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Burned by BABs, Issuers Look for a Way Out: Orrick

Between April 2009 and December 31, 2010, state and local governments borrowed more than $181 billion through the issuance of 2,275 separate issues of Build America Bonds, which were authorized under the federal American Recovery Reinvestment Act of 2009 ("ARRA"). Under ARRA, the U.S. Treasury was supposed to provide cash subsidy payments equal to 35 percent of interest payable on outstanding BABs for the life of the bonds.

The promise of BABs subsidy payments in full was short-lived because of a debt ceiling fight – this one in 2011 between the 112th Congress and the Obama Administration which resulted in the Budget Control Act of 2011 (the "BCA") and the implementation of automatic spending reductions ("sequestration") beginning in March 2013.

Since sequestration took effect on March 1, 2013, BABs subsidy payments have been reduced year over year, with reductions ranging from a high of 8.7 percent in 2013 to a low of 5.7 percent for federal fiscal years 2021 through 2030. Under current law, BABs subsidy payments are subject to sequestration through federal fiscal year 2030 unless Congress takes action to modify or eliminate the sequester.

In addition to this partial sequestration imposed by the BCA, the Statutory Pay-As-You-Go Act of 2010 ("PAYGO") can impose mandatory spending cuts based on legislation that increases the federal budget deficit. In 2022, it was reported that due to COVID-19 relief legislation (which did not include a waiver of the PAYGO reductions), there was the potential for 100% sequestration of BABs subsidies beginning in January 2023. Fortunately, the Consolidated Appropriations Act of 2023, enacted in December of 2022, provides a reprieve from PAYGO sequestration through federal fiscal year 2025.

The prospect of a total elimination of BAB's subsidy payments, combined with uncertainty about the debt ceiling and the ability of Congress and the Biden Administration to resolve the current political logjam, has triggered renewed interest by the public finance community in BABs refundings. Many issuers simply want to get out of BABs altogether at this point.

For issuers that are thinking about "breaking up" with their BABs, important considerations include:

- **Redemption Provisions:** For BABs issued with 10-year par calls, it is straightforward to redeem and refund BABs, and many BABs have been refunded for savings over the past few years with traditional tax-exempt bonds.But many outstanding BABs were issued without a 10-year par call, leaving other redemption provisions as options.

> *Make-whole Call provisions.* A make-whole call is a common redemption provision for taxable bonds, including BABs, that requires a payment by the issuer to the bondholder based on the net present value of future coupon payments, thereby putting the bondholder in the same position they would have been if the bonds were not redeemed.The present value calculation for make-whole calls is usually based on a

spread against Treasuries—the higher the spread against Treasuries, the higher the discount rate and therefore the smaller the redemption price.

As a broad market observation, it has generally not been possible to tax-exempt refund BABs through a make-whole call and achieve savings. However, as the spread between taxable and tax-exempt rates increases, there may be opportunities for savings depending on market conditions. In addition, some issuers may be interested in redeeming their BABs despite some dissavings to avoid the risk of future increases in sequestration.

Extraordinary Call Provisions. In addition to make-whole calls, most BABs included extraordinary redemption provisions ("ERP"), which generally provide for a more issuer-favorable redemption price if specified conditions have occurred resulting in negative affects on the BABs subsidy.The particular conditions for exercise of ERPs vary between the bond documents for different issues of BABs.

For issuers looking to exercise the ERP for their BABs, it is important to closely review the language to determine whether the conditions have been met. Views may differ as to whether the ERP conditions have been met as a result of sequestration, and current bondholders may object to the exercise of an ERP if the issuer undertakes a refunding of BABs using the ERP. It is necessary to consider the potential impact of such an objection on the ability to issue the refunding bonds, including whether litigation might lead to a larger redemption price that would reduce the savings on the transaction and potentially affect the ability to issue the refunding bonds. As another consideration, exercising an ERP under conditions where bondholders object might lead to a negative reputation among taxable bond investors.

- **Budget and Debt Policy Considerations:** Retiring BABs through a refunding and issuance of tax-exempt bonds will result in the loss of the federal interest subsidy.Issuers will need to evaluate the loss of the subsidy in their refunding savings analysis under any applicable debt policy or budgetary procedures for the issuance of any refunding bonds, but may be able to take sequestration into account in reducing the estimated value of those subsidy payment.It may be the case that there are savings from refunding the BABs even taking into account the lost subsidy payments.
- **Refunding Bond Issuance Authority:** Issuers of revenue bonds should consult with counsel and closely review the provisions of their bond documents to evaluate whether the issuance of tax-exempt refunding bonds to redeem BABs qualifies as an issuance of refunding bonds or possibly triggers any additional bonds tests or has other covenant implications.

As a best practice, issuers should be sure to consult with Bond Counsel and other finance team members to fully assess the legal, financial and market considerations of any refunding transaction and financial benefits of any refunding transaction, and especially any transaction calling the bonds using an ERP.

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