Bank Products & Direct Purchases — General Considerations (Non-Tax)

PANEL CHAIR:

Katherine A. Gale – Chapman and Cutler LLP – Chicago, IL

PANELISTS:

Jonathan Casiano – PNC Public Finance – New York, NY

Amy K. Condaras – Frost Brown Todd LLP – Charleston, WV

Michael G. Thomas – Kutak Rock LLP – Denver, CO

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Overview

Market Snapshot – 5 Year Lookback

Factors Affecting the Bank Market

Tales from the Trenches

- Bank Failures
- What's old is new again – the return of LOCs and SBPAs
- R.I.P LIBOR
- Highly Negotiated Document Provisions
- Covenant Defaults
- Navigating Anti-ESG and Pro-ESG Legislation

Kirschner v. JPMorgan Chase Bank, N.A.

Recent SEC Enforcement Actions

Market Snapshot

MUNICIPAL LONG-TERM BOND ISSUANCE – NUMBER OF ISSUES

Year	Revenue (Negotiated and Competitive Sale)	General Obligation (Negotiated and Competitive Sale)	Private Placement	Total Municipal	Private placement percentage of total number of issues
2018	3,275	5,274	1,062	9,611	11.1%
2019	3,945	6,662	995	11,602	8.6%
2020	4,120	7,729	1,492	13,341	11.2%
2021	4,575	7,287	1,271	13,133	9.7%
2022	2,955	4,958	1,270	9,183	13.8%

Source: 2023 SIFMA Capital Markets Fact Book (July 2023) available at: https://www.sifma.org/resources/research/fact-book/

Market Snapshot

MUNICIPAL LONG-TERM BOND ISSUANCE – VALUE ($ BILLIONS)

Year	Revenue (Negotiated and Competitive Sale)	General Obligation (Negotiated and Competitive Sale)	Private Placement	Total Municipal	Private placement percentage of total number of issues
2018	202.0	120.9	23.9	346.8	6.9%
2019	246.2	160.555	19.6	426.4	4.6%
2020	261.3	190.0	33.9	485.2	7.0%
2021	281.7	175.4	26.3	483.4	5.4%
2022	219.9	140.0	30.9	390.8	7.9%

Source: 2023 SIFMA Capital Markets Fact Book (July 2023)
available at: https://www.sifma.org/resources/research/fact-book/

Factors Affecting the Bank Market

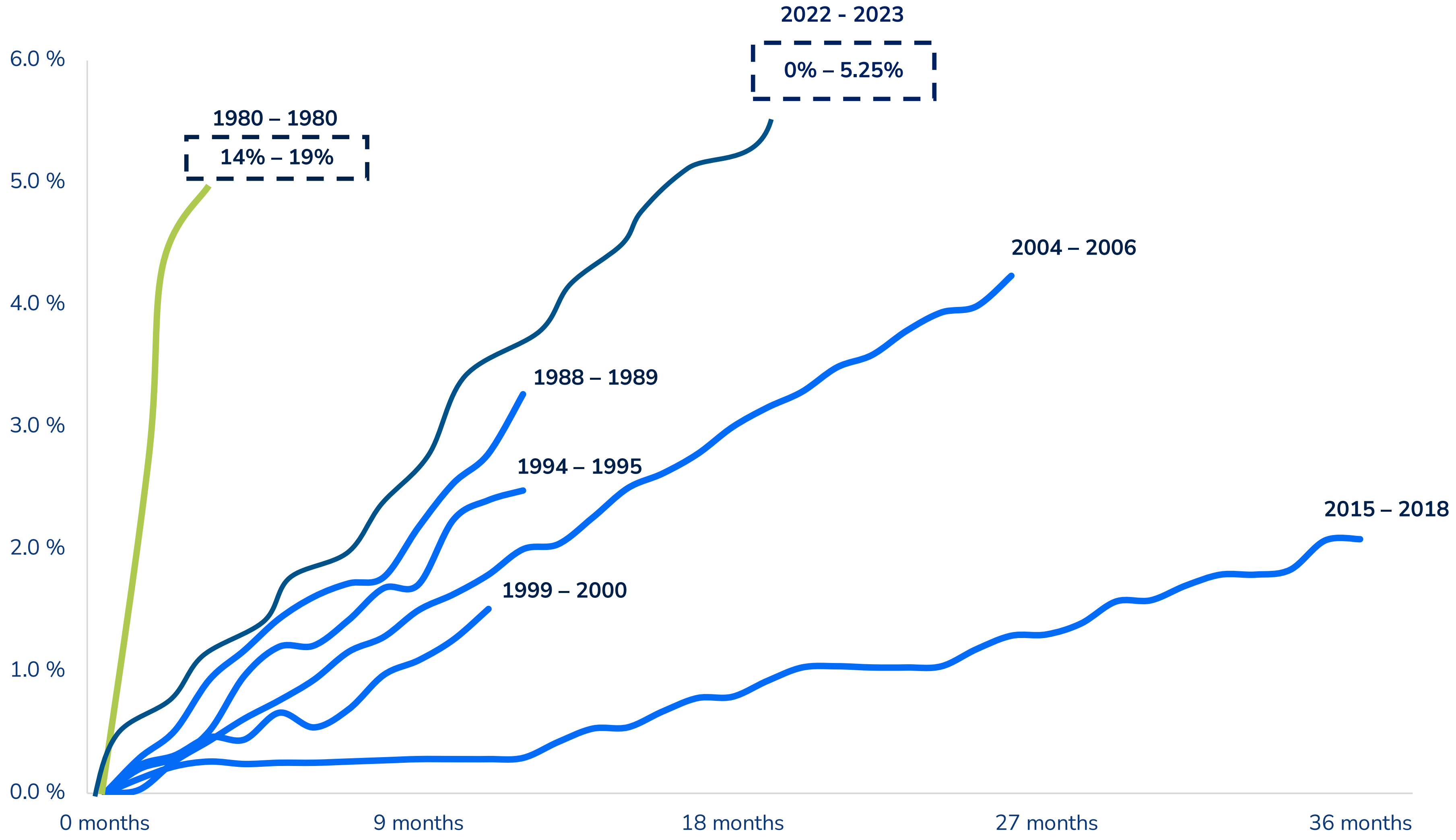
2022

- Fed interest rate increases (March, May, June, July, September, November, December)
- Yield curve inverts
- Recession concerns and first signs of deteriorating credit quality

2023

- Continued Fed interest rate increases (February, March, May, July, September) = increased bank funding costs due to higher cost of deposits
- Bank Failures (starting with SVB in March) = new regulation and higher proposed capital requirements for mid-sized banks
- More prominent credit concerns = increased capital reserves and tighter lending standards
- Rating Downgrades reflecting dual pressures of higher funding costs and increased capital requirements

Unprecedented Rate Increases
Largest Rate Increase and Fastest Percentage Change Since 1980



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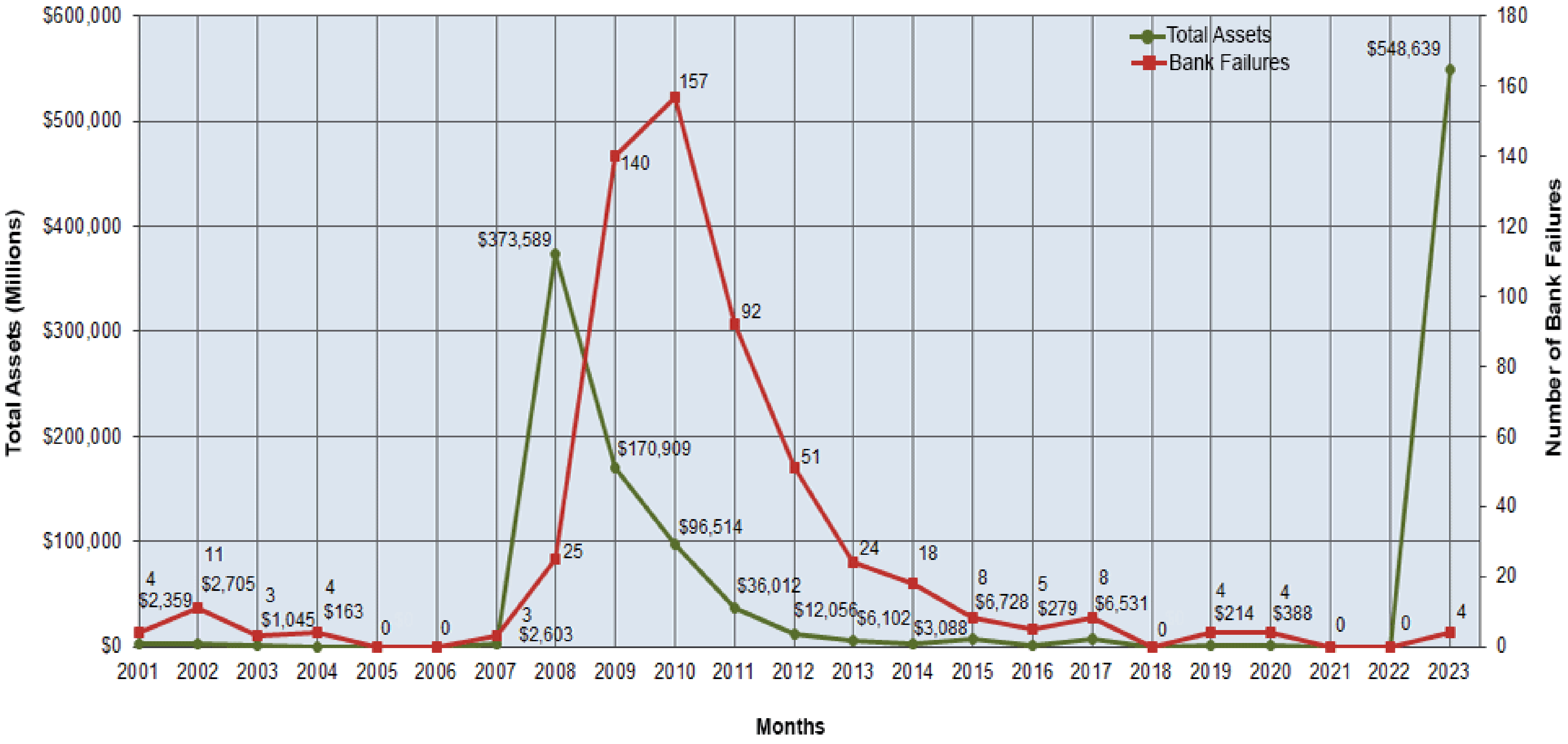
Bank Failures in Brief – Summary 2001–2023

There were 565 bank failures from 2001 through 2023.



Source: https://www.fdic.gov/bank/historical/bank/

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Impact on Bank Activity in the Municipal Market

Costs

- Elevated cost of capital and expectation of prolonged higher rate environment are being priced into longer term deals

Relationships Matter

- Pressure on bank net interest margins put added emphasis on fee-generating relationships

Covenants and Security

- Expectations of economic weakening and credit stress bringing focus back to credit structure

2023 – A Bit of Everything

- **Direct Purchase Structures**
  - Fixed and Variable
  - Forward Bond Purchases
  - Cinderella Structures
- **Traditional Bank Products**
  - Lines of Credit
  - Term Loans
- **Variable Rate Demand Bonds and Put Bonds**
- **Letters of Credit**
- **Standby Bond Purchase Agreements**
- **Self-Liquidity (Hybrid Lines)**
- **Commercial Paper**

Re-Emergence of Variable Rate Demand Bonds

Long-term bonds with short-term rates

Floating Rate resets periodically

Multi-Modal Bond Indentures

Multiple variable rate reset options - weekly, daily, two-day periods, flexible rate periods, etc.

Put option

- Purchaser has the right to tender bonds on specified dates at a predetermined price (par plus accrued interest)
- Failed remarketing credit risk

Rise of Credit and Liquidity Facilities

Self-liquidity

Letter of Credit and Reimbursement Agreement

- Credit Enhancement and Liquidity Support
- Unconditional commitment
- LOC provider pays principal and interest purchaser if issuer cannot
- Short-term and long-term rating based on bank rating

Standby Bond Purchase Agreement

- Liquidity Support
- Conditional, may be terminated under certain circumstances such as:
  - Change in issuer rating
  - Issuer default
  - Issuer bankruptcy
- Short-term rating based on bank, long-term rating based on issuer

Sample Schedule for VRDBs in Daily Rate Mode supported by a Liquidity Facility

11:00 am – Bondholders give formal notice to tender bonds to trustee and/or tender agent

11:30 am – Remarketing agent notifies trustee of amount of tendered bonds successfully remarketed and transfers remarketing proceeds to trustee for deposit in the bond purchase account

12:00 pm – Trustee gives notice of draw on the liquidity facility in the amount of unremarketed bonds plus accrued interest (if the trustee has not yet received remarketing proceeds or formal notification from remarketing agent of amount of bonds tendered but not remarketed by the prescribed time, then trustee assumes a complete failed remarketing and draws on the liquidity facility for the full amount of such tender)

2:00 pm – Liquidity provider transfers funds equal to amount of requested draw to the trustee for deposit in the bond purchase account

2:30 pm – Bondholders are paid with proceeds of remarketing proceeds and/or liquidity draws

Market Intel

Credit and Liquidity Facilities – what are participants seeing in terms of:

- Tenors
- Termination Fees
- Term-Outs
- Conditions to Term-Out

Direct Purchases – what are participants seeing with respect to:

- Tenors
- Taxable Rate Factor: If formula based – does it take into account both increases and decreases in the Maximum Federal Corporate Tax Rate?

Completing the LIBOR to SOFR Transition

The "Adjustable Interest Rate (LIBOR) Act" was signed by President Biden on March 15, 2022

The LIBOR Act broadly applies to any contract, agreement, instrument, or other obligation which uses any of the overnight one-month, three-month, six-month, or 12-month tenors of the U.S. Dollar LIBOR for the determination of interest and

1. does not identify a specific replacement following the discontinuance of LIBOR or

2. does not identify a person with the authority, right or obligation to determine a replacement rate, referred to as a “determining person” under the LIBOR Act

On the first London banking day following the discontinuance of LIBOR (July 3, 2023), affected contracts automatically shifted to a replacement rate selected by the Board of Governors of the Federal Reserve System based on the Secured Overnight Financing Rate (“SOFR”)

Automatic shift also applied if an agreement identifies a determining person, and such person did not select a replacement rate by July 3, 2023

Highly-Negotiated Document Provisions

- Default Rate
- Prepayment Provisions (make whole; breakage)
- Transfer and Participation Provisions
- Change in Law / Increased Costs
- Reporting Requirements
- Indemnification
- Most Favored Nations clauses
- Material Defaults
- Acceleration and other Remedies
- Force Majeure
- Sale/Transfer/Merger Provisions

Navigating Covenant Defaults in Bank Agreements

Borrowers still dealing with effects of COVID-19, supply chain disruptions, staffing shortages, payroll inflation

- Reduced revenue
- Higher expenses

Compliance with financial covenants in debt documents may be at risk

Options:

- Waiver
- Amendment/Covenant ‘holiday’
- Forbearance

15c2-12 reporting requirements

Navigating Anti-ESG Legislation

Anti-ESG laws proposed or adopted in numerous states

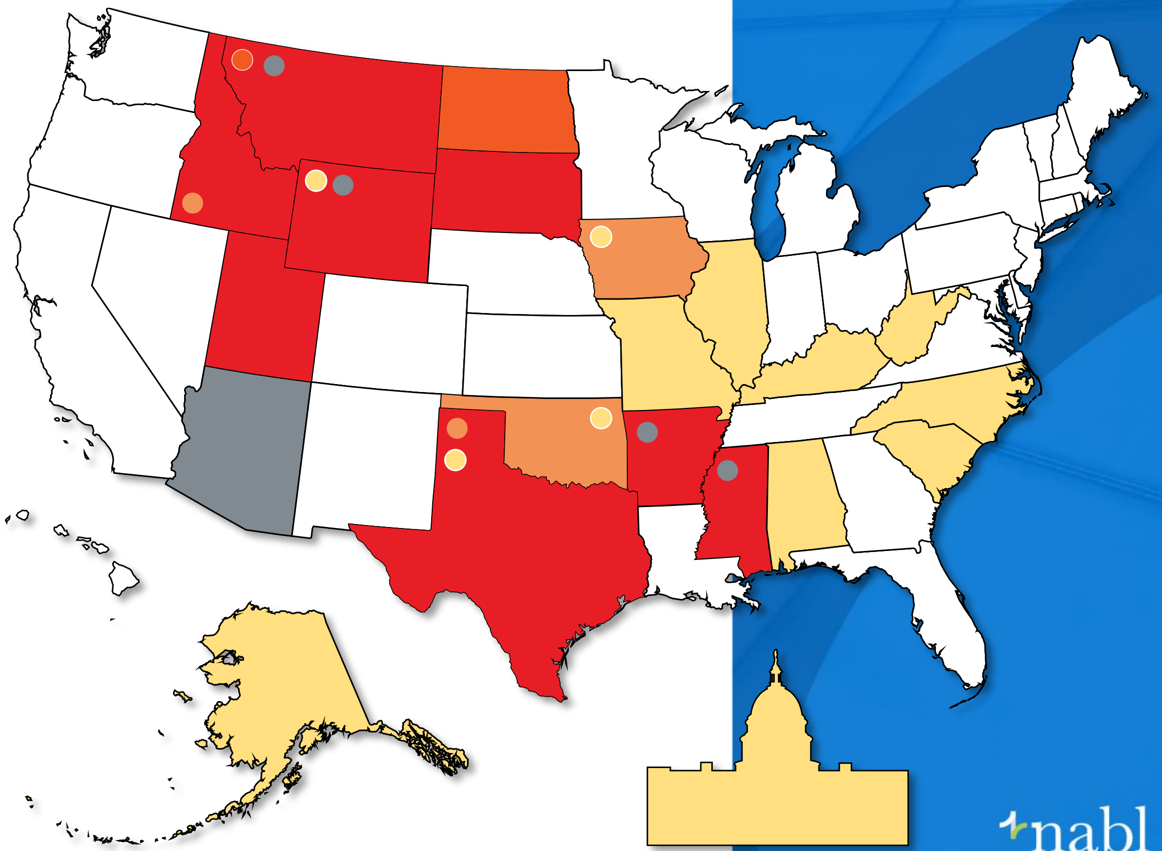
These laws vary considerably from state to state but often fall into two categories:

- **"Anti-Discrimination"** or **"Anti-Boycott Bills"** – laws prohibiting the state from doing business with "financial institutions" that "boycott" or "discriminate against" companies in certain industries (i.e., firearms, oil and gas etc.)
- **"Anti-ESG Bills"** – laws prohibiting the use of state funds for the purpose of social investment

Navigating Anti-ESG Legislation

FIREARM ANTI-DISCRIMINATION BILLS

- Legislation enacted in Texas (2021), Wyoming (2021), Arkansas (2023), Idaho (2023), Mississippi (2023), Montana (2023), Utah (2023), and South Dakota (2023 Executive Order)
- Legislation enrolled in North Dakota and Montana
- Legislation engrossed in Kentucky, Idaho, Iowa, Oklahoma, and Texas
- Legislation introduced in Alabama, Alaska, Illinois, Iowa, Missouri, North Carolina, Oklahoma, South Carolina, Texas, West Virginia, Wyoming, and U.S. Congress
- Legislation vetoed in Arizona; died/did not pass in Arkansas, Mississippi, Montana, and Wyoming



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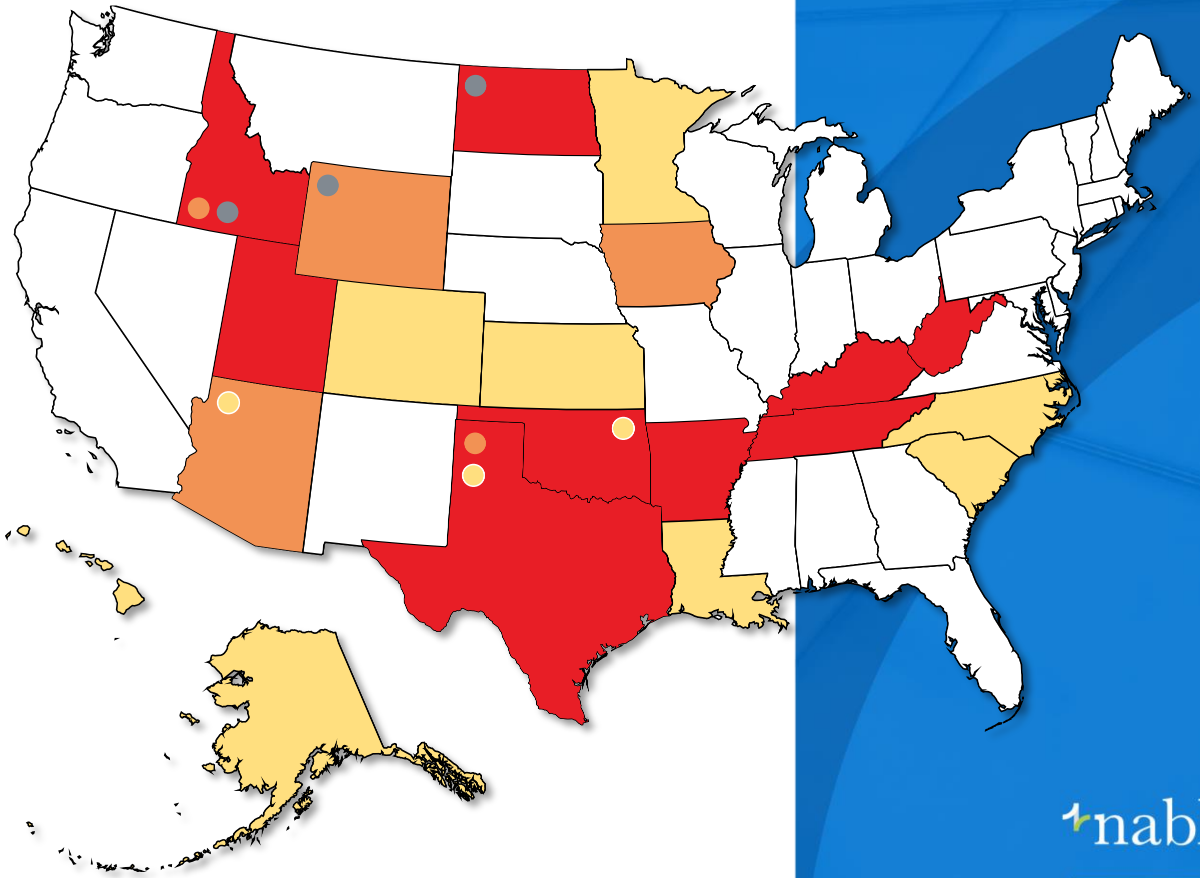
OIL & GAS ANTI-BOYCOTT BILLS

- Legislation enacted in Texas (2021), North Dakota (2021 & 2023), Kentucky (2022), Oklahoma (2022), Tennessee (2022), West Virginia (2022), Arkansas (2023), Idaho (2023), North Dakota (2023), and Utah (2023)
- Legislation engrossed in Arizona, Idaho, Iowa, Texas, and Wyoming
- Legislation introduced in Alaska, Arizona, Colorado, Hawaii, Kansas, Louisiana, Minnesota, North Carolina, Oklahoma, South Carolina, and Texas
- Legislation died/did not pass in Idaho, North Dakota, and Wyoming



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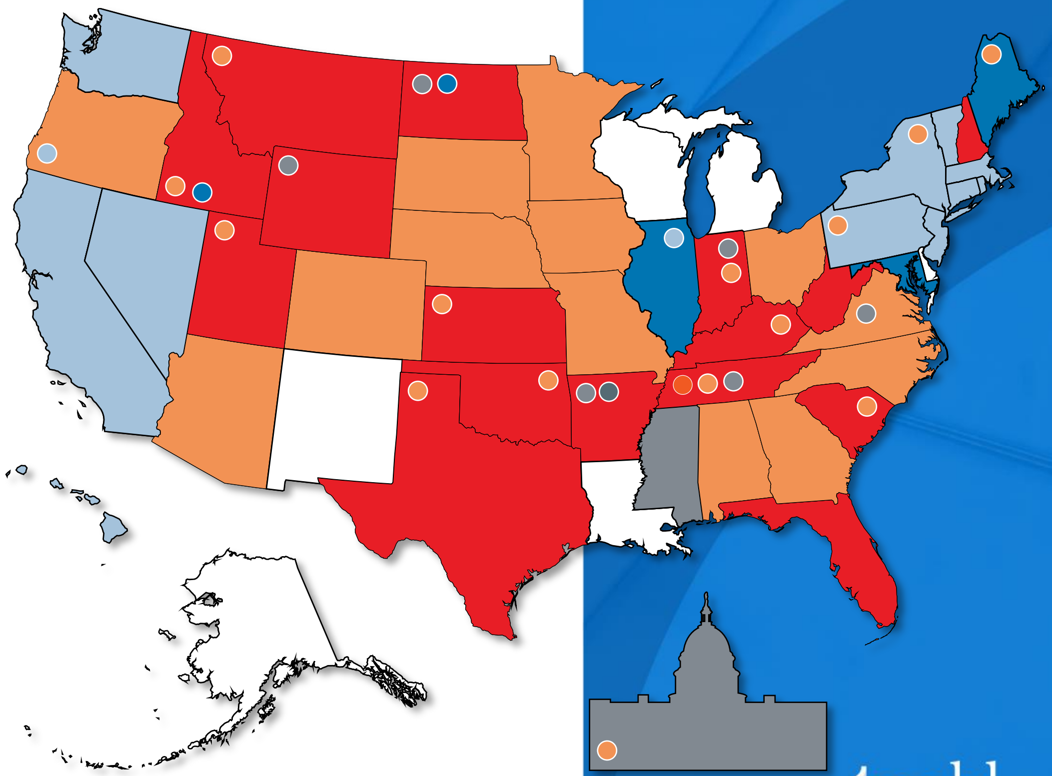
PRO- OR ANTI-ESG DIVESTMENT/INVESTING POLICIES

Actions Promoting Integration of ESG Considerations in Investment Decisions

- Legislation enacted in Illinois (2019), Maine (2021), North Dakota (2021), Idaho (2022), and Maryland (2022)
- New legislation engrossed or introduced in California, Connecticut, Hawaii, Illinois, Massachusetts, Nevada, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Vermont, Washington
- Legislation died in Arkansas

Actions Restricting Use of ESG Considerations in Investment Decisions

- Firearm anti-discrimination, oil & gas anti-boycott and other anti-ESG legislation enacted in North Dakota (2021 & 2023), Texas (2021), Wyoming (2021), Idaho (2023), Kansas (2023), Kentucky (2023), Oklahoma (2022), Tennessee (2022), West Virginia (2022 & 2023), Arkansas (2023), Florida (2023), Indiana (2023), Montana (2023), New Hampshire (Executive Order in 2023), North Dakota (2023), Utah (2023), and West Virginia (2023
- Legislation engrossed or introduced in Alabama, Arizona, Colorado, Georgia, Indiana, Iowa, Kansas, Kentucky, Maine, Minnesota, Missouri, Nebraska, New York, North Carolina, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Texas, Virginia, West Virginia, and United States Congress
- Legislation vetoed in United States Congress; died/did not pass in Arkansas, Indiana, Mississippi, North Dakota, Tennessee, Virginia, and Wyoming



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Navigating Anti-ESG Legislation

- Some Anti-ESG laws require broad representations and ongoing covenants from banks
- Sample Document Provisions:

Section 7.24. Verification Regarding Energy Company Boycotts. To the extent this Agreement constitutes a contract for goods or services for which a written verification is required under Section 2274.002 (as added by Senate Bill 13 in the 87th Texas Legislature, Regular Session), Texas Government Code, as amended, **the Bank hereby verifies that it and its parent company, wholly- or majority-owned subsidiaries, and other affiliates, if any, do not boycott energy companies and will not boycott energy companies during the term of this Agreement**. The foregoing verification is made solely to enable the Authority to comply with such Section and to the extent such Section does not contravene applicable Federal or Texas law. As used in the foregoing verification, "boycott energy companies," a term defined in Section 2274.001(1), Texas Government Code (as enacted by such Senate Bill) by reference to Section 809.001, Texas Government Code (also as enacted by such Senate Bill), shall mean, without an ordinary business purpose, refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations with a company because the company (A) engages in the exploration, production, utilization, transportation, sale, or manufacturing of fossil fuel-based energy and does not commit or pledge to meet environmental standards beyond applicable federal and state law; or (B) does business with a company described by (A) above.

Section 7.25. Verification Regarding Discrimination Against Firearm Entity or Trade Association. To the extent this Agreement constitutes a contract for goods or services for which a written verification is required under Section 2274.002 (as added by Senate Bill 19 in the 87th Texas Legislature, Regular Session), Texas Government Code, as amended, **the Bank hereby verifies that it and its parent company, wholly- or majority-owned subsidiaries, and other affiliates, if any, do not have a practice, policy, guidance, or directive that discriminates against a firearm entity or firearm trade association and will not discriminate against a firearm entity or firearm trade association during the term of this Agreement**. The foregoing verification is made solely to enable the Authority to comply with such Section and to the extent such Section does not contravene applicable Federal or Texas law.

- Other politically-motivated laws affecting municipal financings and bank selection

Loan vs. Security Refresher

The direct placement as a “security” issue impacts the obligations and requirements of placement agents and municipal advisors in a transaction

May trigger MSRB, SEC and FINRA rules and regulations

Implications for Bank

Implications for Issuer – when information is disclosed directly to Lenders, does the obligated person have an obligation to make this information publicly available through EMMA or other means even if not specifically required under a CDA?

- Municipal advisor v. placement agent
- Sale of “Securities” subject to Federal Securities Laws (Town of Sterlington)

Kirschner v. JPMorgan Chase

Second Circuit Court of Appeals reconfirmed the widely accepted view that loans are not securities under federal or state securities laws

Parties in the case agreed that the proper test for determining whether the term loans were securities was the four-part test enunciated by the Supreme Court in 1990 in *Reves v. Ernst & Young*

Test begins with the presumption that every note is a security but then directs the courts to look at the following factors to determine whether the note is in fact a security:

1. **the motivation of the parties** – examination of whether the transaction was motivated by investment (*e.,* did the buyer expect to profit, suggesting a security) or commercial purposes (*i.e.,* did the transaction advance some commercial purpose, suggesting a loan);
2. **plan of distribution** – whether the notes were offered and sold to a broad segment of the general public or to a limited universe of sophisticated institutional entities;
3. **reasonable expectation of investors** – whether the participants in the market understood the instrument to be a security or a loan; and
4. **existence of other risk-reducing factors that render the application of securities laws unnecessary** – such as the existence of other regulatory schemes or collateral securing the instrument.

Enhanced SEC Scrutiny on Underwriters

Limited Offering Exemption – exemption from primary offering requirements (no CDA or official statement required) for municipal securities in denominations of at least $100K that:

1) are sold in a limited placement to no more than 35 sophisticated investors or
2) mature within 9 months

Enhanced SEC scrutiny on Underwriters who fail to satisfy the LOE

7 firms charged with violating the exemption in 2022-2023

Implications for Direct Purchase Transactions?

Selective Disclosure/Material Non-Public Information

- Given that many municipal issuers have stale financial information, direct lenders typically ask questions and require (unaudited) current financial information to extend credit
- If an Issuer is giving out "material non-public information" it needs to take steps to make sure it is not being used in the trading markets and is otherwise kept confidential regardless of whether Reg FD (Fair Disclosure) applies or not
- When public market Issuers provide direct lenders with information (e.g., COVID impacts or up-to-the minute info regarding fund balances) not disclosed to the public market, they often include a disclaimer which serves as a de facto confidentiality non-disclosure agreement:

> "Confidentiality and Nondisclosure Restrictions: Certain of the financial, demographic or statistical information sent to you, or to be sent to you, with respect to this Request for Bank Loan Proposal may be internal or draft information of, or about, the Borrower that is not generally available to the public or to the investment community generally. Accordingly, by acceptance of this Request for Bank Loan Proposal, you are deemed to have agreed to use all financial, demographic or statistical information sent to you, or to be sent to you, solely for your internal evaluation of the creditworthiness and pricing of any Bank Loan Proposal you may submit. Subject to applicable law, no information sent to you, or to be sent to you, with respect to this Request for Bank Loan Proposal may be disseminated to anyone outside of your Bank or to any persons within your Bank not involved in the evaluation of the creditworthiness and pricing of any Bank Loan Proposal you may choose to submit. If you do not, or cannot, agree to abide by this Restriction, you are required to return or destroy all information sent to you with respect to this Request for Bank Loan Proposal."

Any Questions?

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