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Private Debt Placements for Health Care Providers — The Alternative to Accessing the Public Markets

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Agenda

Private Debt Placements for Health Care Providers – The Alternative to Accessing the Public Markets

- Market place developments - pricing, indices, and new purchasers in the marketplace
- Deal structuring concerns
- Purchaser requirements and covenant concerns
- Rating impact on outstanding debt
- Tax issues, including special considerations for modifications and interest rate formulas
- Securities issues and disclosure concerns
- Questions

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Market Place Developments

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Direct Purchase

- Direct Purchase is the terminology for loans currently being offered by banks to the municipal industry
 - Tax exempt or taxable
 - Applicable for 501(c)3 and government bonds
- How we got here: Bank credit ratings have been challenged, so borrowers are getting out of VRDBs that rely on bank credit ratings, leaving banks with lending capacity for which direct placements fill a void; other financial institutions are also lending to capture yield
- Types
 - Lenders/Bondholders: commercial banks, finance companies
 - Vehicle: direct loan vs. multimodal bond

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Direct Purchase (con't)

- Almost 50% of Kaufman Hall transactions are in this form
- Variable rate direct purchase bonds eliminate two of four risks of VRDBs
 - Renewal risk
 - Market-reliant risk
 - *Credit Risk (Bank Provider)*
 - *Accelerated demands on cash*
- Fixed rate direct purchase bonds eliminate yet another risk
 - Renewal risk
 - *Market-reliant risk*
 - *Credit Risk (Bank Provider)*
 - *Accelerated demands on cash*

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Direct Purchase Lending Primer

- What are they?
 - Direct purchase bonds/bank loans have become increasingly popular given the decreased reliance on bank credit, preferable terms, and comparable pricing to publicly issued securities
 - Some banks treat these facilities as loans and others as multi-modal securities; in both cases, the bonds are issued through the usual process and directly bought and held by the bank
- Why do them?
 - Simpler and more streamlined process
 - Avoid public offering: no underwriting costs or public disclosure
 - Overall lower transaction costs than public offering
 - Viewed, depending on structure, as less risky than VRDBs by rating agencies
 - Diversifies debt structure of borrower

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Direct Purchase Lending Primer (con't)

What are the typical terms?

- Bonds are usually sold with a long-term principal amortization (20 to 30 years) with an initial term of 5 to 10 years, and have an extension provision 5, 7, or 10 years after loan closing
- These facilities are priced at a spread to LIBOR, adjusted by applying a tax factor (i.e., 75% of LIBOR + credit spread) or a spread to SIFMA
- Credit spreads depend on borrower's creditworthiness, the bank's appetite for lending, and the initial term of the commitment
- Typical financial covenants include debt service coverage, liquidity, and minimum ratings, maybe debt to cap

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Direct Purchase Lending Primer (con't)

Advantages:

- + No public disclosure needed
 - + (no official statement or Appendix A)
- + Ratings of the obligations usually not needed
- + Rates competitive with publicly issued securities (similar to LOC)
- + Can obtain fixed rates without swaps
- + No debt service reserve fund
- + Essentially no bank credit rating risk
- + Allows for debt diversification
- + Easier to amend business terms than a public issue with many investors
- + Issuance costs are about half of a public bond issue (no auditor, underwriter or official statement)
- + Eliminates daily/weekly put risk associated with VRDBs

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Direct Purchase Lending Primer (con't)

Disadvantages and Risk Factors:

- Put feature, if loan is not until maturity and is not extended, at the end of the term
- Bank imposes covenants
- Banks often require tie-ins to other commercial business
- Still uncommitted funding
- Could end up with higher costs via passthroughs
 - Changes in corporate rates
 - Event of taxability
 - Rating downgrade
 - Basel III
 - Default rate
 - LIBOR reserve percentage

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Capital Market Product Alternatives: Summary Sample

	VRDO with SBPA ⁽¹⁾	VRDO with LOC ⁽¹⁾	Private Direct Placement (Variable) ⁽²⁾	Private Direct Placement (Fixed) ⁽²⁾	Fixed Rate Bonds ⁽³⁾
Risk Characteristics:					
Rate Frequency	Daily, bi-daily, weekly	Daily, bi-daily, weekly	Varies (up to quarterly)	For term of loan	Long term
Demand Frequency	Term out provisions	Term out provisions	Technical default triggers	Technical default triggers	At principal dates
Public Disclosure	Yes	Yes	No	No	Yes
Committed Capital	Uncommitted	Uncommitted	Committed for duration	Committed for duration	Yes
Interest Rate Risk	Yes	Yes	Yes	No	No
Remarketing Risk	Yes	Yes	No	No	No
Bank Renewal Risk	Yes	Yes	Yes	Yes	No
Counterparty Risk	No	No	No	No	No
Indicative Pricing:					
Base Rate	SIFMA	SIFMA	SIFMA / % LIBOR	MMD	MMD
Spread	0 bps	0 bps	75-100 bps	130-165 bps	145 bps
Facility Fee	40-60 bps	70-85 bps	0 bps	0 bps	0 bps
Remarketing Fee	10-15 bps	10-15 bps	0 bps	0 bps	0 bps
All-in Cost	SIFMA + 50-75 bps	SIFMA + 80-100 bps	% LIBOR + 75-100 bps	1.95% - 3.20%	3.70%

(1) Assumes 3-year term. (2) Assumes a 5- to 10-year term. (3) 20-year A rated spread estimate.

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Key Items for Consideration

Structure	Covenants	Economics	Defaults
<ul style="list-style-type: none">Amortization and term; ease of extensionTerm out provisionAssignment and participations	<ul style="list-style-type: none">Financial covenantsMaterial adverse change clause/ conditionsMinimum ratingsAssignment and participationsMinimum bank businessMost favored nations	<ul style="list-style-type: none">Yield protection clausesTax changes and other cost passthroughs/ adjustmentsDowngrade pricingTaxable vs. tax-exempt rateTermination feePricing index	<ul style="list-style-type: none">Grace periods for events of defaultLevels of cross default

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Tidbits

- Make sure to:
 - Run agreement by auditor
 - Run agreement by rating agencies
 - Know your notice periods
 - Pay attention to cure periods
 - Negotiate covenants and disclosure reporting that is clear and works
- Quirks
 - Pay attention to tax issues (to be discussed in greater detail by Mike Bailey later in this Webinar)

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Documentation, Covenants and Securities Law Issues

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Topics Covered in this Section

- Documentation process
- Specific provisions relating to the interest rate options: Advantages and disadvantages and term-out features
- Interest rate adjustments and additional fees
- Covenants, defaults, security
- Other negotiated provisions
- Disclosure and securities law issues

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Documents Typically Used in a Direct Purchase

Two common types of structures:

- Bond purchase and loan agreement
 - Parties include the state or local issuer, the borrower/healthcare system and the purchaser
 - Often used when no trustee is required or desired
 - No separate loan agreement or covenant agreement is used; all of the purchaser's covenants are included in this document
 - Disadvantages: May require issuer board approval to modify covenants that only the purchaser and borrower negotiated
- Multi-modal structure
 - Indenture and loan agreement are the same as what would be utilized in a public offering
 - Purchaser requires separate covenant agreement and/or bond purchase agreement with amendments and defaults similar to a reimbursement agreement

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Documents Typically Used in a Direct Purchase (con't)

- Multi-modal structure (con't):
 - All of the purchaser's covenants and additional defaults are included in the covenant agreement
 - With refundings can utilize existing multi-modal documents and build in purchaser interest rate modes and terms
 - Indenture will provide cross default to the purchaser's covenant agreement
 - Results in defaults not typically seen in bond indentures (ERISA, MAC). For these defaults borrower should request sufficient time to cure or convert to new mode before acceleration to avoid cross defaults to MTI
- Variations of these structures

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Documents Typically Used in a Direct Purchase (con't)

- Documents required for all structures
 - Investor letter executed by the purchaser required by the issuer – provides protections for the issuer (indemnification, representations of purchaser) and restrictions on transfer
 - Collateral and tax documents are similar to those required in a public offering: tax agreement, MTI supplement, mortgage and MTI note securing principal and interest owed on the bonds
- Additional considerations
 - Purchaser MTI note for additional obligations owed under covenant agreement may be required by the purchaser
 - Bond documents should allow ability to convert to different modes if borrower wants to protect against purchaser not extending the loan at the end of the initial term – assuming a longer nominal maturity of the bonds

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Interest Rate Options Typically Offered By Banks

- Index or floating rate interest options
 - Variable rate option that may include SIFMA or LIBOR Based Index (Percentage of the Index if LIBOR based or 100% of SIFMA; plus in either case a Spread)
 - Usually adjusts monthly for LIBOR and weekly for SIFMA
 - Interest typically payable monthly for LIBOR and SIFMA based indexes
- Fixed rate to maturity or a specified tender date
 - Rate is locked in at closing date unless rate lock is executed
 - Interest typically payable quarterly or semi-annually
 - Pricing adjustments based on rating changes or covenants thresholds often included as additional fees rather than interest due to reissuance concerns

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Interest Rate Options Typically Offered By Banks (con't)

- Term of bonds
 - Bonds are often structured with a long maturity – 20-30 years with initial mandatory tender required at the end of the initial term or index period (3, 5, 7, 10 years)
 - Parties set new interest rate spread and term or index period at the end of the initial term – usually at least 90-120 days prior to the end of initial term parties begin negotiating new terms
 - Bond counsel requires certifications by the purchaser that new spread is market rate to avoid reissuance
 - If parties don't agree on new terms and borrower cannot remarket bonds at end of term bonds may convert to term-out mode
- Features of term-out
 - Purchaser provides borrower an additional 12-24 months (or other period) for borrower to remarket bonds or refinance the debt. Some bond counsel allow it to be structured as an additional interest rate mode – so interest is tax exempt to the purchaser
 - Interest rate converts to a pre-set rate which is higher than the initial rate the purchaser commits to for the initial term
 - Borrower can prepay or convert modes during term-out without prepayment penalty since purchaser wants out of the deal
 - At end of term-out if bonds are not converted to another non-bank mode, bonds are redeemed

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Interest Rate Adjustments

Provisions that may be included in the bonds and bond indenture:

- Gross up for event of taxability
 - Index rate or fixed rate automatically increases to a taxable rate
 - Wide variation in definitions of determination of taxability; event of taxability and in the cure periods that are allowed
 - Distinguished from publicly offered debt – where event of taxability triggers a default but not grossed up interest rate
- Event of default often triggers automatic default rate on the bonds
 - May be expressed as a prime rate, reference rate, or existing interest rate plus several hundred basis points
- Decrease in the maximum marginal statutory corporate tax rate may result in an increase in the interest rate
 - Can be included in either the indenture as additional tax exempt interest or in the covenant agreement as an additional fee

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Interest Rate Adjustments (con't)

Provisions that may be included in the bonds and bond indenture (con't):

- Grid Pricing
 - Adjustments to interest rate based on changes in the borrower's unenhanced debt ratings
 - Often these adjustments only result in increases if the borrower's debt rating is decreased and not decreases in pricing based on improved ratings – can be negotiated
 - With fixed or term rate transactions where purchaser has locked in funds, purchasers typically will not allow increased ratings to result in an interest rate reduction below the negotiated initial rate, but may be able to get purchaser to increase the interest rate back to the original rate if there is a downgrade in ratings with increased pricing and subsequent increase in ratings
 - Reissuance concerns particularly with fixed or term rate interest modes

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Pricing Adjustments Based on Covenant Thresholds

- Increases or decreases based on financial covenants such as days cash on hand covenant or debt to capitalization
- Usually structured as a fee and included in covenant agreement, not as an interest rate adjustment in the bond or bond indenture due to tax issues

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Prepayment Adjustments – Break Funding Costs

- Covenant agreement includes an additional fee for any costs incurred by the purchaser as a result of a redemption, acceleration or conversion of the bonds to another mode on a date other than the end of the initial term (mandatory tender date) for fixed rate direct purchases and on a date other than the end of the index period (usually 30 day period) for a LIBOR based interest rate
- Often difficult to measure these costs to the borrower compared to publicly offered securities where a prepayment premium is established up front
 - With direct purchases prepayment may not be expressed as a formula or percentage, but described in general terms with no objective criteria

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Sample Language

- “In the event the Purchaser shall incur any loss, cost or expense (including any loss, cost or expense incurred by reason of the liquidation or re-employment of deposits or other funds acquired or contracted to be acquired by the Purchaser to purchase the Bonds) as a result of: (i) any redemption or prepayment of the Bonds when due on a date other than the Maturity Date of the Bonds or a mandatory sinking fund redemption date or (ii) any failure by the Borrower to make any payment of principal on the Bonds, whether before or after an Event of Default, then immediately upon demand of the Purchaser, the Borrower shall pay to the Purchaser an amount as is necessary to reimburse the Purchaser for such loss, cost or expense.”
- Some purchasers include formulas measuring the cost of funds such as the difference between the net present value of the debt service owed on the bonds discounted at some published indicative rate as of the closing date and the net present value of the debt service payment discounted at such rate as published as of the date of prepayment
- To allow for greater flexibility in prepayments in a fixed rate direct purchase, purchasers may provide separate pricing options for early prepayments

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Other Fees

- Increased cost fees: These fees are imposed due to changes in law or interpretation of laws such as Basel III and Dodd-Frank Wall Street Reform and Consumer Protection Act
 - Imposed if changes in laws result in increased costs or a reduction in the yield or rate of return to the Purchaser of holding the Bonds
 - Purchasers typically can pass these costs on to the Borrower at any time
 - Borrower may be able to negotiate limitations on how far back these costs may be incurred prior to the Borrower receiving notice of the increased costs
 - e.g., “Borrower shall not be required to compensate the Purchaser for any increased costs incurred more than 180 days prior to the date the Purchaser notified the Borrower of a change in law.”

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Other Fees (con't)

- Amendment fees
- Waiver fees
- Regulation D adjustments for LIBOR based interest rates
 - Also referred to in interest rate formulas as the “LIBOR Reserve Percentage” or the maximum effective percentage for determining reserve requirements with respect to Eurocurrency funding under Reg. D. Currently this percentage is zero but could change in the future
 - Sample language used in LIBOR Index Definition:

$$67\% \text{ of } \frac{\text{LIBOR}}{1 - \text{LIBOR Reserve Percentage}} + \text{spread}$$

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Covenants, Defaults, and Security

- Similar to those in Reimbursement Agreements for Letter of Credit transactions and liquidity facilities
- Most Favored Nations Covenant frequently requested
 - Caution: Can result in tax issues if through operation of these provisions additional security becomes pledged to the bonds such as debt service reserves or liquidity covenants that violate IRS Treasury regulations on replacement proceeds
- Material adverse change defaults may be requested similar to reimbursement agreements
 - If included, these provisions should not be subjective but measured by objective criteria such as percent decrease in net revenues or operating margin
- Indenture cross defaults to covenant agreement – may result in minor covenant violations defaulting bonds/cross defaults to MTI
- Can negotiate cure periods, mandatory tender and term-out upon certain events of default rather than automatic acceleration

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Other Negotiated Provisions

- Indemnification
 - Purchaser views purchase of bonds similar to a loan
 - Reduced risk to borrower given no disclosure document
- Assignments
 - Purchasers desire free transferability
 - Issuer will limit transfers to accredited investors and require new investor letters be executed
 - Bonds not in book entry – if assigned the bonds should be registered in name of new purchaser

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Other Negotiated Provisions (con't)

- What rights does new purchaser/assignee have under covenant agreement?
 - Covenant agreement may provide additional bondholders/assignees have the same rights as initial purchaser or may be silent
 - Borrower may be comfortable negotiating with initial purchaser but not subsequent purchasers
 - Restrictions on number of assignments can be negotiated
- Participations
 - Participations language similar to other loan documents – issue as to whether participant is entitled to tax exempt interest if not the owner of the bonds
 - Provisions can be drafted similar to other loan and bond transactions by specifying borrowers only need to deal with initial purchaser

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Securities Law and Disclosure Issues

- Loan vs. Security
 - Structure utilized may depend on whether purchaser wants accountants to treat the transaction as a loan and not a security
 - Securities must be marked to market
 - U.S. Supreme Court case *Reves v. Ernst & Young, Inc.* 494 U.S. 56 (1990) is the principal legal authority most lawyers and the MSRB rely on in analyzing whether a note or bond is a security within the meaning of Section 3(a)(10) of the Securities Exchange Act and for purposes of federal securities laws
 - Facts and circumstances test – name of the instrument is not dispositive

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Securities Law and Disclosure Issues (con't)

- *Reves* uses a four part test to determine if a note is a “security” for securities law purposes
 - Motivations of buyer and seller
 - Distribution method or plan
 - Reasonable expectations of the investing public
 - Existence of alternate regulatory scheme that reduces the risk of the instrument rendering application of the securities laws unnecessary
- MSRB in notice 2011-52 (September 12, 2011) addressed the applicability of MSRB rules or other federal securities laws to certain transactions called “bank loans” that in fact are municipal securities

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Why Does This Matter to a Health Care Borrower?

- MSRB rules only apply to broker dealers and financial advisors but issues could arise if a broker dealer is serving as a placement agent for the debt or an affiliate of the purchaser is involved in placing the debt
- Also may create pressure by the participants to structure a financing to look like a loan if there is a concern that MSRB Rules would otherwise apply and require a financial advisor to report the transaction including interest rate (MSRB Rule G-32) or to obtain CUSIP numbers (MSRB Rule G-34) even though purchaser may not want CUSIP numbers
- Some purchasers may be hesitant to utilize a multi-modal structure – looks less like a loan

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Voluntary Disclosure

- MSRB Notice 2012-18: Notice Concerning Voluntary Disclosure of Bank Loans to EMMA
 - Notice encourages issuer to voluntarily post information about bank loan financings to the Electronic Municipal Market Access (EMMA) website
 - MSRB believes timely information about bank loan financings is important for market transparency
 - Raises concern that holders of Issuer's existing debt may not be aware of the impact bank loans may have on Issuer's outstanding debt until the release of audited financial statements – such as acceleration of debt repayment due to a default under the bank loan or dilution of the existing bondholders security position when the bank loan is parity debt

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Features of bank loans MSRB encourages issuers to disclose include:

- Lender
- Borrower
- Purpose of loan/financing
- Security for repayment
- Third party guarantees
- Source of repayment
- Dated date/closing date
- Par amount
- Interest rates (or index if variable), including method of computation, if applicable
- Payment dates
- Maturity and amortization of loan
- Optional, mandatory, and extraordinary prepayment provisions
- Tax status of interest
- Events of default/remedies
- Current credit rating of borrower (if applicable)
- Governing law
- CUSIP number, if applicable
- Redistribution rights, if applicable

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Rating Issues and Analysis

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Direct Purchase Overview

- Bank loan, typically variable rate, that may be a less expensive source of financing for the borrower
- Eliminates the investor put option that is inherent in a VRDO, but still a contingent liability in many cases
- Reduces exposure to bank credit
- Reduces exposure to periodic roll-over of liquidity facility
- May allow borrower to retain fixed payor swaps while still reducing exposure to VRDOs
- Often includes mandatory tender dates, giving the bank the option to exit the deal
- May contain events of default that, if triggered, will force the obligor to repay the loan in an accelerated fashion
- Events of default may cross-default to other obligations
- Often no public disclosure



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Direct Purchase and Contingent Liabilities Analysis

- Direct purchase bonds are part of a broader concept of contingent liabilities
- Generally includes financial instruments or agreements with payment terms that change upon the occurrence of certain events
- Examples:
 - Direct purchase bonds
 - Swaps
 - Letters of credit
 - Standby bond purchase agreements
 - Guarantees
 - Lawsuits



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Direct Purchase vs. VRDO

- Transactions are not dissimilar from the perspective of the borrower
 - Both are often variable rate instruments
 - Both include significant involvement of a bank
 - In either case, the borrower may be required to repay according to a shortened timetable
 - Direct Purchase: Mandatory tender may lead to accelerated repayment. Event of default may lead to accelerated repayment.
 - VRDO: Investor tender and failed remarketing may lead to accelerated repayment. Event of default and mandatory tender may lead to accelerated repayment.



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Analysis for Direct Purchase and/or VRDO

- Events of default and remedies
 - Identify events of default (standard & non-standard) & remedy period for each
 - Determine whether borrower has sufficient time to cure an event of default should one occur
 - Determine market access, if applicable.
 - Depends on timing of remedies and our view of market access risks for borrower (generally 180 days)
- Liquidity
 - If any non-standard events of default have cure periods of less than 180 days, and/or we deem market access to be questionable, then liquidity analysis determines ability to cover events of default
- Potential rating impact
 - If the obligor doesn't have sufficient liquidity then a rating or outlook change is likely to be considered



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Events of Default

- Immediate and short term (i.e., less than 180 days) events:
 - Standard events of default include:
 - Insolvency
 - Failure to pay bonds
 - Invalidity
 - Payment of parity debt
 - Non-standard events of default include downgrades, covenant breaches, acceleration of parity debt, etc.
- Longer term (i.e., 180 days or more) events:
 - Events are likely to be non-standard and may be extremely permissive (i.e., may include things like a material adverse change [MAC] clause).
 - Market access may be an option with 180 days' notice of termination
- For all events of default, as well as mandatory tenders, we review remedies and related timing. Standard events of defaults are generally acceptable, whereas non-standard events of default require detailed analysis.



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Liquidity Analysis

- Liquidity needs depend on nature of event risk
 - Predictable events: planned mandatory tenders, bullet maturities, sinking funds
 - Unpredictable events: non-standard events of default, failed remarketings, acceleration
 - If a 2-notch downgrade of borrower or counterparty causes a trigger event, we consider it a likely claim on liquidity
- Adequacy of liquidity sources
 - Assets classes, exposure to market fluctuation
 - Understand seasonal investment fluctuations
 - Liquidation procedures and timing
 - Lines of credit can be fair weather friends
 - Understand accessibility of available liquidity



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Management Expectations

- Management should be able to demonstrate familiarity with covenants in its financing and hedging documents
- Specifically, management should be able to:
 - Provide an “inventory” of exposures, such as EODs, termination events, acceleration, collateral requirements, and cross-defaults
 - Communicate their proximity to or distance from extraordinary calls on liquidity, e.g., head room above covenant levels or proximity to collateral or default triggers
 - Identify resources or strategies available to respond to contingent demands on liquidity
 - Articulate the rationale for accepting contingent liquidity risks



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Tax Issues

including special considerations for modifications
and interest rate formulas

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Tax Considerations: Restrictions on Tax-Exempt Interest Rates

- Federal tax regulations restrict the types of interest formulas that can result in entirely tax-exempt interest (restrictions on “contingent payment debt instruments” in Treas. Reg. §1.1275-4(d))
- These restrictions are generally intended to prevent the conversion of investment returns that are not traditionally “interest-based” to tax-exempt interest (for example, an investment return based on a stock index)
- The rules for the types of permitted interest formulas are complicated, and restrict the use of many types of tax-exempt interest formulas that might appear non-abusive
- These restrictions rarely come into play in publicly-offered bonds, but commonly raise issues in direct purchases, where interest rate formulas are often specifically negotiated

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Tax Considerations: Restrictions on Tax-Exempt Interest Rates (con't)

- There is little interpretive authority under the tax-exempt bond “contingent payment debt instrument” restrictions, and different bond counsel have different views on whether specific interest formulas are permitted
- Tax-exempt interest formulas based on whether the obligor meets financial tests (e.g., debt service coverage ratios) generally are not permitted
- Tax-exempt interest formulas based on additional costs to the holder that are not objectively defined generally are not permitted
- Tax-exempt interest formulas based on the credit rating of the obligor may in some circumstances be permitted, depending on the views of bond counsel
- Tax-exempt interest formulas based on changes in tax rates may in some circumstances be permitted, depending on views of bond counsel
- The Foley & Lardner LLP analysis emphasizes in particular whether the interest formula “can reasonably be expected to measure contemporaneous variations in the costs of newly borrowed funds” and whether it depends on circumstances unique to the obligor or the holder

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Tax Considerations: Modifications and “Reissuance”

- A modification to the terms of a tax-exempt bond can result in a “reissuance” (or new deemed bond) for federal tax purposes which can require a retesting of the tax-exempt bond rules, if the modification is treated as “significant”
- Special reissuance considerations apply to direct purchase bonds that do not generally apply to publicly-offered bonds
- Separate agreements (such as “supplemental bondholder agreements”) between the conduit borrower and the holder in particular can raise difficult reissuance issues

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Tax Considerations: Modifications and “Reissuance” (con’t)

- Federal tax regulations clearly state that a transaction between a conduit borrower and a holder can be treated as a modification of a tax-exempt bond, even if the governmental issuer has no involvement (Treas. Reg. §1.1001-3(f)(6)(i))
- The IRS has also ruled that a modification that results in a reissuance will cause a tax-exempt bond to fail to continue to qualify as tax-exempt, unless the governmental issuer takes action approving the transaction (Revenue Ruling 81-281)
- Accordingly, negotiated modification of terms (including the terms of a separate supplemental bondholder agreement) after the date of issuance need to be carefully considered, and requirements for bond counsel opinions are prudent

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Tax Considerations: Modifications and “Reissuance” (con’t)

- Examples of modifications that can result in a reissuance, if treated as “significant”: (1) reduction in interest rate; (2) extension of term; (3) change in redemption provisions
- Modification of other provisions in separate supplemental bondholder agreements (such as additional costs provisions) possibly could also raise reissuance questions that should be considered
- In general, a modification only of financial covenant terms is not likely to be treated as resulting in a reissuance

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Tax Considerations: Multi-Modal Bonds and “Reissuance”

- IRS Notices generally provide for favorable treatment of conversion of interest rates on tax-exempt bonds, provided that the modes are set forth in the bond documents at original issuance
- These favorable IRS Notices, however, are generally framed for publicly-offered bonds, and the application of these favorable rules to direct purchases has not been expressly addressed by the IRS
- Accordingly, there is some increased risk that the conversion of a direct-purchase multi-modal bond could result in a reissuance, and special requirements may apply

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Tax Considerations: Draw-Down Bonds

- Special tax considerations apply to draw-down bonds
- Federal tax regulations provide that a draw-down bond may be treated as a single “issue” for tax-exempt bond purposes, subject to certain restrictions
- An IRS notice also in general provides, however, that for purposes of statutory effective dates, in the case of a “ draw-down” loan), each draw constitutes a separate bond that is issued on the issue date of that draw when the issuer receives the purchase price, and interest begins to accrue, on that draw
- Accordingly, draws under draw-down bonds are generally to subject to change of law risk after the date of issuance, which may increase the need for supplemental bond counsel opinions

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Tax Considerations: Issue Price

- In recent years, the IRS has emphasized tax compliance issues relating to the determination “issue price” (that is, the price at which bonds are treated for tax purposes as sold)
- Special issue price rules apply to tax-exempt bonds that are not publicly-offered, although the basic framework is the same
- In particular, the issue price of direct-placement bonds is determined on the basis of actual sales, not reasonable expectations

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Tax Considerations: “Pledged Funds”

- The federal tax regulations treat certain amounts directly or indirectly pledged to pay debt service on tax-exempt bonds as deemed proceeds of those tax-exempt bonds, where are subject to arbitrage and rebate restrictions (so-called “replacement proceeds”)
- Negotiated terms of a separate supplemental bondholder agreement should be reviewed to determine whether any such “pledged funds” result
- Any requirement to maintain invested amounts at a particular level should be reviewed with particular care by bond counsel

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Tax Considerations: The “Registered Form” Requirement

- Tax-exempt bonds are generally required to be issued in “registered form”, subject to certain limited exceptions
- For example, a bond may be treated as issued in “registered form” if the right to transfer principal and interest must be made through a book-entry system
- Although not usually a problem, care should be taken not to “footfault” into failure to comply with this requirement

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Tax Opinion Considerations

- Although purchasers generally require “unqualified” bond counsel tax opinions, the negotiated nature of direct purchases can permit more flexibility in how opinions are framed than in public offerings
- For example, a purchaser could accept reliance on certain certifications to reduce bond counsel due diligence costs

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A Summary of Tax Questions to Consider

- Is the interest formula permitted for tax-exempt bonds?
- Do bond documents address how future modifications of supplemental bondholder agreement terms can be made (for example, will an opinion of bond counsel be required, at least for certain types of modifications)?
- Has the bond issue been structured to preserve the best argument that a possible future conversion of interest rates or extension can be made without reissuance?
- Has the purchaser provided adequate certifications to establish “issue price”?
- Do the terms create any “pledged funds”?
- Does the bond meet the “registered form” requirement?
- Does the bond counsel tax opinion set forth appropriate limitations?

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Questions?

- Questions can be entered via the Q&A tab located on the menu bar at the top of your screen.

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Mark Your Calendar

- 2013 Access to Capital Session
 - **February 2013:** Preparing Your Institution for Affiliation

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Thank You

- A copy of the PowerPoint presentation and a multimedia recording will be available on our Web site within 2-3 days: <http://www.foley.com/access-to-capital-private-debt-placements-for-health-care-providers-the-alternative-to-accessing-the-public-market/>
- We welcome your feedback. Please take a few moments before you leave the Web conference today to provide us with your feedback: <https://www.research.net/s/NGJ7P62>