02. BANK DIRECT PURCHASES AND OTHER COMMERCIAL BANK PRODUCTS

2A. General Concepts

Chair: **Scott W. Shaver** **Stradling Yocca Carlson & Rauth, P.C. – Reno, NV**

This session will discuss the general concepts of direct purchases and (as time permits) other commercial bank products. The session will walk through a typical direct purchase transaction, from term sheet to closing documentation and funding. The session with emphasize general concepts which practitioners may face on most direct purchase transactions, including, without limitation, pricing mechanics, securities laws, bond document and security documents provisions, and accounting provisions. The session will also consider the challenges at each stage of a transaction from the perspectives of the issuer, the borrower and the purchaser.

2B. Advanced Tax Concepts

Co-Chairs: **Scott W. Shaver** **Stradling Yocca Carlson & Rauth, P.C. – Reno, NV**
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In this session, tax law practitioners will discuss the tax law issues that arise in direct placements and bank loans. Issues that will be discussed include analyzing how to determine the issue price of the obligation, whether a reissuance has occurred upon the occurrence of certain events (e.g. a change in the interest rate or a mandatory or optional tender of an obligation by the holder), how to determine issue price, whether replacement proceeds are created and do the underlying documents have rate-setting or rate-changing mechanisms that lead to the obligation being considered a contingent payment instrument.

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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 connection, please see "Terminology" in the back of this outline.

I. DIRECT PURCHASE OF BONDS

A. STRUCTURE OF DIRECT PURCHASE

As used below, "direct purchase" refers to the purchase of a Bond (tax-exempt or taxable) by a commercial bank without an underwriting or public offering. Prior to the 1986 Tax Act, this had been a popular form 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 VRDBs backed 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 per year 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 (much more importantly) 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 2009 and 2010 for 501(c)(3) Borrowers and brought into the direct purchase market a plethora of smaller banks that purchased such Bonds.

[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.

Although the ARRA provisions expired on December 31, 2010, the market for the direct purchase of Bonds has remained robust.

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:

1. Long-term fixed rate, where the Bonds bear interest at a fixed rate for 10 years or 15 years and the Bonds mature at the end of that period. Most Banks don't have appetite for maturities in excess of 15-17 years, but there are Banks that are active who are willing to go as long as 25 years.

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

3. A variable rate, typically based on a percentage of one-month LIBOR plus a credit spread or SIFMA, with the Bank agreeing to hold the Bonds for a commitment period (typically 5 years, 7 years or 10 years) that is well short of the 25-year or 30-year maturity for the Bonds. At the end of the commitment period, there is a mandatory tender. [Note: The mandatory nature of the tender can be important to the Bank for internal accounting purposes (otherwise, the Bank's internal accountants may book a deal with a five-year commitment period as if it extended over the 30-year life of the Bonds). There is also the practical problem of maintaining a "tickler" system for tracking optional put dates. The put typically doesn't show up on the Bank's internal system as a maturity and the consequence of missing a notice date for an optional put may be that the Bank is forced to continue in the deal at the old rate for another five years.]

B. ADVANTAGES/DISADVANTAGES TO BORROWER

1. **Advantages.** As opposed to VRDBs backed by a Letter of Credit, the direct purchase structure offers the Borrower:

(a) Savings in time and costs. With a direct purchase, the Borrower avoids the costs of the underwriter, preparation of an OS, Remarketing Agent's fees, rating agency fees and possibly Bond Trustee's fees, as well as the time spent waiting in the queue at the rating agencies. Also, these transactions can often be accomplished in a very short timeframe.

(b) Borrower does not bear the risk of Bank downgrade. Again, a risk that was not taken seriously prior to 2008, but is very real today.

(c) Potentially no debt service reserve or a smaller debt service reserve, which saves on borrowing costs. However, this varies significantly among banks.

(d) Opportunity to find an index more stable than SIFMA. It is hard to forget how SIFMA spiked in 2008, while one-month LIBOR remained comparatively stable.

(e) Opportunity to avoid basis risk. Many Borrowers have swaps entered into before 2008 that use 68% of one-month LIBOR as a proxy for SIFMA. Since 2008 that has not been an accurate proxy (in much of 2012, SIFMA and one-month LIBOR were approximately equal), so the basis risk has been costly to the Borrowers. With a LIBOR-based direct purchase, the problem is at least quantified, and does not change over time as the gap between 68% of LIBOR and SIFMA widens or narrows over time.

(f) Freedom from fear of National Put Day. For years, market analysts had raised the theoretical possibility that the holders of VRDBs would all exercise their optional tender rights simultaneously, resulting in a flood of tax-exempt paper that would overwhelm the ability of Remarketing Agents to remarket the Bonds. It was easy to dismiss this as mere speculation until it began to happen in mid-September 2008.

2. Disadvantages (perceived and otherwise).

(a) While not necessarily a "true" disadvantage, there is often more direct negotiation with the Bank, including negotiation of terms which are viewed as standard practice for publically offered transactions. The reality is that the two markets are very different and Banks often analyze credits and terms far differently than an underwriter would on a publically offered transaction. More often than not, Banks are purchasing these Bonds with the intention of holding them to maturity. As a result, their view may be different than an underwriter who will likely dispose of substantially all of Bonds on the day of closing. Borrowers and others (i.e., bond counsel) on a transaction need to accept this early on.

(b) The terms of these deals are often very different than publically offered deals. These differences include, but are not limited to: (i) restrictive call features, including make-whole calls; (ii) restrictive and heavily negotiated covenants; and (iii) other agreements with the Bank relating to maintenance of deposit account and other treasury management relationships with the Bank, etc.

(c) Depending on the terms negotiated with the Bank, Borrower may lose some of the flexibility that would otherwise exist in other multi-modal bond structures. In particular, the Bank may charge exit fees (and, in the case of fixed rate pricing, will typically charge a make-whole payment) if the Borrower wishes to exit the Bank financing prior to the end of the designated commitment period.

C. ADVANTAGES/DISADVANTAGES TO BANK

1. Advantages.

(a) Response to competitive pressure. All the other mothers are letting their kids do it.

(b) Can result in tax-exempt income for the Bank. But what if the Bank doesn't need tax-exempt income today?

(c) Potentially higher (investment grade) credit quality loans which improve the overall loan portfolio credit quality (this helped with the recent decreasing credit quality related to real estate which most banks were involved pretty heavily in).

(d) Diversification of the loan portfolio.

(e) Entry into the customer for pitching other banking products and expanding the relationship and profitability.

2. Disadvantage.

As noted above, IRC §265 provides that the Bank loses a portion of the deduction to which it would have otherwise been entitled for the interest that the Bank pays its depositors, CD-holders, etc. The portion disallowed is equal to the ratio that the Bank's adjusted basis for its investments in tax–exempt obligations that are not bank-qualified bears to the Bank'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 which 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 by bank clients is whether or not the direct purchase bond is a "security" as opposed to a commercial 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 part of the Bank 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 Bank'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.

For accounting purposes, Banks typically want all references to DTC and book entry removed, and often want the Bond identified as a "loan," if at all possible. Banks typically do not want CUSIPs. More often than not, the Bank is stuck with the concept that their loan is represented by a bond, note, etc. As a result, the parties must structure it in a fashion which allows the Bank to book the obligation as a loan for accounting purposes, assuming the Bank 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 disagree when the audit is prepared.

For 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"). For the plain vanilla middle market or lower middle market direct purchase transaction, the method of originating and approving the transaction by the purchaser Bank, the collateral, the amortization and the expectations as to transferability are little different from any LIBOR-based conventional term loan (except that by the use of a conduit Issuer the interest received by the Bank may be tax-exempt and therefore the rate charged to the Borrower may be reduced somewhat from the Bank's conventional rate). Bank purchasers believe this argues for placing these "plain vanilla" direct purchase

transactions outside the definition of "security" for Securities Act purposes. Note that, in any event, even if a direct purchase bond is deemed to be a "security," there may be an exemption from the registration requirements of the Securities Act, even for those issues which are not traditional governmental general obligations. See Section 3(a)(2) of the Securities Act as to tax-exempt IDBs and Section 3(a)(4) as to 501(c)(3) Bonds. Furthermore, transactional exemptions also exist under the Securities Act and related regulations, and it should be easy enough in the plain vanilla situation for the Bank to give the type of representations called for by Rule 144A, thus bringing the transaction within the transactional exception for sales to a qualified institutional buyer not involving a public distribution.

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 Bank would need to obtain a CUSIP number, for the Bonds and typically an investment grade rating for the Bonds. The last requirement alone is sufficient to ensure that Bonds issued for the nursing homes, social service agencies, prep schools, etc. that account for so much of the typical commercial bank 501(c)(3) bond portfolio will not be easily pledged to a Federal Reserve Bank under the rubric of securities.

With respect to the mark-to-market accounting requirement, 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 and the Bond Indenture for the Bonds permits no flexibility to convert out of 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 qualified institutional buyers) may be helpful for this purpose. Finally, it should be noted that some Banks have simply bit this bullet and will treat their direct purchases generally as subject to mark-to-market requirements.

The direct purchase as "security" issue also appears 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 bank or even a "separately identified department or division of the bank") may be subject to MSRB and FINRA requirements, including disclosure rules, in connection with a direct purchase that is deemed to be a "security" as opposed to a "loan".

E. BORROWER'S ALTERNATIVES AT THE END OF BANK'S COMMITMENT PERIOD

1. Repay the Bonds with Borrower's funds or with the proceeds of a conventional loan.

2. Refinance the Bonds with a new issue.

3. Convert into any other mode (if any) 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.

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 interest rate of 25 basis points or more), which creates pressure for more complex arrangements relating to options of Borrower to convert to other modes. For more detail, see the discussion in Section I.I. 5. below.

F. ADJUSTMENTS TO RATE

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

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

2. **Default Rate/Late Fee**. Sometimes the imposition of these is at the option of the Bank. Sometimes it is not. Often bond counsel has legitimate state law concerns about these, as well as taxable rates. These concerns often include statutory limits on maximum rates, authorization limits for voted bonds, etc. In addition, tax counsel may have concerns. See the discussion of contingent payment debt instruments in Section I.I. 7. below and of the characterization of payments as interest in Section I.I. 2. below.

3. **LIBOR Adjustment**. LIBOR to be adjusted for the imposition of any Eurocurrency reserve rate required under Regulation D of the Federal Reserve Board. While the adjustment is formulaic (Adjusted LIBOR = LIBOR/[1 - Reserve Rate]), some tax counsel express concern that the adjustment will result in a reissuance or in the loan being characterized as a contingent payments debt instrument.

4. **LIBOR Breakage Fee**. LIBOR breakage for a LIBOR-based financing or a make-whole for a fixed rate financing, to be used in the case of a prepayment. See the discussion of the characterization of payments as interest in Section I.I. 2. below.

5. **Capital Adequacy/Change in Law**. This adjustment is not tied to a formula, but typically seeks to reimburse the Bank for whatever loss of profitability or increase in costs that the Bank may suffer due to certain (or any) regulatory changes. Since 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. Bank counsel does not want to receive "half a tax opinion" (i.e., one that takes an exception for an adjustment that is built into the bond documents), but the Bank also does not want to forgo an adjustment that is typical for a conventional taxable term loan. The Borrower would be upset if the Bank's invocation of this adjustment caused the Bonds to become taxable. See also the discussion of the characterization of payments as interest in Section I.I. 2. below.

   A popular resolution is to move this extra charge out of the bond documents and to include it in the Bank's Continuing Covenants Agreement as an extra fee that the Borrower would pay to the Bank on a taxable basis. This may also address state law concerns which bond counsel may have, through 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). Note that bond counsel often have legitimate state law concerns about this issue.

6. **Decrease in Maximum Marginal Statutory Corporate Tax Rate.** Increase in tax-exempt rate to compensate for decrease in maximum marginal statutory corporate tax rate. As the corporate tax rate decreases, the tax-exempt nature of the interest does the Bank less "good," to the point that if there were no corporate taxes at all, the Bank should be receiving a taxable rate. NOTE: This can be a difficult provision to negotiate, since Borrower will want the flip side, i.e., if the maximum marginal statutory corporate tax rate increases, then the Bond rate should decrease, while the Bank may feel that it is already at an incredibly low rate and cannot get approval for anything lower no matter what happens to the corporate tax rates. Also note that any decrease in the multiplier used to determine the Bond 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. See also the discussion of contingent payment debt instruments in Section I.I. 7. below.

7. **Grid Pricing**. For a conventional taxable LIBOR-based loan, it is quite common that the spread over LIBOR will be automatically adjusted from time to time based on the Borrower's then-current debt service coverage ratio and/or leverage ratio. Such "grid pricing" provisions have appeared in some direct purchase transactions, despite criticism by bond counsel. The objection seems to be that this "grid pricing" is too subjective on the part of the Bank, though if one adjusted only once a year based on audited financial statements, it is hard to see what is so subjective. Nonetheless there are differences of opinion on this issue. See also the discussion of contingent payment debt instruments in Section I.I. 7. below.

G. TENDER OPTION BOND PROGRAMS

The discussion above has been limited to the situation where the Bank 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 Bank (the "Sponsor Bank") buys the Bond, the Sponsor Bank places the Bond into a custodial trust, the custodian 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 dichotomy, this product is generally considered to be a security.

H. SPECIAL ISSUES ARISING IN A DIRECT PURCHASE TRANSACTION

1. **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 between the Borrower and the Bank. Because a commercial Bank is treating the direct purchase as a loan and underwriting it accordingly, the credit committees of the commercial Bank are requiring a number of covenants obligating the Borrower, which are negotiated both at term sheet and in the loan documentation process. The typical affirmative covenants you might see at the term sheet stage are maintaining a specified debt service coverage ratio, maintaining a specified level of unrestricted liquid assets, maintaining a loan to value ratio for loans secured by real estate or other tangible assets, etc. As bond counsel, it will be your role to help the parties understand some of the tax and state law implications for these covenants.

For example, a test for unrestricted liquid assets can be tested only semi-annually and be permitted to go to zero in the interim, to avoid yield restriction as replacement proceeds. See Treas. Reg. §1.148-1(c). 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.

For example, 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 and 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.

Some examples of relief include negotiating (i) that it 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 defaults is the prohibition on additional indebtedness. A typical set of loan documents will prohibit any kind of additional indebtedness without Bank consent. That is largely unworkable, and the negotiations begin with 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 covenants in direct purchases of general obligation

bonds. However, some covenants that arise in that context are to maintain a specified rating category of the issuer and require financial reporting.

2. **Swaps**. Not infrequently, a commercial Bank is 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 LIBOR 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. See the discussion of interest rate swaps in Section I.I. 9. below.

3. **How Do We Get There?** A common scenario for a direct purchase transaction involves a Bank that has issued a Letter of Credit for VRDBs, no longer wants to play in the Letter of Credit market (or finds that it cannot do so at reasonable pricing) but wants to provide a feasible alternative for its Borrower. In structuring the deal, the question will be how to move from the VRDB to a bank purchase mode, assuming that there is no bank purchase mode in the existing Bond documents.

   One popular strategy invokes the provisions of the Bond Indenture that permit a credit enhancer (so long as it is not in default) to vote in place of the Bondholders on certain matters. The Bank would use this right to add a bank purchase mode to the existing menu of modes under the Bond Indenture. The details of this bank purchase mode would include a mandatory tender in order to shift from variable rate mode to bank purchase mode, tracking the existing language in the Bond Indenture requiring a mandatory tender in order to convert from variable rate mode to long-term fixed rate mode.

   After the new mode is added to the existing Bond Indenture, the Borrower then gives notice of its intent to convert to bank purchase mode, triggering the mandatory tender. The departing Bondholders are paid by a draw on the Letter of Credit, typically on an interest payment date. The Borrower repays the Bank for the interest component of that draw, as it would have done had nothing else been occurring. The Bank, wearing its hat as Bond purchaser, purchases the Bond by paying to itself, wearing its hat as Letter of Credit provider, the purchase price of the tendered bonds (equal to the principal component of the drawing).

   If the foregoing strategy doesn't work (for instance, because the Bond Indenture lacks language allowing the Bank to vote the interests of the Bondholders for an amendment to the Bond Indenture), other scenarios can be employed and, if all else fails (or if the Borrower needs a new money component of the deal), the transaction could be structured as a straight-up refinancing. Note that the amendment described above may result in a reissuance for federal tax purposes just like the refinancing, but may not

create a new issuance for state law purposes, thus reducing time and fees with the conduit Issuer.

4. **Extending BQ Bonds.** Some of the more interesting questions that will arise in the next few years will involve BQ Obligations issued in 2009 and 2010 as the end of the initial Bank commitment period approaches. Bond counsel will be asked to make heroic efforts to maintain BQ status by avoiding a federal tax reissuance. In this regard, see the "deemed designated" rules under IRC §265(b)(3)(D)(ii).

5. **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 Banks have arranged for the 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 Bank's holding company, though not of the Bank, 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), but the debate may not be over.

6. **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 to Bank 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 entities which are able to execute an investor letter in substantially the same form as the one executed by the initial Bank.

7. **MSRB Pronouncements.** MSRB Notice 2012-18 (April 3, 2012) ("Notice Concerning Voluntary Disclosure of Bank Loans to EMMA") urges Borrowers to make voluntary disclosure of direct purchase transactions and even conventional bank loan financings. The concern arises in the situation where a Borrower has an unenhanced debt issue outstanding and held by public market participants. MSRB is trying to ensure that those public market bondholders will receive timely and meaningful disclosure about

bank loans and other bank products that could affect the ability of the Borrower to meet its obligations under the public debt.

8. **NFMA's White Paper.** NFMA's White Paper entitled "Recommended Best Practices in Disclosure for Direct Purchase Bonds, Bank Loans and Other Bank Borrower Agreement" (June 2015) gives specific recommendations to ensure that ". . ..all municipal bond investors have current, complete, and reliable financial disclosures, sufficient time to review that information, and access to borrowers so that market participants can make informed investment decisions.

9. **S&P Pronouncements.** Similarly, S&P has raised questions about non-rated non-public debt incurred by a Borrower who also has an outstanding issue of public debt as to which S&P has provided a rating. S&P has sought to divide the Bank's remedies under the documents for the new unrated loan into major defaults (e.g., payment) as to which the Bank would have traditional remedies with little or no grace period vs. minor defaults (including, unfortunately, financial ratios) as to which the Bank would have a substantial stand back period prior to acceleration and exercise of rights and remedies. Needless to say, if S&P takes such a position, it would make it difficult for some Banks to offer financing to Borrowers which is attractive when compared to a publically offered transaction. More recently, S&P has demanded that issuers which have securities rated by S&P provide S&P with documentation for any direct purchase transaction prior to closing on the transaction. Failure to do so could result in a negative credit watch or a downgrade. Query if this is effectively a demand that S&P rate these issues, which will significantly increase costs associated with these transactions.

10. **Pressure for Longer Tenor**. One common theme in 2012-2013 was the fear by Borrowers and/or their FAs that by the time the Bank's initial commitment expires the world of tax-exempt finance will have changed significantly, perhaps even to the extent of total repeal of tax-exempt treatment for new issues or reissued Bonds. Therefore, Borrowers have pushed for ever-longer commitment terms. Commercial banks that typically provided 3-year or 5-year terms as recently as 2010 are now regularly offering terms of 10 years or even longer. Smaller banks, with the mindset of residential mortgage lenders, are regularly offering 20-year or even 30-year fixed rate financings. Query the result for these banks if the cost of funding increases during the next 20 or 30 years.

I. TAX ISSUES ARISING IN A DIRECT PURCHASES

1. **Issue Price.** Most direct purchase transactions are presented as par value financings, but bond counsel needs to consider if bank charges need to be taken into account for issue price purposes. Bank charges may be separated

into two general categories: debt-related fees and project-related costs. Debt-related fees include origination fees, rate lock fees, bank counsel fees, etc. Project-related costs include charges such as mortgagee title insurance, filing fees for security interests, costs of environmental studies required as a condition of the financing, etc. Most tax counsel agree that project-related costs are not taken into account for purposes of computing issue price.

How should debt-related fees be treated for issue price purposes? The answer depends on whether the fee is treated as interest paid on the obligation, or if the fee must be treated as payment for services or property. Fees that are treated as interest are taken into account when computing issue price. Fees that are payments for services or property are not taken into account when computing issue price. See Treas. Reg. §1.1273-2(g)(2) which discusses the treatment of certain cash payments made incident to private lending transactions.

2. **Characterization of Payments as Interest.** Recently, banks have been requesting payments from Borrowers that may be difficult to classify. For example, a bank may require that the Borrower reimburse bank for certain increases in costs (Dodd-Frank, BASEL III, cost of capital, etc…) or that the Borrower pay "true-up payments" relating to changes in the corporate tax rate that affect the value of the bonds.

To the extent that these payments are not payments for services or property, tax counsel should determine if they should be characterized as interest payments and what impact such a characterization would cause, including whether characterizing one or more payments as interest would result in the loan being characterized as a contingent payment debt instrument. Many tax counsel will not allow these types of payments if they should be treated as interest payments.

There are some interesting rulings in this area, and an analysis of the payments should begin with the definition of "interest." For federal income tax purposes, interest is an amount that is paid in compensation for the use or forbearance of money. Deputy v. DuPont, 308 U.S. 488 (1940), 1940-1 C.B. 118; Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932), 1932-1 C.B. 274. Neither the label used for the fee nor a taxpayer's treatment of the fee for financial or regulatory reporting purposes is determinative of the proper federal income tax characterization of that fee. See Rev. Rul. 72-315, 1972-1 C.B. 49 (as to the label); Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979), 1979-1 C.B. 167, 174-75 (as to financial or regulatory reporting).

The IRS has provided additional guidance in a series of rulings outside of the tax-exempt bond area. Rev. Rul. 72-315, 1972-1 C.B. 49, states that one factor distinguishing service charges on loans from interest is that a

service charge is a fixed charge having no relationship to the amount borrowed or the time given to pay whereas interest is based on the amount deferred and the time of deferral.

Rev. Rul. 2004-52, 2004-22 I.R.B. 973, considers the issue whether credit card annual fees are interest for federal income tax purposes. The revenue ruling states that annual fees are not compensation for the use or forbearance of money, because cardholders pay annual fees to credit card issuers in return for all of the benefits and services available under the applicable credit card agreement. Accordingly, an issuer's annual fee income is not interest income for federal tax purposes.

Rev. Rul. 74-187, 1974-1 C.B. 48, holds that late fees on utility bills are interest absent evidence that the late payment charge assessed by the public utility is for a specific service performed in connection with the customer's account. Even if a charge is a one-time charge or is imposed as a flat sum in addition to a stated periodic interest rate, that charge may still be interest for federal income tax purposes. See Rev. Rul.77-417, 1977-2 C.B. 60 and Rev. Rul. 72-2, 1972-1 C.B. 19.

In PLR 200533023 the IRS considers whether several types of credit card fees received by a bank should be considered interest. The IRS rules that late fees, over-the-limit fees, cash advance fees, and non-sufficient funds fees are interest, and that annual fees are not interest. When analyzing each of these fees, the IRS first determines whether the fee is a payment for services or property, rather than interest. The IRS also takes into account whether the fee charged bore any relationship to the amount borrowed. The IRS does not seem to give any weight to the fact that a fee is not labelled as a finance charge, may be imposed as a flat sum, or is imposed in addition to the stated periodic rate finance charge.

Should a similar analysis be used when considering fees in a tax-exempt bond transaction?

3. **Rights of Setoff.** Banks often require that an Issuer establish a depository account with the Bank as a condition of the direct purchase. Banks typically have a state law or contractual right of setoff with respect to the account. A right of setoff is the bank's legal right to seize the Issuer's account balance in the depository account to apply it toward the borrower's any loan in arrears, or in anticipation of a default. In some jurisdictions, the right of setoff may be exercised without prior notice.

Rights of setoff typically do not provide reasonable assurance that an amount will be available to pay principal or interest on obligations, because rights of setoff, by themselves, do not impose restrictions on the use of funds on deposit. However, to the extent that a right of setoff applies to a

depository account with a minimum balance requirement, tax counsel should consider whether the combination of the right of setoff and the minimum balance requirement create an indirect pledge of the minimum balance amount and therefore a replacement proceeds issue. See Treas. Reg. §1.148-1(c).

Does it matter if the failure to maintain the minimum balance requirement does not result in a default under the bond documents? Are there other requirements within the banking relationship that should be taken into account when analyzing replacement proceeds issues?

4. **Weighted Average Maturity.** Most tax counsel agree that mandatory redemptions identified in bond documents must be taken into account when computing weighted average maturity. See, e.g., Treas. Reg. §1.148-4(b)(2)(ii). However, what if mandatory redemptions are required only by bank documents, such as the continuing covenant agreement or reimbursement agreement? Such bank documents frequently require the Borrower to effect the mandatory redemptions by requiring the Issuer to make redemptions pursuant to the optional redemption provisions contained in the bond documents. Should redemptions required of the Borrower, but not of the Issuer, be taken into account when computing the weighted average maturity? See Treas. Reg. §1.1273-1(e) for the definition of the weighted average maturity of a debt instrument.

5. **Reissuance - Multimodal Financings.** In general, IRC §1001 and the regulations thereunder are the standard for determining whether tax-exempt obligations are reissued. In general, tax-exempt obligations are considered reissued if there is a "significant modification" of the obligations.

Notice 88-130 provides special reissuance rules for "qualified tender bonds." Notice 88-130 provides that qualified tender bonds will not be treated as reissued as a result of certain tender rights and certain changes in interest rate modes and other terms of bonds.

Notice 2008-41 modifies Notice 88-130 and again provides special rules designed to provide greater flexibility to alter a debt instrument after issuance without causing a reissuance. Notice 2008-41 provides that qualified tender bonds will not be treated as reissued solely as a result of (a) a change in the interest rate mode that was authorized under the original terms of the bond, or (b) the existence or exercise of a qualified tender right. Qualified tender rights are authorized under the original terms of the bond, provide an optional tender right or a mandatory tender requirement that allows or requires the bondholder to tender the bond for purchase at par in one or more prescribed circumstances (such as in connection with a mode change) and require the issuer or its remarketing agent to use at least best efforts to remarket a bond upon a purchase pursuant to a tender right.

Some bond counsel have created documents with "springing" Remarketing Agents to set the rate for a subsequent rate period, thus seeking to analogize the direct purchase bonds to qualified tender bonds such as VRDBs. One problem with this analogy is that, unlike the remarketing of a VRDB, where the only variable is the interest rate, in a bank purchase deal the Remarketing Agent would have to evaluate rate, length of commitment period, collateral and restrictiveness of covenants, all of which make it hard to do an "apples to apples" comparison. Another problem with the analogy is that the Borrower typically wants to continue with the same Bank during a subsequent commitment period and does not necessarily want to put its whole banking relationship out to bid to the lowest bidder for its bonds.

Practitioners should be sensitive to reissuance issues in the context of determining what happens at the end of the Bank's commitment period. While a document that leaves it up to the Bank and Borrower to agree upon a new rate suggests that a reissuance is in the offing, different bond counsel firms have varying opinions on how "baked in" the new rate must be before one can be confident that there is not a reissuance. There is an excellent discussion of the reissuance rules in the Refundings and Reissuance outline elsewhere in this Blue Book. Practitioners should consult that outline for an in-depth discussion of the issues touched upon here.

Practitioners also should beware of an instrument being deemed a "contingent payment debt instrument" if there are multiple rates which kick in under various circumstances. See also the discussion of contingent payment debt instruments in Section I.I. 7. below.

6. **Reissuance - Waivers of defaults under financial covenants.** Generally, the failure of an Issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification. However, in some circumstances an Issuer may stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) without causing a modification unless and until the forbearance remains in effect for a period that exceeds (A) two years following the issuer's initial failure to perform; and (B) any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case (as defined in IRC §368(a)(3)(A)). Treas. Reg. §1.1001-3(c)(4).

Accordingly, waivers of default that meet the time limitations in Treas. Reg. §1.1001-3(c)(4)(ii), by themselves, generally do not result in modifications of debt instruments. However, what if the bond documents state that the Bank has the option to grant the Borrower the right to defer all or part of its interest payments? Does the exception for temporary Treas. Reg. §1.1001-3(c)(4)(ii) apply? See Treas. Reg. §1.1001-3(d) Example 11.

7. **Contingent Payment Debt Instruments.** A discussion of contingent payment debt instruments is beyond the scope of this outline. However, bond counsel generally should be aware that rate-setting or rate-changing mechanisms can cause an obligation to be considered a contingent payment debt instrument. See Treas. Reg. §1.1275-4. The consequences of classifying an obligation as a contingent payment debt instrument can range from an impact on the timing of when interest is treated as received to the potential conversion of tax-exempt interest to taxable gain from a deemed sale or exchange of the instrument.

   Contingent payment debt instrument rules need to be considered whenever a debt instrument provides for alternative payment schedules upon the occurrence of particular contingencies. A debt instrument does not provide for an alternative payment schedule merely because insolvency, default or similar circumstances may impair one or more payments. In addition, a payment is not treated as contingent if the contingency is remote or incidental as of the issue date. Any debt instrument that provides for an alternative payment schedule for reasons other than an unconditional option or mandatory sinking fund should be analyzed under the contingent payment debt rules.

8. **Draw Down Obligations.** Issuers often take draws on draw down loans over the period of multiple years. Does each draw get a full 3-year temporary period, or is the 3-year temporary period available only once beginning on the first date the cumulative draws exceed $50,000 and ending three years later? How are the time periods within the spending exceptions to rebate measured?

   The issue date of an issue of bonds may be different than the issue date of the bonds that make up that issue. Treas. Reg. §1.150-1(b) includes a general definition for the issue date of a bond that provides the issue date is the date on which the Issuer receives the purchase price in exchange for that bond, provided that in no event is the issue date of a bond earlier than the first day on which interest begins to accrue on such bond for Federal income tax purposes.

   Treas. Reg. §1.150-1(c)(4)(i) provides that bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of $50,000 or 5 percent of the issue price.

   IRS Notice 2010-81 (the "2010 Notice") stated that the issue date of each bond was relevant when determining compliance with deadlines for issuing Build America Bonds and Recovery Zone Bonds, as well as other deadlines for issuing bonds.

IRS Notice 2011-63 (the "2011 Notice") amended the 2010 Notice for volume cap limitations on private activity bonds under §146 and other bond volume caps and limitations under Federal law. The 2011 Notice permits Issuers to elect to treat an entire issue of bonds as issued as of the date of the first draw, subject to requirements for expending proceeds within the maximum carry forward period for volume cap of the year of the first draw. This election applies solely for purposes of the volume cap limitation for private activity bonds and other bond volume caps on State and local bonds under Federal law.

9. **Replacement Proceeds.** Replacement proceeds include pledged funds. An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged, however, if (A) the issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or (B) the amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

Many tax counsel believe that the test in (B) above allows banks to require that Borrowers maintain an agreed-upon amount for some reasonable purpose, such as for liquidity, if (1) the amount maintained is reasonable, (2) the Borrower covenants to have the amount on deposit in unencumbered funds on the last day of each semiannual period, (3) the Borrower has unrestricted use of the cash in between testing dates, and (4) a failure by the Borrower to hold the amount in unencumbered cash on a testing date results in a default on the bonds.

Note that restrictions on the sale of assets of the Borrower used in its trade or business that are pledged as security for the bonds are not prohibited by the replacement proceeds rules. Such property is not considered investment-type property or property held principally as a passive vehicle for the production of income under Treas. Reg. §1.148-1(e) and is not subject to the arbitrage rules.

10. **Interest Rate Swaps.** There is an excellent discussion of the issues associated with interest rate swaps with banks or their affiliates in direct purchase transactions in the Swaps outline contained elsewhere in this Blue Book. Readers should consult that outline for an in-depth discussion of the issues touched upon here.

This outline focuses on the difficulties that may arise in governmental bond issues[2] when the lender and the swap counterparty in a direct purchase transaction are the same person. In a direct purchase transaction, banks sometimes offer Issuers the option to enter into a swap to hedge the variable interest rate risk on their loan. Likewise, on occasion Issuers that already have entered into a swap with a Bank or Bank affiliate will enter into a direct purchase with the Bank.

In these situations, bond counsel needs to consider if the two transactions should be treated as a single loan transaction for federal tax purposes. The more the tax-exempt loan and the swap are connected, such as with cross defaults, identical maturity dates/effective dates/payment dates, identical notional/principal amounts, etc.), the bigger the chance that the IRS will characterize the loan and the swap as a single debt instrument.

If the direct purchase transaction and the swap are treated as a single debt instrument for federal tax purposes, in some situations a portion of the payment made by the Issuer to the Bank may not qualify as tax-exempt interest. Bond counsel must be aware of these situations, or bond counsel risks issuing an opinion that all "interest" payments under the loan are tax-exempt when they are not.

Could this concern be ameliorated through changing the timing of payments so that, for instance, the Issuer pays the Bank monthly at the floating rate, but the parties account to each other quarterly under the swap?

In any event, many tax counsel will have problems if the LIBOR-based Bond and the swap to fixed rate are inextricably tied together (for instance, because of a requirement in the Bank's documents that the Issuer obtain rate protection coupled with limitations on incurring indebtedness, defined broadly, to any person other than the Bank).

Some tax counsel prefer Issuers to obtain the swap from a counterparty other than the Bank, even if the Bank actually wins the swap on a competitive basis. In the latter case, tax counsel will often ask for (i) carve-outs in the Bank's negative covenants so that, in the future, the Issuer could replace the original swap by a new swap from another party and/or (ii) exceptions to the Bank's typical list of additional termination events in the swap documents so that the swap may continue for its full term even if the Bonds are transferred to another person. See Rev. Ruling 2003-97 for a somewhat analogous situation in which the IRS examined whether a promissory note and a contemporaneous stock purchase agreement were

[2] The issue is less significant in conduit financings where the Borrower (and not the Issuer) enters into the swap with the Bank.

separate instruments or a single instrument for tax purposes. The answer seems to turn on both the legal possibility of separating the two bundles of rights and the economic reality.

II. LETTERS OF CREDIT

A. OBJECTIVES: LOWER INTEREST THROUGH CREDIT AND LIQUIDITY SUPPORT

Access to public markets for smaller Borrowers who could not achieve such access on their own credit. Also, note the "have one's cake and eat it too" aspect. Borrowers want to treat the 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. (For more on this, see Section II.P. 1. below). The optional tender feature of VRDBs provides this opportunity to achieve lower rates and the Bank's 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. A Letter of Credit is an independent, primary obligation of the Bank 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 Bank 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 applicable laws and rules of practice recognized by law (for instance, UCC Article 5, UCP 500, UCP 600 and ISP 96; see II.K. of this outline below), 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 Bank to terminate the Letter of Credit either on a periodic basis (consistent with the 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 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 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/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 3) 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 probably best for the Borrower to simply start early 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 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 as to everything other than the "sacred rights" of the Bondholders.

(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:
  - o Bond documents and Bond Trustee duties are not complicated with collateral.
  - o Letter of Credit Bank directly and solely controls the collateral.
- Disadvantages:
  - o 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.
  - o 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.

- o Creditors can look to the Master Trustee to exercise remedies.

- Disadvantages:

  - o Added layer of documentation and trustee expense.

  - o 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:

  - o Master Notes should be issued to both the Bond Trustee and the Bank (but should not be double counted for voting or payment rights).

  - o 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. 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 asked 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. ISSUE: Does this limitation amount to a bankruptcy opinion with respect to the Borrower? Generally, the requirement for this limitation has been dropped by the rating agencies (or maybe they just aren't clear on what Bank counsel is doing when they take an exception for bankruptcy and insolvency generally without specifying whether they are speaking of the bankruptcy and insolvency of the Bank or the bankruptcy and insolvency of any of the parties).

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 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 are asked to opine as to the exemption of the Letter of Credit from registration under the Securities Act.

M. DISCLOSURE

1. Bank Disclosure.

(a) Historical Practice. In general, the disclosure regarding Banks in offering documents for Bonds supported by a Letter of Credit or a Standby Bond Purchase Agreement or other Bank liquidity facility has been brief, often limited to: (i) one or two paragraphs describing the 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. PRACTICE TIP: 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." This is to be resisted, as the typical Bank disclosure omits to state just about everything. The best the Bank can really say is that whatever is in the disclosure isn't actually false. Also, in the context of this closing certificate, the Bank officer is often asked to certify that the Bank disclosure remains correct on the date of the closing. This is hard on the Bank officer, because the canned Bank disclosure has been handed to her and typically speaks

as of the end of the previous fiscal quarter. How can the Bank officer really know what has happened since then?

(b) Rule 15c2-12. Previously, Rule 15c2-12 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 Rule 15c2-12 ended this exemption and provided that VRDBs would be subject to continuing disclosure requirements. This still begs the question as to exactly what disclosure is required.

2. Bank Disclosure Issues.

(a) References to Bank Reports. Are references to public reports regarding a Bank and/or its holding company (such as call reports and 10-Ks, 10-Qs and 8-Ks) effective to include those reports in a Bank's description? Should there be an undertaking by the Bank to provide copies of such reports on request? Should such documents be formally incorporated by reference into the Bank description?

(b) 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?

(c) 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 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). Letters of Credit are often issued to support Bonds for conduit Borrowers for whom full disclosure is not practicable. In a

cross-over from the turmoil with bond insurers, some investment banks have been uncomfortable with less than full disclosure on the underlying Borrower and the SEC has been openly skeptical of anything other than full disclosure of the underlying borrower. 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? Resolution of this issue is beyond the scope of this Panel, but Bank counsel shouldn't be surprised to hear underwriters calling for a full Appendix A in deals where that was never the case before.

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

(a) 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 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.

(b) 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," Bank 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 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 thereon 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 TOPICS

1. **The Accountants Strike Back**. As described in Section II.A. above, the Borrower wants to book the VRDBs as long-term debt even though they can be optionally tendered by the holders on 7 days' notice. Prior to 2008, the Borrower could plausibly tell its accountants to ignore the put feature on the grounds that such things would never occur. That argument can no longer be made, so now the Borrower argues that the Bond debt is long-term because even if there is an unremarketed tender, the Bonds will become Bank Bonds and will term out. The accountants often ask that if a Borrower is relying on the term-out for this purpose, then the Bank needs to hold the Bonds and not even begin the term out until at least a year and a day following the tender. For another obligation voiced by some (though certainly not all) accountants, see II.P. 3. below.

2. **MTI Covenants**. In many financings, particularly for hospitals, the Bank 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 financial advisors will argue that the 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 Bank is stuck with 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 you can always find the Bank to request a 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 (iv) the Master Indenture covenants are typically written in a way that only an investment banker could love and are not what a Bank credit committee would readily understand. In particular, note that MTI 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. It should not be surprising that the Bank may want a real remedy, such as acceleration.

3. **MAC Attack**. There is increasing scrutiny of default clauses based on "material adverse change" (MAC). In particular, a rating agency may require the deletion of a MAC clause in the Reimbursement Agreement in order to rate a VRDB issue. 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. As described in II.P. 1. above, 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 Bank's part that are so subjective that the financing becomes virtually a demand loan.

4. Revised MSRB Rule G-34(c).

    (a) MSRB Rule G-34(c), relating to the collection and dissemination of market information with respect to variable rate securities, was amended effective May 16, 2011. See MSRB Notice 2011-17 (February 23, 2011) (from which the following points are taken):

(b) The amendments to Rule G-34(c) require brokers, dealers and municipal securities dealers (collectively, “Dealers”) to submit to the MSRB SHORT System documents that define “critical aspects” of VRDB liquidity provisions and interest rate setting mechanisms.

(c) “Critical aspects” for this purpose include, but are not limited to, “termination provisions” detailing those circumstances when the obligation of the liquidity provider to provide liquidity is no longer applicable, the “notification period” that details the length of time that may lapse between the date when a holder of a VRDB tenders a position in the security and the time when the liquidity provider purchases the tendered security, and the “term out period” for amortization of Bank Bonds.

(d) Remarketing Agents will be required to submit documents related to Reimbursement Agreements, Standby Bond Purchase Agreements and any other documents that establish an obligation to provide liquidity, including credit agreements that back “self liquidity” programs.

(e) Summaries of documents, such as those contained in official statements, do not satisfy the submission requirement.

(f) In response to concerns about protecting information in these agreements not intended to be made public, MSRB Notice 2011-17 clarifies that certain information may be redacted from the version posted on the SHORT system. Examples of such information may include the fees assessed by liquidity providers as well as staff names and contact information for making a draw under the liquidity facility, as well as information that could be used in a fraudulent manner, such as Bank routing or account numbers. The MSRB cautions that “redacting must be kept to a minimum” and must not include those items of information that would reasonably be assumed to be used by an investor or other market participant in evaluating a VRDB. ISSUE: Who resolves a dispute among the Bank, the Issuer and the Dealer as to what may or not be redacted? The Dealer is the party subject to the rule and the Dealer will bear the consequences of noncompliance.

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 a 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 remarketed and 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 V 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;

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

3. Failure to pay scheduled debt service on senior or parity bonds, notes or bank loans (other than payments coming due solely through acceleration of bank bonds held by other lenders);

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 withdraw or suspension is for non-credit reasons (ISSUE: How is a Bank to determine if a credit rating 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. 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 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, 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.

D. 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). Having been stung in 2008, Banks are now trying to avoid a recurrence by (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 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 LIBOR 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" means the purchaser of Bonds in a direct purchase transaction, or 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.

"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.

"Issuer" means the governmental entity issuing the Bonds.

"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.

"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" means variable rate demand bonds; 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.