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EFFECT OF SEQUESTER ON DIRECT-PAY BONDS

Beginning as early as 2013, the subsidy that issuers receive under certain tax credit bond programs, including “Build America Bonds” (“BABs”),¹ may be reduced in the event of budgetary sequestration, according to a recent report of the United States Office of Management and Budget (“OMB”). NABL members whose clients have issued, underwritten or purchased such “direct-pay” bonds should be aware the effect the so-called “sequester” may have on them. In addition to a reduction in the subsidy payments, depending on the documents under which the bonds were issued, certain extraordinary call provisions may be triggered.

Effect of Sequestration on BABs Subsidy Payments

The Budget Control Act of 2011 (the “BCA”) requires that the Director of OMB calculate each year for the next 10 years, using a statutory formula, cuts to federal programs necessary to reduce spending to levels specified in the BCA. These cuts are referred to as the “sequester.” The President is required each year to issue an order implementing the cuts for that year. The first such cuts are to be ordered January 2, 2013, for fiscal year 2013. These automatic, formula cuts may be avoided or mitigated if Congress, prior to January 2, 2013, enacts other cuts of an equal or larger amount or takes other action to postpone or change the provisions of the BCA. To date, Congress has not taken any such action. Congress could also, after January 2, 2013, rescind or alter the cuts provided for in the BCA.

In August 2012, Congress required OMB to provide estimates of the cuts to specific programs that would be ordered on January 2, 2013, if sequestration occurs. On September 14, 2012, OMB provided a report containing those estimates. Among the cuts identified by OMB were cuts to the subsidy payments to be made to issuers of “direct-pay” bonds, such as BABs. OMB estimated that payments to issuers of “direct-pay” bonds would be cut by 7.6 percent in 2013. It is too soon to predict by what percentage, if any, cuts would be made to BAB and other “direct-pay” subsidies in 2014 and thereafter.

Impact on Early Redemption Provisions

BABs issues, like most municipal bonds, typically include provisions that permit the redemption of the BABs prior to maturity. Since BABs are taxable bonds, they were frequently marketed in the corporate market where “make whole” call (“MWC”) premiums² were routine and

¹These include, among other bonds, qualified school construction bonds, qualified energy conservation bonds, qualified zone academy bonds, and clean renewal energy bonds. The balance of this alert will refer only to BABs, although the issues discussed may be equally applicable to such other types of tax credit bonds for which the issuer elected to receive a direct payment from the federal government.

²A MWC is typically the greater of the present value of future debt service payments remaining on the bond or the initial offering price (but not less than par) of the bond. Such present value is generally determined by discounting remaining debt service payments at the rates on U.S. Treasury securities with a term comparable to the bond being redeemed, plus a specified spread.

expected. More traditional municipal call features, such as par or nominal redemption premium calls after a “no-call” period, were less commonly used.

In addition, many BABs issues also contain extraordinary optional call provisions where, upon the occurrence of an “extraordinary event,” typically including a change in the BABs legislation that reduces or eliminates the federal subsidy payments, the issuer is given the option to call the BABs, often at a price that is lower than a MWC. The extent to which sequestration triggers an issuer’s right to exercise such an “extraordinary event” call provision in a particular transaction will depend upon the exact wording used in the bond documents defining the “extraordinary event.” NABL members whose clients have issued, underwritten or purchased BABs may want to review the documents for such financings with their clients and discuss the potential ramifications of a sequester, should it come to pass, including the call provisions in such documents.