

Taxable Bonds: Who, What, & Why

Thursday, January 23rd



Please Note.....

- Use the Q&A widget on the left side of the screen to ask the speakers questions.
 - You can find a PDF of the speakers' bios as well as the presentation in the resource widget on the lower left side of the screen.
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Speakers

Moderator:



Dana Lach
Of Counsel
Foley & Lardner LLP
dlach@foley.com

Panelists:



Steve Huser
System Vice President, Treasury
Advocate Aurora Health
steve.huser@aurora.org



Brian G. Lanser
Partner
Quarles & Brady LLP
brian.lanser@quarles.com



Jessica Cameron Mitchell
Managing Director
PFM Financial Advisors LLC
cameronj@pfm.com



Anne Mongoven
Director & Municipal Bond Underwriter
Baird
amongoven@rwbaird.com

Overview

- Repeal of authority to issue tax-exempt advance refunding bonds
 - Advance refunding bonds are bonds issued more than 90 days before the refunded bonds are retired
 - 21% maximum federal corporate income tax rate (2017 Tax Act)
 - Value of tax-exemption is decreased
 - Relief from IRC and Regulations requirements for issuing tax-exempt debt.
 - Market Factors
 - Low overall yields
 - Flattened yield curve means less negative arbitrage
 - Given par nature of market for taxable bonds, yields to maturity (as opposed to yield to call) may be lower than premium tax-exempt bonds
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Market Factors

- Taxable bonds made up approximately 20% of the municipal market in 2019
 - Potential investors include many of the same buyers as traditional tax-exempt bonds plus other municipal entities and international buyers
 - Structuring considerations:
 - Call options
 - Taxable bonds traditionally have a “make-whole” call
 - 10-year par calls may be more costly and may not provide the same call optionality as they would for tax-exempt bonds
 - Arbitrage/Yield Restriction
 - No WAM Requirement (i.e., the weighted average maturity of the bonds cannot exceed the useful life by 120%)
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Choosing Bonds to be Refunded

- Net present value savings
 - Breakeven analysis
 - Escrow efficiency
 - Yield on the escrow cannot be greater than the yield on the bonds to be refunded, with certain exceptions
 - Internal savings targets
 - Same as for tax-exempt refunding bonds
 - More stringent given forgone call optionality
 - More lenient given elimination of tax-exempt bond requirements.
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Potential Issuers

- Direct issuance by governmental entities, with very few changes to the process.
 - Direct issuance by nonprofit and for-profit borrowers, typically with no governmental issuer.
 - However, it may be beneficial to issue taxable bonds through a governmental issuer, if sold in conjunction with a tax exempt transaction, or if there is value in the marketplace for bonds with a municipal CUSIP.
 - No issuer fees; indemnification provisions; issuer-driven covenants.
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Legal Considerations – Advance Refundings

- An advance refunding is a refunding in which the refunded bonds are redeemed more than 90 days after the issuance of the refunding bonds.
 - Given the low interest rates in recent years, advance refundings have been a popular financing mechanism to capture debt service savings or to restructure debt.
 - However, as of January 1, 2018, the Tax Cuts and Jobs Act eliminated the ability to issue tax-exempt bonds to advance refund tax-exempt debt.
 - Basic concept is that issuers should not be permitted to have two sets of tax-exempt bonds outstanding at one time for the same project, due to the cost to the federal treasury.
 - Tax-exempt bonds may still be issued to advance refund taxable debt (including tax-advantaged bonds such as Build America Bonds if the federal subsidy is cut off as of the issuance date of the refunding bonds).
 - Some alternative types of refunding structures have also been used to take the place of advance refundings (e.g. forward delivery issues and Cinderella bonds).
 - In some cases, the issuance of taxable advance refunding bonds is the easiest and most economical way to accomplish a refunding in the current interest rate environment. Not surprisingly, the volume of taxable advance refunding bonds has increased significantly in the last couple of years.
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Legal Considerations: Private Use

- Tax-exempt governmental bonds can be issued only to finance projects (with certain exemptions, such as exempt facility bonds) that do not have private business use and private payment and qualified 501(c)(3) bonds can be issued only to finance a 501(c)(3) organization's exempt activities.
 - If financing projects that do not satisfy these criteria, no choice but to issue taxable bonds.
 - However, if you have a project that could be financed on a tax-exempt basis, you may choose to issue taxable bonds. Why?
 - Flexibility for future change in use.
 - Even if no change in use anticipated, the process of monitoring compliance with private use restrictions can be costly and time-consuming.
 - The increased interest cost associated with doing a taxable financing may be offset in the long-term by lower compliance costs.
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Legal Considerations: Disclosure

- Rule 15c2-12 requires, with certain exceptions, dealers, when underwriting certain types of municipal securities, to ensure that an obligor of the state or local government issuing the bonds enter into an agreement to provide information regarding the securities on an ongoing basis. This information is provided to investors and the public on the MSRB's website known as EMMA.
 - Taxable issuance by a governmental entity is still subject to 15c2-12.
 - The applicability of 15c2-12 does not depend on whether bonds are taxable or tax-exempt, but rather whether they are municipal securities. Rule 15c2-12 does not apply to taxable debt issued by nonprofits or for-profits, but the market still requires disclosure in most cases.
 - For issuers of taxable bonds that are not municipal securities and that do not post on EMMA, website posting is an option for disclosure.
 - Covenant requiring disclosure in Indenture/Loan Agreement/Ordinance/Resolution
 - Should not be an event of default, but instead enforceable by specific performance
 - Alternative: Enter into a continuing covenant agreement, similar to a municipal securities transaction.
 - A taxable financing done as a direct issuance by a nonprofit or for-profit (even if itself not subject to 15c2-12) could be a "financial obligation" that would have to be disclosed if the entity had a prior continuing disclosure undertaking under 15c2-12 entered into after February 2019.
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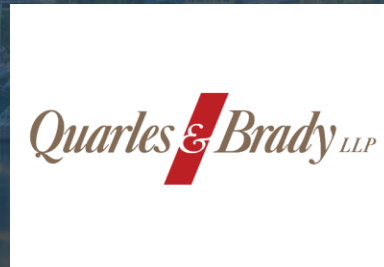
Future Market Conditions

- Rates continue to remain low and demand for municipal bonds high
 - No crystal ball, but closer to next recession than beginning of expansion
 - What are normal/average rates?
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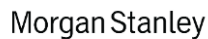
A city skyline at dusk, featuring a large green sailing ship in the foreground and a modern building on the left. The sky is dark with some clouds, and the water reflects the city lights. The text "Q&A" is centered in the image.

Q&A

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Thank you!

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