Bond Case Briefs

Municipal Finance Law Since 1971

Developing Public Finance Concerns in the COVID-19 Era.

INTRODUCTION

The COVID-19 global pandemic presents unprecedented financial, operational and other challenges for participants in the public finance industry. The situation is extremely fluid and new developments occur almost daily. The response by local governments, lenders, borrowers, trustees and underwriters to the unique issues that they will face will have to be tailored to specific circumstances and incorporate "best practices" as they arise. This alert will touch upon three primary areas of impact identified in this early phase of the pandemic. This alert does not address certain Federal relief programs that are available to 501(c)(3) entities.

- Selected Federal tax issues
- Selected covenant compliance issues
- Selected disclosure issues, including continuing disclosure obligations

SELECTED FEDERAL TAX ISSUES

Financing Vehicles to Address Cash Flow Deficits and Working Capital Needs

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 revenues, in the case of 501(c)(3) conduit borrowers, can result in shortfalls in budgets. Certain financing vehicles provide tools to address these shortfalls on a tax-exempt basis.

Cash Flow Deficit Financings. Federal tax law has long permitted the issuance of tax-exempt tax or revenue anticipation notes, generally on a short-term basis, to finance a cumulative cash flow deficit. These obligations are sized taking into account, on a monthly basis, the available amounts of revenues, 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.

Extraordinary Working Capital Financings. Federal 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 revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. The scope of "extraordinary" in the context of the COVID-19 pandemic is not clear. In particular, because the definition focuses on expenditures, it is not certain whether an unexpected loss of revenue will meet this provision. Guidance from the Internal Revenue Service (IRS) on the scope of the extraordinary working capital definition is being sought by the National Association of Bond Lawyers (NABL).

Prior to 2016 there was no stated term limit for extraordinary working capital obligations; the term is now also limited to 13 months. These extraordinary expenditures can also 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 must adopt a reimbursement resolution within 60 days of the expenditure being made to have a valid reimbursement.

Beginning in 2016, IRS permitted by regulations the issuance of long-term working capital obligations, including extraordinary working capital borrowings. The 2016 rules require the issuer (i) 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 available amounts (the "first testing year"), which must be within 5 years of the date of issuance; (ii)beginning in the first testing year and each fiscal year thereafter, to determine the available amount as of the first day of each fiscal year; and(iii) within 90 days of the start of each fiscal year, to apply that amount (or if less, the available amount on the date of the required redemption or investment) to redeem and/or invest in "eligible tax-exempt bonds," up to the amount of the outstanding working capital bonds. These rules effectively require the bond documents to include a provision requiring a call or mandatory partial prepayment from surplus revenues, unless the issuer can acquire certain outstanding bonds.

Forbearance and Reissuance Matters

Issuers and conduit borrowers of outstanding tax-exempt obligations who face financial pressures as a result of the COVID-19 pandemic may consider seeking assistance from their lenders in the form of forbearance or restructuring of their outstanding obligations. While lenders may be amenable to making certain changes, the parties to these obligations should keep in mind that modifications may cause the obligations to be treated as reissued for federal tax purposes. Unless appropriate steps are taken, the reissuance can result in an outstanding obligation being deemed a new taxable obligation under Section 1001 of the Internal Revenue Code. Reissuance can also have gain or loss implications for the lenders.

When Does a Forbearance or Other Loan Modification Trigger Reissuance for Tax Purposes? The tax regulations under Section 1001 look to whether there has been a modification of one or more terms of a debt instrument and whether that modification is significant. The general rule for significant modification under the regulations is not particularly helpful; it provides that 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 is economically significant. Fortunately, the regulations provide safe harbors for certain types of modifications.

Absent a change in another term of the debt instrument, a temporary forbearance by the lender, i.e., an agreement to stay collection or temporarily waive an acceleration clause or similar default right, is not a modification that triggers reissuance unless and until the forbearance remains in effect for a period that exceeds (i) two years after the issuer's initial failure to perform and (ii) any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 bankruptcy or similar case. If the negotiations result in a change in terms of the instrument, a reissuance analysis of that change is required.

If a change in interest rate results in a change in the annual yield of a tax-exempt bond by more than the greater of ¼ of one percent or 5% of the annual yield of the unmodified instrument, there will be a reissuance.

A change in the timing of payments under a debt instrument is significant if it results in a material deferral, taking into account the length of the deferral, the original term, and the amount of the payments. The regulations provide a safe harbor deferral period, beginning on the original due date of the first scheduled payment that is deferred and extending for a period equal to the lesser of 5

years or 50% of the original term of the debt instrument. A deferral that fits within this safe harbor does not trigger a reissuance.

In addition, a modification that adds, deletes or alters customary accounting or financial covenants is not treated as a significant modification that triggers a reissuance. The substitution of new collateral for existing collateral of a tax-exempt bond may cause a reissuance, if it changes payment expectations. A change in payment expectations may occur if there is a substantial enhancement or substantial impairment of an issuer's capacity to meet its payment obligations.

Other Considerations. The regulations under Section 1001 should be consulted when addressing any proposed modification of the term of tax-exempt obligations. Because a reissuance is treated as an exchange of one debt instrument for another, it may be possible to maintain the tax-exemption of reissued debt as a current refunding of the original debt, by meeting all the requirements imposed by the Internal Revenue Code for refunding bonds. At a minimum, the issuer will need to file a new Form 8038 for the reissued bonds. In the case of conduit bonds, this will require that the actual issuer be involved in the transaction. An agreement to modify a debt instrument between just the conduit borrower and the lender/bondholder may result in the new debt instrument being taxable because it is not treated as issued by a state or local government.

SELECTED COVENANT COMPLIANCE ISSUES

If an issuer or conduit borrower experiences cash flow or other operational issues as a result of the COVID-19 pandemic, the impact can be expected to ripple through to its debt obligations. The effect on each party will be specific to the terms of any particular transaction, including the type of security granted, the financial covenants and other tests that must be met, and how an event of default is triggered. The following highlights certain issues that may arise.

Covenant Compliance. Issuers and conduit borrowers should be familiar with all the financial and other covenants in their loan and bond documents, including debt service coverage and liquidity ratios, minimum performance benchmarks and whether a debt service reserve tap triggers an event of default. While some covenant provisions provide opportunities to cure, others trigger immediate defaults. Due to current circumstances, it may be difficult for obligors to respond quickly to cash flow or minimum covenant issues that may cause a technical default under the related documents, although the obligor continues to meet its debt service payments. In certain instances, modifications to covenants may be the best route, but could have federal tax implications, some of which are noted above.

Events of Default and Remedies. Although events of default and remedies are deal-specific, there are some general considerations to be taken into account. Any forbearance arrangement can have federal tax implications, as noted above. The applicable documents may contain cross-default and acceleration provisions. The remedy of specific performance may be impracticable in light of current circumstances, particularly in the context of subject to annual appropriation financings. "Material adverse effect" clauses that trigger defaults are often drafted ambiguously and may be the subject of dispute.

Other Considerations. Obtaining requisite consent to modifications to debt documents from bondholders may prove complicated when bonds are widely owned and held in book-entry-only format, particularly in transactions involving a trustee who may act only at the direction of bondholders.

SELECTED DISCLOSURE ISSUES

Issuers and conduit borrowers face unique considerations in addressing the impact of the COVID-19 pandemic on their financial position, operations and expectations when preparing a disclosure document related to their debt obligations and in evaluating their obligations under Rule 15(c)2-12 ("Rule") of the Securities Exchange Commission (SEC) and their written continuing disclosure undertakings. The following highlights selected concerns.

Primary Disclosure Document Considerations. There is currently no specific guidance from the SEC or the National Association of Bond Lawyers on how to address the impact of COVID-19 in primary disclosure documents and "best practices" in this regard will likely develop over time. Each transaction gives rise to its own unique circumstances in the context of disclosure and issuers and conduit borrowers must evaluate the disclosures to be made in the context of their obligations under the anti-fraud provisions of applicable securities laws. This is made more difficult because of the uncertainty surrounding the COVID-19 crisis, including its duration. Although market participants are aware of this uncertainty, issuers and conduit borrowers should not rely on this "general" knowledge when evaluating the disclosures to be made. In addition, under the Rule, an obligated person must disclose in its offering documents a failure to comply with its continuing disclosure obligations during the prior five years. Offering documents may now have to include an explanation of why a late filing was made due to the effects of the COVID-19 pandemic.

Continuing Disclosure Considerations. During a webinar presented on March 19, 2020 by the Municipal Securities Rulemaking Board (MSRB), two key questions were addressed by Ahmed Abonamah, deputy director of the SEC's Office of Municipal Securities and David Hodapp, assistant general counsel of the MSRB: (1) can the SEC provide relief for late filings due to extenuating circumstances arising from the COVID-19; and (2) should an obligated person file a voluntary general event notice about COVID-19 on the MSRB's Electronic Municipal Market Access website ("EMMA"), including to report that its offices are closed to the public and that personnel is working remotely. From the reported discussion of these questions on the webinar, the following summarizes the responses:

- The SEC lacks the authority to provide relief for late filings. If an obligated person is unable to timely file its annual financial and operating information, it should file a notice of failure to file, along with any other information required to be provided in its undertakings, on EMMA prior to the required filing date.
- The terms of the written undertaking control. Unless the impact of the COVID-19 pandemic on the obligated person gives rise to one of the reportable events under the Rule or is otherwise required to be reported pursuant to the undertaking, there is no need to file a general event notice. An obligated person may always make a voluntarily report regarding specific facts known to and affecting the obligated person (as opposed to general information already available to market participants). The election to make a voluntary report gives rise to other considerations, including whether it will open the door to the need to update the filing in the future.

Obligated persons should be familiar with all of the reporting requirements in their written undertakings, which may trigger notice events in specific circumstances in addition to the material events listed in the undertaking. Among matters, obligated persons should take care to closely follow the ratings of their debt obligations. The SEC has previously indicated in adopting statements for amendments to the Rule that a ratings watch or outlook change is not a reportable event. Depending on the particular undertaking, matters relating to a spike in rates for variable rate instruments, failed remarketings and commercial paper roll overs may trigger a reporting event. For undertakings entered into after February 28, 2019, a notice event may be triggered if an existing privately-placed obligation is modified. Finally, COVID-19 impacts may trigger material events for which notice is required.

As noted at the outset, this is a developing and evolving situation and the proper response will, in large part, be fact specific for each market participant. This alert is only intended to highlight selected matters to be considered in the context of the COVID-19 pandemic. Members of the Greenspoon Marder Public Finance Department are available to provide guidance in these and other matters that arise as we all navigate these unusual times together.

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USA April 22 2020