

Municipal Tender and Exchange Transactions: Technical Concepts and Practical Observations

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SPEAKERS



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TENDER/EXCHANGE: BACKGROUND



- Outstanding Tax-Exempt Bonds with Above-Market Coupon Rate
 - Bonds are not currently callable
 - If bonds were callable, refinancing would produce significant savings for issuer
 - As an alternative to a taxable advance refunding or a delayed delivery structure, a public offer is made by the issuer for holders to either tender their bonds for cash or exchange their bonds for new bonds
 - Limited supply of investment grade tax-exempt bonds in market
 - Existing investors know and like the credit of these bonds

TENDER/EXCHANGE: BACKGROUND



- Tender Offer of Bonds – for cash, funded through issue of bonds
- Exchange Offer of Bonds – purchase from existing holders in exchange for new bonds
 - Issuer/Borrower may choose either or both offers depending on financial analysis and desired outcome
 - In addition to debt service savings, tender/exchange can help obtain bondholder consents for document changes
 - Funding of tender or exchange is generally contingent upon the issuance of new bonds

ISSUANCE CONSIDERATIONS



- Transaction Authority
 - Action authorizing bond issuance needs to include tender and/or exchange of bonds
 - Verify tender/exchange structure is consistent with underlying Bond Indenture terms
- Additional Finance Team Parties to Engage
 - Dealer Manager – firms engaged to serve as underwriters for bonds may also serve as Dealer Manager for tender or exchange of bonds
 - Information Agent and Tender Agent – firm specialized in identifying and engaging with bondholders, distribution of tender offer materials, interfacing with DTC, receiving and processing tenders

SECURITIES LAW CONSIDERATIONS



- Antifraud considerations: Sections 14(d) and 14(e) of the 1934 Act and Williams Act
- Factors Determining Tender Offer
 - Active/widespread solicitation of holders
 - Solicitation made for substantial percentage of outstanding bonds
 - Offer to purchase made at a premium over the prevailing market price
 - Terms of the offer are firm rather than negotiable
 - Offer contingent on the tender of a fixed amount of bonds
 - Offer open for limited time



- Timeline of Tender Offer
 - Sections 14(d) and 14(e) of the 34 Act and related Regulations 14D and 14E and antifraud provisions
 - Registered vs. Exempt Securities
 - Absence of clear guidance for exempt securities
 - MSRB fair dealing rules apply to broker-dealers acting as an agent for an issuer in connection with a tender offer
 - Disclosure must clearly set out the key dates and times for action on the tender

SECURITIES LAW CONSIDERATIONS (cont.)



- **Content of Tender Offer Disclosure:**

- Securities subject to tender and CUSIP numbers
- Specific Terms of the Offer, Issuer's Plan of Finance and Source of Funds for Payment
- Whether offer may be extended beyond announced expiration date and process for such extension
- Can the offeree withdraw and acceptance and the timing and procedures for such withdrawal
- If for less than all bonds of a maturity, the process for selecting bonds in the event of oversubscription
- Conditions for tender offer such as minimum amount of bonds that must be tendered, by maturity, for tender offer to proceed
- Is tender conditioned on the successful offering of an issue of bonds
- Rights of the issuer/borrower to withdraw the tender
- Fees payable by offerees in connection with tender
- Information on the required/expected future redemption of bonds not tendered
- Update of information about the issuer material to the decision since the last OS or continuing disclosure filing

ALTERNATIVE FINANCING STRUCTURES



- Taxable Advance Refunding
 - Issue new taxable bonds at new taxable rates
 - Defeasement of existing bonds incurring negative cost of carry to issuer
 - No reissuance of existing bonds but significant rise in value to holder
- Cash Tender Offer
 - Issue new tax-exempt bonds at new tax-exempt rates
 - Premium tender price paid based on pre-refunded value to holder (avoids negative arbitrage in escrow)
 - Taxable gain or loss to investor, need to find replacement investment



- Exchange Offer
 - Investors retain similar tax-exempt investment, new coupon and call date
 - Exchange is almost certainly a reissuance (deemed new issuance)
 - Questions about gain/loss amount and issue price of "new" bonds
 - Exchange factor matches value of new bonds to tender price for old
- Combination of Options
 - Tax impact for exchange may be very different than for cash tender
 - More complicated tax disclosure as part of tender offer
 - Cash tender prices may establish values of old bonds

TENDER AND EXCHANGE TAX PRINCIPLES



- Tender for Cash
 - Just a sale of bonds by holders: normal gain or loss
 - If tendering holder buys the new bonds, it is not an exchange
- Exchanges
 - Exchanging one debt instrument for another is a modification not a sale
 - Tax treatment depends on whether the modification is substantial enough to cause a reissuance
 - Change in yield (and call date) are likely to be significant, but a reissuance may not always be clear. Then what?

TENDER AND EXCHANGE TAX DISCLOSURE



- Two Separate Disclosure Documents
 - Formal tender/exchange offer document describes tax impact on holders that choose to tender or exchange
 - Offering document for new bonds and new tax opinion use traditional forms
- Cash Tender
 - Simple gain/loss disclosure in tender offer document
 - Standard tax disclosure in new offering document

TENDER / EXCHANGE TAX DISCLOSURE (cont.)



- If Exchange but no Reissuance
 - No tax event for holder
 - Offering document for new bonds, but no new tax opinion?
- If Exchange and Reissuance
 - Gain/loss based on difference between holder's existing basis in the old bonds and the issue price of the new bonds
 - Holders want to know their tax treatment
 - Standard tax disclosure in new offering document
 - See reporting requirements discussion

TENDER AND EXCHANGE REPORTING REQUIREMENTS



- Exchange and Reissuance (cont.)
 - Regulations Section 1.1273-2(f)(9) consistency requirement
 - Issuer determines if new bonds are traded on established market
 - If traded on established market, issuer must determine and provide fair market value (issue price) to holders in a commercially reasonable fashion within 90 days
 - If not traded on established market, then what?
 - IRC Section 6045B imposes a more comprehensive requirement
 - Reporting requirements are very similar

ISSUE PRICE (Under Code Section 1273)



- Issue price is determined separately for each issue of bonds, but issue in this context means bonds with the same credit and payment terms (same CUSIP?). See definition of "issue" in Regulations Section 1.1275-1(f)
- Exchanges are debt issued for property
 - If new debt is traded on established market, then issue price is fair market value of new debt. See 1.1273-2(b)
 - If new debt is not traded on established market but old debt is traded on established market, then issue price is FMV of old debt. See 1.1273-2(c)
 - If neither new debt nor old debt is traded on established market, then the issue price generally is the stated principal amount of new debt. See 1.1273-2(d)

ISSUE PRICE RULES (Cont.)



- Traded on Established Market means both:
 - Outstanding principal amount of issue/CUSIP more than \$100 million (see 1.1273-2(f)(6)), and
 - Actually traded on an established market
 - Actual sales or pricing quotes (see 1.1273-2(f)(1))
 - 15 days before or after the exchange (issue date)
- An exchange combined with a cash tender offer should mean the old bond CUSIPs that are tendered in part are always publicly traded if they are outstanding in a principal amount of more than \$100 million

THOUGHTS ABOUT FAIR MARKET VALUE



- Issuer is obligated to determine FMV and tell holders
 - But holders can determine their own FMV if disclose to IRS
- How does issuer determine FMV? See 1.1273-2(f)(5)
 - Look at actual trades or offers over what period?
- Does cash tender price on old bonds, whether or not accepted, establish FMV on old and new bonds?
 - Offer is the same except that bonds replace the cash
 - Offer is at a premium over perceived market to induce tenders
- Is an exact issue price required for tax-exemption or to report to holders?

OTHER TWISTS AND TURNS



- For new CUSIP issued for cash and also in exchange, a substantial amount of cash sales overrides the other rules. See 1.1273-2(a)
 - But the rules are not symmetrical if a substantial amount is not sold for cash. See 1.1273-2(d)
- Does secondary market bond insurance on a partial CUSIP create two issues?
- Combining Two Old CUSIPs Into One New CUSIP
 - Possible split issue price of new CUSIP
- Bond Purchase Agreements: underwriting but no public offering



QUESTIONS?

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Charles Cardall is a tax partner in the San Francisco office and also a member of the Public Finance Practice Group. Chas was chair of Orrick's Tax Practice Group from 2015 to 2022. Chas primarily focuses his practice on municipal finance tax and nonprofit corporation tax matters.

Practice Areas

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Education

- J.D., University of California, Hastings College of the Law, 1988
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Memberships

- State Bar of California
- National Association of Bond Lawyers, Chair, General Tax Matters Committee, 1999
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Education

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Clerkships/Externships

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