NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

BANK PRODUCTS & DIRECT PURCHASES – GENERAL CONSIDERATIONS (NON-TAX)

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In this panel, we will discuss structuring and legal considerations that arise with respect to bank products and in private placement bond issues and bank loans. Topics to be discussed include a brief overview of and trends in bank products, such as letters of credit, hybrid financings, liquidity and operational financings, and in bank loans and other direct-placement financings; securities law considerations; negotiation of covenants and other contract terms; use of forward delivery arrangements, "Cinderella" and other refunding tools; application of certain MSRB rules; roles and responsibilities of Municipal Advisors and Placement Agents; and considerations relating to continuing disclosure "financial obligation" filings. The session will emphasize general concepts which practitioners may face on direct purchase transactions and specific provisions that are frequently negotiated in such transactions.

Terminology/Terms of Convenience

In this outline, generic terms are used for convenience. It is intended that the meaning of such terms will be apparent to the reader. In this context, please see "Terminology" in the back of this outline.

I. DIRECT PURCHASE OF BONDS

A. EVOLUTION OF DIRECT PURCHASE BONDS

As used in this outline, the term "direct purchase" refers to the purchase of a bond, note or other obligation of indebtedness (tax-exempt or taxable) (a "Bond") by a commercial bank without an underwriting or public offering. The Bond may evidence of a loan from the bank to the Issuer or Borrower, which terms may be in the Bond certificate, or captured in another financing document, such as a loan agreement, financing agreement, continuing covenant agreement, note purchase agreement, or other instrument.

Prior to the 1986 Tax Act, direct purchase had been a popular method of tax-exempt financing. However, the 100% loss of the cost of carry instituted by the 1986 Tax Act[1] dissuaded commercial banks from providing this product, while the expansion of the tax-exempt mutual fund industry created a robust market for variable rate demand bonds ("VRDBs") enhanced or guaranteed by Letters of Credit. The combination of these factors tended to drive out of the tax-exempt arena all commercial banks with ratings less than those required by the mutual funds (at least A-1/P-1 for a short-term rating), unless a confirming Letter of Credit with the appropriate ratings could be obtained.

The 1986 Tax Act contained an exception to the 100% loss of cost of carry rule for "qualified tax-exempt obligations," which are commonly known as "bank qualified obligations" or "BQ obligations." However, the exception is narrow. For example, only certain tax-exempt obligations issued in a year in which the Issuer issued $10,000,000 or less in tax-exempt obligations may be designated as BQ obligations.

This exception was expanded briefly by the American Recovery and Reinvestment Act of 2009 ("ARRA"), which increased the $10,000,000 limit to $30,000,000 for 2009 and 2010 and by providing that, for qualified 501(c)(3) Bonds, the $30,000,000 would be measured per 501(c)(3) Borrower and not per conduit Issuer for 2009 and 2010. In addition, ARRA provided that tax-exempt items up to 2% of a bank's total adjusted assets could be ignored for the purpose of calculating the loss of cost of carry. These changes resulted in a flood of direct purchase deals in

[1] Section 265 of the Internal Revenue Code of 1986, as amended (the "IRC"), provides that taxable entities, such as commercial banks, lose a portion of the deduction to which they would have otherwise been entitled for the interest that the entities pay its depositors, CD-holders, etc. The portion disallowed is equal to the ratio that the entities' adjusted basis for its investments in tax–exempt obligations that are not bank-qualified bears to the entities' total adjusted basis for all assets.

2009 and 2010 for 501(c)(3) borrowers and brought many smaller banks into the direct purchase market.

Although the ARRA provisions expired on December 31, 2010, the market for the direct purchase of Bonds remained relatively strong through the end of 2017. The next hurdle in the direct placement of municipal bonds was the adoption of the 2017 Tax Cuts and Jobs Act ("TCJA"), which became effective January 1, 2018. The TCJA reduced the maximum federal corporate tax rate from 35% to a flat corporate rate of 21%, causing a reduction in most banks' return on tax-exempt investments and thereby causing indicative rates in proposed direct purchases to increase to levels that, in many cases, made direct purchases less attractive than a public market option. The TCJA also impacted the municipal market by eliminating the availability of certain tax-exempt advance refundings.

The volatility in the public markets that occurred in March 2020, at the outset of the COVID-19 pandemic, again increased levels of direct purchase activity. As the municipal markets were stressed after the emergency declaration, many municipalities were similarly stressed to obtain capital funding for projects and to react to lost revenue and costs of responding to the pandemic. This led to a rise in private placements for capital as well as lines of credit and other liquidity loans to reduce immediate capital needs and assist with cash flow.

Most of the discussion below will focus on the situation where a commercial bank is buying Bonds for its own portfolio. The financial terms of such a direct purchase of Bonds are limited only by the ingenuity of the parties. Some popular structures include:

- Long-term fixed rate transactions where the Bonds bear interest at a fixed rate for multiple years and the Bonds mature at the end of that period. Many banks or other lenders that purchase bonds or notes (referred to herein as "Lender") will not offer such products with a term of over 15 or 20 years, however, there are exceptions.

- Formula rate adjustment transactions through the life of the Bonds, in which the Bonds are issued for a 15-, 20-, 25- or 30-year term and the Lender agrees to hold to maturity, with successive periodic interest rate adjustments every five years based on an objective index (such as the Federal Home Loan Bank 10-year Classic Advance Rate).

- Variable rate transactions, historically based on a percentage of a one-month index rate plus a credit spread, with the Lender agreeing to hold the Bonds for a commitment period (typically 3 years, 5 years, 7 years or 10 years). This commitment period may coincide with the final maturity date of the Bond, or it may refer to an initial period that is short of the 25-year or 30-year maturity for the Bonds. In such case, at the end of the commitment period, there is typically a mandatory tender, and sometimes upon satisfaction of certain conditions on such tender date, the ability for

the Borrower to "term-out" over a set period during which the Bond is amortized.

B. POTENTIAL ADVANTAGES/DISADVANTAGES OF DIRECT PURCHASES TO THE ISSUER/BORROWER

1. **Potential Advantages**. Direct purchase transactions offer some potential advantages to Borrower:

(a) *Potential cost savings*. A direct purchase transaction can be structured so that the Borrower avoids certain costs, such as the costs of an underwriter, the costs (and time) of preparing an official statement, the fees of a remarketing agent (if the public option would have been a VRDO), rating agency fees (if the public option would have been rated), interest accrual (if structured as draw-down bonds), and bond trustee fees. These potential cost savings are offset by other Borrower costs applicable in direct purchase transactions, such as Lender origination fees, Lender counsel fees, placement agent fees, and other legal fees.

(b) *Potential time/schedule advantages*. Direct purchase transactions can typically be accomplished in a shorter timeframe than their publicly offered counterparts due largely to the elimination of the need for an official statement and, if the publicly sold bonds would have been rated, the rating process. While some direct purchases are straightforward and require minimal documentation, others (especially those with complex note purchase agreements or continuing covenant agreements) may take additional time to negotiate business points.

(c) *Continuing disclosure.* Direct purchases typically fall into an exception from the ongoing disclosure obligations required by SEC Rule 15c2-12 (the "Rule"). Depending on the Lender and the security for the Bonds, continuing disclosure in direct placements runs the spectrum from simply requiring delivery of audited financials each year, to contractually requiring reporting obligations that are more comprehensive than those provided for in the Rule. Continuing disclosure in bank direct placements exempted from the Rule are purely negotiated business terms. Further, unless required by the Bank, no EMMA postings are required.

(d) *"Financial Obligations" Event Notice under the Rule.* Separate from the reporting requirements provided for in the direct purchase documents themselves, if an Issuer has entered into a continuing disclosure undertaking after February 27, 2019, the direct purchase transaction itself (including a financing lease) and amendments to the direct purchase agreements may need to be disclosed on EMMA if such obligation is a material financial

obligation.[2] The Issuer may also need to keep track of and provide notice of certain defaults, events of acceleration, termination events, modification of terms, or other similar events under the terms of the direct purchase, any of which reflect financial difficulties. [3]

(e) *Amendments.* Direct access to the Lender for waivers, modifications, forbearance, restructurings, and other workout assistance can be a significant benefit, especially in times of financial distress. The nature of a direct purchase allows the parties to remain in dialogue during the term of the deal. Lenders often can also offer assistance and make accommodations in ways that the public market cannot, such as relief from financial or other covenants. [4]

(f) *Alternate Refunding Structures.* Alternate refunding structures, such as Cinderella (a taxable obligation that becomes tax-exempt at a point in the future), forward commitments (a contractual agreement to purchase the Bonds at a later date that is farther out in the future than the traditional pricing/closing period, upon satisfaction of certain conditions), or take-out bonds (issuing taxable Bonds now, with the agreement that tax-exempt take-out Bonds will be issued in the future to currently refund the taxable Bonds), which may not be readily marketable as a public offering, or short-term financings with short or no call features, may serve as alternatives to tax-exempt advance refundings.

(g) *Multiple Structures.* As different Lenders have different appetites for tenors and yields, it is possible for an Issuer to ask more than one Lender to purchase different tenors within the same offering, to obtain different bids along the yield curve, to more closely approximate what it is able to attain in terms of rates in the public market.

(h) *Debt Service Reserve.* Direct purchase transactions may possibly be structured with no debt service reserve or a smaller debt service reserve when a publicly offered transaction might otherwise require one, which would reduce aggregate borrowing costs. However, this varies significantly among Lenders and will be dependent on the credit rating of the Borrower and outstanding bond covenants. Further, many publicly offered transactions are now offered with reduced or no debt service reserve or,

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[2] Financial obligation means a (A) debt obligation; (B) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (C) guarantee of clause (A) or (B) of this definition. The term financial obligation does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule.

[3] See "H.6. - Public Disclosure of Direct Purchases under Amendments to SEC Rule 15c2-12" herein for more information.

[4] Note that modification of terms reflecting financial difficulties may need to be reported under an Issuer's outstanding continuing disclosure undertakings. See (d) above and "H.6. - Public Disclosure of Direct Purchases under Amendments to SEC Rule 15c2-12."

perhaps, offered with only a covenant for a springing reserve if coverage drops below a required level.

(i) *Lien and Priority of Payment Flexibility.* Direct purchase Lenders may be willing to accept a pledge of revenues of an enterprise or Borrower on a subordinate basis from the pledge given to senior lien bond holders. This option gives the Issuer access to capital or liquidity without having to first pass the higher bar commonly associated with future parity bond tests. Lenders are on parity with other subordinate lien obligations, which may give rise to intercreditor or other considerations upon the occurrence of an event of default.

(j) *Downgrade Risk.* The Borrower does not bear the risk of a Lender downgrade as it might in a publicly traded VRDO. This risk was not taken seriously prior to 2008 but was impactful during the Great Recession and has again been a concern during the COVID-19 pandemic.

(k) *Basis Risk.* Direct purchase obligations might present an opportunity to avoid basis risk. In the past, there might have been an interest rate divergence between publicly marketed or remarketed floating rate debt and the rate formula on the variable rate leg of interest rate swaps hedging the debt. A direct purchase of the debt obligation by a bank might permit an issuer to achieve a closer matching of rates.

(l) *Access to Capital*. During certain periods of public market volatility and illiquidity, like the volatility that occurred during the early months of the COVID-19 pandemic, Lenders have sometimes played an important stop-gap and been the only means of accessing capital for certain Borrowers.

2. Potential Disadvantages.

(m) *Additional Negotiation.* There is often more direct negotiation with the Lender, including negotiation of terms that are viewed as standard practice for publicly offered transactions. The direct purchase market and the public market are very different, and Lenders often analyze credits and terms far differently than an underwriter would on a publicly offered transaction. In some cases, a Lender may expect the Borrower to move its lending and treasury management relationships to the Lender.

(n) *Different Covenants.* The terms of direct purchase transactions are often very different than publicly offered deals. These differences include, but are not limited to: (i) restrictive call features, sometimes involving make-whole calls; (ii) material adverse change provisions (see below); and (iii) restrictive and negotiated covenants such as Lender consent rights, default rates, tax gross-ups or financial covenants.

(o) *Higher Rates.* After the corporate tax rate was reduced to 21% by the TCJA, the interest rates in the private placement market typically increased for the

same credit than in the public market because of the greater economic benefit of the tax-exemption to the retail market than to the corporate market.

C. ADVANTAGES/DISADVANTAGES TO LENDER

1. Potential Advantages.

(a) Tax-exempt income for the Lender.

(b) Diversification of the loan portfolio and potentially higher (investment grade) credit quality loans that improve the overall loan portfolio credit quality.

(c) Entry into the customer for pitching other banking products and expanding the relationship and profitability, such as maintenance of deposit accounts and other treasury management relationships with the Lender, etc.

(d) Better capital risk-weighting for municipal obligations than commercial, private purpose obligations.

2. Potential Disadvantages.

Reduction in the corporate tax rate means the economic benefit of the tax-exempt nature of the interest is lessened for banks and corporations.

As noted above, IRC § 265 provides that the Lender loses a portion of the deduction to which it would have otherwise been entitled for the interest that the Lender pays its depositors, CD-holders, etc. The portion disallowed is equal to the ratio that the Lender's adjusted basis for its investments in tax–exempt obligations that are not bank-qualified bears to the Lender's total adjusted basis for all assets.

NOTE: For banks with a large asset base, the portfolio of tax-exempt obligations that are not bank qualified often is so small that the effect of IRC §265 is scarcely felt. Also, at the present time (as opposed to 1986), the rates paid by commercial banks to their depositors and CD-holders are so low that the loss of a portion of that deduction may not be particularly meaningful. Also, many banks that are active in this space have subsidiaries that buy non-bank qualified Bonds. The importance of bank qualified status in these transactions has diminished.

D. IS IT A SECURITY AND WHY DO YOU CARE?

One question frequently asked is whether or not the direct purchase bond is a "security" as opposed to a loan. To answer this question, it is helpful to determine why it is being asked. The distinction between a commercial loan and a security may determine, among other things, which division or group of the Lender

organization has primary responsibility for administration of the transaction, applicability of the Securities Act of 1933, as amended (the "Securities Act"), applicability of MSRB rules governing broker-dealers and municipal advisors, pledging to the Federal Reserve, use of the item to satisfy the Lender's capital requirements, applicability of the "Volker Rule," and applicability of "mark-to-market" requirements. The answer to the question is likely to vary depending on the purpose for which it is asked.

If accounting for the Bond as a "loan", among other things, Lenders typically do not want CUSIPs and typically want all references to DTC and book entry removed, and often want the Bond identified as a "loan," if at all possible.[5] More often than not, the Lender is stuck with the concept that their loan is represented by a bond, note, etc., as a result of state law or the naming convention for the Issuer. As a result, the parties must structure it in a fashion which allows the Lender to book the obligation as a loan for accounting purposes, assuming the Lender has a preference. However, practitioners should be cautious when giving advice on whether an obligation is a loan or security for accounting purposes, as the accountants may have their own criteria in making the determination.

For federal securities law purposes, under the Securities Act the analysis starts with the judicial recognition of a dichotomy between commercial loans and securities, despite the broad definition of "security" in Section 2(a)(1) of the Securities Act, which includes "any note [or] evidence of indebtedness… ." In determining where the dividing line should fall between securities and commercial loans for Securities Act purposes, the courts have not been able to give us more guidance than the "family resemblance" test, i.e., they know one when they see one. Reves v. Ernst & Young, 494 U.S. 56 (1990). Reves and its progeny point to four general factors to be considered: (i) motivation of the seller and buyer (or borrower and lender); (ii) plan of distribution; (iii) reasonable expectations of the investing public; and (iv) alternative means of regulation and risk reduction. In evaluating these factors, the courts give special attention to the protection of those members of the investing public for whose benefit the Securities Act was designed. (Contrast Resolution Trust Corp. v. Stone, 998 F.2d 1534 (10th Cir., 1993) (no "security" where purchaser of instruments was federal savings bank)) with SEC v. Wallenbrock, 313 F.3d 532 (9th Cir., 2002) (notes purchased by over 1,000 individuals, many of whom held the notes in their respective IRAs, held to be "securities").

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[5] On June 14, 2018, amendments to MSRB Rule G-34 took effect. Rule G-34(a)(i)(F) includes an exemption from the requirement that underwriters (including placement agents) and municipal advisors obtain CUSIPs as follows: "A broker, dealer or municipal securities dealer acting as an underwriter of a new issue of municipal securities, or a municipal advisor advising the Issuer with respect to a competitive sale of a new issue, which is being purchased directly by a bank, any entity directly or indirectly controlled by the bank or under common control with the bank, other than a broker, dealer or municipal securities dealer registered under the Securities Exchange Act of 1934, or a consortium of such entities; or by a municipal entity with funds that are, at least in part, proceeds of, or fully or partially secure or pay, the purchasing entity's issue of municipal obligations (*e.g.,* state revolving fund or bond bank), may elect not to apply for assignment of a CUSIP number or numbers if the underwriter or municipal advisor reasonably believes (*e.g.,* by obtaining a written representation) that the present intent of the purchasing entity or entities is to hold the municipal securities to maturity or earlier redemption or mandatory tender."

For the plain vanilla middle market or lower middle market direct purchase transaction, the method of originating and approving the transaction by the Lender, the collateral, the amortization and the expectations as to transferability are little different from any Benchmark Rate-based conventional term loan. This could argue for placing these "plain vanilla" direct purchase transactions outside the definition of "security" for Securities Act purposes.

For the purposes of pledges to Federal Reserve Banks, municipal securities and commercial loans are subject to vastly different margin percentages and mechanics for pledging. (See, Federal Reserve Collateral Guidelines, 6/27/2011, and Federal Reserve Discount Window & Payment System Risk Collateral Margins Table, Effective Date: October 16, 2009 (updated January 3, 2011).) For a pledge of securities to the Federal Reserve, the Bonds would need to be held through DTC and the Lender would need to obtain a CUSIP number for the Bonds and typically an investment grade rating for the Bonds.

With respect to loan accounting treatment, there are different approaches among the commercial banks. Several of the major players in the direct purchase market appear to take the position that if a deal comes from the commercial loan floor then it must be a commercial loan and not subject to the mark-to-market requirements applicable to securities. Other banks will look to specific provisions of the instrument itself (for instance, one large commercial bank will book a direct purchase deal for accounting purposes as a commercial loan only if the Bonds are not rated by a rating agency, the Bonds are not held through DTC, the Bonds do not bear a CUSIP number, the Bonds carry high authorized denomination and significant transfer restrictions and the Bond Indenture for the Bonds permits no flexibility to convert out of a bank purchase mode to a variable rate mode). Other lenders suggest that the accounting treatment should turn not on the Securities Act definition of "security" but on the definition of "security" contained in Section 8-102(15) of the Uniform Commercial Code. This definition describes as a "security" an obligation of any Issuer: "(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the Issuer; (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and (iii) which: (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article." All tax-exempt bonds would satisfy clause (i) of the UCC definition (See, IRC, Section 149(a)) and most would satisfy clause (ii). Therefore, the pressure is on ensuring that clause (iii) is not satisfied. Restrictions on transfer (for instance, a requirement that transferees are limited to commercial banks or qualified institutional buyers) may be helpful for this purpose. Finally, it should be noted that some Lenders are comfortable with treating their direct purchases generally as securities subject to mark-to-market requirements.

Why do Issuers and Borrowers and other parties in the transaction care about whether the obligation is a loan or a security? The direct purchase as "security"

issue impacts the obligations and requirements of *placement agents and municipal advisors* in a transaction. If the Bond is a security for federal securities law purposes, then SEC, MSRB and FINRA rules and regulations would apply to a placement agent. This issue is noted in MSRB Notice 2011-52 (September 12, 2011) ("Potential Applicability of MSRB rules to Certain 'Direct Purchases' and 'Bank Loans'") and MSRB Notice 2016-12 (April 14, 2016) ("Direct Purchases and Alternatives to Public Financing in the Municipal Securities Market"). The MSRB, for this purpose, adopts the Reves tests and cautions that broker-dealers and municipal advisors (including a broker-dealer or advisor that is an affiliate of a lender or even a "separately identified department or division of the bank") may be subject to MSRB and FINRA requirements in connection with a direct purchase that is deemed to be a "security" as opposed to a "loan".

In an effort to address the financial stress on municipal Issuers and Borrowers caused by the COVID-19 pandemic, in June 2020 the SEC granted a temporary, conditional exception for registered municipal advisors from broker-dealer registration to the extent that the municipal advisor solicited Lenders and other qualified providers in the direct placement of securities. This conditional exception was used by some registered municipal advisors until it expired on December 31, 2020, and was objected to by many in the broker-dealer community.

E. BORROWER'S ALTERNATIVES AT THE END OF A LENDER'S HOLD PERIOD

1. Repay the Bonds with the Borrower's funds or with the proceeds of a conventional loan. This may implicate election and other state law requirements for municipal Borrowers.

2. Refinance the Bonds with a new issue. This may implicate election and other state law requirements for municipal Borrowers.

3. Convert into another mode (if applicable) then permitted under the Bond Indenture or (if so permitted) into a new bank purchase mode with a rate determined by index or by a remarketing procedure pursuant to the Bond Indenture. Note that such a conversion may result in a reissuance for federal tax purposes (particularly if the conversion results in a change in yield of 25 basis points or more). See the discussion in F.4. below.

4. Amend the Bond documents to reset the rate and the maturity date. Note that such an amendment may result in a reissuance for federal tax purposes (particularly if the amendment results in a change in yield of 25 basis points or more), which creates pressure for more complex arrangements relating to options of the Borrower to convert to other modes. For more detail, see the discussion in Section F.4. below.

F. ADJUSTMENTS TO RATE OR YIELD MAINTENANCE

The documentation for a direct purchase often contains one or more of the following adjustments to the interest rate or for yield maintenance:

1. **Taxable Rate, for use upon a Determination or Event of Taxability**. This is subject to negotiation. Some Lenders will agree that this only applies if taxability occurs as a result of actions or inactions of the Borrower and not changes in law.

2. **Default Rate/Late Fee**. Sometimes the imposition of these is at the option of the Lender. Sometimes it is not. Often bond counsel has legitimate state law concerns about these provisions. These concerns often include statutory limits on maximum rates, authorization limits for voted Bonds, etc. In addition, tax counsel may have concerns if the imposition of the rate adjustment is optional rather than mandatory.

3. **Downgrade Pricing**. As in the VRDB market, Lenders may impose downgrade pricing to increase the interest rate or spread component in the rate in the event of changes to the Issuer's rating or withdrawals or suspensions to the rate.

4. **Decrease in Maximum Marginal Statutory Corporate Tax Rate**. Increases in the tax-exempt rate often occur to compensate for a decrease in maximum marginal statutory corporate tax rate. As the corporate tax rate decreases, the tax-exempt nature of the interest does the Lender less "good," to the point that if there were no corporate taxes at all, the Lender should be receiving a taxable rate. NOTE: This can be a difficult provision to negotiate, because the Borrower will want the flip side, i.e., if the maximum marginal statutory corporate tax rate increases, then the tax-exempt rate should decrease, while the Lender may feel that it is already at a low rate and cannot get approval for anything lower no matter what happens to the corporate tax rate. Also note that any decrease in the multiplier used to determine the tax-exempt rate to 65% or below may lead to tax problems (including OID), as the rate may no longer be a "qualified floating rate." Practitioners should also be aware of state law concerns discussed in #2 above. For existing deals, where the corporate tax-rate gross-up provision is mandatory and the Lender decides to waive the interest rate increase, the waiver may cause a reissuance for federal income tax purposes (generally if there is more than a 25 bps change in yield for the remaining term of the Bond). Conversely if the corporate tax-rate gross-up provision is discretionary, imposing the interest rate adjustment could cause a reissuance for federal income tax purposes (generally if there is more than a 25 bps change in yield for the remaining term of the Bond). There are nuances to this, in that the exercise or nonexercise of a unilateral option is typically not a modification except in cases where the option is the holder's and the option results in a deferral or reduction in any scheduled payment of principal or interest. An option is not unilateral if the Issuer/Borrower has the right to refinance at the time the lender exercises its option. However, waiving or modifying the option would likely trigger a reissuance unless the change is "de minimis" (generally not more than a 25 bps change in yield for the remaining term of the Bond).

5. **Breakage Fee**. A breakage fee for financing based on a Benchmark Rate is often used in the case of a prepayment of a Bond on a date other than a rate reset date.

6. **Capital Adequacy/Change in Law**. This adjustment is not tied to a formula but typically seeks to reimburse the Lender for whatever loss of profitability or increase in costs that the Lender may suffer due to certain (or any) regulatory changes. Because the determination of loss of profitability or increase in costs is open-ended and somewhat subjective, some tax counsel have questioned whether such an adjustment would cause a reissuance for federal tax purposes.

7. A common resolution is to move this extra charge out of the bond documents and to include it in the Lender's Continuing Covenants Agreement as an extra fee that the Borrower would pay to the Lender on a taxable basis. This may also address state law concerns which bond counsel may have, though that is very fact and state law specific. This may also have implications for the collateral structure for the Bonds (e.g., if the Bonds themselves are secured by a Master Indenture while additional fees reflected only in the Continuing Covenants Agreement may not be entitled to the benefits of the Master Indenture).

8. Bond counsel may also wish to negotiate the terms under which such increased costs may be imposed through a limited look-back period or a right to prepayment. In some instances, the look-back limits the Lender's ability to recover for regulatory changes that occurred more than, say, six months prior. Another negotiated provision may allow for the Borrower to prepay the deal at par for a certain period of time if the Lender elects to impose increased costs.

G. TENDER OPTION BOND PROGRAMS

The discussion above has been limited to the situation where the Lender is buying the direct purchase Bond for its own portfolio and not as part of a wider distribution plan. There are also tender option bond programs in which a Lender (the "Sponsor Bank") buys the Bond and then places the Bond into a custodial trust. The custodian then issues participation interests bearing interest tied to SIFMA, the participation interests (other than a retained interest of the Sponsor Bank) are sold to bond funds and others looking for short-term variable rate instruments, and the Sponsor Bank issues its Letter of Credit supporting the payments coming due on the participation interests. Although this type of transaction begins with a direct purchase, it finishes by replicating a Letter of Credit backed "lower floater" financing. In terms of the commercial loan vs. security analysis, this product is generally considered to be a security. It can provide the Lender with a lower cost of funds.

H. SPECIAL ISSUES ARISING IN A DIRECT PURCHASE TRANSACTION

Direct purchase transactions range the spectrum from lower par amount issuances involving infrequent or unsophisticated Issuers, to sophisticated, frequent Issuers issuing hundreds of millions of dollars of Bonds in a single deal. Since the reduction in the corporate tax rate, the market has seen a migration of large issuances and/or middle of the road or high grade credits issuing in the public market, while forward commitments, Cinderella bonds, unique credits, smaller, less frequent Issuers largely remain in the private market. Specific covenants may be negotiated for a direct purchase transaction. In a lightly documented small issue (e.g., a lower principal amount borrowing), covenants also can be included in the note, bond, authorizing resolution, indenture or other key documentation. In more fully documented transactions, Lenders frequently request that they be included in a separate agreement, such as a "Continuing Covenant Agreement."

1. **Solicitation or Procurement Process**. The process to select a Lender varies depending on local requirements. Issuers/Borrowers may request a term sheet from a local lender that the Issuer/Borrower has a preexisting banking relationship with, to a more robust procurement process pursuant to a request for proposals. The process used raises a host of questions, such as who should prepare the request for proposals, what kind of documentation should be included the level of review to request, require, or expect from Lenders, and the role of the Issuer's municipal advisor.

2. **Covenants**. Covenants (affirmative and negative) are a heavily negotiated component of the direct purchase transaction. Often these agreements are separate from the indenture and are in the form of a "continuing covenants" agreement or appendix to a financing agreement and are usually direct covenants between the Borrower and the Lender. Lenders have to perform annual reviews of their loan portfolios and assign credit levels to each asset. In underwriting a deal for a particular Issuer or Borrower, the credit committee of the Lender may require specific covenants in the deal that are negotiated both at the term sheet stage and later in the loan documentation process. The typical affirmative covenants you might see in an RFP response or term sheet are requirements to maintain a specified debt service coverage ratio, a specific additional bonds test or, depending on the type of Borrower, a specified minimum level of unrestricted liquid assets or a loan to value ratio for loans secured by real estate or other tangible assets, etc. Bond Counsel must ensure that the Issuer or Borrower can reasonably expect to comply with, and understands the tax and state law implications of, these covenants.

> For example, to avoid yield restriction requirements resulting from characterization of funds as replacement proceeds, a test for unrestricted liquid assets can be tested only semi-annually and unrestricted liquid assets must be permitted to go to zero in the interim between testing dates. See Treas. Reg. §1.148-1(c)(3)(ii). Another way to measure the liquid assets that is less likely to result in a characterization of the funds as replacement proceeds is to require a certain multiple of operating expenses, rather than a set number.
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> Depending on the Borrower, debt service coverage can be a sensitive negotiation. First, it is important to understand how the test is defined and whether the Borrower has ample margin for compliance. A common negotiated point is excluding balloon obligations from the definition of current maturities of long term indebtedness. Some Borrowers are more likely to hover around the limit and may try to negotiate relief for the first instance of noncompliance because any dip below would be a default incapable of cure.
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> Some examples of relief include negotiating (i) that failure to maintain a DSCR is not a default unless, after the second testing, the Borrower fails to comply, thus making the initial noncompliance a "soft" default, or (ii) that, after the soft default, a "management consultant" be retained by the Borrower to make recommendations to make operating adjustments to meet the ratio in the future.
>
> One of the more contentious negative covenants is the prohibition on additional indebtedness. For certain credits, the Lender may prohibit any kind of additional indebtedness without Lender consent. Depending on the credit negotiations this

may result in compromises, including allowing indebtedness under a certain dollar limit, allowing additional purchase money indebtedness for assets the Borrower acquires, allowing additional indebtedness if the Borrower is above a higher debt service coverage ratio, and allowing lease financing for equipment purchases. It is less common to include such covenants in direct purchases of general obligation bonds. However, some covenants that arise in that context include maintenance of a specified rating category of the Issuer and financial reporting.

3. **Swaps**. Not infrequently, a commercial Lender may be reluctant to provide a long-term fixed rate for the Bonds but is willing to purchase the Bonds at a rate determined by reference to a Benchmark Rate and then sell the Borrower a swap to fixed rate. This has caused concern among some tax counsel, as it creates a question as to whether the swap and the bond need to be considered a single instrument or should be analyzed separately.

4. **Purchases by Non-Financial Institutions**. The 100% loss of cost of carry provided for by IRC § 265 applies, by its terms, to "financial institutions" and reduces the deduction from taxable income for federal income tax purposes that would otherwise have been available to the Bondholder for interest payments made to depositors, CD-holders and other creditors. Suppose, however, that the Bondholder doesn't take deposits and doesn't have any interest deductions at all? Such a Bondholder would not be affected by the 100% loss of cost of carry. Therefore, a number of Lenders have arranged for direct purchases to run through an entity such as a leasing company or a separate securities corporation. Such an entity typically is a subsidiary of the Lender's holding company, though not of the Lender, and is funded by equity contributed by the holding company. Will this really suffice to avoid IRC §265, assuming that the tax return is filed on a consolidated basis at the holding company level? This issue was decided in favor of the taxpayer in PSB Holdings, Inc. v. Commissioner, 129 T.C. No. 15 (2007).

5. **Transfer and Sale of Directly Held Bonds**. There are discrepancies in treatment of assignability depending on what the parties want to accomplish. If the goal is to avoid having to prepare an official statement and/or to enable the Lender to book the purchase as a commercial loan, then restrictions on transfer would be more common. At the extreme, there are some conduit Issuers who legend their Bonds with restrictions similar to "letter stock," including a requirement for an opinion of counsel upon each transfer. Often, however, subsequent transferees are limited to "accredited investors" and "qualified institutional buyers," and entities which are able to execute an investor or purchaser letter in substantially the same form as the one executed by the initial Lender.

6. **Public Disclosure of Direct Purchases under Amendments to SEC Rule 15c2-12**. On August 20, 2018, the SEC issued Release No. 34-83885 (the "SEC Release") adopting amendments to the Rule ("Amendments") that became effective on February 27, 2019. The Amendments add two new events to the list of reportable events for which an Issuer or obligated person must provide notice to the MSRB on EMMA. The Amendments are effective for continuing disclosure agreements or undertakings entered into on and after February 27, 2019. Accordingly, if a public offering is subject to the Rule, the additional listed events must be included in the continuing disclosure agreement or undertaking delivered in connection with the public offering. The SEC Release indicates: "The amendments are intended to address the need for timely disclosure of important information related to an Issuer's or obligated person's

financial obligations and cover a variety of obligations incurred by Issuers and obligated persons, including but not limited to direct placements." The Amendments added the following two new events (listed event Nos. 15 and 16) to the list of reportable events for which an Issuer or obligated person with publicly offered debt must provide notice to the MSRB's EMMA website within 10 business days:

> 15. (a) the incurrence of a financial obligation of the obligated person, if material, or (b) an agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and
>
> 16. a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of an obligated person, any of which reflect financial difficulties.
>
> Interpretative guidance from the SEC mentions that reportable event #15 extends to material amendments to existing financial obligations as well. Under the Amendments the term "financial obligation" means: "(i) a debt obligation; (ii) a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of (i) or (ii)".
>
> These terms are broadly construed and include *both* short-term and long-term debt obligations of an obligated person under the terms of an indenture, loan agreement, financing lease, or similar contract regardless of the length of the repayment period of the debt obligation.
>
> A "derivative instrument" includes a swap, a security-based swap, a futures contract, a forward contract, an option or similar instrument (or combination) to which an obligated person is a counterparty (keeping in mind that the derivative instrument also must be entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation).
>
> A "guarantee" includes any guarantee provided by an obligated person (as a guarantor) for the benefit of itself or a third party, which guarantees payment of a financial obligation.
>
> A "financial obligation" includes borrowings that might otherwise be exempt from statutory debt limits under state law. The SEC Release specifically notes that lease obligations, revenue bonds and certificates of participation may be considered "financial obligations" even though they are not "debt" under state law or state constitutional provisions. Leases that "operate as vehicles to borrow money" are debt obligations.
>
> The materiality of a financial obligation or its terms is determined under general securities law standards (i.e., would the information be important to a reasonable investor in making an investment decision?), particularly with regard to any rights given to the holder of the financial obligation that are prior to the rights of the

holders of the obligated persons outstanding municipal securities. Beyond this general statement, the SEC has continued its approach of remaining vague in describing any materiality standard.

From pages 44705-44706 of the SEC Release: ". . . the Commission continues to believe that materiality determinations should be based on whether the information [disclosed in an offering document] would be important to the total mix of information made available to the reasonable investor." From page 44706: "Accordingly, under the Rule, as amended, an Issuer or obligated person will need to consider whether a financial obligation or the terms of a financial obligation, if they affect security holders, would be important to a reasonable investor when making an investment decision."

The SEC states in the SEC Release that the material terms of a financial obligation that should be disclosed under the new event include the following:

- date incurred,
- principal amount,
- maturity dates and amortization,
- interest rate, if fixed, or "method of computation," if variable,
- default rates, and
- such other terms as are "appropriate under the circumstances"[6]

For variable rate obligations, a question arises as to whether the Amendments permit the redaction of the interest rate spread similar to the redaction of commitment fees in the VRDB context under Rule G-34.[7] The SEC Release simply requires the disclosure of the "method of computation" for variable rate obligations. So long as the formula for interest rate computation is disclosed, query whether the spread could be redacted. Ultimately this would be a materiality determination by the Issuer.

New event #16 relates to "a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of an Issuer or obligated person, any of which reflect financial difficulties."

A default, acceleration, termination, modification or similar event under a financial obligation "reflects financial difficulties" of an obligated person and should be

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[6] An issuer should consider what may be material to include when speaking to the market and whether a narrowly focused notice can be limited in scope with cautionary language. For example, if an Issuer obtains a bank loan to address a liquidity problem, e.g., to pay operating expenses such as payroll, additional disclosure regarding the issuer's financial condition may be necessary.
[7] Often commitment fees are set forth in a separate fee letter or fee agreement that is not posted on EMMA.

reported if the information is relevant to investors in making an assessment of the current financial condition of the Issuer or obligated person. In the SEC Release, the term "default" includes both payment and non-payment defaults, but distinguishes between those that do not reflect financial difficulties (such as failure to provide timely notice of a change in address) and those that do (such as a failure to replenish a debt service reserve fund).

There are different approaches that Issuers can take in disclosing financial obligations on EMMA. Some provide summaries of the obligations, others post full copies with certain information redacted.

The most efficient way to do this may be to post redacted documents for the prior private placements on EMMA. This approach seems to have become more common than posting summaries of the financial obligation terms, for the following reasons: Summaries are more time-consuming and expensive to produce than simply posting redacted copies of documents. Summaries make it harder for market participants to see all the terms of the deals. Summaries require the author of the summary to choose what to summarize and what to omit, and that judgment call invites potential errors and liability as to material omissions or misstatements.

7. Redaction of Information under Amendments to SEC Rule 15c2-12.

In an age of cybersecurity threats and identify theft concerns, participants in a direct purchase or other public finance bank product deals often are concerned about the posting of sensitive information. There are known instances of bad actors pulling financing documents from EMMA and trying to perpetrate financial or cybersecurity fraud. As such deal participants have a vested interest in protecting or redacting information that can be used fraudulently or nefariously.

The question is, what kinds of redactions are permitted under SEC rules?

Under the SEC Release, the SEC stated that "The [A]mendments **do not** require the provision of *confidential information* such as <u>contact information, account numbers, or other personally identifiable information to EMMA.</u>"

On February 27, 2019, the MSRB hosted a webinar with the SEC to discuss frequently asked questions related to the Amendments. At this webinar, in response to question as to whether certain proprietary information can be redacted from the event notice filings, an SEC representative noted that the SEC permits redaction of such information per the SEC Release, stating:

"In the Adopting Release, we specifically address what can be redacted and the Release states that the amendments do not require the provision of confidential information such as contact information, account numbers, or other personally identifiable information. As noted, an event notice filing should include all material terms of the financial obligation and we provided some examples of those: date of occurrence; principal amount; interest rate, and other terms may be appropriate as well. Notably, when discussing these redactions, the Commission made clear that

all necessary disclosures should be included in an event filing. In other words, Issuers should not redact event notice filings such that the notice does not contain all information about the financial obligation. If you want to make redactions, do so, but recognize that there is an expectation that all material information needs to be included in your event filing when you do so."

II. LETTERS OF CREDIT

A. OBJECTIVES: LOWER INTEREST COSTS THROUGH CREDIT AND LIQUIDITY SUPPORT

Letters of credit serve to provide access to public markets for Borrowers who could not achieve such access on their own credit. Letters of credit are also a useful financial tool for Borrowers that want to treat Bonds as long-term debt for financial statement purposes but want to enjoy the lower rates that come from the left-hand side of yield curve. The optional tender feature of VRDBs provides this opportunity to achieve lower rates and the Letter of Credit is there to make sure that Bondholders have the required liquidity.

B. NATURE OF LETTER OF CREDIT (NOT A GUARANTEE)

Letters of Credit are not guarantees.[8] A Letter of Credit is an independent, primary obligation of the issuer of the Letter of Credit to honor draws, up to an aggregate stated amount, presented in compliance with the terms of the Letter of Credit and prior to its termination. In contrast, a guarantee is a secondary obligation supporting a primary obligation of another person and, typically, does not have a limited term. Even more importantly, it may be a defense to the guarantor's liability on a guarantee that the primary obligor is not required to pay under the primary obligation. By contrast, if the beneficiary properly submits conforming documents under a Letter of Credit, the Letter of Credit issuer is bound to pay, whether or not the account party really owes the underlying obligation to the beneficiary. There is only the narrow exception for "fraud in the transaction" (or "material fraud," as UCC 5-109 describes it). The Comptroller's Office has issued a regulation with respect to the letters of credit (12 C.F.R. §7.1016) which, among other things, provides that (1) a national bank may issue letters of credit within the scope of

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[8] Although technically speaking a Letter of Credit is a primary obligation and not a guarantee per se, for federal tax purposes letters of credit are regularly treated as "qualified guarantees" under Reg 1.148-4, which requires that they be a "guarantee in substance." "Treas. Reg. §1.148-4(f)(3) Guarantee in substance. The arrangement must create a guarantee in substance. The arrangement must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments, such as payments for principal and interest, redemption prices, or tender prices, on the guaranteed bonds. Reasonable procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional. In the case of a guarantee against failure to remarket a qualified tender bond, commercially reasonable limitations based on credit risk, such as limitations on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor, do not cause the guarantee to be conditional. The guarantee may be in any form. The guarantor may not be a co-obligor. Thus, the guarantor must not expect to make any payments *other than under a direct-pay Letter of Credit or similar arrangement for which the guarantor will be reimbursed immediately*. The guarantor and any related parties together must not use more than 10 percent of the proceeds of the portion of the issue allocable to the guaranteed bonds." (emphasis added).

applicable laws and rules of practice recognized by law (for instance, UCC Article 5, UCP 500, UCP 600 and ISP 98), and (2) as a matter of sound banking practice, in issuing a Letter of Credit a bank should consider the following:

1. The independent character of the Letter of Credit should be apparent from its terms (which includes, for this purpose, terms that subject the Letter of Credit to laws or rules providing for its independent character);

2. The Letter of Credit should be limited in amount;

3. The Letter of Credit should (i) be limited in duration, or (ii) permit the issuing bank to terminate the Letter of Credit either on a periodic basis (consistent with the Letter of Credit bank's ability to make any necessary credit assessments) or at will upon either notice or payment to the Borrower, or (iii) entitle the bank to cash collateral from the Borrower on demand (with a right to accelerate the Borrower's obligations, as appropriate);

4. The Letter of Credit bank either should be fully collateralized or have a post-honor right of reimbursement from the Borrower; and

5. In the event that the Letter of Credit provides for automatic renewal, the terms for renewal should be consistent with the Letter of Credit bank's ability to make any necessary credit assessments prior to renewal. In practice, "evergreen" provisions are frowned upon by many banks. Practitioners usually recommend that if an evergreen provision exists at all, there should still be a hard stop on a specified date in order to avoid the "asleep at the switch" problem.

C. PREFERENCE PROTECTION

1. **Object**. It is a major goal of rating agencies to ensure that the money paid to Bondholders is not subject to recovery as a preference in a bankruptcy of the Borrower. Accordingly:

(a) Principal of and interest on Bonds will be paid from draws on the Letter of Credit (i.e., it is the Bank's funds that pay the Bondholders, not the Borrower's money);

(b) Purchase price of tendered Bonds will be paid from remarketing proceeds or Letter of Credit draws upon failure to remarket;

(c) Alternatively, principal and interest or mandatory tender purchase price may be paid from aged money (on deposit with the Bond Trustee for the applicable preference period – generally 90 days under the United States Bankruptcy Code and four months, or 123 days, under some state insolvency laws). Aged money is not typically used as a source of payment (because it is not practical when you can make payment through a draw on a Letter of Credit and simultaneously reimburse the Bank without having to post funds with the Bond Trustee 90 days in advance); and

(d) Preference proof funds are segregated (not commingled with other funds).

2. **Preference Opinions**. Preference Opinions are not generally required anymore but see II.L. 2. Bank Counsel Opinions – Preference Opinions below.

D. DOCUMENTATION STRUCTURE

1. **Letter of Credit**. The Letter of Credit generally names the Bond Trustee as beneficiary. The Letter of Credit is issued in a stated amount equal to the aggregate principal amount of the Bonds, plus a stated number of days interest - typically determined by the rating agency to be the applicable interest period (usually one month), plus certain cushions (e.g., reinstatement period, weekends and holidays, and a reasonable time to assemble and present a draw request), usually for a total of 40 to 55 days interest at a stated maximum rate (usually 10% to 12% per annum). The Bond Trustee is authorized to make draws on the Letter of Credit by presentation of draw certificates in the forms prescribed by the Letter of Credit for (i) bond principal payments (which permanently reduce the amount available under the Letter of Credit), (ii) the current interest payment, a specified number of days (usually 5 to 10 days) after which the Letter of Credit amount is automatically reinstated with respect to such draw, unless prior to the expiration of such period the Bank notifies the Bond Trustee that such reinstatement shall not occur (but see II.E. 1. Reinstatement – Interest Draws below), and (iii) optional or mandatory tender purchase price of Bonds in the event and to the extent remarketing proceeds are not available to pay such purchase price (the principal component of such tender drawing, together with the appropriate interest component, is typically subject to reinstatement if the tendered Bonds are subsequently remarketed). Letters of Credit are generally issued for a stated term (typically, in the past, 3, 5 or 7 years, but more recently for shorter periods) and are subject to extension for additional periods at the option of the Bank upon request of the Borrower. If a Letter of Credit is not extended within a specified period prior to its stated expiration date, the Bond Indenture will typically require a mandatory tender of the Bonds and a corresponding draw on the Letter of Credit prior to its expiration.

2. **Reimbursement Agreement**. Usually, the Letter of Credit is issued pursuant to a Reimbursement Agreement between the Borrower and the Bank, pursuant to which (i) the Bank agrees to issue the Letter of Credit for the account of the Borrower and (ii) the Borrower agrees to reimburse the Bank for all draws honored under the Letter of Credit and to pay certain fees to the Bank, including quarterly fees calculated as a percentage of the amount available under the Letter of Credit. [PRACTICE TIP – In calculating availability for this purpose, the Bank should use the maximum drawable amount, but without giving effect to any temporary reduction that may be subsequently reinstated.] Reimbursement of a draw for payment of interest and/or principal is due the same day such draw is honored. Draws for purchase price of tendered Bonds are generally required to be reimbursed when the Bonds are remarketed or, in absence of remarketing, are treated as term loans which either amortize over the remaining term of the Letter of Credit or another specified period or become due as bullet maturities on the stated expiration date of the Letter of Credit. (At least one major Bank will permit the term loan to remain outstanding for 3 years after the stated expiration date of the Letter of Credit. Counsel may need to remind the Bank officer to obtain approval for an 8-year deal even if the Letter of Credit term is only 5 years.) In a more innocent age, outstanding tender draws had borne interest at conventional Bank rates (often Prime or Prime +1%). Today, many Banks (as the result of being

burned in 2008 by Remarketing Agents who failed to remarket and Borrowers who found that term loan rates were cheaper than SIFMA) insist on punitive rates for these term loans. (At a minimum, it should never be cheaper for the Borrower to force the Bank to purchase the VRDBs, rather than letting the interest rate on the VRDBs increase up to the rate necessary to remarket, right up to the Maximum Rate.) Reimbursement Agreements function as credit application/loan agreements between the Bank and the Borrower and set forth representations and warranties, covenants, reporting requirements, events of default and remedies. Remedies will include the right to direct a mandatory tender or an acceleration of the Bonds and to direct the Bond Trustee in the exercise of remedies under the Bond Indenture, the Loan Agreement and security documents.

3. **Bond Indenture**. A Bond Indenture should include the following provisions relating to the Letter of Credit:

(a) Mechanics and timelines for drawing on the Letter of Credit.

(b) Creation of segregated funds to hold proceeds of draws on the Letter of Credit and remarketing proceeds to be applied to pay (i) principal and interest on the Bonds and (ii) tender purchase price of Bonds. Failure to keep the funds properly segregated may result in the Bondholders being paid from Borrower's money, not the Bank's money, which could lead to a preference problem.

(c) Mandatory tender provisions triggered by (i) impending expiration of the Letter of Credit, (ii) non-reinstatement of the interest component of the Letter of Credit following an interest draw, or (iii) direction of the Bank because an event of default under the Reimbursement Agreement has occurred and is continuing.

(d) Mechanics for substitution of a new qualifying Letter of Credit for the existing Letter of Credit (which often includes mandatory tender).

(e) Provisions for declaration of an event of default, acceleration of the Bonds, draw on the Letter of Credit and exercise of remedies at the direction of the Bank because an event of default has occurred and is continuing under the Reimbursement Agreement. Note that some underwriters and financial advisors insist that the Bank's remedy in this case is only the mandatory tender under (c) above. The idea is that an acceleration and redemption would kill off the Bonds for all time, while a mandatory tender preserves the possibility that the Borrower can find other credit and liquidity support and the Bonds can be remarketed.

(f) Provisions for the Bank to control the exercise of remedies under the Bond Indenture, the Loan Agreement and security documents (so long as the Bank is not in default of its obligation to honor conforming draws under the Letter of Credit) and requiring Bank consent to any proposed amendments to the Bond Indenture, the Loan Agreement or security documents.

4. **Construction Fund.** In the case of construction funds held by the Bond Trustee to pay Project construction costs, a provision requiring Bank approval of each draw of construction funds held by the Bond Trustee. The conditions under which the Bank will give such approval are typically set forth in the Reimbursement Agreement or in another agreement directly between the Bank and the Borrower.

E. REINSTATEMENT

1. **Interest Draws**. In order to maintain full coverage for the Bondholders and provide for the next scheduled interest payment, the amount available under the Letter of Credit to pay interest needs to be reinstated after each drawing to make a regularly scheduled interest payment (typically monthly). Reinstatement mechanics may include the following provisions:

(a) Usually, a Letter of Credit will provide for automatic reinstatement 5 to 10 days after a scheduled interest drawing, unless within such period the Bond Trustee receives notice from the Bank that a Reimbursement Agreement event of default has occurred and is continuing and such reinstatement shall not occur.

(b) Alternatively, a Letter of Credit may provide for immediate automatic reinstatement, with the understanding that the Bank is free to force a mandatory tender or an immediate acceleration of the Bonds if a Reimbursement Agreement default occurs. Immediate reinstatement permits the interest component of the Letter of Credit to be smaller (this gives rise to savings on letter of credit fees). ISSUE: If a Borrower files for reorganization and the Bonds remain outstanding in whole or in part, the Bank might be forced, because of the automatic stay, to watch its Letter of Credit reinstate without reimbursement and without the ability to collapse the transaction. Even absent bankruptcy, there would be a timing risk such that the Letter of Credit could be drawn upon and automatically reinstate at a time when the Bank has not been paid, leading to a possibility that the Bank will extend credit above its credit approval by an amount at least equal to a month's interest.

2. **Purchase Price Draws**. The interest rate on Bonds is generally adjusted within the optional tender notice period as necessary to resell the tendered Bonds at par. Consequently, prior to the market collapse in September 2008, a failure to remarket upon an optional tender resulting in a purchase price draw was virtually unknown. Since September 2008, remarketing failure following an optional tender is now recognized as a very real possibility. Also, a purchase price draw may occur in the event of certain mandatory tenders. In the event of a draw on the Letter of Credit to pay purchase price of tendered Bonds that are not remarketed, such unremarketed Bonds are generally pledged to and/or held in the name of the Bank pending remarketing. If the Bonds are subsequently remarketed, the Bank is reimbursed with the remarketing proceeds and the Letter of Credit is reinstated.

F. PLEDGED BONDS/BANK BONDS

1. **Background**. If Bonds are purchased with the proceeds of a Letter of Credit draw upon an optional or mandatory tender, they are often deemed owned by the Borrower and pledged to the Bank pursuant to the Reimbursement Agreement or a separate pledge agreement pending remarketing of such Bonds and reimbursement of the Bank. For perfection of the pledge, the Bond Indenture should provide that ownership of such Bonds shall be registered in the name of the Bank as pledgee of the Borrower on the registration books of the Bond Trustee and on the records of the applicable DTC Participant. Alternatively, the Reimbursement Agreement may provide that such Bonds are deemed Bank Bonds owned by the Bank, in which case the Bank Bonds would bear interest at a Bank Rate (which needs to be provided for in the Bond Indenture). In the case of Bank Bonds and pledged Bonds that bear interest at a Bank Rate different from other Bonds, DTC requires a separate CUSIP number and compliance with certain procedures. Such CUSIP numbers are now generally being requested at closing instead of waiting for a failed remarketing.

2. **Purpose of Pledge**. Since the Bank would already hold the reimbursement obligation of the Borrower for the tender draw (secured by (i) any collateral and/or guarantees held by the Bank for the Borrower's obligations under the Reimbursement Agreement and (ii) any collateral held by the Bond Trustee), the tendered Bonds often add little intrinsic collateral value for the Bank. However, if the Bonds are secured by a significant trust estate (such as a construction fund, debt service reserve fund or other collateral), it is important for the Bank to block other creditors of the Borrower from acquiring an interest in the tendered Bonds and thereby acquiring an interest in the trust estate. Rights to pledged Bonds may also be important where only the Bonds (and not the Reimbursement Agreement) are secured by certain collateral.

G. RENEWAL

1. **Background**. Bond Indentures typically provide for a mandatory tender of the Bonds prior to the expiration date of the Letter of Credit, unless the Letter of Credit is renewed (extended) or replaced by another Letter of Credit meeting the terms of the Bond Indenture.

2. **Stated Expiration Date**. A Letter of Credit should have a stated expiration date or permit the Bank to terminate upon reasonable prior notice or payment. See ISP 98 §9.01, UCP 500 Article 42, UCP 600 Article 6, and 12 C.F.R. §7.1016.

3. **Prescribed Renewal Procedure**. Often a Letter of Credit or Reimbursement Agreement will set forth procedures and specific time periods for requesting and committing to future Letter of Credit renewals. ISSUE: While such procedures may be helpful in laying out how the parties intend to go about requesting and granting or denying Letter of Credit renewals in the future, they also create false deadlines that are often missed. It is usually best for the Borrower to start early well in advance of the deadlines and diligently pursue the renewal process with its Bank.

H. LETTER OF CREDIT REPLACEMENT

1. **Background**. Bond Indentures for Bonds supported by a Letter of Credit set forth various (sometimes elaborate) requirements to be met in replacing an existing Letter of

Credit with a new Letter of Credit issued by another Bank. Common requirements include (i) the new Letter of Credit must have substantially the same provisions as the old one (not very realistic unless the Bond Trustee is willing to take an expansive view of "substantially the same"), (ii) an opinion of counsel to the new Bank as to the validity and enforceability of the new Letter of Credit, (iii) confirmation by the applicable rating agency of the rating of the Bonds as enhanced by the new Letter of Credit, and (iv) an opinion of bond counsel as to no adverse tax consequences and compliance with the Letter of Credit replacement requirements of the Bond Indenture. Note that older Bond Indentures often provided that so long as the replacement of the Letter of Credit did not cause a reduction in rating level, then there would not be a mandatory tender, while more modern Bond Indentures typically provide for a mandatory tender and remarketing no matter what the rating for the replacement Letter of Credit. PRACTICE TIP: Provide expressly that the new Bank must purchase all Bank Bonds or pledged Bonds in order to take out the old Bank.

2. **Timing Problems**. The foregoing requirements are typically required to be satisfied at some period of time (often 30 days or more) prior to the expiration date of the existing Letter of Credit. This timing permits advance notice to the Bondholders and an orderly mandatory tender and remarketing (or, in some older Bond Indentures, an opportunity for Bondholders to optionally tender their Bonds for purchase prior to replacement of the existing Letter of Credit). If the existing Letter of Credit is about to expire and the replacement requirements are not met, the Bond Indenture will provide for mandatory tender or redemption prior to expiration of the Letter of Credit. Problems arise from Bond Indentures that suggest that somehow the new Letter of Credit needs to actually be in effect 30 days before the termination of the old Letter of Credit. Since this would prevent the new Bank from getting a first lien on the collateral, it creates an impossible situation unless the Bond Trustee can be persuaded to ignore the literal words of the Bond Indenture. PRACTICE TIP: In structuring a replacement transaction that involves a remarketing, remember that the existing Bondholders need to be paid with proceeds of a draw on the old Letter of Credit (i.e., the credit they originally signed up for), rather than the new Letter of Credit.

3. Suggestions.

(a) If Bank counsel has input on the drafting of the Bond Indenture, she should make sure that delivery of the actual replacement Letter of Credit is not required by the Bond Indenture until the interest payment date (or other date) on which the existing Letter of Credit is expected to be surrendered. Reasons: (i) Banks are often unwilling to issue a Letter of Credit unless the existing Bank is simultaneously relinquishing its rights with respect to collateral; and (ii) Banks are generally unwilling to issue a Letter of Credit prior to its effective date (from the Bank's point of view, the Bank is irrevocably committed when the Letter of Credit leaves its hands even if the effective date is at some later time).

(b) The time period for advance delivery of documents should be as short as possible. The Bond Indenture should set flexible timing requirements that will facilitate an effective replacement so long as there is no actual gap or potential shortfall in Letter of Credit coverage for the Bondholders.

I. NEW COLLATERAL TAKEN UPON LETTER OF CREDIT REPLACEMENT

1. **Problem**. If, upon issuance of a replacement Letter of Credit, the new Bank requires additional collateral that does not already secure the prior Reimbursement Agreement or the Bonds, there would be a potential for an indirect preference to the Bondholders in the event of a bankruptcy proceeding within the applicable preference period (generally 90 or 123 days) following the issuance of the replacement Letter of Credit and the concurrent delivery of the additional collateral. See In re Compton Corp., 831 F.2d 586 (5th Cir. 1987) (also known as the "Blue Quail" case); In re Air Conditioning of Stuart, Inc., 845 F.2d 293 (11th Cir. 1988). Consequently, the rating agencies will generally either prohibit the taking of such additional collateral or require an opinion of experienced bankruptcy counsel to the effect that there is no bankruptcy preference risk to the Bondholders in the event of the Borrower's bankruptcy.

2. **Solution**. The preference risk might be avoided if the Bank agrees that (1) the Bank will not foreclose or exercise any right to realize upon the new collateral for a period of 90 days (or 123 days, if applicable) following the date of execution and delivery of the new Letter of Credit and additional collateral documents and (2) if prior to the expiration of such 90-day (or 123-day) period the Borrower should become a debtor in a bankruptcy proceeding, then (i) the additional collateral documents shall be deemed void as of the date of execution and delivery thereof and (ii) the Bank will not claim or accept the benefits of the additional collateral. One sometimes sees a situation in which the new Bank takes over the old Bank's collateral at the date of substitution and then, 90 days later, when the rating agency has already issued its ratings letter and is no longer paying attention to the deal, the new collateral is added. The assumption is that in the event of the Borrower's bankruptcy within the following 90 (or 123, as applicable) days, the additional collateral grant to the Bank could be viewed as preferential, but rights of Bondholders to be paid under the new Letter of Credit would survive.

J. BOND DOCUMENT DRAFTING POINTS

1. Bond Counsel should take care that:

(a) Defined terms in the Bond Indenture, the Loan Agreement and security documents include the original Bank, Letter of Credit and Reimbursement Agreement, as they may be amended from time to time, and any substitute Bank, Letter of Credit and Reimbursement Agreement.

(b) The mechanics of drawings and payments generally work, are practical, and assure that payment of principal, interest and tender purchase price to Bondholders will always be made with Letter of Credit proceeds, remarketing proceeds (excluding any remarketing to the Borrower, its affiliates or the Issuer), or other money not subject to recovery as a preferential transfer in the event of a bankruptcy of the Borrower. In rating Bonds supported by a Letter of Credit, the rating agency will generally review and police these matters.

(c) The provisions governing replacement of an existing Letter of Credit with a new Letter of Credit are synchronized to not (i) allow a gap in the Letter of Credit coverage for the Bondholders or (ii) require an overlap of Letters of Credit such that the existing Letter of Credit and the new Letter of Credit are required to be outstanding at the same time (other than for an instant on the day of closing, such overlaps are virtually never acceptable to the exiting and incoming Banks).

2. Bank Counsel should consider the following in protecting the Bank's interests:

(a) Granting Clauses. The Bond Indenture granting clauses should secure (i) the payment of the Bonds for the equal and ratable benefit of the Bondholders and (ii) all of the Borrower's obligations under the Reimbursement Agreement for the benefit of the Bank. The "TO HAVE AND TO HOLD" and "PROVIDED, NEVERTHELESS" clauses should match the granting clauses in this respect. ISSUE: Sometimes the granting clauses of the Bond Indenture or other security documents state that the Bank is secured on a "subordinated" basis. This isn't exactly accurate; instead the various provisions of the Bond Indenture should specifically provide which money goes to whom and when. Thus, for instance, once the Bank has paid to the Bond Trustee a drawing in respect of a monthly interest payment on the Bonds, the Bank is entitled to be reimbursed from any monies deposited into the Bond Fund by the Borrower in respect of that monthly interest payment and this right is not "subordinated" to any claim of the Bondholders.

(b) Definitions. As a matter of exit strategy, the definitions of "Bank," "Letter of Credit" and "Reimbursement Agreement" should include any substitute Bank, Letter of Credit and Reimbursement Agreement to facilitate transition to a new Bank if the existing Bank declines to extend at the end of the term of its Letter of Credit.

(c) Draw Times. Should be reasonable and allow the Bank sufficient time to process and pay draws without undue risk of failure to timely honor conforming draw requests. The timing of a tender drawing for unremarketed Bonds is particularly sensitive when Bonds are in a daily mode; the fixing of the daily rate, the Bondholder's decision to tender, the remarketing and the draw times are all compressed into a few hours and the timing is further constrained by the DTC deadline governing the time by which the Trustee must remit payment to DTC for the Bondholders. During the troubled times in late 2008, when tenders were occurring with greater frequency than ever before, the compressed timetables for Bonds in daily mode led to mechanical problems in some deals. There simply was not enough time for all parties to perform their obligations smoothly.

(d) Mandatory Tender/Acceleration. The Bond Indenture should provide for a mandatory tender or acceleration as directed by the Bank if the Bank needs to collapse the financing due to an Event of Default under the Reimbursement Agreement. The advantage of mandatory tender over acceleration is that the potential for tax-exempt financing under the existing bond structure can be preserved as a workout option. Accordingly, (i) upon non-reinstatement of a Letter of Credit following a draw for regularly scheduled interest (non-reinstatement is usually conditioned upon a failure to reimburse the Bank for such draw or the existence of an ongoing Event of Default under the Reimbursement Agreement), and absent direction from the Bank to accelerate as described below, the Bond Indenture should provide for a prompt mandatory tender of the Bonds for purchase, and (ii) upon the occurrence of an Event of Default under the Reimbursement Agreement, the Bank should have the option under the Bond Indenture to direct either a mandatory tender or an acceleration of the Bonds.

(e) Control of Remedies. So long as the Bank is not in default of its obligation to honor conforming draws under the Letter of Credit, the Bank should have the right to direct and control the exercise of remedies (including acceleration) under the Bond Indenture, the Loan Agreement and security documents.

(f) Amendments. Amendments of the Bond Indenture, the Loan Agreement and the security documents should be subject to the Bank's consent. Bond Indentures often provide that the right to consent to amendments is conditioned on the Bank not being in default of its obligation to honor conforming draws under the Letter of Credit. ISSUE: The Bank is a direct beneficiary of the Bond Indenture. Should a defaulting Bank, like a defaulting Borrower, retain the right to consent to amendments of documents under which it is a direct beneficiary? ISSUE: Should the Bank be permitted to consent to amendments on behalf of Bondholders so long as it is not in default of its obligation to honor conforming draws under the Letter of Credit? The market will generally permit this, but Bondholders will typically also have consent rights as to their "sacred rights".

(g) Defeasance. Defeasance clauses should be conditioned not only on payment (or provision for payment) of the Bonds, but also on payment of all obligations owing to the Bank under the Reimbursement Agreement.

(h) Swaps/Cross-Default. Standard ISDA swap documents contain cross-default provisions and permit termination by the swap counterparty if there is a default permitting acceleration of debt under any credit agreement constituting Specified Indebtedness (including a Reimbursement Agreement). Bank counsel and Borrower's counsel should consider requiring that the ISDA Schedule modify the ISDA Master Agreement so that a cross-default gives rise to a right of termination of the swap agreement only if the cross-default debt is accelerated. Also, ISDA swap documents

often incorporate by reference the financial covenants of the Reimbursement Agreement as same existed on the closing date and without regard to future waiver or amendment. Obviously, the Bank would have a stronger hand in a work-out scenario if at the time of the closing it had required the swap documents to incorporate the financial covenants of the Reimbursement Agreement as the Bank and the Borrower may amend them from time to time.

3. **Security Structure**. In a Bond financing supported by a Letter of Credit where there is a mortgage or other collateral apart from the general obligation of the Borrower, the security structure usually takes one of the following paths:

(a) Bank Sole Secured Party.

- Advantages:
  - Bond documents and Bond Trustee duties are not complicated with collateral.
  - Letter of Credit Bank directly and solely controls the collateral.
- Disadvantages:
  - Upon substitution of a new Letter of Credit Bank, the collateral documents have to be transferred to the new Bank and, if necessary, modified, and additional title insurance expense may be incurred. This is particularly true in jurisdictions such as Pennsylvania where the ability to negotiate title insurance premiums is limited or nonexistent.
  - Upon a default of the Bank under the Letter of Credit, the Bondholders would not have the benefit of the collateral. Therefore, disclosure documents should stress that the Bondholders are looking only to the Letter of Credit as their source of payment.

(b) Bond Trustee Sole Secured Party.

- Advantages:
  - Facilitates transition to a substitute Letter of Credit Bank.
  - Bondholders will have the benefit of the collateral in the event of a failure of the Letter of Credit Bank.
- Disadvantages:

- The Letter of Credit Bank (which is taking all of the credit risk) does not have direct rights against the collateral and will have to work through the Bond Trustee in the event of an exercise of remedies.

(c) Both Trustee and Bank Secured Parties - Provides a combination of most of the advantages and some of the disadvantages noted in (1) and (2) above. The doubling up of security was popular in the bad old days of Twist Cap, a wrongly decided Florida bankruptcy case (Twist Cap, Inc. v. Southern Bank, 1 B.R. 284 (Bankr. M.D. Fla. 1979)) that treated the drawing under a secured Letter of Credit as giving rise to a preferential transfer at the time of the drawing unless the same security had been given to the holders of the underlying indebtedness secured by the Letter of Credit.

(d) Master Indenture Structure - All collateral held by a Master Trustee under a Master Indenture for the benefit of one or more Bond Trustees and one or more Letter of Credit Banks.

- Advantages:
    - Convenient and effective structure where multiple creditors and/or multiple bond issues are to be secured on a parity basis.
    - Can provide a uniform set of Borrower covenants for the benefit of all creditors. [But see Section II.P. 2. below.]
    - Functions, in part, as an intercreditor agreement.
    - Can also provide a convenient mechanism for securing swap providers.
    - Creditors can look to the Master Trustee to exercise remedies.
- Disadvantages:
    - Added layer of documentation and trustee expense.
    - Letter of Credit Bank does not have direct rights against the collateral and will have to work through the Master Trustee to exercise remedies.
- Bank Counsel Considerations:
    - Master Notes should be issued to both the Bond Trustee and the Bank (but should not be double counted for voting or payment rights).

- The Master Note issued to the Bank should not be limited to the stated amount of the Letter of Credit but should secure all reimbursement amounts, interest payments, fee payments and other amounts payable under the Reimbursement Agreement.

K. LETTER OF CREDIT GOVERNING LAW

Letters of Credit are generally issued under the laws of the state specified therein and are governed by and construed in accordance with Article 5 of the Uniform Commercial Code ("UCC Article 5") as in effect in such state, the Uniform Customs and Practice for Documentary Credits, Publication No. 500, 1993 Revision, adopted by the International Chamber of Commerce ("UCP 500"), the Uniform Customs and Practice for Documentary Credits, Publication No. 600, 2007 Revision, adopted by the International Chamber of Commerce ("UCP 600") or ISP 98 - International Standby Practices, ICC Publication No. 590, 1998 Edition, developed by the Institute of International Banking Law and Practice, Inc. and endorsed and published by the International Chamber of Commerce ("ISP 98"). UCP 600 is the most modern of these sources, but it is geared primarily toward international trade. ISP 98 is specifically oriented toward standby letters of credit (including "direct-pay" letters of credit) intended to support financial transactions. ISP 98 is, therefore, better suited for Letters of Credit supporting Bonds, but any of ISP 98, UCP 500 or UCP 600 will suffice. It should be noted that UCP 500, UCP 600 and ISP 98 are not statutes, but provide contract terms that only govern the Letter of Credit when incorporated therein by reference. Those incorporated terms constitute, in effect, a series of default rules that can be varied by the specific terms of a Letter of Credit. For instance, many Letters of Credit contain specific provisions as to transferability rather than relying on the default rules. As a drafting preference, one would like the Letter of Credit to be transferable in whole, but not in part, to any successor Bond Trustee and to permit successive transfers to successive Bond Trustees.

L. LETTER OF CREDIT BANK COUNSEL OPINIONS

1. **Letter of Credit Valid, Binding and Enforceable**. This is the core Letter of Credit bank counsel opinion. Generally expected and required by underwriter's counsel and bond counsel.

2. **Preference Opinions**. An opinion dealing with the consequences of Borrower's bankruptcy was once a common requirement of rating agencies. Now not usually required except in the case of addition of new collateral. See, Section II.I. above. In some cases, Moody's may still ask for an opinion relating to the consequences of the bank's insolvency, particularly with respect to a state-chartered bank organized in a jurisdiction where there is a question as to ability of the state regulatory authority to obtain a clawback of payments made by an insolvent bank.

3. **Bankruptcy Exception**. When the rating agencies were requiring preference opinions, they also required that the bankruptcy exception to bank counsel's Letter of Credit enforceability opinion be limited to a bankruptcy, insolvency or similar proceeding with respect to the bank, not the Borrower.

4. **Foreign Bank Counsel Opinions**. In the case of foreign banks, (1) domestic bank counsel will be required to deliver an opinion with respect to the validity, binding effect and enforceability of the Letter of Credit under the applicable domestic law, relying on the opinion of foreign bank counsel and (2) foreign bank counsel will generally be required to opine under the applicable foreign law with respect to (i) existence of the bank, (ii) authorization, (iii) enforceability of the Letter of Credit, and (iv) availability of remedies against the bank in its home jurisdiction.

5. **Section 3(a)(2) Exemption Opinions**. As separate securities in bond financings, Letters of Credit issued by domestic banks are exempt from registration under Section 3(a)(2) of the Securities Act. The Securities Act does not specifically address the availability of this exemption in the case of a branch or agency of a foreign bank which has been licensed to do business under the laws of a particular state. Nevertheless, the Securities and Exchange Commission (the "SEC") in Release No. 33-6661 effective September 23, 1986 (the "Release") has taken the position that, for purposes of Section 3(a)(2) of the Securities Act, a branch or agency of a foreign bank located in the United States will have the benefit of this exemption when (1) the extent and nature of the federal and/or state regulation and supervision of the branch or agency is substantially equivalent to that applied to a federal or state chartered domestic bank doing business in the same jurisdiction, (2) the business of the branch or agency is substantially confined to banking and (3) the branch or agency is supervised by a state banking commission or similar official. Although the Release is not dispositive of legal issues raised under the Securities Act, it does reflect the SEC's legal interpretation of the Securities Act. State of New York regulation of New York branches of foreign banks is well recognized as meeting the requirements of the Release. Sometimes, but not always, domestic counsel for foreign banks is asked to opine as to the exemption of the Letter of Credit from registration under the Securities Act.

M. DISCLOSURE

1. Letter of Credit Bank Disclosure.

(a) <u>Historical Practice</u>. In general, the disclosure regarding the issuing Letter of Credit bank in offering documents for Bonds supported by a Letter of Credit or a Standby Bond Purchase Agreement or other bank-provided liquidity facility has been brief, often limited to: (i) one or two paragraphs describing the Letter of Credit bank (and its holding company, if any), (ii) a few primary financial numbers for the most recent financial reporting period (typically, total assets, total deposits, total net loans and total shareholders' equity), (iii) an address where recipients of the offering document could write to obtain copies of current publicly available reports regarding the bank and/or its holding company; and (iv) more recently, websites where such information can be found. <u>PRACTICE TIP</u>: Consider whether any

such websites are incorporated into the offering for purposes of the Federal securities laws. Many practitioners have limited the websites in such disclosure to the SEC's EDGAR site. Beware of issues that pop up just prior to closing in the context of the certificate from the bank standing behind the limited Bank disclosure contained in the Official Statement. Bond counsel or underwriter's counsel may ask for Rule 10b-5 language to the effect that the Bank disclosure "does not omit to state a material fact." Question the intent of this certificate, as typical Letter of Credit bank disclosure omits to state just about everything. Consider whether the Letter of Credit bank should certify to the true and correctness (i.e., the disclosure isn't actually false).

(b) Rule 15c2-12. Previously, the Rule was not applicable to VRDBs supported by a "direct-pay" Letter of Credit because of the exemption for obligations issued in minimum denominations of $100,000 and subject to tender at par at least every nine months. The 2010 amendments to the Rule ended this exemption and provided that VRDBs are now subject to continuing disclosure requirements.

(c) References to Bank Reports. Most recent financial reports are frequently referenced (and incorporated by reference) in the disclosure (such as call reports and 10-Ks, 10-Qs and 8-Ks). Should there be an undertaking by the Letter of Credit bank to provide copies of such reports on request? Should such documents be formally incorporated by reference into the disclosure?

(d) Foreign Banks. Foreign banks often present additional difficult issues. Reports, in English, providing detailed information about the foreign bank in question are often, but not always, available; however, such reports are not necessarily prepared for the United States securities markets, are often prepared only annually and not available soon after the close of the relevant fiscal year, and are necessarily based on the accounting standards of the foreign bank's home country (and may or may not include some discussion of accounting principles). Moreover, obtaining current information from the principal office of the foreign bank in its home country may be impractical. What is the appropriate balance for disclosure regarding foreign banks in light of the foregoing? Should there be reference to (or incorporation by reference of) annual or interim financial reports produced by the foreign bank or to documents filed by the foreign bank with state or federal regulators in the United States?

(e) Disclosure Regarding Underlying Borrower. Disclosure regarding the underlying Borrower in the case of Bonds supported by a "direct pay" Letter of Credit has varied from complete to very limited (on the theory that the Bonds are being sold on the credit of the Letter of Credit bank and not the Borrower and are subject to tender for purchase at the option of the Bondholder and call at the option of the Borrower on short notice). Finance

teams will need to question what level of disclosure of the Borrower and its operations is necessary.

ISSUES: If the Bonds are subject to tender and call on short notice and are fully backed by the Letter of Credit (both as to debt service and tender purchase price) and if they are sold in large denominations to accredited investors, is disclosure regarding the underlying Borrower material to the Bondholder's investment decision? Borrower as an obligated party?

2. Summaries/Descriptions of Letter of Credit and Reimbursement Agreement.

(f) Letter of Credit. Official Statement descriptions of a Letter of Credit will generally include: (i) a statement that it is an irrevocable obligation of the Letter of Credit bank to honor draws presented by the Bond Trustee in compliance with the terms of the Letter of Credit; (ii) a statement of the Letter of Credit amount, the portion thereof available to pay principal of the Bonds or purchase price thereof corresponding to principal, and the portion thereof available to pay accrued interest (including a statement of the number of days interest and maximum rate at which such portion is determined) or purchase price corresponding to accrued interest; (iii) a brief description of the reduction and reinstatement mechanics of the Letter of Credit; and (iv) a thorough description of the expiration or termination provisions of the Letter of Credit. Sometimes the Letter of Credit itself is included as an appendix to the Official Statement.

ISSUES: In light of concerns regarding fraudulent draws on Letters of Credit by bad actors, what steps can be taken to ensure that draw forms cannot be taken from an Official Statement and manipulated for a fraudulent draw?

(g) Reimbursement Agreement. In the case of VRDBs, Official Statement descriptions of a Reimbursement Agreement usually include (i) a brief statement that the Letter of Credit is being issued, and (ii) a statement that the Reimbursement Agreement contains various representations, warranties and covenants of the Borrower. Official Statements typically include a description of the events of default and remedy provisions of the Reimbursement Agreement. If Bank counsel is being asked to give an opinion that the information contained in the Reimbursement Agreement contains "a fair and accurate summary of the substantive provisions of the Reimbursement Agreement," counsel will probably want to include in the Official Statement a more elaborate description of representations and warranties, covenants, reporting requirements, etc. In the case of Bonds in a long-term mode, special consideration should be given to disclosure of Borrower covenants that, if breached, may give rise to an early redemption of the Bonds and loss of the Bondholders' interest rate bargain.

N. RATING AGENCY/UNDERWRITER HOT BUTTONS

Some typical concerns of rating agencies and underwriters include:

1. **Day Count for the Interest Component of the Letter of Credit**. One would think this would be standardized (e.g., a 31-day month, plus a 3-day weekend, plus a 10-day reinstatement period = 44 days), but every rating agency analyst seems to count differently with conflicting results. One key factor is whether the remedy for non-reinstatement of an interest drawing is an acceleration (in which case interest stops accruing) or a mandatory tender (in which case interest continues to run during the notice period for the tender). If the latter, the notice period for that particular type of mandatory tender should be quite short (2 or 3 days should suffice); a 30-day notice period would lead to a sizing of the interest component of the Letter of Credit at 70+ days. PRACTICE TIP: When the underwriter is beating on the Bank about the sizing of the Letter of Credit, remember that for a $10,000,000 Letter of Credit covering Bonds with a Maximum Rate of 10% per annum and bearing an annual fee of 100 basis points, each additional day of interest coverage leads to an incremental $27.40 per year in Letter of Credit fees. This may help put things in perspective.

2. **Payable from Bank's Own Fund.** Making sure that the Letter of Credit is payable from the Bank's own funds. Note that if the Letter of Credit is governed by ISP 98, that term is deemed included whether or not specifically so stated. ISP 98, Rule 1.09.

3. **Notices to Trustee.** Making sure that notices to the Bond Trustee (particularly any notice of non-reinstatement) are stated to be effective only when received by the Bond Trustee, not when given by the Bank.

4. **The "Hurricane Hugo" Clause**. Note the disparate treatment under the various ICC documents. Under UCP 500, Article 17 and UCP 600, Article 36, if the Letter of Credit expires while the Bank is closed due to force majeure, the beneficiary is out of luck. Under ISP 98, Rule 3.14, if the presentment cannot be made in a timely manner due to closure of the Bank, the time for presentment is extended until 30 days after the Bank reopens. For this reason, UCP 500, Article 17 is often excluded by a Letter of Credit that otherwise adopts UCP 500 by reference and the force majeure situation is dealt by the express terms of such Letter of Credit.

O. CONFIRMING LETTERS OF CREDIT

If the Letter of Credit bank lacks (or loses) a sufficient rating to support the VRDBs, a Confirming Letter of Credit may be obtained. A Confirming Letter of Credit typically allows the Bond Trustee to draw on the Letter of Credit if (i) a proper drawing has been made on the underlying Letter of Credit, but the Letter of Credit bank has failed to pay or (ii) something has occurred (for instance, rejection by the Letter of Credit bank of its obligation to pay under the Letter of Credit or the insolvency of the Letter of Credit bank) that would make a drawing under the underlying Letter of Credit futile. Typically, the Letter of Credit bank enters into a reimbursement agreement with the Confirming Letter of Credit bank pursuant to which the Letter of Credit bank agrees to reimburse the Confirming Letter of Credit bank immediately for any drawing on the Confirming Letter of Credit. The

Confirming Letter of Credit bank may also seek direct recourse against the Borrower for this reimbursement and subrogation rights against collateral granted by the Borrower to the Letter of Credit bank. In other instances, the Confirming Letter of Credit bank regards the Letter of Credit bank as its customer and is not concerned with the Borrower.

A Confirming Letter of Credit may be drafted either (i) to permit reinstatement of interest drawings and/or tender drawings in the same way that a Letter of Credit typically would or (ii) as a one-time calamity call with no provision for reinstatement. In the latter case, the Bond Indenture needs to provide for acceleration or mandatory tender of the Bonds so that the Confirming Letter of Credit can be drawn upon in an amount sufficient to pay the Bondholders in full.

P. OTHER CURRENT LETTER OF CREDIT TOPICS

1. **Master Trust Indenture Covenants**. In many financings, particularly for hospitals, nonprofit entities, universities, and other conduit borrowers, the Lender may be stepping into a situation in which there are multiple series of existing long-term bonds held by others and secured by a Master Indenture. The Borrower and its municipal advisors will argue that the Letter of Credit bank should live with the Master Indenture covenants, because they are good enough for the long-term Bondholders. There are several problems with this argument, including: (i) the position of the long-term Bondholders and the Letter of Credit bank are markedly different; if the Bondholders have a problem with the Borrower they can always sell their Bonds, while the Letter of Credit bank is stuck with the contractual arrangement related to the Letter of Credit, (ii) Master Indenture covenants need to be written loosely, because they need to last for 30 years and the Bondholders may be hard to locate for waivers or amendments, while the bank's commitment is much shorter and the bank is more likely to be available to consider an amendment, consent, or waiver, (iii) if the bank doesn't give a requested waiver or consent, the Borrower can replace the bank as fast as it can find a replacement, while there is no way (short of actual refunding) for the Borrower to rid itself of recalcitrant long-term Bondholders and unwieldy or outdated Master Indenture covenants, and (iv) the Master Indenture covenants are typically written in a way that contemplates a large group of bondholders and are not necessarily what a bank credit committee would readily understand. In particular, note that Master Indenture covenants often calculate debt service coverage on the basis of "MADS" (maximum annual debt service). There are typically many pages of definitions, assumptions and exceptions for the MADS calculation. When commercial bankers refer to debt service coverage, they would more typically mean a retrospective actual-to-actual test. The latter at least has the virtue of being ascertainable from the Borrower's financial statements. Note that, even if the bank decides to live with the Master Indenture covenants as written for covenant definition and calculation purposes, the Bank may want a remedy for violation that differs from the Master Indenture's remedy. All too often, the Master Indenture will have a toothless remedy, such as requiring the Borrower to obtain a consultant's report, whereas the bank may want a more meaningful remedy, such as acceleration and/or a default interest rate (if permitted under local law).

2. **Material Adverse Change ("MAC") Attack**. There is increasing scrutiny of default clauses based on "material adverse change" ("MAC"). In particular, a rating agency may have concerns rating a VRDB issue if a MAC clause exists in the Reimbursement

Agreement. The rating agency's real objection doesn't relate to the VRDB issue that the rating agency is being asked to rate (since the holders of the VRDBs would be paid from the Letter of Credit if the bank accelerates), but the other unenhanced bond issues for the same Borrower that the same rating agency may have previously rated. Accountants have also joined in the attack on MAC defaults. In order to avoid a classification of VRDBs as short-term debt, Borrower needs to convince its accountants that the term-out of Bank Bonds will really work. Some accountants believe that a MAC default creates rights on the Letter of Credit Bank's part that are so subjective that the financing in essence becomes a demand loan.

III. STANDBY BOND PURCHASE AGREEMENTS

A. GENERAL

Liquidity facilities generally take the form of a Standby Bond Purchase Agreement but may take the form of a Letter of Credit or a dedicated line of credit. The purpose is to provide liquidity in the event of a tender and failure to remarket or in the event of a mandatory tender in anticipation of expiration of the existing Standby Bond Purchase Agreement. A Standby Bond Purchase Agreement may be used to provide liquidity for VRDBs that bear a long-term rating based on the credit of the Borrower.

In theory, a Standby Bond Purchase Agreement can be provided by a bank less expensively than a Letter of Credit because the associated capital maintenance requirement is less. One critical difference between a Standby Bond Purchase Agreement and a Letter of Credit is that the issuing bank may terminate, without any notice or cure period, its obligation to fund under the Standby Bond Purchase Agreement in certain circumstances (the "Immediate Termination Events") which are carefully limited by the rating agencies, and, if the Bonds are supported by a Bond Insurance Policy, by the Insurer. In addition, a Standby Bond Purchase Agreement may set forth various other events (including breach of financial or other covenants) (the "Notice Termination Events"), the occurrence of which will permit the bank to suspend or terminate its obligation to purchase Bonds under the Standby Bond Purchase Agreement after 30 days' notice to the Bondholders. Such a notice should trigger a mandatory tender under the Bond Indenture, so a 30-day termination notice will result in the bank funding the tender purchase price of all outstanding Bonds and holding such Bonds as Bank Bonds. Moreover, before a Borrower deteriorates to the point of tripping one of the Immediate Termination Events described below, the Bonds will probably have been tendered by the Bondholder under the optional tender provisions, not successfully remarketed, and ultimately purchased by the bank under the Standby Bond Purchase Agreement.

Bonds purchased by the bank under the Standby Bond Purchase Agreement become "Bank Bonds." Pursuant to the Standby Bond Purchase Agreement (and the Bond Indenture by reference to the Standby Bond Purchase Agreement), Bank Bonds will (i) bear interest at a Bank Rate (discussed in more detail in Section IV below) and be subject to full amortization over shorter period than that established for Bonds that are not Bank Bonds (typically 3 or 5 years for an uninsured deal and often

somewhat longer for an insured deal, in either case commencing after a six-month "hold period"). If an event of default has occurred and is continuing, the Bank Rate on the Bank Bonds may be increased to a stipulated default rate and the bank may have the right to direct a mandatory purchase, redemption or acceleration of the Bank Bonds.

B. IMMEDIATE TERMINATION EVENTS

A Borrower with high long-term credit ratings may typically use a Standby Bond Purchase Agreement for liquidity support of Bonds without a Bond Insurance Policy or any other long-term credit support. In such financings, the following is a list of events commonly permitted by the rating agencies that give rise to an Immediate Termination Event:

1. Borrower bankruptcy events or dissolution or termination of the existence of the Borrower;

2. Principal or interest payment default on the Bonds (including any Bank Bonds, other than as a result of an acceleration of the Bank Bonds);

3. Failure to pay scheduled debt service on senior or parity debt including, without limitation, any regularly scheduled payments on swap contracts (other than payments coming due solely through acceleration of Bank Bonds held by other lenders); or default with respect to senior or parity debt, the effect of which is to permit (determined without regard to whether any notice is required) such senior or parity debt to become immediately due and payable;

4. The downgrade by all rating agencies of the rating on the Bonds below investment grade, or withdrawal or suspension of the rating on the Bonds, unless such withdrawal or suspension is for non-credit reasons;

5. Failure to pay a final, non-appealable judgment of $5 million, which has not been stayed, within at least 60 days;

6. The Borrower legally contests or repudiates the validity of the Bond Indenture, the Loan Agreement or the Standby Bond Purchase Agreement or its obligation to pay principal or interest debt service with respect to the Bonds, including any Bank Bonds; or

7. Invalidity of Bond documents or any material provision thereof relating to principal or interest or the security therefor; or governmental declaration of a debt moratorium affecting the Bonds or affecting all parity debt.

C. SUSPENSION EVENTS

In addition to Immediate Termination Events and Notice Termination Events, some Standby Bond Purchase Agreements include events ("Suspension Events") that permit the bank to suspend its obligation to purchase tendered Bonds. For instance, a Standby Bond Purchase Agreement may provide that if a legal challenge is raised to enforceability of the Bonds, bond documents or bank documents or any provision

relating to the pledge or lien of the security for the Bonds or the Borrower repudiates its obligations with respect to the Bonds, bond documents or bank documents, the bank may suspend its obligation to purchase Bonds pending a final judicial resolution of the challenge; if a final judgment is entered within two years holding that the Bonds are enforceable, the bank's commitment would (subject to other expiration or termination provisions) automatically reinstate, otherwise the commitment would terminate without a requirement for notice or mandatory tender of Bonds.

B. BANK BONDS AS COLLATERAL FOR FRB LOANS

Liquidity draws on Standby Bond Purchase Agreements and Letters of Credit have created substantial liquidity needs for a number of Banks, including the U.S. branches of some foreign banks. One possible source of such liquidity is pledging qualified Bank Bonds to the Federal Reserve Bank as collateral for loans at its discount window. To qualify as eligible collateral, Bank Bonds must have an investment grade (Baa3 or BBB-) or higher rating from Moody's, S&P or another recognized rating service (exclusive of the Bank's Standby Bond Purchase Agreement or Letter of Credit) and must be transferred to the Federal Reserve Bank through DTC (for which purpose the Bank Bonds must have a CUSIP number distinct from the CUSIP numbers assigned to other Bonds of the same issue which are not Bank Bonds). Both the credit rating and the CUSIP number of the Bank Bonds must appear on the same Bloomberg screen. Moody's and Fitch (but not S&P) have been willing to issue ratings of Bank Bonds in advance instead of waiting for a failed remarketing. If a Bank Bond rating is not obtained in advance, the Bank may require the Borrower to covenant to obtain such rating promptly upon a failed remarketing.

IV. REMARKETING

A. RESETTING BOND INTEREST RATE UPON REMARKETING FAILURE

One of the lessons from the VRDB market dislocation in September 2008 is that Borrowers and Remarketing Agents had an incentive to stop remarketing VRDBs when the VRDB interest rate exceeded the applicable interest rate for draws on the Letter of Credit or Standby Bond Purchase Agreement (as the case may be). At the same time, many banks were experiencing liquidity shortages and/or funding expenses exceeding the interest rates they could receive under the relevant Reimbursement Agreement or Bank Bond (as applicable). Banks now include language (i) requiring express language in Bond Indentures and Remarketing Agreements requiring Remarketing Agents to remarket VRDBs up to the maximum rate for which there is credit enhancement coverage and (ii) setting applicable interest rates for unreimbursed draws on Letters of Credit or outstanding Bank Bonds at the highest of a menu of indices intended to cover the relevant bank's cost of funds plus a margin. One increasingly common provision requires that the Bank Rate will never be lower than the rate borne by any outstanding Bonds of the same issue (or, if no such Bonds are outstanding, the Maximum Rate).

1. **Remarketing up to Maximum Credit Enhanced Rate**. Most VRDB Bond Indentures provide for the Remarketing Agent to reset the interest rate for VRDBs daily, weekly or otherwise (as applicable) at the rate for which the VRDBs can be remarketed at par, but not in excess of the Maximum Rate.

2. Issues.

(a) In the absence of a provision in the Bond Indenture permitting the Borrower to direct the Remarketing Agent to cease remarketing Bonds, is the Remarketing Agent in breach of its obligations under the Remarketing Agreement if it fails to reset the interest on VRDBs up to the Maximum Rate as necessary to remarket any and all tendered VRDBs at par? More importantly, even if there is such a breach, what is the remedy?

(b) If most of the Bonds, but not all, remain outstanding or can be remarketed at a significantly lower rate, should the Remarketing Agent be required to set a higher interest rate to provide for full remarketing? Setting a significantly higher interest rate on all Bonds to successfully remarket a minor portion of the Bonds is not in the best interest of the Borrower and may not be in the best interest of the bank as long as the rate on the unreimbursed draw fully covers the bank's funds expense plus a negotiated margin. One solution may be to permit the Borrower, but only with the consent of the bank, to direct the Remarketing Agent not to remarket tendered Bonds.

B. UNREMARKETED BONDS

1. **Reimbursement Agreement Rates for Unremarketed Draws**. After the experience of September 2008, many banks now set the applicable interest rate for unreimbursed Letter of Credit draws at Base Rate plus a specified margin, where "Base Rate" is defined as the higher of (i) the bank's prime rate plus a spread, (ii) the Federal Funds Rate plus a spread, and (iii) 30-day Benchmark Rate plus a specified margin. Some banks also have added a fixed floor to the Base Rate or have specified that the rate for unreimbursed draws will not be less than the Maximum Rate. Note that these rate mechanics should be set forth at length in the Bond Indenture (and set forth in, or incorporated into, the Bond itself).

2. **Bank Bond Rates; Term-Out**. In like fashion, banks are also setting applicable Bank Bond interest rates to cover their funding expense and preserve their margins. Also, Bank Bond term-out terms offered by banks have been tightening.

3. **Borrower Ownership of Tendered Bonds**. In instances where Bonds are not remarketed, the Borrower may desire (or be required by the bank) to reimburse the bank for the draw on the Letter of Credit or Standby Bond Purchase Agreement (as applicable) and take ownership of the unremarketed Bonds. For a Borrower with available liquidity, reimbursement of the bank may avoid significant interest expense and/or term-out requirements while the Borrower pursues replacement credit support, refunding or other solutions.

ISSUES: (i) In the case of Bonds purchased with a draw under a Letter of Credit, if such ownership were expected to be for an extended or indefinite period, the Borrower may want to avoid reinstatement of the Letter of Credit and the associated Letter of Credit fee expense. (ii) At what point are the Borrower-owned Bonds deemed by the accountants and the bond lawyers to have been redeemed, thus defeating the Borrower's plan for eventual remarketing?

C. REMARKETING AGREEMENT/BOND INDENTURE PROVISIONS.

1. **Requirement to Remarket**. Banks are increasingly focusing on Bond Indenture and Remarketing Agreement provisions governing the obligations of the Remarketing Agent to remarket any and all tendered Bonds and resetting the Bond interest rate up to the Maximum Rate as and to the extent required to do so. At least one major commercial bank insists that the bank be included as an express third-party beneficiary of the Remarketing Agreement.

2. **Replacement of Remarketing Agent**. Since the experience of September 2008, banks are increasingly insisting on provisions in transaction documents permitting them to approve replacement Remarketing Agents and, in the case of a failure to remarket tendered Bonds, to direct the replacement of a Remarketing Agent.

V. TERMINOLOGY

In this outline, the following terms have the definitions indicated:

"Bank" or "bank" means the issuer of the Letter of Credit or Standby Bond Purchase Agreement, in each case as indicated by the context.

"Bank Bonds" means Bonds purchased by the bank under a Standby Bond Purchase Agreement or under a Reimbursement Agreement (if the Reimbursement Agreement provides for purchase of Bank Bonds in lieu of pledged Bonds).

"Bank Rate" means the interest rate borne by Bank Bonds.

"Benchmark Rates" refers to interbank reference rates such as SOFR and BSBY.

"Bond Indenture" means the trust indenture, trust agreement, resolution or other trust instrument or governing document under which the Bonds are issued and secured.

"Bond Insurance Policy" means an insurance policy issued by a regulated insurance company (typically a so-called monoline insurance company) that insures the payment of principal of and interest on a series of Bonds in accordance with the terms, and subject to the stated limitations, of such policy and any endorsements thereto.

"Bond Trustee" means the trustee, paying agent and/or tender agent acting for the benefit of the Bondholders under a Bond Indenture.

"Bonds" means bonds, notes, certificates of participation or other obligations supported by a Letter of Credit, a Bond Insurance Policy and/or a Standby Bond Purchase Agreement, or purchased in a direct purchase transaction.

"Borrower" generally refers to the conduit borrower or obligated group member(s) in a conduit financing and to the Issuer in a non-conduit financing.

"BSBY" means the Bloomberg Short-Term Bank Yield Index.

"Issuer" means the governmental entity issuing the Bonds.

"Lender" means the purchaser of Bonds in a direct purchase transaction.

"Letter of Credit" means an irrevocable direct-pay letter of credit issued to support principal, interest and purchase price of VRDBs, or similar product.

"Loan Agreement" means the loan agreement, installment sale agreement or lease agreement between the Issuer and a conduit Borrower, under which the Borrower agrees to make payments corresponding to the required payments of principal of and interest on the Bonds.

"Master Indenture" means a master trust indenture between the Borrower (and any other obligated group member(s)) and a Master Trustee, under which master notes or master obligations are issued to secure Bonds, Reimbursement Agreements and other obligations of the Borrower and any other obligated group members party to such master trust indenture.

"Master Trustee" means the trustee under a Master Indenture.

"Maximum Rate" means the maximum interest rate on the Bonds for which the respective Letter of Credit or Standby Bond Purchase Agreement provides the requisite number of days interest coverage.

"Reimbursement Agreement" means the agreement between the Borrower and the bank pursuant to which a Letter of Credit is issued for the account of the Borrower, and the Borrower agrees to reimburse the bank for draws honored under the Letter of Credit.

"Remarketing Agent" means, in the case of VRDBs, the institution that remarkets tendered Bonds pursuant to the terms of the Bond Indenture and the Remarketing Agreement.

"Remarketing Agreement" means, with respect to VRDBs, the agreement between the Remarketing Agent and the Borrower, pursuant to which the Remarketing Agent agrees (i) to set the daily, weekly or other periodic interest rate on the Bonds in accordance with the Bond Indenture and (ii) to remarket tendered Bonds.

"SOFR" means the secured overnight financing rate published each business day by the Federal Reserve Bank of New York.

"Standby Bond Purchase Agreement" means an agreement by and among a Borrower, a Bond Trustee and a Bank, pursuant to which the Bank agrees, subject to the terms and limitations thereof, to purchase unremarketed tendered VRDBs.

"VRDBs" or "VRDOs" means variable rate demand bonds or variable rate demand obligations; i.e., Bonds with a variable interest rate (usually daily or weekly) and a corresponding feature for optional tender, as well as provisions for mandatory tender upon the occurrence of certain events.