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

REFUNDING & REISSUANCE

Chair:

Will Milford — Bryant Miller Olive P.A. – Jacksonville, FL

Panelists:

Johnny Hutchinson: — Nixon Peabody LLP – New York
Katrina Desmond: — Miller Canfield, PLC – Detroit
John Stanley: — Orrick, Herrington & Sutcliffe LLP – San Francisco

I. Tenders and Exchanges

(1) Overview/Mechanics/Definitions

a. **Tender (with proceeds of new bonds)[1]**

i. Issuer issues new bonds to new holders in exchange for bond proceeds received from new holders. Issuer pays those bond proceeds to the holders of the issuer's old bonds. These old holders agree to hand in their old bonds even though in most tender transactions the issuer cannot require them to hand in their bonds (in other words, the bonds aren't yet callable).[2]

ii. Lots of interesting non-tax mechanical questions:

1. How do you sync up the tender with the sale of the bonds?
2. Will the issuer make an offer to purchase the bonds, or will it make invitations to the existing holders to make offers to sell to the issuer (which may allow offers only at prices selected beforehand by the issuer and described in the tender invitation)?
3. How will the price be determined?
   a. Single price for all bonds?

---

[1] The issuer also can use its own cash (rather than proceeds of newly issued bonds) to buy in the old bonds from the holders of the old bonds. This is the Refunding and Reissuance panel, so we're not going to talk about that scenario. It will suffice to say that it is much more boring than real tenders and exchanges (maybe some yield restriction fun if there's a brief escrow period (because the cash used for the tender will become replacement proceeds of the prior issue) but usually the issuer uses the cash to purchase and cancel the prior bonds on the tender date).

[2] *Not* the same as "tender bonds" as discussed in, e.g., Notice 2008-41. In fact, the two things will never overlap.

b. Different prices for different maturities?

c. Price as a spread to an index (per bond or per maturity)?

d. Invitation to holders to make an offer regarding price, or an auction process, etc. (and whether holders can make an offer about the spread (including offering no spread), or whether the issuer will automatically reject any offer that doesn't conform to the price that the issuer invites the holder to offer)?

b. **Exchange –** Similar to a tender, except that the issuer issues the new bonds (which we can call the "Exchange Bonds") directly to old holders in exchange for old bonds.

c. The tender/exchange process is usually run by a **Dealer-Manager**. This same party often will be the underwriter for the new bonds. There may also be an **Information Agent** or a **Settlement Agent** who will assist the Dealer-Manager in all the logistics involved with the tender/exchange (negotiating with existing holders, communicating details about the tender, herding cats, etc.)

d. **Conduit bonds**

i. In general, it will be easier in conduit bond situations for the conduit borrower to deal with the exchange feature. Note that, for the bonds to be cancelled/redeemed, the conduit borrower will need to transfer them to the bond trustee or the issuer for cancellation; the mere purchase in the open market by the conduit borrower doesn't result in cancellation.

ii. For the rest of this outline, when we say "issuer" we mean "conduit borrower" in cases where there's a conduit borrower.

(2) 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 (see footnote 1)	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.[3]
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

(3) Why do a tender or an exchange? (Or, "if it's just a current refunding, why are you doing a panel on it?")

a. **You get the economics of calling bonds that can't be called[4] and can't be advance refunded.**

b. **You can use them to force changes to bond documents that otherwise require bondholder consent.** This can also be done to incentivize existing bondholders to tender their bonds; it is permissible under the securities laws to force changes to the bond documents on bondholders who don't tender. Or, the new bondholders might be willing to offer more favorable terms to the bonds or allow new derivatives, etc.

c. **Historical reasons:**

i. The tender approach might be cheaper than an actual advance refunding (because of negative arbitrage, for example); less applicable now that most bonds can't be advance refunded with tax-exempt bonds.

ii. Before the IRS amended the remedial action rules in 1997 to allow issuers to remediate nonqualified bonds by defeasing them to their first call date, many issuers used tenders to remediate noncallable bonds.

d. Whatever the reason, issuers are doing more of these.

i. "The municipal tender offer trend took hold in 2020 and volume rose above $4 billion in both 2021 and 2022… About $14.1 billion has been tendered

[3] The provisions in the bond documents allowing the issuer to call in the bonds and redeem them will set forth the price the issuer has to pay to do that.

[4] Though there's technically nothing stopping an issuer from doing a tender for callable bonds.

or invited to tender so far this year… Of that, $9.3 billion was taxable and $4.8 billion was tax-exempt."[5]

ii. City of Harvey, Illinois was one recent high-profile case of using an exchange to take out existing holders of its defaulted bonds.[6] The extension of the maturity date of the defaulted bonds and enhanced security features relative to the defaulted bonds resulted in almost 95% participation in the exchange.[7]

(4) Issue Price – in General[8]

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

b. Exchange – not easy – see below.

(5) **Exchanges**

a. **In general.** When Exchange Bonds are issued in exchange for old bonds (as opposed to cash) and constitute "new debt," and neither the old bonds nor the Exchange Bonds are "publicly traded," then:

i. If the Exchange Bonds bear "adequate stated interest," issue price = stated principal amount.

ii. If the Exchange Bonds do not bear "adequate stated interest," issue price = imputed principal amount.

b. **Mind-bending initial aside: Are the Exchange Bonds . . . actually new bonds?**

i. **First Principles:**

1. Exchanging old debt for new debt requires an analysis similar to a reissuance analysis.
2. We usually read 1.1001-3 and about the Supreme Court's decision in *Cottage Savings* as saying that you have "new debt" for tax purposes if you materially modify existing debt (even if you don't give the holder a new piece of paper that says "new debt" at the top).
3. Remember the "other side" of 1.1001-3 and *Cottage Savings*, though: ***Giving an existing holder of debt a new piece of paper that says "new debt" is neither necessary nor sufficient to create "new debt" for tax purposes***

---

[5] Jessica Lerner, "With Tax-Exempt Advance Refundings Gone, Tenders Step Up," *The Bond Buyer* (July 28, 2023).

[6] Yvette Shields, "Harvey, Illinois, aiming to launch exchange on defaulted bonds next month," *The Bond Buyer* (May 17, 2023). ("The proposed exchange – which extends the final maturity date by two decades but offers features like a tax levy with a direct intercept and trust estate – is the cornerstone of the consent agreement the city struck with a group of 2007 bondholders.")

[7] Caitlin Devitt, "Harvey, Illinois finally seals deal ending litigation over bond default," The Bond Buyer (Aug. 29, 2023).

[8] Resources – BNA Portfolio T.M. 535; Federal Income Taxation of Debt Instruments by David Garlock (available on CCH and Lexis), in particular, § 203.

4. Thus, the Exchange Bonds need to be treated as materially different from the old bonds for them to be treated as new debt for tax purposes.
    a. A change in yield by more than 25 basis points would be the easiest way.
    b. In addition, under the general "facts and circumstances" rule under 1.1001-3(e)(1), even if the yield of the new bonds happens to be within 25 basis points of the Exchange Bonds, we still conclude that the volume of activity related to the exchange (the offering documents, a new indenture or bond documents, etc.) in many cases likely leads to the result that the new debt differs materially from the old debt.[9]

c. **Issue Price of Exchange Bonds – A Magical Journey Through Sections 1273 and 1274 of the Internal Revenue Code**

i. **Background**

1. The definition of "issue" – key point:

<u>When you see the word "issue" in 1273 and 1274, think "maturity" or "CUSIP"</u>

a. The word "issue" in 1273 and 1274 refers to bonds that have "the same credit and payment terms."
    i. The credit and payment terms of a bond are the coupon, the maturity date, the call date, and possibly other features.
    ii. In our world, we can think of publicly offered bonds as having the "same credit and payment terms" if they share a CUSIP (and this is how the bankers will talk about things when you do a tender/exchange).
    iii. In some cases in a combined tender/exchange, it may make sense to structure the bonds so that they have different features to avoid having them become part of a single "issue" under 1273 and 1274, but you have to weigh this against the difficulties in marketing that can arise when trying to do this.
b. **In this outline, we will use the term "Maturity" to refer to "bonds with the same credit and payment terms" (i.e., a "CUSIP").**

2. The issue price of the Exchange Bonds may depend in some cases on some of the attributes of the old bonds.

[9] If you were trying to avoid a reissuance, you would not want to argue that all that stuff is going on, but it's nevertheless not a reissuance.

3. Remember that the general rule in 1.148-1(f)(1) is that issue price (for arbitrage purposes) *for all bonds* is determined under 1273 and 1274. The other provisions of 1.148-1(f) are a special set of rules that overrides 1273 and 1274, *only in the case of bonds issued for money*.
4. In addition, 1.148-1(f)(4) provides three special rules:
    a. The issue price for each group of bonds with the same credit and payment terms (i.e., a Maturity) is determined separately. (Confirms the approach reflected in the definition of "issue" in 1273 and 1274.)
    b. 'Substantial amount" in 1273 and 1274 means 10%.
    c. Where the applicable federal rate ("AFR") is relevant in determining the issue price for arbitrage purposes (see below), use the adjusted AFR instead of the AFR. AFR is relevant (see below), use the AAFR instead of the AFR.[10]
5. Remember, as always, this goes Maturity by Maturity – same way we do it in a typical bonds-for-cash deal.
6. **Publicly Traded Property.**
    a. A big turning point in the analysis is whether the old bonds and/or the Exchange Bonds are "publicly traded."[11]
    b. **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.**[12]
    c. Thankfully, this will almost always be true because of the Small[13] Maturity[14] Exception:
        i. 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.[15]

---

[10] 1.148-1(f)(4)(iii)

[11] See Garlock treatise, ¶ 203.04 ("The issue price can be dramatically different depending on whether there is public trading (in which case section 1273(b)(3) applies) or not (in which case section 1274 or section 1273(b)(4) generally applies)."). The 1273 and 1274 rules use the phrase "traded on an established securities market" to refer to property that is publicly traded.

[12] As further discussed below, this is because most tax-exempt bonds will bear "adequate stated interest," which means that their issue price will equal their stated redemption price at maturity.

[13] [sic]

[14] You will see it described in the authorities as the "small issue" exception, but, as we know, "issue" means "Maturity."

[15] 1.1273-2(f)(6).

ii. **Analysis**[16]

1. **Step 1:** Will there be any Exchange Bonds that are part of a single Maturity with bonds issued for money?
   a. If not, continue.
   b. If yes, will those bonds have a price that crosses the 10% threshold?[17]
      i. 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.
      ii. If not, continue.
2. **Step 2:** For any Maturity of the Exchange Bonds where the principal amount of **both the old bonds and the Exchange Bonds will be $100 million or less**:
   a. That Maturity meets the Small Maturity Exception. Thus, by definition, it is not publicly traded.[18]
   b. The issue price of that Maturity then depends on whether it bears "adequate stated interest."[19]
      i. If that Maturity does bear adequate stated interest, then its issue price is its stated redemption price at maturity (i.e., its par amount).
      ii. If that Maturity does not bear adequate stated interest, then its issue price is its "imputed principal amount."[20]
   c. What is adequate stated interest?

---

[16] See the PowerPoint slides for the transaction for a flowchart.

[17] In other words, is there a single price at which 10% of the Maturity is sold? If so, the first price that meets this criterion is the issue price of that Maturity.

[18] 1.1273-2(d)(6).

[19] Tracing through the statute and the regs on whether a Maturity bears adequate stated interest can leave one fairly hopelessly confused. Code Section 1274 is drafted in a circular, confusing fashion. This portion of the outline is intended to provide a path through the mental jungle. At the risk of damning this panel with faint praise, it may be easier to read this outline than the statute and the regs themselves. See Garlock, ¶303 ("A curious and somewhat confusing aspect of the way the statute is drafted is that a debt instrument given in exchange for nonpublicly traded property that has adequate stated interest and all of whose interest payments are qualified stated interest is not technically a debt instrument to which section 1274 applies. Under section 1274(c)(1) and Reg. §1.1274-1(b)(1), section 1274 would not apply to such an instrument because its stated redemption price at maturity would equal its stated principal amount. The issue price of the instrument would be determined under section 1273(b)(4) and would be equal to its stated principal amount. Nevertheless, it is common parlance to say that a debt instrument is "subject to" section 1274 if it is not publicly traded and is issued for nonpublicly traded property, even if it has adequate qualified stated interest. A more accurate formulation would be that the instrument is of the type that must be tested for adequate stated interest under section 1274."). This section of the Garlock treatise has Excel files that assist with the computations.

[20] Defined in 1274.

   i. Single fixed rate of interest that is paid or compounded at least annually, and
   ii. Equal to or greater than the "**test rate**,[21] which is the "**3-month rate**."[22]

d. The **3-month rate** equals **the lower of**:
   i. The lowest adjusted[23] AFR (based on the appropriate period and the same compounding interval as interest on the bonds) in effect during the 3-month period ending with the first month in which the BPA is signed;[24] or
   ii. The lowest adjusted[25] applicable Federal rate (based on the appropriate period and the same compounding interval as interest on the bonds) in effect during the 3-month period ending with the month in which the Exchange Bonds are issued.[26]

e. The appropriate period for the AAFR depends on the term of the Maturity:
   i. **For a Maturity with a term of not more than three years –** use the federal short-term rate.
   ii. **For a Maturity with a term more than three years but not more than nine years)** – use the federal mid-term rate.
   iii. **For a Maturity with a term of more than nine years** – use the federal long-term rate.

f. The "adjustments" to the AFR are done by the Secretary of the Treasury,[27] and then published in the Internal Revenue Bulletin (see link below) - Table 2 (generally) of the

---

[21] 1.1274-2(c)(1).

[22] The "test rate" is governed by 1.1274-4(a)(1)(i). Certain exceptions to the rule noted above apply, but they should not typically apply to tax-exempt bonds.

[23] See 1.148-1(f)(4)(iii) ("Bonds issued for property. If a bond is issued for property, the adjusted applicable Federal rate, as determined under section 1288 and § 1.1288–1, is used in lieu of the applicable Federal rate to determine the bond's issue price under section 1274.").

[24] The regulations say "ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated," which will be the BPA date in most cases. 1.1274-4(a)(1)(ii)(A).

[25] *Id.*

[26] 1.1274-4(a)(1)(i).

[27] 1.1288-1(a).

applicable publication at this link, which is https://apps.irs.gov/app/picklist/list/federalRates.html.[28]

g. As noted above, if, after applying the above tests, a Maturity does not bear adequate stated interest, then its issue price is its imputed principal amount. What is an issue's imputed principal amount?

   i. A Maturity's imputed principal amount is the sum of present values of all payments due under that Maturity, determined by using the **test rate** (defined above) of interest as the discount rate, discounting the payments back to the issue date of the Exchange Bonds.

   ii. If the issuer has a call right with respect to the Exchange Bonds (and it will in most cases), then these rules presume the issuer to exercise its right to call the bonds in a way that *minimizes* the instrument's imputed principal amount.[29] If this rule applies to bonds that are callable less than nine years from issuance, then note that the rule could result in the mid-term AAFR being applicable as opposed to the long-term AAFR.

3. **Step 3:** For any Maturity of the Exchange Bonds where the principal amount of either the Exchange Bonds or the old bonds will be >$100 million, the Exchange Bonds *could be publicly traded:*

   a. Are the bonds actually publicly traded?

      i. In other words, in the 31-day period ending 15 days after the issue date (the "Measurement Period"), is there a "Sales Prices," a "Firm Quote," or an "Indicative Quote"?

      ii. If the bonds are actually publicly traded, then the issue price of that Maturity of the Exchange Bonds is FMV.

      iii. FMV is demonstrated by the presence of Sales Prices, Firm Quotes, or Indicative Quotes during a "Measurement Period," which is the 31-day period ending 15 days after the issuance date. All three are equally legitimate under the regulations, though most

[28] These are the adjusted rates; in other words, you don't have to apply the adjustments described in Reg. 1.1288-1(b); the IRS does the work for you. You just look up the rates.

[29] 1.1274-2(d).

counsel prefer them in the order listed above (i.e. a Sales Price is the best evidence, etc.).

b. Note - this is a very mechanical test that is weighted very heavily in favor of a finding of public trading. The fact that there has not been significant trading "recently" is not enough to conclude that the debt isn't publicly traded.

c. Sales Prices: Look at the sale activity of the old bonds.

    i. Where to find it? Probably EMMA?

        1. MSRB rules require that registered broker-dealers report all trades of municipal securities to EMMA.

        2. Could also be Bloomberg or ICE?

    ii. Could be done via "weighted average sale price" – look for "customer trades" as labeled on EMMA.

    iii. Banker/settlement agent will probably want a carve-out similar to the following:

        1. "For purposes of calculating Sales Price, the Settlement Agents have not considered, inquired or investigated the identity of the counterparties to the transaction, and any Sales Price for the principal amount of a Maturity that exceeds $5,000,000 will be reported as equal to $5,000,000 until the full traded par amount has been "unmasked" after 5 business days."

d. Firm Quotes:

    i. Note that the term "Firm Quote" in the investment banking context 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).

    ii. The legal definition of firm quote for issue price purposes does not appear to require this.

e. Indicative Quotes – a price quote that is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the price quote is not a firm quote.

f. Sample language for Firm/Indicative Quotes:

    i. "Attached as Exhibit B is a report setting forth Firm Quotes or Indicative Quotes, which are provided as

of the end of the day noted on Exhibit B and represent the price observed by [the Settlement Agent] to be a fair reflection of the price of the Maturity in question at that time for each Maturity of the Bonds (each a "Price Quote Bond Value") and in each case the date (or dates) for which the Firm Quotes and Indicative Quotes were obtained. Specifically, at approximately 4:00 pm eastern time each day during the Measurement Period, [Settlement Agent] will provide an Indicative Quote reflecting the fair value of the price of each Maturity. To the extent a Firm Quote exists at the time, [Settlement Agent] will also provide such Firm Quote. To the best of the knowledge and belief of the undersigned, based on information available to the undersigned and taking into account legal restrictions on the availability of such information, there are no other Firm Quotes or Indicative Quotes for the Maturity of the Bonds listed on Exhibit B."

ii. Sample language above is intended to address a situation in which the Settlement Agent may not have access to the firm quote for data control or regulatory reasons. (For example, Bank A may be providing a quote for a position, but the Settlement Agent potentially isn't even legally allowed to *look* for it, much less see it.)

(6) **Disclosure**

a. 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.

b. For the substance of the required tax disclosure, see previous section on issue price. Most of the disclosure is about issue price.

c. It may be important (perhaps more important than in a garden-variety refunding) to disclose that no one is opining on the ongoing tax-exempt status of the refunded bonds.

d. 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 for bondholders to make offers, whether the tender offer is revocable, the sources of funds for the tender, etc.). Talk to your favorite[30] securities lawyer.

(7) **Other Miscellaneous Points**

[30] Or, perhaps your *least favorite* one, given the subject matter.

a. **Combining a Tender/Exchange with Traditional Bonds**

   i. **Uncertainty about the Size of the Issue until Pricing.**

      1. As noted above, the tender/exchange carries some uncertainty about the size of the tender/exchange portion, which will affect the size of the issue as a whole. You won't know how big the tender/exchange portion is until the tender period closes.

      2. You may need to build in some cushion and try to get some guideposts about the likely minimum or maximum size of the tender/exchange portion. This can be important for several purposes:

         a. Amount of proceeds

            i. Not really an overissuance concern (because, by definition, you'll have a use for all of the proceeds required to do the tender or deemed to have arisen as a result of the exchange)

            ii. But, COI limit, amount of volume cap required, and other limits that depend on the amount of proceeds will be affected.

         b. Useful life - if you're calculating useful life on a combined basis, how much of an anchor will the refunding/tender/exchange portion be on the useful life of your new money portion?

         c. Multipurpose issue allocation – will the mix and debt service profile of the tendered bonds affect your savings analysis? Might you be forced into a pro rata allocation when you don't want to do that or can't do that?

   ii. **Uncertainty About Which Bond Issues will be part of Your Issue**

      1. Many times the Dealer-Manager will identify several different prior issues as targets for the tender/exchange, with the final mix dependent on the market.

      2. 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.

b. **What about additional amounts paid to entice bondholders to tender their bonds?** These amounts should be treated as part of the "redemption price" and thus proceeds of a tax-exempt bond issue used for this purpose would be treated as a refunding. [31]

[31] 1.150-1(d)(1) ("Refunding issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue.").

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

   i. Could they be treated as "costs of the refunding" rather than costs of issuance?

If you reach this conclusion, and the Dealer-Manager and/or Information Agent are also underwriting the bonds, you'll need to allocate the fee between COI and these non-COI fees.

II. Forgotten Refunding Considerations in a Positive Arbitrage Environment

I. Current Refunding Escrows

A. Yield Restriction: 90-Day Temporary Period: Treas. Reg. § 1.148-9(d)(2)(ii)

The Treasury Regulations provide a temporary period for current refunding issues. Generally, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days. However, if a current refunding issue has a maturity of 270 days or less, this temporary period is reduced to 30 days. Therefore, in the normal case, tax-exempt bond proceeds may be invested in a current refunding escrow without regard to yield restriction. The earnings in the escrow fund, however, 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.

B. Rebate: Six Month Spending Exception: Treas. Reg. § 1.148-7(b)

In general, the only spending exception applicable to refunding issues is the 6-month exception; although, application of the 6-month spending exception is not mandatory. Additionally, proceeds of the prior issue that become transferred proceeds of the refunding issue (as described in detail below) generally are not treated as proceeds of the refunding issue and need not be spent for the refunding issue to satisfy that spending exception. Therefore, the proceeds of the refunding issue may qualify for the spending exception, even if the unspent proceeds of the prior issue do not. There are certain exceptions to this rule, particularly as it relates to bona fide debt service fund and reasonably required reserve fund monies, as set forth in Treas. Reg. §1.148-7(b)(ii)(B) and Treas. Reg. §1.148-7(c)(3).

C. Temporary Periods for Contributions to the Escrow Fund from Prior Bona Fide Debt Service Funds and Prior Reserve Funds

When determining the sizing of a refunding bond issue, it is often necessary to contribute to the escrow fund (i) any monies set aside to pay debt service on the refunded bonds, and (ii) any monies held in a reasonably required reserve that are no longer needed to secure the refunding bond issue, to ensure that the refunding bond issue is correctly sized. The question becomes whether the foregoing amounts maintain their respective temporary periods, or whether they should be treated as replacement proceeds of the prior bonds and yield restricted to the prior bond yield. With respect to bona fide debt service monies, as long as the prior bond fund was properly sized to meet the 13-month rule for a bona fide debt service fund, the money should retain its temporary period set forth in Treas. Reg. §1.148-2(e).

With respect to prior reserve fund amounts deposited to the escrow fund for a current refunding issue, the Treasury Regulations do not explicitly address whether such amounts retain their temporary period as amounts held in "reasonably required reserve fund". Additionally, when considering the question, it might also be relevant whether the reserve fund is funded with equity or sale and investment proceeds of a prior issue. While it is not clear from the Treasury Regulations, arguably, amounts held in a prior reserve fund, which are contributed to an escrow fund to refund the prior issue, are still being used for their intended purpose – to secure repayment of the prior bond issue – and should not lose their temporary period. Regardless, if the escrow period is less than 30 days, then the amounts will still have a 30-day temporary period for replacement proceeds as described in Treas. Reg. §1.148-2(e)(5).

D. Temporary Period for Transferred Proceeds in Current Refundings: Treas. Reg. § 1.148-9(d)(2)(iii)

In the context of a current refunding, the Treasury Regulations provide that each available temporary period for transferred proceeds of a refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue. Therefore, the regulations allow for the original temporary period to continue to apply. For example, if new money bonds were issued in 2021, the Bond proceeds would qualify for an initial 3-year temporary period through 2024. If the new money bonds are then refunded in 2023, any unspent proceeds of the new money bonds would become transferred proceeds of the refunding issue and maintain the original temporary period through 2024.

In determining the date that amounts become transferred proceeds of a refunding issue, Treas. Reg. §1.148-9(b)(1) provides that proceeds of a prior issue become transferred proceeds of the refunding issue as of the date the refunding issue discharges any of the outstanding principal amount of the refunding issue. In practice, for current refundings, the "transfer date" is typically the same date for all of the proceeds of the prior issue. At this time, if there is no applicable temporary period for the proceeds of the prior issue, such amounts become restricted to the yield of the refunding bond issue. In a typical high-to-low refunding, this often means that any transferred proceeds are restricted to a lower investment yield.

II. Defeasance of Tax-Exempt Bond Issues

A. Defeasance with Taxable Obligations

In recent years, as advance refundings are no longer available, taxable advance refundings of tax-exempt obligations have become more common. Unlike a cash defeasance, the amounts held in the defeasance escrow are proceeds of the taxable obligation, unless the investments de-allocate under universal cap, as set forth in Treas. Reg. §1.148-6(b)(2). If the investments in the defeasance escrow de-allocate from the taxable obligation and become replacement proceeds of the tax-exempt bonds, the yield on such investments will then be restricted to the yield on the tax-

exempt bonds. Pursuant to Treas. Reg. §1.148-5(d)(3)(i), such investments are valued at fair market value at the time of transfer.

B. Cash Defeasance

Often times, an issuer will seek to defease tax-exempt obligations with funds on hand. This may be done for a variety of reasons, including release of bond covenants or as necessary to remediate bonds for private activity as required in Treas. Reg. §1.141-12. If an issuer sets aside funds in a defeasance escrow or otherwise restricts funds for the purpose of paying debt service on an outstanding bond issue, those amounts become replacement proceeds subject to yield restriction at the yield of the defeased issue.

C. Cash Optimization (Cash Defeasance + New Money Bonds)

Cash defeasance transactions are sometimes proposed in connection with an issue of New Money Bonds. Occasionally these are even presented to the Issuer with schedules showing the "refunding savings" achieved by the issuance of the New Money Bonds. Bond Counsel should take care to avoid a nexus between the two transactions that might result in the creation of yield-restricted replacement proceeds. Factors which may be considered in avoiding such a nexus include the timing of the transactions (the cash defeasance should occur prior to the issuance of the new money bonds), separate pricing, and the ability of the New Money Bonds to have been issued independently of the defeasance.

Bond Counsel should take particular care to avoid a "reimbursement refunding" in which New Money Bonds are issued to reimburse the issuer for prior expenditures, which are then deposited into an Escrow Fund to defease a prior issue. Section 1.150-2(h) of the Regulations provides an "anti-abuse" rule, under which a reimbursement allocation is invalid and not an expenditure of proceeds if, within one year after the allocation, funds corresponding to that amount are used in a manner that creates replacement proceeds of the issue or another issuer.

III. Rebate Computations on Refunded Bonds

A. Final Rebate Computation: Code §148(f)(2)

If a bond issue is fully redeemed, then a final rebate computation should be completed, and if the issuer owes, it must make a payment within 60 days of the redemption date. If an issuer is considering contributing unspent proceeds of a prior bond issue, such as prior debt service fund or reserve fund monies, to a refunding escrow, it may want to hold back a portion of such proceeds to make a final rebate payment (see discussion below).

B. Other Rebate Exceptions for Current Refundings

Other than the six-month spending exception, an issuer may also consider the small issuer exception to rebate for current refundings (Code §148(f)(D)), particularly if proceeds borrowed for costs of issuance are not spent within the six-month period to qualify for the spending

exception. Additionally, the step-in-the-shoes rule in Code §148(f)(D)(iii) provides that certain current refunding issues are not taken into account in determining whether an issuer meets the small issuer exception in a particular calendar year. This rule would be helpful if, for example, the issuer issues $5,000,000 of new money bonds and current refunding bonds in the same calendar year. This rule essentially allows the issuer to "ignore" the current refunding bonds in counting up to $5,000,000, as long as the amount of the refunding bonds does not exceed the amount of the refunded bonds.

C. Other Considerations

1. Best Practices? Use of a Rebate Fund in the Indenture waterfall? Provisional rebate computations (which are often required for financial accounting purposes)?

2. Funds used to make a rebate payment. Is it possible to use sale proceeds of a refunding issue to make a rebate payment on the prior bonds? Treas. Reg. §1.148-6 allows rebate to be paid from proceeds of the prior issue. Would this allow transferred proceeds to be used to pay rebate on the refunding issue, as well? Could this be extended to sale proceeds of the refunding issue? It is possible that using sale proceeds of a refunding issue to pay rebate on a prior issue is similar to paying accrued interest or call premium on the prior issue, or is more like a capital expenditure that can generally be tax-exempt financed. The considerations on which funds to use for a rebate payment might be different for exempt facility bonds, for example, which have a strict requirement that at least 95% of the bond proceeds be spent on the qualified purpose.

III. Common Reissuance Patterns

Overview of Reissuance Analysis—are changes to a debt instrument significant enough that original debt instrument should be treated as exchanged for 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 to debt obligations at option of issuer)
  - Proposed Treasury Regulations 1.150-3

Before we get technical—what are the practical consequences to reissuance?

- Treated as "refunding" for purposes of Sections 103 and 141-150
  - Tax analysis/documentation for refunding
    - New Tax Certificate with issuer/conduit borrower covenants and representations
    - Diligence use of projects for private use and other compliance
    - New tax opinion

- New Form 8038 / 8038-G
- If WAM extended, new TEFRA
- Consequences for integrated swaps (deemed termination for tax purposes)
- If "refunded" bonds qualified for transition rules, sensitivity to losing those benefits
  - Eg., Non-AMT refunding opportunities in 2009/2010
- Final rebate payment for "refunded" bonds and new rebate analysis going forward

- Why reissuance may be <u>undesirable</u>
  - Time and expense of tax work
  - Need for new opinion and, if applicable, 501(c)(3) opinion
  - Transition rules, as mentioned above
  - Potential rebate payment, and loss of blending

General rules applicable to all debt instruments under Treas. Reg. 1.1001-3—

Two part test—(1) is the debt instrument *modified*, and (2) is such modification *significant*.

If "yes" to both questions, then reissuance *unless* the special tax-exempt bond rules discussed below apply.

- <u>Is there a modification</u>?
  - "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. § 1.1001-3(c)(1)(i)
    - Such change may be evidenced by writing, conduct or otherwise.
  - Main <u>exception</u>: certain changes or alterations that occur *by operation of the terms of the debt instrument*. Treas. Reg. § 1.1001-3(c)(1)(ii)
    - Occurs automatically pursuant to the terms of debt instrument—such as a reset of the interest rate based on an index rate.
    - Exercise of *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
  - Certain changes always constitute a "modification," even if they occur by operation of the terms of the debt instrument—

    - Changes in obligor, including addition or deletion of a 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.
- If there is a modification, it occurs at the time the parties agree to the change, even if the change does not go into effect until some later date.

- If there is a modification, is it significant? Treas. Reg. § 1.1001-3(e).
    - Combination of bright-line and catch-all "general economic significance" tests—
        - Bright-line tests
            - Change in yield by more than the greater of—25 basis points or 5% of the yield on the original debt
                - Often the applicable test for tax exempt bonds due to modifications not covered by other bright line tests
                - Difficulty with calculation in many circumstances—what are you comparing and who provides comfort?
            - Changes in timing of payments—if a material deferral of the 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 end of safe harbor period
            - Change in obligor/security
                - *For purposes of the rules below, the "obligor" on tax-exempt bonds is generally the actual issuer rather than the conduit borrower*
                - Substitution of new obligor on recourse debt instrument is 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
                - Not a significant modification to substitute the obligor on a nonrecourse obligation.
                    - For tax-exempt bonds that finance conduit loans, this may apply if both the bonds and conduit loan are treated as nonrecourse
                    - Notice 2008-41 (discussed below) has special rule that a change in credit enhancement for nonrecourse debt instrument is not a significant modification unless causes change in payment expectations
                        - Extremely helpful for routine credit enhancement changes

            - Modification is significant if causes substantial enhancement, or substantial impairment, of the obligor's capacity to meet <u>payment expectations</u>
                - Change in priority of debt
                - Addition/deletion of co-obligor
                - Release, substitution, addition or other alteration of collateral/guarantee for <u>recourse</u> debt
        - Change in the nature of debt
        - Multiple modifications over time are tested cumulatively under bright line tests (e.g., an initial extension of maturity might meet the safe harbor and not be significant, but a subsequent extension would need to be tested in the aggregate with the initial extension).
    - General economic significance
        - Multiple modifications are each tested separately under each bright-line test. If the bright-line tests are not applicable, then the modifications are tested collectively under general economic significance standards
            - E.g., change in yield of less than 25 basis points and a temporary deferral of payments that satisfies safe harbor are not a problem under bright line tests
        - Contingent or deferred modifications tested under general economic significance standard

Special Rules for Tax-Exempt Variable Rate Bonds

- History of Notices and Application to Floating Rate Debt—
    - Treas. Reg. 1.1001-3(a)(2) states that the rules set forth above do not apply for purposes of determining whether tax-exempt bonds that are *qualified tender bonds* are reissued for purposes of Sections 103 and 141-150
        - The authorities below addressing qualified tender bonds are intended to avoid reissuances due to changes in interest rate modes of VRDOs and auction rate bonds
        - Treas. Reg. 1.1001-3(a)(2) was specifically intended to address the fact that VRDOs and auction rate bonds are subject to a bilateral option
        - Notices referenced below appear to be optional—can use one or the other, but must be consistent
- **Notice 88-130**
    - Notice 88-130 states that rules under § 1001 apply to qualified tender bonds for changes to terms other than existence or exercise of *tender rights*—so this can

    require coordination among different sets of rules if modifications are being made that are separate from the qualified tender bond guidance

- Qualified Tender Bonds (QTB) defined in Notice 88-130:
    - Final stated maturity 35 years or less (compare to Notice 2008-41, which allows 40 years)
    - Holder may/must tender at par on one or more dates before final maturity
    - Rate is generally set at lowest rate that allows par remarketing (note, no premium remarketing—compare to Notice 2008-41)
- Provides that changes to interest rates that are caused by changes in interest rate modes/tender periods authorized by the terms of the bond ("qualified tender changes") do not cause a reissuance or otherwise require analysis under 1.1001-3
- But, Notice 88-130 contains a "hair trigger" rule—a reissuance occurs when there is a "change" in connection with a change in the period between tender dates that increases from a period of less than 1 year to a period exceeding 1 year, and vice versa
    - In other words, may be a reissuance for QTBs under 88-130 even if not a reissuance under 1.1001-3
- "Change" for purposes of Notice 88-130 is any discretionary alteration in the legal rights or remedies of the holder
    - "Discretionary" unless all elements are entirely outside the control of the issuer, obligor, or holder
    - Accordingly, the following are "changes" for purposes of 88-130
        - Alteration in the period between tender dates (e.g., daily to weekly) that occurs <u>at the option</u> of the issuer
        - Alterations occurring per the terms of the bond ("completion of construction," "upon obtaining a guarantee," etc.)
- Provides that bond treated as retired if acquired by the issuer
    - Compare "issuer" to conduit borrower—other guidance generally provides that a conduit borrower may acquire its conduit bonds without retiring the debt

- **Notice 2008-41**
    - Issued in response to auction rate crisis in 2008
    - Offers more flexibility than Notice 88-130
    - Intended to track the general rules of 1.1001-3, but disregards changes in interest rates if caused by a "qualified interest rate mode change"
        - Qualified interest rate mode change is mode that is *authorized under the terms of the bond on its original issuance*

            - Allows changes between interest rate modes and terms without risk of "hair-trigger" rule in Notice 88-130
            - However, if a rate or mode is not authorized under the original documents, adding it takes you outside this safe harbor and back into 1.1001-3 (in other words, 25 basis point test)
        - Terms of the bond must require par remarketing, except that if bonds are being remarketed in a fixed rate mode out to maturity, they may be remarketed at a premium (compare to Notice 88-130)
            - But, if bond documents do not permit the ability to fix out with premium, then adding the ability to do so would be outside a qualified interest rate mode change, and put you back in 1.1001-3 (in other words, 25 basis points test)

- **Proposed Treasury Regulations 1.150-3 (Dec. 31, 2018)**
    - Proposed regulations to address reissuance rules for tax-exempt bonds, and if finalized, would make Notice 88-130 and Notice 2008-41 obsolete.
    - Section 1.150-3(b)—a tax-exempt bonds is treated as retired when:
        - A significant modification occurs under § 1.1001-3
        - The issuer or its agent (or a related party) acquires the bond in a manner that liquidates or extinguishes the bondholder's investment. A subsequent sale would be a new issuance.
            - Does not apply to a conduit borrower's purchase of bonds
        - The bond is redeemed (such as redeemed at maturity)
    - Section 1.150-3(c)—exceptions:
        - Qualified tender rights are disregarded for purposes of the 1.1001-3 analysis. A qualified tender right is the right or obligation of the holder to tender the bond, and for each such tender, the purchase price must be equal to par. The issuer or its remarketing agent must redeem the bonds or use reasonable best efforts to resell the bonds within a 90 day period, and must resell at par (note difference from allowing premium remarketing in Notice 2008-41)
        - Acquisitions pursuant to a qualified tender right do not result in a retirement provided the bonds are not held for more than 90 days

Acquisitions by a guarantor or liquidity provider pursuant to the terms of the guarantee or liquidity facility do not result in retirement (provided the guarantor is not a related party to the issuer).

IV. Q&A / Discussion

Potential topics:

- LIBOR: Are we finally finished talking about LIBOR?
- Audience questions