Bond Case Briefs

Municipal Finance Law Since 1971

Implications Of COVID-19 Pandemic For Municipal Bond Transactions.

The COVID-19 pandemic is affecting municipal borrowers, including state and local governmental entities and conduit borrowers, as unexpected expenses grow and expected revenue declines as a result of stay-at-home and other similar mandates. Issuers and conduit borrowers likely will encounter in the coming months a number of legal issues relating to tax-exempt borrowings in light of these changing financial conditions. This Alert will address a few of these legal issues relating to continuing disclosure and tax (particularly cash flow deficits and debt restructuring). For more information about the topics discussed below, please contact any member of the Public Finance Group.

Continuing Disclosure

Pursuant to outstanding continuing disclosure agreements, issuers and obligated persons may be required to file notices related to late annual or quarterly filings and listed event notices related to a change in economic conditions because of the COVID-19 pandemic. Issuers and obligated persons should review their outstanding agreements and disclosure policies and procedures.

Under the U.S. Securities and Exchange Commission (the "SEC") Rule 15c2-12 of the Securities Exchange Act (the "Rule"), issuers and obligated persons are required to file a notice regarding late annual or quarterly filings prior to the date listed in the applicable continuing disclosure agreement and listed event notices within 10 business days after the occurrence of the event. These notices must be filed on the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) system. Issuers and obligated persons are not excused from making these filings if an office is closed or if employees are working remotely.

1. Required Filings

Some of the listed events that should be reviewed carefully include:

A. Principal and interest payment delinquencies: Did the issuer fail to make its principal or interest payment related to the bonds on time? Did the obligated person (i.e., the conduit borrower) fail to make its payment to the issuer that will be used to pay the principal or interest on the bonds on time?

B. Non-payment related defaults, if material: Did the change in its economic condition cause the issuer or the conduit borrower to fall below a financial covenant?

C. Rating changes: Did the rating on the bonds change – upgraded or downgraded? Did the rating on the credit enhancement (i.e., the rating of the issuer of municipal bond insurance or letter of credit) change? Typically, a change in "outlook" (such as stable, positive, or negative) is not considered a rating change for the purpose of the Rule.

D. Bankruptcy, insolvency, receivership, or similar event of the obligated person: Was a receiver

appointed in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal laws?

2. Financial Obligations

Additionally, for bonds issued on or after February 27, 2019, issuers and obligated persons may be required to file notices related to the following two listed events:

A. Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material.

Did the issuer or the obligated person obtain a loan from a bank, e.g., the U.S. Small Business Administration's Paycheck Protection Program, or obtain a new line of credit?

B. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.

Did the issuer or the obligated person fail to make a timely payment related to a bank loan or lease because of financial difficulties? Did that failure cause an acceleration of the bank loan or lease?

The term "financial obligation" means a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii). The term "financial obligation" shall not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule.

3. Modifications

Issuers and obligated persons are required to file notices related to modifications to existing agreements related to the two new events related to Financial Obligations listed above and for modifications to rights of the bondholders, if material.

A modification occurs when the modified terms become enforceable against the issuer or the obligated person. A modification may be written or oral. Examples of modifications include a waiver of an interest rate change, changing or waiving a covenant in a bond document, deferring a payment, or entering into a temporary forbearance agreement. These modifications may or may not trigger a reissuance for tax purposes (see discussions in Tax section below).

4. Financial Difficulties

There are several listed events that require the issuer or the obligated person to file a notice if the event is caused by financial difficulties:

A. Unscheduled draws on debt service reserves reflecting financial difficulties: Did the issuer or the obligated person draw on a debt service reserve fund in order to make a payment related to the bonds?

B. Unscheduled draws on credit enhancements reflecting financial difficulties: Did the issuer or the obligated person draw on a letter of credit in order to make a payment related to the bonds?

C. For bonds issued on or after February 27, 2019: Default, event of acceleration, termination event,

modification of terms, or other similar events under the terms of a Financial Obligation of the obligated person, any of which reflect financial difficulties (see above).

For these listed events, if the issuer or obligated person determines that the event would affect the liquidity or overall credit worthiness of the issuer or the obligated person, then the issuer or obligated person is required to file a notice on EMMA.

5. Voluntary Filings

In addition to the filings that are required under the Rule, issuers and obligated persons may decide to make a voluntary filing on EMMA related to a change in their economic condition, presumably upon the occurrence of an event under its disclosure obligation (without regard to the date of the February 27, 2019 update) or included in a regular filing to describe the impact of COVID-19 on operating and financial data. Prior to making these voluntary filings, the issuer and the obligated person should discuss them with bond counsel or disclosure counsel.

Tax

1. Reissuance as a Result of Restructuring

The effect on the bond market resulting from the liquidity crunch caused by the COVID-19 pandemic is proving to be similar to that resulting from the credit crunch caused by the financial crisis in 2008. In both instances, issuers and borrowers are finding the remarketing of their outstanding tax-exempt bonds to be extremely difficult. As a result, they have begun seeking a range of solutions, from debt payment deferrals, covenant waivers, and other debt modifications to purchases of debt obligations by issuers. Such proposed changes to the debt instruments touch on the various aspects of bond reissuance that are discussed below in more detail.

A. Treasury Regulation §1.1001-3
For all federal income tax purposes, Treas. Reg. §1.1001-3 (the "1001 Regulations") generally provide that a modification of terms of a debt instrument that is significant enough will result in a deemed exchange of an old debt for a new debt, or a "reissuance," which results in gain or loss to the holder of the debt instrument. The 1001 Regulations test reissuance in two parts: (i) modification and (ii) significance of the modification. For modification, the 1001 Regulations set forth rules (and exceptions) as to whether a change of a term in the debt instrument (whether addition or deletion) is a "modification." If the change is a considered a modification, the 1001 Regulations set forth rules (and exceptions) to test whether the modification is significant enough to result in a reissuance. Below are highlights of the modification and significance tests that are relevant to changes to bonds:

(i) Modification
Generally, a modification is any change, including any addition or deletion, in a legal right or obligation of the issuer or holder of a debt. Also, a modification generally occurs at the time the parties agree upon the modification, not when it goes into effect.

An alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is generally **not** a modification. However, it still is a modification if the alteration (a) is a change in obligor or nature of the debt instrument (from recourse to nonrecourse or from nonrecourse to recourse), (b) converts the instrument into equity, or (c) results from an exercise of an option by either the issuer or the holder. However, an exercise of an option is **not** a modification if (x) the option is unilateral and (y) for an option exercisable by a holder, the exercise of the option does not result in a deferral of or a reduction in any scheduled payment of interest or principal.

Generally, an issuer's failure to perform its obligations under a debt instrument is not a modification. In addition, a holder's temporary forbearance to stay collection or waive acceleration clauses and default rights for up to two years, plus any additional period during which the parties conduct good faith negotiations or a bankruptcy case is pending, is not a modification.

(ii) Significance

Once there is a modification, the 1001 Regulations set forth a combination of five specific tests and a catch-all "economic significance" test to see whether the modification is significant. Below are the highlights of the six significance tests:

(a) Economic significance: A modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. All modifications to the debt instrument (other than modifications subject to the five specific tests) are considered collectively, so a series of such modifications may be significant when considered together although each modification would not be significant if considered alone.

(b) Change in yield: Generally, a modification that results in a change in yield of the modified debt instrument by more than 25 basis points is significant.

(c) Deferral of payments: A delay of payment of the amount due under a debt instrument (including a change in the amount of the payments) that results in a "material deferral" of scheduled payments is significant. The delay or deferral may result from an extension of the final maturity or a deferral of payments due prior to maturity. **However, as a safe harbor, a delay or deferral of scheduled payments for a period equal to the lesser of five years or 50 percent of the original term of the instrument is not a material deferral. Any option to extend the original maturity and deferrals of de minimis payments are ignored.** Keep in mind, though, that a delay or deferral within the safe harbor period may be limited by 120 percent of the weighted average economic life of the financed facilities.

(d) Change in obligor or security: For tax-exempt bond purposes, Notice 2008-41 has effectively streamlined this test such that any change in obligor, security, or credit enhancement is a significant modification if the modification results in a change in the payment expectations.

(e) Changes in the nature of a debt instrument: A change in the debt instrument from debt to equity is a significant modification. A change in the debt instrument from recourse to nonrecourse and vice versa is also a significant modification.

(f) Changes to the accounting or financial covenants: A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.

B. Notice 88-130

While the 1001 Regulations apply for all federal income tax purposes, they do not apply to "qualified tender bonds" for purposes of Sections 103 and 141 through 150. For 20 years, Notice 88-130 governed what constitutes a "qualified tender bond" ("QTB") and whether there is a reissuance with respect to a QTB. Under Notice 88-130, a QTB is any tender bond with a final stated maturity date that is no later than the earlier of (a) the date that is 35 years after the date of issue or (b) the latest date reasonably expected (as of the date of issue) to be required to carry out the governmental purpose of the issue of which the bond is a part. The key aspect of Notice 88-130 was that a qualified tender change (such as a change in the interest rate mode provided for in the bond documents) with respect to the QTB was not treated as a reissuance that would otherwise have been under the 1001

Regulations. However, Notice 88-130 was generally regarded as being inflexible, with its "hair trigger" reissuance analysis for any changes not otherwise provided for in the bond documents, including and in particular changes to the length of the bonds from a long period (more than one year) to a short period (less than one year) and vice versa. The financial crisis in 2008 showed that Notice 88-130 was not helpful to issuers and borrowers who wanted to amend bond documents either to create or to preserve the opportunities to remarket their existing QTBs while not causing a reissuance at the same time.

C. Notice 2008-41

In response to the financial crisis of 2008 and the shortcomings of Notice 88-130, the Internal Revenue Service ("IRS") issued Notice 2008-41, designed to relax the rules with respect to certain changes to qualified tender bonds and to avoid causing a reissuance. However, Notice 2008-41 did not supersede Notice 88-130, as issuers can elect to apply Notice 88-130. As a general matter, under Notice 2008-41, a tax-exempt bond is treated as reissued if (i) the terms of the bond were significantly modified or the bond was disposed of, (ii) the bond is purchased by or on behalf of the governmental issuer, or (iii) the bond is retired or redeemed.

(i) QTB

Under Notice 2008-41, a QTB is a tax-exempt bond that has all of the following features:
(a) for each interest rate mode that is provided for under the terms of the bond considered separately, the interest of the bond is either a fixed interest rate; a variable interest rate that reasonably can be expected to measure contemporaneous variations in the cost of newly borrowed funds, including interest rates determined by reference to eligible interest rate indexes (e.g., the SIFMA index); a tender option-based interest rate; a Dutch auction rate; or an eligible objective rate for a variable-rate instrument (e.g., a qualified inflation rate or a qualified inverse floating rate);

(b) interest on the bond must be unconditionally payable at least annually;

(c) the final maturity date of the bond is not longer than the lesser of (i) 40 years from the issue date of the bond or (ii) the latest date that is reasonably expected as of the issue date of the issue of which the bond is a part to be necessary to carry out the governmental purpose of the issue of which the bond is a part (with 120 percent of the weighted average economic life of the financed facilities being a safe harbor for this purpose); and

(d) the bond is subject to an optional tender right or a mandatory tender requirement which allows or requires a bondholder to tender the bond for purchase in one or more prescribed circumstances under the terms of the bond.

(ii) Qualified Interest Rate Mode Change and Qualified Tender Right

For a QTB that meets all of the features above, any qualified interest rate mode change or exercise of a qualified tender right is not treated as a modification under the 1001 Regulations and thus will not cause a reissuance of the QTB.

A "qualified interest rate mode change" is a change in the interest rate mode on a bond that is provided for under the bond documents. Furthermore, in order to be a qualified interest rate mode change, the terms of the bond must require that the bond be remarketed at par upon conversion to a new interest rate mode, unless the conversion is to a fixed interest rate mode for the remaining term of the bond to maturity, in which case the bond may be resold at a market premium or a market discount from the stated principal amount of that bond.

A "qualified tender right" is a tender right for the purchase of a bond (regardless of whether the purchase is by or on behalf of a governmental issuer) that is provided for under the bond documents.

The tender right must involve either an optional tender right or a mandatory tender requirement which allows or requires the bondholder to tender the bond for purchase on at least one tender date before the final stated maturity date. The tender right must entitle a tendering bondholder to receive a purchase price equal to par (which may include any accrued interest). The terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to remarket a bond upon a purchase pursuant to the tender right.

(iii) Purchase of Bonds by Issuers

A bond purchased by or on behalf of a governmental issuer pursuant to a qualified tender right is treated as **not** retired pursuant to and as a result of the qualified tender right for a 90-day period from the date of such purchase. After the 90-day period, the bond will be treated as retired if the governmental issuer continues to hold its own bond.

(iv) Purchase of Bonds by Conduit Borrowers or Third Parties

A bond purchased by third-party guarantors, third-party liquidity facility providers, and conduit borrowers (other than a conduit borrower that is a governmental issuer) is not treated as purchased by or on behalf of a governmental issuer. Therefore, any such person may hold a bond purchased pursuant to the exercise of a qualified tender right for an unlimited holding period without causing a retirement of such bond. Furthermore, a governmental issuer may purchase and hold its own bond for a period of 89 days while using best efforts under the terms of the bond to remarket the bond and then resell the bond to a third-party guarantor, a third-party liquidity facility provider, or another independent third party before the expiration of the 90-day period to avoid causing a retirement of the bond.

(v) Program Investment

Under Treasury Regulation § 1.148-1(b), for an issuer to avail itself of the benefits of the special arbitrage rule for "program investments" under which the issuer may set a loan yield that is 150 basis points (1.5 percent) in excess of the bond yield, the issuer must restrict a conduit borrower's purchase of tax-exempt bonds for a governmental program in an amount "related" to the amount of its purpose investment (the loan) financed by the program. The permitted purchase by the conduit borrower of its tax-exempt auction rate bond (without causing a reissuance) that financed its loan to facilitate liquidity under adverse market conditions is treated as not being so related for this purpose. As a result, the issuer's program investment benefits would not be jeopardized as a result of a purchase of the bonds by the conduit borrower.

(vi) Nonrecourse Debt

Solely for tax-exempt bond purposes, in determining whether a modification of the security or credit enhancement on a tax-exempt bond that is a nonrecourse debt instrument is a significant modification, the modification is treated as significant only if the modification results in a change in payment expectations, which is a significant modification test for recourse debt instruments.

D. Consequences of Reissuance

For tax-exempt bonds, a reissuance is treated as a refunding of the bond prior to being reissued, and the consequences of a refunding include a need for new bond counsel opinion, a filing of the proper variation of the 8038 form, and a final rebate calculation for the prior bond that had been reissued. But perhaps the most important consequence is the change in the law applicable to the reissued bonds at the time of the reissuance. For bonds that were issued under programs that have expired, a reissuance would be fatal in that the reissued bond would lose the benefits of the expired program and, in some cases, even tax-exemption unless the reissuance qualifies for a transitional refunding exception designed to grandfather the expired program.

E. Recent Developments

On December 31, 2018, the IRS released proposed Treasury Regulation §1.150-3 (the "Proposed Regulation") to address the issue of reissuance. The Proposed Regulation generally followed Notice 2008-41 except for two points. The first is that the Proposed Regulation did not include the program investment fix about the related amount in the case of a purchase by the conduit borrower. The second is that the Proposed Regulation did not provide for the permissible remarketing of the qualified tender bond with market premium if the conversion of the bond is to the remaining term of the bond to maturity. Comments from the public finance legal community were submitted to the IRS to reinstate those two points in the final regulations.

On March 25, 2020, the National Association of Bond Lawyers submitted a letter to the United States Department of Treasury and the IRS seeking, among other things, (i) an expanded holding period beginning on March 1, 2020, and ending on the later of (a) December 31, 2021, or (b) 90 days after the date on which no United States jurisdiction remains covered by a state or federal declaration of emergency or disaster related to the COVID-19 pandemic for issuers to purchase their own bonds without causing reissuance; (ii) an extension of the general holding period from 90 to 180 days for issuers that might still need to hold their bonds at the end of the requested expanded holding period; and (iii) a suspension of the "best efforts" requirement discussed in the qualified tender right section above during the requested expanded holding period.

2. Cash Flow Deficit and Extraordinary Working Capital Financings

A loss of expected revenue, such as sales taxes and other taxes or assessments in the case of municipalities and other local governments, or operational revenue in the case of 501(c)(3) conduit borrowers, can result in shortfalls in budgets. Certain financing vehicles provide tools for issuers to address these shortfalls on a tax-exempt basis.

The federal tax law has long permitted these entities to issue tax-exempt tax or revenue anticipation notes, generally on a short-term basis, to finance a cumulative cash flow deficit. The obligations are sized taking into account on a monthly basis the available amounts of revenue, the anticipated expenses, and a permitted working capital reserve that results in a cumulative cash flow deficit. The term is typically limited to 13 months, and certain rebate accounting can be avoided by sizing the obligations to cover a deficit that occurs within six months of the date of issuance of the obligations.

The tax law also permits the financing of certain extraordinary working capital expenditures without regard to a cash flow deficit. These are expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenue, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. Prior to 2016, there was no stated term limit for these obligations; the term is now limited to 13 months. These extraordinary expenditures also can be the subject of a reimbursement borrowing, where proceeds of the obligations are used to reimburse the issuer for expenditures made before the date of issuance of the obligations. Generally, the issuer needs to adopt a reimbursement resolution within 60 days of the expenditure being made in order to have a valid reimbursement.

Beginning in 2016, the IRS permitted by regulations the issuance of long-term working capital obligations, including extraordinary working capital borrowings. The 2016 rules require the issuer on the issue date to determine the first fiscal year following the 13-month period after date of issue in which it reasonably expects to have surplus (the "first testing year"), which must be within five years of the date of issuance; determine the amount of surplus at the beginning of each testing year; and redeem bonds and/or purchase eligible tax-exempt bonds up to the amount of the outstanding working capital bonds.

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McCarter & English, LLP

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