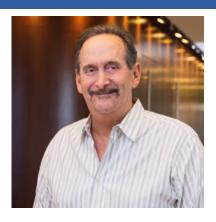
Update on Tax-Exempt Advance Refunding Alternatives Larry Sobel and Barbara Jane League

This webinar is designed to provide Orrick/The Bond Buyer clients and contacts with information they can use to more effectively manage their businesses and access Orrick/The Bond Buyer resources. The contents of this webinar are for informational purposes only. None of the lawyers and other professionals who are speaking today are rendering legal or other professional advice or opinions on specific facts or matters. We encourage you to reach out to your Orrick attorney to discuss the particular facts of your situation.

Larry Sobel





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Education

- J.D., University of Pennsylvania Law School, 1976, cum laude
- B.S., Drexel University, 1973, magna cum laude

Memberships

- American Bar Association, Section of Taxation, Tax Exempt Finance Committee
- National Association of Bond Lawyers, Tax Exempt Finance Committee
- State Bar of California
- District of Columbia Bar
- State Bar of New York
- Pennsylvania Bar Association
- State Bar of Texas

Admissions

- California
- New York
- Texas

Larry Sobel, is a tax partner in the Los Angeles and Houston offices. Larry has more than 35 years of experience in federal tax laws and regulations relating to all types of tax-exempt financings, particularly public power, private activity bonds such as airport facilities, colleges and universities and hospitals and exempt organizations and advance refundings issues.

As both bond counsel and underwriter's counsel, he has been responsible for structuring and analyzing the tax aspects of many tax-exempt financings throughout the country.

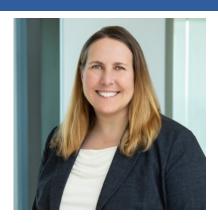
Larry has extensive experience in handling IRS audits of bond transactions. He has represented issuers in dozens of audits all of which have ended favorably either with the IRS issuing a "no change" letter or by negotiating a reasonable settlement when needed. Larry also has handled a number of submissions under the IRS' Voluntary Closing Agreement Program (or VCAP). The two most recent VCAP submissions represented cases of first impression for the IRS; one involving an issue of qualified energy conservation bonds relating to determining the amount of those bonds

eligible for the federal subsidy; the other involved the plan to convert a "new money" bond issue into an advance refunding (which did not meet all of the requirements for a tax-exempt advance refunding). Both cases ultimately were resolved on the original terms proposed to the IRS.

Larry has also been instrumental in developing new financing techniques and structures. He first devised the tax structure and analysis for, and has served as tax counsel on, Orrick's tax exempt tobacco revenue securitizations. He has developed the tax structure on numerous tax-exempt prepayments for natural gas for municipal utilities both within and outside of California.

Barbara Jane League





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Honors

- Martindale-Hubbell, Client Distinction Award, 2012
- "40 Under 40 Up and Comers," Jacksonville Business Journal. 2008

Admissions

- Florida
- Texas

Barbara provides tax advice in connection with tax-exempt financing transactions for cities, counties, states, school districts, charter schools, housing authorities, higher education authorities, state agencies and other tax-exempt organizations.

She also has significant experience representing nonprofit organizations. Formerly an attorney with the Chief Counsel of the Internal Revenue Service, Barbara has represented clients before the IRS in a variety of matters involving tax-exempt bonds, including audits and private letter ruling requests. She has participated in all facets of the tax analysis associated with the issuance of governmental purpose bonds, certain tax credit bonds, qualified 501(c)(3) bonds, qualified residential rental bonds and qualified small issue bonds.

Barbara has served on the Steering Committee and has chaired the Working Capital panel and the Bond Direct Purchase - Advanced Tax Topics panel for the Bond Attorneys' Workshop, the oldest and largest annual gathering of bond lawyers.

Alternatives to Advance Refundings



There are a number of alternatives to tax-exempt advance refundings:

- Tax-exempt current refundings
- Taxable advance refundings
- Taxable sandwich structures, where taxable bonds are issued to advance refund and later currently refunded by tax-exempt bonds
- Forward delivery refundings, including rate locks
- "Cinderella" structures, where taxable bonds convert to tax-exempt bonds at a time when a current refunding would be allowed
- Cash optimization, where the issuer uses cash to pay off outstanding bonds and issues new bonds for projects
- Tender offers and other bond purchase programs
- Anticipatory (and other types of) hedges, including forward starting swaps and swaptions
- Sale of call rights

Each Alternative Has Different Risks and Costs



Potential risks and costs include

- Increased transactional costs associated with new and unusual structures
- Increased borrowing costs as compared to traditional advance refunding
- Interest rate risk
- Ability to lock in savings upfront
- Counterparty risk
- Tax risk associated with future changes in tax law
- Credit risk associated with changes in issuer's credit rating
- Pricing transparency issues that could impact determination of issue price
- Opportunity costs
- Adequacy of disclosures for refunded bonds
- Authority in refunded bond documents or local law for new and unusual structures

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Tax-Exempt Current Refundings



- In new deals, Issuers are negotiating customized call options in the absence of advance refundings
 - Shorter par or premium optional call dates
 - Make-whole calls prior to par call or modified make whole calls
- Other options available but not widely used
 - Provisions to decrease interest rate upon defeasance or purchase of insurance
 - Provisions for purchase in lieu of redemption
 - Provisions to allow for future anticipatory hedges
 - Greater use of variable rate and short-term debt

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Taxable Advance Refundings/Sandwich Structures



- Taxable advance refundings are becoming quite common and increasing in market share
 - Interest rates remain at historically low levels
 - Eliminate many tax issues
 - Must be analyzed for universal cap issues when advance refunding taxexempt bonds
- Sandwich structures where issuers intend to take out taxable advance refunding bonds with tax-exempt refunding bonds remain popular; although it leaves open whether and how to lock in future rates.

Forward Delivery Refunding Bonds – One Obligation Structure



- In this structure, tax—exempt bonds are sold but are not delivered until a future date that is usually several months, or more, in the future
- Use has increased, but remains limited
 - Some issuers still seem uncertain about riskiness of structure
 - Forward structures may cost more
- Underwriters have developed a number of new products
 - Most have a forward period of a year or less
 - A few have the ability to have a longer forward period

Forward Delivery Refunding Bonds – Two Obligation Structure



- The key element to make this work is the transferability of either of the two obligations
- Issuer and lender enter into 2 separate agreements, one for a taxable loan and one for a tax exempt forward
- There needs to be no compulsion on the lender to keep the two agreements together-no legal, regulatory or economic compulsion
 - Lender must be able to sell either obligation and retain the other
 - What constitutes no economic compulsion will have to be determined on a case-by-case basis and the lender will have to certify that it is not compelled to retain both obligations

Forward Delivery Refunding Bonds – Two Obligation Structure with Option



- If there are post issuance compliance concerns, this structure appears also to contain bilateral options
- Issuer may have an option to issue tax exempt bonds or not. If that option is not exercised by the issuer, taxable loan stays in place and is subject to a make-whole call
- If issuer opts to issue tax exempt bonds, lender can accept or reject
- If lender rejects the tax exempt bond option, it will instead pay a breakage fee designed to give the issuer the original benefit of the bargain



- "Cinderella Bonds" are issued as taxable advance refunding bonds that "convert" to tax exempt current refunding bonds on a future date within 90 days of the redemption date (the "Call Date") of the original tax-exempt bonds that were advance refunded by the taxable issue
- Cinderella bonds are the elusive "holy grail" of tax-exempt advance refunding alternatives
- Orrick, and most bond counsel, believe that a Cinderella structure will only work if there is a reissuance of the taxable bonds at the time of conversion
 - Unless a reissuance takes place, the tax analysis is that only one issue ever existed, and it is a taxable advance refunding with a step-down rate
 - Thus, loan terms, including the interest rate change, cannot be "hard-wired" in the original loan documents such that the change from taxable interest to tax exempt interest is automatic
 - Ministerial requirements are not taken into account, e.g., signing tax certificate, bond counsel opinion, etc.



- For a reissuance to occur at the time of conversion, applicable Treasury Regulations require that some type of "significant modification" to the terms of the taxable loan/bonds must occur
 - Change of terms that are included in the original documents and that are executed automatically are not treated as a modification
- Significant modifications include mutual, or two-way, options that are not largely cosmetic and are not economically compelled
 - Whether a term is cosmetic or economically compelled is a factual question that must be addressed by the Issuer and the lender
- Unilateral options, such as an option of the Issuer to convert to a taxexempt interest rate that does not require the consent of the lender, is not a significant modification and does not cause a reissuance



Treas. Reg. § 1.1001-3(e)(2)(iii) states that an alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless -

- The option is unilateral; and
- In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.
- Ex. Bonds pay coupon of 5% for 2 years (taxable), at which point the coupon changes to 4.50% taxable <u>assuming bond counsel can give a tax-exempt opinion if requested</u>, except that holder has the option to reject the 4.50% coupon and instead get 4.24% tax-exempt.

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Treas. Reg. § 1.1001-3(e)(3) states that an option is unilateral only if, under the terms of an instrument or under applicable law -

- There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related to the issuer;
- The exercise of the option does not require the consent or approval of -
 - The other party;
 - A related person, whether or not that person is a party to the instrument; or
 - A court or arbitrator; and
- The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information.

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- We need bilateral options to cause a reissuance
- What kinds of factors may lead to a bilateral option
 - Choice between taxable and tax-exempt debt at conversion
 - Need 25 basis points difference in rates
 - Require consideration to be given
 - Deferral of principal and interest

Cash Optimization



- Cash optimization is always a popular option
- Need to be careful to document in a way that does not create replacement proceeds. Many tax counsel require
 - no "nexus" between the equity defeasance and the project to be financed
 - The equity defeasance of the outstanding bonds and the closing of the new money bonds to be separated (defeasance should be first)
 - The two transactions to be priced separately
 - The new money bonds could have been issued without defeasing the outstanding Bonds, e.g., the new money bonds would satisfy any applicable 'additional bonds' test even if the outstanding bonds were not defeased.

Tender Refundings and Other Buy-Back Programs



- Issuer buys back its bonds with proceeds of new current refunding bonds
- More securities law than tax law issues, especially if the buy-back program involves a "tender offer"
- What is a tender offer? What is not a tender offer?
 - Issuer or borrower engages broker-dealer to purchase up to \$25 million of its outstanding \$100 million in bonds at price range of 92-95 by negotiating with individual holders
 - Broker-dealer is instead instructed to offer a fixed price of 93 to all outstanding holders
- Consequences of being a tender offer (Section 14(e) of 1934 Act)

Tender Refundings and Other Buy-Back Programs (cont.)



- Some practical challenges
 - Difficulty in identifying bond holders
 - Difficulty in purchasing enough bonds to accomplish the purpose of the refunding
 - May have to pay premium above market if not simply purchasing what is available in the open market
- Variation: resell purchased bonds instead of cancelling them
 - After changing terms of the purchased bonds to current market or eliminating unwarranted covenants, the issuer may sell the bonds to new purchasers who agree (by the act of purchasing the bonds) to the amendments of the Indenture
 - Sources might be cash on hand, temporary borrowing repaid from proceeds of the sale of the purchased bonds, or refunding bonds using proceeds of sale of purchased bonds for any lawful purpose

Bondholder/Bank Renegotiations



- Issuer generally must approve changes, usually requires a formal approval by the governing body
- Ability to obtain approval from multiple bondholders is uncertain and can be difficult
- Issuer or holder initiated negotiations for issuer to be paid to extend the non-call period
- Tax counsel should review for reissuance concerns
 - Not always clear if changes trigger a reissuance
 - May have to obtain new opinion if reissuance
 - Usually requires tax due diligence to be updated
 - New tax certificate and 8038-G filing
 - May trigger tax consequences for holders

Questions?





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