Refunding and Reissuance

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The Workshop

OCTOBER 18–20, 2023

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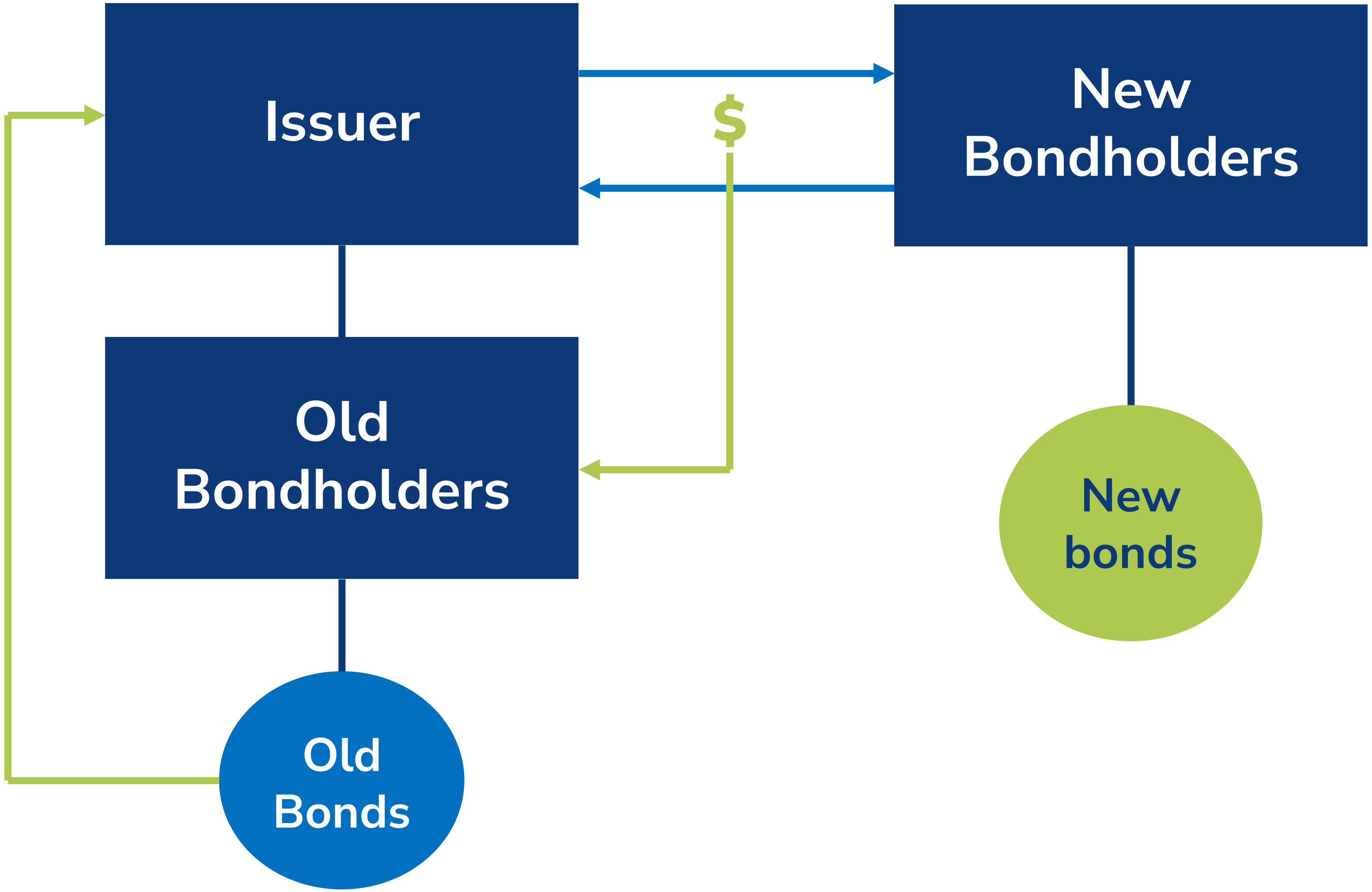
Tenders & Exchanges Overview

Tender (with New Bonds): Issuer issues new bonds to new holders in exchange for bond proceeds received from new holders. Issuer pays those bond proceeds to holders of old bonds, who agreed to hand in their old bonds.

Exchange Bonds: Issuer issues new bonds to holders in exchange for old bonds.

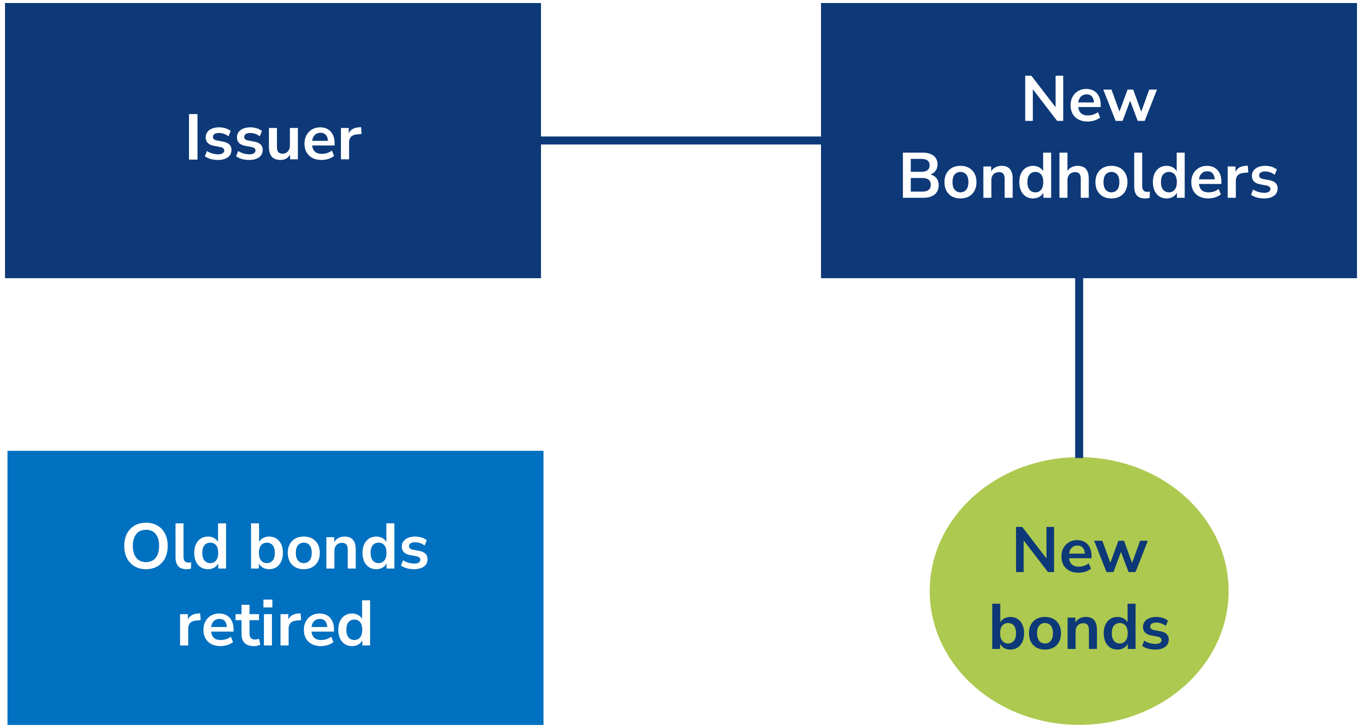
The tender/exchange process is usually run by a **Dealer-Manager.** Usually this party will be the underwriter for the new bonds.

Tender

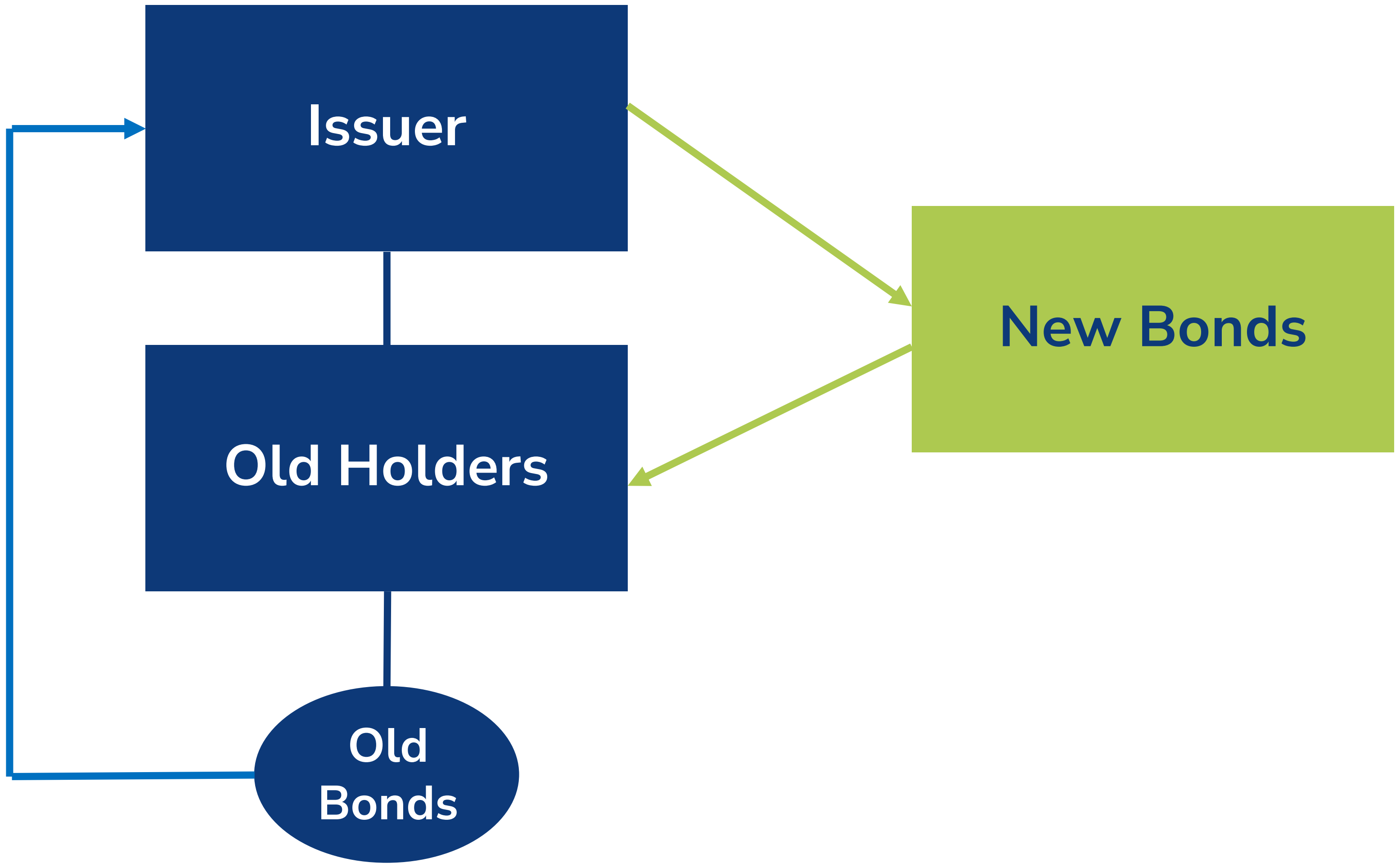


Issuer
New
Bondholders
$
Old
Bondholders
New
bonds
Old
Bonds

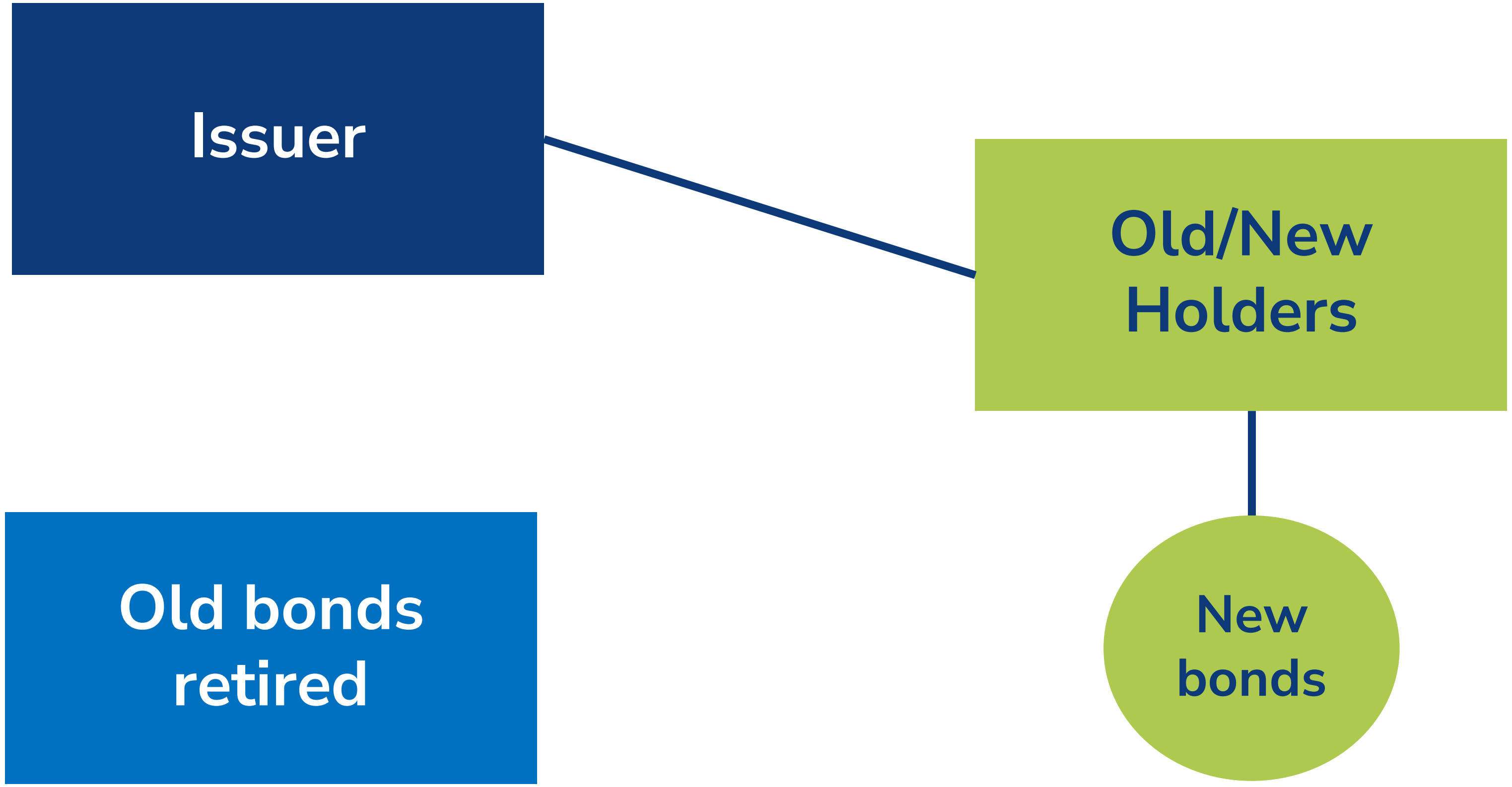
Tender (aftermath)



Exchange



Exchange (aftermath)



Tender vs. Exchange vs. Current Refunding

Question	Tender	Exchange	Traditional Current Refunding
Issue Price of New Bonds	1.148-1(f)	1271-1275	1.148-1(f)
Type of consideration paid to old bondholders	Money from new bond sale	New bonds	Money from new bond sale
Amount of consideration paid to old bondholders	Negotiated price in the secondary market (usually at a premium above the market value of the bonds, to entice)	Specified par value of bonds based on an "exchange factor" derived from market conditions, etc.	Enough money to pay principal, accrued interest, and (in rare cases), redemption premium.
Escrow period?	No.	No.	Up to 90 days.
Can it count as a remedial action?	Yes.	Yes.	Yes.
How many old bonds are involved?	Uncertain - Don't know until the Tender Period ends.	Uncertain - Don't know until the Exchange Period ends.	Certain - Issuer decides.
Disclosure Documents	Tender Offer and other docs for old bonds; POS/OS for new bonds	Exchange Offer and other docs for old bonds; POS/OS for new bonds	POS/OS for new bonds

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Why do a Tender or Exchange?

You get the **economics** of calling bonds that can't be called and can't be advance refunded.

You can use them to **force changes to bond documents** that otherwise require bondholder consent.

Historical reasons:

- Might be cheaper than advance refunding
- Could be used to remediate noncallable bonds before defeasance permitted in 1997 Regulations

Tenders and Exchanges – Issue Price

Tender. Easy. Issue price of the new bonds is governed by 1.148-1(f).

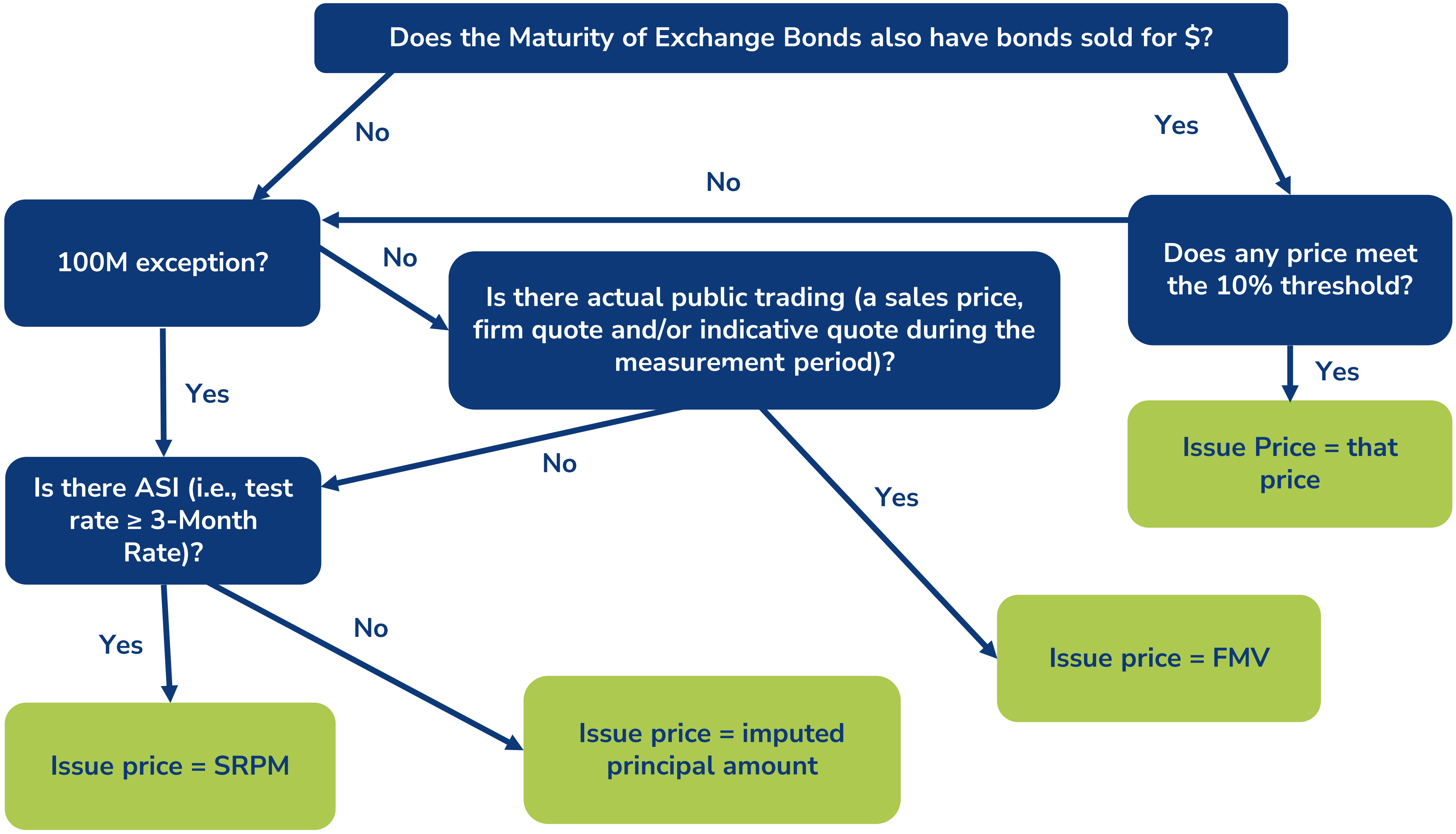
Exchange. Not easy. See below.

"Issue" = "Maturity" for purposes of OID Regs

- Bonds that have the same credit and payment terms are considered a single "issue" for purposes of the OID regs and have a single issue price. Same coupon, maturity, and call date.

- Likely means an individual CUSIP.

Issue Price of a Maturity of Exchange Bonds



Tenders and Exchanges – Issue Price

Issue price in general:

When new bonds are issued in exchange for old bonds (as opposed to cash), and neither the old bonds nor the new bonds are "publicly traded" then:

If the new debt does not bear "adequate stated interest," issue price = imputed principal amount

If the new debt bears "adequate stated interest," issue price = stated principal amount

General rule in 1.148-1(f)(1): issue price for all bonds determined under 1273 and 1274. The other provisions of 1.148-1(f) are special rules *dealing solely with bonds issued for money*.

Tenders and Exchanges – Issue Price

Publicly Traded Property.

- A big turning point in the analysis is whether the bonds are “publicly traded.”
- In general, your life will be much easier if both the old bonds and the Exchange Bonds <u>are not</u> considered publicly traded property.
- If a Maturity has a principal amount of $100,000,000 or less and the amount of old bonds being exchanged has a principal amount that is $100,000,000 or less, then the Small Maturity Exception applies and the old bonds and the Exchange Bonds are not treated as publicly traded.

Tenders and Exchanges – Issue Price Analysis

Step 1

Will there be any Exchange Bonds that are part of a single Maturity with bonds issued for money?

- **If no**, continue.
- **If yes**, will those bonds have a price that crosses the 10% threshold?
  - **If yes**, then the issue price of all bonds of that Maturity, *even the Exchange Bonds*, is that first price to cross the 10% threshold.
  - **If no**, continue.

Tenders and Exchanges – Issue Price Analysis

Step 2

For any Maturity of the Exchange Bonds where the principal amount of **both the old and new bonds will be $100 million or less:**

- That Maturity meets the Small Issue Exception, and by definition is not publicly traded, under 1.1273-2(d)(6)
- If a Maturity has **adequate stated interest**, its issue price is its stated redemption price at maturity (i.e. par amount)
- If a Maturity <u>does not</u> have adequate stated interest, its issue price is its imputed principal amount.

Tenders and Exchanges – Issue Price Analysis

Adequate Stated Interest

If a debt instrument has a single fixed rate of interest that is paid or compounded at least annually, and that rate is equal to or greater than the **test rate**, the debt instrument has adequate stated interest.

Test Rate

“3-month rate” equal to the lower of:

- The lowest adjusted applicable Federal rate (AAFR) in effect during the 3-month period ending with first month in which there is a binding written contract

- The lowest AAFR in effect during the 3-month period ending with the month in which the sale or exchange occurs

Tenders and Exchanges – Issue Price Analysis

Step 3

For any Maturity of the Exchange Bonds where the principal of either the Exchange Bonds or the old bonds will be **more than $100 million:**

- Are the bonds actually publicly traded?
  - If so, Issue Price = FMV
  - FMV is demonstrated by the presence of sales prices, firm quotes or indicative quotes during a 31-day "measurement period" ending 15 days after the issuance date

Note: the fact that there has not been significant trading "recently" is not enough to conclude that the debt isn't publicly traded.

Tenders and Exchanges – Issue Price Analysis

Sales Prices: look at sale activity of the old bonds. EMMA? Bloomberg?

Firm Quotes: Generally means that the party providing the quote has to have cash to support the position (for a quote to buy a bond) or own the bond in question (for a quote to sell a bond)

Indicative Quotes: a price quote that is available from at least one broker, dealer or pricing service for property and the price quote is not a firm quote

Tenders and Exchanges – Disclosure

Tax disclosure may be provided in the Tender or Exchange Offer with respect to the old bonds and in the POS/OS with respect to the new bonds

Issue Price discussion will be the bulk of the disclosure

It may be important to disclose that **no one is opining on the ongoing tax-exempt status of the refunded bonds**

Much of the disclosure will depend on the status of the tender/exchange under the securities laws and the specific facts of the transaction (for example, whether the tender offer is a true "offer" to holders or whether it's an invitation to make offers, whether it's revocable, sources for the tender, etc.)

Tenders and Exchanges – Other Issues

Uncertainty about the Size of the Issue until Pricing

- Tender/exchange carries some uncertainty about the size of the tender/exchange portion, which will affect the overall issue size
- May need to build in some cushion and try to establish guideposts about the likely minimum/maximum size of the tender/exchange portion
  - **Amount of Proceeds**: COI limit, volume cap and other limits depend on the amount of proceeds
  - **Useful Life**: if you're calculating on a combined basis, how much of an anchor will the refunding portion be to your new money portion?
  - **Multipurpose Issue Allocation**: will the debt service profile of the tendered bonds affect your savings analysis?

Tenders and Exchanges – Other Issues

Uncertainty about Which Bonds will be Refunded

- Often the Dealer-Manager will identify several different prior issues
- Best practice is to conduct tax diligence on all candidates, but work closely with Dealer-Manager to determine which candidates are realistic to avoid unnecessary fees/work

Additional Amounts paid to entice bondholders to tender bonds

- Treated as part of the redemption price and thus proceeds of a tax-exempt bond issue used for this purpose treated as refunding

Are fees for the Dealer-Manager/Information Agent COI?

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Current Refunding Escrows

- **Yield Restriction**: 90-Day Temporary Period (1.148-9(d)(2)(ii))
  - Reduced to 30 days if maturity of 270 days or less
- **Rebate:** Six Month Spending Exception (1.148-7(b))
  - Generally transferred proceeds are excluded from calculation and separately subject to rebate
- As a result, the Current Refunding Escrow may be permitted to earn and retain positive arbitrage
- Note that Escrow Fund **earnings are considered investment proceeds** of the Bonds and should be accounted for in the sizing of the Escrow Fund or otherwise allocated to eligible tax-exempt expenditures.

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Current Refunding Escrows – Other Contributions

Prior Bona Fide Debt Service Fund:

- Do prior debt service fund contributions retain their temporary period?
- Are they still considered to be part of a bona fide debt service fund and excluded from the rebate calculation?

Prior Reserve Fund:

- Are prior reserve contributions yield restricted?

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Transferred Proceeds

- **Temporary Period** begins on the date those amounts become transferred proceeds of the refunding issue and **ends on the date the temporary period would have ended under the prior issue**

Hypothetical:

- Issuer has $5M in unspent construction fund proceeds of prior issue and still wants to complete the original project.
- Can the Issuer contribute the unspent proceeds to the Escrow Fund and issue $5M in New Money bonds to finance the same project (and get a new 3-year temporary period)?

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Taxable Refunding

- Amounts held in the escrow are proceeds of the taxable obligation unless deallocated pursuant to application of the Universal Cap
- If proceeds become allocable to the tax-exempt bonds as a result of the Universal Cap, such investments are valued at FMV at the time of transfer

Cash Defeasance

- Defeasance escrow subject to yield restriction at the yield of the defeased issue

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Cash Optimization (Cash Defeasance + New Money Bonds)

Be careful with Cash Defeasance transactions proposed in connection with New Money Bonds

Important to avoid nexus between the two transactions that might create replacement proceeds

No "Reimbursement Refundings" – 1.150-2(h):

- Reimbursement allocation is invalid and not an expenditure of proceeds if, within 1 year after the allocation, funds corresponding to that amount are used in a manner that creates replacement proceeds

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Cash Optimization (Cash Defeasance + New Money Bonds)

Factors to consider:

- Nexus between cash defeasance and the project being financed
- Cash defeasance and new money bonds should be separated, with defeasance occurring first
- Transactions should be priced separately
- New money bonds should have been able to be issued independently of the defeasance
- Avoid schedules showing “savings” of the New Money issue produced with respect to the refunded bonds

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Rebate Computations on Refunded Bonds

- Required within 60 days of final redemption date of refunded bonds
- If an issuer is contributing unspent proceeds of a prior bond issue to a refunding escrow, it may want to hold back a portion of such proceeds to make a final rebate payment

Application of Small Issuer Exception to Current Refundings

- Small issuer exception to rebate only applies if the prior bonds met the small issuer exception
- Current refunding issues ignored when testing other bonds

Forgotten Refunding Considerations in a Positive Arbitrage Environment

Rebate Payments

Is it possible to use sale proceeds of a refunding issue to make a rebate payment on the prior bonds?

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Common Reissuance Patterns

Overview: Are changes to a debt instrument significant enough that original debt instrument should be treated as exchanged for a new debt instrument?

General Rules applicable to all debt instruments:

- Treas. Reg. Section 1.1001-3

Certain special rules for tax-exempt bond purposes (Sections 103 and 141-150)

- Notice 2008-41
- Notice 88-130 (may still apply at option of issuer)
- Proposed Treasury Regulations 1.150-3

Common Reissuance Patterns

Practical consequences of reissuance

- Treated as a "refunding" for purposes of 103, 141-150
  - Tax analysis/documentation for refunding
    - New Tax Certificate
    - Diligence
    - Opinion
  - New Form 8038/8038-G
  - TEFRA (if WAM extended)
  - Consequences for integrated swap
  - Final rebate payment for "refunded bonds"

Common Reissuance Patterns

Practical consequences of reissuance

Why reissuance may be undesirable

- Time and expense of tax work
- Need for new opinion and, if applicable, 501(c)(3) opinion
- Transition rules (e.g. Non-AMT refunding opportunities in 2009/2010)
- Potential rebate payment
- Loss of blending arbitrage with prior issue

Common Reissuance Patterns

Reissuance Analysis under 1.1001-3

Two Part Test:

(1) is the debt instrument **modified**, and

(2) is such modification **significant**?

Is there a modification?

- "Modification" is defined broadly as any change, including any addition or deletion, in a legal right or obligation of the issuer or holder. Treas. Reg. Sec. 1.1001-3(c)(1)(i)
- Such change may be evidenced by writing, conduct or otherwise

Common Reissuance Patterns

Reissuance Analysis under 1.1001-3

- Modification Exception: certain changes or alterations that occur **by operation of the terms** of the debt instrument
- Occurs automatically pursuant to the terms of the debt instrument – such as a reset of the interest rate based on an index rate
- Exercise of a unilateral option by holder or issuer—
  - For an option to be unilateral for this purpose:
    - No counter-rights to other party to terminate, alter or put
    - No consent required from the other party, a related party to the other party, or a court or arbitrator
    - No consideration required other than de minimis or incidental costs or consideration based on objective formula

Common Reissuance Patterns

Certain changes always constitute a "modification", even if they occur by operation of the terms of the instrument:

- Changes in obligor, including addition or deletion of co-obligor
- Changes in recourse/non-recourse nature of debt instrument
- Changes that create non-debt
- Non-unilateral options
- Holder options, even if unilateral, that defer or reduce scheduled debt service payments

Common Reissuance Patterns

- **If there is a modification, is it significant?**
  - Combination of bright-line and catch-all “general economic significance” tests

- Bright-line tests
  - Change in yield
  - Change in timing of payments
  - Change in obligor/security

- General economic significance
  - If bright-line tests not applicable, test modifications collectively under general economic significance

Common Reissuance Patterns

Change in Yield

- **Greater of 25 bps or 5% of the yield on the original debt**
- For bond yields > 5%, the threshold will be higher than 25 bps

When is the bright-line test not so bright?

- Difficulty with calculation – what are you comparing and who provides comfort?
- Changes in **rate** ~25 bps; remember this is a **yield** test

Common Reissuance Patterns

Change in Timing of Payments

- **Material deferral of scheduled payments**
- Safe Harbor: a deferral of payments is not material if it does not exceed the **lesser of** (1) **5 years** from the original due date of the first scheduled payment that is deferred, or (2) **50% of the original term of the debt**, with payments unconditionally due/payable at the end of the safe harbor period

When is the bright-line test not so bright?

- Extensions outside the safe harbor period
- Extensions of the date debt starts amortizing
- Remember that holder options "pursuant to the terms" are still modifications if they result in a deferral of scheduled debt service

Common Reissuance Patterns

Change in Obligor/Security

- For purposes of these rules, the “obligor” on tax-exempt bonds is generally the actual issuer rather than the conduit borrower
- **Substitution of Obligor on Recourse Debt:** Generally a significant modification
  - But for tax-exempt bonds, not a significant modification if new obligor is a related entity to the original obligor/issuer and collateral continues to include original collateral
- **Substitution of Obligor on Nonrecourse Debt:** Not a significant modification
  - For tax-exempt bonds that finance conduit loans, this may apply if both the bonds and the conduit loan are treated as nonrecourse

Change in Payment Expectations results in significant modification:

- Change in priority of debt
- Addition/deletion of co-obligor
- Release, substitution, addition or other alteration of collateral/guarantee for recourse debt

Common Reissuance Patterns

When is the bright-line test not so bright?

- Who determines if a modification causes substantial enhancement or impairment to the obligor's capacity to meet payment expectations?
- Should you get representations from parties on payment expectations if asked to deliver a no adverse impact opinion?

Common Reissuance Patterns

Other modifications tested under “general economic significance” standard

Contingent modifications

Deferred modifications

Common Reissuance Patterns

Special Rules for Qualified Tender Bonds

Notice

88-130

Notice

2008-41

Proposed Treasury Regulations 1.150-3

Q&A / Discussion

Any questions?

Are we finally finished talking about LIBOR?

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