Pursuant to Section 9-9-106, Tennessee Code Annotated, the State Funding Board has a lien on the taxes, revenues and fees from the Special Taxes in the full amount required to pay principal of and interest on the State's general obligation bonds issued under Title 9, Chapter 9, Tennessee Code Annotated. Pursuant to Section 9-9-111, Tennessee Code Annotated, the State has covenanted not to decrease by legislative action the Special Taxes unless the State Funding Board certifies that the State is not in default in the payment of any outstanding debt and that Special Taxes at lower rates specified by the State Funding Board in such year or years (not to exceed two (2) years) will be sufficient to make all payments required to be made therefrom by the State on all of its obligations during the period that such decrease will be in effect.

The principal amount of general obligation bonds that the State may issue is limited by Section 9-9-104, Tennessee Code Annotated, which provides in part as follows:

> "[N]o bonds or other obligations will be made a charge upon the special revenues consisting of the proceeds of the gasoline tax, franchise tax, the special tax on petroleum products provided for by Section 67-3-1303 [currently Section 67-3-203] and motor vehicle registration fees pledged under the provisions of this chapter, in addition to the obligations and charges authorized by this chapter, unless the revenues pledged by Section 9-9-103 or the aggregate of the pledged gasoline tax, the special tax on petroleum products provided for by Section 67-3-1303 [currently Section 67-3-203], motor vehicle registration fees and one-third (1/3) of the entire annual proceeds of franchise and excise taxes imposed by the franchise and excise tax laws compiled in Title 67, Chapter 4, parts 9 and 8 [currently parts 21 and 20], whichever sum is lower, for the last preceding fiscal year shall have aggregated not less than one hundred fifty percent (150%) of the amount necessary to pay the annual interest upon all outstanding obligations and charges, for the payment of which such revenues are pledged, and the annual interest upon the obligations then proposed to be issued, together with the annual amount necessary for the amortization of the outstanding obligations and charges and the obligations then proposed to be issued; provided, that, in determining the outstanding obligations and charges there shall be excluded any outstanding bonds with respect to which refunding bonds have been issued and sold and the proceeds of which are to be applied to retire the outstanding bonds."

The amount of Special Taxes collected, on a cash basis, for the fiscal year ended June 30, 2011 was $774,532,000 (unaudited). The aggregate of the pledged gasoline tax, the special tax on petroleum products, motor vehicle registration fees and one-third of the entire annual proceeds of franchise and excise taxes collected, on a cash basis, for the fiscal year ended June 30, 2011 was $830,108,000 (unaudited). Pursuant to Section 9-9-104, Tennessee Code Annotated, the debt service limit is obtained by dividing the lesser amount ($774,532,000) by one-point-five (1.5). Therefore, the debt service limit for the fiscal year ending June 30, 2012 is $516,355,000. The greatest amount of principal and interest payable in any fiscal year on outstanding bonds for the payment of which Special Taxes have been pledged, excluding the Bonds and CP, but including the Refunded Bonds, is not more than $204,737,000.

Section 67-6-103(a)(5), Tennessee Code Annotated, currently provides that 0.9185% of the sales and use tax collections is appropriated to the State Funding Board for the payment of principal and interest on the State's general obligation bonds. This statutory provision subsequently may be changed or eliminated. The total sales and use tax collections and the amounts allocated to debt service for the last three fiscal years as reported in the State's Annual Financial Reports were as follows (amounts have been rounded):

| | Total Sales and Use Tax Collections (Accrual Basis) | Allocation to Debt Service (Modified Accrual Basis) |
|---|---|---|
| June 30, 2011* | $6,538,141,000 | $46,017,000 |
| June 30, 2010 | 6,170,977,000 | 43,794,000 |
| June 30, 2009 | 6,326,857,000 | 44,977,000 |
| June 30, 2008 | 6,851,481,000 | 48,569,000 |

*Estimated and unaudited

Due to the implementation of GASB Statement 44 "Economic Condition Reporting: The Statistical Section," the total sales and use tax collections are now reported on the accrual basis instead of the modified accrual basis. However, the calculation of 0.9185% of the sales and use tax collections for allocation to debt service continues to be based upon a modified accrual basis of the Total Sales and Use Tax Collections rather than the accrual basis shown above. For a discussion of projected current year collections, see "State Finances – Financial Information and Budget Summary for Fiscal Years 2010-2011 and 2011-2012". For a history of total sales and use tax collections and rates since Fiscal Year 2002, see the statistical data incorporated by reference in Appendix B.

The State is permitted by the State Constitution to levy ad valorem taxes on all of the taxable property within the State for the payment of the principal of and interest on the State's general obligation indebtedness; however, the State does not currently levy such a tax.

All general obligation indebtedness of the State is on a parity and shares pro rata with all other general obligation indebtedness of the State, except that the Special Taxes secure only general obligation bonds. The State may issue, and currently is issuing as CP, general obligation bond anticipation notes, the payment of which the full faith and credit of the State, but not Special Taxes, is pledged. See "State Indebtedness – Commercial Paper Program". In addition, the State is authorized to issue general obligation tax revenue anticipation notes, for the payment of which the full faith and credit of the State, but not Special Taxes, is pledged; however, the State has not heretofore issued any such notes. See "State Indebtedness – Tax Revenue Anticipation Notes".

For a table of annual debt service requirements for all general obligation bonds, see "State Indebtedness – Outstanding General Obligation Bonded Indebtedness".

**Remedies and Rights of Bondholders**

Each Bond when duly issued will constitute a contract between the State and the registered owner of the Bond. If the State defaults in payment of any State obligation to which Special Taxes are pledged and/or other fees and taxes are pledged for this purpose, State law requires the State Treasurer or other appropriate authority to pay the amount required for the payment of such obligations out of the first monies received from such taxes and fees. Under State law, a holder or purchaser of any such obligation, including the Bonds, has a vested right in the performance of the covenants and pledges made by the State in the issuance of such obligations and may enforce by appropriate proceedings such covenants, pledges, and duties imposed on any State agency or officer in connection with the issuance of such obligations. The State has not generally waived immunity from suit or extended its consent to be sued and this may bar actions against such agencies and officers. Current State law provides that monetary claims against the State for breach of its contractual obligations and certain other causes may be heard and determined exclusively in the forum of the Tennessee Claims Commission, an administrative tribunal, where the State may be liable only for actual damages and certain costs.

Under the State Constitution, public money may be expended only pursuant to appropriations made by law. See “State Finances.” Such expenditures include, but are not limited to, the payment of debt service and funding any judgment in the Tennessee Claims Commission. Continuing appropriations exist for the payment of debt service on the State’s general obligation bonds, including the Bonds, from Special Taxes, in connection with the pledge of Special Taxes in Title 9, Chapter 9, Tennessee Code Annotated, and under current law, from a specified percentage of sales and use taxes as discussed above. Furthermore, Section 9-9-103(b), Tennessee Code Annotated, appropriates to the State Funding Board on a direct and continuing basis a sum sufficient for payment of debt service (principal, interest and premium, if any) on outstanding general obligation bonds and other debt obligations (including notes) from any funds held in the State treasury not otherwise legally restricted, independent of an appropriation bill otherwise required by State law. Whether a continuing appropriation exists for the payment of a claim in the Tennessee Claims Commission for unpaid debt service is not clear, and in any event sovereign immunity and other legal principles may bar actions to compel the General Assembly to appropriate monies for such payments.

## STATE INDEBTEDNESS

### General

The State Constitution forbids the expenditure of the proceeds of any debt obligation for a purpose other than the purpose for which it was authorized. Under State law, the term of bonds authorized and issued cannot exceed the expected life of the projects being financed. Furthermore, the amount of bonds issued cannot exceed the amount authorized by the General Assembly.

The procedure for funding State debt is provided by Chapter 9 of Title 9, Tennessee Code Annotated. The State Funding Board of the State of Tennessee is the entity authorized to issue general obligation indebtedness of the State. The State Funding Board is composed of the Governor, the State Comptroller of the Treasury, the Secretary of State, the State Treasurer, and the Commissioner of Finance and Administration. The State Funding Board issues all general obligation indebtedness in the name of the State pursuant to authorization by the General Assembly without concurrence or approval by any other governmental agency or by the electorate. Although the State Funding Board determines the terms of general obligation indebtedness, the interest rate on the general obligation indebtedness cannot exceed the State Formula Rate which is set forth in Section 47-14-103, Tennessee Code Annotated.

### Termination of Existence

The Governmental Entity Review Law provides for the termination of various governmental entities on specified dates. That date for the State Funding Board is June 30, 2016. The law also provides that if the General Assembly does not extend the termination date of an entity, the existence of the entity will continue for an additional year without any diminution, reduction or limitation of its powers. However, the State is required to preserve the rights of the holders of any outstanding indebtedness of the entity at the time of termination and the obligations and rights of such entity shall accrue to the State.

### Bonds

State law provides that the State may issue general obligation bonds for one or more purposes authorized by the General Assembly of the State. As of August 31, 2011, the State had $1,653,625,000 (unaudited) of outstanding general obligation bonds. In addition to the Bonds, the State has also authorized the issuance of the Series C Bonds. The State intends to issue approximately $223,220,000 of its Series C Bonds along with the issuance of the Bonds.

### Commercial Paper Program

Bond anticipation notes may be issued for purposes for which bonds have been authorized, if the notes are also authorized by legislative act. Notes have been authorized to be issued for the purposes of all existing bond authorizations.

In March 2000, the State instituted a commercial paper program for authorized capital projects. CP has been and will be issued under the Commercial Paper Resolution, adopted by the members of the State Funding Board of the State on March 6, 2000, as amended, in a principal amount outstanding at any one time not to exceed $350,000,000. CP constitutes bond anticipation notes and are direct general obligations of the State for the payment of which, as to both principal and interest, the full faith and credit of the State, but not Special Taxes, are pledged.

The State has entered into a Standby Commercial Paper Purchase Agreement (the "Standby Agreement") with the Tennessee Consolidated Retirement System ("TCRS") under which TCRS is obligated to purchase newly issued CP issued to pay the principal of other CP, subject to suspension or termination upon the occurrence of certain events. The Standby Agreement requires that the principal amount of CP maturing on any day shall not exceed $100,000,000 or such greater principal amount as agreed upon by the State and TCRS.

CP may have varying maturities of not more than 270 days from their respective dates of issuance; provided, however, that no CP shall mature on a business day that will permit rollover purchased CP to be issued and mature on a business day that is not later than one business day prior to the stated expiration date of the Standby Agreement without regard to any early termination of the Standby Agreement. Currently, this date is April 1, 2015. CP is not subject to redemption prior to maturity.

As of August 31, 2011, $294,217,000 (unaudited) principal amount of CP was outstanding under this program. Since August 31, 2011, the State has issued an additional $37,160,000 of CP. The Bonds and the Series C. Bonds will retire approximately $171,000,000[*] and $26,000,000[*] of CP, respectively.

**Tax Revenue Anticipation Notes**

The State is authorized to issue general obligation tax revenue anticipation notes ("TRANS") in anticipation of the receipt of tax revenues in the then current fiscal year of the State. TRANS, if issued, will constitute direct obligations of the State for the payment of which, as to principal and interest, the full faith and credit of the State, but not Special Taxes, are pledged. All TRANS must be redeemed in the same fiscal year in which they are issued. The State has not heretofore issued TRANS.

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[*] Subject to change

## Outstanding General Obligation Bonded Indebtedness

As of August 31, 2011, there were $1,653,625,000 (unaudited) State general obligation bonds outstanding, excluding the Bonds and the Series C Bonds.

The annual debt service requirements for the outstanding long-term general obligation bonded indebtedness following the issuance of the Bonds and the Series C Bonds are as follows:

### LONG-TERM GENERAL OBLIGATION BONDED DEBT SERVICE

| | Outstanding Debt Service | | | Less Refunded Debt Service[1/] | | | Plus Debt Service on the Bonds and the Series C Bonds | | | Total Debt Service | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fiscal Year Ending | Principal | Interest | Total | Principal | Interest | Total | Principal | Interest | Total | Principal | Interest | Total |
| 2012 | $113,185,000 | $69,006,438 | $182,191,438 | $ | $ | $ | $ | $ | $ | $ | $ | $ |
| 2013 | 135,910,000 | 68,827,394 | 204,737,394 | | | | | | | | | |
| 2014 | 129,265,000 | 62,752,196 | 192,017,196 | | | | | | | | | |
| 2015 | 121,185,000 | 56,451,263 | 177,636,263 | | | | | | | | | |
| 2016 | 115,900,000 | 50,815,356 | 166,715,356 | | | | | | | | | |
| 2017 | 110,465,000 | 45,526,519 | 155,991,519 | | | | | | | | | |
| 2018 | 102,625,000 | 40,405,056 | 143,030,056 | | | | | | | | | |
| 2019 | 93,630,000 | 36,001,301 | 129,631,301 | | | | | | | | | |
| 2020 | 90,435,000 | 31,805,384 | 122,240,384 | | | | | | | | | |
| 2021 | 83,040,000 | 27,887,598 | 110,927,598 | | | | | | | | | |
| 2022 | 82,985,000 | 24,245,013 | 107,230,013 | | | | | | | | | |
| 2023 | 74,975,000 | 20,695,149 | 95,670,149 | | | | | | | | | |
| 2024 | 74,935,000 | 17,317,186 | 92,252,186 | | | | | | | | | |
| 2025 | 66,740,000 | 14,168,086 | 80,908,086 | | | | | | | | | |
| 2026 | 66,915,000 | 11,068,124 | 77,983,124 | | | | | | | | | |
| 2027 | 59,640,000 | 8,196,106 | 67,836,106 | | | | | | | | | |
| 2028 | 54,325,000 | 5,510,852 | 59,835,852 | | | | | | | | | |
| 2029 | 47,025,000 | 3,210,195 | 50,235,195 | | | | | | | | | |
| 2030 | 21,120,000 | 1,254,156 | 22,374,156 | | | | | | | | | |
| 2031 | 9,235,000 | 338,031 | 9,663,031 | | | | | | | | | |
| Total | $1,653,625,000 | $595,481,401 | $2,249,106,401 | $ | $ | $ | $ | $ | $ | $ | $ | $ |

[1/] Refunded Bonds and bonds proposed to be refunded by the Series C Bonds

**Bond Debt Service Requirement**

The annual debt service requirement for the Bonds is as follows:

| | Series A Bonds | | | Series B Bonds | | |
|---|---|---|---|---|---|---|
| A Bonds (October)<br>B Bonds (August) | Principal | Interest | Total | Principal | Interest | Total |
| 2012 | $ | $ | $ | $ | $ | $ |
| 2013 | | | | | | |
| 2014 | | | | | | |
| 2015 | | | | | | |
| 2016 | | | | | | |
| 2017 | | | | | | |
| 2018 | | | | | | |
| 2019 | | | | | | |
| 2020 | | | | | | |
| 2021 | | | | | | |
| 2022 | | | | | | |
| 2023 | | | | | | |
| 2024 | | | | | | |
| 2025 | | | | | | |
| 2026 | | | | | | |
| 2027 | | | | | | |
| 2028 | | | | | | |
| 2029 | | | | | | |
| 2030 | | | | | | |
| 2031 | | | | | | |
| Total | $ | $ | $ | $ | $ | $ |

The State had authorized as of August 31, 2011, $2,221,633,694 (unaudited) of general obligation bonds that have not been issued, including the Series A Bonds and the non-refunding portion of the Series C Bonds, but excluding an additional amount not to exceed 2.5% of certain authorized amounts to be used for funding discounts and the cost of issuance at the discretion of the State Funding Board. Of such authorized, but unissued authorization, $792,800,000 is for highway projects. Since 1978, highway construction has been funded with current revenue and no bonds have been issued for this purpose, but the State can give no assurance that this practice will continue. In addition, $262,500,000 of the authorized and unissued authorization is allocated to the Tennessee transportation infrastructure improvement bond program, which is for the repair, replacement or rehabilitation of bridges. The State does not anticipate issuing general obligation commercial paper or bonds for this program.

**Rate of Debt Retirement Prior to the Refunding**

The following table sets forth the rate of scheduled debt retirement of the State of Tennessee on all outstanding general obligation bonds as of August 31, 2011, excluding the Bonds and the Series C Bonds and including the Refunded Bonds and the bonds expected to be refunded by the Series C Bonds.

| Principal Amount Due In | Principal Amount | % of Total |
|---|---|---|
| 5 Years | $615,445,000 | 37.22% |
| 10 Years | 1,095,640,000 | 66.26% |
| 15 Years | 1,462,190,000 | 88.42% |
| 20 Years | 1,653,625,000 | 100.00% |

# STATE FINANCES

## The Budget Process

The State budget originates in the executive branch with the Governor's annual budget recommendation to the General Assembly. Initially, budget preparation instructions are issued by the Department of Finance and Administration to all State agencies and departments. These instructions describe the Administration's guidelines related to continuing the current level of service (baseline budget) and proposed cost increase requests. The instructions are to be used by agencies and departments in preparing their budgets for submission to the Department of Finance and Administration in October of each year.

During the fall, each department's budget request is reviewed, and improvement requests are analyzed by the Department of Finance and Administration. Conferences are held with departmental and agency representatives, the Director of Budget, and the Department of Finance and Administration staff to determine which, if any, of the proposals should be recommended.

Under State law, the Governor submits the recommended budget to the General Assembly at the start of the legislative session. The budget document must be presented to the General Assembly prior to February 1 of each year, except that a Governor in the first year of a four-year term of office must present a budget prior to March 1 of that year. However, the General Assembly may extend these deadlines by joint resolution. Subsequently, the Governor submits a General Appropriation Bill and bond authorization bills containing appropriations and general obligation bond authorizations required to finance the program levels and capital outlay proposed in the Governor's budget. Throughout the legislative session, the Finance, Ways and Means Committees and appropriate standing committees of the House and Senate hold budget hearings for each department to determine if changes should be made to the proposals.

During the 1997 legislative session, the Office of Legislative Budget Analysis was created to enable the General Assembly to strengthen its expertise in governmental budgeting and financing and in making public policy decisions. The office was created as an independent department of the legislature working for both the Senate and the House of Representatives and charged with reviewing and analyzing the State's budget and overall financial condition. The staff summarizes and analyzes the Governor's budget proposal for members of the General Assembly, secures budget justification data from the various state agencies, provides recommendations on budget proposals and provides assistance on financial matters to the standing committees, as directed.

Under the State Constitution, money may be drawn from the Treasury only through an appropriation made by law. The primary source of the annual expenditure authorization is the General Appropriation Act as approved by the General Assembly and signed by the Governor. These appropriations are generally limited to a one-year period of availability. The General Appropriation Act requires both a simple majority vote of the House and a simple majority vote of the Senate. Approval of the General Appropriation Bill usually occurs during the last week of the legislative session. Once signed by the speaker of each House of the General Assembly, the General Appropriation Act is sent to the Governor for signature. If the Governor does not act within ten days, excluding Sundays, the General Appropriation Act becomes law without signature. The Governor may reduce or eliminate specific line items in the General Appropriation Act or any other appropriations bill without vetoing the entire bill. Such individual line-item vetoes are subject to override by a vote of a majority of the members elected to each House of the General Assembly.

Appropriations also may be included in legislation other than the General Appropriation Act. The individual bills containing appropriations must be heard by the Finance, Ways and Means Committee, and may be heard by the relevant standing committee, in each House of the General Assembly. After all related committees recommend passage, bills containing appropriations must be approved by a majority vote in each House of the General Assembly and be acted upon by the Governor. Bills of this character are also subject to reduction or elimination by individual line-item veto by the Governor and, subject to further override by the General Assembly, as described above.

Funds necessary to meet an appropriation need not be in the Treasury at the time such appropriation is enacted; revenues may be appropriated in anticipation of their receipt.

**Development of Revenue Estimates**

The development of the general fund revenue estimates begins with a forecast of national economic activity for the State budget period. The State currently contracts with The University of Tennessee Center for Business and Economic Research ("UT-CBER") to prepare an annual Economic Report to the Governor containing short-term business cycle-sensitive forecasts as well as longer-term or trend forecasts for the year and to prepare quarterly updates throughout the year. UT-CBER subscribes to the macroeconomic forecasting services of Global Insight. The Global Insight forecast becomes the principal input to the Tennessee Econometric Model which is utilized to develop a forecast of similar indicators of in-state activity.

At least annually, the State Funding Board secures from UT-CBER the estimated rate of growth of the State's economy as measured by the forecast change in Tennessee personal income. The State Funding Board reviews the estimated rate of growth in Tennessee personal income and reports to the General Assembly its comments relating to the reasonableness of the estimate, including any different estimate deemed necessary.

The State Funding Board is further directed by statute to conduct public hearings to develop consensus ranges of estimates of State revenue for the current fiscal year and the next succeeding fiscal year. At the hearings, representatives of state higher education institution business centers, including UT-CBER, present revenue estimates and economic forecasts. On December 1, or as soon thereafter as practical, the State Funding Board presents its consensus ranges of State revenue estimates, and a summary of the economic forecast on which the estimates are based, to the Governor and the Chairs of the Senate and House Finance, Ways and Means Committees. Although not mandated prior to final legislative action on the budget, the State Funding Board may receive updated estimates and forecasts at public hearings in the spring and may forward any revision to prior estimates and the reasons therefor to the Governor and Chairs of the Senate and House Finance, Ways and Means Committee. Pursuant to Section 9-4-5104, Tennessee Code Annotated, the Commissioner of Finance and Administration has the responsibility for preparing the revenue estimates presented in the budget document.

**Reserve for Revenue Fluctuations**

In 1996, the General Assembly enacted legislation determining the allocation goal for the reserve for revenue fluctuations (the "Reserve" or "Rainy Day Fund") to be five percent of estimated State tax revenues to be allocated to the general fund and education trust fund. Beginning with the budget for the Fiscal Year 1998-1999 and until this funding level is achieved, the Governor is to budget an allocation to the Reserve in an amount at least equal to ten percent of the estimated growth in estimated State tax revenues to be allocated to the general fund and education trust fund. Amounts in the Reserve may be utilized to meet State tax revenue shortfalls. Subject to specific provisions of the general appropriations bill, an amount not to exceed the greater of $100 million or one-half (1/2) of the amount available in the Reserve may be used by the Commissioner of Finance and Administration to meet expenditure requirements in excess of budgeted appropriation levels. Prior to using any amounts in the Reserve for this purpose, the Commissioner shall notify the Secretary of the State Funding Board and the Chairs of the Finance, Ways and Means Committees of the Senate and the House of Representatives that the Reserve funds are to be used for this purpose. The Commissioner shall report information concerning the need to utilize these funds to the various committees.

The Reserve balance at the end of each of the last five fiscal years is as follows:

| **Fiscal Year Ended** | **Balance** |
|---|---|
| June 30, 2007 | 542,900,000 |
| June 30, 2008 | 750,000,000 |
| June 30, 2009 | 556,500,000 |
| June 30, 2010 | 453,100,000 |
| June 30, 2011 | 283,600,000* |

*Estimated and unaudited

The Reserve is budgeted to increase by $27.4 million for the fiscal year ending June 30, 2012. The statutory goal is for the Reserve to be 5% of estimated State tax revenues to be allocated to the general fund and education trust fund. The State can give no assurance that the Reserve for fiscal year ending June 30, 2012 will achieve the estimated goal of $311.0 million. See "STATE FINANCES - Financial Information and Budget Summary for fiscal years 2010-2011 and 2011-2012".

**Budgeting for Authorized and Unissued Debt**

The State's current practice is to budget for five percent of authorized and unissued bonds to account for assumed principal (on the basis of an assumed 20-year, level-principal issue), plus an amount for assumed interest at a rate of six percent. The State cannot offer any assurance that it will continue this practice in the future.

**Financial Control Procedures**

The State Constitution requires, for current operations, expenditures for any fiscal year not to exceed the State's revenues and reserves, including the proceeds of any debt obligation, for that year. The State Constitution prohibits the issuance of debt for operating purposes maturing beyond the end of a fiscal year. State law permits tax anticipation borrowing but any amount borrowed must be repaid by the end of the fiscal year.

Generally, the executive branch controls the expenditure of State funds for the operation of State government. Two important concepts are involved in the execution of the General Appropriation Act: preparation of work programs and development of allotment controls. Analysts of the Division of Budget, Department of Finance and Administration, and fiscal personnel in the various State departments and agencies have the responsibility of reconciling the General Appropriation Act, as approved, with the submitted budget. State law requires that administrative agencies prepare a work program for each fiscal year. These work programs indicate separate annual spending requirements for payroll and other operating expenses necessary to carry out agency programs. The head of any agency may revise the work program during the fiscal year because of changed conditions and submit such revision for approval. If the Commissioner of Finance and Administration and the Governor approve the revision, then the same procedure for review, approval and control is followed as in making the original allotments. The aggregate of all allotments after the revision cannot exceed the total appropriations made to the agency for the fiscal year in question.

All expenditures of State administrative agencies are processed through the Department of Finance and Administration and are measured against work program allotments. Savings which may occur as a result of the difference between the amounts provided in the work program allotments for payroll and other operating expenditures and the amounts actually spent for those expenditures accumulate throughout the fiscal year unless a work program is revised to re-allot unspent amounts. Likewise, departmental revenue surpluses cannot be spent until approved by the Commissioner of Finance and Administration and, in some cases, reviewed by the Finance, Ways and Means Committees of the General Assembly. Such central spending control offers executive flexibility relative to any anticipated surplus or shortfall in the budget.

The Governor may effect spending reductions to offset unforeseen revenue shortfalls or unanticipated expenditure requirements for particular programs. These spending reductions can take the form of deferred equipment purchases, hiring freezes, and similar cutbacks. If necessary, the Governor may reduce portions of administrative budgets prior to allotment. Furthermore, the Governor is authorized to call special sessions of the General Assembly at any time to address financial or other emergencies.

**Financial Information and Budget Summary for Fiscal Years 2010-2011 and 2011-2012**

***Financial Information***

The first session of the 107th General Assembly in May of 2011, acting upon the State Funding Board's April 15, 2011 consensus recommendation (see "Revenue Growth" below), adopted revised revenue estimates for fiscal year 2010-2011 which recognized a revenue growth in total taxes in the amount of $15.1 million and a General Fund growth of $15.2 million. Including base revenue growths submitted to the General Assembly on March 14, 2011, the total increase was $213,600,000 in total taxes and $164,800,000 in General Fund revenue. The 2010-2011 budget was adjusted and passed by the General Assembly to accommodate the revised revenue estimate.

The General Assembly passed, and on June 16, 2011 the Governor signed, the Appropriation Bill for the fiscal year 2011-2012 budget. The fiscal year 2011-2012 budget is balanced with recurring revenues supporting recurring expenditures. Revenue estimates for fiscal year 2011-2012 were increased an additional $18.6 million in the general fund, from the recommended budget document estimates. Revisions to various tax laws in 2011 increased the revenue estimate by $9 million, including $4.3 million in the general fund.

On an accrual basis, August is the first month of fiscal year 2011-2012. State tax collections for August were $19.2 million more than the budgeted estimate and the general fund collections were $18.3 million more than the budgeted estimate. Reserves are available as an additional hedge against a revenue shortfall. The Rainy Day Fund balance is projected to be $311 million at June 30, 2012.

***Revenue Growth***

The official budgeted revenue estimates are based on the State Funding Board's consensus recommendation adopted by the first session of the 107th General Assembly in May of 2011. The State Funding Board held a meeting on April 12, 2011 to hear presentations from various economists. The State Funding Board reconvened on April 15, 2011 and adopted the following revised consensus tax revenue growth projections to assist in budgeting through the balance of the 2010-2011 Fiscal Year (growth measured against actual results for the 2009-2010 Fiscal Year):

| | | Fiscal Year 2010-2011 | |
|---|---|---|---|
| | **Fiscal Year 2009-2010 Results** | **Low** | **High** |
| Total State Taxes | $10,023,508,800 | 3.90% | 4.15% |
| General Fund Only | $8,186,717,500 | 4.20% | 4.50% |

At the same meeting, the State Funding Board adopted the following revised consensus tax revenue growth projections for the 2011-2012 Fiscal Year (growth measured against the potential range of results for the 2010-2011 Fiscal Year, as set forth in the preceding table):

| | Fiscal Year 2011-2012 | |
|---|---|---|
| | **Low** | **High** |
| Total State Taxes | 3.10% | 3.35% |
| General Fund Only | 3.40% | 3.70% |

The State Funding Board is scheduled to convene in December 2011 to hear and discuss updates on economic and revenue projections for the remainder of fiscal year 2011-2012 and to project revenue estimates for fiscal year 2012-2013.

***Budget Summary***

The fiscal year 2011-2012 revised budget reflects major base reductions, but it provides full funding of the State's share of operating expenses for K-12 public education for the State's Basic Education Program. Recurring appropriations are funded by recurring revenues. The revised budget includes estimated funds from the U.S. Economic Recovery Program in the amount of $791.7 million, of which $587.7 million is carryover from prior years.

**TennCare Program**

The TennCare Medicaid expansion program was launched in 1994. The TennCare program operates under a Section 1115 waiver from the Centers for Medicare and Medicaid Services (CMS) in the United States Department of Health and Human Services as a managed care program. Medicaid waiver programs are time-limited. The waiver under which TennCare is now operating began on July 1, 2002, and has been extended through June 30, 2013.

TennCare services are offered through managed care entities. Medical, behavioral and long-term care services are covered by "at risk" Managed Care Organizations (“MCO”) in each region of the State. Enrollees have their choice of MCOs serving the areas in which they live, except that some enrollees are assigned to TennCare Select. TennCare Select is a managed care plan for certain populations such as children in State custody and enrollees who may be living temporarily out-of-state. In addition to the MCOs, there is a pharmacy benefits manager for coverage of prescription drugs and a dental benefits manager for provision of dental services to children under age 21. Coordination of care is the responsibility of the enrollee's primary care provider in his or her MCO. Long-term care services are provided in nursing facilities and intermediate care facilities for persons with mental retardation, as well as by home and community based services providers. These services had been "carved out" of TennCare and paid for by the State through a fee-for-service arrangement. However in 2010, the State implemented the TennCare “CHOICES in Long-Term Care Program” which brought long-term care services for persons who are elderly and disabled into the managed care program.

The Bureau of TennCare within the Tennessee Department of Finance and Administration is the State agency charged with responsibility for administering the TennCare program. In addition to overseeing the contracts with the managed care entities and overseeing the long-term care program, the Bureau of TennCare is responsible for payment of Medicare premiums, deductibles, and/or coinsurance for certain low-income Medicare beneficiaries.

The TennCare program currently has 1.2 million enrollees consisting of 750,000 children and 450,000 adults. For fiscal year 2011-2012, the State budgeted for a 3.8% increase in costs associated with enrollment and medical utilization charges. The fiscal year 2011-2012 TennCare budget is $8.9 billion, including federal funds, and is 28.3% of the total State budget. Excluding federal funds, the cost of the TennCare program is budgeted to be 26% of the total State tax collections.

In fiscal year 2006, TennCare reforms were implemented. The table below depicts the rate of growth or reduction in the TennCare budget since fiscal year 2005.

**TennCare Budget Growth***
(in millions)

| | |
|---|---|
| FY 2005 | $ 254.3 |
| FY 2006 | 46.4 |
| FY 2007 | 78.9 |
| FY 2008 | 59.3 |
| FY 2009 | (103.0) |
| FY 2010 | (214.8) |
| FY 2011 | (166.0) |
| FY 2012 | 117.3 |

*Recurring appropriations, which excludes enhanced Federal Medical Assistance Percentage savings, hospital coverage assessment, and other non-recurring funds.

In fiscal year 2011-2012, the TennCare Reserve is budgeted to be $255 million and is equal to 9.1% of the State funds contributed to the TennCare program. Historically, the TennCare Reserve was $261 million (unaudited) in fiscal year 2010-2011; $442 million in fiscal year 2009-2010; $434 million in fiscal year 2008-2009; and $474 million in fiscal year 2007-2008. The TennCare Reserve is not statutorily required and there can be no assurance that the TennCare Reserve will be available for use in the TennCare program.

**Federal Funding of Certain Programs**

The U.S. Budget Control Act of 2011 (U.S. Public Law 112-25) establishes mechanisms to restrain federal spending and decrease the projected federal deficit through the year 2021. The law places limits on federal spending and establishes a committee of Congress, which by November 23 is directed to submit recommendations and legislation to Congress on program reductions. The act requires a vote by Congress by December 23, with no amendments permitted. If the committee fails to report or Congress fails to endorse the legislation, then automatic across-the-board reductions in federal funding for certain programs would occur. Approximately forty percent (40%) of the State budget is funded by federal aid.

To assist the State in understanding the impact of potential federal reductions and in developing contingency plans, on August 18, 2011, the Commissioner of the Department of Finance and Administration directed all State agencies to submit contingency budget reduction plans for 15 and 30 percent reductions in federal aid by August 24, 2011. The reductions were submitted in two tiers, the first 15 percent and an additional 15 percent of recurring federal aid in the current-year work program.

It is not possible for the State to identify specific program reductions or the magnitude of reductions in funding that might be implemented by the federal government; however, the State has addressed the possibility of such reductions through contingency plans.

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The following tables compare sources and uses of funds for fiscal years 2010 -2011 and 2011-2012:

**2011-2012 Adopted Budget**
**Sources of Funds**
**As of June 30, 2011**

| | Unaudited FY 2010-2011 | | Budget FY 2011-2012 | | Difference |
|---|---|---|---|---|---|
| Tax Revenue - Revised Estimate | | | | | |
| Sales and Use Taxes | $ 6,425,000,000 | | $ 6,658,100,000 | | $ 233,100,000 |
| Other Taxes | 4,014,500,000 | | 4,139,800,000 | | 125,300,000 |
| Other Miscellaneous Revenues | 1,549,123,000 | | 1,705,741,700 | | 156,618,700 |
| Tobacco Funds | 137,500,000 | | 138,000,000 | | 500,000 |
| Lottery for Education Funds | 309,400,000 | | 314,200,000 | | 4,800,000 |
| Debt Service Fund Transfer | 92,900,000 | * | - | | (92,900,000) |
| Reserve Transfers and Adjustments | 35,091,500 | * | 364,122,360 | * | 329,030,860 |
| Reversion - Overappropriation | 166,500,000 | * | 181,200,000 | * | 14,700,000 |
| Rainy Day Fund Transfer | 169,500,000 | * | (27,400,000) | * | (196,900,000) |
| **Sub-Total Appropriations** | **$ 12,899,514,500** | | **$ 13,473,764,060** | | **$ 574,249,560** |
| Federal Funds | $ 13,966,648,800 | | $ 12,848,401,700 | | $ (1,118,247,100) |
| Current Services and Other Revenues | 3,507,247,100 | | 3,409,488,200 | | (97,758,900) |
| Tuition and Student Fees | 1,344,431,800 | | 1,444,431,800 | | 100,000,000 |
| Bonds | 300,500,000 | | 423,000,000 | | 122,500,000 |
| **Total** | **$ 32,018,342,200** | | **$ 31,599,085,760** | | **$ (419,256,440)** |
| * Reserves and Transfers | $ 463,991,500 | | $ 517,922,360 | | $ 53,930,860 |

**2011-2012 Adopted Budget**
**Uses of Funds**
**As of June 30, 2011**

| Program | Unaudited FY 2010-2011 | Budget FY 2011-2012 | Difference |
|---|---|---|---|
| General Government | $ 938,501,800 | $ 911,949,560 | $ (26,552,240) |
| Education | 9,642,082,400 | 9,320,150,900 | (321,931,500) |
| Health and Social Services | 14,377,561,900 | 14,564,139,000 | 186,577,100 |
| Law, Safety, and Correction | 1,543,197,400 | 1,647,170,000 | 103,972,600 |
| Resources and Regulation | 974,509,700 | 912,057,900 | (62,451,800) |
| Business and Economic Development | 909,716,600 | 632,304,900 | (277,411,700) |
| **Total General Fund** | **$ 28,385,569,800** | **$ 27,987,772,260** | **$ (397,797,540)** |
| Transportation | $ 1,804,482,000 | $ 1,816,595,000 | $ 12,113,000 |
| Debt Service Requirements | 393,523,000 | 421,274,000 | 27,751,000 |
| Capital Outlay Program | 448,252,500 | 360,997,500 | (87,255,000) |
| Facilities Revolving Fund | 163,614,900 | 160,747,000 | (2,867,900) |
| Cities and Counties - State Shared Taxes | 822,900,000 | 851,700,000 | 28,800,000 |
| **Total State Budget All Programs** | **$ 32,018,342,200** | **$ 31,599,085,760** | **$ (419,256,440)** |

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**Investment Policy**

The State Funding Board is charged with the establishment of the investment policy for the State. The State Treasurer is responsible for the management of the State Pooled Investment Fund ("SPIF") (which includes the State's cash, various dedicated reserves and trust funds of the State, and the Local Government Investment Pool) and the Intermediate Term Investment Fund ("ITIF") (which includes various funds able to use a longer-term investment option).

The primary investment objective for the SPIF is safety of principal, followed by liquidity and yield. No investments may be purchased with a remaining maturity of greater than 397 calendar days and the weighted average maturity cannot exceed 120 days. Investment instruments authorized by the Investment Policy for the SPIF approved by the State Funding Board pursuant to Section 9-4-602, Tennessee Code Annotated, for purchase by the SPIF include (1) bonds, notes and treasury bills of the United States or other obligations guaranteed as to principal and interest by the United States or any of its agencies; (2) repurchase agreements for obligations of the United States or its agencies; (3) certificates of deposit in banks and savings and loan associations recognized as state depositories pursuant to Section 9-4-107, Tennessee Code Annotated; provided, however, certificates of deposit shall be collateralized in accordance with the provisions of Tennessee Code Annotated; (4) prime commercial paper that is rated in the highest category by at least two nationally recognized commercial paper rating agencies; (5) prime bankers' acceptances that are eligible for purchase by the Federal Reserve System; and (6) securities lending agreements whereby securities may be loaned for a fee; provided, however, eligible collateral as defined in Section 9-4-103, Tennessee Code Annotated, whose market value is at least equal to one hundred two percent (102%) of the market value of the borrowed securities shall be required for each loan and for purposes of this provision, eligible collateral shall include cash collateral, which shall be equal to at least one hundred percent (100%) of the market values of the borrowed securities. For each type of investment, certain terms and conditions must be met. All book entry securities purchased are held by the Federal Reserve Bank in the State Trust of Tennessee Account, or held by a custodian pursuant to a custodian agreement. Securities not eligible for book entry at the Federal Reserve Bank are held by a custodian pursuant to a custodian agreement.

The ITIF portfolio is designed to invest funds in longer-term investments than the SPIF to benefit from the normal steepness of the yield curve. The State Treasurer will seek to enhance total portfolio return by means of active portfolio management. The dollar weighted average maturity of the ITIF cannot exceed 3 years. An appropriate amount of the fund will be maintained in short term investments to cover emergency withdrawals. No security will be purchased with a remaining life of over five years. Investment instruments authorized by the Investment Policy for the ITIF approved by the State Funding Board pursuant to Section 9-4-602, Tennessee Code Annotated, for purchase by the ITIF include (1) bonds, notes and treasury bills of the United States or other obligations guaranteed as to principal and interest by the United States or any of its agencies; (2) obligations guaranteed as to principal and interest by the federal home loan mortgage corporation, federal national mortgage association, student loan marketing association and other United Stated government-sponsored corporations; (3) repurchase agreements for obligations of the United States or its agencies; and (4) prime commercial paper that is rated in the highest category by at least two nationally recognized commercial paper rating agencies. For each type of investment there are certain terms and conditions that must be met. All book entry securities purchased are held by the Federal Reserve Bank in the State Trust of Tennessee Account, or held by a custodian pursuant to a custodian agreement. Securities not eligible for book entry at the Federal Reserve Bank are held by a custodian pursuant to a custodian agreement.

The State Trust of Tennessee, a non-profit corporation established in 1979, is a limited member of the Federal Reserve Bank System.

In addition to the funds in the SPIF and the ITIF, the Tennessee Consolidated Retirement System (a pension trust fund), the Baccalaureate Education System Trust (a private-purpose trust), and the Chairs of Excellence Trust (a permanent fund) are authorized by statutes to invest in long-term investments, including bonds, debentures, preferred stock and common stock, and real estate subject to the approval of the applicable boards of trustees. See Appendix A, Financial Statements - Note 5 A "Deposits and Investments".

## Accounting Standards

The Governmental Accounting Standards Board ("GASB") is the body responsible for promulgating accounting and financial reporting standards that are followed by state and local governments desiring to present financial statements in accordance with generally accepted accounting principles ("GAAP"). The State adheres to GASB rules and issues audited financial statements in conformity with GAAP.

## Other Post-Employment Benefits

The GASB recently issued GASB Statements (Nos. 43 and 45) that provide accounting and financial reporting requirements for retiree healthcare plans and employer participants, commonly known as Other Post-Employment Benefits ("OPEB").

State employees and teachers who meet specified criteria receive pension benefits provided to retirees through a defined benefit plan administered by the Tennessee Consolidated Retirement System. In addition to retirement benefits, certain qualified retirees may continue participation in health insurance sponsored by the State. Retirees who are not yet eligible for Medicare have access to the same benefits as current employees and pay monthly premiums that vary by years of service at retirement. The State has the flexibility to adjust the benefits and premium sharing provisions provided by insurance plans on an annual basis. After age 65, retirees participate in a Medicare supplemental plan. The State's financial support to this supplemental plan is a fixed amount based on years of service.

The first actuarial valuation of post-employment medical benefits, as of July 1, 2005, was performed to determine the impact of providing benefits to retired employees. The study used an attained age actuarial cost method and focused on each State-administered plan as a whole. All four of the State's plans were evaluated—State Employee Group, Teacher Group, Local Government Group, and Medicare Supplement. The State has no obligation for the Local Government Group Plan.

Second and third actuarial valuations of post-employment medical benefits, as of July 1, 2007 and July 1, 2009, have been completed as well as an update, due to plan changes, as of July 1, 2010. These studies were conducted using a projected unit credit actuarial cost method and focused on individual employers within each plan. Primarily as a result of the change in scope for the second and third valuations from the first, the valuations are not comparable. The State's obligations resulting from the July 1, 2010 updated study are summarized below. The annual required contribution ("ARC") consists of the normal cost (the portion of the actuarial present value for OPEB benefits which is allocated to a valuation year by the actual cost method) and an amortization of the unfunded actuarial liability.

| | As of July 1, 2010 (expressed in thousands) | |
|---|---|---|
| | **Unfunded Actuarial Liability** | **ARC** |
| **State Employee Group Plan** | | |
| State obligation for employees (including Component Units) | $ 1,496,018 | $ 145,656 |
| **Local Education Agency Group Plan** | | |
| State obligation on behalf of teachers | 215,202 | 22,478 |
| **Medicare Supplemental Plan** | | |
| State obligation for employees (including Component Units) | 209,622 | 15,554 |
| State obligation on behalf of teachers | 158,789 | 11,517 |
| **Total State Obligation** | $ 2,079,631 | $ 195,205 |

The actuary reports may be reviewed at: http://www.tn.gov/finance/act/OPEB.html. The State has contracted with Buck Consultants, LLC to provide biannual OPEB valuations for the State Employee Group, Teacher Group, Local Government Group and Medicare Supplement plans for fiscal years ended June 30, 2011 through June 30, 2013. The next valuation, as of July 1, 2011, that will cover fiscal years 2011-2012 and 2012-2013, is expected to be available by April 15, 2012.

This data will be reported in the State's CAFR for fiscal year 2010-2011. For fiscal year 2010-2011, the State did not fund any actuarially determined OPEB liability and expects to use pay-as-you-go funding of actual costs of OPEB liabilities incurred for the current fiscal year. Both active employees and pre-age 65 retirees are offered the same health care plan options. The State has the flexibility to adjust the various plan options on an annual basis. It will continue to analyze the cost of the choices available to current employees and retirees and the cost of the choices on the employees, retirees and the State's cash flow to manage these expenditures going forward.

**Financial Reporting and Budgeting Awards**

The Government Finance Officers Association of the United States and Canada (the "GFOA") has awarded Certificates of Achievement for Excellence in Financial Reporting to the State of Tennessee for its comprehensive annual financial report for the fiscal years ended June 30, 1979 to June 30, 2008, thirty consecutive years. The State did not receive the award for the fiscal year ended June 30, 2009 due to the implementation of a new accounting system that delayed the report. The State has applied for the Certificate of Achievement for Excellence in Financial Reporting for fiscal year ended June 30, 2010. The Tennessee Consolidated Retirement System ("TCRS") was also awarded a Certificate of Achievement for Excellence in Financial Reporting for its comprehensive annual financial report for the fiscal year ended June 30, 2010. This was the twenty-third consecutive year that TCRS received this award. To be awarded a Certificate of Achievement for Excellence, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report, the content of which conforms to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

The GFOA also presented its Distinguished Budget Presentation Award to the State for its annual budget for the fiscal years ended June 30, 1992 through June 30, 1995 and June 30, 1998 through June 30, 2012. To receive this award, a governmental unit must publish a budget document that meets program criteria as a policy document, as an operations guide, as a financial plan and as a communication device.

**The Tennessee Consolidated Retirement System**

***Introduction***

The State provides a defined benefit pension plan through a trust (Tennessee Consolidated Retirement System ("TCRS") that covers four large groups of public employees - state employees, higher education employees, teachers, and employees of certain local governments. The State is ultimately responsible for the financial obligation of the benefits provided by TCRS to State employees and those higher education employees that elect to participate, to the extent such obligation is not covered by employee contributions and investment earnings (but is not ultimately directly responsible for the benefits to be provided to teachers (grades K-12) or local government employees). The State employee group and higher education group are combined for actuarial and financial obligation purposes. The obligation is funded by employer contributions as determined by an actuarial valuation. The State employee group includes general employees, judicial employees, and public safety employees.

By statute, an actuarial valuation of TCRS is to be conducted at least once in every two year period. The last valuation was effective July 1, 2009. The TCRS Board of Trustees certifies to the Governor each year the amount necessary to fund the actuarially required contribution ("ARC") for State and higher education employees, and by statute the General Assembly is required to appropriate such amount. Thus, for each year since 1972, the State has paid to TCRS 100% of the ARC for State and higher education employees.

The funded ratio (actuarial value of assets / actuarial accrued liability) for the State and higher education employees was in excess of 99% for the 2001, 2003, and 2005 valuation dates, but was 86.32% as of the 2009 valuation date. In addition, the unfunded actuarial liability as a % of covered payroll has increased from 4.29% as of the 2001 valuation date to 64.53% as of the 2009 valuation date. This reduction in funded ratio, despite contributing 100% of the ARC, is principally attributable to actual investment earnings being less than the assumed investment earnings of 7.5%. The investment returns for the two years following the 2007 actuarial valuation were a negative 1.2% (fiscal year ended June 30, 2008) and a negative 15.3% (fiscal year ended June 30, 2009). Accordingly, on a compounded basis for the two years, TCRS had a negative return of 16.32% while assuming a positive return of 15.56%, a difference in expected earnings from actual earnings on assets of 31.88%. Improving mortality rates among TCRS retirees also contributed to increased liabilities.

For more detailed information, please review carefully this complete section, including the actuarial and demographic assumptions currently being used.

***General Information***

TCRS was established effective July 1, 1972 by Public Chapter 814, Acts of 1972. Specifically, TCRS shall have the powers, privileges and immunities of a corporation and all business shall be transacted, all of its funds invested, and all of its cash and other property held in trust for the purpose for which received. By statute, the general administration and responsibility for the proper operation of TCRS are vested in a twenty member Board of Trustees. The Treasury Department, a constitutional office in the legislative branch of state government, is responsible for the administration of TCRS, including the investment of assets in the plan, in accordance with state statute and in accordance with the policies, rules, and regulations established by the Board of Trustees.

Higher education employees must become members of TCRS except the employees exempt from the Federal Fair Labor Standards Act may waive membership in TCRS and elect to participate in the Optional Retirement Plan (ORP), a defined contribution plan. The State is ultimately responsible for the financial obligation of benefits provided by TCRS to those higher education employees electing to participate in TCRS to the extent such obligations are not covered by employee contributions and investment earnings. The obligation is funded by employer contributions as determined by an actuarial valuation. The ORP is described in the section “Other Retirement Programs”.

Public school teachers in grades K-12 are members of TCRS. The 138 local school systems in Tennessee, referred to as local education agencies (LEAs), are responsible for the financial obligation of the benefits provided by TCRS to K-12 teachers to the extent such obligations are not covered by employee contributions and investment earnings. The obligation is funded by LEA employer contributions as determined by an actuarial valuation. LEAs do not have taxing authority. The local governing body provides funding and the State of Tennessee provides significant funding to LEAs to finance the cost of providing a system of education for the children of the State. The State’s education funding formula includes an amount to be used toward some, but not all, of the LEA’s pension cost (LEA’s employer contributions to TCRS). For TCRS purposes, the teacher group includes certified teachers and does not include non-teaching personnel such as bus drivers, cafeteria workers, maintenance employees, custodians, and secretaries.

Local governments may join TCRS as a participating employer to provide pension benefits for their employees. However, each local government is responsible for the financial obligation of the benefits provided by TCRS to their employees to the extent such obligations are not covered by their employee contributions and investment earnings. The State of Tennessee is not responsible for the liability associated with local governments participating in TCRS. Local governments participating in TCRS include cities, counties, special school districts, utility districts, emergency communication districts, and other political subdivisions of the state. At June 30, 2011 there were 486 local governments in the TCRS plan. Employees of local governments could include general employees, non-teaching employees of a school system, transportation department employees, public safety employees, utility employees, and employees of other departments of the local government.

The State employee group and higher education group are combined for actuarial and financial obligation purposes. The LEAs are combined into a teacher group for actuarial and financial obligation purposes. Each participating local government in TCRS is maintained separately for actuarial and financial purposes. However, the assets of all four public employee groups participating in TCRS are commingled for investment purposes with each group receiving its pro rata share of investment gains and losses.

By statute, an actuarial valuation of TCRS is to be conducted at least once in each two year period. The purpose of the actuarial valuation is to determine the financial position of the plan and to determine the appropriate employer contribution rate. By practice, an actuarial valuation is performed every other year. The last valuation was effective July 1, 2009. The current valuation was effective July 1, 2011 and the results should be available in late December, 2011. In addition, it has been the practice to conduct an actuarial audit every ten years, the last audit being completed effective with the 2009 valuation. By statute, an actuarial experience study shall be conducted at least once every six years to establish demographic assumptions (pattern of retirement, turnover, mortality, etc.) and economic assumptions (investment earnings rate, salary, retiree cost of living, etc.). By practice, an actuarial experience study is conducted every four years. The last experience study was conducted in 2008 and the next will be performed in 2012.

TCRS issues audited financial statements on an annual basis. By statute, an independent audit is conducted by the Comptroller of the Treasury, an office established by the state's Constitution. The Comptroller of the Treasury is a part of the legislative branch of State government and is accountable to the Tennessee General Assembly. The financial statements are prepared in conformity with generally accepted accounting principles in the United States of America.

By statute, the TCRS Board of Trustees shall certify to the Governor each year the amount necessary to finance the actuarially required employer contributions for state employees and higher education employees, as well as the amount required to cover the expenses of administering the retirement system. By statute, the General Assembly shall make appropriations sufficient to provide for the actuarially required employer contributions for State employees and higher education employees. A separate certification is provided for the amount necessary for LEAs to finance the pension liabilities associated with the teacher group. An actuarially determined employer contribution rate is provided to each local government participating in TCRS.

As of June 30, 2011 the membership in TCRS was:

| | Active Members | Retired Members |
|---|---|---|
| State Employees | 42,142 | 28,501 |
| Higher Education Employees | 16,409 | 14,640 |
| Teachers | 79,583 | 39,961 |
| Local Government Employees | 81,780 | 34,083 |
| Total | 219,914 | 117,185 |

***General Plan Provisions***

State employees, higher education employees, and teachers are vested upon completing five years of employment. Eligibility for a retirement benefit is either age 60 and vested or at any age after 30 years of service credit. A reduced benefit is available at age 55. Disability benefits are available after five years of employment if the member is totally and permanently disabled and cannot engage in gainful employment. Death benefits are available under certain conditions.

The benefit provided by TCRS is a mathematical formula that uses a member's five year average salary and a member's years of creditable service. The formula is a multi-step calculation that provides a benefit which, stated in a simplified manner, is somewhat less than 1.6% of the member's five year average salary multiplied by years of service. For example, a thirty year employee will receive approximately 48% of their five year average salary.

Retirees are entitled to cost of living adjustments ("COLA") after retirement. As required by Section 8-36-701, Tennessee Code Annotated, cost of living adjustments are made every July 1 for retirees who have been retired at least 12 months and if the consumer price index (all items-United States city average as published by the US Department of Labor) increases by more than one-half percent. If the consumer price index increases between one-half percent and one percent, the increase granted is one percent. Otherwise, the adjustment is the actual increase in the consumer price index except that the COLA is capped at a maximum of 3%.

State employees and higher education employees are non-contributory. Teachers are required to contribute five percent of salary.

***Investments and Investment Policy***

Investment authority is governed by State statute, Section 8-37-104, Tennessee Code Annotated, which establishes the type of investments that are permitted. An investment policy is adopted by the Board of Trustees related to the authorized investment types and portfolio structure. The statute also provides for an Investment Advisory Council (IAC) consisting of five investment professionals from the private sector to serve as consultants for the Board of Trustees and investment staff.

The actual allocation of assets and the policy target range at June 30, 2011 are:

| Asset Class | Policy Range | Actual Allocation |
|---|---|---|
| Domestic Stocks | 25-50% | 40.0% |
| Domestic Bonds | 20-60% | 30.7% |
| Inflation Indexed Bonds | 0-15% | 7.7% |
| Short-term Securities | 0-10% | 1.5% |
| International Bonds | 0-10% | 1.6% |
| International Stocks | 5-25% | 15.0% |
| Private Equity | 0-5% | 0.2% |
| Real Estate | 0-10% | 3.2% |

The historical annualized rates of return (net of fees) on TCRS investments as of June 30, 2011 are:

| 1 Year | 3 year | 5 year | 10 year | 15 year | 20 year | 25 year |
|---|---|---|---|---|---|---|
| 19.6% | 3.8% | 4.5% | 4.9% | 6.3% | 7.4% | 7.8% |

The historical annual rates of return (net of fees) on TCRS investments for the last ten years are:

| Year Ended June 30 | Rate of Return |
|---|---|
| 2011 | 19.6 % |
| 2010 | 10.2 % |
| 2009 | (15.3)% |
| 2008 | (1.2)% |
| 2007 | 13.2 % |
| 2006 | 6.9 % |
| 2005 | 7.3 % |
| 2004 | 9.3 % |
| 2003 | 5.0 % |
| 2002 | (2.0)% |

Investment performance is calculated by the system's current general investment consultant, Strategic Investment Solutions, Inc.

The vast majority of the assets of TCRS are managed internally. The investment division of TCRS, consisting of 25 investment professionals, is responsible for the internal management of the domestic stock, domestic bond, international bond, inflation indexed bond, and short-term securities portfolios. The TCRS staff monitors the nine external investment managers for the international stock portfolio.

TCRS utilizes the services of other investment consultants and advisors including a real estate consultant, real estate advisors and a private equity consultant.

***Actuarial Methodology***

The actuarial valuation utilizes the frozen initial liability method for determining the employer contribution rate. Unfunded accrued liabilities were originally established and funded over a 40-year period commencing in 1975. If, through reestablishment, no unfunded accrued liabilities are recognized, the aggregate actuarial funding method is utilized. Effective July 1, 2009, unfunded accrued liabilities were reestablished and the liabilities are being amortized over a 20-year period. Essentially, under the frozen initial liability method, the amount of the unfunded accrued liability is frozen and amortized over the amortization period. Any actuarial gains and losses from one actuarial valuation to the next actuarial valuation are included in the normal cost rather than the unfunded accrued liability. The normal cost is financed on a level percent of salary basis over the average remaining working life of the active employees, which is estimated to be approximately 12 years. However, the Board may elect to recalculate (reestablish), rather than leave frozen, the unfunded liability and amortize the reestablished unfunded liability over the amortization period.

For fiscal years prior to June 30, 2007, a five year moving market average was used to value assets for actuarial purposes. Earnings in excess or below expected investment returns are recognized over a five year period. Investment gains and losses are applied to offset accumulated investment gains and losses prior to determining the amount of earnings to be phased in. Effective for fiscal years ending after June 30, 2007, a ten year moving market average is used to value assets for actuarial purposes. Earnings in excess or below expected investment returns are recognized over a ten year period. However, in no event will the actuarial value of assets be less than 80% of the market value of assets or greater than 120% of the market value of assets.

***Economic and Demographic Assumptions***

The latest actuarial experience study was conducted in 2008 and determined the economic and demographic assumptions utilized in the 2009 actuarial valuation. The next experience study will be conducted in 2012 with the resulting assumptions being utilized in the 2013 actuarial valuation.

The long term investment earnings assumption of 7.5% is compounded annually. A graded salary increase assumption based on age is utilized with larger increases expected for younger employees and smaller increases for older employees. The approximate average salary assumption increase is 4.5%. The social security wage base is assumed to increase 3.5%. The cost of living adjustment for retirees is assumed to increase 2.5% annually. A rate of inflation of 3% is assumed in establishing the economic assumptions.

The demographic assumptions include: post-retirement mortality, pre-retirement mortality, withdrawal rate for termination of employment, disability rate, and pattern of retirement. The demographic assumptions are based on the past experience of participants in TCRS.

The economic assumptions did not change as a result of the 2008 experience study except that the COLA assumption for retirees was lowered to 2.5% from the previous 3%. The assumption was changed to reflect the fact that a 3.0% COLA is not granted every year, that the maximum COLA by law is 3%, that COLA increases can change from 0.0% to 3.0% and that a COLA of 2.5% is a reasonable long term assumption.

The demographic assumptions were changed to be reflective of the mortality, disability, withdrawal, and retirement patterns experienced by the plan.

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**Funded Status At July 1, 2009[*]**
**(dollars expressed in thousands)**

| Group | Actuarial Value of Assets | Actuarial Accrued Liability | Unfunded Actuarial Accrued Liability | Funded Ratio | Covered Payroll | Unfunded Actuarial Liability as a % of Covered Payroll |
|---|---|---|---|---|---|---|
| State & Higher Education Employees | $10,303,444 | $11,936,316 | $1,632,873 | 86.32% | $2,530,585 | 64.53% |
| Teachers | $16,031,755 | $17,118,650 | $1,086,895 | 93.65% | $3,523,943 | 30.84% |
| Total TCRS | $26,335,199 | $29,054,966 | $2,719,768 | 90.64% | $6,054,528 | 44.92% |

**Comparison of Market Value of Assets to Actuarial Value of Assets**
**At June 30, 2009***
**(dollars expressed in thousands)**

| | Market Value of Assets | Actuarial Value of Assets | Difference |
|---|---|---|---|
| State & Higher Education Employees | $ 8,586,203 | $10,303,444 | $(1,717,241) |
| Teachers | $ 13,359,797 | $16,031,755 | $(2,671,958) |
| Total TCRS | $ 21,946,000 | $26,335,199 | $(4,389,199) |

**Unfunded Liability if Actuarial Value of Assets were Valued at Market**
**At June 30, 2009***
**(dollars expressed in thousands)**

| | Unfunded Actuarial Accrued Liability per 2009 Valuation Based on Actuarial Value of Assets | Unfunded Actuarial Accrued Liability Based on Market Value of Assets |
|---|---|---|
| State & Higher Education Employees | $1,632,873 | $3,350,144 |
| Teachers | $1,086,895 | $3,758,853 |
| Total TCRS | $2,719,768 | $7,108,997 |

[*] Date of last valuation. See "General Information" above.

**Historic Funding Progress**
**State and Higher Education Employees**
**At June 30**
**(dollars expressed in thousands)**

| Valuation Date | Actuarial Value of Assets | Actuarial Accrued Liability | Unfunded Actuarial Accrued Liability | Funded Ratio | Covered Payroll | Unfunded Actuarial Liability as a % of Covered Payroll |
|---|---|---|---|---|---|---|
| 2009* | $10,303,444 | $11,936,316 | $1,632,873 | 86.32% | $2,530,585 | 64.53% |
| 2007 | 10,221,899 | 11,241,864 | 1,019,965 | 90.93 | 2,501,095 | 40.78 |
| 2005 | 9,162,582 | 9,202,389 | 39,807 | 99.57 | 2,245,692 | 1.77 |
| 2003 | 8,589,389 | 8,641,882 | 52,493 | 99.39 | 2,011,145 | 2.61 |
| 2001 | 8,131,000 | 8,212,227 | 81,227 | 99.01 | 1,891,359 | 4.29 |

**Historic Funding Progress**
**Teachers**
**At June 30**
**(dollars expressed in thousands)**

| Valuation Date | Actuarial Value of Assets | Actuarial Accrued Liability | Unfunded Actuarial Accrued Liability | Funded Ratio | Covered Payroll | Unfunded Actuarial Liability as a % of Covered Payroll |
|---|---|---|---|---|---|---|
| 2009* | $16,031,755 | $17,118,650 | $1,086,895 | 93.65% | $3,523,942 | 30.84% |
| 2007 | 15,993,095 | 15,998,286 | 5,191 | 99.97 | 3,241,772 | 0.16 |
| 2005 | 14,464,578 | 14,464,578 | 0 | 100.00 | 3,000,297 | na |
| 2003 | 13,509,863 | 13,509,863 | 0 | 100.00 | 2,762,152 | na |
| 2001 | 12,629,990 | 12,629,990 | 0 | 100.00 | 2,560,093 | na |

*Date of last valuation. See "General Information" above.

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***Historic Market Value of Assets***

The historic market value of assets for the last ten years for the state employee and higher education group and the teacher group are shown in the following table:

**Historic Market Value of Assets**
**At June 30**
**(dollars expressed in thousands)**

| Year ended June 30 | State Employee and Higher Education Employee Group | Teacher Group |
|---|---|---|
| 2011 | $10,764,495 | $16,875,007 |
| 2010 | 9,219,743 | 14,389,656 |
| 2009 | 8,586,203 | 13,359,796 |
| 2008 | 10,376,878 | 16,136,072 |
| 2007 | 10,633,938 | 16,637,769 |
| 2006 | 9,485,405 | 14,930,609 |
| 2005 | 8,985,992 | 14,185,802 |
| 2004 | 8,481,141 | 13,412,946 |
| 2003 | 7,953,295 | 12,509,484 |
| 2002 | 7,759,392 | 12,148,298 |

**Historic Funding Progress**
**State and Higher Education Employees**
**At June 30**
**(dollars expressed in thousands)**

| Valuation Year | Market Value of Assets | Actuarial Accrued Liability | Unfunded Actuarial Accrued Liability | Funded Ratio | Covered Payroll | Unfunded Actuarial Liability as a % of Covered Payroll |
|---|---|---|---|---|---|---|
| 2009* | $8,586,203 | $11,936,316 | $3,350,113 | 71.93% | $2,530,585 | 132.38% |
| 2007 | 10,633,938 | 11,241,864 | 607,926 | 94.59 | 2,501,095 | 24.31 |
| 2005 | 8,985,992 | 9,202,389 | 216,397 | 97.65 | 2,245,692 | 9.64 |
| 2003 | 7,953,295 | 8,641,882 | 688,687 | 92.03 | 2,011,145 | 34.24 |
| 2001 | 8,050,924 | 8,212,227 | 161,303 | 98.04 | 1,891,359 | 8.53 |

*Date of last valuation. See "General Information" above.

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**Historic Funding Progress**
**Teachers**
**At June 30**
**(dollars expressed in thousands)**

| Valuation Year | Market Value of Assets | Actuarial Accrued Liability | Unfunded Actuarial Accrued Liability | Funded Ratio | Covered Payroll | Unfunded Actuarial Liability as a % of Covered Payroll |
|---|---|---|---|---|---|---|
| 2009* | $13,359,796 | $17,118,650 | $3,758,854 | 78.04% | $3,523,942 | 106.67% |
| 2007 | 16,637,769 | 15,998,286 | (639,483) | 104.00 | 3,241,772 | (19.73) |
| 2005 | 14,185,802 | 14,646,578 | 460,776 | 96.85 | 3,000,297 | 15.36 |
| 2003 | 12,509,484 | 13,509,863 | 1,000,379 | 92.60 | 2,762,152 | 36.22 |
| 2001 | 12,509,407 | 12,629,990 | 120,583 | 99.05 | 2,560,093 | 4.71 |

*Date of last valuation. See "General Information" above.

***Cash Flows***

**Cash Flows**
**State Employees, Higher Education Employees, and Teachers**
**(dollars expressed in thousands)**

| | Cash Inflows | | Cash Out Flows | | |
|---|---|---|---|---|---|
| Fiscal Year | Contributions | Interest and Dividends | Benefits and Refunds | Administrative Cost | Net Cash Flows |
| 2011 | $914,811 | $737,951 | $1,434,416 | $3,951 | $214,395 |
| 2010 | 769,038 | 708,925 | 1,336,574 | 3,924 | 137,465 |
| 2009 | 769,714 | 793,334 | 1,271,327 | 3,616 | 288,105 |
| 2008 | 774,648 | 928,037 | 1,167,609 | 3,711 | 531,365 |
| 2007 | 738,472 | 877,122 | 1,081,995 | 3,385 | 530,214 |

*Remainder of Page Left Intentionally Blank*

### *Funding Policies*

By statute, it is the policy to fund the pension plan liabilities at the rate determined by an actuarial valuation. The employer contribution rate includes the normal cost, accrued liability cost, and cost of administration. The cost associated with the accrued liability is financed using the level dollar amortization method.

**Annual Required Contributions and Percentage Contributed**
**(dollars expressed in thousands)**

| | State & Higher Education Employees | | Teachers | |
|---|---|---|---|---|
| Year Ended June 30 | Annual Required Contribution | Percentage Contributed | Annual Required Contribution | Percentage Contributed |
| 2011 | $383,365 | 100% | $339,833 | 100% |
| 2010 | 341,585 | 100 | 236,545 | 100 |
| 2009 | 350,770 | 100 | 233,215 | 100 |
| 2008 | 374,530 | 100 | 218,882 | 100 |
| 2007 | 358,327 | 100 | 204,402 | 100 |
| 2006 | 299,138 | 100 | 175,741 | 100 |
| 2005 | 277,740 | 100 | 170,414 | 100 |

### *Employer Contributions*

The 2009 actuarial valuation established the employer contribution rates for the fiscal years ending June 30, 2011 and June 30, 2012. Accordingly, the employer contribution requirement for the fiscal year ending June 30, 2012 will be the rate of 14.91% of salary for State employees and higher education employees. LEAs will make employer contributions at the rate of 9.05% of salary for teachers.

It is anticipated that there will be upward pressure on the employer contribution rates in future actuarial valuations as deferred market losses that have been smoothed are recognized pursuant to the smoothing schedule previously described.

During 2011, management of TCRS engaged the retirement system's actuarial firm to conduct a review to determine an inclination of the potential employer contribution rates for the next fifteen years. This review showed that the employer contribution rate for State employees and higher education employees could increase to a peak of 21.58% by 2017 and then begin a decline to a rate of 19.40% by 2027. The employer contribution rate for the teacher group could increase to a peak of 15.29% in 2019 and then begin a decline to a rate of 13.35% by 2027. These are merely an indication of potential rates and the actual employer contribution rates could be more or less than the projection. A stress test was also preformed using an investment return of 5.0% each year going forward rather than the 7.5% earnings assumption. In this case, the employer contribution rate for State employees and higher education employees could steadily increase reaching 25% in 2017 and continuing to increase reaching 30% in 2026. For teachers, the employer rate could be 20% by 2019 and continuing to increase reaching 25% in 2027.

### *GASB Exposure Draft Amending Statement 27*

The Governmental Accounting Standards Board (GASB) has issued an exposure draft amending GASB statement number 27 relative to accounting and reporting for pensions. If adopted as proposed, it would separate pension accounting from pension funding, which heretofore have been tied together. The amendment proposes a methodology for measuring pension expense to be presented in the employer's financial statements. Moreover, the amendment proposes a methodology for measuring the pension liability to be presented in the employer's financial statement. No prediction can be made as to whether and in what form it might be adopted and as to any actual effects. However, financial statement presentation will not affect the pension funding methodologies described herein.

***Other Retirement Programs***

*Optional Retirement Plan in Higher Education*

Employees in higher education that are exempt from the Federal Fair Labor Standards Act may waive membership in TCRS and elect to participate in the Optional Retirement Plan (ORP), a defined contribution plan. Employees do not contribute to the ORP. By statute, employer contributions are made on behalf of employees at the rate of 10% up to the social security wage base and 11% of salary above the wage base. Employees are immediately vested in employer contributions. Employees make the determination as to how the employer contributions made on their behalf are invested. Employees have a variety of investment products to choose among from three different vendors.

Employer contributions to the ORP totaled $81.4 million for the year ended June 30, 2011. There were 11,117 ORP participants at June 30, 2011.

*Deferred Compensation Plan for State Employees and Higher Education Employees*

The deferred compensation program is a voluntary defined contribution plan to provide state employees and higher education employees with the opportunity to accumulate supplemental retirement income on a tax advantaged basis. The program offers employees two plans, a 457 plan and a 401(k) plan. The contributions to the 401(k) plan can be made to both traditional and/or Roth accounts.

Employee contribution limits are established by federal statute. In the 401(k) plan, employee contributions are matched by employer contributions up to a maximum of $50 per month. Employer contributions are subject to the funding being appropriated in the budget each fiscal year; otherwise no match will be made.

For the year ended June 30, 2011, 51,782 employees made contributions to the 401(k) plan and 3,353 employees made contributions to the 457 plan. Employer contributions totaled $30.4 million while employees contributed $110.5 million.

Employees are immediately vested in employee and employer contributions. Employees can choose among a variety of investment products.

## DEBT OF CERTAIN AGENCIES AND AUTHORITIES

The following entities are the corporate governmental agencies and instrumentalities of the State authorized to issue various debt instruments. The State is not liable for any debt instrument issued by any of the following entities, and no such debt instrument is a debt or obligation of the State and the full faith and credit of the State is not pledged to the payment thereof.

**Tennessee Local Development Authority**

In 1978, the General Assembly created the Tennessee Local Development Authority (the "TLDA") pursuant to Sections 4-31-101 et seq., Tennessee Code Annotated. TLDA is a corporate governmental agency and instrumentality of the State. TLDA is authorized to (i) loan funds to local governments for sewage treatment and waterworks (the "State Loan Programs"), capital projects, firefighting equipment, and airport facilities; (ii) loan funds to certain small business concerns for pollution control equipment; (iii) make funds available for loans for agricultural enterprises; (iv) make loans to not-for-profit organizations providing certain mental health, mental retardation, and alcohol and drug services; and (v) make loans to local government units to finance construction of capital outlay projects for K-12 educational facilities. In order to fund these loans, TLDA is empowered to issue its bonds and notes. The aggregate amounts outstanding for certain programs are limited as follows: $10,000,000 for firefighting equipment; $200,000,000 for airport facilities; $50,000,000 for pollution control equipment;

$50,000,000 for mental health, mental retardation, and alcohol and drug services; $30,000,000 for agricultural enterprises; $15,000,000 for petroleum underground storage tank cleanup costs; and $75,000,000 for capital outlay projects for K-12 educational facilities.

Bonds and notes issued by TLDA are secured by: (i) in the case of loans to local governments, monies received by TLDA under loan program agreements with the local governments and by the local governments' allocation of state-shared taxes; (ii) in the case of loans to small business concerns, monies received under agreements with those concerns; (iii) in the case of agricultural loans, monies received under agreements with lenders and a pledge of any money, income or revenue from any source; (iv) in the case of loans to not-for-profit organizations, monies received under State grant agreements and a pledge of the department of mental health and mental retardation's annual budget; and (v) in the case of loans to local government units to finance construction of capital outlay projects for K-12 educational facilities, monies received by TLDA under loan agreements with local education agencies payable from taxes authorized to be levied for the purpose and certain proceeds of the Tennessee lottery for education.

Currently the only program being funded by TLDA is the State Loan Programs. As of August 31, 2011, TLDA had $8,845,000 (unaudited) of bonds outstanding for this program.

**Tennessee State School Bond Authority**

In 1965, the General Assembly created the Tennessee State School Bond Authority (the "Authority"), pursuant to Sections 49-3-1201 et seq., Tennessee Code Annotated. The Authority is a corporate governmental agency and instrumentality of the State of Tennessee. The Authority is authorized to issue its bonds and notes to finance capital outlay programs for higher educational facilities which may be required or convenient for the purposes of The University of Tennessee, including its branches and divisions, and for the purposes of the institutions of higher education under the supervision and administration of the Tennessee Board of Regents of the State University and Community College System of the State of Tennessee. In 1980, the General Assembly further authorized the Authority to issue its bonds or notes to provide funds for the making of student loans by the Tennessee Student Assistance Corporation; however, no such bonds or notes have been issued for this purpose. The Authority also is authorized to issue Qualified Zone Academy Bonds ("QZAB") and Qualified School Construction Bonds ("QSCB") to finance improvement loans to cities and counties for qualifying K-12 schools for capital projects.

Generally, all outstanding higher educational facility debt obligations of the Authority are secured by financing charges payable under contracts and agreements entered into by the Authority and the Board of Trustees of The University of Tennessee and the Tennessee Board of Regents of the State University and Community College System of the State of Tennessee, as successor to the State Board of Education; legislative appropriations; and certain funds and accounts established by the Higher Educational Facilities General Bond Resolutions of the Authority. The QZABs and QSCBs are part of a Federal government program in which a Federal income tax credit is given to investors in lieu of interest on the bonds. For certain of the QSCBs, a Federal income tax credit is given to bondholders in lieu of the payment of interest on bonds, and in certain other QSCBs an election is made by the Authority to receive direct interest subsidy payments from the United States Treasury, which if not needed to cure defaults under loan agreements with the borrowers, are transferred to them. The QZABs and QSCBs are secured by a general obligation pledge of the borrowers and a pledge of unobligated State-shared taxes of the borrowers.

As of August 31, 2011, the Authority had outstanding $1,018,980,000 (unaudited) aggregate principal amount of higher educational facility bonds (including accretion of College Savings Bonds), $180,813,000 (unaudited) of higher educational facility commercial paper, and $57,210,000 (unaudited) aggregate principal amount of QZAB bonds. As of August 31, 2011, the total par amount of QSCBs outstanding was $389,440,000 (unaudited).

**Tennessee Housing Development Agency**

In 1973, the General Assembly created the Tennessee Housing Development Agency (the "Agency"), pursuant to Sections 13-23-101 et seq., Tennessee Code Annotated (the "Tennessee Housing Development Agency

Act"). The Agency is authorized, among other things, to issue its bonds and notes to make funds available for the financing of residential housing for persons and families of lower and moderate income.

The Agency has established a mortgage finance program and is making funds available for loans for residential housing for persons or families of lower and moderate income. Such loans are secured by eligible mortgages on the properties. The Agency has made, but does not currently make, loans for multi-family residential housing for rental occupancy.

In order to accomplish its objectives, the General Assembly has authorized the Agency to issue its bonds and notes, provided that the aggregate principal amount outstanding on such bonds and notes may not exceed $2,930,000,000, excluding bonds and notes which have been refunded. The Agency's net indebtedness, excluding the bonds and notes which have been refunded, at August 31, 2011, was $2,117,260,000 (unaudited).

Obligations of the Agency are secured by, among other things, mortgage loans made by the Agency from the proceeds of such obligations. The Tennessee Housing Development Agency Act provides a mechanism for certifying to the Governor and to the Commissioner of Finance and Administration amounts, if any, needed for debt service or operating expenses of the Agency and authorizes the General Assembly to appropriate, to expend and to provide for the payment of such amounts, but imposes no legal obligation upon the General Assembly to do so. These provisions of the Tennessee Housing Development Agency Act do not constitute a legally enforceable obligation of the State to pay any such amounts. Under the Constitution of the State, no monies may be withdrawn from the Treasury but in consequence of appropriations made by law.

**Watkins Institute**

Watkins Institute (the "Institute") is an educational institution located in Nashville. Since 1881, the State has served as trustee of a trust providing for the maintenance of the Institute. On behalf of the State as trustee and with the approval of the State Senate, the Governor of the State appoints commissioners of the Institute, all as provided in the wills and codicils establishing the trust. In 1956, the Chancery Court of Davidson County determined that the Institute was a State agency for the purpose of providing capital improvements through the issuance of bonds. As of August 31, 2011, the amount of outstanding bonds was $2,478,860 (unaudited).

**State Veterans' Homes Board**

In 1988, the General Assembly created the Tennessee State Veterans' Homes Board (the "Veterans' Homes Board") pursuant to Sections 58-7-101 to 58-7-112, inclusive, Tennessee Code Annotated. A political subdivision and instrumentality of the State, the Veterans' Home Board is authorized to issue its debt instruments to finance public homes for the support and care of honorably discharged veterans of the United States armed forces. Such homes will be established only if Federal Veterans' Administration funds are available to provide a share of the construction and operation costs. Prior to the issuance of any debt instruments, the Veterans' Homes Board must receive the approval of the State Funding Board. The Veterans' Homes Board has no outstanding bonds. Loans to the Veterans' Homes Board were funded through the issuance of general obligation bonds authorized by the General Assembly.

## LITIGATION

Due to its size and broad range of activities, the State and its officers and employees are involved in a number of legal actions. In view of the financial condition of the State, it is the opinion of the Commissioner of Finance and Administration that the State's financial condition will not be materially affected by such litigation, based on information known at the date of this Official Statement.

On January 1, 1994, after receiving a waiver from the United States Department of Health and Human Services, the State replaced a substantial portion of its Medicaid Program with a managed care demonstration project called TennCare. TennCare has been the subject of much litigation, and several cases remain active.

*Grier, et al. v. Goetz, et al.* (U.S. District Court, M. D. Tenn.) deals with the procedural protections to be afforded all enrollees when TennCare services are denied, delayed, suspended, or terminated. A revised consent decree setting out these procedural protections was entered on October 26, 1999, and modified by order entered September 25, 2003. The 2003 Revised Consent Decree has been further modified pursuant to a series of orders entered in 2005 granting in part and denying in part a Motion to Modify the Revised Consent Decree filed by the State on June 15, 2005. The State's largely successful Motion to Modify has enabled the State to enact reforms to the TennCare program such as placing limits on the prescription drugs the State must provide when prescribed without prior authorization, allowing the State to impose and enforce numerical limits on certain benefits, allowing the State to modify the rules of medical necessity, allowing the State to dismiss without hearing enrollee appeals that fail to raise a valid factual dispute, and restoring TennCare's ability, as the single-state Medicaid agency, to have adverse decisions by an administrative law judge reviewed by the Commissioner or his designee.

In a separate aspect of this decades-old case, the Court vacated a 1987 injunction that had operated to prohibit the State from redetermining the continuing TennCare / Medicaid eligibility of enrollees who had lost their Supplemental Security Income (SSI) benefits. Starting in May 2009 the State began to move forward with redetermining the Medicaid eligibility of this group of former SSI recipients, using procedures approved by the Court. The process of redetermining the eligibility of TennCare enrollees for other Medicaid categories as they lose SSI-based eligibility is ongoing.

*John B., et al. v. Emkes, et al.* (U.S. District Court, M. D. Tenn.) was brought on behalf of all TennCare enrollees under the age of 21, alleging that the State was not meeting its obligation to provide these children with the early and periodic screening, diagnosis, and treatment (EPSDT) services required by the federal Medicaid Act. The case was settled by a Consent Decree entered in March 1998.

In the years following entry of the Consent Decree the activity in the case has been generated by issues regarding the status of the State's compliance with that Consent Decree. In early 2006 the district court indicated that it intends to hold a hearing in which the State will bear the burden of demonstrating that it is in compliance with the Consent Decree. The hearing is scheduled to begin on October 31, 2011.

Since 2006 the parties have been engaged in extensive discovery regarding the State's compliance. Those discovery activities have themselves given rise to a number of disputes, one of which culminated in the filing by plaintiffs of a motion to compel discovery and for sanctions. In a Memorandum Opinion and Order entered October 10, 2007, the district court granted the motion to compel and, among other things, concluded that consideration of an award to plaintiffs for their attorneys fees and costs on the motion as well as the document production costs and attorneys fees of the managed care companies is appropriate. Fee and cost requests have been filed, which the State has vigorously opposed. The amount of any award of attorneys fees and costs has not yet been determined.

*United States of America v. State of Tennessee (Arlington Developmental Center)* (U.S. District Court, W. D. Tenn.) is a case brought pursuant to the Civil Rights of Institutionalized Persons Act, alleging that the constitutional rights of residents at Arlington were being violated. The trial was in August, 1993. A remedial order was approved on September 1, 1994. Since entry of the remedial order, six separate contempt actions have been filed. Some of these have resulted in fines against the State. The Court subsequent to the remedial order has issued an order interpreting the third category of the definition of class, i.e., persons at risk of being placed at Arlington Developmental Center, to consist of all individuals who reside in West Tennessee and who have demonstrated medical needs sufficient to require institutional care in the absence of home or community-based services. This interpretation increases the number of class members from 452 to an estimated 3,000. A notice of appeal was filed with the Sixth Circuit Court of Appeals and a stay granted. A new settlement agreement was reached to resolve the at risk class definition interpretation. Under the new definition, the scope of the class has been more narrowly defined than in the order entered by the District Court and pending in the Sixth Circuit. It is not possible at this time to know how many additional individuals will be added to the Arlington class under this new settlement agreement or the potential liability to the State to provide additional services to these individuals. But, it is expected to be substantially less than under the prior order. In addition, the State agreed to close Arlington Developmental Center. No new class members can be added after closure. Arlington Developmental Center closed on October 27, 2010. The State has a pending motion to vacate and dismiss this lawsuit based on the closure of Arlington Development Center. A hearing on this motion is schedule for October 7, 2011. Based on the closure of the center, it is the State's position that no other individuals may be admitted to the class but there is a pending motion asserting that the State failed to admit some eligible individuals. Even if this lawsuit is not dismissed and the State is required to admit some additional members to the class, the size of the class should at most increase from 1025 individuals to 1650 individuals.

At this time, there are two lawsuits pending against the State of Tennessee that could affect the payments the State receives under the 1998 Tobacco Master Settlement Agreement ("MSA"). In *Grand River Enterprises Six Nations Ltd., et al. v. Pryor, et al* (U.S. District Court, Southern District of New York, No. 02-05068), a Canadian tobacco company that has not signed the MSA (a Non-Participating Manufacturer) has filed suit against Tennessee and thirty other states asserting that the defendant states' tobacco laws violate the Sherman Antitrust laws and various provisions of the United States Constitution. Early during the proceedings, the District Court dismissed Tennessee and the other non-New York defendants based on the lack of personal jurisdiction. The Second Circuit Court of Appeals reversed this ruling, finding that negotiations of the MSA occurring in New York, involving Tennessee and the other defendant states, created personal jurisdiction in the Southern District of New York. The case has progressed through the discovery process and on August 12, 2009, Tennessee and the other defendant states filed a motion for summary judgment, seeking a dismissal of all claims. On March 17, 2011 Judge Keenan granted the states' motion for summary judgment dismissing the plaintiff's claims against Tennessee and the other defendant states. On April 20, 2011 plaintiff filed a motion to alter Judge Keenan's summary judgment. Defendants have filed a response to the motion, which is still pending. On April 21, 2011 plaintiff filed a notice of appeal to the Second Circuit U.S. Court of Appeals, seeking a reversal of the summary judgment. That appeal is currently pending. If the plaintiff were ultimately to prevail on its claim, Tennessee could lose a substantial portion of its tobacco payment, not to exceed 65% of its annual payment.

In *Vibo Corporation, Inc. d/ba/ General Tobacco v. Conway, et al.*, ($6^{th}$ Circuit Ct. App., No. 10-5043), Plaintiff, Vibo Corporation, d/b/a General Tobacco is a Subsequent Participating Manufacturer ("SPM") that joined the MSA in August of 2004. From the date it joined the MSA, General Tobacco struggled to meet its financial obligations including the backpayment provisions that apply to SPMs under MSA §II(jj). In October of 2008, General Tobacco filed suit against the MSA Settling States, including Tennessee in an attempt to invalidate the MSA's backpayment provisions and the escrow statutes that were passed by Settling States as a result of the MSA. In its complaint, plaintiff asserted claims against defendants for civil rights and antitrust violations. Defendants moved to dismiss and to quash service.

Under the terms of the MSA § IX(d)(2)(F), if a state's tobacco escrow statute is ruled invalid or illegal, a state may face a reduction of up to 65% of its allocated payment. For Tennessee, this would be an approximately $100 million reduction of its MSA payment.

On January 5, 2009, the Western District of Kentucky granted Defendant Kentucky's motion to dismiss for lack of subject-matter jurisdiction and failure to state a claim. The Court granted the non-Kentucky defendants' motion to dismiss for lack of personal jurisdiction and improper venue. General Tobacco filed its Notice of Appeal on January 13, 2010. Subsequently, on February 5, 2010, a Notice of Appearance was filed on behalf of Tennessee. On February 10, 2010, plaintiff/appellant filed its Civil Appeal Statement of Parties and Issues. The Court issued a briefing schedule on February 19, 2010. Thereafter, the Court granted plaintiff/appellant's Motion for Extension of Deadline to file its brief. Plaintiff/appellant filed its Opening Brief and Addendum to Brief of Appellant General Tobacco on May 8, 2010 which was later supplemented on May 18, 2010.

On July 12, 2010, defendants/appellees filed their Response to Appellant's Brief. Plaintiff/appellant then motioned the Court for an extension of time to file its Reply Brief and to Increase Word Limitation. On July 28, 2010, the Court denied their motion to increase the size of their reply brief, but granted an extension of time to reply to defendant/appellee's response, due by August 12, 2010. On October 11, 2010, Vidal Suriel, President of General Tobacco, sent a letter to the Department of Revenue stating, "General Tobacco, Inc. hereby surrenders its authority to transact business in the State of Tennessee. The effective date shall be September 30, 2010." On October 29, 2010, defendant/appellee Conway filed Additional Supplemental Authority, the *Freedom Holdings* case. Oral argument before the $6^{th}$ Circuit Court of Appeals is set for October 6, 2011.

In addition to the above lawsuits, the State could receive reduced MSA payments pursuant to provisions contained in the MSA that allow for the Participating Manufacturers ("PMs") to withhold payments under certain circumstances. These provisions, referred to in the MSA as the "Non-Participating Manufacturer ("NPM") Adjustment", may be applied to the settlement payments received by the Settling States, including Tennessee. In order for the adjustment to apply, there are several pre-conditions that must be satisfied. First, there must be more than a two percent (2%) market share loss experienced by the PMs. Second, the disadvantages experienced by the PMs as a result of the MSA must have been a significant factor contributing to their market share loss. States that have enacted a model escrow statute and "diligently enforced" it during the time period in question have a safe-harbor against the adjustment.

In March of 2006, the economic firm selected by the Settling States (including Tennessee) and PMs determined that the disadvantages experienced by the PMs during 2003 as a result of the MSA's provisions were a significant factor in the PMs' loss of market share. As a result of this determination, the PMs withheld approximately $18 million from Tennessee's 2006 MSA payment. The States, including Tennessee, have commenced arbitration against the PMs to determine whether each State diligently enforced its model escrow statute during 2003. This arbitration will be decided by a three-member panel of retired federal judges, in accordance with the procedures set forth in the MSA. If Tennessee is found to have diligently enforced its tobacco escrow laws during 2003, it will recover the $18 million that was withheld from the 2006 MSA payment. If Tennessee is found to have not diligently enforced its tobacco escrow laws during 2003, Tennessee could stand to lose anywhere between approximately $30 million to $150 million from its next tobacco payment, depending on how many other States are found to have not diligently enforced. The amount of the payment reduction is inversely proportional to the number of States that lose the diligent enforcement determination (i.e., the greater the number of losing States, the lower the payment reduction). Once the current arbitration is concluded, there will likely be subsequent arbitrations to determine if the State diligently enforced statutes during later years and whether Tennessee is entitled to recover money withheld from MSA payments for 2007 through 2010.

On June 30, 2009, the Settling States, including Tennessee, and the PMs entered into an agreement whereby the parties stipulated that the cost disadvantages experienced by the PMs during 2007, 2008 and 2009 as a result of the MSA were a significant factor in the PMs' loss of market share during such years. As a result of this stipulation, the PMs were entitled to withhold approximately $15.6 million from the April 2020 payment. In return, the Settling States received a $5 million payment to the States' Tobacco Enforcement Fund in 2009 and will receive the same payments in 2010 and 2011.

The multi-state arbitration to determine whether Tennessee and the other States diligently enforced their escrow statutes during 2003 is progressing through the discovery stage, with discovery likely to conclude in November. Tennessee has made substantial document disclosures and two depositions of fact witnesses for the state have been taken. In November, the PMs will announce which States, if any, they will no longer contest. States will then have one month to announce if they will challenge any State let go by the PMs. Formal evidentiary hearings will likely begin in March of 2012. How long they last will depend on many factors, starting with how many State are still in the arbitration. At this time, it is expected that the hearings will be complete by the end of 2012, but there is a good chance that decisions may not be announced until the following year. The States and PMs have filed statements of claims and are preparing to file briefs on preliminary legal issues that will be decided by the arbitration panel prior to the evidentiary hearings. It is anticipated that the evidentiary, "diligent enforcement", hearings will begin this winter.

In addition, the Independent Auditor responsible for disbursing settlement payments may elect to preliminarily make adjustments to the State's tobacco settlement payments without resorting to litigation. These potential adjustments, most notably relating to sales volume, have been made in the past and may be made in the future. The State may vigorously dispute any such adjustments or withholdings, but it could take years to have those disputes resolved. Lastly, litigation in other states may have a material effect on the tobacco settlement payments in the State.

*Pfizer, Inc. v. Reagan Farr, Commissioner of Revenue, State of Tennessee* (Davidson County Chancery No. 09-1946-II) and Pharmacia Corp. v. Reagan Farr, Commissioner of Revenue, State of Tennessee (Davidson County Chancery No. 09-1945-II) are related tax refund cases concerning the sale of the companies' (Pharmacia is a wholly-owned subsidiary of Pfizer) "consumer healthcare products division" (the "CPD") in 2006 that these companies claim had no constitutionally significant connection to Tennessee. The companies also contend that the CPD was a business segment unrelated to and separate from their established "pharmaceutical products division" that had operations in Tennessee. Consequently, they allege that the gains from the sale are not taxable because they are non-business earnings under Tennessee's excise tax statute and because they arose from outside of the unitary business that they conduct within Tennessee. Alternatively, the companies seek a variance from their statutorily-determined excise tax liability on the grounds that their sales through a distribution channel operated by McKesson Corporation (which has a distribution center in Memphis) have distorted the amount of the taxpayers' income apportioned to Tennessee under the statutory formula. In total, Pfizer seeks a refund of over $84 million and Pharmacia of over $40 million.

In *Atmos Energy Marketing, LLC v. Reagan Farr, Commissioner of Revenue*, Davidson Chancery No. 10-10-I, the taxpayer directly challenges an unpaid business tax assessment of about $5.5 million, but also has presented a challenge to the business tax structure. Atmos contends that the tax violates Article II, Section 29, of the Tennessee Constitution, which provides that the General Assembly may authorize counties and cities to levy taxes for county and city purposes. Atmos asserts that while the business tax is purportedly imposed by counties and cities, the General Assembly has directed that 43% of the resulting revenues go to the State's general fund. Atmos thus claims that the business tax structure is unconstitutional. The Chancellor presently has the matter under advisement on Atmos' motion for summary judgment. If the court should agree that distribution of a portion of business tax revenues to the State general fund is unconstitutional, the next questions concern what remedy is appropriate, whether taxpayers are entitled to refunds, and whether such plaintiffs have standing to force a change in the distribution of business tax revenues. The State receives $120-150 million in business tax revenues each year. Because State law allows taxpayers to claim refunds up until the end of the third year after payment, in the neighborhood of $500 million in State revenue as well as the annual collection of business tax revenues could be in jeopardy if Atmos were ultimately to prevail on the issues of both constitutionality and remedy.

## TAX MATTERS

**Federal Tax Matters**

*General*

In the opinion of Hawkins Delafield & Wood LLP, Bond Counsel to the State, under existing statutes and court decisions and assuming continuing compliance with certain tax covenants described herein, (i) interest on the Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"), and (ii) interest on the Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. In rendering its opinion, Bond Counsel has relied on certain representations, certifications of fact, and statements of reasonable expectations made by the State in connection with the Bonds, and Bond Counsel has assumed compliance by the State with certain ongoing covenants to comply with applicable requirements of the Code to assure the exclusion of interest on the Bonds from gross income under Section 103 of the Code.

Bond Counsel expresses no opinion regarding any other Federal tax consequences with respect to the Bonds. Bond Counsel renders its opinion under existing statutes and court decisions as of the issue date, and assumes no obligation to update its opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation or otherwise. Bond Counsel expresses no opinion as to the effect of any action hereafter taken or not taken, in reliance upon an opinion of other counsel, on the exclusion from gross income for Federal income tax purposes of interest on the Bonds.

For the proposed form of opinion of Bond Counsel relating to Federal tax matters, see Appendix C.

*Certain Ongoing Federal Tax Requirements and Covenants*

The Code establishes certain ongoing requirements that must be met subsequent to the issuance and delivery of the Bonds in order that interest on the Bonds be and remain excluded from gross income under Section 103 of the Code. These requirements include, but are not limited to, requirements relating to use and expenditure of gross proceeds of the Bonds, yield and other restrictions on investments of gross proceeds, and the arbitrage rebate requirement that certain excess earnings on gross proceeds be rebated to the Federal government. Noncompliance with such requirements may cause interest on the Bonds to become included in gross income for Federal income tax purposes retroactive to their issue date, irrespective of the date on which such noncompliance occurs or is discovered. The State has covenanted to comply with certain applicable requirements of the Code to assure the exclusion of interest on the Bonds from gross income under Section 103 of the Code.

*Certain Collateral Federal Tax Consequences*

The following is a brief discussion of certain collateral Federal income tax matters with respect to the Bonds. It does not purport to address all aspects of Federal taxation that may be relevant to a particular owner of a Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the Federal tax consequences of owning and disposing of the Bonds.

Prospective owners of the Bonds should be aware that the ownership of such obligations may result in collateral Federal income tax consequences to various categories of persons, such as corporations (including S corporations and foreign corporations), financial institutions, property and casualty and life insurance companies, individual recipients of Social Security and railroad retirement benefits, individuals otherwise eligible for the earned income tax credit, and taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is excluded from gross income for Federal income tax purposes. Interest on the Bonds may be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Code.

*Original Issue Discount*

Original issue discount ("OID") is the excess of the sum of all amounts payable at the stated maturity of a Bond (excluding certain "qualified stated interest" that is unconditionally payable at least annually at prescribed rates) over the issue price of that maturity. In general, the "issue price" of a maturity means the first price at which a substantial amount of the Bonds of that maturity was sold (excluding sales to bond houses, brokers, or similar persons acting in the capacity as underwriters, placement agents, or wholesalers). In general, the issue price for each maturity of the Bonds is expected to be the initial public offering price set forth on the inside cover page of this Official Statement. Bond Counsel is of the opinion that, for any Series A Bonds having OID (a "Discount Bond"), OID that has accrued and is properly allocable to the owners of the Discount Bonds under Section 1288 of the Code is excludable from gross income for Federal income tax purposes to the same extent as other interest on the Bonds.

In general, under Section 1288 of the Code, OID on a Discount Bond accrues under a constant yield method, based on periodic compounding of interest over prescribed accrual periods using a compounding rate determined by reference to the yield on that Discount Bond. An owner's adjusted basis in a Discount Bond is increased by accrued OID for purposes of determining gain or loss on sale, exchange, or other disposition of such Bond. Accrued OID may be taken into account as an increase in the amount of tax-exempt income received or deemed to have been received for purposes of determining various other tax consequences of owning a Discount Bond even though there will not be a corresponding cash payment.

Owners of Discount Bonds should consult their own tax advisors with respect to the treatment of original issue discount for Federal income tax purposes, including various special rules relating thereto, and the state and local tax consequences of acquiring, holding, and disposing of Discount Bonds.

*Bond Premium*

In general, if an owner acquires a Bond for a purchase price (excluding accrued interest) or otherwise at a tax basis that reflects a premium over the sum of all amounts payable on that Bond after the acquisition date (excluding certain "qualified stated interest" that is unconditionally payable at least annually at prescribed rates), that premium constitutes "bond premium" on that Bond (a "Premium Bond"). In general, under Section 171 of the Code, an owner of a Premium Bond must amortize the bond premium over the remaining term of the Premium Bond, based on the owner's yield over the remaining term of the Premium Bond, determined based on constant yield principles (in certain cases involving a Premium Bond callable prior to its stated maturity date, the amortization period and yield may be required to be determined on the basis of an earlier call date that results in the lowest yield on such bond). An owner of a Premium Bond must amortize the bond premium by offsetting the qualified stated interest allocable to each interest accrual period under the owner's regular method of accounting against the bond premium allocable to that period. In the case of a tax-exempt Premium Bond, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to that accrual period, the excess is a nondeductible loss. Under certain circumstances, the owner of a Premium Bond may realize a taxable gain upon disposition of the Premium Bond even though it is sold or redeemed for an amount less than or equal to the owner's original acquisition cost.

Owners of any Premium Bonds should consult their own tax advisors regarding the treatment of bond premium for Federal income tax purposes, including various special rules relating thereto, and state and local tax consequences, in connection with the acquisition, ownership, amortization of bond premium on, sale, exchange or other disposition of Premium Bonds.

*Information Reporting and Backup Withholding*

Information reporting requirements apply to interest on tax-exempt obligations, including the Bonds. In general, such requirements are satisfied if the interest recipient completes, and provides the payor with a Form W-9, "Request for Taxpayer Identification Number and Certification," or if the recipient is one of a limited class of exempt recipients. A recipient not otherwise exempt from information reporting who fails to satisfy the information reporting requirements will be subject to "backup withholding," which means that the payor is required to deduct and withhold a tax from the interest payment, calculated in the manner set forth in the Code. For the foregoing purpose, a "payor" generally refers to the person or entity from whom a recipient receives its payments of interest or who collects such payments on behalf of the recipient.

If an owner purchasing a Bond through a brokerage account has executed a Form W-9 in connection with the establishment of such account, as generally can be expected, no backup withholding should occur. In any event, backup withholding does not affect the excludability of the interest on the Bonds from gross income for Federal income tax purposes. Any amounts withheld pursuant to backup withholding would be allowed as a refund or a credit against the owner's Federal income tax once the required information is furnished to the Internal Revenue Service.

**State of Tennessee Tax Matters**

In the opinion of Bond Counsel to the State, under existing laws of the State, the Bonds and the interest thereon are free from taxation by the State or any county, municipality or taxing district of the State, except for inheritance, transfer and estate taxes, and except to the extent such interest may be included within the measure of privilege taxes imposed pursuant to the laws of the State.

Bond Counsel expresses no opinion regarding any other state or local tax consequences with respect to the Bonds. Bond Counsel renders its opinion under existing statutes and court decisions as of the issue date and assumes no obligation to update its opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation or otherwise. Bond Counsel expresses no opinion as to the effect of any action hereafter taken or not taken, in reliance upon an opinion of other counsel, under state and local tax law.

For the proposed form of opinion of Bond Counsel relating to State tax matters, see Appendix C.

**Proposed Legislation and Other Matters**

Tax legislation, administrative actions taken by tax authorities, or court decisions, whether at the Federal or state level, may adversely affect the tax-exempt status of interest on the Bonds under Federal or state law or otherwise prevent beneficial owners of the Bonds from realizing the full current benefit of the tax status of such interest. In addition, such legislation or actions (whether currently proposed, proposed in the future, or enacted) and such decisions could affect the market price or marketability of the Bonds. For example, on September 12, 2011, President Obama sent to Congress draft legislation entitled the "American Jobs Act of 2011" (the "Proposed Act"). On September 13, 2011, Senate Majority Leader Reid introduced the Proposed Act in the Senate (S.1549). The Proposed Act includes a provision that, if enacted as proposed, would limit the amount of exclusions (including tax-exempt interest, such as interest on the Bonds) and deductions certain high income taxpayers could use to reduce their income tax liability for taxable years after 2012, and accordingly the Proposed Act could affect the market price or marketability of the Bonds.

Prospective purchasers of the Bonds should consult their own tax advisors regarding the foregoing matters.

## UNDERWRITING

Citigroup Global Markets, Inc., on behalf of itself and other underwriters shown on the front cover of this Official Statement (collectively, the "Underwriters"), has agreed, subject to certain conditions, to purchase the Bonds pursuant to a Bond Purchase Agreement (the "Purchase Agreement") at an aggregate purchase price of par, [plus net original issue premium] [less net original issue discount] of $__________ less an underwriting discount of $_________. The Bond Purchase Agreement provides that the Underwriters shall purchase all of the Bonds if any are purchased, subject to the conditions contained therein. The Bonds may be offered and sold to certain dealers, banks and others at prices different than the offering prices indicated on the inside front cover page hereof, and such offering prices may be changed from time to time.

Citigroup Inc. and Morgan Stanley, the respective parent companies of Citigroup Global Markets Inc. and Morgan Stanley & Co. LLC, each an underwriter of the Bonds, have entered into a retail brokerage joint venture. As part of the joint venture, each of Citigroup Global Markets Inc. and Morgan Stanley & Co. LLC will distribute municipal securities to retail investors through the financial advisor network of a new broker-dealer, Morgan Stanley Smith Barney LLC. This distribution arrangement became effective on June 1, 2009. As part of this arrangement, each of Citigroup Global Markets Inc. and Morgan Stanley & Co. LLC will compensate Morgan Stanley Smith Barney LLC for its selling efforts in connection with their respective allocations of Bonds.

Wells Fargo Bank, National Association ("WFBNA"), one of the underwriters of the Bonds, has entered into an agreement (the "Distribution Agreement") with Wells Fargo Advisors, LLC ("WFA") for the retail distribution of certain municipal securities offerings, including the Bonds. Pursuant to the Distribution Agreement, WFBNA will share a portion of its underwriting or remarketing agent compensation, as applicable, with respect to the Bonds with WFA. WFBNA and WFA are both subsidiaries of Wells Fargo & Company. Wells Fargo Securities is the trade name for certain capital markets and investment banking services of Wells Fargo & Company and its subsidiaries, including Wells Fargo Bank, National Association.

## FINANCIAL ADVISOR

Public Financial Management, Inc. ("PFM") is employed by the State to perform professional services in the capacity of financial advisor. In its role as financial advisor to the State Funding Board, PFM has provided advice on the plan of financing and structure of the Bonds, reviewed certain legal and disclosure documents, including this Official Statement, for financial matters, and reviewed and will give an opinion to the State Funding Board on the fairness of the pricing of the Bonds by the underwriting syndicate. PFM has not independently verified the factual information contained in this Official Statement, but relied on the information supplied by the State and other sources and the State's certification as to the Official Statement.

## VERIFICATION AGENT

The arithmetical accuracy of certain computations included in the schedules provided by PFM on behalf of the State relating to (a) computation of forecasted receipts of principal and interest on the obligations deposited under the Refunding Trust Agreement and the forecasted payments of principal and interest to redeem the Refunded Bonds, and (b) computation of the yields on the Refunding Bonds and the obligations deposited under the Refunding Trust Agreement was examined by Robert Thomas, CPA, LLC. Such computations were based solely upon assumptions and information supplied by PFM on behalf of the State. Robert Thomas, CPA, LLC has restricted its procedures to examining the arithmetical accuracy of certain computations and has not made any study or evaluation of the assumptions and information upon which the computations are based and, accordingly, has not expressed an opinion on the data used, the reasonableness of the assumptions, or the achievability of the forecasted outcome.

## RATINGS

Moody's Investors Service, Inc. (Moody's), Standard & Poor's Ratings Services ("Standard & Poor's) and Fitch Ratings ("Fitch") have given the Bonds ratings of Aaa, AA+ and AAA, respectively. Such ratings reflect only the respective views of such organizations and an explanation of the significance of a rating may be obtained only from the rating agency furnishing the same. There is no assurance that any rating will be maintained for a given period of time or that it will not be revised downward or withdrawn entirely by the rating agency if in its judgment, circumstances so warrant. Any such downward revision or withdrawal of ratings may have an adverse affect on the market price of the Bonds.

Moody's has assigned a negative outlook to Tennessee's rating on the basis of the State's indirect links to the United States government. On August 4, 2011, Moody's confirmed the Aaa ratings of Tennessee and four other states previously identified as indirectly linked to the U.S. government. These actions followed the August 2, 2011 confirmation by Moody's of the United States Aaa governmental bond rating and assignment of a negative outlook. Moody's stated: "In conjunction with assignment of a negative outlook (to) the U.S. government, the outlooks for indirectly linked U.S. public finance issuers (including Tennessee) have been revised to negative…(and)…their outlooks will be reviewed on a case by case basis in the coming weeks." The complete press release is available at: http://www.moodys.com/research/Correction-to-Text-Aug-4-2011-Moodys-confirms-Aaa-ratings?lang=en&cy=global&docid=PR_224016. The content of such release is maintained solely by Moody's and the State assumes no responsibility for the content or continued availability thereof.

## LEGAL OPINIONS

The validity of the Bonds will be approved by the legal opinion of Hawkins Delafield & Wood LLP, New York, New York, Bond Counsel to the State. For the proposed form of Bond Counsel opinion relating to the Bonds, see Appendix C. Certain legal matters will be passed upon by the Attorney General and Reporter of the State of Tennessee, as counsel to the State Funding Board and for the Underwriters by their counsel, Bass, Berry & Sims PLC, Nashville, Tennessee. No representation is made to the holders of the Bonds that any such counsel have verified the accuracy, completeness or fairness of the statements in this Official Statement, and such counsel assume no responsibility to the holders of the Bonds except for the matters that will be set forth in their respective opinions.

## CONTINUING DISCLOSURE

The State has authorized Continuing Disclosure Undertaking (the "Undertaking") with respect to the Bonds to assist in complying with U.S. Securities and Exchange Commission Rule 15c2-12(b)(5) (the "Rule"). The Undertaking will be for the benefit of the holders of the respective Bonds, and beneficial owners will be third-party beneficiaries thereof. The form of the undertaking is included herein as Appendix E.

The State has not failed to comply in any material respect with any previous undertaking in a written contract or agreement specified in the Rule.

## FORWARD LOOKING STATEMENTS

The statements contained in this Official Statement, and in any other information provided that are not purely historic, are forward-looking statements, including statements regarding the expectations, hopes, intentions, or strategies regarding the future.

Readers should not place undue reliance on forward-looking statements. All forward-looking statements included in this Official Statement are based on information available on the date hereof, and assumes no obligation to update any such forward-looking statements.

The forward-looking statements herein are necessarily based on various assumptions and estimates and are inherently subject to various risks and uncertainties, including risks and uncertainties relating to the possible invalidity of the underlying assumptions and estimates and possible changes or developments in social, economic, business, industry, market, legal and regulatory circumstances and conditions and actions taken or omitted to be taken by third parties, including customers, suppliers, business partners and competitors, and legislative, judicial and other governmental authorities and officials. Assumptions related to the foregoing involve judgments with respect to, among other things, future economic, competitive, and market conditions and future business and policy decisions, all of which are difficult or impossible to predict accurately and, therefore, there can be no assurance that the forward-looking statements included in this Official Statement would prove to be accurate

## MISCELLANEOUS

Any statements in this Official Statement involving matters of opinion or estimates, whether or not expressly so stated, are intended as such and not as representatives of fact. No representation is made that such statements will be realized.

All financial and other information presented in this Official Statement has been provided by the State from its records, except for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information, and it is not intended to indicate future or continuing trends in the financial position or other affairs of the State. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future.

References to and summaries of provisions of the Constitution and laws of the State or of any other documents referred to in this Official Statement are qualified in their entirety by reference to the complete provisions thereof.

This Official Statement is not to be construed as a contract or agreement between the State and the purchasers or holders of any of the Bonds.

STATE OF TENNESSEE

________________________________

By: Justin P. Wilson
Comptroller of the Treasury;
Secretary of the Funding
Board of the State of
Tennessee

**Financial Statements**

The Comprehensive Annual Financial Report ("CAFR") of the State, including the audited Basic Financial Statements, for the fiscal year ended June 30, 2010 has been filed with the Municipal Securities Rulemaking Board through its Electronic Municipal Market Access ("EMMA") system (see "Continuing Disclosure" and Appendix E) and is obtainable from them in accordance with their procedures. A printed version is also available upon request to the State Funding Board, James K. Polk State Office Building, Suite 1600, 505 Deaderick Street, Nashville, Tennessee 37243-1402, telephone (615) 401-7872, fax (615) 741-5986. The 2010 CAFR and certain prior year CAFRs are posted on the State's website at **http://tn.gov/finance/act/cafr.html**.

The following reports, each of which are included in the 2010 CAFR and have been posted on the State's website, are incorporated herein by reference:

Auditor's Report

Management's Discussion and Analysis

Basic Financial Statements:
- Government-wide Financial Statements:
  - Statement of Net Assets
  - Statement of Activities
- Fund Financial Statements:
  - Balance Sheet-Governmental Funds
  - Statement of Revenues, Expenditures, and Changes in Fund Balances-Governmental Funds
  - Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities
  - Statement of Net Assets-Proprietary Funds
  - Statement of Revenues, Expenses, and Changes in Fund Net Assets-Proprietary Funds
  - Statement of Cash Flows-Propriety Funds
  - Statement of Fiduciary Net Assets-Fiduciary Funds
  - Statement of Changes in Fiduciary Net Assets-Fiduciary Funds
- Notes to the Financial Statements

Required Supplementary Information:
- Infrastructure Assets Reported Using the Modified Approach
- Other Post Employment Benefits Schedule of Funding Progress – Primary Government
- Other Post Employment Benefits Schedule of Funding Progress – Component Units
- Two-Year Claims Development Table – Access TN Insurance Fund
- Schedule of Revenues, Expenditures, and Changes in Fund Balances-Budget and Actual-Major Governmental Funds
- Reconciliation of Budget to GAAP-Note to RSI

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**APPENDIX B**

**Statistical Section**

The Comprehensive Annual Financial Report ("CAFR") of the State, including selected statistical data (unaudited), for the fiscal year ended June 30, 2010 has been filed with the Municipal Securities Rulemaking Board through its Electronic Municipal Market Access ("EMMA") system (see "Continuing Disclosure" and Appendix E) and is obtainable from them in accordance with their procedures. A printed version is also available upon request to the State Funding Board, James K. Polk State Office Building, Suite 1600, 505 Deaderick Street, Nashville, Tennessee 37243-1402, telephone (615) 401-7872, fax (615) 741-5986. The 2010 CAFR and certain prior year CAFRs are posted on the State's website at **http://tn.gov/finance/act/cafr.html**.

The following statistical data, all of which is included in the 2010 CAFR and has been posted on the State's website, is incorporated herein by reference:

Financial Trends

Revenue Capacity

Debt Capacity

Demographic and Economic Information

Operating Information

Component Units

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**APPENDIX C**

**Form of Proposed Opinion of Bond Counsel**

______, 2011

The Honorable Governor and Members of
the Funding Board of the State of Tennessee
Nashville, Tennessee 37243

Dear Sirs:

**STATE OF TENNESSEE**
**GENERAL OBLIGATION BONDS**
**2011 SERIES A, $255,480,000***
**2011 REFUNDING SERIES B, $105,575,000***

At your request we have examined into the validity of $255,480,000* General Obligation Bonds, 2011 Series A (the "Series A Bonds"), and $105,575,000* General Obligation Bonds, 2011 Refunding Series B (the "Series B Bonds") (collectively the "Bonds) of the State of Tennessee (the "State"). The Bonds are dated as of ______, 2011 and mature, are subject to redemption prior to maturity, are payable and bear interest, all as provided in the resolution of the Funding Board hereinafter mentioned.

The Bonds recite that they are issued under and pursuant to and in full compliance with the Constitution and laws of the State, including specifically Title 9, Chapter 9, Tennessee Code Annotated, various Public Acts of the General Assembly of the State of Tennessee, and a resolution adopted by the Funding Board of the State of Tennessee on September 8, 2011, to fund capital projects of the State and to provide for the retirement at maturity of certain of the State's general obligation bond anticipation notes heretofore issued as commercial paper for such purposes in the case of the Series A Bonds or to provide for the refunding of certain of the State's outstanding general obligation bonds in the case of the Series B Bonds.

We have examined the Constitution and statutes of the State; certified copies of proceedings of the Funding Board of the State of Tennessee and Public Acts of the General Assembly of the State of Tennessee authorizing the issuance of the Bonds, and an executed Bond, and have made such other examination of law and fact, as we have considered appropriate for purposes of this opinion.

Based on the foregoing, we are of the opinion that:

(1) The Bonds have been authorized and issued in accordance with the Constitution and laws of the State, and constitute valid general obligations of the State for the payment of which as to both principal and interest the full faith and credit of the State is pledged. As additional security for all of the Bonds and interest thereon there is also pledged the annual proceeds of a tax of up to five cents per gallon upon gasoline; the annual proceeds of a special tax of one cent per gallon on petroleum products; one-half of the annual proceeds of motor vehicle registration fees now or hereafter required to be paid to the State, and the annual proceeds of the franchise taxes imposed by the franchise tax law of the State. All of the Bonds, together with interest thereon, are entitled to the benefit of the foregoing taxes, fees, and revenues and to share therein pro rata with any other obligations of the State that might be entitled to share therein as provided by Sections 9-9-101 to 9-9-208, inclusive, Tennessee Code

* Subject to change

Annotated. The State has not waived immunity from suit or extended its consent to be sued. Monetary actions against the State for breach of contractual obligations may be heard and determined under current law exclusively in the Tennessee Claims Commission, an administrative tribunal, where the State may be liable only for actual damages and certain costs.

(2) Under existing statutes and court decisions, (i) interest on the Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the “Code”), and (ii) interest on the Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. For any Bonds having original issue discount ("OID"), OID that has accrued and is properly allocable to the owners of such Bonds under Section 1288 of the Code is excludable from gross income for federal income tax purposes to the same extent as other interest on the Bonds. In rendering the opinions in this paragraph (2), we have relied on certain representations, certifications of fact, and statements of reasonable expectations made by the State in connection with the Bonds, and have assumed compliance by the State with certain ongoing covenants to comply with applicable requirements of the Code to assure the exclusion of the interest on the Bonds from gross income under Section 103 of the Code. Under the Code, noncompliance with such requirements may cause the interest on the Bonds to be included in gross income for Federal income tax purposes retroactive to the date of issuance thereof, irrespective of the date on which such noncompliance occurs or is discovered.

(3) Under the existing laws of the State, the Bonds and the interest thereon are free from taxation by the State or any county, municipality or taxing district of the State, except for inheritance, transfer and estate taxes and except to the extent such interest may be included within the measure of privilege taxes imposed pursuant to the laws of the State.

The opinions expressed in paragraph (1) above are subject to applicable bankruptcy, insolvency, reorganization, moratorium and other laws heretofore or hereafter enacted affecting creditors’ rights, and are subject to the application of principles of equity relating to or affecting the enforcement of contractual obligations, whether such enforceability is considered in a proceeding in equity or at law.

We express no opinion herein as to (i) Federal, state or local tax consequences arising with respect to the Bonds, or the ownership or disposition thereof, except as stated in paragraphs (2) and (3) above, (ii) the effect of any action taken or not taken, in reliance upon an opinion of other counsel, on the exclusion from gross income for Federal income tax purposes of interest on the Bonds, or under state or local tax law, or (iii) the accuracy, adequacy, sufficiency or completeness of the Official Statement dated _________ __, 2011 (or any update or amendment thereof or supplement thereto) relating to the Bonds, or any other financial or other information which has been or may be supplied to purchasers or prospective purchasers of the Bonds.

This letter is rendered solely with regard to the matters expressly opined on above and does not consider or extend to any documents, agreements, representations or other material or matters of any kind not specifically opined on above. No other opinions are intended nor should they be inferred.

This opinion is issued as of the date hereof, and we assume no obligation to update, revise or supplement this letter to reflect any action hereafter taken or not taken, or any facts or circumstances, or changes in law or in interpretations thereof, that may hereafter occur, or for any other reason.

Very truly yours,

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**APPENDIX D**

## BOOK-ENTRY ONLY SYSTEM

The Depository Trust Company ("DTC"), New York, New York, will act as securities depository for the Bonds. The Bonds will be issued as fully-registered bonds registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Bond certificate will be issued for each maturity of the Bonds of each series bearing interest at each interest rate, each in the aggregate principal amount of such maturity of each series bearing interest at such rate, and will be deposited with DTC.

DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments from over 100 countries that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has Standard & Poor's highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com.

Purchases of Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds on DTC's records. The ownership interest of each actual purchaser of each Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participant's records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of the Bonds with DTC and their registration in the name of Cede & Co or such other nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holding on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory and regulatory requirements as may be in effect from time to time. Beneficial Owners of the Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Bond documents. For example, Beneficial Owners of the Bonds may wish to ascertain that the nominee holding the Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

Redemption notices shall be sent to DTC. If less than all of the Bonds of a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the State as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal and interest payments on the Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the State or any Paying Agent, on payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name", and will be the responsibility of such Participant and not of DTC or the State or any Paying Agent, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the State or any Paying Agent, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct or Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the Bonds at any time by giving reasonable notice to the State. Under such circumstances, in the event that a successor securities depository is not obtained, Bond certificates are required to be printed and delivered.

The State may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, Bond certificates will be prepared and delivered to DTC.

THE FOREGOING INFORMATION CONCERNING DTC AND DTC'S BOOK-ENTRY ONLY SYSTEM HAS BEEN OBTAINED FROM DTC, A SOURCE THAT STATE BELIEVES TO BE RELIABLE, BUT THE STATE TAKES NO RESPONSIBILITY FOR THE ACCURACY THEREOF. NEITHER THE STATE, THE UNDERWRITERS, NOR THE PAYING AGENT AND REGISTRAR CAN MAKE ANY ASSURANCE THAT DTC OR THE DTC PARTICIPANTS WILL ACT IN A MANNER DESCRIBED HEREIN, NOR WILL THEY HAVE ANY RESPONSIBILITY OR OBLIGATION TO THE DTC PARTICIPANTS OR BENEFICIAL OWNERS FOR (1) SENDING TRANSACTION STATEMENTS; (2) MAINTAINING, SUPERVISING OR REVIEWING, THE ACCURACY OF, ANY RECORDS MAINTAINED BY DTC OR ANY DTC PARTICIPANT; (3) PAYMENT OR THE TIMELINESS OF PAYMENT BY DTC, ANY DIRECT DTC PARTICIPANT, OR ANY INDIRECT DTC PARTICIPANT TO ANY BENEFICIAL OWNER OF ANY AMOUNT DUE TO ANY BENEFICIAL OWNER IN RESPECT TO THE PRINCIPAL OR REDEMPTION PREMIUM, IF ANY, OR INTEREST ON BONDS; (4) DELIVERY OR TIMELY DELIVERY BY DTC OR ANY DTC PARTICIPANT TO ANY BENEFICIAL OWNER OF ANY NOTICE (INCLUDING NOTICE OF REDEMPTION) OR OTHER COMMUNICATIONS TO ANY BENEFICIAL OWNER WHICH IS REQUIRED OR PERMITTED UNDER THE TERMS OF THE BOND DOCUMENTS TO BE GIVEN TO BONDHOLDERS; (5) THE SELECTION OF THE BENEFICIAL OWNERS TO RECEIVE PAYMENT IN THE EVENT OF ANY PARTIAL REDEMPTION OF BONDS; OR (6) ANY ACTION TAKEN BY DTC OR ITS NOMINEE AS THE REGISTERED OWNER OF THE BONDS.

So long as Cede & Co. is the registered owners of the Bonds, as nominee for DTC, references in the Official Statement to the Bondholders or registered owners of the Bonds (other than under the caption "Tax Matters" in the Official Statement) shall mean Cede & Co. or any other DTC nominee, as aforesaid, and shall not mean the Beneficial Owners of the Bonds.

**APPENDIX E**

CONTINUING DISCLOSURE UNDERTAKING

This Continuing Disclosure Undertaking (the "Undertaking") is dated and made as of October __, 2011, by the State of Tennessee (the "State") in connection with the issuance of the State's $________ aggregate principal amount of General Obligation Bonds, 2011 Series A and General Obligation Bonds, 2011 Refunding Series B (collectively the "Bonds"). As authorized by Section 10 of the resolution (the "Bond Resolution") of the Funding Board of the State of Tennessee (the "Funding Board") adopted on September 8, 2011, authorizing the Bonds, the State agrees as follows:

ARTICLE I

Definitions

Section 1.1. Definitions. The following terms used in this Undertaking shall have the following respective meanings:

(1) "Annual Financial Information" means (i) updated versions of the following financial information and operating data contained in, or incorporated by reference pursuant to an Appendix to, the Official Statement with respect to the State, for each fiscal year of the State:

- Collections for Special Taxes
- Total Sales and Use Tax Collections
- Allocation of Sales and Use Tax to Debt Service
- Outstanding General Obligation Bonded Indebtedness
- Long-Term General Obligation Bonded Debt Service by Fiscal Year and Maturity
- Maximum and Actual Principal Amounts of Commercial Paper Outstanding
- Other Post-Employment Benefits
  - Unfunded Actuarial Liability
  - Annual Required Contribution
- Rainy Day Fund Reserve Balance
- TennCare Budget Growth
- Tennessee Consolidated Retirement System
  - Statistical data
  - Tables
- Debt of Certain Agencies and Authorities
  - Tennessee Local Development Authority
  - Tennessee State School Bond Authority
  - Tennessee Housing Development Agency
  - Watkins Institute
  - State Veterans' Homes Board
- The statistical data incorporated by reference in Appendix B to the Official Statement

and (ii) the information regarding amendments to this Undertaking required pursuant to Sections 4.2(c) and (d) of this Undertaking. Annual Financial Information shall include Audited Financial Statements, if available, or Unaudited Financial Statements.

The descriptions contained in clause (i) above of financial information and operating data constituting Annual Financial Information are of general categories or types of financial information and operating data. When such descriptions include information that no longer can be generated because the operations to which it related have been materially changed or discontinued, a statement to that effect shall be provided in lieu of such information.

(2) "Audited Financial Statements" means the annual financial statements of the State, audited by the Comptroller of the Treasury, Division of State Audit, as now required by State law (or such other auditor as hereafter may be required or permitted by State law). Audited Financial Statements shall be prepared in accordance with GAAP.

(3) "Counsel" means Hawkins Delafield & Wood LLP or other nationally recognized bond counsel or counsel expert in federal securities laws, in each case acceptable to the State.

(4) "EMMA" means the MSRB's Electronic Municipal Market Access system or its successor

(5) "GAAP" means generally accepted accounting principles for governmental units as prescribed by the Governmental Accounting Standards Board, the Financial Accounting Standards Board, or any successor to the duties and responsibilities of either of them.

(6) "MSRB" means the Municipal Securities Rulemaking Board established pursuant to the provisions of Section 15B(b) of the Securities Exchange Act of 1934, as amended, or any successor to the MSRB or the functions of the MSRB contemplated by this Undertaking.

(7) "Notice Event" means any of the following events with respect to the Bonds:

(i) principal and interest payment delinquencies;

(ii) non-payment related defaults, if material;

(iii) unscheduled draws on debt service reserves reflecting financial difficulties;

(iv) unscheduled draws on credit enhancements reflecting financial difficulties;

(v) substitution of credit or liquidity providers, or their failure to perform;

(vi) adverse tax opinions, or material notices of determinations with respect to the tax status of the Bonds or other material events affecting the tax-exempt status of the Bonds;

(vii) modifications to rights of Bondholders, if material;

(viii) bond calls, if material, and tender offers;

(ix) defeasances;

(x) release, substitution, or sale of property securing repayment of the Bonds, if material;

(xi) rating changes:

(xii) bankruptcy, insolvency, receivership or similar event of the State;

(Note to clause (xii): For the purposes of the event identified in clause (xii) above, the event is considered to occur when any of the following occur: the appointment of a receiver, fiscal agent or similar officer for the State in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or government authority has assumed jurisdiction over substantially all of the assets or business of the State, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the State.)

(xiii) the consummation of a merger, consolidation, or acquisition involving the State or the sale of all or substantially all of the assets of the State, other than in the ordinary course of business, the entry into a definitive agreement to undertake such action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and

(xiv) appointment of a successor or additional trustee or the change of name of a trustee, if material.

(8) "Notice Event Notice" means notice of a Notice Event.

(9) "Official Statement" means the Official Statement dated October __, 2011 of the State relating to the Bonds.

(10) "Rule" means Rule 15c2-12 promulgated by the SEC under the Securities Exchange Act of 1934 (17 CFR Part 240, §240.15c2-12), as in effect on the effective date hereof, including any official interpretations thereof.

(11) "SEC" means the United States Securities and Exchange Commission.

(12) "Unaudited Financial Statements" means the same as Audited Financial Statements, except that they shall not have been audited.

ARTICLE II

The Undertaking

Section 2.1. Purpose. This Undertaking is being executed, delivered and made solely to assist the underwriters of the Bonds in complying with subsection (b)(5) of the Rule.

Section 2.2. Annual Financial Information. (a) The State shall provide Annual Financial Information with respect to each fiscal year of the State, commencing with the fiscal year ending June 30, 2011, by no later than 7 months after the end of the respective fiscal year, to the MSRB.

(b) The State shall provide, in a timely manner, notice of any failure of the State to provide the Annual Financial Information by the date specified in subsection (a) above to the MSRB.

Section 2.3. Audited Financial Statements. If not provided as part of Annual Financial Information by the date required by Section 2.2(a) hereof because not available, the State shall provide Audited Financial Statements, when and if available, to the MSRB.

Section 2.4. Notice Events. (a) If a Notice Event occurs, the State shall provide, in a timely manner not in excess of ten (10) business days after the occurrence of such Notice Event, a Notice Event Notice to the MSRB.

(b) Any such notice of a defeasance of Bonds shall state whether the Bonds have been escrowed to maturity or to an earlier redemption date and the timing of such maturity or redemption.

Section 2.5. Additional Disclosure Obligations. The State acknowledges and understands that other State and federal laws, including but not limited to the Securities Act of 1933 and Rule 10b-5 promulgated under the Securities Exchange Act of 1934, may apply to the State and that, under some circumstances, additional disclosures or other action in addition to those required by this Undertaking may be required to enable the State to fully discharge all of its duties and obligations under such laws.

Section 2.6. Additional Information. Nothing in this Undertaking shall be deemed to prevent the State from disseminating any other information, using the means of dissemination set forth in this Undertaking or any other means of communication, or including any other information in any Annual Financial Information or

Notice Event Notice, in addition to that which is required by this Undertaking. If the State chooses to do so, the State shall have no obligation under this Undertaking to update such additional information or include it in any future Annual Financial Information or Notice Event Notice.

Section 2.7. No Previous Non-Compliance. The State represents that since July 3, 1995, it has not failed to comply in any material respect with any previous Undertaking in a written contract or agreement specified in paragraph (b)(5)(i) of the Rule.

ARTICLE III

Operating Rules

Section 3.1. Reference to Other Documents. It shall be sufficient for purposes of Section 2.2 hereof if the State provides Annual Financial Information by specific reference to documents (i) available to the public on the MSRB Internet Web site (currently, www.emma.msrb.org) or (ii) filed with the SEC. The provisions of this Section shall not apply to Notice Event Notices Events pursuant to Section 2.4 hereof.

Section 3.2. Submission of Information. Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time.

Section 3.3. Filing with Certain Dissemination Agents or Conduits. The State may from time to time designate an agent to act on its behalf in providing or filing notices, documents and information as required of the State under this Undertaking, and revoke or modify any such designation.

Section 3.4. Transmission of Notices, Documents and Information. (a) Unless otherwise required by the MSRB, all notices, documents and information provided to the MSRB shall be provided to EMMA, the current Internet Web address of which is www.emma.msrb.org.

(b) All notices, documents and information provided to the MSRB shall be provided in an electronic format as prescribed by the MSRB (currently, portable document format (pdf) which after January 1, 2010, must be word-searchable except for non textual elements) and shall be accompanied by identifying information as prescribed by the MSRB.

Section 3.5. Fiscal Year. (a) The State's current fiscal year is July 1 – June 30. The State shall promptly notify the MSRB of each change in its fiscal year.

(b) The State shall provide Annual Financial Information at least annually notwithstanding any fiscal year longer than 12 calendar months.

ARTICLE IV

Effective Date, Termination, Amendment and Enforcement

Section 4.1. Effective Date; Termination. (a) This Undertaking shall be effective upon the issuance of the Bonds.

(b) The State's obligations under this Undertaking shall terminate upon the legal defeasance, prior redemption or payment in full of all of the Bonds.

(c) This Undertaking, or any provision hereof, shall be null and void in the event that the State (1) receives an opinion of Counsel to the effect that those portions of the Rule which require this Undertaking, or such provision, as the case may be, do not or no longer apply to the Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as shall be specified in such opinion, and (2) delivers copies of such opinion to the MSRB.

Section 4.2. Amendment. (a) This Undertaking may be amended without the consent of the holders of the Bonds, if all of the following conditions are satisfied: (1) such amendment is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules and regulations) or in interpretations thereof, or a change in the identity, nature or status of the State or the type of business conducted thereby, (2) this Undertaking as so amended would have complied with the requirements of the Rule as of the date hereof, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the State shall have received an opinion of Counsel to the same effect as set forth in clause (2) above, (4) the State shall have received either an opinion of Counsel or a determination by a person, in each case unaffiliated with the State, to the effect that the amendment does not materially impair the interests of the holders of the outstanding Bonds, and (5) the State shall have delivered copies of such opinion(s) and amendment to the MSRB.

(b) This Undertaking may be amended without the consent of the holders of the Bonds if all of the following conditions are satisfied: (1) an amendment to the Rule is adopted, or a new or modified official interpretation of the Rule is issued, after the effective date hereof which is applicable to this Undertaking, (2) the State shall have received an opinion of Counsel to the effect that performance by the State under this Undertaking as so amended will not result in a violation of the Rule as so amended or officially interpreted and (3) the State shall have delivered copies of such opinion and amendment to the MSRB.

(c) To the extent any amendment to this Undertaking results in a change in the categories or types of financial information or operating data provided pursuant to this Undertaking, the first Annual Financial Information provided thereafter shall include a narrative explanation of the reasons for the amendment and the impact of the change in the type of operating data or financial information being provided.

(d) If an amendment is made pursuant to Section 4.2(a) hereof to the accounting principles to be followed by the State in preparing its financial statements, the Annual Financial Information for the fiscal year in which the change is made shall present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles. Such comparison shall include a qualitative and, to the extent reasonably feasible, quantitative discussion of the differences in the accounting principles and the impact of the change in the accounting principles on the presentation of the financial information.

Section 4.3. Contract; Benefit; Third-Party Beneficiaries; Enforcement. (a) The provisions of this Undertaking shall constitute a contract with and inure solely to the benefit of the holders from time to time of the Bonds, except that beneficial owners of Bonds shall be third-party beneficiaries of this Undertaking and shall be deemed to be holders of Bonds for purposes of Section 4.3(b) hereof. The provisions of this Undertaking shall create no rights in any person or entity except as provided in this subsection (a).

(b) The obligations of the State to comply with the provisions of this Undertaking shall be enforceable by any holder of outstanding Bonds; however, the holders' rights to enforce the provisions of this Undertaking shall be limited solely to a right, by action in mandamus or for specific performance, to compel performance of the State's obligations under this Undertaking.

(c) Any failure by the State to perform in accordance with this Undertaking shall not constitute a default or an event of default under the Bond Resolution or State law and shall not result in any acceleration of payment of the Bonds, and the rights and remedies provided by the Bond Resolution and applicable State law upon the occurrence of such a default or an event of default shall not apply to any such failure.

(d) This Undertaking shall be construed and interpreted in accordance with the laws of the State, and any suits and actions arising out of this Undertaking shall be instituted in a court of competent jurisdiction in the State; provided, however, that to the extent this Undertaking addresses matters of federal securities laws, including the Rule, this Undertaking shall be construed in accordance with such federal securities laws and official interpretations thereof.

Section 4.4. Effective Date. This Undertaking shall be effective upon the issuance and delivery by the State of the Bonds.

STATE OF TENNESSEE

By:___________________________________
Mary-Margaret Collier
Assistant Secretary, Funding Board
of the State of Tennessee, *and*
Director, Office of State and Local Finance,
State of Tennessee

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